The 1989-90 Budget: Perspectives and Issues

Report of the Legislative Analyst to the Joint Legislative Budget Committee

California Legislature

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INTRODUCTION

The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the 1989 Budget Act. It seeks to accomplish this by (1) providing perspectives on the state's fiscal condition and the budget proposed by the Governor for 1989-90 and (2) identifying some of the major issues now facing the Legislature. Many of these issues are long-range in nature. Even in these cases, however, legislative action during 1989 is warranted since the Legislature generally will have a wider range of options for addressing these issues now than it will have in subsequent years. As such, this document is intended to complement the *Analysis of the 1989-90 Budget Bill*, which contains our traditional item-by-item review of the Governor's Budget.

The *Analysis* continues to report the results of our detailed examination of all programs and activities funded in the Governor's Budget. In contrast, this document presents an analytical overview of the state's fiscal condition. The recommendations included herein generally cut across program or agency lines and do not necessarily fall under the jurisdiction of a single fiscal subcommittee.

The 1989-90 Budget: Perspectives and Issues is divided into four parts.

Part One, "State Fiscal Picture" provides an overall perspective on the fiscal dilemma the Legislature faces in the coming year.

Part Two, "Perspectives on the 1989-90 Budget: Expenditures" presents data on the state's spending plan, focusing on proposed General Fund and special fund expenditures. It describes how the budget differs from the current year, and highlights major program changes and expenditures not recognized in the budget.

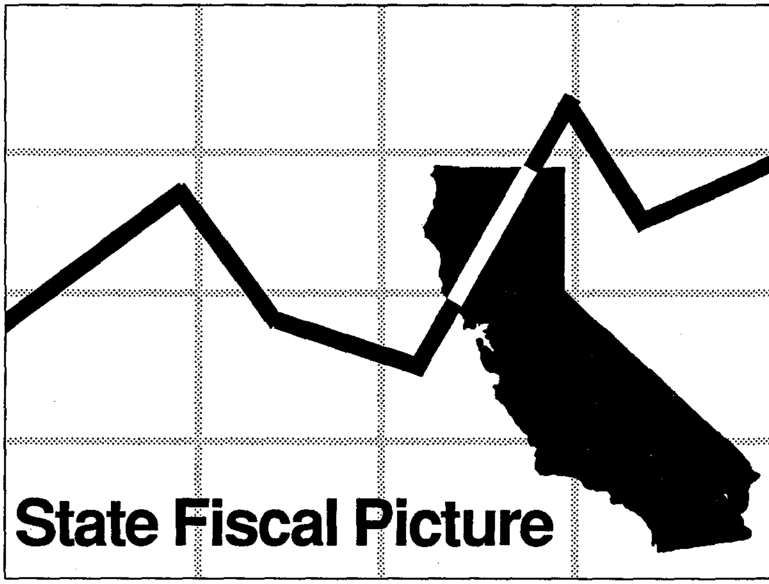
Part Three, "Perspectives on the 1989-90 Budget: Revenues" describes the state's major funding sources and evaluates the administration's economic and revenue forecasts.

Part Four, "Major Issues Facing the Legislature," discusses significant issues that we have identified in reviewing the state's current fiscal condition and the Governor's Budget for 1989-90. Wherever possible, our analysis identifies options that the Legislature may wish to consider in addressing these issues. The issues in this part fall into five general categories: (1) issues pertaining to growth (such as, state options for better accommodating growth, waste management, and the state's appropriations limit); (2) matters relating to infrastructure and capital spending (for instance, state bonded debt, prison capacity, and asbestos abatement); (3) crosscutting programs (such as state child care programs and immigration reform); (4) specific program reviews (for example, insurance reform, the state's mental health system, and out-of-home placement of juvenile offenders); and (5) public employee issues (such as retiree cost-of-living adjustments and state annuitant health care).

1

State Fiscal Picture

Part 1



State Fiscal Picture

In beginning its work on the state budget for 1989-90, the Legislature faces the most adverse set of fiscal circumstances it has faced since the recession of 1981-82. The state's budget reserve has been completely depleted, and at this point a deficit in the current-year's budget appears likely. Based on the state's current levels of service, expenditure requirements for 1989-90 will exceed projected revenue growth by at least $500 million, and the full restoration of the state's reserve fund would require another $1.1 billion. This fiscal situation has come about despite the continued strength of the California economy.

This set of adverse fiscal circumstances also comes at a time when state government faces a number of formidable challenges, such as the need to provide for the anticipated growth in the state's population. The state's success in addressing these issues will have a substantial effect on the health of the California economy and the quality of its citizens' lives in the coming decades.

In this part, we briefly review the challenges facing the Legislature and the state. We review the state's fiscal condition, the major areas where demand for state services is outstripping its ability to provide them, and the extent to which the state's existing revenue base is capable of supporting the delivery of existing and additional state services. Finally, we provide a brief examination of the strategies proposed in the Governor's Budget for resolving the state's fiscal dilemma.

Fiscal Dilemma Facing the Legislature

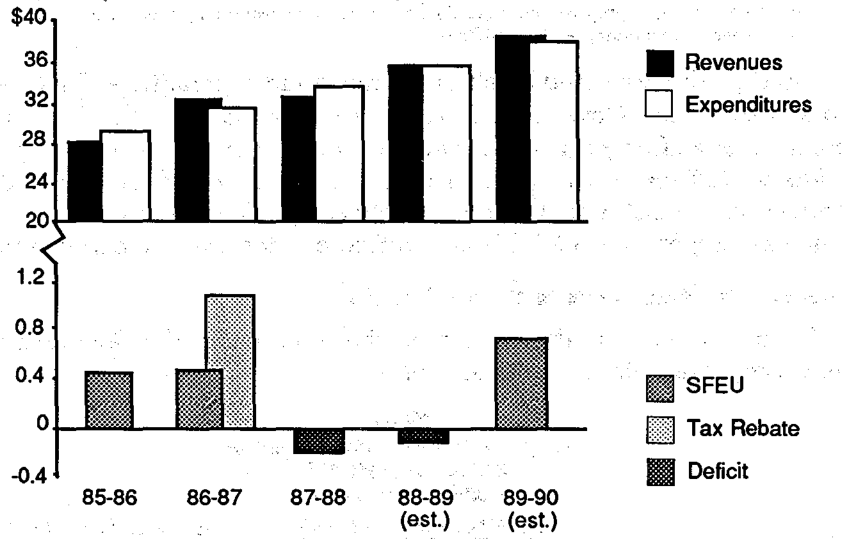
Overview of the General Fund Condition

Chart 1 provides information on annual General Fund revenues, expenditures and the Special Fund for Economic Uncertainties (SFEU) from 1985-86 through the budget year. Table 1 presents the same information in greater detail. (In both cases, the numbers are based on traditional state accounting practices, and do not reflect accounting changes contained in the Governor's Budget.)

Chart 1

Comparison of General Fund Revenues, Expenditures and the Special Fund for Economic Uncertainties (SFEU)

1985-86 through 1989-90 (in billions)



The chart shows that General Fund revenues have exceeded expenditures in only one of the last four years. In that case, however, the excess of 1986-87 revenues over expenditures was returned to state taxpayers as a tax rebate, under the provisions of the state's constitutional limit on appropriations. In 1987-88, a significant shortfall in state income tax receipts late in the year wiped out the state's reserve fund, and ultimately resulted in a deficit. Projections for the current year indicate that revenues will be essentially equal to the level of estimated expenditures. Unless additional savings or revenues materialize, the state will not have enough money to pay off last year's deficit. As a result, it appears likely that the state will end 1988-89 in deficit as well.

Table 1
General Fund Revenues, Expenditures and the Special Fund for Economic Uncertainties (SFEU) [a,b]
1985-86 through 1989-90
(dollars in millions)

	Actual 1985-86	*Actual 1986-87*	*Actual 1987-88*	*Est. 1988-89* [c]	*Est. 1989-90* [c]
Prior-year resources	$1,448	$710	$680	−$83	−$83
Revenues	28,227	32,535	32,579	36,002	38,877
Expenditures	28,988	31,482	33,342	36,002	38,010
General Fund balance	$686	$1,764	−$83	−$83	$784
Continuing appropriations	(243)	(190)	(117)	(43)	(30)
SFEU	(443)	(478)	—	—	(754)
Tax rebate	—	(1,096)	—	—	—
Deficit	—	—	−$200	−$126	—

[a] Source: State Controller. Data for 1986-87 and 1987-88 reflect adjustments to highlight funding provided for tax rebates.
[b] Detail may not add to totals due to rounding.
[c] Source: Governor's Budget. Data reflect adjustments to exclude effect of accounting changes and to reflect continuing appropriations. Data do not reflect administration's anticipated savings from cancellation of encumbrances ($80 million).

Based on the projected levels of revenues and expenditures for 1989-90 contained in the Governor's Budget, *we estimate that the Governor's proposed spending program would leave the General Fund with approximately $750 million in the SFEU.* These funds would be retained as protection against unanticipated declines in General Fund revenues (such as happened in 1987-88) and unforeseen increases in expenditures.

Revenue Shortfall Leads to Budget Deficits

Table 2 summarizes the changes in the condition of the General Fund that have taken place in the last year.

Table 2
Change in General Fund Condition
1987-88 and 1988-89 [a]
(dollars in millions)

	1987-88 General Fund Condition			*1988-89 General Fund Condition*		
	January 1988 (Est.) [b]	*January 1989 (Actual)* [c]	*Effect on 1987-88 Balance*	*January 1988 (Proj.)* [b]	*January 1989 (Est.)* [d]	*Effect on 1988-89 Balance*
Beginning resources	$626	$680	$54	$962	−$83	−$1,045
Revenues and transfers	33,678	32,579	−1,099	36,249	36,002	−$247
Expenditures	33,343	33,342	—	36,101	36,002	$99
General Fund balance	$962	−$83	−$1,045	$1,110	−$83	−$1,193

[a] Detail may not add to totals due to rounding.
[b] Source: 1988-89 Governor's Budget.
[c] Based on information provided by State Controller's Office.
[d] Based on information provided by State Controller's Office and 1989-90 Governor's Budget.

1987-88. As shown in the table, last year's Governor's Budget anticipated that the state would close 1987-88 with a $962 million General Fund balance. Shortly after the Legislature began its deliberations on the budget proposed for 1988-89, however, a dramatic shortfall in personal and corporate income tax revenues occurred. This shortfall, which totaled $1.1 billion, primarily reflected lower-than-anticipated levels of capital gains income realized by state taxpayers. Funds which had been appropriated to the SFEU were redirected to cover the shortfall, and several actions were taken by the administration to reduce or delay expenditures. It was anticipated that these actions would leave the state with a small amount of funds remaining in the SFEU at year's end.

When the state's books for 1987-88 were closed by the State Controller, however, it turned out that these actions had not been sufficient to avert a small deficit. Based on the state's traditional method of accounting, the Controller has reported that the state ended 1987-88 with a $343 million deficit. This deficit consists of two parts. First, the Controller indicated that cash outlays and expenditure commitments exceeded available resources by $83 million. Second, the Controller reported that $260 million of appropriations were still available for expenditure at year's end. The reduced figure of $117 million shown in Table 1 reflects our estimate of the amount of those appropriations which are likely to be spent.

1988-89. Table 2 also shows that last year's budget anticipated that the current fiscal year would end with a General Fund balance of about $1.1 billion. Although the current projections of state revenues and expenditures are similar to those of a year ago, our current estimates indicate that a second deficit is now likely. This is primarily due to the loss of the carryover resources anticipated in last year's budget which, as mentioned above, were used to offset the 1987-88 revenue shortfall.

Averting this second-in-a-row deficit will be a difficult task. The administration has taken action to cancel some outstanding contracts and purchase orders issued in 1987-88 in order to save an estimated $80 million, but our analysis indicates that the potential success of this effort is very limited. While actions which could be taken in the near future (such as a hiring freeze) may result in some additional savings, it is not likely that they will be sufficient to offset the cost of expected deficiency expenditures which have not been provided for in the budget (such as a $27 million regional center deficiency). Finally, the state's appropriations limit and Proposition 98 reduce the prospect that higher-than-expected revenue collections in the current year will provide the necessary cushion. Because the administration calculates that the state is only $134 million below the limit for 1988-89, the state could retain only this amount of any additional revenue. Furthermore, about 40 percent of this amount would have to be allocated to K-14 education under the provisions of Proposition 98, and could not be used to help reduce the deficit.

Budget Portrays Different Story. The Governor's Budget does not acknowledge the deficit that was reported by the Controller for 1987-88, nor the potential for a deficit in the current year. Instead, it shows a small amount of funds left over in the SFEU in each year. To achieve this result, the Department of Finance reduced the level of reported state spending by $251 million in 1987-88 and by a net amount of $80 million in the current year. The department has also eliminated the traditional set-aside for appropriated funds which have not yet been spent. The budget asserts that these changes were necessary to move the state towards greater conformity with "Generally Accepted Accounting Principles," and are consistent with state laws on this subject enacted in 1984. The data presented in this part do *not* reflect the department's adjustments, so that the Legislature can evaluate the state's fiscal condition as reflected by the traditional basis of accounting. In our judgment, this method gives the Legislature a more accurate picture of funds available for appropriation. We also note that the official records of the state prepared by the State Controller will reflect funds in this manner rather than the method proposed by the administration.

Budget Year Promises Hard Choices

The Governor's Budget proposes that $870 million of the projected $2.9 billion increase in General Fund revenues be used to restore the state's reserve fund. This policy choice leaves $2 billion to fund expenditure increases, which is well below the amount needed to fund normal program growth and maintain the current level of state services. As discussed in more detail in Part Two of this document, we estimate that approximately $4.5 billion in resources would be needed to accommodate the normal growth in state expenditures, and to restore the reserve to the 3-percent level. Thus, the Legislature faces a $1.6 billion funding gap as it begins its deliberations on the state's budget for 1989-90.

Fiscal Pressures Increased by Additional Program Demands. In addition to the gap in normal funding requirements, the Legislature faces demands for increased state funding in a variety of program areas. In many cases these demands reflect requests for additional funds to offset declines in service levels that have been occurring over the past several years. In other cases, they simply reflect requests for funding to provide existing levels of service to an expanding population. More specifically:

- ***State and local health care programs*** for indigents have been unable to meet the demand for these services in recent years, and the idea of providing some form of insurance coverage is receiving greater attention.

- ***Prison inmate populations*** are expanding faster than the state's ability to house them, and current estimates indicate that another $1.6 billion will be needed to build additional prisons in the next five years.
- ***Higher education enrollments*** are increasing and new campuses and facilities are being sought to accommodate the additional students.
- ***State transportation funds*** are nowhere near the level needed to cover the projected expenditures outlined in the state's plan for transportation improvements.

While some of these demands may be addressed by the provision of additional bond act authority or from sources other than the state's General Fund, these mechanisms still would have an impact on the General Fund. Bond authorizations must ultimately be paid for by the General Fund in the form of debt service on the bond issues. Also, other potential funding sources, such as increased gasoline taxes, would be subject to the state's appropriations limit and require compensating reductions in General Fund appropriations for other programs.

State Budget Has a Structural Problem

As noted above, the demands for state funding increases exceed the amount of revenue that is available to pay for them. This imbalance between funding demands and revenues is largely the result of policy decisions made in past years. For example, today's rapidly increasing cost of building and staffing state correctional facilities is the result of decisions made several years ago to impose longer sentences as punishment for criminal activities. The budget's growth also reflects the growth of entitlement programs such as Aid to Families with Dependent Children (AFDC), Supplemental Security Income/State Supplementary Program (SSI/SSP) and Medi-Cal. Because of statutory requirements, these programs are not subject to legislative control *in the budget process*. The adoption of Proposition 98 by the voters in November places another 40 percent of the budget "off-limits" to legislative control of its funding level.

By our estimates, almost 70 percent of the state's General Fund budget is controlled by policies placed in statute or the state Constitution. As a result, there is only about 30 percent of the budget that the Legislature can influence without changes to existing law. Further, the programs which comprise this 70 percent of the budget are generally growing faster than the state's constitutional appropriations limit, thereby adding to the fiscal pressure placed on the remainder of the budget.

The portion subject to legislative control in the budget process includes state funding for higher education, public health, mental health and developmental disability programs, resources programs, and a variety of social services programs. While these programs enjoy little statutory protection, they also reflect policy choices made in the past. The state has, however, used its control over these programs in past years to help balance the budget. By refusing to grant many of these programs additional spending authority to compensate for caseload growth and inflation, the state has required that fewer persons be served, that those served receive a lower level of service, or that new funding sources be found to support the programs.

While many state laws have been changed over the past 10 years to directly or indirectly require automatic program expenditure increases, the state's revenue base has not been altered to support these changes. In fact, largely because of voter-approved initiatives, the state's revenue base has actually been reduced. For example, voter-approved initiatives abolished the state's inheritance and gift tax, and required the adjustment of the personal income tax to compensate for inflation. Largely because of the "indexing" of the personal income tax, the state's revenue base will no longer grow at a rate significantly faster than the rate of growth in the economy.

The situation faced by the Legislature in preparing the budget for 1989-90 is more complicated than in prior years because it will not be possible to balance the budget by simply "freezing" spending on "controllable" programs. This is because existing expenditure commitments for the so-called "uncontrollable" programs exceed the growth in revenue. Thus, the Legislature has essentially three options. First, it can make significant reductions in the level of expenditures requested for those programs subject to control in the budget process. Second, it can make statutory changes or pursue constitutional changes to permit reductions in the 70 percent of expenditures not subject to control in the budget process. Third, the Legislature can pursue the statutory and constitutional changes which would be necessary to accommodate a higher level of state revenues.

Governor's Approach to Balancing the Budget

The Governor's Budget reflects one strategy that is available to the Legislature for resolving its fiscal dilemma. This strategy, however, does not reflect a long-term solution to the structural budget problem facing the state. Rather, the proposed budget reflects a short-term perspective, relying on one-time savings, deferrals of costs to future years and short-term funding shifts to achieve its results. Further, the budget makes little attempt to address policy challenges facing the state which will have a significant affect on the future of the state's economy. This section examines in more detail the key elements of the administration's budget-balancing strategy.

Deferrals of State Costs (—$349 million). The budget includes several proposals which would defer existing General Fund costs to future years, thereby increasing the structural imbalance that will have to be reckoned with later. These proposals include:

- ***STRS COLA Funding (—$164 million).*** The Governor proposes to place in statute a guaranteed annual increase in benefits for retired teachers. In 1989-90, the cost of this benefit would be paid out of State Teachers' Retirement Fund assets, but it would subsequently be paid for by the state's General Fund. The annual state costs of this proposal, once fully phased in, would amount to approximately *$400 million* in today's dollars.
- ***UC Pension Costs (—$68 million).*** The state traditionally funds the employer's share of retirement costs for the University of California. The budget proposes to pay the state's 1989-90 contribution with accrued interest, over a 30-year period beginning in 1990-91.
- ***Debt Service (—$47 million).*** The budget estimates of state costs for debt service on General Obligation bonds reflect the administration's assumption that the level of bond sales can be constrained below the level anticipated by the Treasurer's Office. The budget displays indicate a total volume of bond sales equal to $2.2 billion over the next 18 months, but the budget actually provides enough funding to support only $1.6 billion in sales. This slowdown reduces budget-year debt-service costs by approximately $47 million.
- ***Other deferrals (—$70 million).*** These include the administration's plan to delay one Medi-Cal check write from next June to next July, and to slow down the occupancy of new state correctional facilities in order to save on budget-year staffing costs.

Redirect Proposition 99 Revenues to Pay State Costs (—$296 million). The new cigarette and tobacco products surtax imposed by Proposition 99 is expected to support about $700 million worth of expenditures in the budget year. Despite language contained in the measure, the administration proposes to use a portion of these funds to replace existing state General Fund support for the Medically Indigent Services program. In addition, the administration proposes to use these monies to cover growth in Mental Health, Public Health, and certain other programs. Traditionally, these costs are borne by the General Fund.

Lower Reserve Funding Level (—$230 million). The state's reserve fund is proposed to be funded at $870 million, or $230 million less than the 3-percent-of-expenditures level used in recent years as the state's funding goal.

Reductions in Services (—$543 million). The budget proposes to provide reduced levels of services in a variety of areas. This occurs due to the proposed suspension of statutory cost-of-living adjustments for specified programs, and due to the reductions or outright elimination of funding for other programs. The most significant of these include:

- ***Suspension of Statutory COLAs (−$272 million).*** A one-year suspension of statutory cost-of-living adjustments for AFDC, SSI/SSP, and certain health programs is proposed for 1989-90.
- ***Medi-Cal Program Changes (−$63 million).*** A new drug cost-containment program, and new procedures to curb claims for services provided to persons eligible for both Medicare and Medi-Cal, are expected to reduce utilization of this program.
- ***Family Planning (−$36 million).*** The budget proposes to eliminate all state support for family planning programs.
- ***Greater Avenues to Independence (GAIN) (−$41 million).*** The administration plans to limit the planned expansion of the GAIN program and cut back on services offered.
- ***State Mandates (−$42 million).*** The budget proposes to repeal 27 state mandates, ranging from funding absentee ballot costs to filing missing persons reports.
- ***In-Home Supportive Services (−$64 million).*** Limits on provider reimbursement rates and the number of hours of service provided are expected to freeze state costs at the current-year level.

Shifting Costs to Counties (−$137 million). The budget includes two proposals which will, at least in part, result in a shift of program costs to county governments. For example, the budget proposes a $100 million reduction in General Fund support for the Medically Indigent Services program, and states that State Legalization Impact Assistance Grants (SLIAG) monies will be available to counties to replace these funds. Because of differences in the populations served by these programs, and the difficulties counties are expected to have in claiming the SLIAG funds, this proposal is likely to result in a higher funding burden for counties (or a reduction of services). The budget also proposes that the $37 million share of state support for county juvenile justice systems be eliminated, so that counties will have to pay nearly all of these costs.

In summary, the Governor's Budget addresses the gap between available resources and program demands by (1) suspending statutory COLAs for one year in health and welfare programs, (2) reducing or eliminating state programs, primarily in the health area, (3) providing a smaller reserve, and (4) relying on other one-time savings or cost deferrals. The structural imbalance in the budget is yet to be addressed.

Conclusion

Clearly, the state must begin to address the budget's structural problem now. It may not be possible to resolve fully the dilemma in the coming year, as some changes may require a phase-in period and others may require voter approval. We recommend, however, that the Legislature take a longer-term view of the state's needs and resources in the coming budget debate, so that the ultimate consequences of the short-term actions that may be necessary can be considered in the context of how the structural problem may ultimately be resolved.

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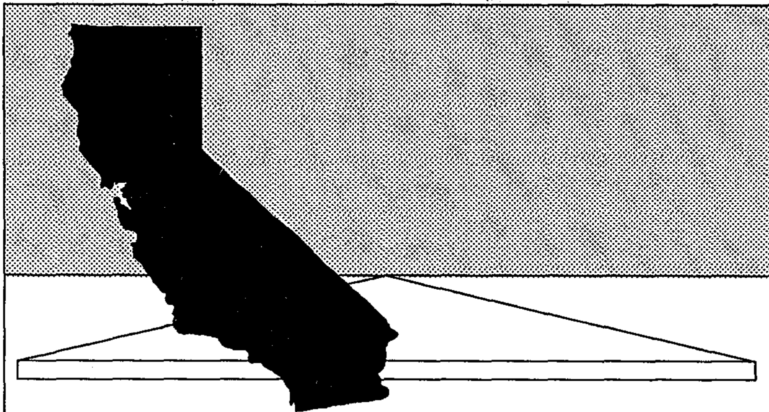
Perspectives on the 1989-90 Budget: Expenditures

Part 2



Perspectives on the 1989-90 Budget:
Expenditures

This part provides an overview of the spending plan proposed in the Governor's Budget. It discusses the level of proposed expenditures and the factors which determine this level, the major components of the budget, the priorities reflected in the budget, and the major program changes proposed in the budget. It also identifies some potential state expenditures that are not funded in the budget, and describes the administration's plans for the implementation of two major initiatives approved by the voters in November. The major findings of this section include:

- General Fund expenditure growth for the budget year is restrained to 5.8 percent by the proposed allocation of $870 million—almost 30 percent of the projected General Fund revenue growth—to the Special Fund for Economic Uncertainties.
- The General Fund cost of maintaining current levels of service, including the restoration of the reserve to the 3-percent level, would amount to $4.5 billion in 1989–90. Because General Fund revenues are expected to total $2.9 billion, this leaves a $1.6 billion funding gap.
- Of the net $2.1 billion expenditure growth provided in the budget, $1.3 billion is for workload growth, $900 million is for cost-of-living adjustments (including salary increases), and $600 million is provided for all other expenditure increases—primarily the second-year costs of implementing the trial court funding program and Proposition 98. These costs are partially offset by baseline reductions totaling $700 million.

- Special fund expenditure growth of 13.9 percent in the current year and 7.4 percent in the budget year is distorted by two special factors. First, the expenditure of Proposition 99 tax revenues increases the current- and budget-year spending totals. Second, the anticipated expenditure of $1.6 billion in bond funds approved for school facilities is shown in the budget as a special fund expenditure in the current and budget years.

Expenditures in 1989-90

TOTAL STATE SPENDING PLAN

The Governor's Budget for 1989-90 proposes total expenditures of $87 billion. This amount represents a 5.2 percent increase over last year's total spending plan and includes:

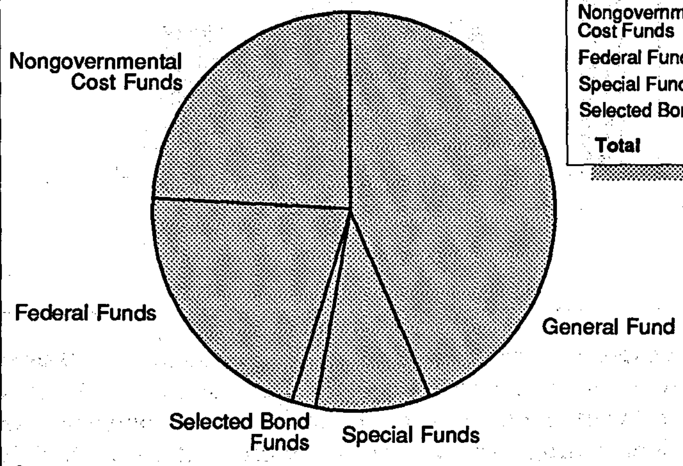
- $38 billion in expenditures from the *General Fund*, which represents an increase of 5.8 percent over 1988-89;
- $8 billion in expenditures from *special funds*, which represents an increase of 7.4 percent over 1988-89;
- $18 billion in expenditures from *federal funds*, which represents an increase of 3 percent over 1988-89;
- $20 billion from various *nongovernmental cost funds*, which includes funds established for retirement, working capital, public services enterprise, and other purposes; and
- $2 billion in expenditures from *selected bond funds*.

Chart 1 shows the relative distribution of the $87 billion in total expenditures by funding source. As shown, General Fund expenditures of $38 billion amount to almost half (44 percent) of total state expenditures.

Chart 1

Total State Spending Plan

1989-90



Total Budget[a] (in billions)

General Fund	$38.0
Nongovernmental Cost Funds	20.4
Federal Funds	18.5
Special Funds	8.1
Selected Bond Funds	1.7
Total	$86.6

[a] Detail does not add to total due to rounding.

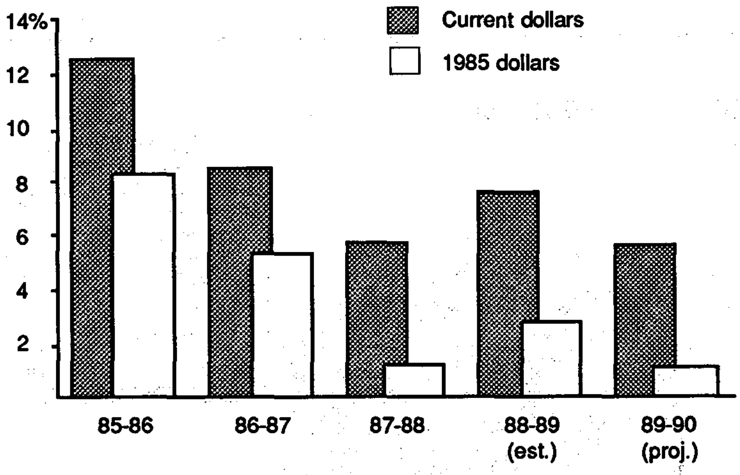
General Fund Expenditures

The state's General Fund receives the bulk of the state's tax revenues, and is the most sensitive to changes in economic conditions. The budget projects that the state's economy will continue to grow at a moderate pace, so that the level of expected revenues would permit significant growth in the state's expenditures. The proposed increase in General Fund expenditures of 5.8 percent, however, reflects certain other constraints on state spending, as discussed below.

Chart 2 shows the growth trend in recent General Fund expenditures on an annual percentage basis, both in terms of "current dollars" (amounts as they appear in the budget) and "real dollars" (current dollars adjusted for the effect of inflation since 1985). Comparing growth rates in terms of real dollars allows expenditure growth rates in different years to be compared on a common basis.

Chart 2

Annual Percentage Change in General Fund Expenditures
1985-86 through 1989-90



As the chart indicates, the proposed General Fund budget for 1989-90 will be 5.8 percent greater in current dollars than estimated General Fund expenditures for 1988-89. In terms of real dollars, however, the General Fund budget is proposed to increase by only 1.2 percent. This compares to an increase of 2.9 percent in real terms for the current year. This lower rate of growth for expenditures in 1989-90 in part reflects a slower rate of revenue growth in the budget year—8.3 percent compared to 10.4 percent for the current year. It also reflects the administration's proposal to rebuild the state's reserve—the Special Fund for Economic Uncertainties—which was depleted during 1987-88. This proposal consumes 30 percent of the growth in state revenues expected for 1989-90, and results in a lower level of funds available for expenditure growth in state programs.

General Fund Expenditures by Function and Category

Chart 3 shows the major components of the General Fund budget, by function and by category. As usual, more than half (53 percent) of the General Fund expenditures proposed in the budget are for educational programs and about one-third for health and welfare programs (31 percent). The remaining expenditures are proposed in the areas of youth and adult corrections (6.1 percent), tax relief (2.3 percent), resources (1.8 percent), and all other (6.1 percent).

Chart 3

1989-90 General Fund Expenditures by Function and Category

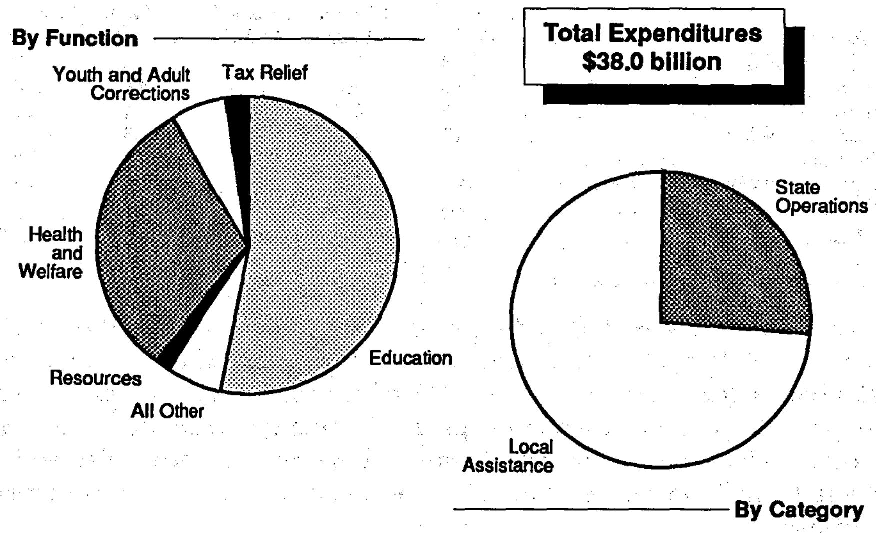


Chart 3 also shows the distribution of General Fund expenditures between state operations—26 percent, and local assistance—74 percent. In addition, a very small amount ($195,000) is proposed for capital outlay projects. The budget proposes General Fund expenditures for state operations of $9.8 billion in 1989-90, which is $0.8 billion, or 8.9 percent, greater than the level provided for this category in 1988-89. General Fund expenditures for local assistance are proposed at $28.2 billion in 1989-90, which is $1.2 billion, or 4.5 percent, greater than estimated 1988-89 expenditures. The slower rate of growth for local assistance expenditures reflects the administration's proposals to reduce funding for a variety of health and welfare programs.

Special Fund Expenditures

The budget proposes special fund expenditures of $8.1 billion in 1989-90, which is an increase of $558 million, or 7.4 percent, over the current-year level. Special funds are used to allocate tax revenues (such as gas and cigarette tax monies) for *dedicated* purposes. In this way, they differ from General Fund revenues, which can be spent by the Legislature for *any* purpose. Table 1 shows the major components of the special fund budget, and Chart 4 shows the relative distribution of these funds by function and category.

Table 1
Special Fund Expenditures by Function [a]
1987-88 through 1989-90
(dollars in millions)

Function	*Actual 1987-88*	*Estimated 1988-89*	*Proposed 1989-90*	*Change From 1988-89 Amount*	*Change From 1988-89 Percent*
State and consumer services	$228	$260	$261	$2	0.8%
Business, transportation and housing	2,160	2,293	2,581	288	12.5
Resources	415	517	503	−14	−2.7
Health and welfare	157	404	812	408	101.0
Education	782	1,075	692	−383	−35.6
Local government/shared revenues	2,463	2,623	2,766	143	5.4
All other	408	363	476	114	31.3
Totals	$6,614	$7,535	$8,093	$558	7.4%

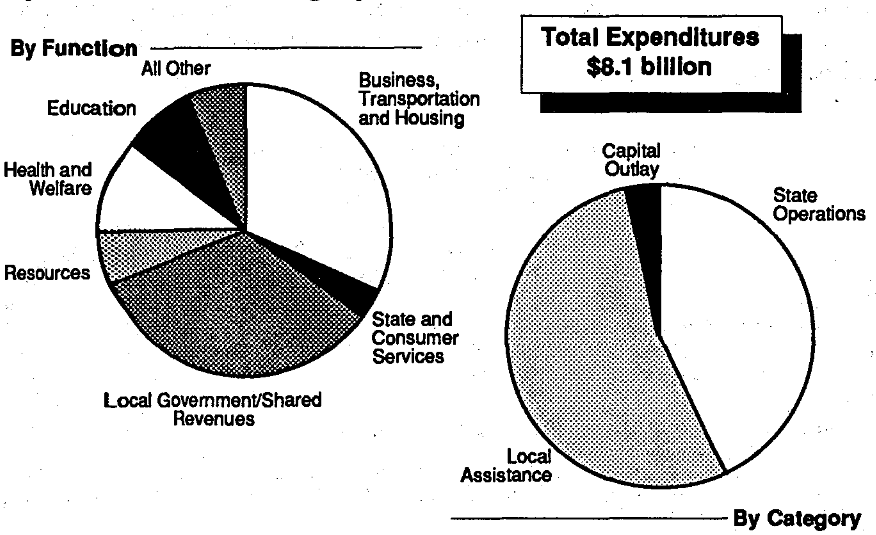
[a] Detail may not add to totals due to rounding.

Local Government/Shared Revenues. The largest item in the state's special fund budget is the Shared Revenues program, which accounts for $2.8 billion (or 34 percent) of the $8.1 billion total. The revenues which support this program are derived primarily from taxes and fees levied on motor vehicles and motor vehicle fuels. These revenues are collected by the state and apportioned to local governments on the basis of statutory formulas.

The largest single source of shared revenues is the motor vehicle license fee (VLF), which accounts for almost $2.1 billion, or approximately 75 percent, of the $2.8 billion in shared revenues. The VLF is imposed annually on motor vehicles on the basis of market value and is apportioned to cities and counties for general purposes according to population.

Chart 4

1989-90 Special Fund Expenditures by Function and Category



Business, Transportation and Housing. The second largest component of the 1989-90 special fund budget is for business, transportation and housing programs, which account for 32 percent of the total. The Governor's Budget proposes expenditures in this area of $2.6 billion. This is an increase of $288 million, or 13 percent, above the current-year level. Of the total increase for business, transportation and housing programs, $213 million is to fund additional staff and projects in the Department of Transportation.

The bulk of these special funds comes from: (1) a nine-cent-per-gallon tax on gasoline and diesel fuel and (2) various user fees, primarily truck weight fees, motor vehicle registration fees, and driver's license fees. Most of these funds go to support the Department of Transportation, the California Highway Patrol and the Department of Motor Vehicles.

Health and Welfare. In 1988-89, health and welfare programs made up only 5 percent of special fund expenditures. In 1989-90, however, special fund expenditures on health and welfare programs have more than doubled, primarily as a result of the passage of the Tobacco Tax and Health Protection Act of 1988 (Proposition 99). The Governor's Budget proposes total expenditures in this area of $812 million, more than two-thirds of which is from Proposition 99 revenues.

Selected Bond Fund Expenditures

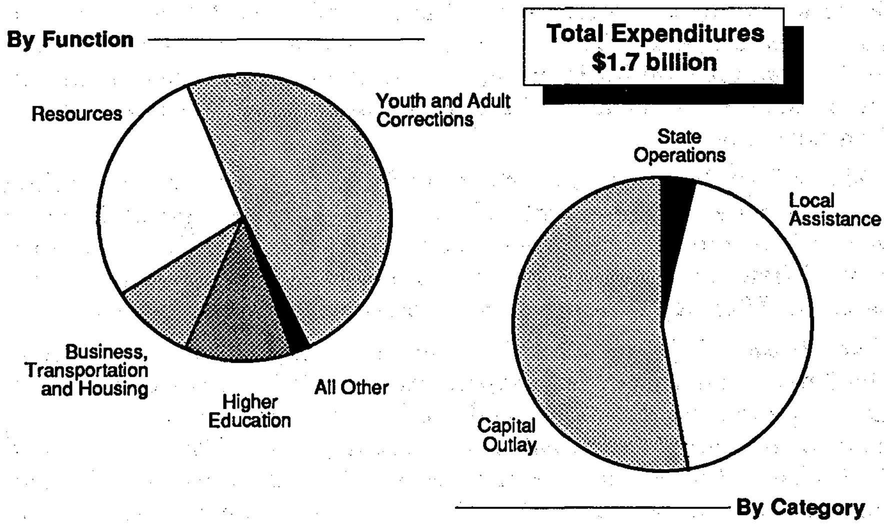
The budget proposes selected bond fund expenditures of $1.7 billion in 1989-90, which is an increase of $40 million, or 2.5 percent, from the current-year spending identified in the budget. Table 2 shows the proposed 1989-90 selected bond fund expenditures by function, and Chart 5 illustrates the relative distribution of these expenditures by function and category.

Table 2
Selected Bond Fund Expenditures by Function [a]
1987-88 through 1989-90
(dollars in millions)

Function	*Actual 1987-88*	*Estimated 1988-89*	*Proposed 1989-90*	*Change From 1988-89 Amount*	*Change From 1988-89 Percent*
Higher education	$217	$516	$211	−$306	−59.2%
Business, transportation and housing	—	1	151	150	— [b]
Resources	231	448	454	6	1.2
Youth and adult corrections	369	638	810	172	26.9
All other	1	7	26	18	253.7
Totals	$817	$1,611	$1,651	$40	2.5%

[a] Detail may not add to totals due to rounding. Does not include proceeds from the School Facilities Bond Acts of 1988. These expenditures are treated as special fund expenditures from the State School Building Lease-Purchase Fund.
[b] Not a meaningful figure.

Chart 5
1989-90 Selected Bond Fund Expenditures by Function and Category



As has consistently been the case in recent years, the budget overstates the amount of bond fund expenditures which are likely to occur in the current and budget years. Given the delays which have been experienced by the state in bringing various bond-funded projects to the construction phase, it is not likely that this level of expenditure can be realized. For example, the level of bond fund expenditures proposed for youth and adult corrections programs is overstated in both the current and budget years. Specifically, the budget proposes to spend more than $120 million in the current year and $221 million in the budget year for two prisons in Los Angeles County. The Department of Corrections, however, does not anticipate completing the preliminary planning for these prisons until May 1989. Once preliminary planning is completed, the department must still complete working drawings before construction bids can be solicited, meaning that construction is not likely to start until well into the budget year. In total, we estimate that the budget overstates likely expenditures for these two prisons by a total of $170 million in the current and budget years.

In addition to being overstated, the budget-year total is not a good indication of the actual level of capital outlay activity which will occur in 1989-90. This is because, from an accounting perspective, certain "project commitments" are counted as bond fund expenditures even though the projects will not actually commence in the budget year (please see the K-12 Education section, below).

The vast majority of bond fund expenditures are proposed to be spent in the following five program areas:

K-12 Education. The budget proposes expenditures of $1 billion in the current year and $600 million in the budget year from the State School Building Lease-Purchase Fund (where the proceeds of both 1988 school facilities bond acts will be deposited). Thus, the budget proposes to spend *all* of the school facilities bond funds authorized in 1988. The expenditures reflected in the budget, however, reflect only a *commitment* to provide funding for the school districts when they are ready to begin construction, rather than the actual transfer of funds to school districts.

Higher Education. The Governor's Budget reflects 1989-90 selected bond fund expenditures for higher education totaling $211 million, of which $176 million is for capital outlay. The proposed bond fund expenditures for capital outlay would spend all of the 1988 Higher Education General Obligation bond issue except for about $45 million set aside by the Department of Finance for augmentations and interest payments on loans from the Pooled Money Investment Account. The budget also proposes expenditures of $306 million in "revenue" bonds for higher education.

Business, Transportation and Housing. The budget proposes selected bond fund expenditures totaling $151 million in 1989-90 for housing programs. Of the total proposed, $76 million is from the Earthquake Safety and Housing Rehabilitation Bond Act and $75 million is from the Housing and Homeless Bond Act. The budget indicates that none of these bonds will be sold before 1990-91. Instead, the proposed expenditures are intended to be funded by loans from the Pooled Money Investment Account (PMIA).

Resources. The Governor's Budget reflects selected bond fund expenditures for resources programs totaling $454 million, or 28 percent of total bond fund expenditures in 1989-90. This amount reflects expenditures of $157 million from the California Wildlife, Coastal and Park Land Conservation Bond Act. In addition, $143 million would be used to provide assistance to local agencies to improve the quality and efficiency of local drinking water systems. Another $95 million would be used to provide grants and loans to local agencies to construct waste water treatment plants and to improve agricultural drainage systems.

Youth and Adult Corrections. The budget proposes selected bond fund expenditures totaling $810 million for 1989-90 for youth and adult correctional programs. Of this amount, $221 million would provide assistance to local governments for construction of adult correctional facilities, and $10 million would provide assistance to local governments for construction of juvenile facilities. But, as discussed earlier, because the budget makes overly optimistic assumptions about the speed at which construction of correctional facilities will take place, the total amount proposed in the budget year is not likely to be spent.

Table 3 shows proposed expenditures for the current and budget years from bond issues approved at the June and November 1988 elections. (An additional discussion of the proposed expenditure of bond funds for capital outlay purposes is included in the capital outlay section of the *Analysis*.)

Federal Funds Expenditures

The budget proposes $18.5 billion in federal funds expenditures in 1989-90, which is about one-fifth of total state spending. This level of federal funds expenditures is $545 million, or 3 percent, higher than the current-year level. Table 4 shows federal funds expenditures by program for the past, current and budget years.

The largest dollar increase, $584 million, is shown for health and welfare programs. Of this amount, more than 40 percent ($242 million) is due to increased federal funding for the Medi-Cal program. Another $138 million (approximately 24 percent) is the result of estimated increases in State Legalization Impact Assistance Grant (SLIAG) funds for public health services to immigrants.

Table 3
Proposed Expenditures from 1988 Bond Issues [a]
1988-89 and 1989-90
(dollars in thousands)

Program	Amount Authorized	Expenditures Estimated 1988-89	Expenditures Proposed 1989-90
Earthquake Safety and Housing Rehabilitation	$150,000	$561	$75,945
School Facilities [b]	1,600,000	1,000,000	600,000
Higher Education Facilities	600,000	344,197	210,153
New Prison Construction	817,000	294,369	478,671
County Correctional Facilities	500,000	—	416
California Safe Drinking Water	75,000	—	10,954
Water Conservation	60,000	—	15,942
Clean Water and Water Reclamation	65,000	—	—
Housing and Homeless	300,000	—	75,000
Library Construction and Renovation	75,000	49	156
Wildlife, Coastal and Park Land Conservation	776,000	84,704	156,574
Totals	$5,018,000	$1,723,880	$1,623,811

[a] Excludes self-liquidating bond acts.
[b] The budget treats expenditures from these bond acts as special fund expenditures from the State School Building Lease-Purchase Fund.

Table 4 also shows that the amount of federal funding provided for higher education in the state is expected to increase by $176 million in 1989-90. Two items account for this increase: (1) $129 million for Department of Energy laboratories at the University of California and (2) $47 million for federal research contracts at the University of California.

Table 4
Federal Funds Changes, by Program
1987-88 through 1989-90
(dollars in millions)

Program	Actual 1987-88	Estimated 1988-89	Proposed 1989-90	Change from 1988-89 Amount	Change from 1988-89 Percent
Legislative/judicial/executive	$43	$57	$57	$1	1.3%
State and consumer services	16	19	19	1	3.5
Business, transportation and housing	1,207	2,083	1,829	−254	−12.2
Resources	117	304	284	−20	−6.7
Health and welfare	8,846	10,325	10,910	584	5.7
Youth and adult corrections	1	1	1	—	—
K-12 education	1,261	1,465	1,524	59	4.0
Higher education	2,916	3,114	3,290	176	5.7
All other	544	573	571	−2	−0.3
Totals [a]	$14,950	$17,941	$18,486	$545	3.0%

[a] Detail may not add to totals due to rounding.

Finally, business, transportation and housing programs are projected to receive $254 million, or 12 percent, *less* in federal funds in 1989-90 than in the current year. Most of the change occurs in the Department of Transportation's capital outlay program. The overall expenditure totals shown in the budget, moreover, overstate the likely level of federal receipts because they do not reflect the administration's decision to defer $600 million in capital outlay projects that had previously been scheduled to commence over the next 18 months.

HOW IS THE MONEY SPENT?

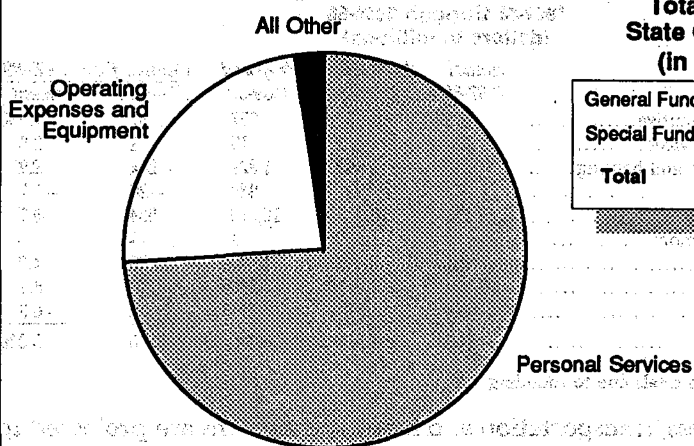
The Governor's Budget proposes state expenditures of $46.1 billion from the General Fund and special funds. These are the funds over which the Legislature exercises the most control in the budget. State expenditures have traditionally been categorized as spending for "state operations," "local assistance," and "capital outlay." This section takes a closer look at the proposed allocation of these funds.

State Operations

State operations refer to expenditures made to support state departments, boards, and commissions in their day-to-day operations. Chart 6 shows that General Fund and special fund expenditures for state operations are largely distributed between personal services and operating expenses and equipment (OE&E). As the chart indicates, more than seven out of every 10 dollars spent in this category (74 percent) are used to pay for personal services, which include salaries, wages, and staff benefits.

Chart 6

Distribution of 1989-90 State Operations Budget General Fund and Special Funds Only[a]



Total Budget State Operations (in billions)

General Fund	$9.8
Special Funds	3.4
Total	$13.2

[a] Source: Legislative Analyst's Office estimates.

The California State University and the University of California have the largest personal services budgets in the state, amounting to approximately $1.7 billion each (almost all General Fund). The Department of Corrections, the next largest budget in terms of personal services costs, has a General Fund personal services budget of nearly $1.2 billion.

Special fund expenditures for personal services amount to approximately $2.2 billion. Of this amount, over half is spent for personal services for the Department of Transportation, the Department of Motor Vehicles and the California Highway Patrol.

The bulk of the remaining General Fund and special fund expenditures for state operations is made for OE&E. This category includes all costs needed to support state employees—rent on facilities, phones, desks, etc.—as well as the costs of services contracted with the private sector. The "All Other" category shown in Chart 6 reflects special items of expense, such as one-time lease payments.

The State's Work Force. Table 5 shows trends in the total state employee work force (all funds) for 1987-88 through 1989-90. As the table indicates, the Governor's Budget would increase the state's work force by 6,810 personnel-years (pys), or 2.7 percent, in 1989-90. This compares to a 4.5 percent increase between 1987-88 and 1988-89.

Table 5
The State's Work Force, by Function (All Funds)
1987-88 through 1989-90
(in personnel-years)

Function	*Actual 1987-88*	*Estimated 1988-89*	*Proposed 1989-90*	*Change from 1988-89 Amount*	*Change from 1988-89 Percent*
Legislative/judicial/executive	11,201	12,273	12,493	220	1.8%
State and consumer services	12,061	12,916	13,270	354	2.7
Business, transportation and housing	33,728	35,761	36,927	1,166	3.3
Resources	14,415	15,176	15,310	135	0.9
Health and welfare	37,419	39,161	39,750	589	1.5
Youth and adult corrections	25,357	28,401	30,725	2,324	8.2
Education	92,838	93,285	94,677	1,392	1.5
General government	10,742	11,569	12,199	630	5.4
Totals[a]	237,761	248,541	255,351	6,810	2.7%

[a] Detail may not add to totals due to rounding.

The following items account for most of the budget-year increase in pys:

- ***Youth and Adult Corrections*** programs are proposed to increase by 2,324 pys, 2,314 of which are budgeted for the Department of Corrections. The growth is primarily due to significant increases in the adult inmate population and the opening of new facilities to accommodate them.
- ***Business, Transportation, and Housing*** programs are proposed to increase by 1,166 pys. Of this amount, 408 pys are proposed for the

Department of Transportation, primarily for congestion relief and ridesharing projects and for increased maintenance activities. In addition, the budget requests increases for the Department of Motor Vehicles (348 pys) and for the California Highway Patrol (350 pys).

- ***Education*** programs are proposed to increase by 1,392 pys. Of this amount, 1,262 pys are for the University of California and the California State University to accommodate increased enrollment.

Local Assistance

Local assistance, as the term is used in the budget, encompasses a wide variety of programs. As the name implies, these funds are generally provided to help carry out programs administered locally or for the support of local activities. Some of these programs, however, do not provide assistance to local government agencies; rather, they provide assistance to individuals. Such payments may be made directly to individuals, as in the case of the Renters' Tax Relief program, or through an intermediary, such as the federal or county government. Among the programs which make payments through intermediaries are the Supplemental Security Income/State Supplementary Program (SSI/SSP), which is administered by the federal government, and the Aid to Families with Dependent Children (AFDC) program, which is administered by county governments.

Aid to Individuals. Table 6 identifies 11 local assistance programs which our analysis indicates are appropriately categorized as "Aid to Individuals." Overall, the Governor's Budget proposes a General Fund increase of $340 million, or 3.9 percent, for these programs in the budget year. Virtually all (98 percent) of the growth takes place in the three largest programs: Medi-Cal, AFDC and SSI/SSP.

Aid to Local Governments. Table 7 displays the major local assistance programs which our analysis indicates provide "Aid to Local Governments." Overall, the Governor's Budget proposes an increase in funding for these programs of approximately $974 million, or 4.3 percent, above current-year levels. This compares with an increase of $2.1 billion, or 10 percent, in the current year. The changes in individual program areas are discussed in more detail later in this part.

Table 6
Major Local Assistance Programs[a] Providing Aid to Individuals 1987-88 through 1989-90 (dollars in millions)

General Fund	Actual 1987-88	Estimated 1988-89	Proposed 1989-90	Change from 1988-89 Amount	Change from 1988-89 Percent
Medi-Cal[b]	$2,702	$3,056	$3,155	$99	3.2%
AFDC[c]	2,148	2,338	2,506	168	7.2
SSI/SSP	1,836	1,990	2,055	65	3.3
Renters' Tax Relief	472	481	490	9	1.9
Developmental services	450	475	464	–11	–2.2
Homeowners' Property Tax Relief	344	351	358	7	2.0
Senior Citizens Renters' Tax Relief	21	18	19	1	5.9
Subventions for Open Space	14	15	15	—	—
Senior Citizens' Property Tax Deferral	7	8	8	—	—
Senior Citizens' Property Tax Relief	5	4	4	—	—
Subtotals, General Fund	($8,000)	($8,733)	($9,073)	($340)	(3.9%)
Special Funds					
Developmental Services	$4	$5	$3	–$2	–34.0%
Totals	$8,003	$8,739	$9,077	$338	3.9%

[a] Detail may not add to totals due to rounding.
[b] Excludes county administration.
[c] Grant payments only.

Table 7
Major Local Assistance Programs Providing Aid to Local Governments 1987-88 through 1989-90 (dollars in millions)

General Fund	Actual 1987-88	Estimated 1988-89	Proposed 1989-90	Change from 1988-89 Amount	Change from 1988-89 Percent
Public health services	$1,080	$1,133	$731	–$402	–35.5%
California Children's Services	61	65	68	3	4.6
Department of Rehabilitation	69	78	75	–2	–3.0
Mental health programs	553	583	586	4	0.7
Alcohol and drug programs	72	73	73	—	—
Social services—programs	488	791	803	12	1.5
Social services—county administration	141	167	180	12	7.5
County justice subvention	67	67	—	–67	–100.0
K-12 education	12,430	13,288	14,179	891	6.7
Community colleges	1,300	1,392	1,493	101	7.2
Local government financing	148	74	58	–16	–21.6
State mandates	109	148	203	54	36.7
Trial court funding	—	182	433	250	137.4
All other	408	255	281	26	10.2
Subtotals, General Fund	($16,927)	($18,296)	($19,162)	($867)	(4.7%)
Special Funds					
K-12 education	$753	$1,056	$630	–$425	–40.3%
Public health services	—	200	514	314	156.9
Shared revenues	2,463	2,623	2,766	143	5.4
All other	337	373	449	77	20.5
Subtotals, special funds	($3,553)	($4,251)	($4,359)	($108)	(2.5%)
Totals[a]	$20,480	$22,547	$23,521	$974	4.3%

[a] Detail may not add to totals due to rounding.

HOW ARE SPENDING LEVELS DETERMINED?

The state's spending plan reflects a multitude of decisions made in the preparation of the proposed budget. In general, most of the proposed spending reflects the "baseline" cost of maintaining existing state programs. Thus, most of the decisions made in the course of the normal budget process are focused on how *additional* resources will be allocated. This year's budget, however, also reflects a number of decisions to reduce "baseline" expenditures. These decisions were made because the level of additional resources for 1989-90 will be insufficient to meet expected resource requirements.

In distributing these additional resources to individual programs, the Legislature and the Governor must consider a variety of factors. These factors include statutory requirements which necessitate higher expenditures, as well as policy decisions to maintain, expand or cut back existing levels of state services. In the case of programs supported by special funds (whose revenues are usually dedicated to singular purposes), spending decisions are governed largely by the level of resources available, and the budget process focuses on how to set priorities for each individual program's additional spending needs. For programs supported by the General Fund, however, spending decisions are also influenced by competing demands from different program areas. The Governor's Budget reflects the administration's view as to how these competing demands should be accommodated.

In preparing the budget this year the Governor and the Legislature face particularly tough choices. We estimate that maintaining current service levels, meeting existing statutory requirements for certain programs, and restoring the state's reserve to the 3-percent of expenditures level would require more than $4.5 billion in additional resources for 1989-90. Table 8 summarizes these budget-year funding requirements.

Table 8
General Fund Current-Service Level Funding Requirements
1989-90
(dollars in millions)

Program	*Amount*
COLAs:	
Statutory	$951
Discretionary	717 [a]
Workload increases	1,263
Special Fund for Economic Uncertainties	1,100
Proposition 98	289
Trial Court Funding	218
Other, net	11
Total	$4,549

[a] Includes funding for salary increases which have already been agreed to by the administration.

As revenue growth for the budget year is estimated to be only $2.9 billion, the state is left with a $1.6 billion funding gap. This section discusses the major factors which typically influence *General Fund* spending decisions and identifies some of the choices the Governor has made about how to address the $1.6 billion funding gap facing the state.

Cost-of-Living Adjustments (COLAs)

Each year, the Governor's Budget typically includes funds for various cost-of-living adjustments, commonly referred to as COLAs. These adjustments attempt to compensate for the effects of inflation on the purchasing power of the previous year's funding level.

Discretionary and Statutory COLAs. Existing law authorizes *automatic* COLAs for nearly 30 different programs, most of them in the health, education and welfare areas. These adjustments generally are referred to as statutory COLAs. Many other programs traditionally have received COLAs on a *discretionary* basis through the budget process.

In 1989-90, statutory COLAs range from 3.2 percent to 8.0 percent. As in previous years, the statutory COLAs having the largest costs are those for K-12 apportionments ($428 million), SSI/SSP grants ($138 million) and AFDC grants ($105 million). The 1989-90 General Fund cost of fully funding *statutory* COLAs is $951 million, with discretionary COLAs adding another $717 million.

Governor's Budget Proposal. The budget proposes a total of $913 million from the General Fund for COLAs in 1989-90, including $668 million for statutory COLAs and $245 million for discretionary COLAs, which primarily reflects funding for increased employee compensation. The total COLA amount is equal to 44 percent of the total proposed increase in budget-year General Fund expenditures. The specific increases proposed by the Governor are shown in Table 9.

Table 9
General Fund Cost-of-Living Increases
1988-89 and 1989-90
(dollars in thousands)

Department/Program	*1988-89* Budgeted Percent Increase	*1989-90* 1% Dollar Increase	Statutory Percent Increase	Statutory Dollar Increase	Budget Percent Increase	Budget Dollar Increase
HEALTH AND WELFARE						
Aging	—	$323	—	—	—	—
Alcohol and drug programs	—	731	—	—	—	—
Medi-Cal:						
Noncontract hospitals	7.1%	504	8.0%	$4,033	8.0%	$4,033
Long-term care—skilled nursing facilities	6.7 [a]	4,935	— [b]	—	—	—
Long-term care—intermediate care facilities	1.9 [a]	586	— [b]	—	—	—
Long-term care—state hospitals	4.5	1,795	— [b]	—	—	—
Obstetrical physicians	36.9 [c]	226	—	—	—	—
Children's services	10.0	71	—	—	—	—
Home health	10.0	28	—	—	—	—
Portable X-ray	50.0	3	—	—	—	—
Capitation contracts—inpatient [d]	7.1	164	8.0	1,314	8.0	1,314
Capitation contracts—noninpatient	3.3	1,013	— [e]	— [e]	—	—
Dental	—	539	—	—	—	—
Other providers	—	4,700	—	—	—	—
Beneficiary spin-off	4.7	2,365	4.8	9,500	—	—
Drug ingredients	6.7	1,433	6.0	8,599	6.0	8,599
Health Services:						
County health services (AB 8)	5.1	4,500	4.6	20,600	—	—
Medically indigent services	—	1,537	—	—	—	—
Public health	—	1,597	—	—	—	—
Emergency medical services	—	29	—	—	—	—
Developmental Services:						
Regional centers—residential care	10.0	2,692	—	—	—	—
Regional centers—personal services	6.0 [f]	1,203	—	—	4.0 [g]	2,406
Regional centers—other	—	2,496	—	—	—	—
Mental Health:						
Local programs	—	5,614	—	—	—	—
Institutions for mental disease	3.8	712	—	—	—	—
Social Services:						
SSI/SSP	4.7	28,722	4.8	137,557	—	—
AFDC—FG & U	4.7	21,885	4.8	104,831	—	—
AFDC—foster care	—	5,260	—	—	—	—
IHSS provider	14.2 [h]	4,903	—	—	—	—
Deaf access	—	34	—	—	—	—
Maternity care	—	22	—	—	—	—
Child abuse prevention	—	202	—	—	—	—
Adoptions	—	184	—	—	—	—
Community care licensing	—	100	—	—	—	—
Department of Rehabilitation	—	752	—	—	—	—
YOUTH AUTHORITY						
County justice system subvention	—	673	—	—	—	—
Delinquency prevention	—	23	—	—	—	—

Table 9—Continued
General Fund Cost-of-Living Increases
1988-89 and 1989-90
(dollars in thousands)

Department/Program	*1988-89 Budgeted Percent Increase*	*1989-90 1% Dollar Increase*	*1989-90 Statutory Percent Increase*	*1989-90 Statutory Dollar Increase*	*1989-90 Budget Percent Increase*	*1989-90 Budget Dollar Increase*
K-12 EDUCATION						
Apportionments:						
District revenue limits	4.1%	$129,376	3.2%	$412,847	3.2%	$412,847
Necessary small schools	4.1	708	3.2	2,273	3.2	2,273
Meals for needy pupils	4.1	336	6.0	2,018	6.0	2,018
Summer school	4.1	965	3.2	3,099	3.2	3,099
Apprentice programs	—	69	—	—	—	—
Transportation	—	2,933	—	—	—	—
County offices of education	4.1	2,462	3.2	7,903	3.2	7,903
Regional occupation centers/programs	—	2,205	—	—	3.1	6,916
Court-ordered desegregation	4.1	2,702	3.2	8,672	3.2	8,672
Voluntary desegregation	4.1	522	3.2	1,677	3.2	1,677
Child nutrition	4.1	421	5.3	2,208	5.3	2,208
American Indian education centers	—	9	—	—	—	—
Native American Indian education	—	4	—	—	—	—
Child development, local education agency	4.1	1,984	—	—	3.0	5,938
Child development, private provider	4.1	1,317	—	—	—	—
Special education	4.1	18,982	3.2	60,932	3.2	50,882 [i]
Mentor teacher	—	647	—	—	—	—
Other staff development	—	63	—	—	—	—
Gifted and Talented Education	4.1	234	—	—	6.0	1,406
Instructional materials (K-8)	3.6	836	4.3	3,594	4.3	3,594
Instructional materials (9-12)	—	217	—	—	—	—
Demonstration programs in reading and math	—	44	—	—	—	—
Economic Impact Aid	—	1,970	—	—	—	—
Dropout programs	—	84	—	—	—	—
Adult education	4.1	2,597	6.0	15,579	6.0	15,579
Adults in correctional facilities	4.1	24	6.0	144	6.0	144
School Improvement Program (K-6)	4.1	2,140	3.2	6,870	3.2	6,870
School Improvement Program (7-12)	—	325	—	—	—	—
Miller-Unruh Reading Program	—	199	—	—	—	—
High school pupil counseling	—	72	—	—	—	—
Specialized secondary schools	—	21	—	—	—	—
Opportunity programs and classes	—	10	—	—	—	—
Foster youth services	—	8	—	—	—	—
HIGHER EDUCATION						
Community Colleges:						
Apportionments	4.7	20,058	4.9	97,885	4.9	97,885
Community college categoricals	4.7	835	—	—	4.9	4,075
Student Aid Commission:						
Financial Aid Awards	6.5	1,411	—	—	—	—

Table 9—Continued
General Fund Cost-of-Living Increases
1988-89 and 1989-90
(dollars in thousands)

Department/Program	1988-89 Budgeted Percent Increase	1989-90 1% Dollar Increase	Statutory Percent Increase	Statutory Dollar Increase	Budget Percent Increase	Budget Dollar Increase
ALL OTHERS						
Trial Court Funding Program:						
Block grant	—	$3,555	6.0%	$21,331	6.0%	$21,331
Trial court judge salaries	6.0% [j]	1,010	4.0 [g]	2,021	4.0 [g]	2,021
State contribution to STRS	5.0	2,540	6.0	15,239	6.0	15,239
STRS purchasing power protection	6.8	—	—	—	—	— [k]
Library local assistance	—	77	—	—	2.4	184
Employee compensation: [l]						
Civil service and related	6.0 [j]	35,582	—	—	4.0	123,230
University of California						
Faculty	3.0 [j]	9,176	—	—	4.7	27,946
Staff	6.0 [j]	7,135	—	—	4.0	22,721
California State University						
Faculty	4.8 [j]	9,198	—	—	4.8	29,612
Staff	6.0 [j]	6,184	—	—	4.0	20,742
Totals		$373,803		$950,726		$913,364

[a] These increases were provided in August 1988.
[b] Long-term care COLAs will not be determined until July 1989.
[c] Effective March 1988, 16 percent for OB physicians, 10.45 percent for OB clinics, $150 for comprehensive perinatal providers. An additional 18 percent for OB physicians was effective January 1989.
[d] Including Redwood in current year. Excludes Redwood in budget year. Excludes dental in both years.
[e] COLA will not be determined until time of May revision.
[f] Six percent for salaries and 1 percent for benefits effective June 1989.
[g] Effective January 1, 1990.
[h] Most IHSS providers received a 14.2 percent increase in their hourly rate or reimbursement effective July 1, 1988 as a result of the increase in the minimum wage to $4.25 per hour. Prior to the increase in the minimum wage, individuals who provided IHSS were paid $3.72 per hour.
[i] Budget amount reflects a $10.1 million reduction to the COLA, to eliminate one-time funding proposed for a special education deficiency in 1988-89.
[j] Effective June 1, 1989.
[k] The budget proposes to fund purchasing power protection COLAs from the State Teachers' Retirement Fund in 1989-90.
[l] Effective January 1, 1990. Dollar amounts include both the 4 percent across-the-board cost-of-living adjustment, health benefits, and, where applicable, a 1 percent equity adjustment.

This year's budget does not contain funding for a total of $272 million in statutory COLAs. This reflects proposals to suspend for one year the following statutory COLAs: (1) Medi-Cal beneficiary ($9 million); (2) County Health Services—AB 8 ($21 million); (3) SSI/SSP ($138 million); and (4) AFDC ($105 million). The budget also states that if the Legislature does not concur with the suspension of these COLAs, then other state support for health and welfare programs will have to be reduced or eliminated.

The budget, as in the past three years, does not provide funding for the statutory COLA for Medi-Cal long-term care facilities. The amount of funding required for the long-term care program will not be known until the new reimbursement rates for these facilities are adopted. Although the Governor's Budget has traditionally not included any funds for this purpose, the required funding is normally requested at the time of the May revision of expenditures. Although the administration proposes waiving statutory COLAs in many other programs, it is likely that the long-term care statutory COLAs will be funded due to requirements in federal law.

Workload

Increased workload for state programs is another major factor contributing to the increase in spending from the current to the budget year. The major workload increases reflected in the budget are: (a) enrollment growth at educational institutions; (b) caseload growth for health and welfare programs; and (c) population growth at youth and adult correctional facilities. We estimate that these and other workload increases projected for the budget year account for nearly $1.3 billion in proposed General Fund expenditures.

Other Requirements

A third major factor contributing to the increase in spending from the current to the budget year are statutory requirements other than COLAs. For example, the budget provides over $600 million from the General Fund to meet new state requirements for the full-year implementation of the Trial Court Funding programs, the implementation of Proposition 98, and for a variety of other new statutory obligations.

WHAT PRIORITIES ARE REFLECTED IN THE GOVERNOR'S BUDGET?

As noted earlier, the cost of maintaining current service levels, meeting statutory requirements for funding for certain programs, and restoring the state's reserve exceeds the $2.9 billion increase in revenues available in the budget year. This section provides additional detail on how the budget proposes to allocate the available resources among different state programs in the budget year.

Summary of Major Program Changes

For 1989-90, the budget proposes a net increase of General Fund expenditures of $2.1 billion, or 5.8 percent, above the level of expenditures estimated for the current year. Table 10 shows the primary factors that account for the proposed change in expenditures.

Table 10
Estimated General Fund Program Changes [a]
1987-88 through 1989-90
(dollars in millions)

	Actual 1987-88	*Estimated 1988-89*	*Proposed 1989-90*	*Change from 1988-89 Amount*	*Change from 1988-89 Percent*
Health and Welfare:					
Medi-Cal [b]	$2,783	$3,150	$3,254	$104	3.3%
Public health [b]	1,141	1,198	799	−399	−33.3
SSI/SSP [b]	1,836	1,990	2,056	66	3.3
AFDC grants [b]	2,148	2,338	2,506	168	7.2
Social services programs [b]	488	791	803	12	1.5
Mental health	897	936	962	26	2.8
Developmental services	472	495	551	56	11.4
Other, health and welfare	609	682	692	9	1.4
Subtotals, health and welfare	($10,373)	($11,579)	($11,622)	($42)	(0.4%)
Education:					
K-12	$12,018	$12,836	$13,830	$994	7.7%
State teachers' retirement	506	547	449	−97	−17.8
University of California	1,889	1,975	2,053	79	4.0
California State University	1,715	1,824	1,981	157	8.6
California community colleges	1,310	1,407	1,521	114	8.1
Other, higher education	139	156	156	−1	−0.4
Subtotals, education	($17,577)	($18,745)	($19,991)	($1,246)	(6.6%)
Other:					
Youth and adult corrections	$1,720	$1,945	$2,105	$160	8.2%
Resources	461	498	483	−14	−2.9
Tax relief	863	876	893	18	2.0
Bond interest and redemption	512	524	610	86	16.3
Interest on PMIA loans	78	44	16	−28	−63.6
All other	1,436	1,712	2,290	578	33.8
Subtotals, other	($5,071)	($5,598)	($6,397)	($799)	(14.3%)
Totals	$33,021	$35,922	$38,010	$2,088	5.8%

[a] Based on amounts shown in Governor's Budget. Detail may not add to totals due to rounding.
[b] Local assistance only.

As was the case in the current year, the largest dollar increase is proposed for K-12 education—$994 million. The major General Fund changes are discussed below:

Medi-Cal local assistance expenditures are up by $104 million, or 3.3 percent. This increase is primarily due to increases in caseload and in the cost of providing services. This level of increase is predicated on achieving savings from the following proposals: (1) reducing Medi-Cal "crossover" claim costs by limiting reimbursement rates for a variety of procedures ($23 million); (2) reducing Medi-Cal drug costs ($40 million); (3) deferring the June 1990 checkwrite until 1990-91 ($40 million); and (4) suspending the statutory Medi-Cal beneficiary COLA ($9.5 million).

Public Health local assistance is budgeted at $799 million, a *decrease* of $399 million, or 33 percent. This decrease is largely the result of three proposals: (1) a $359 million reduction in the Medically Indigent Services Program (MISP); (2) the elimination of the Family Planning program

($36 million); and (3) the suspension of the statutory COLA for County Health Services—AB 8 ($21 million). The budget proposes to offset the reductions in the MISP by appropriating $331 million from Proposition 99 revenues for a new California Health Care for Indigents program and by increasing allocations by $108 million from State Legalization Impact Assistance Grant (SLIAG) funds for services to legalized aliens in the budget year.

SSI/SSP is expected to increase by $66 million, or 3.3 percent. The major changes in SSI/SSP funding are: (1) an increase of $89 million for an estimated 4.5 percent caseload increase; (2) an increase of $55 million for the full-year cost of the 4.7 percent COLA provided effective January 1, 1989; and (3) an offset of $78 million as a result of the 4.8 percent federal COLA effective January 1, 1990. In addition, the budget proposes to suspend the state's statutory COLA on the total SSI/SSP grant, for a cost-avoidance of $138 million.

AFDC grant costs are budgeted to increase by $168 million, or 7.2 percent, above current-year expenditures. This increase is primarily due to: (1) an increase of $73 million in the AFDC-Family Group and Unemployed Parent (AFDC-FG&U) programs, primarily due to an anticipated 3.7 percent caseload increase; and (2) an increase of $94 million in the AFDC-Foster Care program, due to a 12 percent increase in caseload and an 11 percent increase in the average rate paid to group homes. The budget also proposes a one-year suspension of the state's statutory COLA for AFDC-FG&U recipients, for a cost-avoidance of $105 million.

Social Services Programs expenditures are budgeted to increase by $12 million, or 1.5 percent, above current-year expenditures. This growth is primarily due to: (1) an increase of $41 million in the Child Welfare Services (CWS) program due to caseload increases; (2) an increase of $15 million in CWS costs due to COLAs that counties granted to their welfare department employees during 1988-89; (3) an increase in the In-Home Support Services (IHSS) program of $57 million, primarily due to an 11 percent caseload increase and a 4 percent increase in the average hours of service per case; (4) an increase of $4 million for the adoption of IHSS administration programs; (5) a reduction of $64 million in the IHSS program due to a proposal to place limitations on both the average hours of service that counties award to IHSS clients and the hourly rate at which the state reimburses counties to pay for the services; and (6) a reduction of $41 million in the Greater Avenues for Independence (GAIN) program.

K-12 Education expenditures are expected to increase by $994 million, or 7.7 percent, above the estimated current-year level. The primary factors accounting for this increase include: (1) $532 million for cost-of-living adjustments (generally 3.21 percent), most of which are required by statute; (2) $407 million for costs related to increased enrollments, including $15 million for growth in special education programs; (3) $110 million for reducing class sizes in grades 1-3 and 9-12; (4) a $48 million increase in reimbursements for mandated local programs; and (5) a $181 million increase in the size of a reserve for funding deficiencies and other priorities in compliance with Proposition 98 ($220 million total reserve in 1989-90). These increases are partially offset by state apportionment reductions of $249 million due to increased local property tax revenues.

Higher Education expenditures are expected to increase by $350 million, or 6.7 percent, over the estimated 1988-89 level. The primary factors accounting for this increase are: (1) $72 million for undergraduate enrollment growth at the University of California (UC), the California State University (CSU), and the California Community Colleges (CCC); (2) $77 million for faculty and staff salary increases; and (3) $146 million for baseline budget adjustments, which include annualization of salary increases granted in 1988-89. The budgets for UC and CSU each include approximately $500,000 for new campus planning to accommodate growth in enrollment. No new funding is provided to implement Chapter 973, Statutes of 1988 (AB 1725, Vasconcellos), the community college reform measure. The budget also proposes no current-year funding increase for the community colleges related to the implementation of Proposition 98.

Youth and Adult Corrections expenditures are proposed to increase by $160 million, or 8.2 percent, in the budget year. This net increase will fund 2,314 additional personnel-years for the Department of Corrections, primarily to accommodate growth in the prison population. The budget is based on an 8 percent growth rate in the inmate population between June 30, 1989 and June 30, 1990 and a 15 percent growth rate in the parole population over the same period. The increase in youth and adult correctional spending is partially offset by a General Fund reduction of $67 million from the Department of the Youth Authority's County Justice System Subvention Program in the budget year. The budget proposes to finance that portion of the program which is related to a state-mandated local program (Chapter 1071, Statutes of 1976) with a $37 million appropriation from the Restitution Fund, and proposes to eliminate the remainder of the block grant program.

All Other expenditures increase by $578 million. Nearly 40 percent of this growth is due to a $230 million increase to provide full-year funding for the Trial Court Funding Program. Also, $120 million is provided to fund the January 1990 4 percent state employee salary increase which was agreed to last year as part of a three-year contract.

Expenditures Not Recognized in the Budget

In preparing the Governor's Budget, the Department of Finance must estimate the impact of program caseload growth, court decisions, and other factors on expenditure levels in the current and budget years. While most of these factors have been accounted for, our analysis indicates that the Governor's Budget has potentially underestimated General Fund expenditures in several areas for both the current and budget years.

Department of Developmental Services (DDS)—Regional Centers. The current-year budget assumes receipt of $27.2 million in federal Medi-Cal funds for case management at DDS regional centers, but it is unlikely that the state will receive the required federal approval and funds in the current year. This may result in additional General Fund expenditures of $27.2 million to cover the shortfall in 1988-89. In addition, DDS regional centers are experiencing increased costs for purchasing services for clients. These increased costs could result in increased General Fund expenditures of $7.9 million in the current year.

Emergency Firefighting. Based on the state's experience over the last 12 years, we would expect General Fund expenditures for emergency firefighting by the Department of Forestry and Fire Protection to total $24 million more than the budget provides for 1989-90. Any additional expenditures, up to $10 million, could be paid for directly from the Special Fund for Economic Uncertainties under control language in the Budget Bill.

Flood Control Projects. We estimate that the state's 1989-90 share of cost for federal flood control projects in California will total approximately $10.5 million. The budget does not include funds to pay these costs (usually paid for from the Special Account for Capital Outlay—SAFCO). The state could incur penalties of $800,000 for withholding these payments, and the penalties would have to be paid by the General Fund.

Medi-Cal. As in the last three years, the budget fails to provide for increases in Medi-Cal reimbursements for long-term care facilities and for the cost of Medi-Cal abortions. In the current year, the statutorily required increase for long-term care facilities resulted in a net increase of $24 million. This amount, however, includes increases in costs due to increasing the minimum wage from $3.35 to $4.25 on July 1, 1988. While the budget-year requirement is not yet known, it is likely to be less than the current-year cost. The 1989-90 costs for abortions would be similar to the current-year cost of $15 million.

Cost of External Borrowing. The budget estimates that the interest rate the state will pay on external borrowing will be 5.8 percent in the budget year. We estimate, however, that this rate is at least one percentage point too low. On this basis, the budget underestimates likely expenditures by $31 million.

Implementation of Initiatives

The Governor's Budget also makes several proposals for implementing Propositions 98 and 99, which were approved at the November 1988 election.

Proposition 98. The primary purpose of Proposition 98—the Classroom Instructional Improvement and Accountability Act—is to increase state funding for K-12 schools and community colleges. The mechanism for achieving this increase is the establishment of a minimum funding level requirement for K-12 schools and community colleges.

The Governor's Budget proposes to spend $116 million in the current year to implement the provisions of Proposition 98. Of the total, $77 million has been proposed to fund estimated current-year K-12 funding deficiencies and $39 million has been proposed for a K-12 Proposition 98 reserve. The reserve would be distributed to school districts at the end of the current year. The Governor's Budget proposes no Proposition 98 funds for community colleges in the current year.

For 1989-90, the budget proposes to spend approximately $400 million to meet the minimum funding level: (1) $230 million for an education reserve ($220 million for K-12 school and $10 million for community colleges); (2) $110 million for class size reduction in grades 1-3 and 9-12; (3) $30 million for year-round school incentive payments; (4) $17 million for drug education; and (5) $15 million for funding discretionary growth in special education programs. The budget also proposes that the education reserve be used first to fund any K-14 deficiencies that occur during the budget year. Any funds remaining in the reserve at the end of the budget year would then be distributed to schools.

Proposition 99. The Governor's Budget also makes several proposals for implementing the Tobacco Tax and Health Protection Act of 1988 (Proposition 99). Proposition 99 imposes an additional excise tax of 25 cents per pack of cigarettes (prior to the passage of Proposition 99, the excise tax on a pack of cigarettes was 10 cents). In addition, it imposes a new excise tax on other types of tobacco products. The initiative specifies that the additional revenues should be spent for the following purposes: health education, hospital and physician services for the medically indigent, tobacco-related disease research, and public resources.

The budget contains the following proposals to spend Proposition 99 revenues:

- ***California Health Care for Indigents Program (CHIP).*** The budget proposes $200 million in the current year and $331 million in the budget year for a new program to fund county medical care programs for the indigent. At the same time, however, the budget proposes to reduce the major existing General Fund-supported program serving the medically indigent (the Medically Indigent Services Program) by $359 million in the budget year.
- ***Mental Health Capital Outlay.*** The budget proposes $18 million as part of a multi-year program to renovate the state's mental hospitals. Previously these projects had been funded from the Special Account for Capital Outlay (SAFCO).
- ***Health Education.*** The budget proposes $176 million for a new health education program funded through the Department of Health Services. The budget contains no specific proposals regarding the scope of this program.
- ***Public Resources.*** The budget proposes a total of $44 million for public resources programs. These funds would be used to: augment and enhance some existing programs; implement new programs (such as a new waterfowl habitat program); fund workload and cost increases in existing programs; fund capital outlay projects (including beach erosion mitigation and wildlife habitat acquisition); and fund some one-time program increases (for example, to purchase additional helicopters for fire protection).
- ***Other.*** The budget proposes an additional $109 million to fund other projects authorized under Proposition 99. For example, the budget includes $44 million for research (to be directed by the University of California) and $33 million for augmentations or new programs (including drug and alcohol treatment programs for pregnant women, outpatient mental health services for prisoners and an augmentation for county mental health programs).

THE STATE'S APPROPRIATIONS LIMIT

In addition to the factors which help determine state spending mentioned above, the appropriations limit imposed by Article XIII B of the state's Constitution may also play a part in determining total spending levels. This would be the case whenever state revenues exceed the amount which can be appropriated, as occurred in 1986-87. As Table 11 shows, the Governor's Budget indicates that the state will be $134 million below its limit in 1988-89 and $128 million below in 1989-90.

Table 11
State Appropriations Limit and Appropriations Subject to Limitation Governor's Budget Estimates 1988-89 and 1989-90 (dollars in millions)

	Appropriations Limit	*Appropriations Subject to the Limit*	*Amount Under the Limit*
1988-89	$27,079	$26,945	$134
1989-90	29,184	29,056	128

Current Year. The estimate of the appropriations limit included in the 1988 Budget Act, $26,940 million, has been adjusted in reaching the current estimate of $27,079 million. One adjustment reflects an increased level of limit transfers to school districts, which were made to prevent districts from exceeding their appropriations limits in the current year. A second adjustment reflects the adoption of the Trial Court Funding Program, which shifts a portion of the responsibility for funding local courts from counties to the state. The budget estimates that appropriations subject to the limit will be $26,935 million in the current year. Due to an error in addition, however, the department's figure should actually be $26,945 million, leaving the state $134 million below its limit for 1988-89.

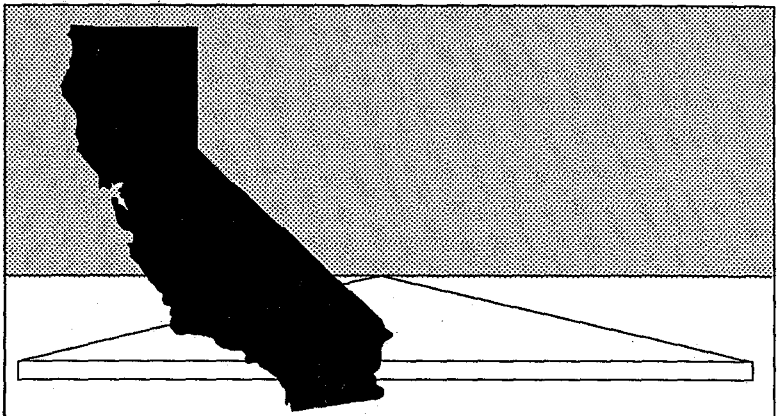
Budget Year. The 1989-90 appropriations limit estimate, which corresponds to that presented in the Governor's Budget, reflects a $215 million transfer of financial responsibility from the counties to the state for the full-year impact of the Trial Court Funding program. The limit calculation also reflects a 4.6 percent cost-of-living adjustment, based on growth in California per capita personal income, and a 2.3 percent population adjustment. On this basis, the Department of Finance estimates that the state will be $128 million below its limit in 1989-90, given the estimates of revenues contained in the budget.

The estimates presented in Table 11 are subject to revision over the next 18 months. These revisions could occur for several reasons. For example, if state revenues were to decline from the budget estimates, the state would be further below its limit than estimated. On the other hand, a stronger-than-expected economy could quickly push the state over its limit.

3

Perspectives on the 1989-90 Budget: Revenues

Part 3



Perspectives on the 1989-90 Budget: Revenues

This section provides an overview of the revenues proposed to fund the spending plan proposed in the Governor's Budget. It first discusses the economic forecast upon which the revenue estimates are based. It next discusses the revenue projections themselves, including the individual taxes and other sources from which they will be derived. Lastly, it discusses that reliability of revenue projections, including their uncertainties and potential error margins. The major findings of this section are that:

- Continued modest economic expansion is assumed for both 1989 and 1990, though at a more subdued pace than in 1988. The budget's economic forecast is generally reasonable, though slightly conservative relative to the consensus forecast of other economists for California.
- General Fund revenues are projected to increase moderately in 1989–90, by 8 percent ($2.9 billion). This reflects the economy's expected modest growth.
- The budget implicitly assumes that 1987–88's $1.1 billion revenue shortfall was primarily due to an overestimate of capital gains income. The budget also assumes that most of this shortfall will be ongoing.
- It is only realistic to expect revenue estimating errors of at least several hundred million dollars, and it is within this band of uncertainty that the budget's revenue estimates should be viewed.

- The revenue estimates are generally reasonable for the Legislature's initial planning purposes, though they have some upward potential. Critical information will become available in April regarding personal income taxes, and the revenue estimates should be revised at that time.

Revenues in 1989-90

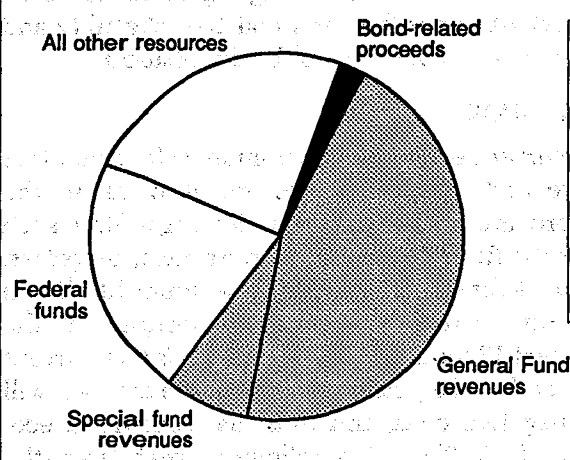
The resources needed to fund the 1989-90 state spending plan will come from a variety of difference sources. The most important of these sources are:

- Revenues from taxes, licenses, fees and investments;
- Transfers of previously accumulated monies out of funds that have been storing them;
- Borrowed money, such as proceeds from the sale of bonds; and
- Federal funds.

Chart 1 summarizes the relative importance that these different types of resources are expected to play in funding the total 1989-90 state spending plan. It shows that the single largest resource category will be state revenues. These revenues account for over half of the state's entire resource base and support both the General Fund and special fund expenditure proposals that are summarized in Part Two.

Chart 1

Resources for Funding the 1989-90 State Spending Plan



Total Resources (dollars in billions)

Funding Source	Amount
General Fund revenues	$38.9
Special fund revenues	7.1
State revenues	($46.0)
Bond-related proceeds	1.7
Federal funds	18.5
Other[a]	20.4
Total resources	$86.6

[a] Includes nonfederal nongovernmental cost-fund monies from public service enterprise funds ($5.9 billion), working capital and revolving funds ($0.8 billion), retirement funds ($4.0 billion) and various other funds ($9.7 billion).

This analysis reviews the budget's estimates of state revenues, including the economic projections and other assumptions upon which they are based. Section I discusses the budget's economic forecast, followed by a discussion of General Fund revenues in Section II and special fund revenues in Section III.

I. THE ECONOMIC OUTLOOK

The Economy's Importance to Revenues

The economy's performance during 1989 and early 1990 is expected to be the single most influential determinant of state revenue collections during the remainder of 1988-89 and throughout 1989-90. This is because most of the state's revenues are derived from sources which directly reflect economic conditions. For example, personal income taxes are influenced by wage levels and the number of people who are employed, sales taxes depend on the level of consumer spending, and corporate taxes depend on the amount of profits that businesses report. Thus, the stronger (weaker) the economy is, the larger (smaller) will be the state's revenue base and the amount of income it generates.

The sensitivity of state revenues to economic conditions also means that inaccurate economic forecasts can result in significant revenue estimating errors. When revenues are overestimated, serious fiscal disruptions can result, including cutbacks in public programs. Alternatively, when revenues are underestimated, time and opportunities may be wasted to move forward with those programs that the Legislature supports and the public values.

Given the above, it is critical that the state's budget plan be based on as accurate an economic forecast as possible, and that the reliability and potential error margins of the economic forecast be understood.

THE CURRENT ECONOMIC CLIMATE

Chart 2 summarizes the current economic environment. It shows that a mixture of both positive and negative forces are at work in the economy. In addition, there are major uncertainties regarding such important considerations as the future course of interest rates, oil prices, consumer spending, federal defense cutbacks and the drought. Given this, considerable uncertainty surrounds anyone's projections of the economy's course over the next 18 months. Nevertheless, it is the current consensus view of economists that the positive factors in the outlook will most likely outweigh the negative ones, and thus that continued economic growth will occur in 1989. This view follows in part from the economy's relatively favorable performance throughout 1988.

1988 In Retrospect

Table 1 shows how the state's economy generally performed in 1988 compared with what was forecast. It surpassed last year's budget forecast for essentially every major economic variable, including income and job growth, unemployment, inflation, housing starts, car sales, taxable sales and corporate profits. For example, personal income growth—the single

Chart 2

Key Factors in the 1989 Economic Outlook

POSITIVE FACTORS +

- Continued strength in income and job growth
- Current moderate inflation
- Modest crude oil prices
- Possible further softening in the dollar's value
- Record-low unemployment
- Continued gains in exports
- Strength in California's nondefense aerospace industries like commercial aircraft manufacturing
- Recent improvements in land values, cash flows and debt positions of California's agribusiness sector
- Relative stability in the stock market
- Balanced business inventories
- Positive outlook for capital equipment expenditures

NEGATIVE FACTORS —

- Continued large foreign trade deficit
- High consumer debt levels
- Low household savings rate
- International debt problems
- Concerns about solvency of financial institutions
- Reduced defense and military spending in California
- Slow growth in labor productivity
- Persistent large federal budget deficit
- Inflation threat from high factory capacity utilization rates and tight labor markets
- Potential for tighter monetary policy and higher interest rates

MAJOR AREAS OF UNCERTAINTY ?

- What course will federal monetary policy take and how will this affect interest rates?
- To what extent will the dollar continue to depreciate and the trade deficit improve?
- How strong will consumer spending be, given the positive forces of job and income growth versus the negative forces of high real interest rates, low savings levels and high debt burdens?
- Will world oil prices remain moderate, or eventually trend upward again due to output restrictions by OPEC?
- Will drought conditions continue, and if so, how will this affect agriculture, construction and other areas of the economy?
- What types of federal government spending and tax changes will the new administration propose, and how will they affect the California economy?

Table 1
Accuracy of Economic Forecasts for California in 1988

Economic Indicator	*Original Forecasts:* *Department of Finance* [a]	*Original Forecasts:* *Average of Other Forecasters* [b]	*Revised Department of Finance May 1988 Forecast*	*Actual* [c]
Percent change in:				
Personal income	6.5%	7.3%	7.8%	7.4%
"Real" personal income [d]	1.4	2.6	3.6	2.8
Wage and salary jobs	2.6	2.4	4.1	3.4
Consumer prices	5.0	4.6	4.7	4.5
Taxable sales	5.7	—	7.5	8.3
Taxable corporate profits	7.1	—	9.9	8.2
Unemployment rate (%)	5.8	6.0	5.0	5.4
Residential building permits (thousands)	220	210	214	237
New car sales (thousands)	1,211	—	1,278	1,467

[a] *1988-89 Governor's Budget.*

[b] Includes First Interstate Bank, Security Pacific Bank, Bank of America, UCLA, Wells Fargo Bank and the Commission on State Finance. Forecasts were as of approximately year-end 1987, corresponding to when the Department of Finance constructed the economic assumptions contained in the *1988-89 Governor's Budget.* For detail on these forecasts, see *The 1988-89 Budget: Perspectives and Issues,* Table 16, page 53.

[c] As reported in the *1989-90 Governor's Budget.*

[d] Defined here as nominal personal income deflated by the California Consumer Price Index.

most important economic variable for revenue estimating purposes—was nearly a full percentage point above the budget forecast. The department's budget forecast was revised upward in May 1988 because of the strong economic growth that had occurred early in the year. Table 1 shows that these revised projections proved to be overly optimistic. Nevertheless, the economy experienced a very good year in 1988, with moderate gains in real income and employment, modest inflation, and reasonably strong performance in the housing and automobile sectors.

How 1989 Began

California's economy ended 1988 and entered 1989 with considerable forward momentum. As of year-end 1988, California's employment growth was running at a healthy 3-percent pace and its unemployment rate was the lowest in 19 years—4.7 percent. Thus, the economy closed 1988 and entered 1989 on a generally positive note.

THE BUDGET'S ECONOMIC FORECAST

Table 2 summarizes the budget's economic forecast for 1989 and 1990 for California and the nation.

Continued Moderate Expansion Assumed

Neither a recession nor a strong economic upturn is expected in either year. Rather, the department assumes that the current economic expansion will continue throughout the next two years at a moderate pace, with growth being a bit more subdued than in 1988. Both inflation and interest rates are expected to be higher in 1989 than in 1988, though not by enough to derail the expansion.

Highlights of the National Forecast

Table 2 and Chart 3 indicate that for the nation:

- ***Real GNP growth*** is projected to drop from 3.8 percent in 1988 to 2.6 percent in 1989 and 2.5 percent in 1990. (Average GNP growth during the past 10 years has been 3.2 percent, and most economists view growth of under 3 percent as unsatisfactory over the long run.)
- The ***unemployment rate*** is projected to hold fairly steady as the rate of job growth slows to about the same pace as labor force growth.
- The ***prime interest rate*** is predicted to jump from 9.3 percent in 1988 to 10.7 percent in 1989, then decline slightly to 10.5 percent in 1990. (Higher interest rates are one of the factors expected to subdue 1989's rate of GNP growth.)
- The ***savings rate*** (that is, savings as a percent of disposable income) is forecast to inch upward slightly, as consumers become more conservative about borrowing and attempt to reduce their current high household debt burdens. As a result, only modest growth in consumer spending is anticipated.

Table 2
Department of Finance Economic Outlook for California and the Nation 1988 through 1990[a]

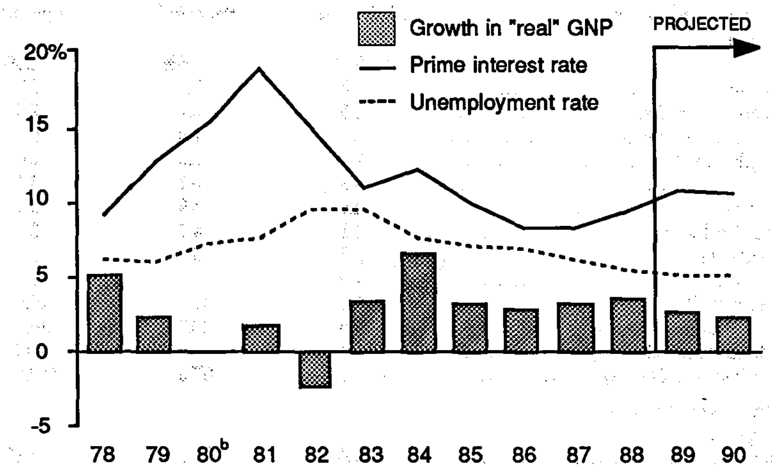
National Economic Indicators	*1988 Estimated*	*1989 Projected*	*1990 Projected*
Percent change in:			
Real GNP	3.8%	2.6%	2.5%
Personal income	7.3	7.3	6.7
Pre-tax corporate profits	6.6	0.4	−7.0
Wage and salary employment	3.6	2.8	2.7
Civilian employment	2.2	2.0	2.0
GNP prices	3.3	3.7	3.1
GNP consumer prices	4.2	4.9	3.9
Consumer Price Index	4.1	4.7	3.9
Unemployment rate (%)	5.5	5.3	5.2
Savings rate (%)	4.0	4.1	4.4
Prime interest rate (%)	9.3	10.7	10.5
New car sales (millions of units)	10.6	10.2	10.1
Housing starts (millions of units)	1.47	1.39	1.49
Net exports (billions of dollars)[b]	−$97.5	−$77.9	−$62.2
California Economic Indicators			
Percent change in:			
Personal income	7.4%	7.5%	7.1%
Wage and salary income	7.2	7.1	7.3
Wage and salary employment	3.4	3.2	3.1
Civilian employment	3.2	3.1	2.8
Consumer Price Index	4.5	5.6	4.6
Key elements of the state's tax base:			
Taxable personal income[c]	7.8	7.6	7.4
Taxable sales[d]	8.3	6.0	6.3
Taxable corporate profits	8.2	8.4	7.4
Unemployment rate (%)	5.4	5.1	5.2
New car registrations (thousands of units)	1,467	1,424	1,460
New building permits (thousands of units)	237	212	249

[a] Source: *1989-90 Governor's Budget* and Department of Finance. Data for 1988 are preliminary estimates.
[b] Defined as United States exports minus imports, measured in constant 1982 dollars.
[c] Defined as total personal income plus Social Security contributions, minus transfer payments and certain other nontaxable income components. This income concept historically has shown a strong correlation with adjusted gross income reported for tax purposes in California.
[d] Excludes the Department of Finance's assumptions regarding taxable sales from out-of-state mail-order sales. These assumptions, which include the enactment of federal legislation to require out-of-state retailers to remit taxes on such sales to the state, raise taxable sales growth to 8.4 percent in 1988, 6.4 percent in 1989 and 6.6 percent in 1990.

The 1989 forecast also calls for continuing large (though improving) federal budget and foreign trade deficits, some further decline in the dollar's international value, modest oil prices, fairly stable car sales and housing starts, and softness in corporate profits.

Chart 3

Trends in Key National Economic Variables
1978 through 1990[a]



[a] Source: Department of Finance. Data are estimated for 1988.
[b] "Real" GNP declined by 0.2 percent.

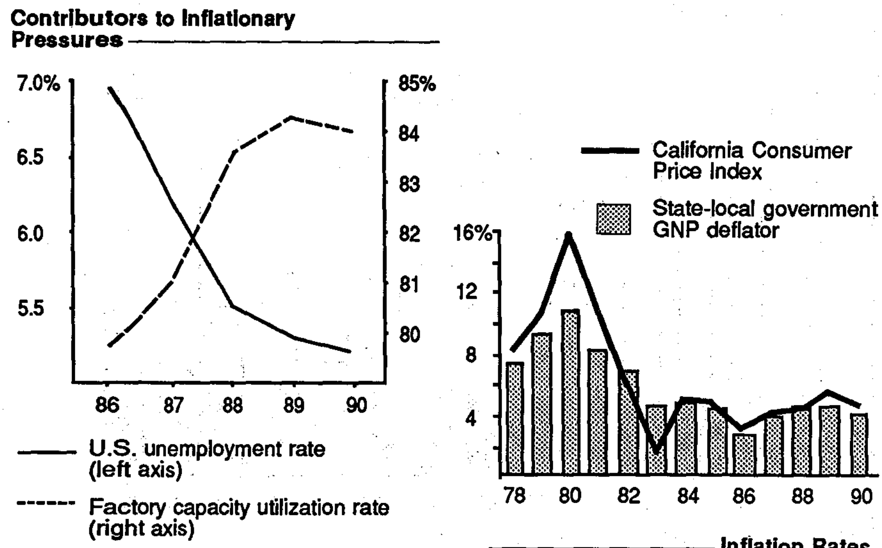
Accelerating Inflation—Will It Be A Problem?

Of all the many current uncertainties regarding the economic outlook, the possibility that inflation might accelerate significantly during 1989 has been one of the greatest concerns of economists. The fear is that the economy's sustained growth during recent years has pushed the unemployment rate down and the factory capacity utilization rate up so far (see Chart 4) that additional growth will result in rising labor costs and input prices, and thus an upsurge in inflation. Many economists believe that this would in turn cause the federal monetary authorities to "tighten up" on the money supply, in an effort to control inflation by slowing down the economy through higher interest rates. The worry is that this could push the economy into a recession.

Moderate Inflation Is Assumed. As shown in Chart 4, the budget assumes inflation will increase only modestly in 1989 and then drift back down in 1990. Thus, the department is not assuming that inflation will become a significant problem during the next 18 months. This is a plausible inflation scenario, given the department's assumption that economic growth will be slower than in 1988. However, if this favorable inflation view proves incorrect and restrictive federal monetary policies are pursued, economic performance could be weaker than assumed.

Chart 4

Factors Relating to Inflation[a]



[a] Source: Department of Finance.

California To Outperform Nation

Regarding California, Table 2 indicates that the state is forecast to experience the same modest economic growth as the nation. However, the state's performance is predicted to be a bit stronger than the nation's in a number of respects. For example:

- ***Personal income*** is expected to increase in California by 7.5 percent in 1989 and 7.1 percent in 1990 (see Chart 5). These growth rates are not high by historical standards, but they do exceed the nation's. As a result, California's share of U.S. personal income is expected to reach a record high—over 13 percent (see Chart 6).
- ***Wage and salary employment*** is expected to rise a bit over 3 percent for the state in both 1989 and 1990 (see Chart 7). Again, these predicted gains are not particularly strong for a nonrecessionary period. However, they are greater than the nation's and will raise California's share of U.S. employment to a new high (see Chart 6).
- California's ***unemployment rate*** is projected to remain extremely low by historical standards—only slightly over 5 percent (see Chart 7).

The forecast also assumes that both ***new building permits*** and ***new car sales*** will weaken somewhat in 1989 from their 1988 levels, being constrained by the slow pace of the economy, higher interest rates and consumer debt burdens.

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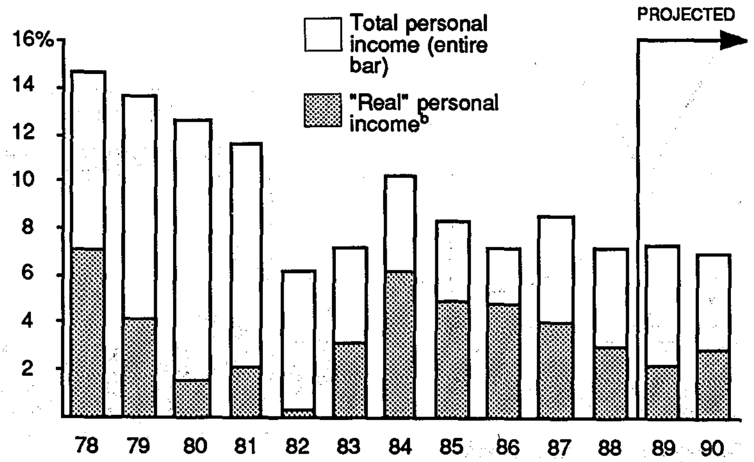
Chart 5

Annual Growth in California Personal Income

1978 through 1990[a]



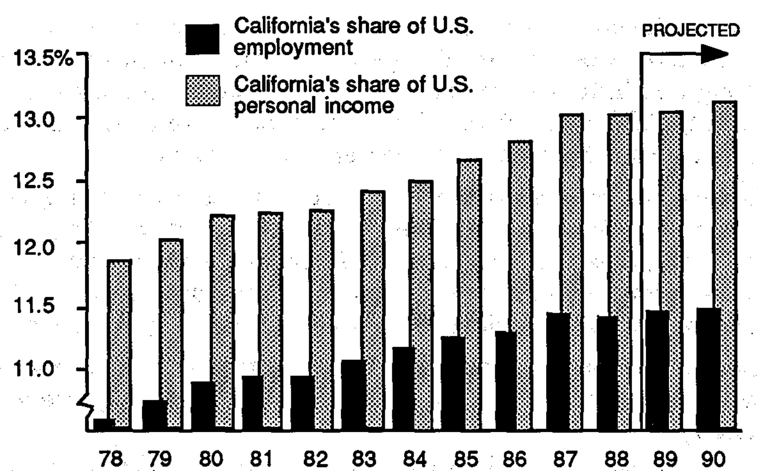
[a] Source: Department of Finance. Data are estimated for 1988.

[b] "Real" personal income is defined as total personal income deflated by the GNP consumption expenditures deflator.

Chart 6

Size of California's Economy Compared to the U.S. Economy

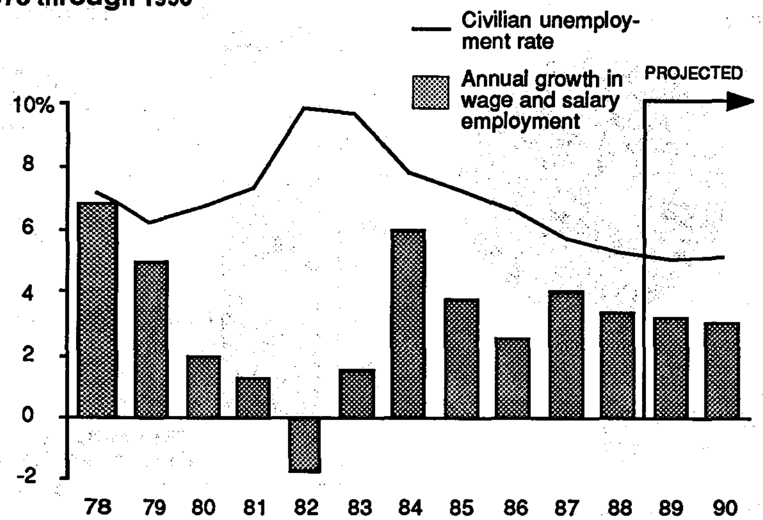
1978 through 1990[a]



[a] Source: Department of Finance.

Chart 7

Trends in California's Employment and Unemployment
1978 through 1990[a]



[a] Source: Department of Finance and Employment Development Department. Data are estimated for 1988.

Where Will the New Jobs Be? Chart 8 shows that the majority of new jobs and strongest rates of job growth in 1989 will be in the service and trade sectors. These sectors already account for about one-half of all employment in California. Conversely, Chart 8 indicates that growth in manufacturing employment is expected to be sluggish, due to weaknesses in many durable goods industries caused by the slower economy.

Reduced Defense Spending—How Much Will It Hurt?

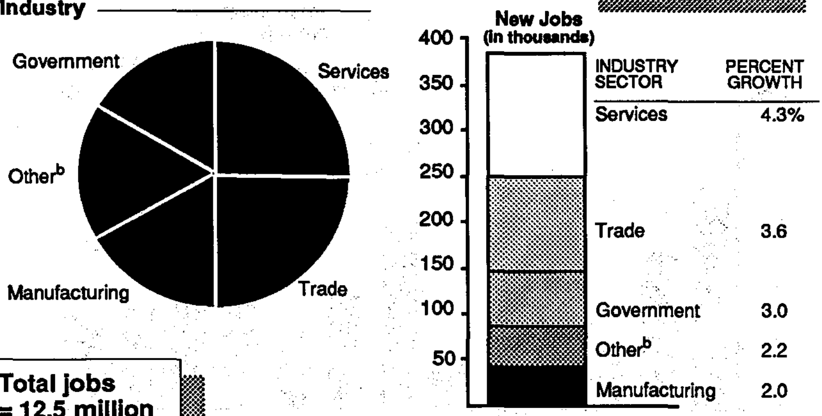
Defense Spending in California. Federal defense spending has long been an important source of stimulus to the California economy. Chart 9 shows that defense spending in California recently has been in the range of $50 billion annually, or equivalent to about 8 percent of gross state product (GSP). About half of this amount is for nonprocurement purposes, including pay for defense-related employees and operation of military bases. The remaining spending is for defense contracts, most of which generate jobs in the aerospace industry. California traditionally has received about 15 percent to 20 percent of all federal defense prime contract awards, and around 20 percent of the output produced in California's aerospace sector appears to be defense-related.

Chart 8

California Employment in 1989[a]

Total growth = 3.2%

Distribution of 1989 Employment by Industry



Total jobs = 12.5 million

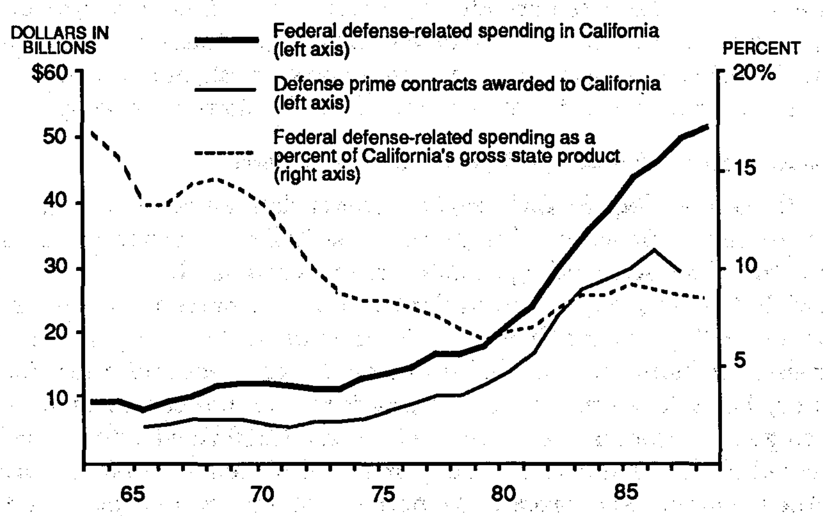
Distribution of 1989 Employment Growth by Sector

[a] Source: Department of Finance.
[b] Includes mining, construction, transportation-communications-utilities, and finance-insurance-real estate.

Chart 9

Federal Defense-Related Spending in California

Mid-1960s through Late 1980s[a]



[a] Source: Commission on State Finance. Data are for fiscal years ending in years specified.

Cuts Are Coming. Chart 9 shows that throughout most of the 1980s federal defense spending increased rapidly in California, rising at an inflation-adjusted average annual rate of over 8 percent. This contributed greatly to California's strong economic growth during these years. Recently, however, federal budget restrictions have softened the outlook for defense spending in California. For example, the dollar volume of defense contracts and defense spending relative to GSP already have dipped (see Chart 9), and a recommendation has been made to close six California military bases, beginning in 1990, that currently employ over 20,000 civilians and military personnel.

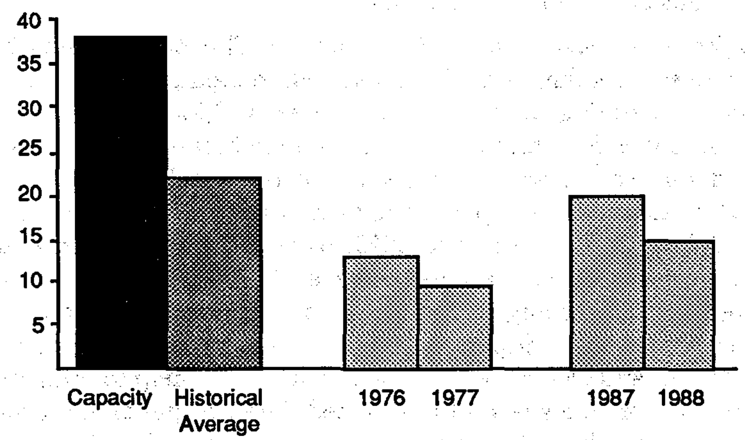
Net Effects—Negative But Not Disastrous. The exact effects of reduced defense spending on California will depend on the eventual magnitude and timing of the cuts. However, California definitely can expect to get much less stimulus from this source in the future than in the past, and defense cutbacks certainly will hurt the state's economy as they unfold. For example, aerospace employment is expected to actually *decline slightly* in both 1989 and 1990, partly due to reduced defense spending. Fortunately for the state, however, the aerospace industry also is expected to enjoy strength from both domestic demand and a strong export market for such outputs as commercial aircraft, computer equipment and parts, and electronics products. This should help to mitigate the immediate economic losses due to reduced defense spending. Likewise, in the longer run the state's ongoing economic growth and economic diversity should soften the negative impacts of the cutbacks on California's economic performance.

What About the Drought?

The Current Situation. As of early February, it appeared that California might be experiencing its third consecutive critically dry year, which would be the first such occurrence in nearly 400 years. Chart 10 shows that as of the end of 1988, water reservoir storage was about two-thirds of average. This was better than during the last bad drought period in the late 1970s, but was down 25 percent from one year earlier. Recently, the water outlook has appeared to worsen. For example, cumulative precipitation through early February had slipped to less than 80 percent of normal, and water runoff—the principal supply source for dams and reservoirs—was less than 50 percent of normal. Last year, there still was sufficient water storage available to meet most water demands in California. This year, however, water authorities have already told users to expect shortages—40 percent cutbacks for agricultural customers of the State Water Project and 25 percent cutbacks for customers of the federal Central Valley Project. During 1988, 14 counties declared drought emergencies, 42 counties received federal emergency agricultural feed, and 180 water agencies in 45 counties reported water shortages. These numbers could be considerably greater if the drought continues. In addition, urban water rationing and problems with obtaining groundwater will become more prevalent.

Chart 10

Water Storage in Major California Reservoirs
Selected Years (millions of acre feet)[a]



[a] Source: California Department of Water Resources, as published in *Drought Assistance: A Report to the Legislature in Response to Senate Bill 32*, January 22, 1989. Figures are as of December 31 of years shown.

How Is the Economy Affected? Drought conditions have the potential to negatively affect the economy in many ways. These include destroying fish and wildlife, reducing agricultural and timber production, raising food prices, increasing fire hazards, restricting new construction, making energy more expensive due to less hydroelectric power generation, limiting the use of recreational sites and causing environmental damages. Other effects include reductions in farm proprietors' incomes and reduced federal payments for crop support programs.

Possible Future Effects—Unknown But Potentially Serious. The U.S. Department of Commerce has estimated that nationwide drought conditions reduced real GNP growth by about one-third of a percentage point (nearly $13 billion) in 1988. No estimate is available for California. However, it was undoubtedly less affected because the state's extensive water storage and delivery systems and increased use of wells to capture groundwater enabled severe water shortages generally to be avoided. In addition, Southern California continues to be cushioned from the drought by its access to Colorado River water supplies.

No one has a reliable way of estimating exactly how continuation of the drought will affect California's future economic performance. This is because California has not experienced a persistent drought in recent times. The budget does not assume that the drought will significantly damage the state's near-term economic performance. However, continuation of the drought in 1989 will undoubtedly hurt California's economy much more than in 1988. Thus, the drought is a real "wild card" in the economic forecast.

HOW RELIABLE IS THE ECONOMIC FORECAST?

General Thrust Is Reasonable

Given current economic conditions, the general thrust of the department's economic forecast—continued modest growth—appears ***reasonable*** at this point in time. Table 3 shows that this same basic type of outlook is shared by most other economic forecasters.

Table 3
Comparisons of Different Economic Outlooks for 1989 [a]

National Forecasts	*Percent Change In: Real GNP*	*GNP Prices*	*Pre-Tax Profits [b]*	*Unemployment Rate*	*New Car Sales (millions)*	*Housing Starts (millions)*
Department of Finance	2.6%	3.7%	0.5%	5.3%	10.2	1.39
NABE Survey [c]	2.3	4.4	—	5.6	10.0	1.40
Blue Chip Survey: [d]						
—Average forecast	2.6	4.4	3.3	5.5	10.1	1.43
—Low-end forecast	−1.0	2.8	−7.6	4.7	9.5	1.30
—High-end forecast	4.0	5.4	15.0	6.1	11.5	1.66

California Forecasts	*Percent Change In: Personal Income*	*Consumer Prices*	*"Real" Personal Income [e]*	*Wage and Salary Jobs*	*Unemployment Rate*	*New Residential Building Permits (thousands)*
Department of Finance	7.5%	5.6%	1.8%	3.2%	5.1%	212
Other Forecasters:						
UCLA	8.3	4.6	3.5	2.2	5.7	178
Security Pacific Bank	7.7	4.8	2.8	2.7	—	208
First Interstate Bank	7.2	5.7	1.4	1.9	5.5	184
Bank of America	9.5	5.6	3.7	2.5	5.0	196
Wells Fargo Bank	8.0	5.3	2.7	2.9 [f]	5.2	210
Commission on State Finance	7.8	5.2	2.5	2.6	5.4	203
Average of "Other" Forecasters	8.1%	5.2%	2.7%	2.5%	5.4%	196

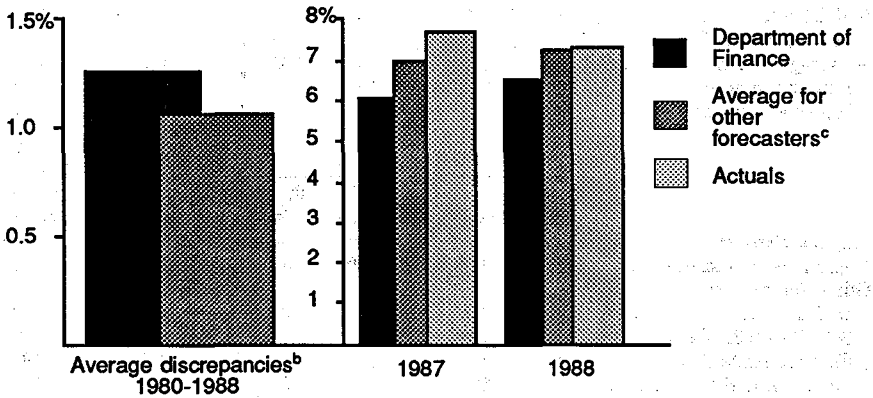
[a] Forecasts available as of approximately year-end 1988.
[b] Defined as pre-tax profits *with* inventory valuation and capital consumption adjustments. This variable is not published by NABE. The most relevant profit measure for revenue estimating *excludes* these adjustments. However, the Blue Chip Survey does not report such a figure. The department's 1989 projection for growth in this latter measure is 0.4 percent.
[c] Consensus median forecasts of a 60-member panel of professional forecasters selected by the National Association of Business Economists (NABE).
[d] Includes the projections of about 50 economists as published in *Blue Chip Economic Indicators*. Permission to reprint data granted by Capitol Publications, Inc.
[e] Defined as personal income adjusted for consumer price inflation.
[f] Figure shown represents civilian employment.

Personal Income Forecast May Be Conservative

Regarding California, however, the department's forecast for 1989 personal income growth—the single most important revenue-determining economic variable—*is somewhat below the consensus view and less than all but one of the other individual forecasts identified.* This is an important difference, since each one percentage point of income growth typically translates into at least $300 million in additional revenues. We have found that the consensus forecast for personal income growth has been slightly more accurate over the past decade than the predictions of any single forecaster, including the department (see Chart 11). Thus, from a revenue estimating perspective, the department's economic forecast may be *somewhat conservative.* Chart 11 shows that this proved to be the case with respect to the budget's economic forecast for personal income in both 1987 and 1988.

Chart 11

Discrepancies Between Projected and Actual California Personal Income Growth[a]



[a] Projections are as of approximately the end of the calendar year preceding the forecast year; actuals are as of January following the end of the forecast year.
[b] Data represent absolute values of percentage-point differences between projected and actual California personal income growth.
[c] Includes UCLA, Security Pacific Bank, First Interstate Bank, Bank of America, Wells Fargo Bank and the Commission on State Finance.

The Uncertainties Are Considerable

Of course, many things could occur during the next year that would dramatically alter the economic environment, including a re-escalation of world oil prices, a retrenchment by consumers, accelerating inflation followed by restrictive monetary policies, severe drought conditions, and so forth. Such developments, which no economist can accurately predict, obviously could require substantial revisions to the economic outlook. Thus, *there is a large band of economic uncertainty within which the revenue forecast must be viewed.*

II. THE FORECAST FOR GENERAL FUND REVENUES

Table 4 presents the department's forecast for state revenues, by source, for the current and budget years. This section discusses the forecast for General Fund revenues, which account for about 85 percent of all revenue collections.

Table 4
State Revenue Collections
1987-88 through 1989-90
(dollars in millions) [a]

General Fund	*Actual 1987-88*	*Estimated 1988-89*	*Projected 1989-90*	*Change from 1988-89 Amount*	*Change from 1988-89 Percent*
Taxes:					
Personal income [b]	$12,947	$14,715	$16,350	$1,635	11.1%
Sales and use [c]	11,631	12,520	13,368	848	6.8
Bank and corporation [d]	4,776	5,215	5,550	335	6.4
Insurance [e]	1,158	1,411	1,279	−132	−9.4
Estate, inheritance and gift	304	376	421	45	12.0
Cigarette	176	172	167	−5	−2.9
Alcoholic beverage	129	127	126	−1	−0.8
Horse racing	110	110	119	9	8.2
Subtotals, taxes	($31,231)	($34,646)	($37,380)	($2,734)	(7.9%)
Other Sources:					
Interest on investments [f]	$428	$452	$532	$80	17.7%
California State University fees	269	327	360	33	10.1
Abandoned property [g]	76	116	250	134	115.5
Oil and gas revenues [h]	101	25	15	−10	−40.0
Other revenues [i]	255	271	262	−9	−3.3
Transfers and loans	174	165	78	−87	−52.7
Totals, General Fund	$32,534	$36,002	$38,877	$2,875	8.0%
Special Funds					
Motor Vehicle Revenues:					
License fees (in lieu)	$1,878	$2,015	$2,165	$150	7.4%
Fuel taxes	1,280	1,304	1,330	26	2.0
Registration, weight and miscellaneous fees	1,096	1,145	1,197	52	4.5
Subtotals, motor vehicle revenues	($4,254)	($4,464)	($4,692)	($228)	(5.1%)
Other Sources:					
Cigarette and tobacco products tax [j]	$75	$373	$696	$323	86.6%
Interest on investments	152	140	131	−9	−6.4
Sales and use taxes [k]	20	73	80	7	9.6
Oil and gas revenues [h]	109	52	38	−14	−26.9
School lease-purchase bond proceeds [l]	600	1,600	—	−1,600	−100.0
Other	1,029	1,197	1,513	316	26.4
Totals, special funds	$6,239	$7,899	$7,150	−$749	−9.5%
Totals, state funds	$38,773	$43,901	$46,026	$2,125	4.8%

[a] Detail may not add to totals due to rounding.

[b] Estimates include special net upward adjustments of $214 million in 1988-89 and $506 million in 1989-90. These adjustments reflect a recent court decision regarding taxation of interest passed through to mutual fund shareholders, the base-broadening revenue effects of tax reform legislation, other legislation, and proposed adjustments and augmentations relating to audit and collection activities by the Franchise Tax Board (FTB).

[c] Estimates include special net upward adjustments of $39 million in 1988-89 and $119 million in 1989-90. These adjustments reflect assumptions regarding the payment of taxes by out-of-state retailers on mail-order sales, new legislation, and increased dollar expenditures on tobacco products due to Proposition 99 (November 1988). For additional detail, see text discussion.

[d] Estimates include the revenue effects of tax reform legislation, and special upward adjustments of $155 million in 1988-89 for settlements regarding tax liabilities and $11 million in 1989-90 for proposed adjustments and augmentations relating to audit and collection activities by the FTB.

[e] Estimates include one-time revenues of $51 million in 1987-88 and $208 million in 1988-89 due to a court decision regarding taxation of "excess risk" arrangements between employers and insurers.

[f] Includes gross interest income earnings under the state's external borrowing program, which are partly offset by borrowing costs. For additional detail, see text discussion.

[g] Includes revenue increases due to Ch 286/88 (AB 3815, O'Connell) of $36 million in 1988-89 and $165 million in 1989-90. This measure shortened the time period after which unclaimed property escheats to the state, from seven years to five years.

[h] Represents oil and gas royalties from state lands, about 80 percent of which come from the state's tidelands located adjacent to the City of Long Beach. Excludes royalties allocated to other funds and federal land royalties.

[i] Includes revenues from various regulatory taxes and licenses, local agencies, user charges for services provided to the public, property-related income and other miscellaneous sources.

[j] Includes revenues due to Proposition 99 (November 1988) of $300 million in 1988-89 and $625 million in 1989-90, and local governments' share of the state's 10-cents-per-pack excise tax on cigarettes. For additional detail, see text discussion.

[k] Reflects allocation of state revenues to the Transportation Planning and Development Account in the Transportation Tax Fund.

[l] Represents bond proceeds under the State School Lease-Purchase Bond Acts of 1986 and 1988. These proceeds are transferred into a special fund prior to their expenditure for purposes designated by the acts.

OVERVIEW

Table 4 shows that General Fund revenues are projected to total $36 billion in 1988-89 and $38.9 billion in 1989-90. Chart 12 indicates that 91 percent of these revenues will come from three large taxes—the personal income tax, the sales and use tax, and the bank and corporation tax. The remaining 9 percent of revenues is derived from the insurance tax, interest income from investments, death-related taxes and various other sources.

Moderate Revenue Growth Expected

General Fund revenues are projected to grow by about 11 percent ($3.5 billion) in 1988-89 and 8 percent ($2.9 billion) in 1989-90 (see Table 4). Chart 13 shows that this growth is moderate by historical standards, both before and after adjustment for inflation. Chart 13 also shows that General Fund revenues will amount to about 6.6 percent of state personal income in both years, similar to the historical average. The outlook for moderate revenue growth is consistent with the moderate growth rates predicted for the economy and such key revenue-determining economic variables as taxable personal income, taxable sales and taxable corporate profits (see Table 2).

Chart 12

1989-90 General Fund Revenues, by Source

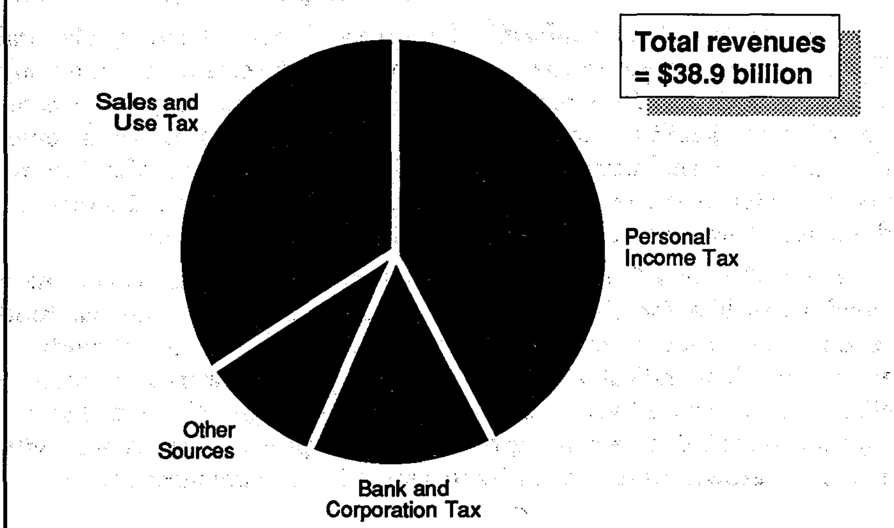
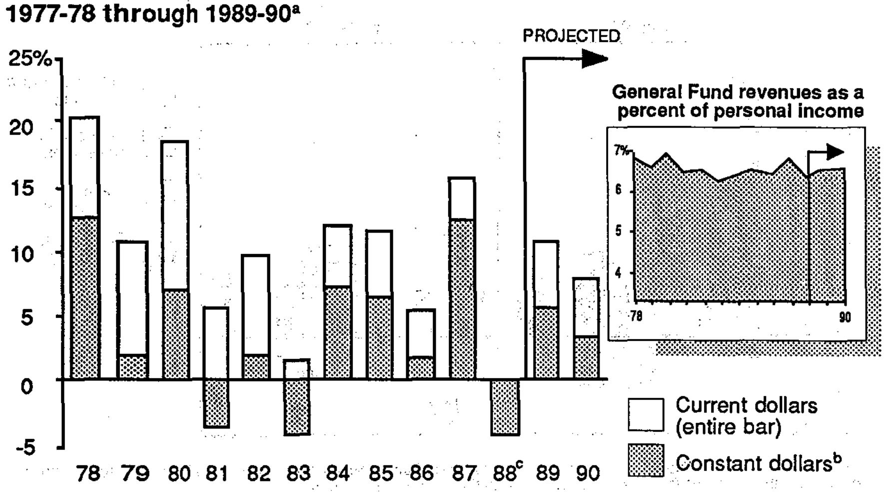


Chart 13

Annual Growth in General Fund Revenues

1977-78 through 1989-90[a]



[a] Source: Governor's Budgets and State Controller's reports. Data are for fiscal years ending in years shown.
[b] Revenue growth adjusted for inflation using the GNP state and local government price deflator.
[c] Current-dollar revenues increased by 0.05 percent.

Special Factors Distort Revenue Trend

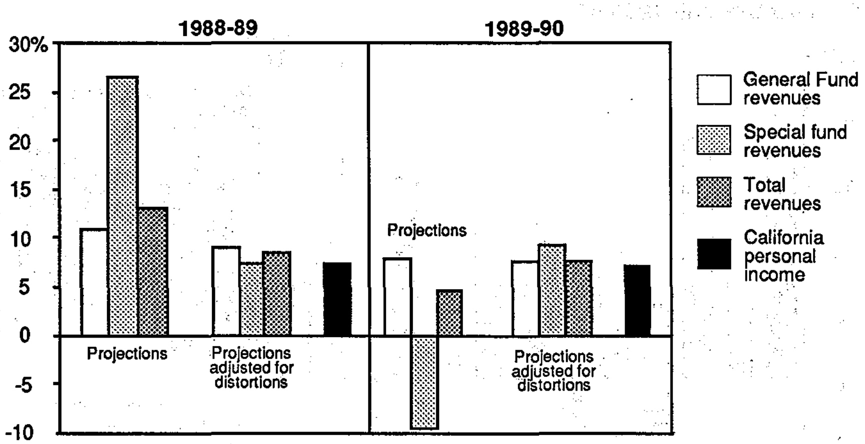
As is true in most years, the projected current-year and budget-year revenue growth rates incorporate various special factors and distortions which cause them to differ from the underlying revenue growth trend.

What Factors Are Involved? The special factors affecting General Fund revenue growth in the current and budget years include, among others, the effects of tax reform and other state legislation, court cases involving tax liabilities, tax audit settlements, expanded use of income-generating external borrowing, and declining oil-related royalty income due to reduced crude oil prices and oil extraction. (These factors are discussed elsewhere in the text and in the notes to Table 4.)

How Is Revenue Growth Affected? Chart 14 shows what the growth trend looks like for General Fund revenues, as well as special fund revenues and total revenues, when the net impacts of these distortions are removed. It indicates that the effect of special factors has been to *slightly raise* current-year General Fund revenue growth, and that the adjusted underlying revenue growth rates are pretty much in line with economic growth as measured by increases in personal income.

Chart 14

Projected Revenue Growth Rates With and Without Distortions
1988-89 and 1989-90[a]



[a] Source: Department of Finance and Legislative Analyst. Distortions include a variety of special factors including those identified in the footnotes to Table 4. For additional detail see text discussions.

What About Last Year's Billion-Dollar Revenue Shortfall?

In May 1988, the department had to adjust downward its estimate of 1987-88 revenues by $1.1 billion, due to huge shortfalls in personal income tax and bank and corporation tax receipts that appeared in March and April. It is important to determine for revenue estimating purposes whether this shortfall represented merely a one-time phenomenon or an ongoing permanent reduction in the state's revenue base. Because economic performance was *stronger* than expected in 1988 (see Table 1), factors other than the economy are responsible for the shortfall.

Possible Explanations. Two primary explanations have been advanced for the shortfall. One is that the state's 1987 tax reform legislation was not "revenue neutral," as it was intended to be. A second theory is that the department simply overestimated the amount of capital gains that would be reported for tax purposes during 1987. (Because tax reform changed both tax rates and the portion of capital gains that is taxable, these two theories are not necessarily mutually exclusive.)

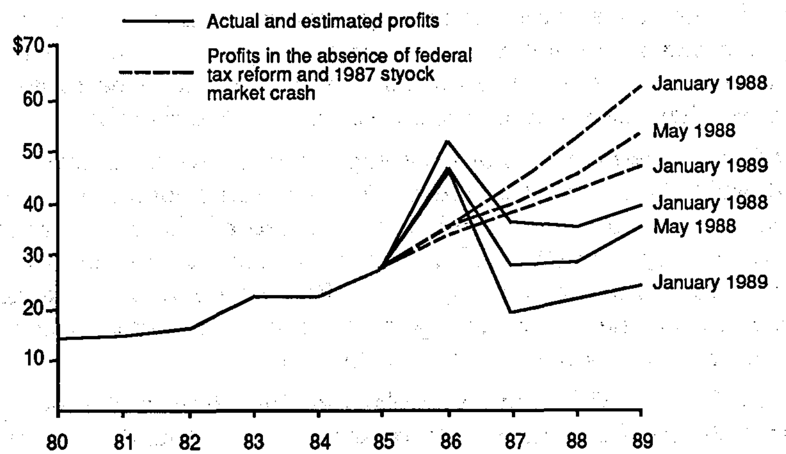
What Do We Know? A complete explanation for the shortfall is not yet available. Both the Franchise Tax Board and the Department of Finance have been reviewing 1987 income tax returns in an effort to answer this question, and a special study by outside consultants is due to be completed this April. Hopefully, these efforts will produce a clearer picture of exactly why the shortfall occurred. However, given the complexity of the issues and the data problems involved, we would not be surprised if a complete explanation for the shortfall is lacking *even after* the special study is completed.

Budget Assumes Capital Gains Were A Key Factor. Although the exact causes for the shortfall are not yet fully understood, the budget implicitly assumes that capital gains were a key factor. Chart 15 shows that the department's current assumptions about the level of capital gains have been reduced from one year ago by $17.1 billion for 1987, $13.8 billion for 1988 and $15.1 billion for 1989. Using the *department's* assumption about the rate at which these gains would have been taxed had they materialized, the revision of the forecast to 1987 capital gains translates into a revenue reduction of over $850 million. However, the department's tax rate assumption appears to be *conservative.* Using a higher tax rate suggests that capital gains may have accounted for nearly *all* of the shortfall. Because the capital gains forecast also has been reduced for 1988 and 1989, *the department is assuming that most of the portion of last year's revenue shortfall attributable to capital gains will be ongoing.*

Chart 15

Changes In Capital Gains Estimates[a]

1980 through 1989 (in billions)



[a] Source: Department of Finance and Franchise Tax Board. Data shown represent profits from the sale of capital assets, and have not been adjusted to reflect the partial exclusions from taxation of medium-term and long-term capital gains that were in effect prior to 1987, or capital losses.

What About the Other Theory? Regarding the theory that tax reform per se contributed to the shortfall, the budget makes *no explicit estimates*. However, given the department's revised assumptions about capital gains, *the budget does not appear to have assumed that tax reform and other factors played a significant role in causing the shortfall.* (Tax reform did, however, magnify the revenue loss caused by the capital gains overestimate due to its repeal of the partial exclusion of capital gains income.)

INDIVIDUAL GENERAL FUND REVENUE SOURCES

The Forecast for Personal Income Taxes—Above-Average Growth

Background. The personal income tax (PIT) is the single largest General Fund revenue source, accounting for over 40 percent of the total. The tax is imposed on income using a progressive tax rate schedule ranging from 1 percent to 9.3 percent, and includes a variety of income exclusions, deductions and credits. In 1987, legislation was enacted which significantly restructured the tax to more closely conform with federal law. This included adopting most of the base-broadening provisions of the federal Tax Reform Act of 1986 (including limiting or eliminating various deductions, making capital gains fully taxable and restricting "passive losses"), conforming to the federal standard deduction, and establishing a number of new tax credits such as for low-income housing and certain research activities. *These law changes have made it much more difficult to accurately forecast PIT revenues than previously.*

The PIT Forecast. Table 4 indicates that PIT revenues are projected to total $14.7 billion in 1988-89 (14 percent growth) and $16.4 billion in 1989-90 (11 percent growth).

The PIT forecast is constructed using a three-step process. First, estimates must be made of the *income-year tax liabilities* which will be generated from the taxable personal income produced by economic activity. Second, estimates must be made of taxes to be paid on *capital gains*, which have accrued in past years but are just now being realized and reported by taxpayers. Third, *special adjustments* are required for factors like new legislation and audit collections.

Tax Liabilities—Healthy Increases Assumed. Chart 16 (top panel) shows income-year PIT liabilities, by type of income. The bottom panel indicates that total tax liabilities are projected to increase by about 9 percent in 1989 and 10 percent in 1990. It also shows that when the volatile capital gains and preference tax liabilities are excluded, liability growth is reduced and is more in line with personal income growth. These general relationships make sense, as tax liability growth normally should increase slightly faster than income growth due to the state's progressive marginal tax bracket structure.

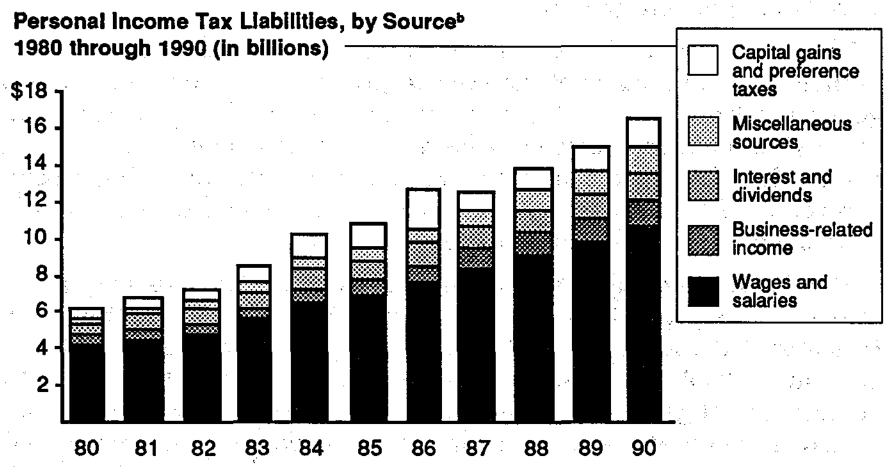
Capital Gains—Estimates Have Been Lowered. Chart 15 shows the budget's assumptions regarding capital gains. As noted earlier, the estimates of these gains have been reduced substantially during the past year. This is due to difficulties discerning both the underlying trend in these gains, and the effect federal tax reform and the 1987 stock market crash had in causing reported gains to fluctuate in 1986 and 1987.

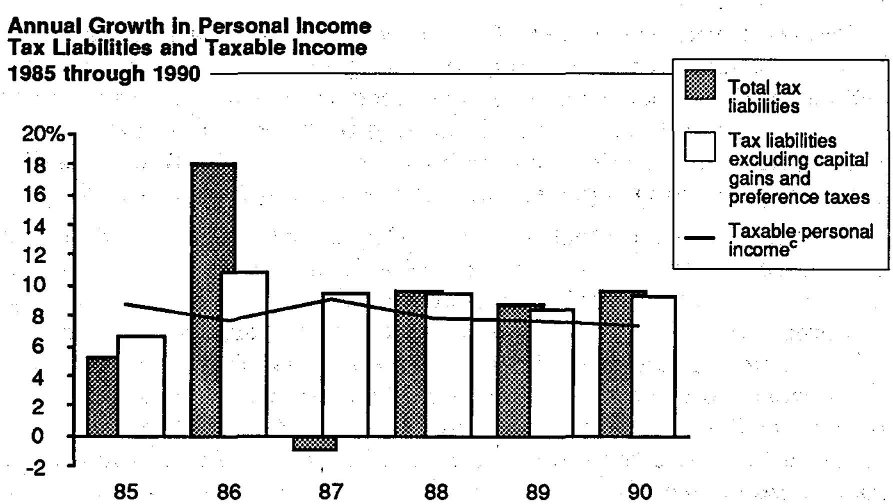
The budget assumes that the underlying growth trend in capital gains will be 10 percent in 1988 through 1990. This compares to an average annual increase of nearly 18 percent over the past 10 years and more than 15 percent during the first half of the 1980s. Projecting capital gains is to a large extent guesswork. *If history is any guide, the budget's assumptions could prove conservative.* Potentially offsetting this factor, however, is the possible negative near-term revenue effect of the President's proposal to reduce the federal capital gains tax rate in the future. *This could cause a reduction in reported capital gains,* if taxpayers wait to realize them until a lower tax rate is in effect. Thus, *the capital gains forecast is uncertain.* Each added (reduced) percentage point in capital gains growth would increase (decrease) annual tax liabilities by over $20 million.

Special Factors Boost Revenue Growth. The budget also assumes that personal income tax liabilities will be higher than in 1987-88 by about $215

Chart 16

Personal Income Tax Liabilities[a]





[a] Source: Department of Finance and Franchise Tax Board. Data shown are on a calendar-year basis. All tax liability data shown are preliminary for 1987 and projected for 1988 through 1990.

[b] Liability shares shown have been allocated using the *average* tax rates applying to taxpayers reporting each type of income.

[c] Defined as total personal income plus Social Security contributions, minus transfer payments and certain other nontaxable income components.

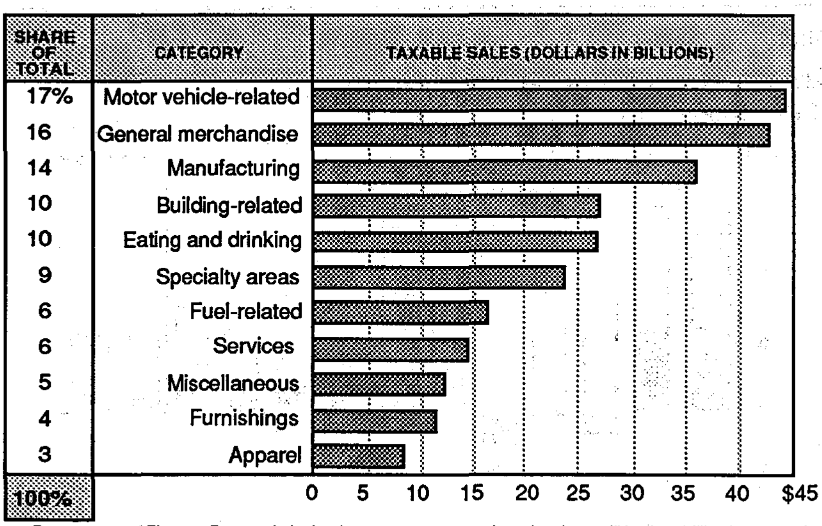
million in the current year and $500 million in the budget year, due primarily to the effects of tax reform. These factors have the effect of raising 1989-90 PIT growth above its underlying long-term trend. In the absence of these factors, budget-year PIT growth would be about 8.6 percent instead of over 11 percent, and thus more reflective of the growth in personal income.

The Forecast for Sales and Use Taxes—Modest Growth

Sales and use taxes are the second largest source of General Fund revenues—around 34 percent of the total—and are projected to reach $12.5 billion (7.6 percent growth) in the current year and $13.4 billion (6.8 percent growth) in the budget year. These revenues are derived from the state's 4.75-percent levy on taxable sales. In addition, sales and use taxes of up to 2.25 percent are levied by local governments and transit districts. The key to forecasting this tax is projecting the level of taxable sales in California. Chart 17 summarizes the expected composition of 1989 taxable sales, by major spending category.

Chart 17

1989 Taxable Sales, by Category[a]



[a] Source: Department of Finance. Data exclude the department's assumptions that there will be $1.4 billion in reported 1989 taxable sales due to mail-order sales by out-of-state retailers. These assumptions include the enactment of federal legislation to require that use taxes on such sales be remitted to the states.

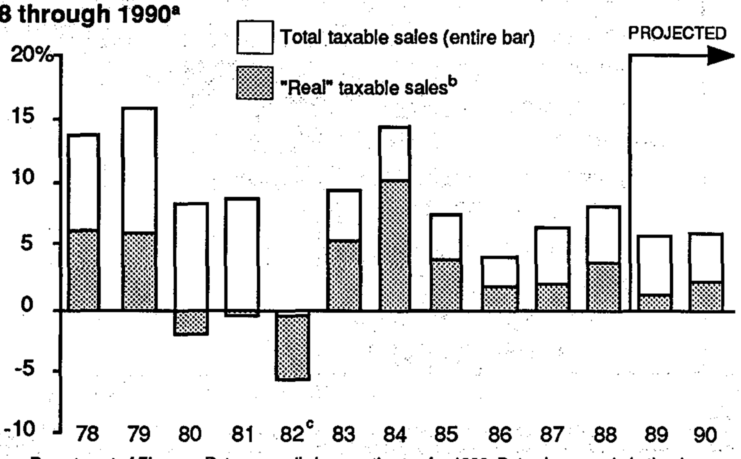
Taxable Sales To Trail Income Growth. The budget predicts that taxable sales will rise by 6 percent in 1989 and 6.3 percent in 1990, well down from 1988's 8.3 percent growth. Chart 18 shows that this growth is *modest by historical standards,* both before and after adjusting for inflation. Chart 19 also indicates that because taxable sales growth is assumed to be less than personal income growth, the sales-to-income ratio will decline to its lowest level ever. Our own revenue-estimating procedures also suggest that taxable sales growth will trail income growth, though we estimate that the taxable sales growth rate will be a *bit stronger* than the department's.

Special Adjustments May Be Overstated. The budget includes upward adjustments of nearly $40 million in 1988-89 and $120 million in 1989-90 due to special factors. Over $130 million of the two-year total is for taxes on mail-order sales which 1987 California legislation requires out-of-state retailers to collect and remit to the state. This estimate presumes enactment of federal legislation to require such reporting, and thus may or may not fully materialize. In addition, $44 million is included for increased sales taxes on cigarettes, due to higher cigarette prices resulting from the additional 25-cents-per-pack excise tax imposed by Proposition 99 (November 1988). This revenue gain also may be overstated, since the department assumes that the new tax will have an extremely minor effect on cigarette consumption, and increased total spending on cigarettes will cause no reduction whatsoever in other types of spending.

Chart 18

Annual Growth in California Taxable Sales

1978 through 1990[a]



[a] Source: Department of Finance. Data are preliminary estimates for 1988. Data shown exclude the department's estimates regarding taxable mail-order sales by out-of-state retailers. These estimates partly reflect the department's assumption that federal legislation will be enacted to require retailers to remit use taxes on such sales to the states, as California law currently requires.

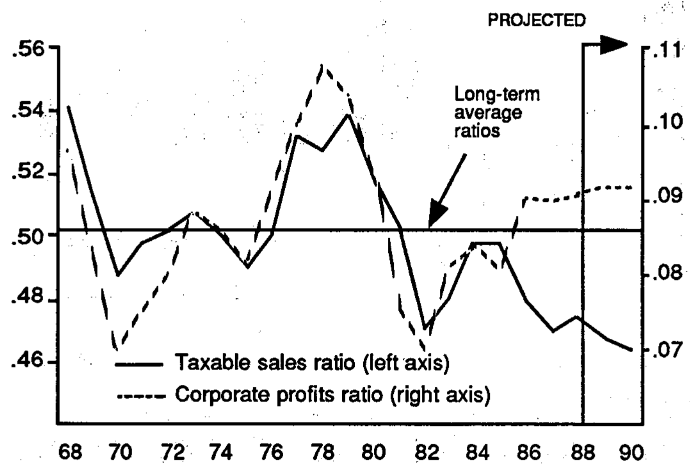
[b] "Real" taxable sales equal total taxable sales (current dollars) deflated by the GNP price deflator for consumption expenditures.

[c] Total taxable sales declined by 0.5 percent.

Chart 19

Ratios of California Taxable Sales and Corporate Profits to Personal Income

1968 through 1990[a]



[a] Source: Department of Finance. Data are estimated for 1988 and projected for 1989 and 1990.

The Forecast for Bank and Corporation Taxes—Moderate Increases

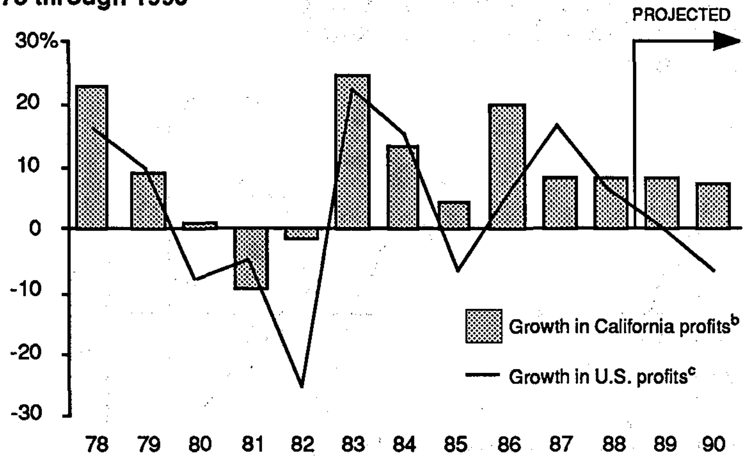
Bank and corporation taxes, the third-largest source of General Fund revenues, are derived primarily from a 9.3 percent levy on the taxable profits of corporations doing business in California. These revenues are projected to total $5.2 billion (9.2 percent growth) in the current year and $5.6 billion (6.4 percent growth) in the budget year. A number of significant changes were made to this tax in 1987 and, as with the personal income tax, *these law changes have made it much more difficult to accurately forecast revenues than before.*

Taxable Profits To Increase Moderately. The key to forecasting this tax is to predict the level of taxable corporate profits. Chart 20 shows that the department assumes that California corporate profits will increase by 8.4 percent in 1989 and 7.4 percent in 1990, following an 8.2 percent rise in 1988. Because these rates of increase are similar to projected personal income growth (see Table 2), the ratio of profits to statewide personal income will remain fairly stable (Chart 19).

Chart 20

Annual Growth in Taxable Corporate Profits

1978 through 1990[a]



[a] Source: Department of Finance.
[b] Data for 1988 are preliminary estimates by the Department of Finance and Franchise Tax Board.
[c] California and U.S. profit data are not strictly comparable in certain years due to definitional differences. Data incorporate the effects of various federal and state tax law changes during the 1980s which revised the definition of taxable corporate profits.

Forecast Contains Offsetting Biases. Chart 20 shows that the level, moderate rate of profit growth assumed for California from 1987 through 1990 differs markedly from the department's predictions of U.S. profit performance—a steady deterioration from 17 percent growth in 1987 to under 7 percent growth in 1988, negligible growth in 1989 and a 7 percent decline in 1990. Although taxable California profits depend upon many factors unique to the state, they also show a significant correlation historically with U.S. profit growth. This is only natural, given California's use of the unitary method and various profit-determining factors that affect both state and national profit performance (such as economy-wide interest rates). As is shown earlier in Table 3, the budget's U.S. profits forecast is consistent with other forecasters. *If the historical correlation continues to be valid, the budget's projected growth rates for California profits in 1989 and 1990 could be overstated.*

Offsetting this factor is the fact that 1987 tax refunds paid out in December 1988 and January 1989 were $90 million *less* than expected. This revenue gain, *which is not reflected in the budget's revenue estimates,* suggests that 1987 profits were stronger than assumed in Chart 20, and thus that the 1988 and 1989 profit growth assumptions should work off a higher base than assumed in the budget.

For the current and budget years combined, the above two biases appear to offset one another.

Insurance Taxes—Proposition 103 Uncertainties

Insurance tax revenues, which primarily are derived from a 2.35 percent tax on the dollar volume of insurance premiums written, are projected to total $1.4 billion in the current year and $1.3 billion in the budget year.

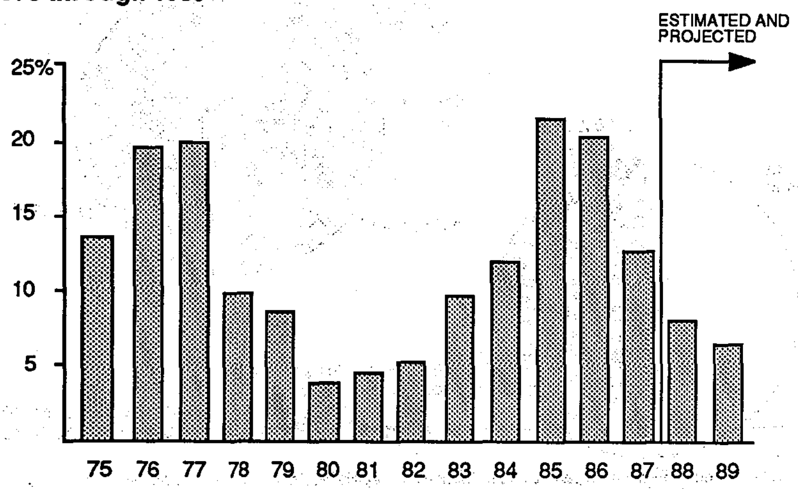
Large One-Time Gains Distort Revenue Trend. A recent court decision regarding the taxation of benefits paid to employees under "excess risk" arrangements between employers and insurance companies has increased revenues by $51 million in 1987-88 and a projected $208 million in 1988-89. Removing these one-time gains shows that underlying revenue growth is moderate—8.7 percent in the current year and 6.3 percent in the budget year.

Insurance Premiums—Slower Growth Predicted. Because of the way in which insurance tax prepayments are computed, 1988-89 revenues primarily depend on 1988 premiums, and 1989-90 revenues will depend primarily on 1989 premiums. The department's forecast for premiums is based on statistical analysis of survey data from firms collecting about one-half of California's insurance premiums. Chart 21 indicates that growth in insurance premiums is assumed to slow from over 12 percent in 1987 to about 8 percent in 1988 and 7 percent in 1989. This growth is slightly less than personal income growth and well below the average for the last 10 years—nearly 11 percent.

Chart 21

Annual Growth in California Taxable Insurance Premiums

1975 through 1989[a]



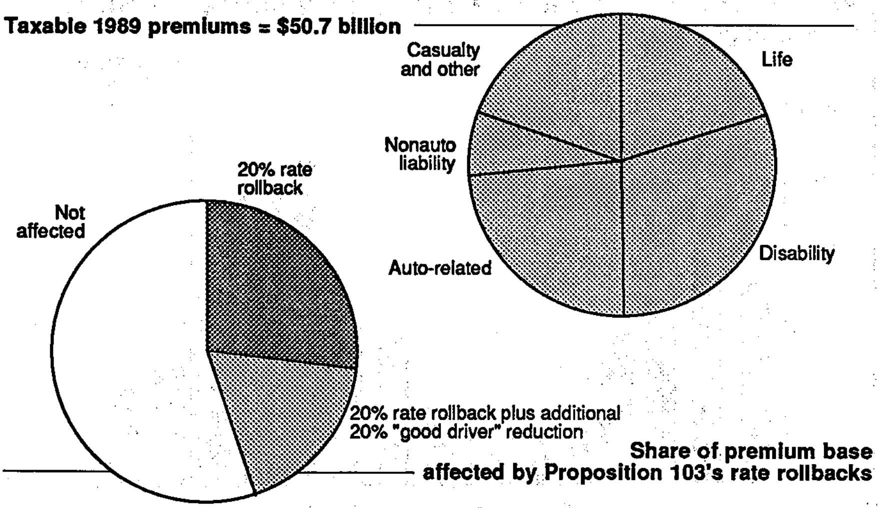
[a] Source: Department of Finance. Data shown are for premiums subject to the standard 2.35 percent tax rate, and exclude certain premiums for pension and profit sharing plans, surplus lines and ocean marine insurance, which are taxed at special rates.

Why the Slowing? Taxable insurance premiums are related both to economic activity and the cyclical financial position of the insurance industry. Our own revenue estimating procedures indicate that (consistent with the department's view) the budget's economic forecast, taken alone, would generate only modest growth in insurance premiums. In addition, however, Chart 21 shows that insurance premiums follow a definite cyclical pattern over time. This is because the industry experiences cycles of underwriting profits and losses, in response to which it continually adjusts its premium rates. Thus, periods of large underwriting losses typically are followed by periods of large premium increases, and vice versa. Chart 21 suggests that the department is assuming that California will remain in the lower part of the cycle. Of course, because of Proposition 103, *the premiums forecast is prone to much greater-than-normal error.*

Proposition 103—Will It Affect Revenues? Proposition 103 (November 1988) mandates reductions in premium rates for certain types of insurance. Chart 22 shows the distribution of California's premium volume by insurance type, and indicates that the rate-reduction requirement will apply to about 45 percent of the premium base. Proposition 103

Chart 22

Taxable Insurance Premiums
By Type[a]



[a] Source: Department of Finance, Department of Insurance and Legislative Analyst. Data regarding Proposition 103 computed using actual 1987 premium data.

provides that the insurance tax rate be adjusted to compensate for any decrease in state revenues which might result from the premium rate reductions. The budget assumes that because of this clause, there will be no state revenue losses due to the measure. However, it remains to be seen exactly how this rate adjustment process will work, including (1) whether it can be timed so that the state will have no initial cash-flow revenue losses, and (2) whether it will be possible to accurately account for not only reductions in premium rates per se, but also their induced effects, and those of other provisions in the measure, on premium sales. It is likely that Proposition 103 will affect state revenues in some manner, *but what this effect will be is unknown.*

Death-Related Taxes—Sizable Gains

Death-related tax revenues are predicted to increase by nearly 24 percent in 1988-89 and 12 percent in 1989-90 (see Table 4). These taxes total in the range of $400 million and account for about 1 percent of all revenues. They include estate taxes, inheritance taxes and gift taxes. Although Proposition 6 (1982) abolished inheritance and gift taxes and replaced them with the estate tax, revenues continue to be collected under the former taxes from unclosed accounts of persons who died before the law was changed.

All Other Taxes—No Growth

General Fund revenues from the state's remaining taxes are projected to total a combined $412 million in the budget year. This is about 1 percent of total revenues and nearly identical to collections in both the prior and current years. These taxes include the cigarette tax ($167 million), alcoholic beverage taxes ($126 million) and horse racing taxes ($114 million).

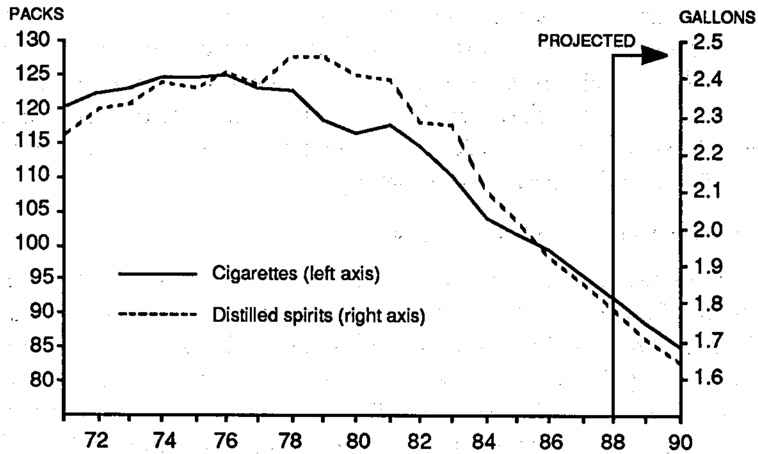
Cigarette and Beverage Taxes Are Declining. Both cigarette and beverage taxes are projected to decline in the current and budget years. Chart 23 shows this is because per capita consumption of alcoholic beverages and cigarettes are expected to continue trending downward as in recent years, and by more than the rate of population growth. This, combined with the fact that the General Fund revenues from these sources come from fixed "cents-per-unit-consumed" excise taxes, means that taxes do not increase over time even as the prices for these items rise.

The Effect of Proposition 99. The budget assumes that the 25-cent-per-pack tobacco surtax imposed by Proposition 99 (1988) will cause an ongoing consumption reduction of only about 1 percent. This implies

Chart 23

California Per Capita Consumption of Cigarettes and Distilled Spirits

1970-71 through 1989-90[a]



[a] Source: Department of Finance and State Board of Equalization. Data shown are for fiscal years ending in years specified.

a net General Fund revenue gain in the current and budget years combined of $41 million, representing increased sales taxes of $44 million and reduced excise taxes of $3 million. (The special fund revenues from this surtax are discussed in the next section.) Empirical studies, however, suggest that the consumption decline will be greater than predicted by the department, in which case there might be no General Fund revenue gain.

Special Wagering Tax Boosts Revenues. Total pari-mutuel wagering is projected to increase by only about 3 percent in the budget year. This increase is primarily due to increased activity at satellite wagering facilities located at fairs and other sites. However, General Fund revenues are projected to rise by about 8 percent ($9 million). This is due to imposition of a special license fee at the satellite facilities, which is aimed at protecting the General Fund from revenue losses caused by their existence. (Wagering taxes at these satellite facilities primarily accrue to special funds, and such wagering can hurt the General Fund by reducing attendance and wagering at racetracks.) Without this special tax, General Fund revenues would only be up about 3 percent.

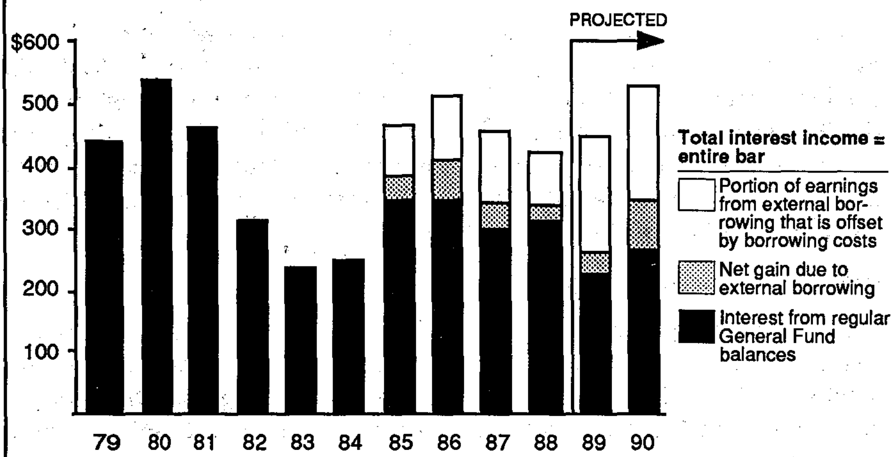
Interest Income—Higher Due To Interest Rates and External Borrowing

General Fund interest income accounts for slightly under 2 percent of total revenues. Chart 24 shows that it is projected to total $532 million in the budget year, well up from the current and prior years.

Chart 24

General Fund Revenues From Interest Income

1978-79 through 1989-90 (dollars in millions)[a]



[a] Source: *1989-90 Governor's Budget*, Department of Finance and State Treasurer. Data shown are for fiscal years ending in years specified.

Where Does Interest Income Come From? Interest income is derived from four primary sources: (1) the investment of monies carried over from prior years (such as balances in the Special Fund for Economic Uncertainties); (2) earnings on certain special fund balances to which the General Fund is entitled; (3) investment of incoming General Fund revenues that are temporarily not needed to pay for expenditures; and (4) "arbitrage income" from the short-term investing of temporarily idle monies that the General Fund has borrowed to handle its intra-year cash-flow imbalances. These monies all are invested through the state's Pooled Money Investment Account (PMIA).

Borrowing Profits and Higher Yields to Boost Earnings. The regular General Fund PMIA balance is projected to be $2.8 billion in the budget year, only slightly above the current year's $2.6 billion and far down from the prior year's $4.1 billion. This reduced average balance reflects the tightened budgetary situation. Budget-year interest, however, is assumed to be higher than in either previous year because:

- The PMIA's *average interest yield* is projected to rise to 9.5 percent in 1989-90, well above the 8.7 percent for 1988-89 and 7.9 percent in 1987-88. This yield is consistent with the budget's assumptions regarding economy-wide interest rates in 1989 and 1990.
- The *volume of external borrowing* is assumed to rise to $3.5 billion in the budget year, up from $3.2 billion in the current year and $2.1

billion in 1987-88. Undertaking this volume of borrowing will require a change in existing state laws governing the external borrowing program. Without this change, only about $3.2 billion could be borrowed.

Net Benefits from Borrowing Appear Overstated. The budget's estimates of net profits from external borrowing in 1989-90 assume that the borrowing rate will be only 5.8 percent. This is too low, compared to the 9.5 percent earnings yield assumed for the PMIA. Although adjusting the borrowing rate upward will not affect the total interest income shown in Chart 24, *it will reduce the net gain shown and increase 1989-90 General Fund expenditures accordingly.*

Other General Fund Revenues

The remaining sources of General Fund revenues include a variety of regulatory taxes and fees, California State University fees, monies from local agencies and miscellaneous revenue sources. Together, budget-year revenues from these sources are projected to total $965 million, or 2.5 percent of total revenues.

Big Gain from Unclaimed Property. Revenues have been increased by $36 million in 1988-89 and $165 million in 1989-90 due to Ch 286/88 (AB 3815, O'Connell), which reduced from seven to five years the period of time before unclaimed property held by banks and other financial institutions must be turned over to the state. These revenue gains represent accelerations of revenue collections which would otherwise have been received in future years.

RELIABILITY OF THE GENERAL FUND REVENUE FORECAST

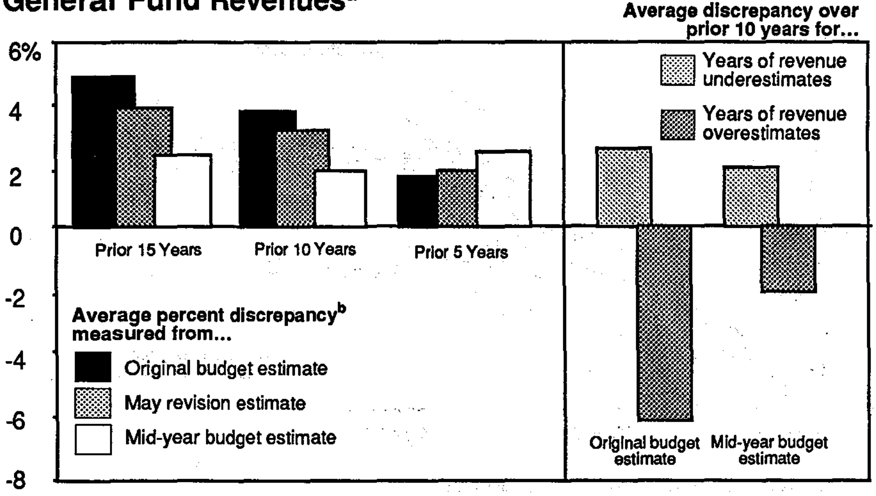
How Reliable Have Past Forecasts Been?

The reliability of past revenue forecasts has been quite variable. This serves as an important reminder that the current forecast also is prone to error. Chart 25 shows what the percentage revenue estimating discrepancies have averaged in past years. For example, it indicates that over the past 10 years:

- The average discrepancy has been almost 4 percent for the original budget estimate and over 2 percent for the midyear budget estimate.
- The average discrepancy in years of *revenue overestimates* has been over 6 percent for the original budget estimate and nearly 2 percent for the midyear estimate.
- The average discrepancy for years of *revenue underestimates* has been a bit under 3 percent for the original budget estimate and over 2 percent for the midyear estimate.

Chart 25

Discrepancies Between Actual and Estimated General Fund Revenues[a]



[a] Source: Estimates by Legislative Analyst, based on analysis of Department of Finance revenue estimates.
[b] Percentage discrepancies shown represent the average absolute values of discrepancies for the years specified that are attributable to economic forecasting revisions and revenue estimating procedures. Data have been adjusted for the initial estimates of new legislation, budget actions, audit settlements and various other factors.

Large Dollar Errors Are Likely

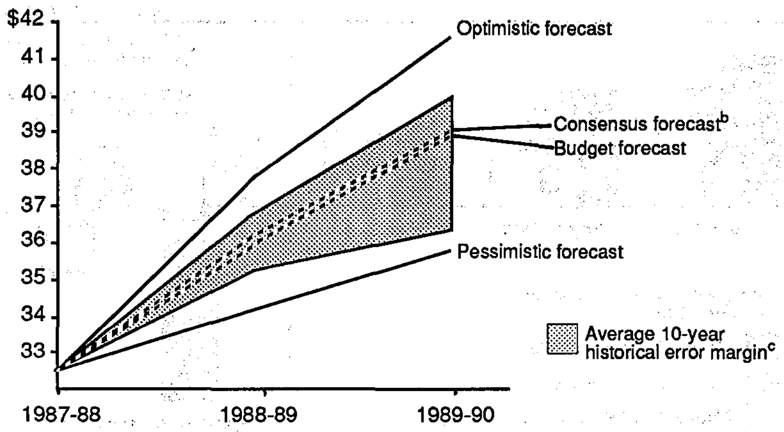
Percentage errors of these magnitudes translate into *very large dollar amounts*. For example, in 1989-90 a forecasting error of only 1 percent will produce a revenue error of nearly $400 million. Thus, a historical average error—4 percent—would cause a revenue error of $1.6 billion. Of course, much larger percentage errors than this have occurred in past years and certainly could occur again.

Chart 26 (see shaded region) indicates how revenues would differ from the budget estimate if the 10-year average percentage errors for years of revenue understatements and overstatements, respectively, were to occur. The combined current-year and budget-year error range shown is $1.9 billion on the upside ($800 million in the current year and $1.1 billion in the budget year) and $3.8 billion on the downside ($700 million in the current year and $3.1 billion in the budget year).

Chart 26

Alternative General Fund Revenue Forecasts

1988-89 and 1989-90 (in billions)[a]



[a] Source: *1989-90 Governor's Budget* and Legislative Analyst.
[b] Reflects consensus economic forecast plus other possible adjustments for which data appear in Table 5.
[c] Upper and lower bounds shown are based on the average percent errors in years of revenue underestimates and overestimates, respectively (see Chart 25).

Even Larger Errors Could Occur

Should the economy follow a significantly stronger or weaker path than assumed in the budget, Chart 26 (outer lines) shows that even larger revenue estimating errors could occur. It indicates that, according to the department's optimistic and pessimistic forecasts, the budget-year error range could be $2.7 billion on the upside and $3.1 billion on the downside.

Given the above, ***it is only realistic to expect revenue-estimating errors of at least several hundred million dollars, and it is within this band of uncertainty that the budget's revenue estimates should be viewed.***

Nevertheless—Are the Revenue Estimates "Reasonable"?

Even though significant error margins surround revenue estimates, it still is necessary that a specific revenue projection eventually be used in developing the state's budget plan. Thus, the relevant question is: *Are the budget's revenue estimates reasonable to use for this purpose?*

Where Might the Estimates Go Wrong? Assessing the reasonableness of the budget's revenue projections involves considering such factors as the consistency of the revenue projections with the budget's economic forecast, the reliability of the economic forecast itself, and how revenues have performed since the revenue estimates were made. Table 5 summarizes some of the possible factors that could give rise to errors in the revenue estimates. It indicates that:

- Our own revenue estimating procedures suggest that the *budget's economic forecast* would generate *$305 million less* revenues than projected. However, use of the more optimistic *consensus economic forecast* would generate *$325 million more* revenues than projected. Thus, accounting for technical revenue estimating adjustments and substituting the historically more reliable consensus economic forecast would put revenues within about $20 million of the budget forecast.
- If the historical-average capital gains growth rate were to occur, revenues would be *higher than estimated* by about $330 million. On the other hand, the response of taxpayers to the President's proposal to reduce the federal capital gains tax rate could *significantly lower* near-term gains reported for tax purposes.
- Recent revenue collections data suggest that current-year bank and corporation tax revenues should be *adjusted upward* by about $90 million. Recent revenue data also indicate that personal income tax estimated payments have been much stronger than expected. If not offset by other factors later this year, this could cause current-year personal income taxes to end up *higher* than assumed.

Table 5

Selected Possible Adjustments to the Department of Finance's General Fund Revenue Estimates 1988-89 and 1989-90 (dollars in millions)

Possible Sources of Adjustments	*1988-89*	*1989-90*	*Two-Year Total*
Technical revenue estimating procedures and methodologies	−$115	−$190	−$305
Use of consensus economic forecast	110	215	325
Subtotals	(−$5)	($25)	($20)
Capital gains:			
—Upward adjustment for historical capital gains growth rate	$100	$230	$330
—Downward adjustment due to proposed reduction in federal capital gains tax rate	—	Unknown potential reduction	Unknown potential reduction
Recent cash revenue trends:			
—Bank and corporation tax	90	—	90
—Personal income tax [a]	Unknown potential gain	—	Unknown potential gain
Proposition 103	Unknown effect	Unknown effect	Unknown effect
Selected other factors [b]	−15	−85	−100

[a] Personal income tax declarations of estimated tax payments for the months of December 1988 and January 1989 increased by 32 percent over the same months one year earlier. The budget assumes that this surge will be offset by reduced final tax payments in April 1989; however, whether this actually will happen is unknown.

[b] Includes assumptions regarding use taxes on out-of-state mail orders and the effects of Proposition 99 on cigarette consumption.

- Proposition 103 could end up *either increasing or decreasing* revenues, depending upon how insurance purchasers and providers respond to the measure, how insurance tax rates are adjusted, and determinations by the courts regarding the legality of the measure's provisions.
- Certain other factors could end up *reducing* revenues over the two-year period by about $100 million.

General Conclusion—Estimates Reasonable With Some Upward Potential

One cannot say with certainty which of the possible revenue adjustments listed in Table 5 actually will materialize. It seems likely, however, that at least some net upward revenue adjustments will result from these sources. Chart 26 shows that if *all* of the possible adjustments for which data are shown in Table 5 were to occur, revenues would be increased by *several hundred million dollars* over the two-year period. Chart 26 also shows, however, that while such gains may be significant in dollar terms, *they are "swamped" by the error margins* within which the revenue forecast should be viewed. Given this, our conclusion is that budget's revenue estimates are *generally reasonable for the Legislature's initial planning purposes, though they have some upward potential.*

April Will Provide Critical Missing Information. During each of the past two years, the budget's revenue projections have been significantly revised in May, following the filing of personal income tax returns in April. This is primarily because recent federal and state tax-law changes have made it difficult to anticipate both the amount of tax liabilities and the timing of tax payments. This year's April revenue data will again provide important information which could *significantly change* the revenue estimates. For example, we will know in April if the large volume of declarations payments in recent months (see Table 5) represents a net gain or not, and whether the budget's assumptions regarding 1988 capital gains are correct. Thus, *depending on what these April data show, the revenue estimates could be subject to considerable revision this May.*

III. THE FORECAST FOR SPECIAL FUND REVENUES

Special fund revenues are projected to total $7.9 billion in 1988-89 and $7.1 billion in 1989-90 (see Table 4). As shown in Chart 14, the volatile growth rates that these projections imply—a 27 percent gain in 1988-89 and 9.5 percent decline in 1989-90—are due to various special factors and distortions. After accounting for such factors, the underlying rate of revenue growth is much more stable and moderate—a bit higher than personal income growth. The growth rates for individual special fund revenue sources differ considerably from one another, however.

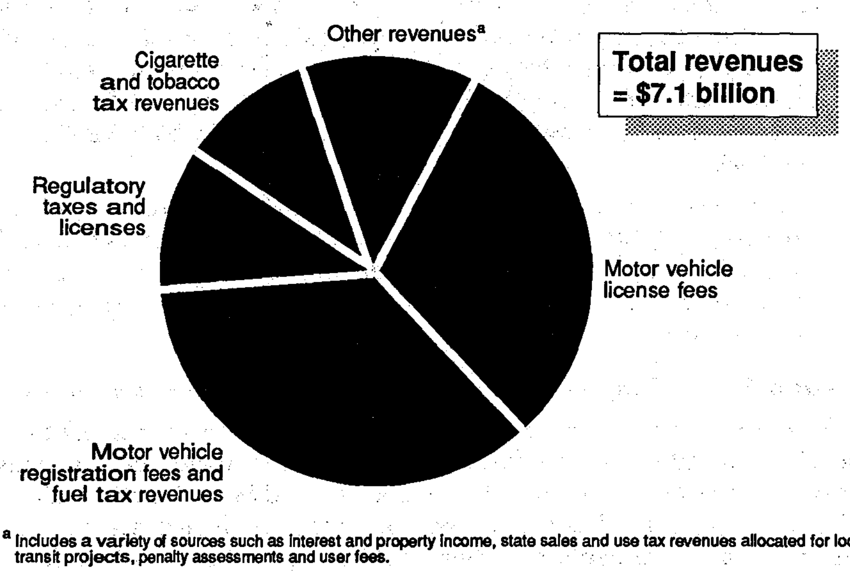
Where Do Special Fund Revenues Come From?

Table 4 and Chart 27 indicate that:

- Nearly two-thirds ($4.7 billion) of special fund revenues are derived from motor vehicle-related sources. These include those dedicated for transportation purposes—namely fuel taxes ($1.3 billion) and vehicle registration and related fees ($1.2 billion). Also included is the vehicle license fee ($2.2 billion), which is imposed on motor vehicles in lieu of the local property tax.
- The remaining one-third ($2.5 billion) of special fund revenues include tobacco-related taxes (about $700 million) and interest income (about $130 million). Also included are oil and gas revenues, state sales and use tax revenues allocated for local transit projects, and other smaller sources such as various business and professional license fees, utility surcharge receipts, and penalties from traffic violations and criminal convictions.

Chart 27

1989-90 Special Fund Revenues by Source



[a] Includes a variety of sources such as interest and property income, state sales and use tax revenues allocated for local transit projects, penalty assessments and user fees.

How Are Special Fund Revenues Used?

Special fund revenues are used for a wide variety of purposes. For example:

- Over half of motor vehicle-related revenues are returned to local governments for transportation-related and other purposes. The remainder is used for various state programs relating to transportation and vehicle use, including support of the Department of Motor Vehicles (DMV), the California Highway Patrol (CHP), and the Department of Transportation (Caltrans).

- Revenues raised by the new tobacco-related taxes imposed by Proposition 99 (1988) are distributed to various state accounts to be spent for health and natural resources-related purposes.
- The local 3-cent share of the basic 10-cent state cigarette tax in effect prior to Proposition 99 is distributed between cities (83 percent) and counties (17 percent).
- Oil and gas revenues are used primarily to finance capital outlay projects.

Mixed Growth Trends for Motor Vehicle-Related Revenues

These revenues are projected to grow by about 5 percent in both the current and budget years. Regarding the individual revenue sources:

- ***Vehicle license fees*** are projected to increase moderately (about 7 percent) in both the current and budget years. These fees—the single largest special fund revenue source—are imposed for the privilege of operating vehicles on public roads in California, and are in lieu of the personal property tax on vehicles. The revenue projections assume that new car sales will be relatively flat throughout the forecast period and car prices (which determine a vehicle's actual license fee) will increase by about 5 percent per year.
- ***Registration fees,*** which are levied at a flat per-vehicle rate, are projected to increase by a bit under 5 percent in both 1988-89 and 1989-90.
- ***Fuel taxes,*** which also are levied at a flat rate, are projected to increase very little—less than 2 percent per year. Chart 28 shows that this is because of weak growth in gasoline sales. Per capita gasoline consumption is expected to actually decline slightly, despite soft gasoline prices.

Tobacco-Related Taxes—$625 Million In New Proposition 99 Revenues

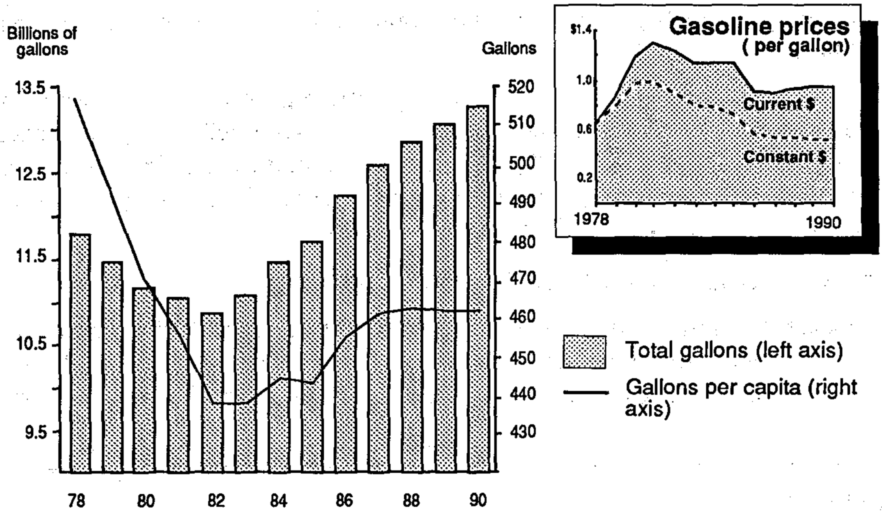
Special fund revenues from tobacco-related taxes are estimated to total nearly $375 million in the current year and $700 million in the budget year. Most of this money—$300 million in 1988-89 and $625 million in 1989-90—is due to Proposition 99. This measure levied an additional cigarette tax of 25 cents per pack and imposed a tax on other tobacco products equivalent to that on cigarettes. Chart 29 shows the trend in tobacco-related revenue collections.

Is the Proposition 99 Estimate Reasonable? The budget's estimates of the revenue effect of Proposition 99 assume that the new tax on cigarettes will increase the average price per pack by a bit over 20 percent, and that this in turn will reduce packs consumed by slightly over 1 percent. Admittedly, predicting the effects of this tax increase is somewhat speculative. Studies by economists, however, suggest that the consumption reduction *may be greater*, especially given the large price increase

Chart 28

California Gasoline Consumption and Prices

1978 through 1990[a]

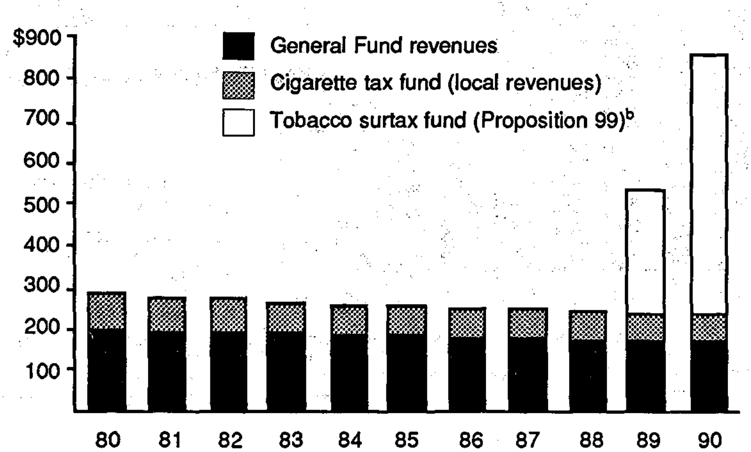


[a] Source: *1989-90 Governor's Budget* and State Board of Equalization. Data are estimated for 1988 and projected for 1989 and 1990.

Chart 29

Cigarette and Tobacco Tax Revenues

1979-80 through 1989-90 (in millions)[a]



[a] Governor's Budgets and State Controller. Data shown are for fiscal years ending in years specified.

[b] The Cigarette and Tobacco Products Surtax Fund was established by the Tobacco Tax and Health Protection Act of 1988, which increased the cigarette tax to $0.35 per pack and added an equivalent tax to other tobacco products. These tax increases became operative January 1, 1989. The revenues from these tax increases are deposited into the fund and subsequently transferred to six separate accounts to finance various program activities.

involved. If these studies are correct, the new tax could reduce consumption by as much as 8 percent, or possibly even more. Each additional 1 percent decline in cigarette consumption beyond that assumed in the budget would reduce Proposition 99 revenues by about $6 million. Thus, for example, an 8 percent decline would reduce revenues by over $40 million.

Future Revenues Likely to Decline. Total cigarette consumption has fallen every year during the 1980s due to steady declines in per capita consumption (see Chart 23). If this trend continues, Proposition 99 revenues will experience absolute dollar declines in future years, since the cigarette tax is a fixed cents-per-pack levy.

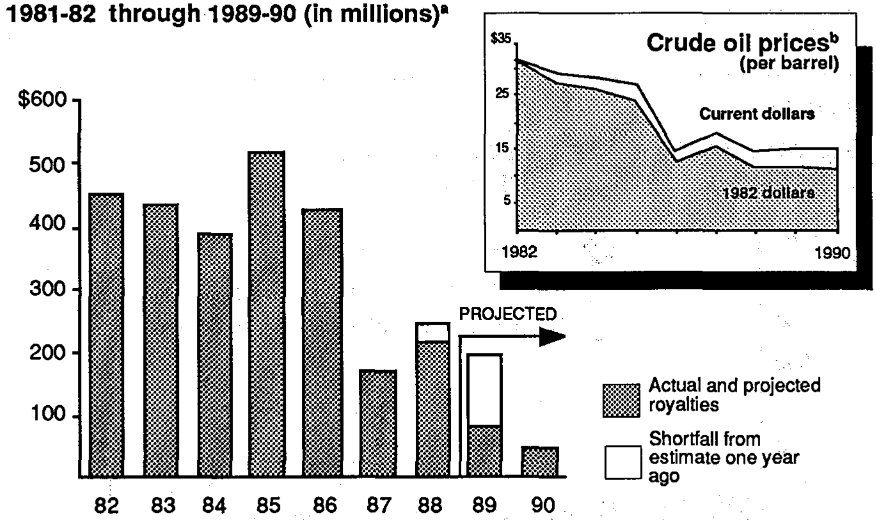
Oil and Gas Revenues—Extremely Depressed

Chart 30 shows that state oil and gas royalty income has been revised down substantially over the past year and will be far below its high level experienced during the first half of the 1980s. As shown in the chart, this

Chart 30

State Oil and Gas Royalties

1981-82 through 1989-90 (in millions)[a]



[a] Source: *1989-90 Governor's Budget* and State Lands Commission. Data shown are for fiscal years ending in years specified, and include oil, gas and mineral royalties collected by the State Lands Commission.

[b] Source: Wharton Econometrics. Data represent average U.S. refiners' crude oil acquisition prices.

reflects the current modest level of crude oil prices, which reduces both the revenues obtained from oil produced on state-owned lands and the volume of oil that is profitable to extract. Total state oil and gas royalty income is projected to be only $80 million in the current year and $50 million in the budget year. This compares to $220 million in the prior year and an average of $450 million annually for the period 1981-82 through 1985-86.

California State Lottery Revenues

The special fund revenue totals contained in the budget do *not* include any revenues derived from the California State Lottery. This is because lottery revenues have been classified as "nongovernmental trust and agency funds," and monies so designated are not reported in the budget. However, because the lottery is a major source of state income, its revenue outlook is summarized below.

Projected Lottery Sales—$2.5 billion. Lottery sales are projected to total $2.5 billion in both 1988-89 and 1989-90. This is nearly 20 percent above lottery sales in 1987-88, and the current-year estimate is almost 40 percent above the estimate made one year ago. As these estimates indicate, lottery sales have been exceeding expectations. Two-thirds of budget-year sales are expected to come from on-line lotto wagering and one-third from instant ticket sales.

Sales Forecast—Reasonable But Subject To Error. Given recent wagering experience, the budget's estimates are not unreasonable. However, as last year's wagering experience demonstrated, lottery projections are subject to considerable error.

Use of Lottery Proceeds—Nearly $950 Million To Education. Chart 31 shows how the $2.5 billion in budget-year lottery proceeds will be distributed. It indicates that:

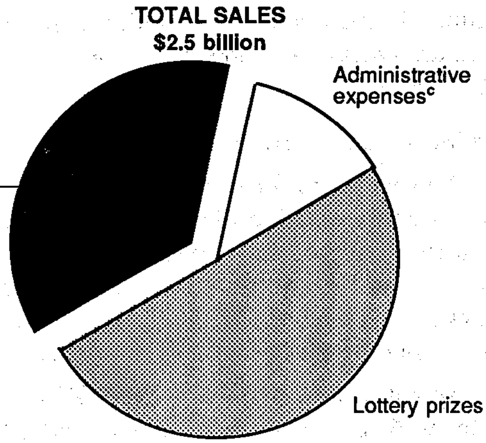
- 50 percent ($1.25 billion) will be paid out in prizes, as statutorily required.
- About 13 percent ($325 million) will be used for lottery-related administrative expenses, including commissions to lottery retailers. (This is about $75 million less than the maximum 16-percent share that current law permits for administrative costs.)
- The remaining 37 percent ($925 million), plus certain interest earnings, will go to public education.

Chart 31

Estimated Distribution of 1989-90 State Lottery Receipts

Revenues to Education (in millions)

K-12 Education	$763
Community Colleges	114
California State University	42
University of California	24
Other[a]	2
Total	**$944[b]**



[a] Includes Hastings College of Law, California Maritime Academy, Department of Youth Authority, and certain state special schools.

[b] Detail may not add to total due to rounding. Total includes $925 million from 1989-90 lottery sales and $19 million in net interest income.

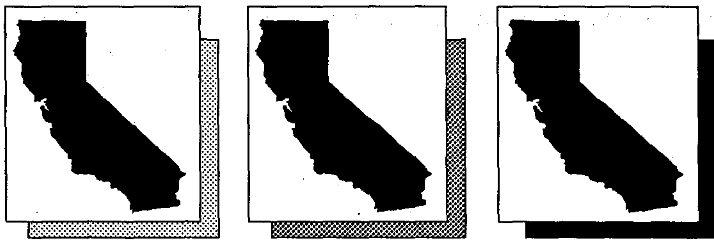
[c] Includes commissions to retailers, instant-game ticket costs, on-line lotto-game costs, and general operating expenses.

Chart 31 also shows how the monies going to education are to be allocated to different educational levels. Existing law provides that this be done on the basis of educational enrollments and attendance. Altogether, the 1989-90 lottery revenues earmarked for education amount to about 4.7 percent of total proposed General Fund educational expenditures.

4

Major Issues Facing the Legislature

Part 4



Major Issues Facing the Legislature

In addition to the major policy and funding issues identified in the *Analysis,* this part discusses some of the broader issues currently facing the Legislature. Many of these issues are closely linked to funding requests contained in the Governor's Budget for 1989–90; others are more long-range in nature and will, in all probability, persist for many years beyond 1989.

The issues in this part fall into five general categories. The *first* involves *issues related to how the state will cope with its current and future populations:* accommodating growth, providing for clean air and solid waste disposal capability, and addressing problems with the state's appropriations limit. The *second* category is related to the first, but focuses on *infrastructure needs:* the level of state indebtedness, the transportation funding problem, year-round schools, asbestos abatement in state buildings, and California prisons.

The *third* category provides information on *cross-cutting issues involving many public-sector programs:* the allocation and expenditure of federal immigration funds, state child care programs, programs for substance-abusing pregnant women and their babies, and state programs for older Californians.

The *fourth* category includes *reviews of specific programs:* insurance reform, mental health, the treatment of youthful offenders, the impact of trial court funding on county finances, energy regulation in the 1990s, the implementation of Proposition 98 and a discussion of the changes in state accounting practices reflected in the Governor's Budget.

Finally, we discuss three issues related to *public employee compensation:* retiree cost-of-living adjustments, retiree health care benefits and the new PERS-CARE health plan.

Accommodating California's Growth

How Can the Legislature Improve California's Ability to Accommodate Growth?

Summary

- *California's population will increase by 8.3 million, or about 30 percent, over the next two decades.*
- *California's ability to accommodate its current population is strained in several important respects. Moreover, because many of these problems are becoming worse or more difficult to solve, they also may hinder California's economic growth in the future.*
- *Our analysis indicates that there are two primary factors under the state's control which contribute to California's difficulties in accommodating growth. The first factor concerns the way in which decision-making authority over important land development decisions is distributed among the various levels of government. The second factor relates to the consistency of California's economic policies with state economic development goals.*
- *The Legislature and the Executive Branch have three major alternatives for strengthening the state's ability to accommodate growth. Specifically, the state could (1) expand the role of regional bodies in land-use decision making, (2) change economic policies related to growth, and/or (3) expand its direct efforts to guide planning for growth and development.*

In 1987 alone, California's population grew by over 680,000 people—more people than live in the entire state of Vermont. While the state's recent rate of growth (about 2.5 percent per year) is expected to decline somewhat in the foreseeable future, it will still dramatically exceed that of the nation as a whole. According to Department of Finance projections, California's population will increase by 8.3 million people, or about 30 percent, over the next two decades.

California's growing population and rapidly urbanizing landscape pose serious challenges for the state. While all of these challenges cannot be addressed immediately, it is clear that the Legislature and the Executive Branch must begin to address these challenges *now* to ensure that California will have the roads, housing, clean air and water that will be necessary to accommodate the additional people. In this analysis, we describe some of the difficulties California is experiencing in trying to accommodate its *current* population. We then discuss why these difficulties have developed and outline a series of options for strengthening California's ability to accommodate its *future* population.

HOW WELL IS CALIFORNIA ACCOMMODATING ITS CURRENT POPULATION?

California's ability to accommodate its current population is strained in several important respects. California highways are severely congested in many areas. The air quality in many regions of the state violates federal standards, and housing prices are among the highest in the nation. Some California beaches and bays are regularly contaminated with the overflow from undersized or decaying sewage-treatment systems.

These deficiencies—and others—adversely affect the health of California citizens and the quality of their lives. Moreover, because many of these problems are worsening or becoming more difficult to solve, they may also hinder California's future economic growth. Specifically:

Traffic Congestion Is Increasing. About 530,000 hours are lost each day by Californians in freeway traffic jams. The Department of Transportation (Caltrans) estimates that traffic delays cost Californians around $800 million each year in wasted time and increased auto operating costs. The number of hours people lose in traffic congestion is growing by 15 percent annually in Los Angeles and 25 percent annually in the Bay Area. Given the importance of the transportation system for commerce and industry, the existence of such delays make California a much less desirable place for doing business.

Housing Is Becoming Less Affordable. California's housing costs are among the very highest in the nation—and continue to escalate. According to industry experts, only 21 percent of California households could afford the median price home of $177,485 in November 1988, down from 32 percent just one year before. Given the impact of housing costs on business' ability to attract and retain workers, these high costs could influence businesses to locate in other states.

Air Pollution Problem Is Becoming More Difficult to Solve. California has one of the worst air pollution problems in the country. More than 75 percent of Californians live in areas which violate federal clean air standards. If California's population were to remain constant, its air pollution problem would probably improve somewhat as older cars are gradually replaced with newer, cleaner cars and as the benefits of other air pollution control measures are realized. Given the projections for strong population growth, however, these factors will not be enough to prevent further declines in air quality. Other strategies under consideration by air districts, such as staggering work hours and the conversion of autos to cleaner fuels, are much more difficult to implement.

Water Pollution Problem Is Becoming More Expensive to Solve. At least 11 California sewer districts, including the districts which serve the Los Angeles area and the cities of San Francisco and San Diego, are in violation of the federal Clean Water Act. Moreover, because the federal government recently changed its policy from providing *grants* to local governments for the construction of sewage treatment plants to providing *loans*, local governments will find it more costly to comply with the federal Clean Water Act.

Water Supply Is Becoming More Limited. Already, growth in many coastal and rural areas of the state has been constrained by the lack of adequate water supplies. Much of southern California is expected to face forced rationing in the next two decades if additional water supplies are not identified. Finally, experts advise that the amount of water that will be available to serve California's expanding population is being reduced by the pollution of ground water.

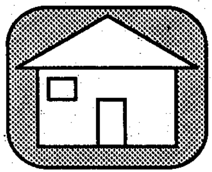
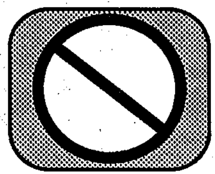
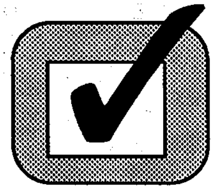
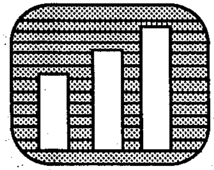
More and More Californians Are Voting to Institute Controls on Growth. Largely as a result of the difficulties highlighted above, surveys indicate that many Californians are becoming increasingly resistant to growth in their communities. According to the California Association of Realtors, almost 200 measures to control growth have been placed on local ballots since 1971—and nearly 60 percent of these measures have prevailed. Almost two-thirds of these were approved in the last three years. Growth control measures have been adopted in 80 cities, 14 counties and eight special districts in the state. While the specific terms of these measures vary (please see Chart 1), most reduce residential construction in the community—either by mandating predetermined building caps or by instituting stringent preconditions to development.

Although growth control measures are heralded as ways to manage development and reduce the ill effects of growth, research indicates that these measures may not produce the results intended by their supporters. For example, recent studies have found that growth control measures tend to shift housing construction to outlying communities where there are few growth restrictions. To the extent that jobs remain in the controlled community, workers now must travel further from their homes to their place of employment, increasing traffic congestion and air pollution. Growth controls also tend to increase the cost of housing, resulting in some families being unable to purchase a home or having to spend a disproportionate amount of their income on shelter. On the positive side, growth control measures have had some success in protecting environmentally sensitive lands and in slowing growth to keep pace with local infrastructure development.

In summary, California is experiencing many serious problems in accommodating our current population. As California adds new residents, these difficulties are becoming more difficult to solve. In order for the Legislature to be able to take steps to improve the state's ability to accommodate growth, we focus in the next sections on *why* the state is experiencing these difficulties—and *what* can be done to address them.

Chart 1

Major Provisions of Growth Control Measures Adopted by Local Voters[a]

				
MEASURE	**Building Permit or Population Growth Caps**	**Moratoriums, Height Limits & Downzonings**	**Voter Approval for Land-Use Changes**	**Performance Standards**
PERCENT OF ADOPTED MEASURES	23%	52%	22%	8%
DESCRIPTION	Measure establishes a maximum number of building permits which can be issued or specifies a local governmental population growth limit.	Measure institutes various construction moratoria, restrictions or zone changes (e.g., temporary construction bans, limits on building heights, "downzoning" to require less intensive use of land, and prohibitions on the construction of certain facilities.)	Measure identifies specific land areas and/or potential general plan amendments and requires voter approval before the identified land can be developed or amendments adopted.	Measure specifies minimum performance standards and public facility levels (e.g., traffic flow or school availability) and prevents or reduces development if these standards are not maintained.

[a] Source: California Association of Realtors *"Matrix of Land Use Measures 1971-1988."* Percentages limited to measures for which effect could be readily determined. Totals do not add to 100 because some measures have multiple impacts.

WHY IS CALIFORNIA EXPERIENCING DIFFICULTY ACCOMMODATING GROWTH?

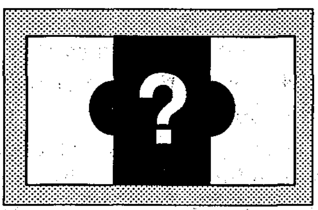
Our analysis indicates that there are two primary factors under the state's control that contribute to California's difficulties in accommodating growth. The first factor concerns how decision-making authority over important land development decisions is distributed among the various levels of government. The second factor relates to the consistency of California's economic policies with state economic development goals. These factors are summarized in Chart 2.

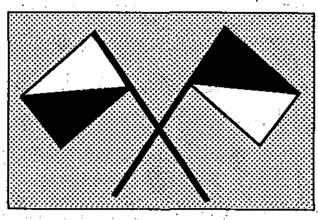
Chart 2

Why Is California Having Difficulty Accommodating Growth?

Dated Government Structure Leaves Gap Between Responsibility and Regional Needs

- Cities and counties lack responsibility for regional impacts
- Regional organizations lack authority to mitigate regional impacts





State Economic Policies Send Wrong Signals

- Many important services are underpriced
- Fiscal incentives unduly influence land use decision-making process
- Few incentives exist for attainment of state and regional objectives

Dated Structure Leaves Gap Between Governmental Authority and Regional Needs

The California Constitution establishes two types of municipal service providers—cities and counties—and assigns responsibilities and authority to each. At the time the Constitution was drafted, most matters related to growth and development could be addressed satisfactorily at the city and county level. With population growth and advances in communications, transportation, and technology, however, more and more matters related to growth have evolved into *regional issues* which are beyond the scope of any single city or county's authority to resolve. Thus, with respect to regional issues, the government structure which has served California has become somewhat dated. There is a gap between local government's authority and the responsibility to mitigate the regional impacts of growth and development.

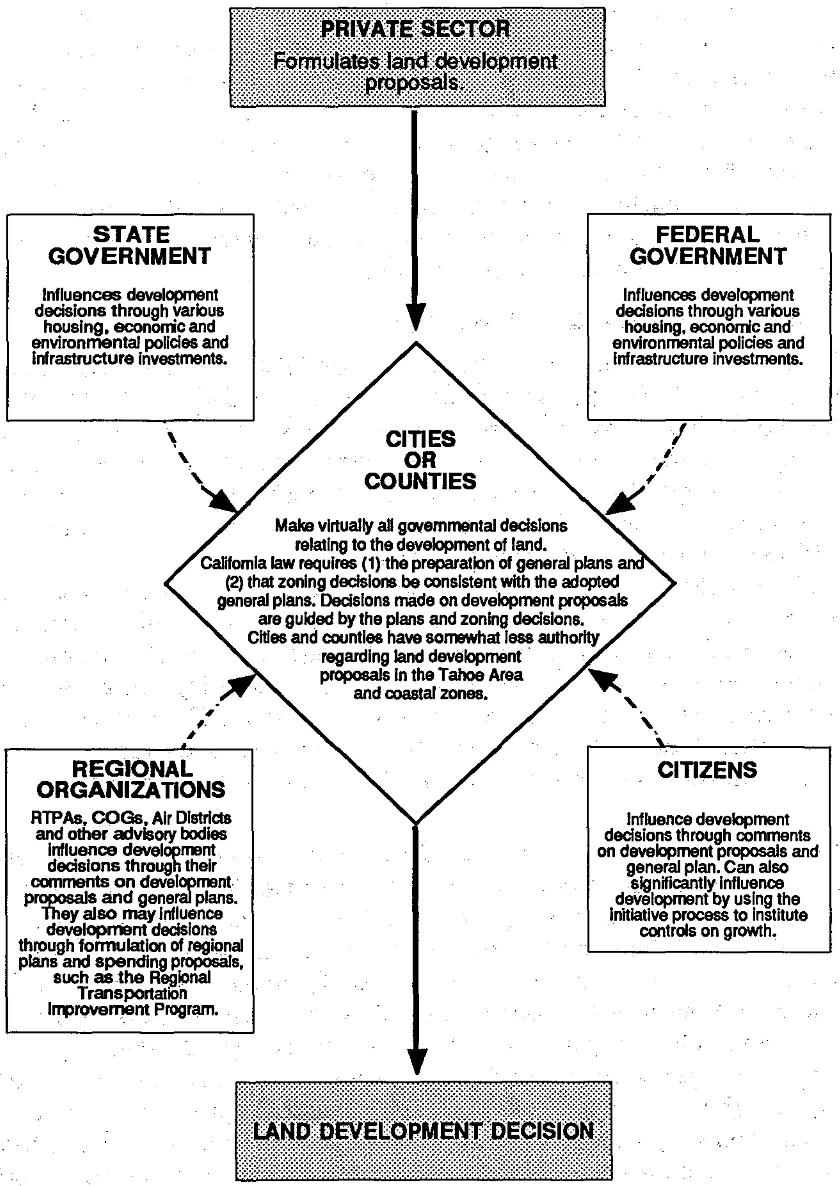
This gap is most noticeable in the area of land-use development. One of the most significant powers vested in local governments is the authority to approve, reject or place conditions on land-development proposals in their jurisdiction. Chart 3 summarizes the forces shaping these local land development decisions. As the chart indicates, the state does not play a direct role in the land-use development approval process. State involvement in local land development matters has generally been limited to (1) outlining the legal framework within which a city or county must exercise its land use authority and (2) indirectly influencing land development decisions through its efforts to promote affordable housing and economic development, through infrastructure investments and through its comments in the environmental review process.

Cities and Counties Lack Responsibility for Regional Impacts. California's approach to land-use regulation places most of the authority for land-use decisions in the hands of cities and counties. At the same time, however, city and county governments do not have commensurate levels of responsibility for the consequences of their actions. For example, cities and counties are not responsible for the achievement of air quality goals within their regions. Land-use decisions made by a single entity can have adverse impacts on the achievement of regional air quality goals, as may be the case when a city's approval of a commercial or industrial project requires longer commutes for the project's employees than would be the case if an alternative site had been chosen. Cities and counties also are not responsible for maintaining traffic flow on the state's freeway system. For example, a city may provide funding for Caltrans to construct numerous interchanges to a state freeway which bisects the city. The interchanges may make land near the interchanges more valuable and relieve congestion on local roads, but the additional interchanges are likely to slow the inter-regional traffic which the freeways were constructed to serve. Thus, there is often a gap between governmental land-use decision-making authority and the responsibility for achieving regional and statewide goals affected by those land-use decisions.

Regional Organizations Generally Lack Authority To Mitigate Regional Impacts. Regional planning in California is generally carried out by advisory bodies divided along functional lines. For example, Regional Transportation Planning Agencies (RTPAs) are responsible for regional highway and transit planning, air pollution control districts are responsible for coordinating district-wide air pollution abatement efforts and Councils of Governments (COGs) are responsible for—among other things—calculating each locality's "fair share" of housing in accordance with state law.

Chart 3

How Are Land Development Decisions Made?



While regional organizations have significant responsibilities for improving the region's transportation network, housing inventory, air quality and meeting other regional goals, they do not have the authority to require changes in local general plans or land development decisions in order to effect these improvements. For example, if a city's general plan enables far more jobs to be established than houses, an air district might comment that additional housing is needed near job centers in order to reduce the number of long auto commute trips and, consequently, auto emissions. Air districts, however, have no authority to require changes in the city's general plan. Similarly, a Regional Transportation Planning Agency may comment on the location of a proposed business park, fearing that construction may result in substantial degradation to part of the state freeway system. The agency, however, has no ability to require changes to the proposal.

State Economic Policies Send Wrong Signals

Over the years, the Legislature, the administration and the state's citizens have forged public policies—both direct and indirect—which influence Californians' consumption of goods and services and the financing of state and local government activities. Although these policies have been adopted to address a variety of needs, we refer to them as "state economic policies" because they represent government attempts to influence economic decisions. Ideally, the state's economic policies should assist the state in its efforts to accommodate growth. For example, economic policies should (1) encourage citizens to use public goods and services carefully to minimize cost and damage to the environment and (2) encourage local governments to make land development decisions which meet state policy objectives and result in attractive and affordable communities. Our analysis indicates that there are at least three ways in which California's economic policies fall short from these goals. Specifically:

Many Important Government Services are Underpriced. Governments provide many important goods and services to California citizens and businesses. For example, governments build roads, libraries, schools, universities and jails, and provide water, sewer, and waste disposal services. When governments set the price of a good or service at *below* its full cost, they in effect encourage citizens to use the good liberally. This underpricing may be desirable with certain goods—for example, governments generally *want* their citizens to use libraries and parks freely. On the other hand, sometimes governments prefer their citizens to use a good very carefully because the good is expensive and can have negative effects on the environment. In these cases, setting the good's price at below its full cost may not be desirable because it encourages *additional* consumption.

For example, the state freeway system is one of the most important publicly provided goods, and its use is underpriced. While freeway users *in the aggregate* pay for most of the cost of building and operating the freeway system, freeway users do not pay for the health and other costs of air and noise pollution which freeways cause. In addition, individuals who drive on freeways during peak hours do not pay for the *full* cost of the delays they impose on others or for the expensive increments to state freeways required to keep peak-hour traffic flowing smoothly. Thus, freeway use is underpriced in general and peak-hour freeway use is particularly underpriced.

California has similar problems in the pricing of water and waste disposal, where below-market costs or flat fees fail to provide the price signals that would encourage individuals to use less of these goods. Raising the price of these goods to reflect a greater portion of the full market cost would encourage consumers to use these goods and services more thoughtfully.

Fiscal Incentives Unduly Influence Land Use Decision-Making Process. The fiscal condition of California counties has deteriorated significantly over the last decade. California city governments have also found it more difficult to raise revenues sufficient to provide the full range of services their citizens demand. This has occurred for several reasons:

- Proposition 13 left local governments, particularly counties, with few avenues for generating revenues to fund general operations or to build infrastructure;
- The cost of state-mandated programs has increased faster than the state and local revenues available to finance them; and
- The demand for many local government services has increased.

Our analysis indicates that the strained fiscal condition of counties and the aspirations of cities to maintain or expand levels of services, have in many cases caused them to look to the revenues generated by land development as a source of funding. This has decreased their ability to use their land use authority to serve traditional local government planning goals, such as ensuring a balance between jobs and housing, providing for homes affordable to all income groups, protecting open space, and preventing leap-frog development. Growth control proponents frequently cite local governments' pursuit of revenue-generating land developments and their neglect of traditional planning goals when explaining why a growth control initiative is needed.

A key example of the effect of strained local financing options on land use is the undue competition between localities for land uses which generate sales and property tax revenues. Because commercial developments generate sales tax revenues and most nonresidential developments generate more property tax revenues than they cost to service, cities and counties tend to *compete* with each other for these land uses and, occasionally, to permit their construction in areas not well suited for the purpose. Alternatively, because many moderate- and low-income residential developments result in more expenses to local government (in terms of schools, public assistance and roads) than property tax revenues, cities and counties are less likely to solicit or encourage their construction.

Few Incentives for Attainment of State and Regional Objectives. While the state has established many policies which depend on cities and counties for implementation, state agencies have few incentives (or sanctions) at their disposal to reward or discourage city and county land-use decisions. For example, the state depends on each city and county to establish policies and programs in the housing element of its general plan which will enable the community to provide its calculated "fair share" of housing affordable to low- and very low-income households. While the state Department of Housing and Community Development (HCD) reviews draft housing elements for compliance with state law, there are virtually no sanctions which HCD can impose if these elements do not comply. Even if the HCD determines that the housing element violates state law, the community is still permitted to commence and expand redevelopment activities, receive federal Community Development Block Grant funds allocated by the department, and obtain revenue bond subsidies. Similarly, because state law requires the California Transportation Commission (CTC) to allocate a certain "minimum" of transportation money to each county, the CTC is limited in its ability to target transportation funds to support state objectives.

Partially as a result of the lack of incentives and sanctions for city and county compliance with statewide objectives, we have found that cities and counties often take actions which are inconsistent with state or regional objectives. For example, according to the Bay Area Council, only one of 97 bay area communities will meet its 1980-1990 "fair share" goal for the provision of low- and very low-income housing.

In summary, California's structural gap between governmental authority and regional needs, and its lack of coordinated economic policies, are contributing to the state's difficulties in accommodating growth. In the next section, we outline options for the Legislature to consider to mitigate these problems.

WHAT OPTIONS DOES THE LEGISLATURE HAVE TO IMPROVE CALIFORNIA'S ABILITY TO ACCOMMODATE GROWTH?

The Legislature has three major alternatives for strengthening the state's ability to accommodate growth. Specifically, the Legislature could:

- Shift some land-use approval authority from cities and counties to regional bodies so that major land development decisions are reviewed in a regional context;
- Alter economic policies to change the signals received by consumers and cities and counties; and/or
- Expand the state's direct efforts to guide planning for growth and development.

Expanding the Role of Regional Bodies

As we discussed above, California's allocation of decision-making authority for the land development process does not ensure that decisions are made by the level of government responsible for fully considering *and* mitigating undesirable consequences of the decision. The Legislature could correct this by granting additional powers to regional bodies. For example, regional bodies could be authorized to review and approve major local land-use development decisions for consistency with regional goals, including air quality improvement, traffic abatement, and housing affordability. There are at least two ways this could be accomplished.

Consolidate Existing Regional Planning Organizations. The Legislature could consolidate the existing regional planning organizations into a single regional authority, headed by locally elected or regionally elected officials. The consolidated organization could then be granted the additional authority to approve city and county general plans and to veto major land-use decisions, such as the granting of building permits for industrial parks or shopping centers. Regional veto systems such as this operate to some extent in Vermont and Maine and in the coastal areas of several states. Establishing a regional authority would ensure that the costs and benefits of land development decisions are reviewed in a regional context. The Legislature could also increase the regional authority's ability to coordinate local land-use decisions by empowering the authority to allocate some additional federal, state and regional transportation funds *and* to raise funds for transportation, environmental or open space purposes through taxes or fees approved by the voters.

Establish a Regional Adjudicatory Body. Alternatively, the Legislature could establish separate new regional adjudicatory bodies. These bodies could adopt region-wide growth plans and hear appeals from regional organizations, such as RTPAs, or from cities and counties regarding land use decisions or general plan changes which may have regional impact. The adjudicatory body would be empowered to approve, reject or place conditions on the development proposals it reviewed. A process somewhat similar to this exists in Florida.

Change Economic Policies Related To Growth

As discussed above, California's economic policies do not consistently reward consumer and local government actions which enhance the state's ability to accommodate growth. Motorists who drive during nonpeak hours pay about the same tax as motorists who drive during periods of peak congestion. Cities and counties which actively encourage the construction of low-income housing (1) may generate insufficient property tax revenues for general operations and (2) do not receive any preference in the award of state grants and subsidies. As discussed in more detail below, the Legislature could encourage citizens and cities and counties to work with the state in accommodating growth by: adjusting the price of public goods and services, reducing local financing constraints, and/or providing incentives to cities and counties to encourage them to meet state objectives.

Adjust the Price of Public Goods and Resources. Some of the strain on California's roads and resources could be reduced by the state, regional organizations and cities and counties by requiring individuals and businesses to bear more of the costs of public goods. For example, the Legislature could increase the gas tax to more nearly reflect the full roadway *and* environmental costs of auto usage. Cities and counties could adjust water and waste disposal fees to reflect a greater share of the true cost of the services. Regional bodies could be empowered to impose congestion fees on users of freeways during high occupancy times.

Reduce Local Financing Constraints. As California gains new residents, the demand for local government funds for roads, police and fire protection, public assistance, recreation and other purposes will continue to grow. In order to lessen local governments' reliance on the tax revenues related to retail, commercial and industrial development, the Legislature has essentially three options:

- Provide cities and counties an additional ongoing revenue source to lessen their dependence on growth-related revenues (for example, distribute additional state funds as unrestricted subventions or authorize cities and counties to levy new county-wide taxes). By improving city and county fiscal conditions, their fiscal reliance on development-related revenues would be lessened.
- Relieve cities and counties of some existing responsibilities, or provide them with greater flexibility in determining how to meet them. For example, the state could assume responsibility for financing county General Assistance programs. Actions of this type would reduce the cost pressures that contribute to deteriorating fiscal conditions and reliance on development-related revenues.
- Establish a mechanism to redistribute the additional local property and sales tax revenues resulting from commercial and industrial developments on a regional basis. This option could reduce the fiscal incentive present in development-related decisions.

Provide Incentives or Sanctions Which Encourage Cities and Counties to Meet State Objectives. The Legislature could encourage cities and counties to meet state goals by placing conditions on state grants or targeting subsidies and capital outlay expenditures. For example, the state could withhold subsidies or grants to a community whose housing element is not in compliance with state law. While placing conditions on state money should be done carefully and in a manner consistent with overall state goals, these funds can provide an effective "carrot" to guide the local decision-making process.

Expand The State's Efforts In Guiding Development

Finally, the Legislature could consider taking action to enhance the state's role in guiding California's development. These actions could range from relatively modest steps, such as expanded monitoring of local efforts to achieve these statewide goals, to more extreme measures, such as direct intervention in the land-use decision-making process. Below, we offer three modest steps as an initial point of departure:

Collect Information on the State's Performance in Accommodating Growth. As the state adds new residents, the Legislature could direct state agencies to gather information on how well this growth is being accommodated. This could be accomplished to some extent by strengthening existing state agency review functions. For example, under state law, HCD is required to review draft local housing elements and is authorized to review final elements. The HCD is not required, however, to summarize its findings in any report to the Legislature. The HCD could be required to review *final* housing elements and analyze (1) the extent to which local housing elements comply with state law (2) the effectiveness of local actions to promote housing, and (3) the extent to which the sum of the units of housing called for in the local elements will meet the expected need for housing in each region and statewide.

Similarly, the Legislature could amend the California Clean Air Act to require that local air districts comment in their existing three-year plans as to local governments' cooperation with air district pollution abatement efforts. For example, local air districts could comment as to whether (1) local general plans ensure a balance of jobs and houses, (2) new developments are added to the city in a manner which will minimize auto usage, and (3) local parking policies are consistent with regional efforts to promote ride-sharing and transit use. The Air Resources Board could report to the Legislature on the local air districts' comments.

Coordinate State Activities Related to Growth. The Legislature could improve the coordination of state activities related to growth. For example, the Legislature could establish a formal role for the state Air

Resources Board and local air districts in the annual State Transportation Improvement Program process. Also, the Legislature could again enact legislation establishing a comprehensive multi-year capital outlay plan. This plan would ensure that the state has a central process for identifying state infrastructure needs, establishing priorities and developing financing plans. (Such a plan was approved by the Legislature in 1988, but was vetoed by the Governor.)

Develop a Statement of Overall Goals and Policies. While the state requires that cities and counties develop general plans to guide land-use decision making, the state itself has no such document. State goals, policy statements and objectives are scattered throughout state statutes. The primary objectives of a state planning document would be to identify where:

- Conflicts exist between current goals and objectives;
- Additional goals or objectives should be added; and
- Impediments to the achievement of these goals and objectives exist.

In 1970, the Legislature took a step toward addressing the need for a coherent statement of overall state goals and policies when it specified that the Governor's Office of Planning and Research (OPR) should develop and maintain a comprehensive *Environmental Goals and Policy Report* and transmit it to the Legislature every four years. The Government Code specifies that the report is to identify the state's objectives for land use, population growth, development, transportation, conservation and other matters. The OPR submitted a report to the Legislature in 1978, but has not prepared a document since that date. The Legislature may wish to specify in the *Supplemental Report of the 1989 Budget Act* that the OPR shall develop the *Environmental Goals and Policy Report* in the budget year.

CONCLUSION

The state already faces many significant challenges in accommodating its *current* population. The challenges posed by the state's *future* population are even more complex and demanding. Many difficult changes will be needed for California to comfortably accommodate the coming population growth. While the actual changes could take many forms—from road pricing to expanded regional decision-making to new state incentives for cities and counties—it is critical that the Legislature and the Executive Branch begin working on these changes now.

Implementing the California Clean Air Act

How Can the Legislature Ensure That Planning Required by the California Clean Air Act Results in Improved Air Quality?

Summary

- *Despite having one of the most stringent air pollution control programs in the nation and making significant improvements in air quality since the early 1970s, California still has the country's worst air quality. Many areas of the state, including most urban areas, fail to meet both federal and state air quality standards.*
- *The deadline for complying with federal air quality standards expired in 1988 with many areas of the state out of compliance. The continued federal role in achieving air quality goals is currently in question. As a result, the Legislature stepped in and passed the California Clean Air Act (CCAA) and a number of other related pieces of legislation aimed at strengthening state and local efforts to improve air quality.*
- *The CCAA establishes a mandate, independent of the federal Clean Air Act, to bring all areas of the state into compliance with state air quality standards. Specifically, the act (1) establishes a district-level planning process overseen by the state Air Resources Board (ARB) and (2) increases both state and air district regulatory authority.*
- *Our review of the CCAA planning process suggests that negative air quality effects from land use and transportation planning decisions at the local level are likely to limit the extent to which the CCAA actually results in cleaner air.*
- *In order to ensure that the planning process required by the CCAA results in effective action at the state and local level, we recommend that (1) air districts be given a greater role in local and regional transportation and land use planning processes, (2) the Legislature consider options to expand air districts' authority to implement local land use and transportation control measures, and (3) that legislation be enacted giving all districts the authority to assess motor vehicle registration surcharges.*

Introduction

In the last year, the Legislature has taken many significant steps to address increasingly severe air pollution problems throughout the state. By passing the most far-reaching of these laws, the California Clean Air Act, the Legislature acted to develop a comprehensive planning process to address California's air pollution problems. This new statewide process, which requires the active participation of several levels of government, fills the planning and regulatory gap created when deadlines for complying with air pollution standards under the *federal* Clean Air Act expired in August 1988.

In this analysis we describe the continuing air pollution problem that besets many areas of the state. We then discuss the California Clean Air Act, which seeks to clean up the state's air within 20 years. Finally, we offer some options and recommendations for increasing the likelihood that California will actually meet that goal.

Background

California exceeds all other parts of the country in terms of both the number of days and the amount by which the state violates federal air pollution standards. Federal standards establish emission levels for specific pollutants (known as "criteria pollutants"), including ozone, carbon monoxide, nitrogen dioxide, sulfur dioxide, lead, and small particulate matter (known as "PM-10"). (A federal PM-10 standard was only recently set by the Environmental Protection Agency (EPA); consequently, we will not address compliance with the PM-10 standard in this analysis.) Under the federal Clean Air Act, states may not exceed the standards for criteria air pollutants after 1988. Other pollutants that pose potential risks to California's air quality are not regulated by the federal government as criteria pollutants. These "noncriteria pollutants" include toxic air contaminants, acid deposition (such as acid rain), and other emissions for which federal standards have not been established.

To date, the state's air pollution control program has been directed toward bringing the state into compliance with federal standards, as required by federal law. For some pollutants, such as ozone, the state has set more stringent standards than the federal government. In the past, however, state law did not require compliance with state standards by specific dates.

To meet these standards, California has used several approaches to control emissions. For instance, cars must have specific types of on-board equipment, such as catalytic converters, and must be inspected periodically to ensure that emissions do not exceed permissible levels. Stationary sources of pollutants, such as manufacturing industries, must demonstrate the ability to comply with emissions limits before receiving an operating permit. In general, measures adopted by the state have required specific pollution control steps rather than providing individuals with economic incentives to reduce pollution.

As a result of these regulatory actions, the state has successfully complied with some emissions standards. Chart 1 shows that high-emissions areas of the state now are in compliance with both the federal standard and the more stringent state standard for sulfur dioxide. Sulfur dioxide reductions have resulted from both emission control measures and economic changes, such as relocation of high-emitting industries to other areas or other states.

Chart 2 illustrates the compliance history of these same four areas with regard to lead emissions. As the chart shows, the areas have lowered lead emission levels dramatically since 1976, and today all are in compliance with the federal standard for lead emissions. This reduction in lead emissions largely resulted from requirements for the use of unleaded fuel in newer vehicles.

Despite control efforts, however, several parts of the state have not been able to comply with the criteria pollutant standards for ozone, carbon monoxide and nitrogen dioxide. Chart 3 shows that 25 areas of the state exceed federal standards for one or more of these pollutants, and thus have been designated as "nonattainment areas" by the EPA.

Since the 1970s, various patterns have emerged in different parts of the state for these three pollutants:

- ***Ozone.*** Levels of ozone have not decreased markedly in most nonattainment areas. The South Coast region of the state has shown a general decline, while many regions have stayed at relatively stable levels. In some areas, such as the southern San Joaquin Valley, ozone levels have increased somewhat over time.
- ***Carbon Monoxide.*** Reductions in carbon monoxide emissions have been dramatic. The South Coast region has reduced the number of days that standards are exceeded tenfold since the early 1970s, although it still experiences levels greater than any other in the state and is significantly out of compliance with federal standards. The only area which has not shown a steady decline in carbon monoxide emissions is the Sacramento area.
- ***Nitrogen Dioxide.*** The only area of the state that is still not in compliance with nitrogen dioxide standards is the South Coast region. While most parts of the region are in compliance, some urban areas still do not meet the standard.

Why Has It Been Difficult for the State to Meet Federal Standards for Some Pollutants?

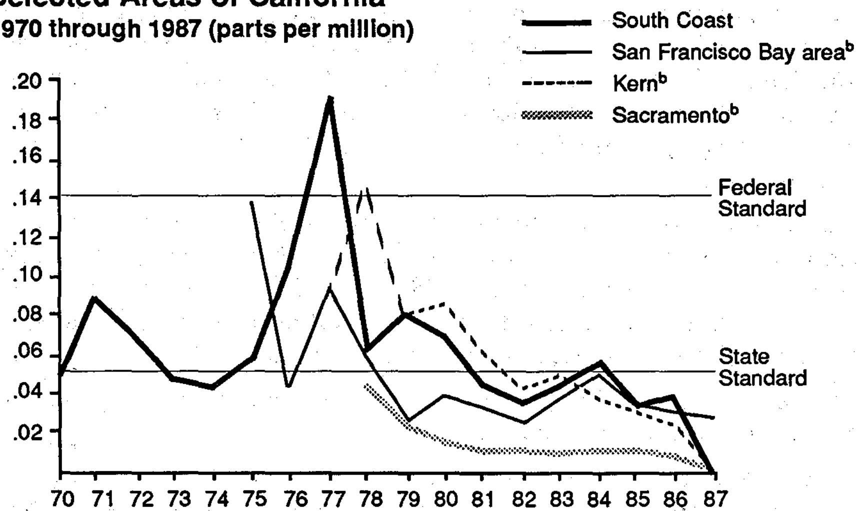
There are three primary reasons why air pollution is more severe in California than elsewhere and why it is difficult to meet federal and state standards for various air pollutants.

Weather and Topography. The climate and topography of many regions of the state work together to maximize exposure to—and the formation of—air pollutants. Because several areas of the state form basins, they have static or trapped air patterns which increase exposure

Chart 1

Attainment of Sulfur Dioxide Standards Selected Areas of California[a]

1970 through 1987 (parts per million)

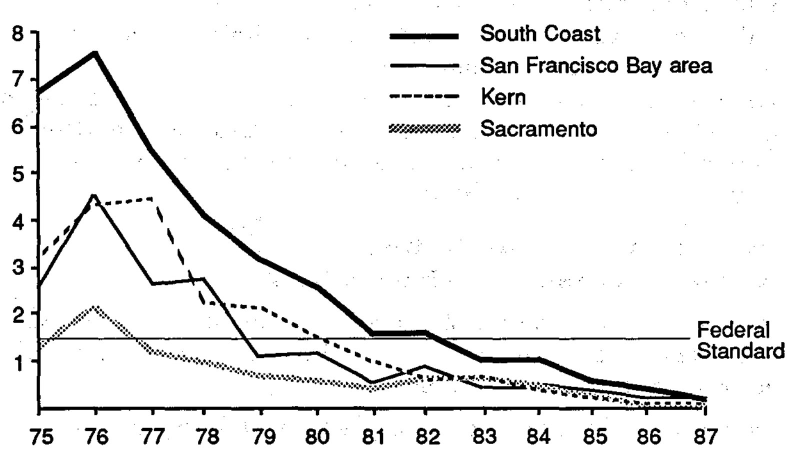


[a] Source: ARB. Data represent the year's maximum 24-hour average.
[b] Years shown are those in which reliable data is available.

Chart 2

Attainment of Federal Lead Standard Selected Areas of California[a]

1975 through 1987 (micrograms per cubic meter)



[a] Source: ARB. Data represent maximum quarterly average lead concentration.

Chart 3

California Counties Exceeding Federal Air Pollution Standards

January 1989

	AREA	Ozone	Carbon Monoxide	Nitrogen Dioxide
SAN FRANCISCO BAY AREA	Alameda	●		
	Contra Costa	●	◒	
	Santa Clara	●	◒	
	Solano	●	◒	
SOUTH CENTRAL COAST	Santa Barbara	◒		
	Ventura	●		
SOUTH COAST	Los Angeles	●	◒	◒
	Orange	●	●	●
	Riverside	◒		◒
	San Bernardino	◒		◒
SAN DIEGO	San Diego	●	●	
SACRAMENTO VALLEY	Butte	◒	●	
	Placer	●	◒ [a]	
	Sacramento	●	◒	
	Yolo	●		
	Yuba	●		
SAN JOAQUIN VALLEY	Fresno	●	◒	
	Kern	●		
	Kings	●		
	Madera	●		
	Merced	●		
	San Joaquin	●	◒	
	Stanislaus	●	◒	
SOUTHEAST DESERT	Imperial	●		
MOUNTAIN COUNTIES	El Dorado	●	◒ [a]	

● Does not meet standards

◒ Urban areas do not meet standards

[a] Lake Tahoe Basin area.

to pollutants. In addition, California's weather, with a high proportion of sunny days, contributes to the formation of some pollutants. Ozone, a principal component of smog and one of the most significant pollution problems in the state, is formed by sunlight reacting with "smog precursors," gases (such as carbon dioxide) emitted from motor vehicles.

Population Growth. California has experienced extremely rapid growth, increasing by almost 16 million people since 1960. Current Department of Finance projections indicate that an additional 8.3 million people will live in California by 2010. Population growth affects the amount of pollution in three ways: (1) emissions increase from both manufacturing (primary) industries and the secondary service industries that support them and the workforce; (2) emissions from household and consumer products, such as paint or hair-care products, increase; and (3) emissions increase due to the greater use of automobiles (see below). As long as the state's population continues to grow, efforts to control and reduce air pollution will be partially offset by increasing emissions from more sources.

Automobile Use. Partly as a result of increasing population and partly due to changes in where Californians live in relation to where they work, emissions from automobiles have not decreased as rapidly as those from stationary sources. While the total amount of smog agents emitted from automobiles and other motor vehicles *decreased* from 1979 to date, state experts expect the amount to *rise* again after 2000. This is primarily because the number of miles traveled by motor vehicles is expected to increase by 5 percent annually. In addition, increasing congestion on roadways leads to much higher emissions from individual vehicles because cars do not burn fuel as completely at decreased operating speeds.

What Is the Federal Role in Regulating Air Pollution in California?

Under the federal Clean Air Act of 1977 and a subsequent congressional extension, states were required to submit to the EPA air pollution control plans developed by local air districts that would ensure compliance with *federal* standards for ozone and carbon monoxide by August 31, 1988 (plans for nitrogen dioxide—NOx—were required in 1982, and deadlines were not extended). The EPA's review of state plans placed areas that did not meet federal standards by the deadline into two categories: (1) potentially sanctioned areas and (2) other nonattainment areas.

Potentially Sanctioned Areas. The EPA is only required to take action, such as imposing sanctions, against those areas which *knowingly did not include sufficient measures to meet* standards by August 1988. Four areas of the state (the South Coast region, Ventura County, Fresno County, and Sacramento County) submitted plans that contained measures to control emissions to the maximum extent the districts considered feasible, but that would not result in compliance with federal standards by 1988. In these areas, the EPA is required to take some action to ensure achievement of federal air quality standards.

Other Nonattainment Areas. The other areas of the state that did not manage to meet federal standards by 1988 submitted plans to the EPA that included measures which *they thought would meet* standards by the deadline. These areas will be required to submit new plans to the EPA that demonstrate compliance within three to five years, but will not be subject to sanctions at this point.

The EPA Approach to Sanctions. For potentially sanctioned areas, the EPA is required to impose a ban on construction of facilities—such as large refinery complexes—that would emit more than 100 tons per year of hydrocarbons, volatile organic compounds (such as gasoline vapors), or carbon monoxide. To date, the EPA (under court order) has imposed the construction ban on the South Coast, Ventura, and Sacramento areas. (This sanction is not especially significant in that few, if any, facilities of this size are planned in the state in the foreseeable future, largely because of existing air pollution control restrictions.) In addition, the EPA has other, discretionary sanctions that it could impose on these areas. At present, the EPA's general approach appears to be to avoid imposing sanctions on a district so long as the district and state continue their efforts to resolve the air quality problem.

What Does the California Clean Air Act (CCAA) Require State and Local Agencies to Do to Achieve Air Quality Goals?

With many areas of the state out of compliance with federal air quality standards, the expiration of the federal Clean Air Act deadline has resulted in uncertainty. This uncertainty is caused by (1) concern over the future direction of EPA actions and (2) the possibility of congressional amendments to the federal act. Because the state's air pollution control efforts were driven by the federal process, this uncertainty resulted in a void in California's efforts to improve air quality.

The Legislature took the initiative by enacting a number of significant pieces of air pollution legislation. In the area of criteria air pollutants, the most significant piece of legislation enacted was Ch 1568/88 (AB 2595—Sher), known as the California Clean Air Act (CCAA). This and other significant legislation relating to criteria air pollutants are summarized in Chart 4. (The chart does not include enacted legislation relating to noncriteria pollutants, such as toxic "hot spots" and acid rain).

The California Clean Air Act establishes a mandate, *independent of the federal Clean Air Act,* for state and local government agencies to clean up California's air. Under the federal system, specific deadlines were established for meeting federal air quality standards and the states and

Chart 4

Summary of Major Air Pollution Legislation Enacted During the 1987-88 Legislative Session

California Clean Air Act

Chapter 1568/88 — Assembly Bill 2595 (Sher)

This act establishes a stand alone state air pollution control program. The act establishes a planning process overseen by the ARB and provides additional regulatory authority to both the ARB and Air Pollution Control Districts.

Smog Check Program

Chapter 1544/88 — Senate Bill 1997 (Presley)

This act both extends and expands the Smog Check Program administered by the Bureau of Automotive Repairs.

State Agency Ridesharing

Chapter 1435/88 — Senate Bill 2723 (Seymour)

This act requires state agencies to develop flex-time and ridesharing programs and creates a loan and grant program under the Department of Transportation to establish vanpools.

Expanded Authority for Local Air Pollution Control Districts

Chapter 1596/88 — Assembly Bill 3971 (Cortese)
Chapter 1541/88 — Assembly Bill 4355 (Connelly)
Chapter 1546/88 — Senate Bill 2297 (Rosenthal)
Chapter 1301/87 — Senate Bill 151 (Presley)

These four acts expand the Bay Area (Chapter 1596), Sacramento (Chapter 1541), and South Coast (Chapter 1546 and 1301) air districts' regulatory authority over mobile and indirect sources of air pollution.

local governments were to determine how to meet those deadlines. In the past, California's air pollution program focused primarily on (1) requirements for on-board air pollution control equipment for passenger vehicles and (2) local regulation of large stationary sources of pollution.

The CCAA makes three fundamental changes to California's air pollution program: (1) it establishes the *state's* existing air quality standards as the goals to be met, (2) it creates a new process to plan and implement these goals, and (3) it gives air pollution control districts (APCDs) and the state Air Resources Board (ARB) greater regulatory authority and enhanced funding in order to better achieve the act's goals.

New Goals and Requirements. The goals established by the CCAA differ significantly from the federal act in three ways. First, air districts must meet *state* air quality standards, which generally are *more* stringent than federal standards. Second, the CCAA classifies nonattainment districts into three different categories—moderate, serious and severe—each with different compliance timeframes and progressively more stringent requirements. Third, the CCAA requires that all nonattainment districts demonstrate annual reductions in excess emissions of nonattainment pollutants of *at least 5 percent.* Under the federal act there was no requirement to demonstrate annual reductions in emissions, only that the states be in compliance with the federal standards by 1988.

Chart 5 shows the specific goals and requirements placed on APCDs by the CCAA.

Chart 5

The California Clean Air Act Requirements For Non-Attainment Districts

ALL NON-ATTAINMENT DISTRICTS

General Requirements
- Meet emissions reductions goal of 5% per year.
- Upgrade emissions inventory.
- Upgrade public education program.
- Mitigate air pollution transported to other districts.

Mobile Source Requirements
- Require adoption of all reasonable available transportation control measures.
- Develop transportation control program.

Indirect/Area Source Requirements
- Develop area and indirect pollution control program.

MODERATE NON-ATTAINMENT DISTRICTS

General Requirements
- Attain state standards by December 31, 1994.

Stationary Source Requirements
- No increases in emissions from permitted stationary sources emitting more than 25 tons per year.
- Require reasonable available control technology on all permitted sources of pollution.

SERIOUS NON-ATTAINMENT DISTRICTS

General Requirements
- Attain state standards by December 31, 1997.

Stationary Source Requirements
- No increases in emissions from permitted stationary sources.
- Require best available retrofit control technology on all permitted sources of pollution.

Mobile Source Requirements
- Substantially reduce the rate of increase in the number of passenger trips and vehicle miles traveled.

SEVERE NON-ATTAINMENT DISTRICTS

General Requirements
- Meet emissions reduction goal of 5% per year plus 25% per capita reduction by 1995, 40% by 1998, and 50% by 2001.

Stationary Source Requirements
- No increases in emissions from permitted stationary sources.
- Require best available retrofit control technology on all permitted sources of pollution.

Mobile Source Requirements
- Substantially reduce the rate of increase in the number of passenger trips and vehicle miles traveled.
- Increase commuter ridership to 1.5 persons per vehicle by 1999.
- No net increase in vehicle emissions after 1997.
- Develop measures for low emissions automobiles.

The Planning and Implementation Process under the CCAA. As with the federal Clean Air Act, the CCAA requires air districts to develop air pollution control plans. The CCAA, however, requires air districts to include elements in their plans not required previously under the federal program. These include (1) emission reductions from a wide variety of sources—mobile sources, indirect sources (facilities like shopping centers that attract cars or other sources of pollution) and area sources (multiple, nonspecific sources of pollution such as agricultural burning and use of consumer products like aerosols)—that previously were not regulated by districts, and (2) contingency measures to be implemented if the plan fails to meet the requirements of the act. In addition, the CCAA institutes an ongoing approach to planning, requiring APCDs to update their plans for compliance with air quality standards every three years.

The ARB is the state agency responsible for implementation of the CCAA. Among other things, it is responsible for reviewing and approving all district plans. Once a district plan is approved by the ARB, the district must adopt the individual regulations and control measures necessary to implement the plan. The ARB is responsible for overseeing this implementation and ensuring that the individual regulations are adopted and enforced. Toward this end, ARB enforcement options include (1) requiring districts to implement contingency measures, (2) withholding state funding to districts for pollution abatement activities, and (3) taking over a district's program and implementing a plan on behalf of the district. In addition to approving and overseeing the implementation of district plans, the CCAA requires the ARB to adopt *more stringent* air pollution control standards for products sold in California that it currently regulates, such as motor vehicles and motor vehicle fuels, and adopt *new* standards for many consumer and other products it does not currently regulate.

New Regulatory Authority Granted by the CCAA. The CCAA and related legislation give both the ARB and air districts significant new authority to regulate previously unregulated sources of air pollution. As shown in Chart 6, new laws enacted during the 1987-88 legislative session grant the state—through the ARB—additional authority to (1) set product standards for most consumer products, (2) set product standards for previously unregulated mobile sources of pollution (off-road vehicles, marine vessels, construction equipment, etc.), (3) assess certification fees

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Chart 6

Air Pollution Control Regulatory Authority By Level of Government Before and After the 1987-88 Session

	ARB		LOCAL	
MAJOR EMISSION SOURCES	**BEFORE**	**AFTER**	**BEFORE**	**AFTER**
MOBILE SOURCES				
Passenger vehicles[a]	Set standards	Set more stringent standards Assess fees on motor and vehicle manufacturers	None	Regulate use Require rideshare programs Assess motor vehicle registration surcharge fee[b]
Medium and heavy trucks	Set standards	Set more stringent standards Roadside inspection program	None	Regulate use
Motor vehicle fuels	Set standards	Set more stringent standards	Vapor recovery program	Vapor recovery program
Other mobile (trains, construction equipment, marine vessels, etc.)	None	Set standards Regulate use	Varies by type	Varies by type
STATIONARY SOURCES[c] (Factories, refineries, etc.)	Fee authority for specific programs	Expanded fee authority	Regulate emissions Permit authority Fee authority	Regulate emissions Permit authority Fee authority
INDIRECT SOURCES[c] (Office complexes, retail malls, etc.)	None	None	None	Regulate emissions Fee authority
AREA SOURCES[d] Consumer products[e]	None	Set standards	Set standards	None

[a] In addition, the Department of Consumer Affairs runs the Motor Vehicle Inspection and Maintenance (smog check) program.
[b] Only the South Coast and Sacramento air districts have the authority to assess this fee.
[c] In addition, local governments have land use authority to plan, permit, regulate and site land developments.
[d] Include many sources other than consumer products, such as house paints, agricultural burning, pesticide use, and other small sources of pollution.
[e] Under the CCAA, APCDs are prohibited from adopting standards different than the ARB until 1994.

on motor and vehicle manufacturers, and (4) assess fees on stationary sources of pollution.

In addition, the CCAA grants air districts new authority to (1) control the use of mobile sources, (2) regulate indirect sources of pollution, such as office complexes and shopping centers, and (3) assess fees on indirect sources which are regulated but for which permits are not issued.

The CCAA Requires Development of New Control Measures. The CCAA will result in districts and the ARB developing a new array of measures to control pollution because it requires (1) the implementation of transportation control measures in all nonattainment districts, (2) no net increase in emissions from new or modified stationary sources in moderate and severe nonattainment areas, and (3) a 5 percent annual reduction in emissions.

Unlike many other parts of the country, California has already implemented many stringent control measures, so that there are very few, if any, "quick fixes" left to reduce air pollution emissions in the state. In general, in order to achieve the act's air quality goals, future control measures will need to (1) squeeze an additional increment of reductions from sources already under some degree of control (such as cars and factories), (2) reduce emissions that previously were not regulated (such as consumer products, diesel engines, and construction equipment), and (3) alter individuals' behavior either through direct regulatory intervention or by providing individuals with incentives to reduce pollution (for example, the use of diamond lanes or the encouragement of flexible work schedules to reduce traffic congestion). Incentive programs might affect how much people drive, or where they choose to shop, live and work.

HOW CAN THE LEGISLATURE ENSURE THAT THE PLANNING PROCESS RESULTS IN ACHIEVEMENT OF AIR QUALITY GOALS?

The CCAA provides a new set of goals for APCDs and the ARB in achieving air pollution reductions. These goals include specific annual percentage reductions in air emissions and require the implementation of specific types of control measures. In our view, the CCAA is an important step in bringing about significant reductions in air pollution. To ensure achievement of air quality goals, however, the Legislature should consider taking further steps. These steps would involve increasing the degree of coordination among the various agencies involved in planning at the local level, and improving the ability of districts to implement programs that can accomplish the goals set by the CCAA.

Goals of Local Agencies Should Be Integrated in the Planning Process

We recommend that the Legislature expand the role of air pollution control districts in local land use and regional transportation planning in order to enhance coordination between districts and other local and regional governmental agencies.

Both transportation and land use planning decisions affect the achievement of air pollution control goals, but neither planning process is closely coordinated with air pollution control plans. The goals of different local planning agencies, including APCDs, may conflict, decreasing the effectiveness of the planning process.

Land Use Planning. The role of air districts in land use planning is very limited. Air districts have no formal role in reviewing city and county general plans—the major vehicle for land use planning decisions. In fact, there is not even a requirement that city or county general plans address air quality by including an air quality element. As a result, local decisions concerning the siting of facilities such as office buildings, shopping centers, and industrial parks are made outside the purview of the APCD, even though such facilities are potential indirect sources of air pollution because they attract automobiles.

When local agencies site these facilities, their decisions often reflect local fiscal priorities that rank commercial and industrial development higher than residential development. This can result in local growth patterns in which insufficient housing for the needed workforce is available near industrial and commercial growth centers. As a consequence, individuals may live far from their work, increasing the length of commuting trips. This in turn, increases vehicle miles traveled and traffic congestion, both of which worsen air quality. The CCAA directs air districts to consider controlling indirect sources of pollution, but does not clarify how differing goals of local planning agencies should be balanced when in conflict.

Transportation Planning. Under the CCAA, districts classified as serious or severe nonattainment areas are required to substantially reduce the rate of increase in passenger vehicle trips and in miles traveled per trip. In order to meet this requirement, changes in the way we use automobiles will be necessary. In the past, however, air districts and the ARB have played only a small role in the transportation and land use decisions that have a direct impact on traffic congestion, travel patterns and automobile use. For instance, air districts have no formal role in the regional transportation improvement planning process—including both the development of the longer-term Regional Transportation Plans (RTPs) and the shorter-term program of projects contained in the Regional Transportation Improvement Programs (RTIPs). Similarly, the ARB has no formal role in the development of the State Transportation Improvement Program (STIP) adopted annually by the California Transportation Commission. The plans reflected in the RTPs and the projects to implement these plans contained in the RTIPs and STIP have broad implications for future emissions from motor vehicles.

If substantial gains in air quality are to be made, air quality goals need to be reflected in the planning process for siting of industrial and commercial concerns and transportation projects. Currently, coordination often is lacking between land use and transportation planning agencies and the air pollution control district. As a result, air quality goals are not integrated with other local planning efforts. In order to better facilitate the inclusion of air quality goals within broader local and state planning concerns, we recommend that the Legislature (1) require that local general plans include an air quality element and (2) specify that local general plans and plan amendments be consistent with the APCD air quality attainment plans. In addition, the Legislature should consider requiring air districts to review and comment on RTPs and RTIPs, and the ARB to review and comment on the STIP, as a way of promoting consistency between transportation and air quality goals.

Legislative Options to Improve Districts' Ability to Implement Air Quality Measures

The CCAA has increased APCD authority over some sources of air pollution, but as discussed above, APCDs have only a limited and often informal role in local land use and transportation planning decisions. Moreover, they have no permitting authority over *new* developments or transportation projects, and little or no authority over the operation of *existing* transportation systems or indirect sources of pollution. As a result, general authority granted to air districts by the CCAA to (1) regulate or decrease emissions from indirect sources and (2) affect the use of motor vehicles, may be ineffectual unless strengthened.

There are at least three options available to strengthen the ability of APCDs to implement effective control measures on indirect and mobile sources of pollution.

Explore Methods to Give APCDs Increased Authority over New Projects and Operation of Existing Projects. Districts could be given greater regulatory authority over local facilities and transportation projects. For example, the Legislature could expand the number and types of local projects which are subject to APCD permit requirements. This approach would ensure that air quality goals are considered in siting and operating decisions. The major disadvantage of this option is that it could result in delays in projects because a new level of government would be interjected into the permitting process.

Better Integrate Decision-Making Roles of Local Government Agencies. As we discussed earlier in "Accommodating California's Growth," a single body could be charged with the responsibility for approving city and county general plans, and given the authority to veto major land use decisions. This would allow better coordination of these decisions with air quality objectives. Alternatively, if an adjudicatory body were established, conflicts between local agencies could be resolved.

Greater Use of Economic Incentives—or Disincentives—to Get Polluters to Modify Their Behavior. Generally, APCDs have little ability to implement pricing programs that make citizens and businesses face the economic costs of their decisions. Such programs might include mileage charges for automobile use, or tax incentives to locate indirect source facilities so as to minimize air quality impacts.

Legislature Needs to Be Informed about Progress in Achieving Air Pollution Goals

We recommend that the Legislature amend the CCAA to require (1) air districts to include an analysis of the impact of land use and transportation decisions on district programs and air quality in their three-year plan reviews and (2) the ARB to report these findings to the Legislature.

Because local land use decisions may impinge on meeting air quality goals, the Legislature needs to know if it should consider taking further action to strengthen compliance efforts. However, the extent to which district compliance problems result from local agency decisions on land use and transportation projects is not known. While the CCAA requires APCDs to review their plans every three years to correct deficiencies, it does not require districts to identify in their plans the extent to which problems in achieving air quality objectives were due to factors outside their control, but within the control of local land use or transportation planning agencies. Although the ARB is required to report to the Legislature on expenditures of fees collected and on the funding of large APCDs, there is no requirement to report on overall progress towards meeting state standards, or to identify the extent that local land use and transportation decisions affect air quality.

In order to ensure that the Legislature is informed concerning the air quality impacts of transportation and land use decisions, we recommend that districts be required to include in their three-year plans an analysis of the impact of land use and transportation decisions on district programs and air quality, and that the ARB report these findings to the Legislature. We recommend that the ARB include in its report (1) an assessment of the extent that local land use and transportation decisions prevent districts from meeting the goals of the CCAA, and (2) specific legislative options to address this problem. If the report indicates that localities are not acting in a manner consistent with regional air quality goals, the Legislature may wish to consider further options to more closely integrate air quality objectives into local planning processes.

Drivers Should Help Pay for District Programs

We recommend that legislation be enacted extending the authority to assess motor vehicle registration surcharges to all air pollution control districts.

In the past, air pollution control district programs have focused primarily on stationary sources, and fees charged to these sources have paid for district regulatory costs. Now, however, the CCAA authorizes districts to broaden their scope of regulation to include transportation control measures and indirect sources. As a result, APCDs will incur costs to regulate cars and their use.

The CCAA authorized APCDs to increase fees on stationary sources and assess new fees on regulated indirect sources of pollution. In addition, Ch 1546/88 and Ch 1541/88 gave the South Coast and Sacramento air districts the authority to assess surcharges of $1 and $4, respectively, on motor vehicle registrations to support alternative fuel, indirect source and mobile source programs. The authority to assess a vehicle registration surcharge was not extended, however, to other APCDs. As a consequence, in most districts drivers still will not pay the costs of district air pollution control programs aimed at regulating the use of automobiles.

In our view, automobile users should pay for district regulatory costs related to automobile use. Consequently, to ensure that the cost of air district regulatory programs are borne by all of the regulated community, we recommend the Legislature enact legislation to give all districts the authority to assess motor vehicle surcharges similar to the authority granted to the South Coast and Sacramento districts during the past legislative session.

Conclusion

The CCAA represents a major new effort by the state to meet air quality goals within a 20-year timeframe. As a first step, it requires that the state and air pollution control districts develop plans for meeting air quality objectives. In addition, it grants new authority to the districts and the ARB to strengthen regulatory efforts related to sources of air pollution that they already regulate, and it extends to the districts and the ARB the authority to regulate some sources of pollution that previously have not been regulated. The CCAA, however, does not provide for a process that balances or integrates air quality objectives with other local planning goals and land use decisions. This will limit the ability of districts to achieve the CCAA's air quality goals.

In order to enhance the ability of air districts to actually meet air quality goals, we recommend that the Legislature, among other things, increase air district and ARB participation in land use and transportation planning at the state and local level, and consider options to increase the ability of districts to effectively reduce emissions.

Solid Waste Management in California

Is California Facing A Solid Waste Management "Crisis"?

Summary

- *Current fees for waste disposal in California are relatively low. Future disposal costs are likely to escalate some, but increases affecting residential and commercial waste generators will probably be relatively small.*
- *Fees charged for trash collection and disposal often do not reflect the full cost of providing collection and disposal services. As a result, there is little economic incentive to reduce the volume of waste or to recycle waste.*
- *State law requires counties to plan on an ongoing basis for the provision of disposal capacity sufficient to last at least eight years. Most counties either already have or will soon develop additional capacity in order to comply with this requirement. Some counties, however, face short-term shortages of disposal capacity due in large part to public opposition to constructing new facilities.*
- *Despite prohibitions against it, household hazardous waste is often disposed of in municipal garbage. If these materials are not sorted out of the waste stream, or if disposal facilities are not designed to handle such wastes, the result may be water contamination or air pollution.*
- *Despite these concerns, our review indicates that there is no "crisis"—either in terms of cost or landfill availability—in the state's waste management system.*
- *However, in order to address certain existing problem areas and improve the state's solid waste management system, the Legislature can take steps to:*
  - *(1) Ensure that local governments impose fees for waste disposal that reflect all applicable costs.*
  - *(2) Assist counties in facility siting decisions.*
  - *(3) Minimize the potential environmental threats of disposal operations.*

Californians discard an average of about 7.5 pounds of various materials per person each day. This amounts to more than 38 million tons of waste each year, enough to fill 80 football stadiums with trash 100 feet deep. There appears to be a widespread perception that this mountain of waste is about to bury the state and bankrupt it in the process. In contrast to this perception, the available evidence indicates that, although there are problems with the existing solid waste management system, in general the waste we produce can be disposed of safely and at relatively low cost.

This analysis attempts to put the status of waste management in California into perspective and focus discussion on those problem areas that do need attention. We first provide background information on the structure of the solid waste management system. Next, we evaluate how well the existing system is working. Then, we briefly outline specific actions the Legislature can take to address problems with the existing waste management system.

Background

In California, responsibility for solid waste management is divided between the state and local governments. The state is responsible for developing general solid waste management policies and guidelines. Cities and counties manage the collection systems and disposal facilities needed to dispose of the waste produced in their jurisdictions.

The California Waste Management Board (CWMB) is the lead state agency responsible for developing and implementing state-wide solid waste management policy. The board:

- Sets minimum standards for handling solid waste and operating waste disposal facilities,
- Reviews waste disposal facility operating permits issued by local enforcement agencies (LEAs) to ensure compliance with state standards,
- Conducts oversight inspections of waste handling facilities to ensure effectiveness of LEAs,
- Approves landfill closure and postclosure maintenance plans,
- Approves county solid waste management plans, and
- Evaluates and promotes new waste management strategies.

In addition to the CWMB, other state entities conduct a variety of activities related to solid waste. For example, the Department of Conservation manages the Beverage Container Recycling Program, the State Water Resources Control Board monitors potential groundwater contamination caused by landfills, the Air Resources Board and local air districts enforce air pollution standards that apply to landfills and waste-to-energy facilities, and the Energy Commission evaluates the energy market impact of large scale waste-to-energy proposals.

In contrast to the general policy setting responsibilities conducted at the state level, local governments are responsible for "hands on" waste management activities such as:

- Operating or contracting for waste management facilities and services within their jurisdiction,

- Issuing operating permits to private entities for waste handling facilities,
- Setting rates for trash disposal services provided within their jurisdictions, and
- Designating local enforcement agencies (generally county health departments) and setting fees to cover the cost of enforcement activities.

To help ensure that solid waste management activities are adequately planned and coordinated, the state requires each county to develop and implement a comprehensive county solid waste management plan (CoSWMP). The CoSWMP must include:

- A schedule of the combined capacity of existing solid waste facilities available to the county;
- A plan for maintaining disposal capacity sufficient to last at least 8 years;
- Plans, including an implementation schedule, detailing how the county will recycle at least 20 percent of its solid waste; and
- An analysis of the economic feasibility of the plan, including the cost of waste disposal in the designated jurisdiction.

The CoSWMP must first be approved by the city councils of a majority of the cities containing a majority of the county's population, and then must be approved at the county level. A CoSWMP must also be approved by the CWMB to ensure that the plan satisfies applicable state laws and regulations. Counties are required to update their CoSWMPs at least every three years.

There are 389 landfills, 245 transfer stations (facilities where waste is transferred from the collection truck to a tractor/trailer rig or train for long-distance hauling) and two waste-to-energy facilities currently operating in California. More than half of the 38 million tons of waste produced annually in California is disposed of in the state's 10 largest landfills. In addition to the 389 operating landfills, there are approximately 1,800 closed landfills that no longer accept waste. The range of problems associated with closed landfills varies considerably. Some closed landfills have few, if any problems, and are now used for such purposes as golf courses. Other closed landfills have created such serious problems that they have been listed by the Environmental Protection Agency as federal Superfund toxic waste sites.

HOW WELL IS CALIFORNIA'S SOLID WASTE MANAGEMENT SYSTEM WORKING?

Economic and environmental considerations are the underlying subjects in much of the recent media attention on solid waste issues, with particular emphasis given to the subject of landfills. The conclusions often drawn in the media are that (1) landfills are a cause of environmental problems, (2) landfill space is rapidly disappearing throughout the country, and (3) the scarcity of landfill space is likely to cause significant price increases for trash disposal services. Our analysis indicates, however, that—at least in California—the situation is not as serious as is being suggested by many.

Current Waste Disposal Fees Are Low and Likely to Remain That Way

Currently, charges for waste disposal in California are relatively low when compared to other regions of the country or to other basic services. Table 1 illustrates the fees charged for *residential* trash collection in a sample of local governments throughout the state. As the table shows, the fees for these entities average about $8.35 per month. Fees for *commercial* trash collection are highly variable, depending on the volume of waste, the frequency of collection, the location of collection bins, and the type of trash. In general, however, commercial trash collection is less expensive for a given volume of waste than is residential collection. At the prevailing collection fees, it costs each of us an average of about 20 cents per day to dispose of the waste we generate in activities at home and at work.

Table 1
Residential Trash Collection Fees
In Selected California Cities
December 1988

Local Agency	*Monthly Fee*	*Weekly Volume Limit (gallons)*
Ventura	$11.10	55
Riverside	10.63	32
Sacramento	9.68	32
Thousand Oaks	9.25	45
Oxnard	9.15	105
San Francisco	8.49	32
Oakland	8.15	45
Los Angeles County	7.37 [a]	no limit
San Jose	6.31	no limit
Anaheim	6.11	220
Milpitas	5.65	no limit
San Diego	no fee [b]	no limit
Los Angeles	no fee [b]	no limit
Average	$8.35	

[a] Average cost, based on a range of fees from $5.25 to $9.50 per container.
[b] Trash collection and disposal are supported by city general fund revenues. These cities were not included in the average cost figure.

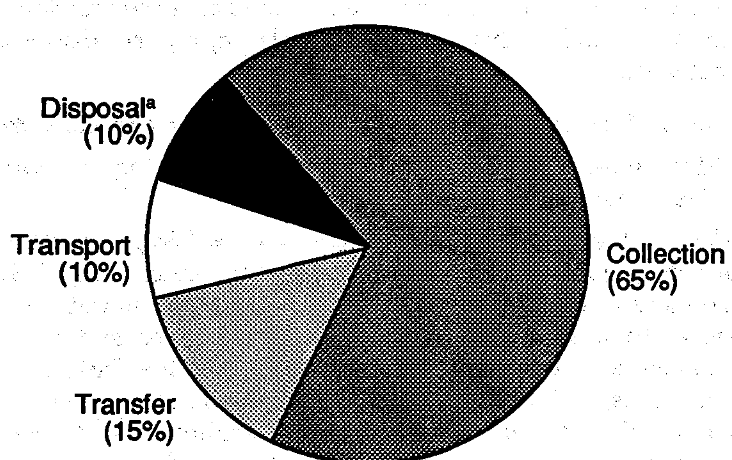
The comparatively small price we pay to dispose of our solid waste is likely to remain relatively low. This is because solid waste management involves numerous activities and the cost of only one of those activities, landfilling, is likely to rise significantly in the near future. Differentiating the various aspects of waste disposal helps to illustrate this point.

After we throw our trash away, it must be (1) collected from the containers on the curb or in the alley, (2) transferred from the collection truck to a tractor/trailer rig or train for long distance hauling, (3) transported to a disposal facility, and (4) disposed of either by burying, burning, or reprocessing (recycling). If waste disposal facilities are reasonably close to the collection area, transfer operations may be unnecessary.

Chart 1 illustrates the percentage of overall costs attributable to these four components, based on the statewide average landfill tipping fee (the charge for dumping materials at the landfill) and estimated average costs for collection, transfer, and transportation. It shows that collecting waste from the curb or alley is by far the most expensive aspect of waste management, accounting for about 65 percent (with costs ranging from 60 percent to 70 percent) of the overall cost of waste disposal. In contrast, the cost of landfilling—at the rates currently prevailing in California—generally contributes only about 10 percent (with a range of 5 percent to 20 percent) of the total cost. Costs for waste transfer operations (which may include the cost of screening for and removing hazardous wastes and/or recovering recyclable materials) make up another 15 percent

Chart 1

Distribution of Solid Waste Management Costs
Average Costs for Selected California Cities
December 1988



[a] Primarily landfilling.

(with a range of 0 percent to 25 percent) of the total cost. The cost of transporting waste to disposal facilities is similar in proportion to landfilling costs—about 10 percent (with a range of 5 percent to 15 percent).

Landfill tipping fees, which in California currently average about $10 per ton, are beginning to increase, due primarily to more stringent environmental regulations. Industry sources estimate that after landfill operators comply with requirements for new environmental safeguards, the cost of landfill disposal will probably level off in the range of $20 to $25 per ton. Increasing land acquisition costs may also push tipping fees up. The impact of land costs on fees, however, is relatively insignificant because the cost of land on which to build a landfill generally accounts for less than 5 percent of the total cost of developing, operating, closing, and properly maintaining the landfill.

These rising tipping fees, however, will not significantly affect trash collection bills because, as explained previously, landfill costs are such a relatively small component of the total cost of waste collection and disposal. For example, if landfill tipping fees double from the current statewide average of around $10 per ton to $20 per ton, the overall cost of residential waste disposal would probably increase by only about 10 percent (or less than $1.00 per month per household).

Although the economic cost of waste disposal is likely to remain relatively low in California, there are still problems with California's existing system of waste management. The most significant problems include: an economically inefficient pricing system that often does not impose the full cost of waste disposal on waste generators, local difficulties in siting new facilities, and potential groundwater contamination and air pollution caused by hazardous materials improperly disposed of in municipal waste.

The Full Cost of Waste Disposal Is Not Directly Imposed on Individuals

Individuals often do not bear the full cost of disposing the waste they create. This occurs for two reasons:

- ***Individuals are not billed for trash disposal in proportion to the waste they generate.*** In some cities, such as Anaheim and San Jose, residences are charged a flat fee for essentially unlimited disposal service. In other cities, such as in Los Angeles and San Diego, residences are not directly charged even a flat fee. Instead, funding for trash disposal services is provided by general tax revenues.
- ***Disposal fees do not reflect all of the economic and social costs associated with waste disposal.*** Most tipping fees in California do not reflect the full cost of financing landfill closure and postclosure maintenance costs and the cost of environmental safeguards such as

methane gas and "leachate" collection systems (a leachate is any substance that drains out of a landfill). Fees also may not reflect the social cost of nuisances (such as dust, noise, and pests) that may be caused by landfills.

In both cases, the true cost of waste disposal is masked and greatly understated to most individuals. Consequently, people produce *more* waste than they would if confronted with the full cost of the service. Better price signals not only would influence individuals to reduce the amount of waste they generate, they also would improve the relative position of alternatives to landfilling (such as recycling).

Unfortunately, there are several obstacles that make it difficult to directly and accurately bill each individual for the waste he/she produces and that undermine the benefit of direct billing:

- ***Expense of Separate Billing.*** The procedures involved in billing individuals for the waste they produce may be so expensive that billing costs outweigh the benefits.
- ***Difficulty of Determining the Source of Waste.*** In many cases, garbage from numerous sources is combined at one collection point, such as a large dumpster serving several apartment units. Such collection systems make it impossible to bill individuals accurately for the waste they generate.
- ***Tendency of Higher Prices to Encourage Illegal Dumping.*** Direct billing may increase the level of illegal dumping as waste generators attempt to avoid paying the full cost of disposing the waste they generate.
- ***Relative Insignificance of Waste Disposal Fees.*** To the extent that accurate pricing of waste disposal services results in higher costs, individuals should reduce the amount of waste they generate. However, since the magnitude of an individual's trash bill is likely to be small relative to other expenses (such as housing payments, grocery bills, and phone expenses) direct and accurate billing for waste disposal services may not appreciably affect individuals' waste disposal decisions.

Some Counties Face Disposal Capacity Problems

Our review of California's waste disposal system indicates that, while the state is not in imminent danger of running out of landfill capacity, there are certain counties with *short-term* capacity problems. In response to the landfill problems experienced by some local agencies, the Legislature recently imposed a new requirement on counties that they plan for disposal capacity sufficient to handle the county's projected volume of waste for at least eight years. These plans must be updated every three years, thereby continually extending the eight-year planning horizon.

Because the capacity planning provision is so new, not all counties have as yet fulfilled this requirement. Based on CoSWMPs filed with the Waste Management Board, 46 of the state's 58 counties already have eight years' worth of landfill capacity. Table 2 lists those 12 counties that do not now meet this requirement. Most of the counties shown are rural counties with small populations. The list also includes Los Angeles County, however, which is responsible for almost two-fifths of the state's total waste stream.

Table 2
Remaining and Planned Disposal Capacity for Counties That Currently Have Less Than Eight Years Capacity
December 1988

County	*Annual Waste Generation (Thousands of tons)*	*Percent of State Waste Stream*	*Currently Remaining Disposal Capacity (Years)*	*Disposal Capacity Coming On-Line*[a] *(Years)*
Calaveras	18	—[b]	0	100
Madera	78	0.2%	0	35
Del Norte	10	—[b]	1	—[c]
Contra Costa	914	2.4	3	20
Tuolumne	43	0.1	3	40
Sonoma	394	1.0	4	30
Ventura	730	1.9	4	40
San Bernardino	1,554	4.1	5	300
Sutter-Yuba	82	0.2	5	15
Los Angeles	14,612	38.5	5	30
Lassen	20	0.1	5	—[c]
Kings	93	0.2	6	35
Totals	18,668	48.8%[d]		

[a] Indicates capacity of facilities anticipated to open within 5 years.
[b] Accounts for less than 0.05 percent of California annual waste generation.
[c] Volume of proposed facilities is unknown.
[d] Detail does not add to total due to rounding.
Source: California Waste Management Board.

Table 2 also shows the disposal capacity which is expected to be available within five years in these counties. It indicates, for instance, that Los Angeles County soon expects to expand existing facilities or construct new facilities that will be able to dispose of the county's waste for 30 years. Furthermore, San Bernardino County has reserved a site that, when fully developed, will be able to hold an estimated 462 million tons of waste—enough capacity to handle that county's current annual volume of waste for more than 300 years. Thus, even those counties included in Table 2 would appear to face problems which are generally of a short-term nature.

The lack of adequate disposal capacity in some counties is due to the increasing difficulty in California of gaining public approval to locate new waste disposal facilities near urban areas. For example, in spite of the current shortage of disposal capacity in Contra Costa County, in the 1988

November general election voters in that county disapproved of all three initiatives proposing new landfills for the county. In addition, only four *new* waste disposal facilities have been sited in the state since 1984. Consequently, almost all new landfill capacity in California has been added by expanding existing facilities, rather than siting new ones.

Disposal Facilities May Cause Environmental Damage

The perceived environmental problems associated with disposal facilities are probably the most significant reason that few new facilities have been constructed. For instance, many people are concerned about toxic wastes in general purpose landfills. The greatest threat of toxic contamination, however, is posed not by *new* disposal facilities (which generally are designed to limit this threat), but by landfills that are now closed. Many of these landfills accepted hazardous industrial wastes that they were not designed to handle. Consequently, these closed facilities may cause groundwater contamination. The full extent and significance of this problem is unknown. The Water Resources Control Board (WRCB) currently is evaluating the results of water quality assessment tests conducted at 50 landfills that pose the greatest threat of water contamination. Preliminary results indicate that some of these landfills have caused low concentrations of contamination in groundwater. The contamination is primarily from petroleum-related sources.

In addition to the problems at closed landfills caused by improperly disposed industrial toxins, existing disposal facilities may contribute to environmental pollution due to *nonindustrial* sources. State law prohibits disposing of hazardous materials in municipal garbage collection systems. However, many common household products—such as paint, batteries, motor oil, and some household cleaners—are hazardous materials that people either unknowingly or illegally discard in their household trash. Consequently, if these materials are not sorted out of the waste stream, or are not deposited in waste disposal facilities that are constructed to handle such materials, they can produce water contamination (if the materials leach from landfills) or air pollution (if the materials are not completely incinerated in waste-to-energy facilities).

In addition to pollution problems resulting from hazardous materials in the waste stream, pollution may also be caused by burying materials that are normally harmless. In landfills, the natural decomposition of biodegradable materials, such as food and yardwastes, produces methane gas. Landfills can be constructed with systems to collect this gas and use it for fuel to generate electricity. Older landfills, however, rarely have such collection systems, and in many cases the gas escapes from the landfill and causes air pollution. Some cases of gas buildup have even resulted in explosions.

New disposal facilities that are properly designed and managed are much less likely to cause pollution problems than are older facilities. Landfills can be constructed with impermeable caps and bottom liners that prevent rain and snowmelt intrusion and reduce the chances of toxic materials leaching from the facility and contaminating groundwater. Waste-to-energy (WTE) facilities that burn garbage as fuel can also be constructed with high-temperature combustion chambers and filters enabling them to meet existing air quality requirements.

Although air pollution control requirements regulating emissions from WTEs are very specific, state regulations pertaining to leachate control at landfills indicate only that "the [landfill] operator shall take adequate steps to monitor, collect, treat, and effectively dispose of leachates." Thus, the application of available methods of preventing landfills from contaminating water is to a large degree left up to individual landfill operators.

Since landfill management decisions made by local governments can potentially affect the groundwater used by other entities, there is a definite statewide interest involved in how these disposal facilities are built and run. In the next section, we offer the Legislature suggestions on how it might address this concern, as well as the pricing and siting problems identified earlier.

OPTIONS TO IMPROVE CALIFORNIA'S WASTE MANAGEMENT SYSTEM

As the preceding discussion indicates, California currently does not face a waste management crisis. There are, however, a number of problems with the existing waste management system, including (1) a pricing system that obscures choices facing individuals and underprices waste generation, (2) local capacity concerns in some areas, and (3) potential environmental damage resulting from (a) individuals disposing of hazardous materials in municipal garbage and (b) unsorted waste being disposed of in facilities that are not constructed to contain hazardous materials. We discuss below ways for the Legislature to address these concerns, thereby improving the way in which solid waste is managed in the state.

Promote Fees That Include All Costs for Waste Disposal Services

Fees for trash collection and disposal services should reflect the full cost of providing the service. Fees that reflect all costs of disposal would influence individuals to minimize their waste generation, resulting in a reduced demand for landfills. As our previous discussion indicates, however, there are numerous instances in which individuals are either not directly charged for waste disposal or are charged much less than the full economic and social costs of disposal.

While there are obstacles to ensuring that individuals face the costs of waste generation, it is possible to improve pricing systems. For instance, many cities have shown that it is practical to impose trash collection fees that are proportional to the weekly volume of waste that is collected from a household or business. For example, the city of San Francisco charges residential customers $8.49 a month for weekly collection of one 32-gallon can of trash, and an additional $3.86 per month for each additional 32 gallon can. The effect of proportional billing on the volume of waste individuals produce can be dramatic. For example, in 1988 the town of High Bridge, New Jersey required that town-issued stickers be placed on each 30-gallon trash container prior to collection. The stickers cost $140 for 52, and additional stickers cost $1.25 each. Eleven months after implementing the sticker system, the town's volume of trash has declined 25 percent.

Thus, perhaps one of the most important steps the Legislature can take in this area is to promote the direct billing of full waste disposal costs to users. One way to accomplish this end would be to require CoSWMPs to include an outline of the billing system and fee rates imposed in each city within the county jurisdiction, and compare those fees against the estimated full costs of providing waste disposal services. Hopefully, this type of information would help counties—especially those facing short-run capacity problems—move toward a more rational pricing system.

By promoting direct and accurate billing for waste disposal, the Legislature would help achieve two positive results. First, individuals would tend to minimize the quantity of waste they produce. Second, this approach would also indirectly promote alternative waste management strategies. For example, in California landfill tipping fees average roughly $10 per ton. The average tipping fee, however, does not reflect the full cost of financing landfill closure and postclosure maintenance costs and the cost of environmental safeguards (such as gas and leachate collection systems). If these costs were incorporated into tipping fees, the average fee would probably increase to about $25 per ton. At this fee level, alternatives to landfill disposal may be more economical. For example, based on our calculations, the net cost of San Jose's curbside recycling program is roughly $20 to $25 per ton (depending on the market prices for certain recyclables). Thus, under these conditions, the cost of recycling would be an economically viable alternative to landfilling.

Help Counties Resolve Disposal Facility Siting Issues

As noted above, there are only a few counties with serious landfill capacity shortfalls, and the problem in most of these cases does not appear to be over land availability as much as local resistance to having such facilities sited nearby. The Legislature may want to consider ways to help localities resolve impasses in siting needed disposal facilities. One way to address this problem would be to grant the CWMB the authority to certify when local jurisdictions are in need of additional disposal capacity, and allow the CWMB (or some other designated entity) to act as arbitrator in stalled local siting negotiations.

Granting a state agency this type of authority has proven successful in Wisconsin. There, a state agency first certifies the need for new or expanded disposal facilities in a given jurisdiction. Next, the prospective facility operator is required to negotiate the terms of an operating agreement with the host community's government. If the operator and the host community cannot reach an agreement, either party may petition the state's Waste Facility Siting Board for arbitration. Under Wisconsin's law, the board must select one of the parties' last best offer (which covers such factors as site location, operating hours and fees). Since 1982, 21 siting agreements have been signed in Wisconsin without any cases going into arbitration.

Consider More Stringent Environmental Requirements for Disposal Operations

Unless hazardous materials are prevented from entering the waste stream, separated out before waste is buried or burned, or disposed of in facilities designed to handle such materials, they may cause water contamination and/or air pollution. While current groundwater monitoring has not discovered any serious contamination levels, the extent and significance of the problem is really not known. If the Legislature is concerned about the future threat to the environment from these hazardous materials, there are at least two options available to it.

First, the Legislature could impose more stringent environmental protection requirements on landfills. For instance, depending on such factors as the level of the groundwater, the state could require that new landfills be constructed with various types of liners and caps capable of preventing hazardous materials from leaching into water supplies. Because the cost of landfilling is a relatively small component of the overall cost of waste collection and disposal, such a requirement would probably result in only a small increase in disposal fees for residences and businesses. Alternatively, the Legislature could require all landfills only to accept waste that has been sorted to remove potentially hazardous materials. The cost of sorting these materials from the waste stream is unknown.

Second, the Legislature could take additional steps to encourage the proper disposal of hazardous wastes by individuals. For instance, the state could require CoSWMPs to contain a plan element devoted to household hazardous waste separation. The CWMB currently provides local governments with technical assistance and advice on household hazardous waste as part of the board's hazardous substance information program. The success of this program in influencing a significant number of individuals to properly dispose of their household hazardous waste has not been demonstrated. However, requiring that CoSWMPs include a household hazardous waste separation element would probably encourage cities and counties to take advantage of the information available through the CWMB.

Conclusion

Our review suggests that California is not presently facing a waste management crisis. The overall cost of waste disposal in California is relatively low and not likely to substantially increase in the near future. Most counties have adequate disposal capacity, and there is little evidence at present of significant environmental damage caused by waste disposal facilities. There are, however, problems with the state's existing solid waste management system: (1) in many areas, waste disposal services are not realistically priced; (2) some local governments have difficulty gaining public approval to site new disposal facilities; and (3) without preventive measures, household hazardous waste can pose a threat to the environment.

To address these problems, the Legislature can take steps to: (1) ensure that fees which reflect the true costs of waste disposal are imposed wherever practical, (2) assist counties in landfill facility siting decisions, and (3) minimize the potential environmental threats of disposal facilities. These steps will help influence individuals to minimize the waste they generate, stimulate efficient competition among conventional and alternative waste management strategies, help maintain an adequate supply of disposal capacity, and ensure that waste is disposed of safely.

State Appropriations Limit

How Should the Legislature Address Problems With the Appropriations Limit?

Summary

- *Based on the estimates of revenue and the spending plan contained in the Governor's Budget, the state is very close to its appropriations limit for both the current and budget years—$134 million and $128 million, respectively. Using the administration's long-term forecast of state revenues, we estimate that revenues will exceed the appropriations limit by 1990-91.*
- *State spending authority, as adjusted for changes in the price of goods and services faced by the state, has declined under Article XIII B. The limit does not allow sufficient growth in spending authority to maintain current service levels or to keep pace with growth in the economy.*
- *In many cases, the current limit tends to distort government decision making, thereby adding to the cost and complexity of the public sector.*
- *As a result of the appropriations limit, the state is facing increasingly difficult choices about which programs can be funded and at what level they can be funded. Changes in public demands for services, as in the case of education and transportation, are increasing pressures on spending subject to the limit. Further, funding for the state's reserve fund can only be provided at the expense of other state programs.*
- *Because there is no apparent consensus as to which programs should be eliminated or reduced in order to accommodate the magnitude of spending increases sought in program areas where demand is building (such as transportation), and because in the long run the limit will hamper the state's ability to provide the services needed to keep the state's economy functioning efficiently, we recommend that the Legislature place on the ballot a constitutional amendment calling for the repeal of Article XIII B.*
- *Whether a different type of limit should also be adopted is a policy choice only the Legislature can make. In reviewing the arguments for and against limits, we are not convinced of the need for a limit from an analytical perspective. If an alternative type of limit is desired, however, we recommend that several considerations be carefully addressed in determining how it should operate.*

As discussed in Parts One and Two of this document, the Legislature and the Governor face an extremely difficult situation in developing a state budget for 1989-90. In addition to finding a way to avert a deficit for the current fiscal year, the Legislature faces a funding gap of over $1.6 billion between expected General Fund revenues and the cost of maintaining current service levels, including a provision for a prudent reserve. At the same time, the Legislature faces pressing demands for increased funding for transportation and other infrastructure projects.

Faced with such prospects, some consideration ordinarily would be given to increasing the level of General Fund and special fund revenues. However, the Department of Finance's calculations indicate that the state is very close to its appropriations limit for both the current and budget years—$134 million and $128 million under the limit, respectively. This situation effectively precludes the state from considering a revenue increase as part of its effort to balance these demands, unless changes are made to the appropriations limit.

This section provides background on the appropriations limit imposed by Article XIII B of the California Constitution. It also discusses the long-term effect on the budget process and on the provision of state services of operating under the current limit. Finally, this analysis provides the Legislature with our recommendations as to actions it needs to take to ensure that the state can effectively address the demands for state services in the future.

Background

Article XIII B was added to the State Constitution when the voters approved Proposition 4 on the November 1979 Special Election ballot.

Briefly, Article XIII B does three things:

- It limits the level of tax-funded appropriations (General Fund and special funds) which can be made by the state and individual local governments in any given year. The limit for each year is equal to the limit for the prior year, adjusted for changes in the cost of living and population, and other adjustments as required (for example, transfers of financial responsibility).
- It requires that state and local governments return to the taxpayers any revenues collected—from both tax and nontax sources—that exceed the amount which can be appropriated in any given fiscal year.
- It requires that the state reimburse local governments and school districts for the cost of complying with state mandates.

The limit applies only to appropriations financed from the "proceeds of taxes," which include tax revenues, proceeds from the investment of tax revenues (such as interest earned on tax proceeds), and any revenues collected by a regulatory license fee or user charge in *excess* of the amount needed to cover the cost of providing the regulation, product, or service. Appropriations financed by other sources of revenue (for example, bond funds) are not subject to the limit.

Certain specific categories of appropriations are also excluded from the limit. These include payments for interest and redemption charges on preexisting debt or voter-approved bonded indebtedness, appropriations needed to pay the state's cost of complying with federal laws and court mandates, and unrestricted state subventions to local governments. For additional information on the background of the appropriations limit, please see *The 1987-88 Budget: Perspectives and Issues*, pp. 111-127.

State's Current Position Relative to the Appropriations Limit

Table 1 presents estimates of the state's position relative to the limit for 1988-89 through 1991-92, based on the Department of Finance's estimates of long-term revenue growth included in the Governor's Budget. The Department of Finance estimates that the state will be $134 million below its limit in 1988-89 and $128 million below its limit in 1989-90, given the estimates of revenue contained in the budget. Table 1 also shows that, under the moderate economic growth assumptions underlying the budget's revenue forecast, the state could have $500 million in excess revenues by 1991-92. A stronger-than-expected economy, or higher levels of capital gains realizations than anticipated by the budget, could easily result in the state receiving revenues in excess of the limit as soon as the current year.

Table 1
State Appropriations Limit and Appropriations Subject to Limitation 1988-89 through 1991-92 [a]
(dollars in millions)

	Appropriations Limit	*Appropriations Subject to the Limit*	*Amount Under/(Over) the Limit*
1988-89	$27,079	$26,945	$134
1989-90	29,184	29,056	128
1990-91	31,227	31,427	(200)
1991-92	33,412	33,912	(500)

[a] Figures for 1988-89 and 1989-90 are from the Governor's Budget. Figures for 1990-91 and 1991-92 are estimates by the Legislative Analyst's Office, based on the long-term revenue projection contained in the 1989-90 Governor's Budget.

Is There a Problem with the Limit?

Two years ago (please see *The 1987-88 Budget: Perspectives and Issues*, pp. 111-127), we addressed the issue of what the effect of Article XIII B might be in future years, and whether the state would have a problem in both providing the levels of service demanded by state taxpayers and complying with the appropriations limit. This section updates that analysis and examines how the limit has constrained the state's ability to provide services. We do not explicitly consider the impact of the limit on local governments in this analysis.

Current Service Levels Cannot Be Maintained. As we noted two years ago, the current appropriations limit grows more slowly than the cost of government services. This slower growth is largely the result of using the *lower* of the change in inflation (as measured by the United States Consumer Price Index—USCPI) or the change in California per capita income as a cost-of-living adjustment. In seven of the last 10 years, the USCPI has been the lower index. This index, however, does not reflect the increased costs faced by *governments* in providing services. Rather, it reflects the price changes faced by *individual consumers,* such as changes in housing and transportation costs. The price changes faced by government entities are influenced by other factors not reflected in the USCPI, such as salary payments for government workers and construction costs. A more appropriate index for the measurement of government cost increases is the Gross National Product (GNP) implicit price deflator for state and local purchases of goods and services.

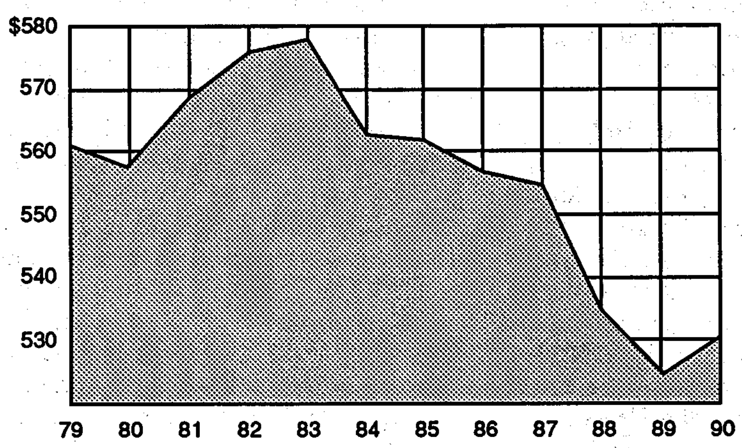
Because the GNP index has exceeded the USCPI each year since 1982-83, the current inflation adjustment formula has resulted in a *decrease* in state purchasing power since 1978-79, as shown in Chart 1. Real per capita state spending authority (the appropriations limit adjusted for inflation using the GNP deflator) has fallen from just over $560 per person in 1978-79 to about $530 per person in 1989-90. If the limit had been adjusted using the GNP deflator since 1978-79, Chart 1 would show a flat line over time. Instead, real state purchasing power has declined.

Because the inflation adjustment that has been used to calculate the appropriations limit each year has not kept pace with the cost of providing government services (as the GNP deflator has exceeded the USCPI), the limit has not provided sufficient authority to maintain current service levels. As the price of government goods and services is expected to continue to increase faster than the cost-of-living factor used in the appropriations limit calculations, the state will find it necessary to reduce service levels to compensate for the difference.

Chart 1

Real Per Capita State Spending Authority

1978-79 through 1989-90[a]



[a] 1979 dollars. Data are for fiscal years ending in year shown.

Government Spending Authority Will Not Keep Pace with the State's Economy. When the economy grows faster than inflation, as it has in seven of the last 10 years, the appropriations limit acts to "restrain" the growth in government spending relative to the growth in the economy. However, the economy's growth brings with it expanded needs for existing government services, such as improved transportation facilities to move increasing amounts of goods and services as well as commuter traffic. Yet, because of the limit, existing state services cannot increase in proportion to the growth in the economy. The result is a lower average level of government service in the state.

One example of an area in which services have not increased proportionately with the economy is infrastructure development. Several reports completed in the last few years have identified an infrastructure funding shortfall in California over the next 10 years that is in the tens of billions of dollars. In the area of transportation, the 1989 State Transportation Improvement Program (STIP) is now projected to have a five-year estimated funding shortfall of $4.5 billion. As discussed in our recent report, *A Perspective on the California Economy*, these kinds of funding shortfalls have long-term consequences for the future economic health of the state. To the extent that the current limit impairs the ability of the state and local governments to finance the full range of necessary public services in the future, it will hinder efficient economic growth in the state.

Limit Distorts Public Decision Making. During each year's budget process, the Legislature must make decisions regarding how available funding will be allocated among different programs. As part of this process, it often examines alternatives for funding those programs. In the past few years, however, the structure of the limit itself has influenced how these decisions are made. For example, because the current limit excludes some sources of revenue (for example, fee revenues) and some kinds of spending (for example, debt service, unrestricted subventions to local governments), it has provided incentives to fund or implement programs inefficiently—just to get around the limit. In 1988, for instance, the Legislature considered legislation to deal with the problem of abandoned cars by creating new governmental entities—with their own appropriations limits—in order to be able to raise and spend funds outside the confines of existing state and local limits. The creation of new governmental entities just to escape the constraints of the limit increases the cost and complexity of government.

The limit also provides an incentive to increase the use of voter-approved bonds, since the debt service on these bonds is exempt from the limit. As we discuss elsewhere in this volume, the state is not in any immediate danger of having "too many" bonds issued, and a substantial amount of additional authorizations would have to be approved by the voters before the state's debt-service levels reach the point where concern may be warranted. However, there are many situations where bond financing may not be preferable to pay-as-you-go financing (for example, when a project's benefits last only a short time). In such cases, the use of bond financing increases the cost of the project. Moreover, while bond financing allows the state to spend revenues in excess of the limit in years when revenue growth is strong, the use of bonds also locks in higher levels of required debt payments that cannot be reduced if revenues fall in the future. Thus, the incentive to use bonds to get around the limit can both increase the cost of providing government services and reduce the state's flexibility with respect to spending priorities in years when revenue growth is not strong.

The constraints of the limit also have produced incentives to increase the use of tax expenditures. Tax expenditure programs result from various tax exclusions, exemptions and deferrals which reduce the amount of revenue collected from the state's "basic" tax structure. Although tax expenditure programs effectively allow spending outside the limit, these programs are generally less efficient than direct spending programs, make legislative oversight of programs more difficult, and add complexity to the tax system.

Finally, the inflexibility of the limit has led to an increase in efforts to earmark state funds and place programs *outside* the appropriations limit, in order to "protect" them from limit-related budget cuts. Propositions 71 and 72, which were defeated on the June 1988 ballot, both sought to exempt transportation spending from the constraints of the limit. Proposition 98, which was approved at the November 1988 election, guarantees K-14 education a fixed percentage of the state budget (roughly 40 percent), regardless of the overall condition of revenues and spending in the state. Proposition 99, also approved on the November 1988 ballot, creates a new dedicated revenue source, generated by increased taxes on cigarettes and tobacco products, and places it permanently outside the limit. The incentive to try to remove particular categories of spending or revenues from normal budgetary oversight makes it increasingly difficult for the Legislature to allocate state revenues in accordance with overall statewide priorities.

Special Factors Have Cushioned the Impact of the Appropriations Limit

During the last three years, three factors have cushioned the impact of the appropriations limit, thereby forestalling the trade-offs among program expenditures that would otherwise have been necessary.

K–12 Education. One factor that has allowed for additional growth within the limit for some program areas is a shift in the method of computing appropriations subject to limitation for school districts. This change, implemented in 1987–88, reduced the amount of local school district appropriations that count against the state's limit and increased the amount charged to school district limits. Thus, while *overall* state funding for K–12 education increased by 9.8 percent between 1986–87 and 1988–89, the amount of state expenditures *subject to limitation* for K–12 education actually shrank by 6.5 percent. Moreover, it does not appear that the state can make additional changes of this magnitude in the method of computing local school districts' appropriations subject to limitation in the future, since most of the benefits of these changes have already been realized. In 1988–89, increases in school district appropriations subject to limitation have outpaced increases in the appropriations limit and we expect that this will continue to be the case for future years. In part, this reflects the adoption of Proposition 98 by the voters in November 1988. As a result, K–12 education will no longer help provide the cushion necessary to accommodate growth within the limit for other state programs.

Transportation. In recent years, transportation programs have also helped cushion the impact of the appropriations limit on other state programs because transportation programs are largely dependent on the slow-growing state gasoline tax for funding. As a result, transportation expenditures have grown more slowly than overall state spending authority over the past several years. In the future, however, it is unlikely that the state will be able to rely on slow growth in transportation programs to help accommodate higher-than-average growth in other state programs. This is because, as discussed elsewhere in this volume, increased expenditures for transportation will be required in the future in order to meet recently enacted funding requirements.

Reserve Funding. Finally, in the last three years, none of the state's overall spending authority has been used to build or maintain a prudent reserve. In fact, the reserve has been *drawn down* each year since 1986–87. The state has used all of its appropriations authority to cover state program requirements, and none has been available to maintain the reserve. Because the state's appropriation authority in the current year is "fully allocated" to pay for state programs, the appropriation proposed to rebuild the Special Fund for Economic Uncertainties (SFEU) in 1989–90 *must displace appropriations needed to maintain other state programs which are subject to the limit.* While the state will always face a direct trade-off between funding the reserve and spending on state programs, this trade-off is made more difficult in the budget year because the reserve has been completely depleted over the last two years. Moreover, normal growth in the limit does not allow sufficient room to completely restore the reserve in the budget year without reducing current service levels in other programs areas.

Without changes in state laws or the constitution then, the Legislature must choose between funding the reserve or funding the current level of services in a variety of state programs. Yet, in the long run, even if statutory and constitutional changes were made to permit reductions to be made across a larger portion of the state's expenditure base, this basic conflict between funding for the reserve and funding for state programs would still remain.

In summary, the change in the method of accounting for appropriations to K–12 school districts, the slower rate of growth for transportation spending and the lack of additional funding for the reserve have enabled the state to avoid difficult limit-forced trade-offs for the last three years.

Program Demands Building within the Limit

Eight programs make up more than 80 percent of all state appropriations subject to limitation: public health, K–12 education, higher education, Aid to Families with Dependent Children (AFDC), Supplemental Security Income/State Supplemental Program (SSI/SSP), Medi-Cal, youth and adult corrections, and transportation. Of these eight programs, four—AFDC, SSI/SSP, Medi-Cal and youth and adult corrections—have consistently grown more quickly than the limit. For example, state spending on youth and adult corrections grew more than 8 percent more quickly than the limit between 1986–87 and 1988–89. The faster growth in these four programs is largely the result of existing statutory requirements requiring annual increases in spending to accommodate caseload and cost-of-living increases.

The faster-than-average growth in these programs over the last several years has largely been accommodated by "extra room" in the limit made available by other, slower growing programs, as noted earlier. Yet, the cushion provided by these slower growing programs is declining, as evidenced by the multi-billion dollar increases being sought in the area of transportation. For 1989–90, we estimate that providing K–12 education, AFDC, SSI/SSP, Medi-Cal, youth and adult corrections, and transportation programs with funding increases consistent with current laws and expected caseload growth would consume over $1.6 billion of the $2.1 billion projected growth in the state's appropriations limit between 1988–89 and 1989–90. This would leave only $500 million available to fund the state's reserve *and the growth in all other state programs.*

The ultimate result of these increasing program demands is that spending for programs that have historically grown more quickly than the limit will have to be scaled back to accommodate growth in other programs. Yet, in the face of increasing program demands, there is as yet no apparent consensus as to which of the state's current programs can be reduced or eliminated to accommodate all of the existing spending demands within the limit.

What Should the Legislature Do?

As discussed above, the state's current appropriations limit has a number of defects. Given the state's current demands for services and the formidable challenges posed by the anticipated growth in the state's economy, it appears that the existing limit will significantly constrain the state's ability to provide the level of services demanded by its taxpayers. For this reason, ***we recommend that the Legislature place on the statewide ballot a constitutional amendment calling for the repeal of Article XIII B.***

Should a Different Type of Limit Be Adopted? In the event that the Legislature agrees with our recommendation that the current limit should be repealed, it has two basic options. First, it can choose to rely on the traditional constraints on spending embodied in the two-thirds vote requirement on expenditure and tax measures and the availability of revenue. Second, it can choose to adopt a different type of limit which ideally would avoid the shortcomings of the current limit. In considering these options, it is useful to review the basic arguments which have been advanced in support of and in opposition to the adoption of limits. Specifically:

- ***Proponents of limits*** argue that government cannot always be relied upon to make rational spending choices, and that a limit is necessary to force the elimination of low-priority expenditures. Without the elimination of these low-priority expenditures, it is argued that government spending will require a constantly increasing share of the state's economic resources, and will ultimately become a restraining influence on economic activity.
- ***Opponents of limits*** argue that limits are arbitrary and that there are a sufficient number of *other restraints* on government spending that can hold it "in check" without a formal limit. These other restraints include the supermajority vote requirements for appropriations and tax increases, the line-item veto power of the Governor, and perhaps most importantly, the natural constraint imposed by the growth of revenue. Given recent changes in the state's tax structure, such as the indexing of the personal income tax and the allowance of offsets against corporate income for net operating losses, state revenues no longer can be expected to expand significantly faster than the state's economy. In our view, this natural constraint will itself force the reconsideration of expenditures for lower-priority state programs.

In reviewing these arguments, *we are not convinced from an analytical perspective that there needs to be a spending limit.* From the Legislature's perspective, there may nevertheless be reasons why some sort of formal limit on state expenditures is necessary or desirable. If the Legislature chooses to replace the current limit with some other form of limit, however, we recommend that it consider several important factors in its design.

Impact on Decision Making. As noted earlier, one of the defects of the current limit is that it has produced a bias against making government decisions in the most efficient manner. This bias stems from the limit's provision of preferential treatment for certain types of expenditures and the exclusion of non-tax revenues. One way to address this concern would be to use a limit which operates solely as a constraint on the amount of revenue from all sources that can be made available for expenditure.

Impact on Services. A more reasonable limit would allow government spending to keep pace with the growth in the state's economy, so that as the economy grows, the services needed to accommodate that growth can be provided. This could be accomplished by restricting the level of governmental receipts to a certain percentage of state personal income. A more difficult issue, however, is how to determine at what level a revised limit should be set. As a practical matter, this decision must be based largely on the existing level of state resources, but consideration should be given to how the expected need for additional funds in such areas as transportation is to be accommodated.

Impact on Reserve Funding. Because of the importance of an adequately funded reserve to the maintenance of state services under adverse conditions, consideration should be given to allowing "excess" revenues to be allocated to the reserve fund without regard to the limit. The expenditure of such funds could then be prohibited except under conditions where state revenues fell below some allowable level. Under this scenario, other cost increases, such as unanticipated caseload increases would have to be accommodated by reordering priorities among other state programs.

Impact on Legislative Flexibility. One of the major concerns we have about a limit is that it can prevent the Legislature from responding to changing conditions in a timely and effective manner. An override provision which allows the limit to be changed more easily than the current limit could provide the necessary flexibility.

Conclusion

In the 10 years since the constitutional limit on appropriations was adopted, state financial and program decisions have become increasingly dominated by the constraints of the appropriations limit. Because of increasing public demands for higher levels of expenditure in transportation and education, and the importance of funding for the reserve, significant pressures are building within the constraints of the limit. These pressures will ultimately require the elimination of state programs in order to stay within the limit, or the limit will have to yield to these pressures. Because there is no apparent consensus of opinion as to which programs should be eliminated in order to allow significant spending increases in program areas where demand is building (such as transportation), and because in the long run the current limit will hamper the state's ability to provide the services needed to keep the economy functioning efficiently, ***we recommend that the Legislature place on the statewide ballot a constitutional amendment calling for the repeal of Article XIII B.*** Although there are existing constraints already in place to restrain the growth of state spending, the Legislature may wish to put in place a different type of limit. This is a *policy decision* that should reflect the Legislature's view as to the ability of the budget process to reconcile competing demands for the state's resources. Should another limit be desired, then it can be crafted to avoid most of the problems which are inherent in the existing constitutional limit on appropriations. It is likely, however, because of the state's inability to predict the future, that such a limit would have to be modified along the way to respond to future changes in circumstances and the demand for state services.

The Level of State Indebtedness

Should the Legislature Be Concerned about the Level of State Bonded Indebtedness?

Summary

- *California's voters approved over $5.5 billion in new general obligation bonds during 1988. As a result, the state now has over $13 billion in authorized General Fund indebtedness.*
- *Although California's bonded indebtedness is large in absolute dollar terms, it is* ***not*** *particularly large relative to either the state's economy or its budget. California's bonds currently are highly rated and popular with investors.*
- *Although California's debt burden will increase as the new bonds authorized in 1988 are issued, the share of General Fund expenditures needed to pay debt service still will be* ***relatively modest*** *compared to other states — about 3 percent of General Fund expenditures as opposed to between 4.5 percent and 5 percent for other states.*
- *If the same volume of new bonds were authorized in future election years as occurred in 1988, debt service as a percent of General Fund expenditures would increase to somewhat over 5 percent shortly after the turn of the century.*
- *There is a strong argument* ***against*** *the state establishing a formal "debt limit," since such a limit could prevent the state from meeting the capital outlay needs of California's citizens. If a debt limit were nevertheless adopted, it should have some flexibility to prevent this from occurring.*
- *What California needs most is a* ***comprehensive multi-year capital outlay planning process*** *that can serve as the basis for making decisions about using bonds, including determining how much and for what purposes debt should be issued. Such a planning process was enacted by the Legislature in 1988 but was vetoed by the Governor. Working together to implement such a process during the budget year should be a top priority for both the Legislature and the Executive Branch.*

California's voters have authorized the issuance of nearly $15 billion in general obligation bonds during the 1980s, including a record of over $5.5 billion during 1988. This dramatic increase in authorized borrowing largely reflects the growing need that California has for financing the capital outlay requirements of its expanding population. However, the increased use of bonds also has raised concerns about whether the state's debt level is becoming too high, and whether some type of action is needed to limit the amount of additional borrowing that can occur in the future.

This analysis addresses the general topic of the state's debt level. It first reviews the state's current debt situation, including the volume of bonded indebtedness presently outstanding and the financial burden that paying this debt off imposes on the state budget. Next, it discusses the question of how much debt is "too much" and whether a formal limitation on debt is advisable. Finally, it considers how the state can best ensure that its borrowing capacity will be effectively used in the future.

WHAT IS THE STATE'S CURRENT DEBT SITUATION?

In discussing the state's current debt situation, it is first important to distinguish between the following four basic categories of bonds which the state issues:

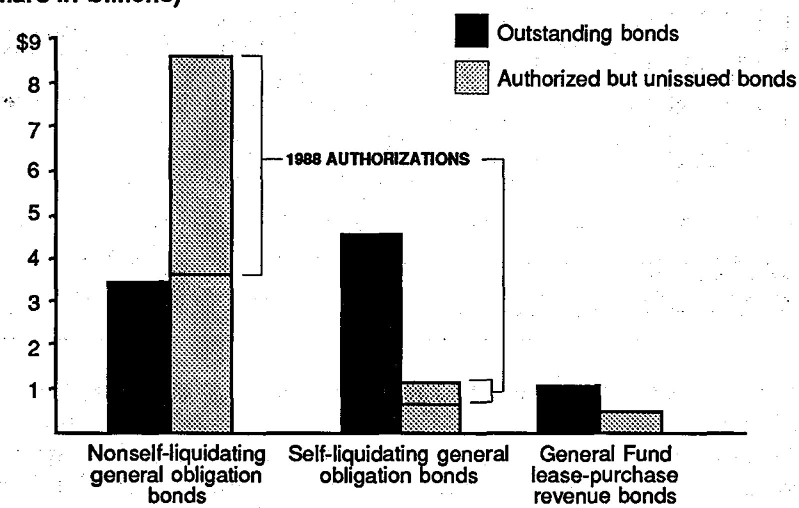
- ***Self-liquidating general obligation (GO) bonds*** are bonds which are backed by the full faith and credit of the State of California. This means that the payment of principal and interest on these bonds has "first claim" on the state's revenues and other financial resources. These self-liquidating bonds do *not*, however, generally impose any direct costs on the General Fund. This is because their debt-service costs (that is, principal repayment and interest costs) are paid from revenues generated from the projects they finance, and the General Fund incurs costs only if these revenues prove insufficient to service the debt. An example of such bonds is those sold to provide loans to home buyers, who in turn make mortgage payments that are used to pay off the bonds.
- ***Nonself-liquidating GO bonds*** also are backed by the full faith and credit of the state. However, they are *fully paid for* by the General Fund, through statutory appropriations of principal and interest payments.
- ***Lease-purchase revenue bonds*** are currently used to finance certain higher education and prison capital outlay projects. They are issued by the State Public Works Board, and their debt service is funded out of the lease payments made to the board by state agencies that use the facilities. The money for these lease payments is appropriated from the General Fund in the annual Budget Act. Because these bonds are not voter approved, they are not GO debt. However, for all practical purposes, the state has taken on a "moral obligation" to pay them off.
- ***Other revenue bonds*** are issued for a variety of purposes, and are fully paid for out of revenues generated by the projects they are used to finance. Such bonds impose *no* direct General Fund cost.

How Much Debt Is There?

Chart 1 shows that the amount of state bonds currently outstanding includes about $3.5 billion of nonself-liquidating GO bonds, $4.6 billion of self-liquidating GO bonds and $1.1 billion of lease-purchase revenue bonds. In addition, there are over $20 billion in other revenue bonds outstanding. Thus, the amount of debt outstanding that must be directly paid off by the General Fund—that is, the nonself-liquidating GO bonds and lease-purchase revenue bonds—is about $4.6 billion. In addition to these outstanding bonds, there are about $8.6 billion of nonself-liquidating GO bonds that have already been authorized by the voters but are as-of-yet unsold, including $5 billion worth of bonds approved in June and November of 1988.

Chart 1

State Bonded Indebtedness as of December 31, 1988
(dollars in billions)[a]



[a] Excludes self-liquidating revenue bonds, which total in excess of $20 billion.

How Significant Is the State's Debt Burden?

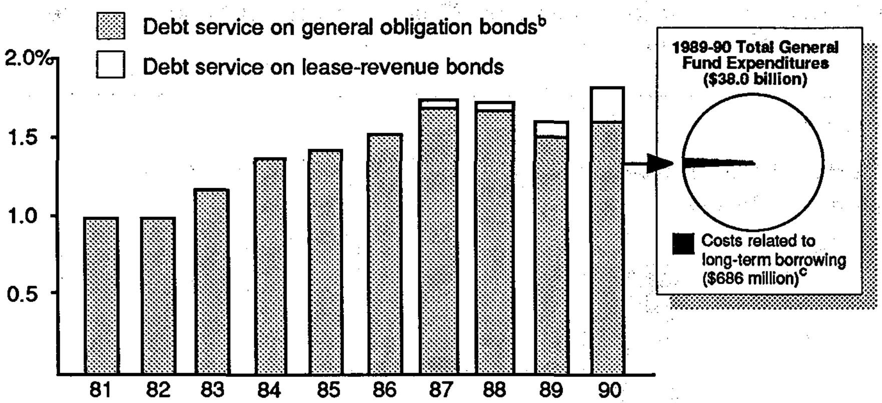
Although the amount of outstanding state bonded indebtedness is large in absolute dollar terms, it is *not* particularly large relative to the size of the state. For example, the value of California's gross economic product exceeds half a trillion dollars yearly and the state's annual budget is well over $40 billion.

Probably the single best general measure of California's "debt burden" is the percent of total state General Fund expenditures that must be devoted each year to making debt-service payments on nonself-liquidating GO bonds and lease-purchase revenue bonds. Chart 2 shows that at present, this "debt-service ratio" is under 2 percent. This compares to an average ratio of between 4.5 percent and 5 percent for other states.

Chart 2

General Fund Debt Service and Related Borrowing Costs as a Percent of State Expenditures

1980-81 through 1989-90[a]



[a] Source: *1989-90 Governor's Budget*, State Treasurer and State Controller. Data are for fiscal years ending in years shown.

[b] Includes both debt-service payments on bonds and net interest costs of loans to bond programs from the Pooled Money Investment Account (PMIA).

[c] Includes about $610 million for debt service on general obligation bonds, $4 million for net interest on PMIA loans, and $72 million for debt service on lease-revenue bonds.

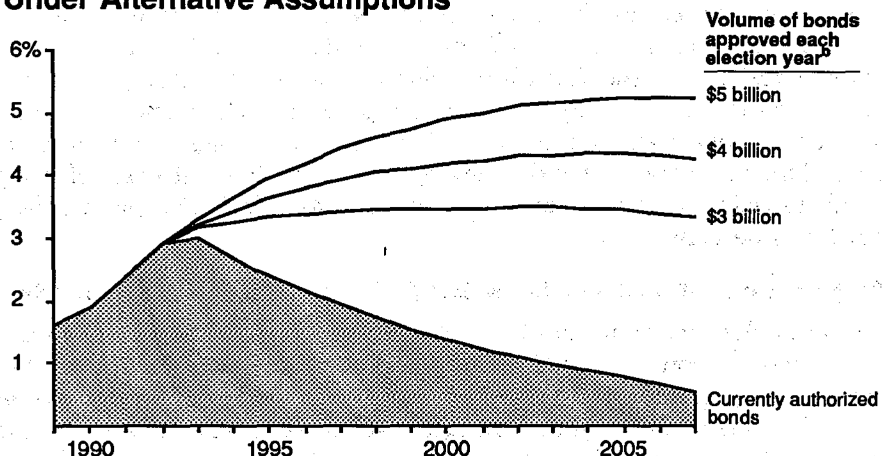
California also is well below the national average in terms of alternative debt-burden indicators, such as the amount of general obligation debt outstanding, both in per capita terms and as a percent of statewide personal income. Thus, California is *not* at present a "high debt" state. This view appears to be shared by the nation's bond rating agencies and the investment community generally. For example, California's bonds are popular with investors who buy government securities and currently have a very high credit rating, both of which enable the state to sell its bonds at relatively favorable interest rates.

WHAT WILL HAPPEN TO THE DEBT BURDEN AS ADDITIONAL BONDS ARE SOLD?

As currently authorized but as-of-yet unissued bonds are marketed in coming years, the state's debt-service ratio will increase from its current level. Chart 3 shows that given the budget's proposed bond sales in 1988-89 and 1989-90, and reasonable assumptions about the timing of subsequent bond sales, trends in interest rates and state expenditures, the debt-service ratio will increase to approximately 3 percent by the early 1990s. Thus, even after the sale of these authorized bonds, California's debt-service ratio still will be *relatively modest* compared to other states. (A more complete discussion of the budget's proposed bond sales and debt-service requirements for 1988-89 and 1989-90 is contained in the capital outlay section of the *1989-90 Analysis of the Budget Bill.*)

Chart 3

Future Trends in the General Fund Debt-Service Ratio Under Alternative Assumptions[a]



[a] Data shown are for fiscal years ending in years shown. The "debt-service ratio" represents General Fund costs for paying off nonself-liquidating general obligation bonds and lease-purchase revenue bonds, plus net cost of PMIA loans, as a percent of total General Fund expenditures. Projections assume that new bond authorizations are marketed within three-to-four years and paid off over 20 years at an average interest rate of 7.5 percent.

[b] Constant 1988 dollars.

Exactly what happens to the debt-service ratio beyond the early 1990s will depend upon the extent to which additional bond sales are authorized in future election years. For example, Chart 3 indicates that if the same volume of new General Fund bonds were authorized in each future election year as was authorized in 1988 ($5 billion), the state's debt-service ratio would drift upward throughout the 1990s and eventually level off at about 5.2 percent by the early 2000s. Alternatively, the chart shows that the ratio would level off at a lower amount if fewer bonds were authorized.

HOW MUCH DEBT IS IT APPROPRIATE FOR THE STATE TO HAVE?

There is no simple formula or "rule of thumb" to come up with the level of indebtedness that it is appropriate for California to have, or for that matter to say how much debt is "too much." Rather, the amount of debt California issues should reflect a variety of factors. The single most important consideration on which the debt level should be based is the *need* for public projects and programs that bonds are typically used to finance. These public needs should be identified and prioritized by the administration and the Legislature in a multi-year statewide capital outlay plan, which in turn can be used to determine the total amount of bonds necessary to fund these needs and the amount of annual debt service this would entail. The Legislature could then arrive at the appropriate level of bonded indebtedness for the state by making policy decisions regarding which of the projects and programs should actually be undertaken, based on the amount of the debt-service requirements relative to other competing expenditure needs. Because bonds are simply a "tool" for financing the state's capital outlay needs, the focus of the administration and the Legislature should not be on bonds per se, but rather on the capital outlay needs of state programs. Of course, in making decisions about using bonds, such factors as the state's overall fiscal condition, the views of bond rating agencies, the interest costs of using bond financing, and the burden on future generations of repaying debt must also be considered.

At What Level of Debt Would the State's Credit Rating Be Jeopardized?

One of the factors to consider in deciding how much debt the state should have is how various levels of indebtedness would affect the state's bond ratings. California has been successful in achieving a high credit rating by the nation's major credit rating agencies. It is important that the state try to maintain this rating because a high credit rating helps to minimize the interest costs that the state must pay on its bonds. Once lost, it can take considerable effort to "win back" a high credit rating. Given this, the effect of issuing additional debt on the state's credit rating certainly should be taken into account in deciding how much debt to issue.

The 1988 Bonds Pose No Problem. During the past year, we discussed with a number of financial experts active in the bond markets how the issuance of additional bonds would affect both the state's credit rating and the interest rates at which it borrows. The general conclusion presented to us was that the 1988 bonds would *not* adversely affect either the state's credit rating or the interest rates at which its bonds could be sold, largely because of the state's relatively low current debt burden and healthy economy. As noted above, California's debt-service ratio would remain relatively modest even after the 1988 bonds are sold. Thus, it appears *very unlikely* that the issuance of the bonds authorized in 1988 would, *by itself*, cause California's bond ratings to be hurt.

What about the Future? Looking *beyond* the bonds authorized in 1988, it is impossible to predict how much additional debt the state could authorize and issue before its bond ratings would suffer. We have asked the bond rating agencies this same question on a number of occasions, and we have never been given a specific answer. Rather, the rating agencies have indicated that they consider a *variety* of factors in arriving at their bond ratings, only one of which is the actual level of debt. For example, the agencies examine such factors as the state's overall budgetary situation, the size of its contingency reserve fund, its economic and revenue outlook, the purposes for which debt is being issued, and the state's overall debt-management policies. Given this, there is not necessarily any close correspondence between the amount of debt a state issues and the bond ratings it receives. In fact, there are some states that receive high bond ratings despite having above-average debt-service ratios, and other states that receive lower ratings despite having below-average debt-service ratios.

It is our general understanding, however, that a state's bond ratings do come under increasingly close scrutiny when its debt-service ratio stays on a persistent upward trend, particularly once that the ratio begins to significantly exceed 5 percent. As shown in Chart 3, California could issue significant amounts of additional debt for quite a few years before its debt-service ratio exceeded 5 percent. As noted above, it is impossible to predict what the state's bond ratings actually would be if this volume of indebtedness (or an even higher level) were to be undertaken, since other factors—such as the state's overall budgetary situation—would play a key rôle in the decisions made by the rating agencies.

Will Additional Debt Restrict the State's Future Fiscal Flexibility?

Another factor to consider in determining how many bonds it is appropriate for the state to issue is their effects on the state's fiscal flexibility in future years. Generally speaking, the state's fiscal flexibility is reduced whenever irrevocable future financial commitments are made, including debt-service requirements. This fact is often used as an argument against increased issuance of debt. However, the exact effects on fiscal flexibility of issuing more bonds would vary, depending primarily upon three factors: (1) the level of revenues in future years, (2) the extent to which the state's appropriations limit constrains the expenditure of state revenues, and (3) the amount of money needed to fund other, nonbond state programs.

If, for example, state revenues consistently exceed the appropriations limit, the debt service for additional GO bonds could be paid from the excess revenues without having to reduce basic funding levels for other programs or increase taxes. (This is because debt service on voter-approved debt is exempt from the appropriations limit.) On the other hand, if revenues fall short of both the appropriations limit and the amount of money needed to fund basic state programs, issuing additional bonds could require that nonbond programs be reduced or taxes raised. (This is because debt service on GO bonds basically has "first claim" on state revenues.)

SHOULD THERE BE A FORMAL LIMIT OR "CAP" ON THE STATE'S DEBT LEVEL?

As the state has increased its use of bond financing in recent years, the idea that the state should adopt a formal debt limit has received increasing attention. Given that the Legislature's decisions about funding public services should be the primary determinant of how many bonds the state issues, does imposing a formal debt limit make sense?

A Formal Limit Isn't Necessarily Needed

There are arguments both for and against having a formal debt limit:

- ***Opponents*** of debt limits argue that such limits can interfere with a state's ability to fund the full range of projects and programs that the public demands and the economy needs to effectively function. Such demands include roads, prisons, schools, water systems and a clean environment.
- ***Proponents*** of debt limits argue that bonds are often approved without closely scrutinizing the relative costs and benefits of the programs they are to finance, partly because bond costs are not paid until future years and therefore can seem "less real" than direct appropriations. Given this, proponents say that some type of limit is needed to keep excessive amounts of debt from being issued. They also argue that debt limits can sometimes help a state obtain better bond ratings, and that a limit can always be raised if more bonds are truly needed.

While there is some truth to both of the above views, it is our opinion that California does *not* need a debt limit, *especially if it implements a comprehensive multi-year capital outlay planning process like the one enacted by the Legislature in 1988 but vetoed by the Governor.* This is because such a limit could in some cases *prevent* the Legislature and the Governor from exercising their responsibility to make capital outlay decisions in a fashion consistent with the needs of the state. While it is true that there may be some tendency for additional bond issuances to sometimes be sought simply in order to avoid direct spending, especially with the constitutional limit on appropriations in place, the use of a capital outlay planning process would act as an effective "screening device" to help minimize inappropriate uses of the state's bond authority.

If a Limit Is Nevertheless Adopted, What Form Should It Take?

If the Legislature nevertheless were to adopt a debt limit, it has several options to choose from in structuring it. For example, it could place an upper limit on per capita debt, or debt as a percent of personal income or gross state product. Another alternative is to simply place a limit on the debt-service ratio, thereby ensuring that debt-service costs do not rise above a specified percent of total General Fund expenditures. We know of no firm analytical basis for either choosing amongst these various alternatives or deciding at what level such limits should be set, other than that they should not be so low as to keep needed public capital outlays from being funded. One commonly suggested option, however, is to limit the state's debt-service ratio to 5 percent, on the grounds that this is both the approximate upper bound of the average for states, and also the range at which the bond raters apparently begin to become concerned about excessive debt issuance. As noted earlier, California currently is well below this 5-percent threshold and probably would not reach it for a number of years.

A Debt Limit Should Have Some Flexibility. If the Legislature were to enact a debt limit, we firmly believe that regardless of its form it should *not* be thought of as an "iron clad," absolute maximum limit on borrowing. Rather, there should be some *flexibility* for the Legislature to adjust the limit upward if and when a legitimate need for issuing more bonds exists. Such flexibility would prevent the limit from keeping needed capital outlay projects from being funded in the future. At the same time, requiring that specific action be taken to adjust the limit upward would still make it a practical "warning signal" to the Legislature that any further increases in the debt level need to be carefully reviewed, given that the more debt there is, the greater is the potential for debt-related problems to occur.

WHAT REALLY IS NEEDED—A COMPREHENSIVE CAPITAL OUTLAY FINANCING PLAN

Even if a debt limit were to be adopted for California, the real solution to the question of how much and what type of debt the state should have lies elsewhere. Specifically, what California really needs is something which it has never had—*a comprehensive, multi-year state capital outlay plan* which can be used as the basis for determining how much debt is appropriate and for what purposes it should be issued.

Why Is Such a Plan Needed?

As noted earlier, decisions about bonded indebtedness should reflect California's *needs* for the types of projects and programs that bonds are typically used to finance. This, in turn, requires that a comprehensive state multi-year capital outlay plan exist that identifies such needs and their relative priorities. The capital outlay plan can then serve as the basis for determining what volume of bonds and annual debt-service payments would be necessary to fund this list of needs. Once this is accomplished, the Legislature would have the information necessary to make its policy decisions about which elements of the plan to adopt, and establish a comprehensive multi-year schedule for the state's bond financing needs. Thus, proceeding in this manner would help identify the appropriate level of state indebtedness and debt-service costs, and also help ensure that the state's limited borrowing capacity is allocated to different purposes in an effective way.

No Such Process Now Exists

Formulating a comprehensive multi-year state capital outlay plan and using it to identify the state's bond financing needs must involve both the Executive Branch and the Legislature in order to be successful. In response to a recommendation we made in 1987 that such a process be established, the Legislature enacted Senate Bill 2214 (Campbell) in 1988 to accomplish this. The Governor, however, vetoed this measure. Thus, California *still lacks* an effective process for determining and ranking capital outlay needs and making decisions regarding the use of bonds.

Conclusion

Given the increasing urgency of addressing California's rapidly growing capital outlay infrastructure needs, working together to initiate such a process should be a top priority of both the Executive Branch and the Legislature during the coming year.

State Transportation Funding

What Is the Extent of the Funding Shortfall in the State Highway Transportation Program and What Options Are Available to Address It?

Summary

- *Highway user fee revenues have not kept pace with the growth in state highway costs. Consequently, as highway maintenance and rehabilitation expenditures outpace revenues, less funds are available for capital outlay projects to improve the system's operational efficiency or to expand the system's capacity.*
- *Chapter 24, Statutes of 1988, among other objectives, sought to ensure adequate funding to maintain and operate the state highway system and to stop the decline in highway capital outlay funding. The measure established specific funding levels for various categories of transportation improvements and stated the intent of the Legislature and the Governor to provide additional state resources as necessary to maintain these funding levels.*
- *Based on the 1989 State Transportation Improvement Program Fund Estimate adopted by the California Transportation Commission, about $4.5 billion in additional resources would be needed over the next five years to meet the statutory levels specified in Ch 24/88 and to provide for projects which improve the operation of the state highway system.*
- *The size of the funding shortfall, however, may vary. For instance, if capacity enhancement projects are programmed annually at a level higher than is included in the 1989 Fund Estimate and a state-local demonstration program is to be funded in 1990-91, the funding gap for the five-year period would be about $6 billion.*
- *The Legislature and the Governor will need to act during 1989 to address the highway transportation funding shortfall by raising revenues or reducing expenditures. The state is limited, however, in its ability to reduce highway maintenance and operation expenditures over the long term without producing adverse impacts on motorists. The state would also need to consider how reductions in expenditures for highway projects would affect California's future economic prospects.*
- *The state has several alternatives available to it for increasing resources to address the transportation funding shortfall. Increases in transportation user charges would provide the best approach by linking system costs with those who most directly benefit from the system. Accordingly, we recommend that these fees be increased.*

- *The level by which these fees should be increased depends on the extent to which the state relies on a "pay-as-you-go" system or bond financing to support transportation programs in the future.*

The Governor's Budget for 1989-90 acknowledges a $666 million shortfall in State Highway Account funding for the state highway transportation program in the budget year. As discussed in our *Analysis of the 1989-90 Budget Bill* (please see Item 2660), the budget proposes the following actions in order to address this shortfall: (1) transfer funds from the Motor Vehicle Account and the Highway Construction Revolving Fund, (2) defer advertising and construction of highway capital outlay projects, and (3) reduce other State Highway Account (SHA) expenditures in both the current and budget years.

While this shortfall in state funds materializes for the first time in 1989-90, it is not a one-time problem. Based on expenditures currently planned for the next five years, a funding *shortfall* will continue to exist in future years, totaling about $4.5 billion for the five-year period 1989-90 through 1993-94. As a consequence, the State would need to provide additional resources in order to maintain and operate its highway system and to carry out the program of capital outlay improvements required by current law. Alternatively, the State would have to reduce the size of its highway transportation program.

This section discusses the magnitude of the shortfall in state funds for the highway transportation program over the next five years based on the program required by current law. It also discusses the issues the state will need to address in confronting this shortfall.

Background

Our review of the 1989-90 Governor's Budget shows that the state would spend about $2.5 billion in state and federal funds on the state's highway transportation program. About 69 percent of these expenditures would be for highway maintenance, operations, project design and engineering, and local transportation purposes. The remaining expenditures would be for highway capital outlay improvement activities. About $1.2 billion of the program would be funded from federal funds and $1.3 billion from state funds.

Maintenance and operations expenditures generally are not eligible for federal funding. Consequently, state funds must be used to pay for virtually all of these costs. In 1989-90, these expenditures are estimated to consume about one-half of the available state funds. When these amounts are added to those for highway design and engineering services, and local assistance, about 84 percent of state funds will be expended for noncapital outlay activities. By contrast, about two-thirds of all federal funds are used for capital outlay projects, with the rest used for noncapital costs.

Five-Year State Transportation Improvement Program. Under current law, the California Transportation Commission (CTC) is annually required to adopt a five-year State Transportation Improvement Program (STIP). The STIP is the basic plan for all transportation capital outlay projects funded from state and federal resources. The highway component of the STIP constitutes the state's five-year highway capital outlay plan.

Until recently, the amount of projects which could be programmed for funding in the STIP was limited to those levels which could be funded from resources reasonably expected to be available *after* highway maintenance, operations and other support and local assistance expenses are met. The STIP was developed first by estimating for the STIP period (1) all transportation revenues available and (2) expenditures for noncapital costs such as highway maintenance or project design. Remaining revenues available for the period were then programmed to fund capital outlay projects.

Capital Program Squeezed by Slow Growth in Revenues

After meeting noncapital expenses, the amount of revenues available for capital improvements has been declining. This is because revenues have not grown commensurately with the increase in costs of highway maintenance and construction, primarily due to the following reasons:

1. Fuel consumption no longer adequately reflects the demands placed on the state's transportation system. The existing highway financing mechanism—the state gas tax—is based on the consumption of fuel. In other words, the more fuel used by vehicles, the more revenues that are generated. However, because vehicles have become more efficient, increased usage of the highway system (miles traveled) has not resulted in a corresponding growth in fuel consumption or gas tax revenues.

2. The state's transportation revenue sources are not responsive to inflationary increases in the costs of the state's transportation system. This is because the revenue sources that the state relies on to finance transportation programs—the fuel tax, weight fees, and registration fees—are fixed in dollar terms and do not change with inflation. As a result, inflation reduces the purchasing power of these tax and fee rates.

3. Revenue generation is not closely linked to funding needs. Because the bulk of the state's highway system was constructed more than 25 years ago, many road segments are now, or soon will be, in need of major repairs and rehabilitation in order to maintain their serviceability. Revenues, however, do not recognize and respond to this aging of the state's transportation network.

Consequently, as maintenance and rehabilitation expenditures increase faster than the growth in revenues, less funds are left available for capital outlay projects to improve the system's operational efficiency or to expand the system's capacity.

Legislature Enacts Change in Funding Policies

Chapter 24, Statutes of 1988 (SB 140, Deddeh), made significant changes in the state's policies relating to programming and funding of transportation activities. These changes were made, in part, to stop the decline in highway capital outlay funding by establishing specific funding levels to be maintained through provision of additional resources.

Project Funding Levels. Prior to enactment of Chapter 24, capital projects were programmed in the STIP only up to the amount of resources reasonably expected to be available during the five-year STIP period. However, Chapter 24 establishes the amount for specific categories of transportation capital outlay improvements to be programmed annually in the STIP. These amounts include:

- The amount needed for rehabilitation and safety improvements of state highways,
- $1 billion for projects which expand the capacity of the highway system, and
- $15 million for soundwalls.

Chapter 24 also makes two other changes which affect the highway transportation program. First, it requires $75 million of SHA funds be programmed annually for capital improvements of mass transit rail guideways. Second, it establishes a state-local demonstration program to provide state funds ($300 million in 1990-91) to match local dollars for transportation improvements.

By setting the above funding levels, Chapter 24 defines a minimum annual capital outlay program for highway transportation. We estimate the *annual* costs of this program to be between $1.1 billion and $1.3 billion beginning in 1989-90. (The range in program level depends on a legal interpretation as to whether the $1 billion for highway capacity enhancement projects is only for construction costs or if it also includes related design and engineering support costs. Pending clarification, the CTC has programmed capital outlay costs for these projects at $750 million, with the remainder for engineering support activities.)

When capital outlay expenditures are added to noncapital outlay costs (maintenance, operations, engineering support and local assistance), the state highway program under Chapter 24 would average about $3 billion annually for the five-year period from 1989-90 through 1993-94. (This program level, however, does not include funding for the state-local demonstration program.)

Bond Measure Failed. Chapter 24 also placed a $1 billion general obligation bond measure for transportation before the voters at the June 1988 statewide election. This measure was intended to provide the first increment of additional money needed to fund transportation programs at the specified levels. The bond measure, however, was defeated.

Six-Year Financing Plan. In addition to the bond measure, Chapter 24 stated the intent of the Legislature and the Governor to provide additional state resources as necessary to support a highway program at the level specified by the act. In order to determine the additional resources needed, Chapter 24 requires the Governor to submit biennially a six-year transportation financing plan that identifies anticipated transportation expenditures and the amount of any shortfall in state resources available to fund those expenditures. The plan must also identify new revenue sources necessary to address any funding shortfall.

The first plan was due in January 1989 with submission of the 1989-90 Budget Bill. However, the administration has not yet submitted the required plan.

1989 STIP Fund Estimate Indicates $4.5 Billion Shortfall

Based on policy guidelines and requirements specified in Chapter 24, the CTC has adopted a Fund Estimate of the resources available and needed to support a highway program for the 1989 STIP period from 1989-90 through 1993-94. This is summarized in Table 1.

As Table 1 shows, the Fund Estimate projects total resources for the five years to be about $10.9 billion, while expenditures are projected to be $15.4 billion. Thus, resources would fall short of anticipated expenditures by about $4.5 billion. Consequently, if the STIP is to be *fully* funded during this period and if federal funds are not increased above anticipated levels, about $4.5 billion of *additional* state resources would be needed.

Table 1
Fund Estimate for the 1989 STIP
1989-90 through 1993-94 [a]
(dollars in millions)

		Expenditures			
Funding Sources	*Total Resources*	*Support and Local Assistance*	*Capital Outlay* [b]	Total	Balance
State Highway Account	$6,270	$7,468 [c]	$979 [d]	$8,447	−$2,177
Federal funds	4,653 [e]	1,869	5,109	6,978	−2,325
Totals	$10,923	$9,337	$6,088	$15,425	−$4,502

[a] Detail may not add to totals due to rounding.
[b] Assumes 85 percent of project costs added in 1989 STIP are federally eligible.
[c] Includes $802 million in reservations for workload increases.
[d] Includes $658 million to match federal funds for capital outlay.
[e] Funds remaining after funding $767 million of prior project commitments.

Size of Shortfall May Vary. The funding shortfall, however, may vary depending on the following factors:

First, the Fund Estimate reflects a policy decision by the department and the commission to set aside about $800 million for workload and other increases in support expenditures, such as highway maintenance and operations, over the five-year period. To the extent that actual increases in workload vary, the amount of actual expenditures and, consequently, the funding gap would differ.

Second, the Fund Estimate anticipates additional costs of about $550 million to construct projects as a result of changes in project scope or delays in construction schedules. These cost impacts, however, may differ depending on the actual project scopes and construction schedules.

Third, the Fund Estimate reflects the CTC's decision to program $750 million annually for capacity enhancement projects for the five-year period. If $1 billion of these projects is programmed instead, total expenditures over the STIP period would be $1.25 billion *higher*, resulting in a correspondingly larger shortfall.

Fourth, the Fund Estimate also does not include $300 million the Legislature indicated it intends to appropriate for a state-local demonstration program. If funding for this program is to be provided in 1990-91, as intended by Chapter 24, the funding gap would be commensurately larger.

Consequently, depending on the above factors, the funding gap for the five-year period from 1989-90 through 1993-94 would differ from that projected by the Fund Estimate. For instance, if capacity enhancement projects at the higher $1 billion-per-year level are to be funded together with the 1990-91 funding of the state-local demonstration program, the five-year shortfall would be $6 billion—or $1.5 billion more than the $4.5 billion reflected in the Fund Estimate.

Resources Inadequate in the Budget Year

The shortfall in funding the STIP is beginning to have a real and immediate impact on the state's transportation program. As discussed in greater detail in the *Analysis*, this funding shortfall first materializes in the budget year. The administration identifies a funding gap of $666 million in the proposed 1989-90 budget, and it proposes to address the shortfall by a combination of transfers from other fund sources and reductions in highway activities.

Our review shows that the funding gap is an ongoing problem. By 1993-94, the last year of the 1989 STIP, the shortfall would increase to about $1 billion *annually* if the state highway program is funded at the levels specified in Ch 24/88 and projects are provided to improve the operation of the system. *Without additional resources, reductions in expenditures would be required in each year from 1989-90 through 1993-94 to make up the total $4.5 billion gap for the five-year period.*

After 1993-94, a shortfall of about $1 billion would continue annually if no additional state and federal funds become available.

Options to Address Funding Shortfall

The Legislature and the Governor will need to act now in order to address the state highway transportation funding problem. The state's options are to reduce expenditures below currently planned levels, increase resources, or do a combination of both.

Reducing Expenditures—Not a Long-Term Alternative. One approach that could be taken to eliminate the funding shortfall would be to reduce the size of the highway program. However, if the current highway system is to continue to provide adequate service to motorists, the state could not achieve reductions in expenditures for maintenance and operations sufficient to address the funding shortfall. For example, even if maintenance and operations expenditures were reduced by one-half, only about $500 million would be saved annually (or $2.5 billion over five years). Thus, there would still be a funding gap of $2 billion over the life of the STIP. Consequently, in order to eliminate a fund shortfall, the state would be faced with cutting back state funding of the capital outlay program and related design and engineering work.

Reducing the capital improvement program, however, may not be a desirable long-term solution. In making such a decision, the state would need to consider how such a reduction would affect the California economy. As we indicated in our December 1988 report, *A Perspective on the California Economy*, deficiencies in the transportation infrastructure, like other infrastructure deficiencies, can result in significant economic costs and inefficiencies. For example, it is conservatively estimated that congestion on state highways in 1987 cost drivers the equivalent of $800 million in lost time, vehicle maintenance and operating costs, and commercial driver wages.

Increased Resources—A Must for the Long Run. Consequently, the Legislature and the Governor must seek to increase resources to fund transportation programs over the long term, especially if the state highway program is to be sustained at levels specified in Ch 24/88. The state has essentially two options to increase resources for transportation: redirect resources from other areas of the state budget or increase revenues.

Increased Revenues Are Needed

While the state could redirect resources from other areas of the budget, it is our judgment that redirections of the magnitude required to make up the STIP shortfall on an ongoing basis are *not* feasible without severe impacts on other state programs. As a consequence, we believe the state will need to *increase revenues*. To accomplish this, the Legislature and the Governor will have to decide what funding source the state should use and what level of revenue increase is needed.

User Charge Approach Is Reasonable. The state could increase various funding sources to provide additional revenues. Historically, however, California has funded its highway system through a set of user charges, such as the gas tax and weight and registration fees. This approach charges those who most directly benefit from the highway system for the costs of the system. While the benefits of an efficient transportation system extend well beyond highway users, they are the ones who most directly benefit from the use of the system. In this sense, user charges to support the system are reasonable.

What Level of Increase Is Needed? The Legislature and the Governor will also have to determine the appropriate level of increase in the selected funding source. In part, this decision will depend on the extent to which the state relies on a "pay-as-you-go" system or bond financing to support transportation programs. There are advantages and disadvantages to both financing methods, which we have discussed in more detail in our report *A Perspective on Bond Financing* (December 1987).

Assuming the historical "pay-as-you-go" approach is used, and $4.5 billion in additional revenues needed for the five-year period were to be raised through an increase in the gas tax, an average increase of about 6 cents per gallon (above the current 9 cents-per-gallon state tax rate) would be needed. This increase would generate about $4.4 billion for the five-year period, assuming historical growth in fuel consumption. To the extent cities and counties continue to receive about one-half of gas tax revenues, as under current law, the increase would need to be twice as large—about 12 cents per gallon. Concurrent increases in other fees, such as truck weight fees, would reduce the amount of the needed gas tax increase.

As an alternative to the "pay-as-you-go" approach, the state could issue bonds to be repaid from gas tax or other highway user charges in order to fund the shortfall in the 1989 STIP. For example, raising the $4.5 billion needed during the period 1989-90 through 1993-94 from bond sales would require about a 2.2 cent increase in the gas tax if the bonds were to be repaid over a 20-year period. *This would be a short-term solution because it would fund the shortfall only during the five-year STIP period.* To fund the shortfall after 1993-94, additional tax increases would be needed.

Appropriations Limit Poses a Constraint. As discussed elsewhere in this *Perspectives and Issues*, the state is near the level of appropriations from tax revenues allowed under the California Constitution. If the Legislature and the Governor decide to increase taxes to fund transportation program costs on a "pay-as-you-go" basis, it must also determine how the increased revenue is to be accommodated within the appropriations limit. One option would be for the state to seek voter approval to modify or repeal the state's appropriations limit (see below).

The limit, however, would not be a consideration if increased gas tax revenues were used to pay off voter-approved bonds.

Recommendation

We recommend that the Legislature increase the state's gas tax and other highway user fees to provide additional funding for the state's highway transportation program. We further recommend that the Legislature provide for future increases in these sources based on an index of highway construction and operation costs.

Our review indicates that up to $4.5 billion in additional revenues will be needed during the next five years if the program required by Ch 24/88 is to be carried out. Annually thereafter, depending on the availability of federal funds, the state highway program will have a shortfall of about $1 billion. In order to provide the additional resources needed to fund this program at levels specified in Ch 24/88, we recommend that the Legislature increase the state's gas tax and other fees. The level by which these fees should be increased depends on the extent to which the state relies on a "pay-as-you-go" system or bond financing to support transportation programs in the future.

Elsewhere in this *Perspectives and Issues*, we have recommended that the Legislature seek voter approval to repeal the existing appropriations limit, and either rely on traditional mechanisms to control state spending (such as the 2/3 vote requirement for tax increases) or replace the limit with one which provides more flexibility to deal with problems like the current transportation funding gap. In either case, this would allow revenues from such increased taxes to be appropriated to fund transportation programs.

Furthermore, to ensure that these user fees keep pace with increases in highway maintenance and improvement costs in the future, we recommend that the Legislature provide for periodic increases in these fees based on an index of costs to build, maintain and operate the state highway system.

Year-Round Schools

What Are Year-Round Schools and How Can Their Use Reduce the Demand for Limited School Facilities Aid Funds?

Summary

- *Currently, school district requests for state aid to accommodate unhoused students through the State School Building Lease-Purchase program far exceeds–by several billion dollars–the amount of funds currently available from the state. In addition, the demand for these limited state resources will mount in the coming years as the K-12 school-age population continues to grow.*
- *Through the use of year-round education, school districts can make more intensive use of existing facilities, thereby expanding the capacity of a school site by up to one-third (or more, in certain cases).*
- *As a result, year-round school programs can reduce the demand for school construction funds by hundreds of millions of dollars. In addition, these programs can reduce school district per-pupil operating costs.*
- *The academic achievement of students attending year-round school programs is generally comparable to that of their counterparts in traditional calendar schools.*
- *In order to maximize the number of pupils that can be housed with limited state financial resources for school construction, we recommend that the Legislature enact legislation requiring Lease-Purchase program funds for new construction to be allocated to school districts as if the facility would operate on a year-round basis.*

Introduction

The Department of Finance (DOF) estimates that, on a statewide basis, the California K-12 school-age population will grow by approximately 140,000 students per year between now and 1997, resulting in a need for an additional 2,100 new schools. The State Department of Education (SDE) estimates that the cost associated with providing these additional facilities could be as high as $11 billion. There are several methods available to school districts to finance their school facilities needs using either state resources, local resources, or a combination of the two. First, the State School Building Lease-Purchase program provides most of the money used by local public school districts to construct and/or modernize school facilities. Currently, school district requests for state aid through the Lease-Purchase program far exceed the funding available for this purpose. Specifically, as of November 1988, applications from school districts for state aid ($4.3 billion) exceeded existing available funding ($800 million) by approximately $3.5 billion.

In addition to the state program, school districts may raise funds locally for school facilities through three primary methods:

- ***The Mellow-Roos Community Facility Act of 1982.*** Pursuant to this act, school districts are authorized to form "community facilities" districts, subject to the approval of two-thirds of the voters, to sell bonds to raise revenue for building new, or modernizing existing school facilities.
- ***Local General Obligation Bonds.*** School districts are generally authorized to incur bonded indebtedness for school facilities construction purposes, subject to a two-thirds voter approval.
- ***Developer Fees.*** Since January 1, 1987, school districts have been authorized to impose developer fees, as specified, on a per-square-foot basis upon new residential and commercial/industrial construction. These fee revenues can be used only for the construction or modernization of school facilities.

One important way to reduce the cost of providing school facilities is through the use of year-round schools. Year-round school provides a more intensive use of existing facilities, thereby expanding the capacity of a school site, and commensurately reducing the need for new facilities. In the discussion that follows, we describe what year-round education is, how its use can accommodate more students at an existing site, why it is educationally sound, and why we believe it should be an essential component of any state program to assist school districts in meeting their school facility needs.

What Is Year-Round Education?

Year-round education is an alternative *schedule* for learning; it is not an alternative *curriculum* for learning. Students attending a year-round school go to the same types of classes and receive the same amount of instruction–generally 180 days per academic year–as students attending traditional nine-month calendar schools. The year-round school calendar is organized into instructional blocks and vacation periods that are evenly distributed across a 12-month calendar year.

Specifically, on a traditional calendar, students generally attend school for nine months followed by a three-month summer vacation. On a year-round calendar, the three-month summer vacation is divided into several shorter vacation periods which are then spread throughout the school year. As a result, year-round students receive several shorter vacations; however, the total amount of vacation afforded to each pupil is still the same as that of students attending a traditional-calendar school. Typically, a year-round student receives three one-month vacations or four three-week vacations during one academic year.

Single-Track Versus Multitrack. Year-round schools can be operated on either a "single-track" or "multitrack" basis; however, *it is only when the multitrack format is implemented that the capacity of the school can be increased.* A single-track system provides for the entire school population (that is, all students and teachers) to follow the same calendar with the same vacation periods. This means that, at any given time, all of the students and teachers are in school, or they are all on vacation. The school is typically closed during the vacation periods when neither the students nor teachers are present.

On a "multitrack" system, students and their teachers are grouped into different tracks, with staggered instructional blocks and vacation periods. While one track is on vacation, another track can use its space, thereby allowing for an increase in the capacity of the school. For example, depending on the actual calendar used, students and their teachers may be divided into four tracks. At any one time, three of these tracks, or three-quarters of the school's students/teachers, will be in school, and the remaining track, representing one quarter of the school's students/teachers, will be on vacation. (The remainder of this discussion will focus on the characteristics of multitrack programs because it is only on a multitrack system that the capacity of a school site can be increased and corresponding facility-related costs reduced.)

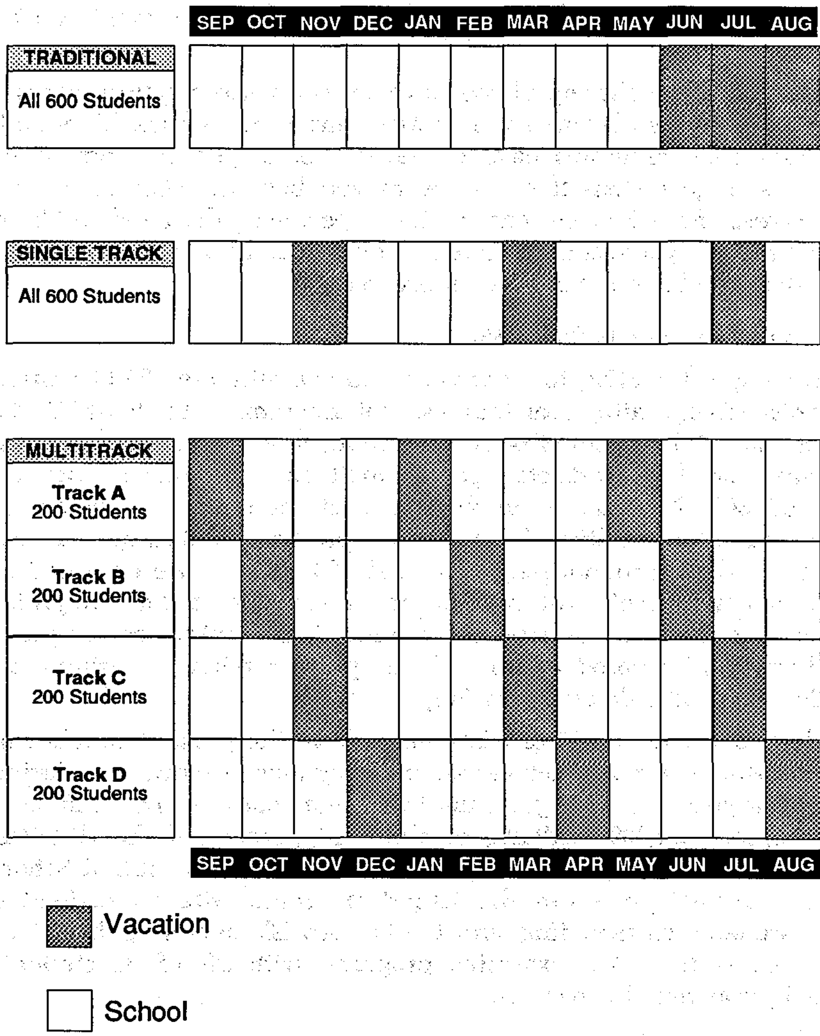
Chart 1 compares the different attendance patterns for a traditional, single-track and multitrack calendar program. It shows that both the traditional calendar and single-track calendar can accommodate only 600 students and that all students are either in school or on vacation at the same time. Chart 1 also shows that, by dividing students into four tracks and staggering instruction and vacation periods, the multitrack calendar can accommodate 800 students, a 33 percent increase in capacity.

Track Assignments. On a multitrack system, students and teachers typically are assigned to one of either three or four "tracks." There are a variety of methods for assigning students to tracks including: (a) geographically (that is, by address), with entire blocks, sides of streets, or apartment buildings assigned to the same track; (b) randomly (for example, alphabetically); (c) by ability grouping (for example, by a student's proficiency with English); (d) self-selection; and (e) individually (that is, a one-by-one placement to customize the characteristics of each track).

Most districts offer parents the opportunity to indicate a preferred choice of tracks, and also provide for students from the same family to be

Chart 1

Attendance Patterns
Traditional, Single-Track and Multitrack Calendar Programs[a]
For A School Which Can Accommodate 600 Students At Any Time



[a] For purposes of illustration, we have assumed: (1) a "60-20" calendar (60 school days – or about 3 months – on and 20 days – or about one month – off); (2) that school starts September 1 and ends June 1, (3) no winter vacation, and (4) that full capacity increase can be obtained.

assigned to the same track. Similar variations occur regarding the assignment of teachers to tracks, although generally a much larger degree of self-selection is available (providing that each track yields the necessary number of teachers for each grade level).

Shared Classrooms. Because a classroom remains in use when one track goes on vacation, teachers are generally grouped so that four teachers share three classrooms. Teacher grouping is generally made on the basis of grade level, so that similar supplies and equipment can be shared.

By necessity, the sharing of rooms requires a revised system for the storage of teacher and classroom materials during the "off-track" period. Most multitrack programs have developed some type of modular or portable storage system that can be moved between classrooms and storage areas. Innovative designs in schools specifically designed and built to accommodate year-round programs provide a central teacher storage/workspace area linked to several classrooms.

Year-Round Education in California

According to the SDE, there are currently an estimated 69 California school districts operating year-round school programs, with about 360,000 students (about 8 percent of pupils statewide) attending such programs. Thirty-five of these districts operate multitrack programs, with an estimated 300,000 students enrolled in such programs. A review of districts operating multitrack year-round programs indicates that the majority of these programs–approximately 90 percent–are operated at the elementary school level, with the remainder operated at the junior high or senior high school level. For the most part, multitrack programs have been implemented for the sole purpose of relieving either site-specific or districtwide overcrowding.

Table 1 identifies the 10 districts which have the greatest number of students attending multitrack year-round programs. It shows that during the current year, the 10 largest multitrack year-round programs include approximately 234,000 students, or about 25 percent of the districts' overall enrollment. Of these programs, the Los Angeles Unified School District (LAUSD) operates the largest program, with an estimated 135,000 students participating, and the Oxnard Elementary School District operates the most extensive program, with *all* of its students attending year-round programs.

Table 1
Ten Largest Multitrack Year-Round Programs
(by district)
1988-89

	Enrollment		
		Year-Round	
District	*Districtwide*	*Number*	*Percent of Total*
1. Los Angeles Unified	594,000	135,000	22.7%
2. San Diego City Unified	117,000	17,700	15.1
3. Fresno Unified	65,500	17,900	27.3
4. Santa Ana Unified	40,000	12,000	30.0
5. Montebello Unified	31,600	8,200	25.9
6. Lodi Unified	22,500	9,900	44.0
7. Fontana Unified	22,300	7,600	34.1
8. Rialto Unified	17,300	7,700	44.5
9. Oxnard Elementary	11,800	11,800	100.0
10. Hesperia Unified	10,900	6,200	56.9
Totals	932,900	234,000	25.1%

Of the 10 largest school districts in California, six currently operate multitrack year-round school programs, with a range from between 5 percent to 35 percent of students attending a year-round program.

Variation of Calendars. Our review indicates that there are four basic calendars used by the districts in the state which operate year-round programs. The calendar adopted by a school district for its year-round education program determines the frequency and length of the instructional blocks and vacation periods that students and teachers will receive. Generally, the type of calendar selected does not affect the extent to which a facility will be able to accommodate additional pupils; rather, it only affects the number of transitions students and teachers have to make between periods of instruction and vacation.

The majority of students attending multitrack year-round programs are accommodated by some variation of the following four basic calendars:

- ***"90/30."*** On the "90/30" calendar, each track of students and their teachers are present in school for 90 days (18 weeks), and then recess for 30 days (6 weeks). This calendar is similar to a "two semester" school schedule in that instruction occurs during two 18 week blocks, each separated by a six-week break.
- ***"60/20."*** On the "60/20" calendar, each track attends school for 60 days (12 weeks), and then recesses for 20 days (4 weeks). On this type of calendar, students/teachers are present in school during three three-month blocks, each separated by a one-month break.
- ***"45/15."*** On the "45/15" calendar, students/teachers are present in school for 45 days (9 weeks), and then recess for 15 days (3 weeks). This calendar involves four transitions–the most of any of these calendars–between instruction and vacation during an academic year.

- *"Concept 6."* This calendar provides for only 163, rather than 180 days of instruction; however, the school day is lengthened by 25 to 38 minutes, depending on the grade level. Consequently, over an academic year students still receive the same amount of instructional time as their counterparts in a traditional-calendar school.

The "Concept 6" calendar divides the year into six instructional terms (each about two months long), with students required to attend four of the six terms (for an eight-month school year). This calendar allows a district to accommodate the greatest percentage increase in additional students (up to 50 percent). Despite this, Concept 6 has not been used by many districts. This is because, prior to July 1, 1988, school districts (with the exception of the LAUSD) were prohibited from offering students fewer than 175 days of instruction per academic year. This made the Concept 6 calendar difficult to implement. From July 1, 1988 through July 1, 1995, however, current law authorizes *all* school districts to offer a Concept 6-type calendar, provided that the total amount of instructional time provided to students meets existing statutory requirements.

Table 2 provides a comparative summary of these four basic year-round calendars with that of the traditional-calendar school. It shows that, although the length and number of instructional terms vary among the different calendars, all but the Concept 6 calendar provide students with the same number of instructional days–generally 180–per academic year. Table 2 also shows that, although the length and number of vacations vary between the different calendars, all students receive approximately 12 weeks of vacation, except for Concept 6 students, who receive approximately 16 weeks of vacation.

Table 2
Comparative Summary
Traditional and Year-Round School Calendars

	Calendar				
Features	*Traditional*	*90/30*	*60/20*	*45/15*	*Concept 6*
Number of instructional days	180	180	180	180	163
Number of instructional terms	1	2	3	4	4
Length of term	180 days (36 weeks)	90 days (18 weeks)	60 days (12 weeks)	45 days (9 weeks)	41 days (8.2 weeks)
Number of Vacations	1	2	3	4	2
Length of Vacation	12 weeks	6 weeks	4 weeks	3 weeks	8.1 weeks
Maximum percent capacity gain	–[a]	33%	33%	33%	50%
Number of Tracks	–[a]	4	4	4	3

[a] Not applicable.

As mentioned above, districts often modify a particular basic calendar format in order to meet their individual needs. For example, one school with a typically low enrollment during January arranged its calendar so that the school was closed that month. Other districts that wanted to provide a slightly longer vacation period during the summer months lengthened the vacations falling during this period and commensurately shortened other breaks. Our review of California school districts which operate a year-round program indicates that no two districts have identical calendars; in fact, it is not uncommon for a single district to operate several different calendars.

No "Best" Calendar. Our review indicates that, although there are virtually an unlimited variety of calendars that can be implemented for year-round education, *there is no single "best" calendar.* For example, a school needing to accommodate only 20 percent more students may not want to implement the Concept 6 calendar, which provides for increasing student capacity by up to 50 percent. Similarly, a district with a larger degree of overcrowding might determine that it makes more sense to operate one or several Concept 6 calendar schools, rather than an increased number of "45/15" or "60/20" schools, each of which individually affords a smaller capacity increase. A district with overcrowding only at the high school level might elect to implement the Concept 6 model, as it provides the greatest flexibility for scheduling classes where students rotate among teachers because it has fewer but larger tracks. On the other hand, a district with overcrowding only at the elementary level might opt for a calendar which allows for the easiest transition for students from a year-round calendar elementary school to a traditional-calendar secondary school. In sum, our review indicates that the "best" calendar is the one that fits a particular district's (and its community's) needs.

Capacity. As illustrated above, most multitrack calendars allow for a 33 percent increase in capacity. Most schools, however, achieve a *lower* capacity increase for several reasons.

First, not all classrooms that are available on a traditional calendar can be maintained as classroom space in a year-round calendar program. For example, because generally one quarter of the teachers are not present at any one time, space needs to be allocated for the storage of these teachers' materials and as a workroom in which they can prepare upcoming materials during their "off-track" time. Second, because the school site is in continual use, such necessary maintenance and upkeep activities as cleaning and painting are difficult to perform unless some classrooms are periodically "cycled out" and kept empty and available for such services. Finally, in order to operate "intersession" programs–the year-round school equivalent of summer school–additional classroom space must also remain unoccupied.

Uses of Increased Capacity. The increased capacity that results from a multitrack system may be desirable for reasons other than providing space for unhoused students. For example, where overcrowding has already been accommodated through other means–such as using libraries, computer labs, special education or multipurpose rooms as classroom space–the conversion to multitrack may simply allow a school site to again "free up" these areas for their originally designated educational purposes.

Where overcrowding is unique to a particular site or sites, rather than districtwide, the increased capacity can be used to reduce or eliminate the need for busing students from a crowded site to one that has available space or for altering individual school site attendance areas.

The increased capacity also can be used to integrate selectively a school that is segregated racially, socially, or by ability. For example, the increased capacity generated at a racially segregated school can be filled with students of underrepresented races.

Finally, a change to a year-round calendar could be made to reduce class sizes without having to expand the facility. For example, a school with an enrollment of 480 students and an average class size of 30 students requires 16 classrooms. To reduce the class size by 20 percent (to 24 students per class), four additional classrooms (a total of 20 classrooms) would normally be required. By converting to a multitrack schedule, however, the school could make five additional classrooms available, thereby avoiding the costs of constructing any additional classroom spaces.

Advantages and Disadvantages

There are both benefits and costs–monetary and otherwise–associated with operating multitrack year-round educational programs. Below, we focus on two of the more significant areas of state concern–the costs and savings associated with year-round schools and its impact on students' academic achievement. In addition, we summarize other advantages and disadvantages of a multitrack calendar.

Costs and Savings. In the area of *capital outlay,* the use of multitrack year-round programs could result in major state and local savings in school construction and rehabilitation costs. For example, our analysis indicates that, on average, it costs almost $5 million to purchase acreage and build a new elementary school to house 500 California students, for a per-student cost of about $10,000. Thus, each unhoused student who is accommodated through the use of a year-round schedule saves the local district a significant amount of capital outlay funds. For the state, the implementation of year-round programs in lieu of constructing new facilities would reduce the demand for state school facilities aid funds by potentially hundreds of millions of dollars.

These savings would be offset by certain capital and one-time costs to operate year-round schools. For example, many schools would require air conditioning and added insulation to operate during summer months, and almost all schools would have additional storage needs. Our review indicates, however, that these one-time costs are fairly small in comparison to the capital savings.

In the area of *operating expenditures,* we are aware of only two in-depth financial analyses which compare the costs of year-round and traditional schools: one by the Oxnard Elementary School District and the other by the San Diego City Unified School District.

The Oxnard district is an entirely year-round district serving approximately 11,800 K-8 students. In a study conducted in 1986-87, the district compared actual per-pupil costs over a four-year period (1981-82 through 1985-86) of operating its year-round schools to its costs of operating traditional-calendar schools. The study found that the annual per-pupil cost of maintaining year-round schools averaged about 5.5 percent (or $123) *less* than what the district paid for traditional schools. The district attributes the overall savings primarily to economies of scale–that is, the additional enrollment permitted by a year-round program did not require a proportionate increase in expenses. In addition, the study identified four specific factors which contributed to these operational savings:

- Sharing of classroom and reference materials since four classes of students share three sets of materials.
- Avoiding the cost of additional benefit packages, as staff extended from 10-month to 11- or 12-month contracts did not require additional benefits.
- Reduced student and teacher absenteeism.
- Reduced school site burglary and vandalism.

The San Diego Unified School District is a K-12 district serving approximately 117,000 pupils. Of these, almost 18,000, or 15 percent, attend year-round schools. In a study focusing on the 1987-88 school year, the district compared the ongoing operational costs of accommodating excess enrollments through year-round schools to those of traditional schools. The district determined that, on an ongoing, per-pupil basis, there were *no increased costs* when capacity was increased by 20 percent and there were *savings of $8.92 per pupil per year* when capacity was increased by 25 percent. (The district's analysis also identified $400,000 in one-time costs associated with the conversion to year-round operations.)

Thus, while there currently is limited information on this issue, the evidence from these two studies indicates that, *on a per-pupil basis,* the operational costs of year-round schools are slightly *less* than those of their traditional calendar counterparts.

Academic Achievement. In evaluating year-round education, a critical concern is its impact on academic performance. The field of literature addressing this issue is quite limited. Following are the conclusions of several of the studies that have been conducted:

- A 1979 study of the Pajaro Valley Unified School District conducted by the Stanford Research Institute indicated that its year-round school program had little impact on a student's achievement test scores.
- A 1984 study conducted by the Los Angeles Unified School District concluded that its year-round programs relieved overcrowding without reducing educational quality or negatively affecting student's academic performance.
- The authors of a 1986 study of proficiency scores in the Oxnard Elementary School District found that year-round students outperformed traditional students in math, but the reverse was true in reading–although the differences in performance in both cases were small.
- The SDE, in a 1987 report on year-round education, analyzed test scores of students attending traditional, single-track, and multitrack calendar schools. Allowing for the special needs and demographics of the communities in which multitrack year-round schools have been placed, SDE concluded that the year-round calendar is a viable educational option "that can be associated with achievement at or above predicted levels."

Thus, a review of these studies suggests that students in year-round programs generally do no better or no worse than their counterparts in traditional calendar schools. We also discussed the issue of academic achievement with various practitioners during the course of our review. There appears to be a general consensus among principals and teachers in year-round schools that students' retention of subject matter is greater, thereby leading to a reduction in the amount of time that must be devoted to reviewing old material and enabling more new material to be covered.

Other Considerations. Chart 2 highlights many of the advantages and disadvantages associated with multitrack year-round education programs. Specifically, the chart indicates that year-round education can increase both the supply of substitute teachers and teachers' overall earnings to the extent that "off-track" teachers make themselves available as substitute teachers during some or all of their vacation time. Our visits to districts operating year-round programs indicate that almost all offer off-track teachers first priority for substituting at their home school during their vacation periods. Multitrack programs generally also offer the opportunity for classified personnel (for example, maintenance and cafeteria workers) to increase their overall earnings by converting from 10- or 11-month contracts to full-year contracts.

Chart 2

Multitrack Year-Round Schools Advantages and Disadvantages

ADVANTAGES

Fiscal:

- Is a cost-effective alternative to constructing or modernizing a new facility.
- Can reduce per-pupil operating costs.
- Reduces student and teacher absenteeism.
- Reduces school site burglary and vandalism.

Facility Utilization:

- Generally increases school site capacity up to 33 percent depending on the calendar selected, number of tracks, and other facility needs. Alternatively, allows for a reduction in class size, without adding additional classroom spaces.
- Acts as an alternative to busing, double sessions, or extended day schedules when overcrowding is present.
- Increases both school and community facility use.
- Allows more students to attend neighborhood schools.
- Increases flexibility for meeting district desegregation needs.

Academic/Instructional:

- Reduces the amount of remedial review done each September after the traditional vacation period learning regression.
- Encourages/requires teaching staff to be better organized.
- Enables intersessions to be offered for enrichment/remediation programs at more frequent intervals than summer school.

Employment:

- Increases availability of substitute teachers to the extent that year-round teachers elect to substitute during some or all of their "off-track" periods, and also increases salary opportunities for those teachers electing to substitute.
- Provides the opportunity for year-round employment for both support service personnel and educators.
- May provide secondary students with greater opportunities for vacation employment.

Other:

- Allows staff and families the opportunity to take vacations during "nonpeak" times.

DISADVANTAGES

Fiscal:

- May present large initial implementation costs for building renovation (for example, the addition of air conditioning or storage facilities).

Administrative:

- Increases difficulty in scheduling schoolwide educational and extracurricular activities because one group of staff/students is always absent.
- Makes it difficult to communicate with "off-track" students and staff.
- Increases scheduling problems with transportation, central supply, and maintenance.
- Presents storage difficulties for "off- track" teacher's and classroom materials.
- Generally requires an increased level of coordination with ancillary community service organizations that provide recreational and child care services to vacationing students.
- May be difficult to schedule children from the same family that are in different grades.
- Becomes more difficult to regroup students once they are assigned to a track.

Employment:

- May reduce staff professional development opportunities, to the extent that courses are offered only in the summer.

Other:

- Parents have difficulty adjusting to a change in the traditional school calendar.
- Periodic vacations may create baby- sitting/child care problems.
- May be difficult for families to coordinate vacations where children attend different schools that do not use the same calendar.

Chart 2 also indicates that there are many administrative difficulties associated with operating a multitrack year-round program, such as communicating with off-track students and staff, and scheduling such activities as maintenance, transportation, staff development and schoolwide events. In addition, discussions with school district personnel indicate that parents frequently resist attempts to convert to a year-round education program until many of the advantages and disadvantages can be identified and thoroughly discussed.

Legislature's Interest in Year-Round Education

State School Building Lease-Purchase Program. As noted earlier, the state currently has an estimated $800 million in bond funds available to finance $4.3 billion in requests from school districts under the State School Building Lease-Purchase program. This aid is provided primarily in the form of grants. To the extent that school districts file additional requests for aid between now and the next time additional funds could be made available to the program–either July 1989 (an appropriation in the Budget Act) or June 1990 (bond funds provided at the next statewide election)–the disparity between requests and availability of funds will continue to grow.

In addition to aid provided through the Lease-Purchase program, the Legislature also has enacted two year-round school "incentive" payment programs–SB 813 (Ch 498/83) and SB 327 (Ch 886/86)–which provide approximately $30 million annually to eligible school districts operating year-round programs. [A detailed discussion of these programs appears in our *1987-88 Analysis* (please see page 1008) and *1988-89 Analysis* (please see page 889).]

There is one low- or no-cost method through which the Lease-Purchase program could promote the use of year-round schools, thereby increasing the number of pupils that can be housed with available state revenues. Specifically, the Legislature could revise the funding allocation formulas to reflect year-round school operations.

Revise Funding Formula. Under current law, school districts qualifying for the new construction program are awarded a total amount of funds based on a complex funding formula. This formula assumes that the new school to be constructed will operate on a traditional nine-month calendar, rather than on a multitrack year-round calendar. However, if the facility to be built were to operate on a year-round basis, the same number of students could be accommodated in a smaller facility at a significantly lower cost. To the extent that the state were to allocate funds on this multitrack basis (assuming a minimum 20 percent capacity increase), the $800 million currently available for expenditure could finance the equivalent of $935 million (an additional $135 million) in new facilities construction. (The savings is less than 20 percent because there are certain fixed costs–such as basic acreage allotments and administrative facilities–that do not vary with the incremental addition of students.) To the extent that the state were to allocate funds on the assumption that newly constructed schools could accommodate greater than a 20 percent capacity increase (such as the Concept 6 calendar, which yields up to a 50 percent capacity increase), state savings would be even greater.

Summary and Recommendation

We recommend that the Legislature enact legislation requiring Lease-Purchase program funds for new construction to be allocated to school districts as if the facility would operate on a year-round basis.

Our review indicates that multitrack year-round programs greatly reduce the demand for school facilities, are educationally sound and provide a viable alternative to the traditional nine-month calendar educational program. In light of this, and given the state's limited financial resources for constructing new school facilities, our analysis indicates that it is appropriate for the state to promote the use of year-round educational programs in lieu of the traditional nine-month calendar schools. Further, we can find very little analytical justification for the state to continue to provide funds under the Lease-Purchase program for the construction of traditional, rather than year-round schools.

Accordingly, to maximize the number of pupils that can be housed with available state revenues, we recommend that the Legislature enact legislation requiring Lease-Purchase program funds for new construction to be allocated to school districts as if the facility would operate on a year-round basis. In implementing this recommendation, the Legislature would not have to *require* districts participating in the Lease-Purchase program to operate year-round schools. Rather, the funds would be allocated *as if* the school were to be operated on a year-round basis, and the district could retain the option to operate the school on a nine-month calendar basis if locally raised funds were used to construct the larger (and more costly) facility needed to house the same number of students.

State Asbestos Abatement Programs

How Can the Legislature Best Address Asbestos Abatement in State-Owned Buildings and K-12 Public Schools?

Summary

- *Since 1984-85, the Legislature has appropriated approximately $105 million to abate hazardous asbestos-containing materials in state-owned buildings and K-12 public schools. Based on asbestos surveys conducted by various state agencies, the future cost of abating the most hazardous remaining asbestos conditions could exceed $200 million in state-owned/state-supported buildings. Removal of all asbestos in state-owned/state-supported buildings, however, could exceed **$1 billion.** The future cost of asbestos abatement in K-12 schools is unknown.*
- *We have identified the following problems with current state asbestos abatement programs: (1) no clear basis for determining the health risks of asbestos in buildings; (2) inconsistent criteria for determining abatement project priorities; (3) excessive reliance on removal of asbestos, regardless of its condition; and (4) inaccurate information about the future cost of abatement projects.*
- *The best available evidence indicates that the airborne asbestos concentrations in most buildings are well below the levels for which there is a conclusive health hazard. Given this, and the risks associated with abatement projects, we recommend that the Legislature fund abatement projects only in those cases where concentrations of airborne asbestos are 0.1 fibers per cubic centimeter or higher—the federal regulatory asbestos limit for workers.*
- *If, however, the Legislature on a policy basis decides to continue to fund asbestos abatement, its programs should be guided by four principles: (1) projects should be funded in priority order, by level of hazard to be addressed; (2) removal of all asbestos, regardless of its condition, is not necessary to protect public health and safety; (3) the abatement method adopted for any given project should protect the health and safety of building occupants in the most cost-effective manner; and (4) asbestos abatement work creates hazards which must be carefully controlled.*
- *Based on these principles, we recommend several specific steps the Legislature should take to improve the efficacy of its asbestos abatement programs.*
- *We also identify the future abatement costs the Legislature may face and discuss how those costs can be funded.*

The existence of asbestos in public buildings has recently received a great deal of public attention, in part because of the uncertainty surrounding the health risk of exposure to low concentrations of asbestos in buildings, and in part due to the high cost and high risk of asbestos abatement efforts. Over the past five fiscal years, the state has spent $105 million to identify and remove asbestos in buildings owned by state agencies, in state-supported higher education facilities, and in K-12 public schools. Over the next several years, the Legislature could receive requests to fund asbestos abatement projects totaling hundreds of millions of dollars more.

In this analysis we provide background on the problem of asbestos exposure and summarize the state's response to asbestos in state-owned/state-supported buildings and K-12 public schools. We then review certain problems with the state's current abatement programs, and offer recommendations as to how to improve those efforts.

BACKGROUND

What Are the Health Risks of Asbestos Exposure?

From the mid-1940s to the mid-1970s, materials containing asbestos were widely used for insulation, fireproofing and acoustical purposes in the construction of buildings. Under certain conditions, these materials are or may become *friable*—that is, when dry they may be crumbled or broken by hand pressure. Once crumbled or broken, these materials *may* release asbestos fibers into the air.

Risks to Workers. Sustained, long-term breathing of high concentrations of asbestos fibers, as a result of working directly with asbestos-containing materials, is a known, quantifiable health risk. It significantly increases the risk of lung cancer. Long-term exposure in occupational settings can also lead to mesothelioma, a rare cancer of the lung and abdominal membranes, and asbestosis, a chronic and progressively restrictive lung disease. Workers in the construction, automotive repair, and shipbuilding industries are considered particularly vulnerable because they frequently come into contact with high concentrations of airborne asbestos in the course of their work. The removal or repair of asbestos-containing materials poses a health risk to construction and maintenance workers because high concentrations of asbestos fibers are generally released into the air by such work. These workers are protected by a variety of state and federal regulations concerning the conduct of work which involves disturbance of asbestos-containing material. For instance, federal regulations require workers dealing with asbestos to take specific, protective actions (such as training and periodic medical exams) when airborne concentrations reach 0.1 fibers per cubic centimeter (cc).

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Risks to Building Occupants. In contrast, the health risk posed to building occupants by aging materials that contain asbestos is uncertain, and is the subject of controversy. There are no medical reports of deaths resulting from exposure to *low* concentrations of airborne asbestos in buildings. According to the U. S. Environmental Protection Agency (EPA), asbestos-containing materials, left in good condition and undisturbed, most likely pose a negligible risk to health. In fact, the best available evidence indicates that average concentrations of airborne asbestos in buildings, even in areas with significantly damaged asbestos-containing material, are 100 to 1,000 times lower than the aforementioned federal exposure limit for asbestos workers (0.1 fibers/cc of air). Neither EPA, nor medical researchers, however, have shown that there is some "threshold" concentration of airborne asbestos at which exposure poses no health risk. Consequently, EPA regards the presence of asbestos-containing materials in buildings as a *potential* health risk.

Why Is Asbestos Abatement a Concern of State Government?

There are currently thousands of state and public school buildings in California, many of which have some asbestos materials in them. For purposes of this analysis, we categorize these facilities in two groups:

- ***State-Owned/State-Supported Buildings.*** We use this definition for buildings that are either owned by or whose operations are supported by the state. These include facilities occupied by state agencies as well as campuses of the University of California, the California State University and the community colleges. This does not include private buildings leased by the state or public K-12 schools.
- ***Public K-12 Schools.*** Although these schools are state-supported, we consider them separately because asbestos abatement in the public schools is currently conducted under a unique set of state and federal statutes and regulations.

State-Owned/State-Supported Facilities. Table 1 shows that the state owns and/or supports approximately 19,000 buildings (containing about 192 million gross square feet of building space). Many of these were built during the 1950s and 1960s, when use of asbestos in building materials was common. Consequently, the vast majority of these buildings probably contain some asbestos.

Table 1
State-Owned and State-Supported Facilities

Agency	*Number of Buildings*	*Gross Square Feet (in 000s)*
Non-Education	10,600	60,000
Higher Education:		
University of California	3,800	60,900
California State University	1,195	27,350
Community Colleges	3,420	44,000
Subtotals	(8,415)	(132,250)
Totals	19,015	192,250

Public K-12 Schools. The State Department of Education indicates that there are about 7,100 K-12 public schools in California. Many of these schools were built between 1946 and 1972, a period during which asbestos-containing building materials were in common use. Federal law and regulations have required K-12 schools to take asbestos abatement measures since 1982. The state funds two programs to help school districts bear the financial burden of this abatement.

How Much Has the State Spent on Asbestos Abatement?

Although the state is not *required* to take any abatement actions, it has in recent years funded asbestos abatement programs for state-owned/state-supported buildings and K-12 public schools. Since 1984-85 approximately $105 million has been appropriated to identify and abate asbestos. Almost half of this amount was provided from the General Fund (including tidelands oil revenue). The rest was provided from bond revenues and the State Transportation Fund. Chart 1 shows the distribution of these funds. It indicates that almost half of the funds have been spent on state higher education facilities, about one-third on non-education state agencies and almost one-quarter on K-12 schools. The specific abatement programs are discussed in more detail below.

THE STATE'S RESPONSE TO ASBESTOS IN STATE-OWNED/STATE-SUPPORTED BUILDINGS

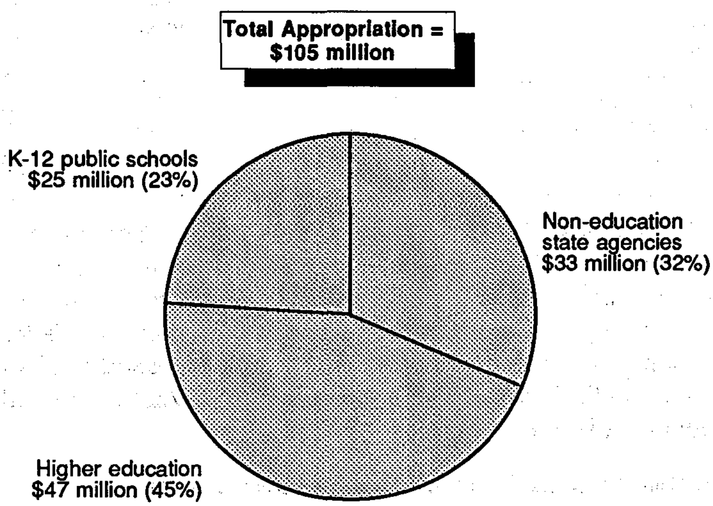
What Does Federal and State Law Require?

Neither California nor federal law requires state agencies which own buildings to undertake asbestos abatement measures within the buildings. Moreover, neither California nor federal law contains standards for identifying an indoor asbestos hazard (except in K-12 schools—see below) other than disturbance of asbestos-containing materials during repair or renovation of a building.

Chart 1

Funds Appropriated for Asbestos Abatement

1984-85 through 1988-89



The EPA, however, *recommends* that all building owners take actions to prevent conditions which may lead to release of asbestos fibers within a building. A recently enacted state law (Chapter 1502, Statutes of 1988, Connelly) requires building owners who know of asbestos-containing construction material in their buildings to notify their employees of the nature and location of the material. Building owners must also inform employees about the health risks of asbestos and proper procedures for handling asbestos-containing materials.

Federal and state laws make specific provision for controlling the release of asbestos fibers during repair, renovation or demolition of a building. Regulations established pursuant to these laws define maximum permissible levels of asbestos exposure for employees engaged in such work, establish licensing and registration procedures for contractors permitted to do asbestos-related work, and govern the work and safety practices of such contractors.

Although the state is not *required* to take any specific abatement actions, it has in recent years established and funded several programs to address asbestos in its buildings.

Department of General Services Asbestos Abatement Program

An asbestos abatement program was established in the Office of the State Architect (OSA) in 1986-87. This program, which has received appropriations of approximately $19 million, is part of a larger effort to control or eliminate toxic substances in state facilities. These funds have been used for the following purposes:

- ***Surveys ($4.5 million).*** OSA recently completed, under contract, asbestos surveys of all state-owned buildings other than higher education facilities. The surveys rank the hazard posed by asbestos-containing material according to friability of material, asbestos content, condition of material, accessibility of material, and level of human and mechanical activity near the material. OSA conducted its asbestos surveys in two phases. The first, covering approximately 20 million square feet, was completed in 1987-88. The second phase, covering approximately 40 million square feet, was completed in November 1988.
- ***Asbestos Removal ($12.5 million).*** The program also funds asbestos abatement projects for buildings owned by General Fund agencies. OSA plans to spend $10.5 million (some work is complete, all contracts to be awarded by June 30, 1989) for the removal of asbestos-containing material judged to require immediate action (friable and damaged). In addition, OSA plans to spend about $2 million (all contracts to be awarded by June 30, 1989) for removal of asbestos-containing material identified during 1987-88 and judged to require action within two years of identification (friable with potential for damage).
- ***Administrative Costs ($2 million).*** These costs have been incurred for OSA staff (currently eight personnel-years), operating expenses and equipment.

The OSA estimates that it will need an additional $63 million to remove all remaining asbestos-containing material judged to require action within two years.

In addition to funds appropriated to the OSA asbestos abatement program, $1.7 million has been appropriated directly to General Fund agencies for asbestos-related repair and maintenance projects. OSA has handled the contracting for most of this work, as well as the design work, where necessary.

Asbestos Abatement Programs of Special Fund Agencies

Buildings owned by the Department of Transportation (Caltrans) and other special-funded agencies, including the California Highway Patrol (CHP) and the Department of Motor Vehicles (DMV), were included in the OSA asbestos survey of state buildings. These agencies fund their abatement programs through their own budgets, rather than through the OSA program. Caltrans has allocated $12.2 million in State Highway Account Funds since 1985-86 to remove asbestos-containing material in district headquarters facilities. Not all of the material removed was identified by OSA as requiring immediate or short-term action. In addition, DMV has spent $300,000 in Motor Vehicle Account funds for similar purposes.

The OSA estimates that the future cost of addressing immediate and two-year projects in buildings owned by special fund agencies is $21 million. Staff at Caltrans and DMV indicate that they will immediately seek funds to abate asbestos conditions identified as needing immediate attention. Caltrans staff also indicate that they will propose removal of *all* asbestos-containing building material identified in Caltrans facilities by the OSA survey, regardless of whether the asbestos is friable or damaged. The DMV and CHP have not yet developed long-term plans for asbestos abatement.

Higher Education Asbestos Abatement Programs

The Legislature first appropriated funds for asbestos-related work in higher education facilities in the 1984 Budget Act. Since then, the Legislature has appropriated over $47 million from the General Fund or from bonds whose debt service is paid by the General Fund to the California State University ($21.5 million), the California Community Colleges ($18.7 million), and the University of California ($6.9 million) for each system to operate an independent asbestos assessment and abatement program.

The California State University. The CSU initially surveyed its facilities for asbestos-containing materials in 1984-85, and resurveyed these facilities in 1987-88. Using a hazard ranking system, CSU distinguished between materials (1) to be removed as soon as possible, (2) to be isolated and removed when feasible, (3) to be repaired and maintained, (4) or simply to be monitored and maintained. In 1988 Budget Act language, the Legislature specified that money appropriated to remove asbestos at CSU campuses be spent only on projects in the first two categories. The 1987-88 survey consultant estimated that asbestos removal work in these categories will cost a total of $52 million. This estimate, however, significantly underestimates the full cost of this work because it does not count the cost of replacing asbestos-containing material that has been removed. The CSU has allocated a total of $16.6 million (all of its 1987-88 and 1988-89 asbestos abatement appropriations) to projects in categories (1) and (2).

Community College Districts. At the direction of the Legislature (1985 Budget Act language), each district conducted an asbestos survey of its buildings. Surveys were conducted by district employees using a ranking system similar to the system used by CSU in its first asbestos survey. The Chancellor's Office compiled district reports to create a statewide ranking of asbestos conditions by severity. The Chancellor's Office policy, however, is to remove, as soon as possible, *all* asbestos-containing material identified in the survey, regardless of its condition on the threat it poses to occupants. The Chancellor's Office estimated that it would cost $25 million to remove all the identified asbestos. Between 1985-86 and 1988-89, the state has appropriated $18.7 million (General Fund) to the community colleges for asbestos abatement.

Staff in the Chancellor's Office now indicate that the $25 million of work identified in the survey significantly understates the cost of removing *all* asbestos-containing material in the community college system, for two primary reasons. First, many districts did not include the cost of replacing asbestos-containing material after it has been removed. Second, some districts have subsequently hired an asbestos consultant to resurvey their buildings. The consultant has discovered more than twice the amount of asbestos-containing material identified in the original survey.

University of California. All UC campuses have recently completed asbestos surveys of state-supported facilities. The surveys, based on a procedure developed by the Berkeley campus, classify asbestos-containing materials into one of three categories: (1) materials that now present an active and serious hazard, (2) materials with damage and potential for further deterioration into a serious hazard, and (3) materials presenting little or no active hazard. Language in the 1985 Budget Act required that the University allocate all asbestos abatement funds for projects in the first category, before addressing any lower priority project. University staff indicate that they continue to follow this guideline in allocating asbestos abatement funds. The state has appropriated $6.9 million to UC since 1984-85 for these activities. Based on a preliminary analysis of asbestos surveys, University staff estimate that the future cost of abatement work in the first category exceeds $75 million.

THE STATE'S RESPONSE TO ASBESTOS IN K-12 PUBLIC SCHOOLS

What Do State and Federal Law Require?

Federal Law. The federal Asbestos Hazard Emergency Response Act (AHERA) is the most recently enacted (1986) and the most stringent federal legislation concerning asbestos in K-12 schools. The EPA regulations (published in October 1987) established pursuant to the Act require each K-12 school to:

- Identify and assess the condition of all asbestos-containing material in school buildings;
- Develop an asbestos management plan based on this assessment prior to October 12, 1988 (or prior to May 9, 1989, if an extension is granted);

- Inform all parent, teacher and employee organizations that an asbestos management plan exists and is available to the public for inspection; and
- Begin implementing responses to asbestos-containing material (including abatement, employee training, and monitoring and maintenance), as recommended in a management plan, by July 9, 1989. The AHERA regulations set no deadline for completion of asbestos abatement actions.

These regulations permit *broad local discretion* in choosing responses to asbestos containing material, in order to protect human health and the environment. A school may choose the least economically and operationally burdensome action from a range of alternative responses. Alternatives include removal, repair, encapsulation, enclosure, and/or monitoring and maintenance, depending on the type and condition of asbestos-containing material identified.

The fiscal effect of AHERA on K-12 public schools includes the cost of: developing management plans (including an asbestos inspection), providing special asbestos maintenance training and programs, and taking asbestos abatement actions specified in management plans. Based on EPA cost estimates, and assuming that all 7,100 California public K-12 schools contain some friable asbestos-containing material, the cost of developing management plans could total $20 million to $30 million statewide. At this time, the cost of providing AHERA-required training and maintenance programs, and taking asbestos abatement actions for school districts statewide cannot be estimated. The Office of Local Assistance (OLA), within the Department of General Services, should be able to estimate these costs after it has received asbestos management plans from all schools in early May 1989.

The AHERA requires two things of the states. Each state must adopt an accreditation program for asbestos professionals and workers which is at least as stringent as the EPA model program. In addition, a state agency designated by the Governor must receive all management plans. A school district must implement its plan if that state agency does not disapprove the plan within 90 days after receipt. In California, the Governor designated OLA as the agency which will receive these plans. The 1988 Budget Act includes a General Fund appropriation of $1.1 million (19 personnel-years) to OLA for review of asbestos management plans from K-12 schools. As discussed in the *Analysis* (Item 1760-001-001), OLA is not conducting a substantive review of these plans. Instead, it has contracted with the Franchise Tax Board to perform an essentially clerical verification that required forms have been completed.

State Law. Chapter 1751, Statutes of 1984, created the Asbestos Abatement Fund. Under this statute, monies in the fund, which is supported entirely by the General Fund, must be distributed by the State Allocation Board to match local funds for the containment and removal of hazardous asbestos materials in public K-12 schools. The statute requires a dollar-for-dollar match of state and local funds, but permits the board to increase the state share of the match where necessary to complete critical abatement projects. The policy of the board is to provide 50 percent of the cost of qualifying abatement projects in large districts, and 75 percent in small districts. Subsequent legislation set the following criteria for determining eligibility for grants from the fund:

- The asbestos must be friable or potentially friable, as identified through visual inspection and laboratory analysis of samples; and
- The airborne concentration of asbestos within a building must exceed either 0.01 fibers/cubic centimeter (cc) or the airborne concentration of asbestos in the outdoor air immediately adjacent to the school, whichever is higher.

State Funding of Asbestos Abatement in K-12 Public Schools

Asbestos Abatement Fund. The Legislature has appropriated a total of $24.75 million from the General Fund to the Asbestos Abatement Fund between 1984-85 and 1986-87. There have been no appropriations to the fund since that time. The State Allocation Board has set aside *$24.4* million for asbestos abatement projects that qualify under the program. OLA estimates that it has received an additional *$5.6* million in applications which qualify for a grant from the Asbestos Abatement Fund, but for which no funds are available.

By November 1988, OLA had released only *$16.2* million to school districts because several districts had not completed the necessary project documents. In order to hasten the undertaking of qualified projects, the State Allocation Board adopted a policy in March 1988 of rescinding apportionments over one year old where the applicant has not submitted the documentation necessary for release of funds. In October 1988, the board initiated this policy by rescinding and reapportioning $3.3 million.

Proposition 79. The 1988 School Facilities Bond Act was approved by the voters on November 8, 1988. This Act authorizes the State Allocation Board to apportion up to $100 million of the $800 million in bond proceeds for identification, assessment and abatement of asbestos in K-12 public schools. The measure specifies no further criteria for allocation of these monies. The current policy of the board is to allocate these monies only where a school has been closed because of an asbestos hazard, either by order of a court or by the Department of Industrial Relations. In addition, the board requires school districts to pay 25 percent of the cost of removing asbestos in each eligible project, and *all* of the cost to replace asbestos-containing material with non-asbestos material.

WHAT ISSUES AND PROBLEMS ARE RAISED BY STATE ASBESTOS ABATEMENT PROGRAMS?

Five basic questions should be answered in determining the state's approach to asbestos in its buildings:

1. What degree of hazard is posed to building occupants by asbestos in building material?
2. In what priority order should asbestos hazards be abated?
3. What methods of asbestos abatement are the safest and most cost-effective?
4. What is the full cost of asbestos abatement proposals?
5. What procedures should be established for handling asbestos permitted to remain in the buildings after abatement projects have been completed?

Our review of state-funded asbestos abatement programs, based on these questions, raises the following issues and problems which warrant consideration by the Legislature.

1. There Is No Clear Basis for Determining When Asbestos in Buildings Constitutes a Health Hazard

As discussed above, EPA reports that the best available evidence indicates that average concentrations of airborne asbestos in buildings, even in areas with significantly damaged asbestos-containing material, are 100 to 1,000 times lower than the aforementioned federal asbestos exposure limit for workers. Moreover, there is no *known* health hazard associated with exposure to airborne asbestos at such low concentrations — the levels most likely to be encountered by building occupants. Concerns about exposure to low concentrations of asbestos are based on *extrapolations* from the documented adverse health effects of exposure by workers to high concentrations of asbestos over a period of years. Research, however, indicates that such extrapolations are not reliable because they are based on too many unproven assumptions. Thus, the state has undertaken multimillion dollar abatement projects involving low-level concentrations of airborne asbestos for which there is no known health risk.

2. Asbestos Abatement Projects Are Not Proceeding on a Priority Basis

Asbestos abatement work is going forward on projects ranked under five different procedures using inconsistent criteria. Moreover, in some cases, the ranking of projects is based on incomplete information. The Legislature, therefore, does not have consistent data on which to base decisions about the relative priority of abatement projects proposed by various agencies.

Inconsistent Criteria. OSA, CSU, and the community colleges use different criteria for setting priorities, but at least the criteria are somewhat similar and compatible with the criteria established in the EPA AHERA regulations. The University of California uses an independently developed set of criteria. Due to data limitations, we have been unable to assess the compatibility of UC's criteria with those used by other agencies. The criteria used to set priorities for allocating state asbestos abatement funds to K-12 public schools are not compatible with the criteria used in any of the other state programs. In fact, the air monitoring and school closure criteria used in the K-12 program are so restrictive that they would result in the denial of state support for school projects which would be funded under other state-funded asbestos abatement programs.

Incomplete Information. The University of California, the Community Colleges and OSA have not yet ranked all asbestos abatement projects on the basis of a comprehensive asbestos survey. Consequently, neither these agencies nor the Legislature can judge the priority of projects currently submitted by them for funding.

3. Alternatives to Removal Are Not Fully Considered

The EPA recommends that decision makers carefully weigh the cost *and hazards* of removal against the cost and hazard of leaving asbestos-containing material in place and controlling it by an alternative method (repair, monitoring and maintenance, enclosure, or encapsulation).

State agencies, however, have adopted a very limited range of abatement methods. At one extreme, some state agencies have adopted a policy of removing *all* asbestos from their facilities. Others, while permitting some asbestos materials to stay in place, do not consider options to removal of asbestos in the abatement projects they do undertake. Caltrans and the Community Colleges for example, see removal as the *only* means of control for asbestos containing material. By contrast, OSA and CSU acknowledge that under certain conditions, asbestos-containing material is best managed through a regular program of observation and maintenance until it can be removed in the course of building renovation or demolition. Neither OSA nor CSU, however, consider the choices of repair, encapsulation, or enclosure over removal on a project-by-project basis.

4. Existing Estimates May Significantly Understate the Future Cost of Asbestos Abatement

Based on our review, we conclude that asbestos abatement proposals received by the Legislature often understate the full cost of the projects. For example, the estimated future costs of asbestos removal projects at CSU and the Community Colleges do not include the cost of replacing asbestos-containing material after it has been removed. Moreover, none of the available estimates under any of the abatement programs include the potentially significant costs of displacing building occupants during asbestos abatement projects.

5. There Are No Statewide Standards for Conducting an Asbestos Monitoring and Maintenance Program

Asbestos consultants hired for every major survey of state-owned facilities recommend monitoring and maintenance as a means of controlling certain asbestos-containing material. There are, however, no statewide standards for determining the components of such programs:

- What activities are required, and how often?
- Which maintenance staff and supervisors should get state and federally required training for handling asbestos?
- How much special equipment is necessary?

The Legislature needs such standards to make informed decisions about funding requests from state agencies to establish and operate asbestos monitoring and maintenance programs.

HOW CAN THE LEGISLATURE IMPROVE ITS ASBESTOS ABATEMENT PROGRAMS?

As discussed above, the EPA and other experts generally agree that asbestos in buildings is clearly a health hazard when airborne concentrations reach levels of 0.1 fiber/cc. Where airborne concentrations of asbestos in buildings reach this level, asbestos abatement should be undertaken. The best available evidence from EPA, however, indicates that concentrations of airborne asbestos in most buildings are *well below* levels for which there is any conclusive evidence of a health hazard. As such, there is currently no clear analytical basis to justify the expenditure of funds on virtually all proposed, state-supported abatement projects. Moreover, the pressure to remove asbestos in buildings because of potential health hazards needs to be weighed against the potential for leaving workplaces and schools in *worse condition* as a result of abatement projects. Accordingly, *we recommend that the Legislature fund abatement projects only in those cases where concentrations of airborne asbestos are 0.1 fibers/cc or higher.* Should the Legislature decide to take this action, it would defer action on the majority of proposed asbestos abatement projects. In addition, the state would still need to spend some money on periodic surveys and monitoring and to finance abatement in those cases where asbestos would be disturbed during the course of a renovation or repair project.

The suggested airborne concentration standard should be modified in the future based on the advice of researchers and other experts on the health risks associated with exposure to low concentrations of airborne asbestos. In order to ensure this input, we recommend that the Department of Health Services, in cooperation with the Department of Industrial Relations, assemble and summarize the best available evidence concerning the health risks of exposure to low concentrations of asbestos and the risks associated with asbestos removal. The departments should present this information to the Legislature during the fall of 1989 and periodically thereafter.

If the Legislature, however, decides as a matter of policy to continue its current approach to asbestos abatement, we recommend that it use the following principles as a guide to develop a statewide program that will address the most serious *potential* asbestos hazards in state-owned/state-supported buildings and K-12 schools:

- ***Asbestos abatement projects should be funded in priority order, by level of potential hazard.*** The potential hazard posed by asbestos-containing materials varies with the location and condition of the material. EPA regulations (under AHERA) explicitly acknowledge that under some conditions, asbestos-containing materials present a serious active or potential hazard, while these materials under other conditions present little chance of releasing asbestos fibers.
- ***It is not necessary to remove all asbestos-containing materials, regardless of condition, in order to assure the safety of building occupants.*** Materials that do not pose a hazard can be left in place and monitored and maintained according to appropriate procedures. Such materials can then be removed either (1) after all hazardous conditions are abated or (2) during the normal course of building renovation.
- ***The method of abatement adopted for any given project should protect the health and safety of building occupants in the most cost-effective manner.*** The federal AHERA regulations recognize a broad range of alternatives to asbestos removal (repair, encapsulation, enclosure, and monitoring and maintenance) as potentially sufficient to protect building occupants.
- ***Asbestos abatement work creates hazards and therefore must be carefully controlled.*** The Legislature should assure that all state-funded agencies which administer asbestos abatement programs take adequate precautions to protect the health and safety of workers and building occupants exposed to abatement projects.

Using these principles, we make the following recommendations (except where otherwise noted, the Legislature could carry out these recommendations as part of the budget process):

1. ***The Legislature should only fund abatement of the following asbestos conditions (including those in K-12 schools) in the priority listed:***

(1) The asbestos is friable, exposed to building occupants, *and* airborne asbestos concentration exceeds 0.01 fiber/cc, unless the concentration in the air outside the building is greater than 0.01 fiber/cc. (In the latter case, abatement should be considered only if airborne asbestos concentration inside the building exceeds the level in the outside air. Otherwise, air from external sources would recontaminate the building as soon as abatement is completed.)

(2) The asbestos is friable, damaged, and exposed to building occupants, but the airborne asbestos concentration does not exceed the specified limits.

(3) The asbestos is friable and undamaged, but is very likely to incur damage that would expose building occupants to asbestos fibers.

(4) The asbestos is friable and damaged, but airborne transmission of asbestos to occupied building space is highly unlikely.

With the exception of the air monitoring standard, these criteria are consistent with the criteria used in the CSU and OSA asbestos surveys and in AHERA regulations to identify the highest priority asbestos abatement projects in a building. The air monitoring standard is recommended to give highest priority to situations in which release of asbestos fibers has actually occurred. While we have no analytical basis for using the 0.01 level as a standard, it is the level currently specified in statute for state funding of asbestos abatement in K-12 public schools. The Legislature should reevaluate this standard as more conclusive information about the risk of exposure to low concentrations of asbestos becomes available.

Application of these criteria to a state program for asbestos abatement in public K-12 schools would require a change in existing statutes. This is because current law permits state funding *only* if airborne concentration of asbestos exceeds the 0.01 fibers/cc level.

If the Legislature were to use these criteria, it would exclude many projects state agencies now propose to fund (for example, Caltrans plans to eliminate *all* asbestos — even if it is not friable). Thus, adoption of these criteria would reduce the demand for state abatement funds.

2. ***The Legislature should create a Task Force on Asbestos Abatement Priorities and Procedures.*** This task force should include representatives from OSA, UC, CSU, the community colleges, OLA, and the K-12 public schools. The task force should accomplish the following and report to the Legislature in the fall of 1989:

- Review the criteria used by these agencies to place projects in priority order for consistency with the criteria listed above;

- Recommend a statewide standard for the conduct of asbestos maintenance and monitoring programs, including training of maintenance employees, critical tasks, essential equipment, and program organization; and
- Recommend statewide standards for the qualifications and responsibilities of asbestos project inspectors employed on state-funded projects.

3. ***The Legislature should expand the OSA asbestos abatement program to include immediate and short-term abatement projects identified by the OSA asbestos survey in special funded agencies.*** The Legislature should not fund independent asbestos abatement programs for each of these special fund agencies. Budgeting and administering their abatement projects instead through the OSA program would provide the following benefits:

- Abatement projects identified in the OSA surveys would proceed in priority order, statewide, regardless of fund source;
- Special fund departments could take advantage of OSA's experience in contracting and monitoring asbestos abatement work; and
- The Legislature would know the full cost of asbestos abatement activity.

In addition, special fund agencies should be required to identify the cost of planned asbestos abatement activity in the Budget Bill and to transfer those funds to OSA.

Because of the practical difficulties of undertaking the higher education programs through OSA, the systems should continue to identify and fund abatement costs in their individual Budget Bill items. They should, however, conduct their asbestos abatement projects in accordance with the funding criteria established by the Legislature and the findings of the task force.

4. ***The Legislature should require the State Allocation Board to develop a program for allocating Proposition 79 asbestos abatement funds according to the criteria outlined above.*** The OLA should report to the Legislature in the fall of 1989 concerning its policies and procedures for reviewing applications under this program. Moreover, OLA should provide the Legislature with quarterly reports on the status of these applications.

5. ***The Legislature should require every funding proposal for an abatement project to include an analysis showing how the recommended abatement action assures the safety of building occupants in the most cost-effective manner.*** Such an analysis would assure the Legislature that state asbestos abatement programs are considering alternatives to asbestos removal. State agencies should consider such

alternatives as encapsulation, enclosure, repair, or monitoring and maintenance, where they assure the safety of building occupants. In addition, cost estimates should include the costs of displacing building occupants while abatement work is in progress and the cost of replacing asbestos materials with non-asbestos materials.

6. ***The Legislature should require before-and-after air sampling for all state-funded asbestos abatement projects.*** Budget Act language currently requires asbestos abatement contractors working for OSA, CSU, UC, and the community colleges to leave a facility at least as free of airborne asbestos as when they start work. This assures that state-funded abatement projects will mitigate, not aggravate asbestos hazards. This requirement should be extended to *all* state-funded projects, including K-12 schools.

WHAT FUNDING ALTERNATIVES EXIST FOR FINANCING ASBESTOS ABATEMENT IN STATE-OWNED/STATE-SUPPORTED BUILDINGS AND K-12 SCHOOLS?

Future Costs

Table 2 shows that the estimated future cost of asbestos abatement in state-owned/state-supported buildings, under the guidelines recommended above, is $231.4 million. This estimate assumes that funding is restricted to projects which meet the four funding criteria we recommended above. The estimate includes state-owned non-education facilities ($84 million) and state-supported higher education facilities ($147.4 million). In contrast, OSA indicates that the cost of removing *all* asbestos from state-owned, non-education facilities would exceed $1 billion.

Table 2
Future Cost of Asbestos Abatement in State-Owned and State-Supported Buildings: Projects That Meet LAO Recommended Funding Criteria (dollars in millions)

Agency	*Future Cost*
Non-Education:	
General Fund (OSA Program)	$ 63.0 [a]
Special Fund Agencies	21.0 [a]
Subtotal, Non-Education	($ 84.0)
Higher Education:	
Community Colleges	$ 37.0 [a]
California State University	35.4 [a,b]
University of California	75.0 [a]
Subtotal, Higher Education	($147.4)
Total	$231.4

[a] Does not include potential costs of displacing employees and/or students.
[b] Cost of asbestos *removal* only. Does not include replacement of asbestos-containing material with non-asbestos material.

The future cost of asbestos abatement in the public K-12 schools is uncertain. However, the $100 million potentially set aside for asbestos abatement under Proposition 79, if allocated to public K-12 schools on a dollar-for-dollar matching basis (see below), may be sufficient to abate all *friable* asbestos. This conclusion is based on EPA cost estimates of asbestos abatement in K-12 schools, the average cost of asbestos abatement projects funded since 1985-86 from the Asbestos Abatement Fund, and information concerning the average cost of abatement projects noted in the few asbestos management plans already received by OLA.

Funding Alternatives for State-Owned Buildings

The Legislature has three alternative means of funding the future cost of asbestos abatement:

- General Fund and various special funds;
- General obligation bond financing;
- Redistribution of tidelands oil revenues.

Factors which the Legislature should consider in deciding on a method of funding for asbestos abatement include:

- Over what period of time should projects be completed?
- What effect will use of funds for asbestos abatement have on the availability of funds for other state programs?

For example, if the Legislature decides that abatement of the most serious asbestos hazards should occur within five years, it will require an immediately available source of funds which can support appropriations of about $46 million annually. The use of General Fund or special fund appropriations or redistribution of tidelands oil revenues (to the extent they are available) in such amounts would have significant immediate effects on the availability of funds for other programs. As an alternative, the Legislature could propose a bond measure for voter approval. While approval of a bond measure could require a year or more, the annual impact on the General Fund would be much smaller, as costs would be distributed over a period of up to 20 years. The *total* cost of using bonds, however, would be higher, because of interest payments and finance charges.

On the other hand, if the Legislature decided that asbestos abatement could occur over a longer period of time, the annual level for asbestos abatement expenditures would be smaller, and the need for an immediate, large funding source (such as a bond measure) would not be so important.

Bond Funds for Asbestos Abatement in K-12 Public Schools

We recommend that the Legislature enact legislation to allocate Proposition 79 bond funds according to the matching formula now used for the Asbestos Abatement Fund monies.

Under the current formula for grants from the Asbestos Abatement Fund (AAF), the state pays half or more of the total cost of an eligible project, depending on the size of the district responsible for it. The total cost includes asbestos removal, if necessary, *and* replacement with non-asbestos material. Under the State Allocation Board's current policy of allocating Proposition 79 bond funds, however, the state pays 75 percent of abatement removal costs and none of the costs of replacement.

We find no basis for having these inconsistent funding allocations. Consequently, we recommend that the Legislature specify in statute that all state funds for asbestos abatement in K-12 schools be allocated according to the matching formula now used for the AAF. The higher local match required for the AAF would help assure that school districts choose the most cost-effective means of asbestos abatement when designing a project eligible for state funding.

California's Prisons

How Can the Legislature Minimize the Cost of an Ever-Expanding System?

Summary

- *California is in the midst of the largest prison construction effort ever undertaken in the United States.*
- *The Legislature in this decade has appropriated $3 billion to plan and build prison facilities at 21 locations throughout the state. Based on overcrowding guidelines chosen by the California Department of Corrections (CDC) and the department's latest projection of inmate population growth, the state will need to spend an additional $1.6 billion on prison facilities. At the end of this construction effort, prisons will be more overcrowded than when the construction program began.*
- *The annual cost of running the prison system will increase from $1.6 billion to $3.1 billion between now and 1994-95, a 90 percent increase. This growth will come at the expense of other state programs subject to the appropriations limit since the limit is expected to grow by roughly 50 percent during this time period.*
- *The Legislature has options to significantly reduce the additional costs of building and operating an expanded prison system. These options include: selective reductions of prison sentences, changes in parole supervision, expansion of the conservation camp system, and overcrowding facilities more intensively than currently planned by CDC.*
- *We recommend that the Legislature consider all available options to minimize costs before appropriating funds for additional prison facility construction.*
- *We recommend that the Legislature direct CDC to improve its Facilities Master Plan to assist the Legislature in this process. We further recommend that the Legislature consider CDC's Facilities Master Plan and all CDC capital outlay funding requests during the annual budget process.*

In response to a burgeoning prison population, the Legislature in the past eight years has appropriated approximately $3 billion to plan and build new prison facilities throughout the state. The California Department of Corrections (CDC), however, projects additional capital needs of almost $1 billion through the year 1993. Even at the end of that period, the state's prisons would be overcrowded by an average of 134 percent. In addition, by 1994-95 the state would be spending at least $3.1 billion annually (in 1994 dollars) to operate these correctional facilities. This is a 700 percent increase in the cost of operations since 1980, with inflation accounting for only one-seventh of the increase.

Given the increasing share of the General Fund budget absorbed by the prison system, the Legislature may wish to examine ways to control these future costs. In this analysis, we: provide background on the state prison system and CDC's current five-year facilities plan, examine the future costs associated with that plan, and suggest several ways available to the Legislature to reduce — or at least minimize — the costs of housing state prisoners.

Background

In mid-1980 California's inmate population was approximately 23,500, which was roughly equal to the prison system's design capacity. Between that time and June 30, 1988, the inmate population more than tripled, growing from 23,500 to 72,100. Looking ahead, CDC now projects an inmate population of 110,200 by mid-1994.

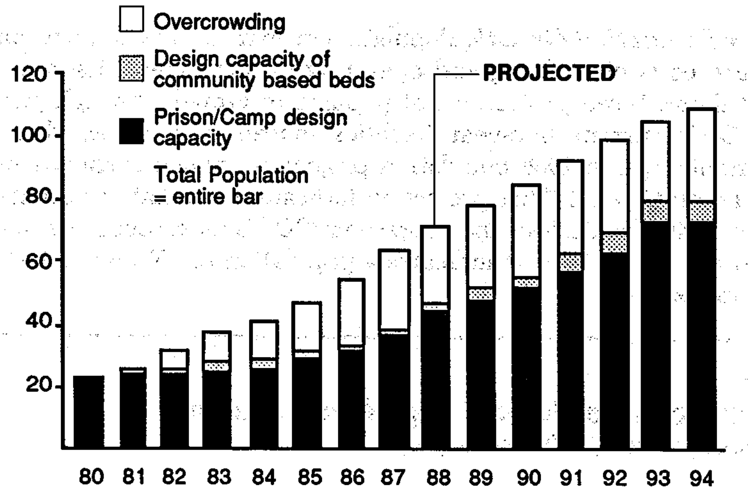
In response to this burgeoning population, California initiated — and is now in the midst of — the largest prison construction effort ever undertaken in the United States. Since 1980, the Legislature has authorized construction of more than 40,000 new prison beds. As of June 30, 1988, about 21,100 of these beds were completed and occupied. The remainder were under either construction or design. The completion of these beds will increase the prison system's design capacity by nearly three times, to 63,900 beds.

Chart 1 shows past and projected increases in the state's prison population and design capacity. The chart also includes the design capacity of community-based beds—locally operated facilities housing parole violators and/or inmates on work furlough programs. These community-based beds, while outside the prison system per se, do provide housing for some inmates. As Chart 1 shows, prison system overcrowding is the difference between the actual or projected population and the design capacities of the prison system and community-based facilities.

The CDC has been able to overcrowd its facilities by placing two inmates in cells designed for one and converting gymnasiums and other activity areas into dormitories. Prison system overcrowding peaked in March 1987 at 178 percent of design capacity before beds added by new construction began to outpace population increases. Today, overcrowding stands at 158 percent of design capacity.

Chart 1

State Prison Population and Capacity[a]
1980 through 1994 (inmates in thousands)



[a] Data as of June 30 for each year. Population is based on CDC's fall 1988 projections. Projected design capacity is based on CDC's five-year facilities master plan.

CDC's Five-Year Facilities Master Plan

The CDC annually submits to the Legislature a five-year master plan for new facility construction. In addition, supplemental report language adopted in the 1987 Budget Act directs CDC to submit this plan by December of each year so that the Legislature may review it in conjunction with the Governor's annual budget. The most recent plan available to the Legislature at the time this analysis was prepared was the plan submitted for the 1988-89 Budget and updated in May 1988. The plan calls for construction by 1993 of 9,800 beds that as yet have not been authorized by the Legislature.

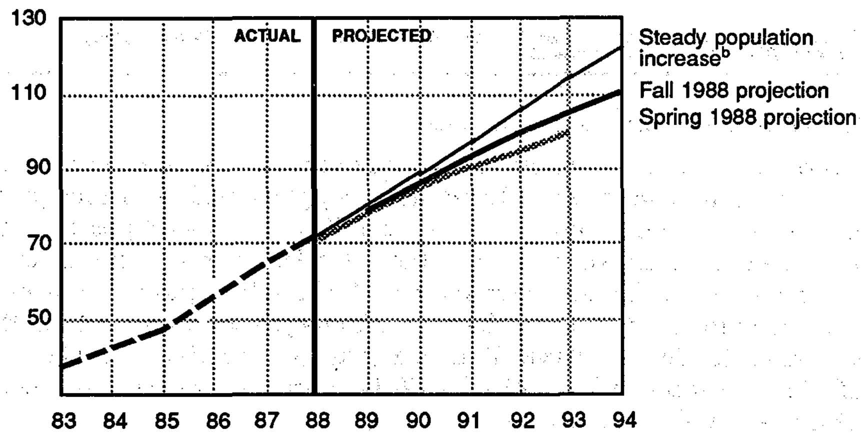
This plan is based on two fundamental factors—projected increases in inmate population and a policy of deliberate overcrowding (with overcrowding guidelines varying by inmate security classification levels). We have concerns with the adequacy of the plan with regard to both of these factors. First, the plan is based on a population projection that now is outdated. The latest CDC projection, released in the fall of 1988, indicates that the prison system will have to accommodate 5,500 more inmates by 1993 than was assumed in the plan. Second, even under the earlier population assumption, the plan did not call for the construction of enough beds to meet the plan's stated overcrowding objectives. This situation is exacerbated by the latest population projection.

According to CDC staff, the department intends to release a new five-year facilities master plan (for 1989-90 through 1993-94) prior to budget hearings. The new plan will be based on CDC's fall 1988 population projection. Presumably, it will call for construction of more beds.

Future Population Growth. Population growth is a key determinant of the future costs of building and operating an expanded prison system. Chart 2 shows three projections of population growth through June 30, 1993. CDC's current five-year facilities master plan is based on the department's spring 1988 population projection, which is shown by the lower line on Chart 2. That projection indicates an inmate population of 99,800 in 1993. The middle line represents CDC's most recent projection, made in the fall of 1988. It indicates a population of 105,300 in 1993 and 110,200 in 1994.

Chart 2

Alternative Projections of Inmate Populations
1983 through 1994 (in thousands)[a]



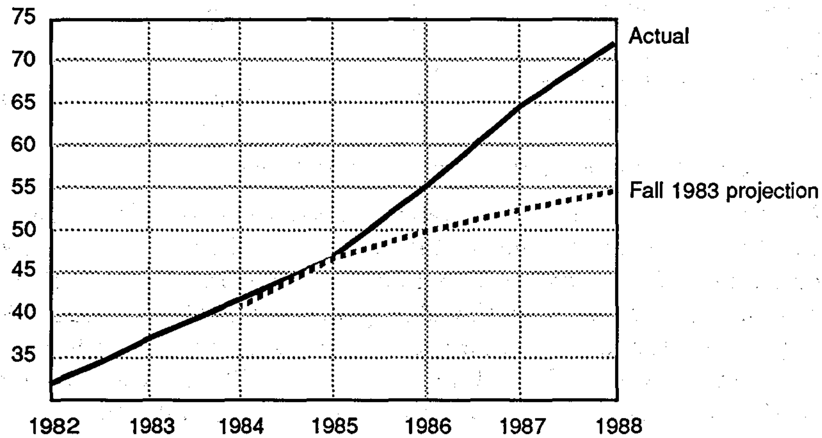
[a] Data as of June 30 for each year.
[b] Projection assumes population increases by 8,300 inmates per year (the average annual increase between 1985 and 1988).

Although growth is higher in the fall 1988 projection, both estimates assume that annual population increases will be smaller than in recent years. Prior CDC projections have made the same assumption, however, and have consistently fallen short of the mark. For example, as Chart 3 illustrates, in fall 1983 CDC projected that the inmate population would increase by 17,500 from June 30, 1983 to June 30, 1988. Instead, the population increased by twice that amount.

Chart 3

Comparison of Previous Population Projection with Actual Population

1982 through 1988 (in thousands)[a]



[a] Data as of June 30 for each year.

CDC's current projections may still underestimate eventual population growth. In view of the above, and for purposes of estimating a potential *range* of future capital and operating costs, we have estimated a continuation of recent population trends. Under this "steady population increase" scenario (see Chart 2), 8,300 inmates would be added each year (the average increase over the last three years), reaching 121,900 in 1994.

The Plan's Overcrowding Targets. CDC's master plan states the department's intent to limit overcrowding to "manageable" levels. CDC would accomplish this by setting guidelines for maximum overcrowding, varying from 100 percent of design capacity (for medical/psychiatric facilities) to 130 percent (for maximum security facilities and reception centers). According to the plan, completion of authorized and planned facilities would result in an average overcrowding level of 126 percent of design capacity in 1993.

It should be noted, however, that with the prisons proposed in CDC's construction plan, overcrowding for some inmate categories would *exceed* CDC's guidelines. As Table 1 shows, the overcrowding guideline for minimum security beds is 120 percent of design capacity. Yet CDC's planned construction would result in overcrowding of 143 percent of design capacity for minimum security beds.

Table 1
CDC Overcrowding Guidelines and Outcome of Current Master Plan

	Percent of Design Capacity		
Classification	*Overcrowding Guidelines*	*Outcome of Master Plan*[a]	*Difference*
Reception Centers	130%	127%	−3%
Level I (minimum security)	120	143	23
Level II	120	119	−1
Level III	130	118	−12
Level IV (maximum security)	130	136	6
Women	120	129	9
Medical/psychiatric	100	107	7

[a] Based on spring 1988 population projection and planned construction.

Moreover, the average overcrowding ratio cited in the plan is based on population projections made in the spring of 1988. CDC's most recent projections (fall of 1988) assume 5,500 *more* inmates by 1993 than the spring projections. Based on the latest population projection, completion of currently planned and authorized construction would result in average prison/camp overcrowding of 134 percent in 1993, with overcrowding exceeding the guidelines in five of the seven bed classifications.

The plan also assumes that the number of community-based beds will increase from 1,970 to 6,370 by 1993. This assumption appears to be optimistic, given that the number of these community beds increased by only 670 (from 1,300 to 1,970) between 1982 and 1988. If the assumed increase in available community-based beds is not realized, further overcrowding of minimum security, women's prisons and camps would result.

Bed Shortfall in Facilities Master Plan. CDC's five-year master plan is divided between "Stage 1" and "Stage 2" projects. The Legislature already has authorized construction of all Stage 1 projects and has appropriated funds for various advance planning activities for all Stage 2 projects. The Legislature, however, has not yet authorized the specific Stage 2 projects. The nature of these projects will have major implications for future capital outlay and support expenditures.

Under Stage 2, CDC proposes to increase prison capacity by 9,800 beds, consisting of: (1) 4,500 minimum security (Level I) beds, (2) 2,900 reception center beds (the point of entry for the system, where new inmates are evaluated and assigned to prisons of appropriate security levels), and (3) 2,400 medical/psychiatric beds (no distinction is made in the plan between medical and psychiatric beds). As noted above, this plan is based on (1) a population projection that is now outdated and (2) overcrowding levels for some inmate categories in excess of CDC's guidelines.

Table 2 shows the numbers of beds (beyond those already authorized) that would have to be constructed by 1994, based on CDC's overcrowding guidelines and more recent inmate population estimates. The middle column of Table 2 shows, for instance, that based on CDC's fall 1988 population projection, the state would need to build 19,900 beds by 1994. On the other hand, if the "steady population increase" scenario were used, the state would need to build 27,800 beds, a difference of 7,900 beds.

Table 2
Additional Beds Needed to Meet Overcrowding Guidelines Under Alternative Population Projections

Bed Classification	*Authorized Bed Capacity*	*Additional Beds Needed (Fall '88 pop. proj.)*	*Additional Beds Needed (Steady population increase scenario)*
Reception Centers	6,480	4,100	5,100
I (minimum security)	11,003	9,500	13,500
II	15,507	2,200	4,000
Women	4,442	1,000	1,600
Medical/psychiatric	1,535	3,100	3,600
Totals	38,967	19,900	27,800

FUTURE COSTS

Future prison system costs consist of capital and operating costs. Approximately 95 percent of the state's prison capital outlay expenditures in this decade have been funded through either general obligation or lease-purchase revenue bonds (both types of bonds are ultimately repaid from the General Fund). About 95 percent of CDC's annual operating costs are met through the General Fund. In this section we review the costs the Legislature will face in the coming years as a result of its construction program—past and proposed.

Capital Costs

According to the CDC's current master plan, the Legislature will need to appropriate approximately $1 billion over the next five years: $900 million to carry out Stage 2 projects and construct the Imperial County prison (authorized as a Stage 1 project), and $116 million to renovate /modify older prison facilities.

These costs, however, are much higher if CDC overcrowding guidelines are met, and alternative population estimates are used. For instance, we estimate a capital outlay cost of approximately $1.6 billion under CDC's most recent population estimate, and a cost of about $2.0 billion under an assumption of steady population growth.

General Obligation Bonds. Of the funds appropriated in the 1980s for prison construction, about 60 percent has come from general obligation bonds. This financing source is the least expensive form of debt financing available to the state. If the $1.6 billion of capital outlay expenditures required under CDC's latest population estimate were funded by general obligation bonds sold at an interest rate of 7.5 percent, the principal and interest payments would cost the General Fund about $2.9 billion over the next 20 years. This would be equivalent to approximately $2.0 billion in 1989 dollars (which adjusts for the effect of anticipated inflation on payments made in the future).

Lease-Purchase Revenue Bonds. Over one-third of the funds appropriated in this decade for new prison construction have come from lease-purchase "revenue" bonds. These bonds, which do *not* require voter approval, entail higher financing costs than general obligation bonds. In the context of prison facilities, the term "revenue" is a misnomer. This is because prison facilities do not generate any revenues that can be used to repay the bonds. Revenue bonds for prisons are repaid from the General Fund. For example, the Governor's 1989-90 Budget includes $55.3 million from the General Fund for payments on existing prison revenue bonds.

If the $1.6 billion program needed under CDC's overcrowding guidelines and latest population estimate were funded entirely by lease-purchase revenue bonds, we estimate the principal, interest and other financial payments would cost the General Fund approximately $3.1 billion over the next 20 years (or $2.2 billion in 1989 dollars).

Thus, we estimate the state would pay a premium of about $175 million in 1989 dollars from the General Fund by using lease-purchase revenue rather than general obligation bonds.

Operating Costs

Since 1980-81, CDC's annual support budget has quadrupled, from $400 million to $1.6 billion in 1988-89. Table 3 provides an indication of what two population projections mean for future General Fund costs to operate/maintain an expanded prison system. The cost projections are based on the 1988-89 estimated per inmate operating cost ($19,355), adjusted for an assumed 5 percent annual inflation rate. (We also have made allowances for different per capita costs experienced in the department's parole and community bed programs.) Under CDC's current population projection, the department's annual support budget would increase from $1.6 billion in 1988-89 to $3.1 billion in 1994-95. If, however, inmate populations continue to increase each year as they have during the last three years, the annual cost would rise to $3.4 billion in 1994-95. *This increase in operating costs (between 93 percent and 112 percent) over the next six years far exceeds the increase of roughly 50 percent that we expect in the state appropriations limit during the same period.* Growth of this magnitude in the CDC support budget must therefore come increasingly at the expense of other state programs subject to the appropriations limit.

Table 3
Annual CDC Support Costs
Based on Alternative Population Projections

	Support Costs (billions)	*Percent of General Fund Budget*
1988-89 cost	$1.6	4.2%
1994-95 costs based on CDC's fall 1988 population projection[a]	3.1	5.7
Based on steady population increase scenario[a,b]	3.4	6.3

[a] Based on 1988-89 inmate costs adjusted by 5 percent per year for projected inflation. Assumes per inmate costs will not increase as degree of prison overcrowding declines.
[b] Assumes population increases by 8,300 inmates per year, which was the average annual increase experienced during the last three years.

The above projections probably *understate* the eventual costs because we have not adjusted per capita costs to account for increases that should be expected as more prisons become operational and overcrowding ratios decline relative to current overcrowding ratios. As a prison becomes less overcrowded, *per inmate costs increase* because the fixed costs of operating the prison are spread among fewer inmates. The higher, per inmate cost related to these factors should be available to the Legislature so that cost implications of the various options in meeting prison needs are known. Data on these factors, however, are not currently available.

The Special Case of Medical and Psychiatric Beds

CDC's facilities plan calls for the addition of 2,400 medical/psychiatric beds at an estimated cost of $240 million. The plan does not indicate how many medical and psychiatric facilities should be built or where they should be built. The plan also does not indicate how CDC determined its needs for medical/psychiatric beds. At the time this analysis was written, CDC staff were unable to provide data substantiating the basis for this estimate. Clearly, a rapidly expanding inmate population requires an increase in medical/psychiatric services. Whether or not this requires more psychiatric and acute care medical beds *located in correctional facilities* depends, however, on the extent to which CDC (1) uses existing prison system medical/psychiatric beds and (2) contracts for medical/psychiatric services at outside hospitals.

In the *Supplemental Report of the 1987 Budget Act,* the Legislature directed CDC to develop and submit (1) a definitive systemwide plan addressing CDC's short-term and long-range plans for providing health care services to inmates and (2) a report on its use of contracted and in-house medical services. The language specified that CDC submit the systemwide plan to the Legislature by October 1, 1987 and submit the report on contracted and in-house services by November 1, 1987. CDC submitted the report on contracted and in-house services on April 27, 1988. To date CDC has not submitted the requested systemwide plan.

Contracted and In-House Services. The Legislature requested that the report on contracted and in-house services include "a review of the criteria and guidelines used to determine whether medical services will be provided in-house or on a contractual basis." The CDC's report lists current guidelines for determining whether patients will be treated in-house or outside the institution. These guidelines state that patients will be treated outside the institution when needed "specialized" equipment, diagnostic procedures or physician services are not available in-house. This, however, does not help the Legislature address the main issue in planning for medical/psychiatric facilities: Which services *should* CDC provide in-house?

Systemwide Plan. The Legislature needs the plan it requested in 1987 to assure that the state is effectively addressing inmate medical needs and doing so in a cost-effective manner. To be useful, the plan must—at a minimum—clearly assess current and projected needs, distinguishing between acute care and psychiatric needs, emergency and elective surgery needs, and the growing problem of AIDS. The plan should include cost-benefit analyses to address the issue of which services should be provided in-house and on a contracted basis. In evaluating *where* facilities should be built, the plan also needs to address fully the availability of medical specialists to work within the specific correctional facilities.

OPTIONS TO MINIMIZE THE COST OF THE STATE'S PRISON SYSTEM

We recommend that the Legislature consider all available options to minimize capital and support costs of the prison system before appropriating funds for additional facility construction.

As described above, the prison system will continue to place heavy fiscal demands on the state. At the same time the Legislature responds to these demands, it is reasonable to examine ways to minimize the projected costs of building and operating prisons. We have reviewed several options to control spending that can be grouped into three categories: (1) methods of reducing the rate of growth of inmate populations, (2) measures to reduce per capita costs of constructing and operating facilities, and (3) steps to improve the process of reviewing CDC capital outlay plans and projects, including an option to reduce the cost of financing capital outlay projects.

Several of these options involve difficult policy choices, in which the cost implications must be weighed against the interests of public safety. These options, however, could result in major reductions in General Fund costs for the prison system.

Options to Reduce Inmate Population

Three significant options fall under this category: (1) selective reduction of prison terms, (2) early release and (3) changes in parole supervision.

Selectively Reduce Prison Terms. The simplest way to reduce the ongoing cost of the state prison system is to reduce prison terms for selected offenses, thus incarcerating inmates for shorter periods of time. For instance, if sentencing laws were modified to reduce the prison terms of all newly admitted inmates by an average of 30 days per inmate, there would be an eventual, ongoing reduction in the inmate population of roughly 1,600. The resulting savings would be an estimated: $80 million in capital outlay expenditures (by not having to build as many new prison beds), and $37 million in annual operating costs by 1992-93. These savings would increase in out-years as the reduced prison terms applied to a larger prison population.

Early Release. Another option that has been used effectively in other states to reduce the number of inmates in the prison system and limit overcrowding is to release *some* inmates a *short* time prior to the end of their terms. Such a program could, for example, allow CDC to release on parole certain nonviolent inmates 30, 60, or 90 days in advance of their scheduled parole dates. For instance, if all property offenders admitted in 1986 were released an average of 30 days before their sentences were completed, the state would reduce inmate-years by 720. As a result, the state would save about $7.5 million in one-time operating costs. As this option does *not* reduce the prison population on an ongoing basis, it would not achieve savings in *capital* costs. Early release could be tied to overcrowding levels and could be used under limited circumstances—such as when the prison system reaches a certain level of overcrowding or when the release is authorized by emergency proclamation of the Governor or resolution by the Legislature.

Changes in Parole Supervision. The fastest-growing segment of the inmate population consists of parolees who have been returned to custody for (1) offenses that probably would not have been prosecuted, or (2) violating parole conditions in some way—such as failing urine tests for marijuana usage or failing to report to a parole officer as required. The CDC could reduce the number of technical violators returned to custody by modifying the conditions it imposes on parolees or developing additional resources for supervising technical violators in the community, rather than returning them to the institutions.

For instance, if 10 percent fewer parolees were returned to custody for technical violations of their parole, the department would eventually achieve a reduction in inmate population of approximately 1,800. This would result in capital savings of about $120 million and savings in annual incarceration costs, by 1991-92, of about $40 million. It is likely that the operational savings would be offset to some extent by additional expenditures in parole supervision and programming that would be necessary to achieve the 10 percent revocation reduction.

Options to Reduce Construction/Operating Costs

In addition to reducing the inmate population, there are at least four significant ways the state can minimize construction and operating costs of its prisons: (1) modify overcrowding levels, (2) meet minimum security bed needs by expanding the conservation camp system, (3) meet additional minimum security bed needs by expanding housing at *existing* prisons and (4) determine the optimum mix of in-house and contracted medical/psychiatric services.

Modifying Overcrowding Levels. Design bed capacity represents the number of inmates a prison is designed to house under ideal conditions. Design bed capacity can be exceeded on a long-term basis, however, through double-celling and multiple shift operations of educational/vocational programs and other activities. In fact, CDC's plan is to overcrowd by as much as 130 percent of design capacity in maximum security prisons and reception centers.

As described in the "Background" section, CDC has established overcrowding guidelines for all of its bed classifications. The department has not, however, provided information identifying the implications of or the bases for these overcrowding ratios. The Legislature needs the above information because overcrowding at a greater intensity than outlined in CDC's master plan could significantly reduce construction needs as well as the department's operating costs. On the other hand, overcrowding at any level raises questions concerning staff and inmate safety, humane treatment, and availability of programs and services for the inmates. *These questions need to be addressed regardless of the amount of overcrowding.* To assist the Legislature in evaluating overcrowding levels, CDC needs to provide construction and operating cost information, and programmatic and security implications of various overcrowding assumptions. With this information, the Legislature (and CDC) can choose among overcrowding alternatives, knowing what each implies for CDC's future capital and support costs.

Expanding the Conservation Camp System. CDC operates 39 camps statewide, including 30 jointly operated with the Department of Forestry and Fire Protection and five with the Los Angeles County Fire Department. Qualified Level I (minimum security) inmates are selected and trained for work in the camps, which are designed to accommodate from 80 to 160 inmates. (Level I inmates who do not qualify for camp work—escape risks or those unable to engage in vigorous physical activity—are housed in conventional minimum security prisons.) Camp inmates provide firefighting services as well as conservation work (such as tree planting, repairing levees and clearing logging debris from streams).

Camps are less costly to build and operate than conventional prisons, due largely to less stringent security requirements. CDC's master plan indicates a per-bed construction cost of $35,000 for *all* types of Level I beds, but does not show a cost for camps versus Level I beds in a prison setting. According to CDC staff, the department does not have reliable estimates of the relative per capita costs to operate camps and Level I prisons. The department's five-year plan also does not indicate what portion of the proposed 4,500 Level I beds can or will be met through the camp program. The plan simply indicates that "the department is also considering expansion of the camp program." CDC needs to provide this information to the Legislature so that it can be considered along with other factors in determining the extent to which Level I bed needs should be met through camps.

Expanding Level I Facilities at Existing Prisons. The state's maximum and medium security prisons include separate housing for some minimum security (Level I) inmates. The Level I inmates perform a variety of tasks that are needed for the operation of the prisons and which take place outside the security perimeters established for other inmates. Many existing prisons have sufficient land and infrastructure to accommodate additional Level I housing. This approach has potentially significant cost advantages compared to constructing new Level I prisons since there would be no need to acquire land, install major new utilities and/or build administrative and support facilities.

Determining the Proper Mix of In-House and Contracted Medical/Psychiatric Services. The cost of providing inmates with adequate medical, dental and psychiatric care is significant. CDC's 1988-89 budget for these services, including pro-rata facilities operations costs, exceeds $200 million, or almost $2,900 per inmate throughout the prison system. The cost of constructing new medical and psychiatric beds is also significant, an estimated average cost of $100,000 per bed according to CDC's five-year facilities plan.

In addition to infirmaries and clinics at each prison, CDC operates three acute care hospitals and, in cooperation with the Department of Mental Health, psychiatric care facilities at the California Medical Facility in Vacaville. CDC contracts with outside hospitals for specialized medical services not available in CDC facilities.

To the extent CDC contracts for medical/psychiatric services, it can reduce the need to construct new medical/psychiatric beds, for savings of roughly $100,000 per bed. There also may be potential operating savings from an increased use of contracted medical services. The Legislature, however, does not have the detailed data and cost benefit analyses it needs to evaluate these alternatives and to determine the optimum mix of contracted and in-house services. This, essentially, is the information the Legislature requested in 1987 and still has not received.

Options to Improve Review/Financing of Capital Outlay Plans and Projects

We recommend that the Legislature implement the options discussed below to improve the review/financing of capital outlay plans and projects.

The Legislature can better assess and control future prison costs by receiving more meaningful and timely information on CDC's capital outlay plan and by reviewing the plan and funding needs in the annual budget process.

Needed Improvements in Facilities Master Plan. CDC's current Facilities Master Plan needs to be improved in many ways in order to become a useful guide for the Legislature (and the department). Such improvements would include:

- Assessing in detail *needs for medical and psychiatric beds.*
- Identifying the *number, nature and location* of facilities proposed to meet overall bed needs.
- Specifying a *time frame* for authorization, planning and construction of facilities.
- Assessing projects/actions that would be needed in the event underlying *assumptions*, such as projected population, change over time.
- Including *operating cost estimates* for each type of facility, and assessing how operating costs would be affected by different levels of overcrowding.
- Assessing the efficacy of *alternative courses of action*, including alternatives to incarceration and options to minimize construction costs.

To obtain the information the Legislature needs in making decisions with significant long-range policy/fiscal impacts, and to assure that the most cost effective financing option is available, we recommend that the Legislature adopt supplemental report language directing CDC to incorporate the above improvements into its facilities master plan.

The submittal of such an improved plan will assist the Legislature in assessing the needs, options and costs of the prison system. Moreover, through careful planning and *timely* submittal of information to the Legislature, the most cost-effective method of financing the capital needs could be determined.

General Obligation Bonds More Cost-Effective Than Revenue Bonds. So far, the state has relied almost exclusively on bonds to finance new prison construction. Of approximately $3 billion in construction costs in this decade, the state has used about $1.7 billion in general obligation bonds, almost $1.2 billion in lease-purchase revenue bonds and about $100 million from the General Fund and the Special Account for Capital Outlay (SAFCO). The magnitude of prison capital outlay needs relative to available resources (that is General Fund and tidelands oil revenue) makes the choice of funding alternatives, as a practical matter, between general obligation bonds and lease-purchase revenue bonds.

As discussed in the "Future Costs" section, the state pays a "premium" (in the form of higher financing costs) to use revenue bonds instead of general obligation bonds to finance prison construction. We estimate that the state would pay added costs of approximately $175 million (1989 dollars) from the General Fund over the next 20 years if the estimated cost for CDC's capital outlay needs were funded through lease-purchase revenue bonds rather than general obligation bonds. Moreover, revenue bond payments are subject to the appropriations limit and therefore limit the Legislature's ability to fund competing needs. In view of this, the use of these revenue bonds should be used only under the most urgent circumstances. In most cases, such circumstances can be avoided through proper and timely planning.

On several occasions, however, CDC has placed the Legislature in the untenable position of either approving proposals for lease-purchase revenue financing or having needed prison projects delayed. With proper planning on CDC's part and timely submittal of the plans to the Legislature, further use of lease-purchase revenue financing could be avoided, with significant savings to the state.

Evaluation of Prison Facility Needs Should Be Part of the Budget Process. In addition to a more useful five-year facilities master plan, the Legislature also needs the opportunity to review CDC's master plan and construction requests during the annual budget process in the context of overall CDC and state funding needs. In recent years CDC has not presented its plans and funding requests for new prison construction in the Budget Bill. Instead, it has presented its funding requests for new facilities in separate legislation, generally late in the legislative session. This places the Legislature in the untenable position of attempting to meet the prison overcrowding problem without benefit of the context of an overall approach to the state's prison needs and the opportunity to evaluate the impact on other state programs. This process is neither beneficial to the state nor necessary. The process could be improved substantially through proper planning on the department's part, and by presenting capital outlay plans and funding requests in the annual budget. Therefore, we recommend that the Legislature consider CDC's facilities master plan and all capital outlay funding requests in the annual budget process along with other statewide spending needs.

Blue Ribbon Commission May Develop Additional Options

The Blue Ribbon Commission on Inmate Population Management, established by Chapter 1255, Statutes of 1987, is composed of leaders of the California criminal justice system, representatives of the judiciary and law enforcement, and various other experts. It is charged with the mission to review the state's system for dealing with prisoner and parolee populations, and examine whether there are viable alternatives and solutions to the problems of overcrowding and rising costs. The commission's first report to the Governor and the Legislature is due in September 1989, with a final report due by the end of the year. In these reports, the commission may recommend other options (in addition to the ones discussed here) that would reduce the growth of the inmate population or that would reduce the costs of housing inmates once they are in prison.

CONCLUSION

Faced with an ever-increasing inmate population, the state for most of this decade has attempted to build its way out of a prison overcrowding situation. Following the appropriation of approximately $3 billion for new prison construction, overcrowding today (158 percent of capacity) is worse than it was when the construction program began (100 percent of capacity). Even if the Legislature spends another $1 billion (per CDC's current plan) over the next five years, overcrowding will be about 141 percent at the end of that period. Moreover, annual CDC support costs have climbed from $400 million in 1980-81 to an estimated $1.6 billion in 1988-89. Under CDC's current population projections these costs will rise to at least $3.1 billion by 1994-95. Thus, in 14 years, CDC's annual support budget will have increased by $2.7 billion or almost eight-fold.

Under the current appropriations limit, the increased annual cost of the state's prison system will necessitate significant reductions in the share of General Fund resources available for other state programs. This is because the rate of increase in the cost of the prison system will dramatically outpace both anticipated General Fund revenue growth and inflationary increases for other state programs.

The Legislature has options for minimizing the projected costs of building and operating/maintaining prisons. These options include—but are not limited to—selective reductions of prison terms, early release programs, changes in parole supervision, expansion of the conservation camp system, adding minimum security housing at existing prisons and improving the legislative review/financing process for capital outlay plans and projects.

Many of the options considered in this review involve minimum security inmates, a category where trade-offs between significant cost reductions and public safety considerations are most favorable.

Federal Immigration Reform: An Update

What Is the Status of the Expenditure of Funds Provided under the Federal Immigration Reform and Control Act (IRCA)?

Summary

- *More than 1.3 million persons have applied for legal status in California under IRCA, a substantial increase over last year's projection of 900,000.*
- *The budget year will be a critical one for thousands of newly legalized persons seeking to meet the educational requirements of IRCA.*
- *The administration has substantially revised its five-year expenditure plan for federal State Legalization Impact Assistance Grants (SLIAG) due to revised estimates of (1) program utilization and (2) federal funds available to the state.*
- *There have been very few claims for SLIAG funding in the current year. Although the reasons for the lack of claims are not clear, the administration believes that the newly legalized population may not need the level of health and welfare services originally projected and that some may fear disqualification from legalization because of federal rules regarding the use of public assistance by this population.*
- *The SLIAG expenditure plan offers a number of issues for consideration by the Legislature, including: the reliability of the program cost estimates, the reliability of SLIAG as a funding source, the problems of data collection, funding uncertainties at the federal level, and the use of SLIAG to fund other services.*

In 1986, Congress approved legislation amending federal law governing legal and illegal immigration into the United States. This legislation, known as the Immigration Reform and Control Act (IRCA), authorized general amnesty for certain groups of illegal aliens already in the United States, holding out eventual citizenship to these individuals. In addition, the legislation created employer sanctions in hopes of discouraging future illegal immigration.

The IRCA legislation included $4 billion in federal funds to pay for the costs of certain state and federal services that would be available to legal aliens, as well as the costs of registering, reviewing, and approving individuals applying for legal alien status. These funds—known as State Legalization Impact Assistance Grants (SLIAG)—are generally available to the states from 1987-88 through 1991-92.

In this section we review SLIAG expenditures in the current year and the administration's revised allocation plan for SLIAG for 1989-90 through 1991-92. We discuss several issues related to SLIAG in more detail in our individual department reviews included in the *Analysis of the 1989-90 Budget Bill.*

The Legalization Process

The IRCA recognizes two new groups that may lawfully gain citizenship in the United States.

Pre-82s. Undocumented aliens who have lived in this country continuously since January 1982 may become legal residents if they applied to the federal Immigration and Naturalization Service (INS) between May 1987 and May 1988 (the Governor's Budget refers to these individuals as "pre-82s"). After reviewing an application for legalization, the INS grants eligible individuals *temporary* resident status. Each applicant then must submit an application for permanent residency status within a one-year period beginning with the 19th month after the person was granted temporary residency. Consequently, these newly legalized persons must submit applications for permanent residency status to the INS between November 1988 and November 1990.

Special Agricultural Workers. The IRCA permits undocumented immigrants to apply for temporary resident status if they worked in U.S. agriculture for a minimum of 90 days between May 1985 and May 1986. These individuals are known as "special agricultural workers" (SAWs). The deadline for SAWs to apply to the INS for temporary status was November 30, 1988.

Number of Persons Seeking Legal Status Greater than Expected

Last year, the Department of Finance (DOF) estimated that 900,000 individuals would seek legalization in California. Based on the latest figures from the INS, the department now estimates that approximately *1.3 million* individuals have applied for legal status. This includes approximately 945,000 persons who were in the United States prior to 1982, and 370,000 SAWs. According to the DOF, newly legalized persons represent approximately 4.5 percent of the state's total population. More than half of all applicants for legalization in the nation live in California.

Budget Year Is Critical for Legalization Process. Newly legalized persons must meet specified criteria in order to convert to permanent residency. One of the most important criteria is that each person must show progress toward attaining minimum competency in English, history, and civics. INS regulations indicate that individuals can meet these requirements by either passing a short INS exam or by attending English-as-a-second-language (ESL) and civics classes for at least 40 instructional hours in an approved 60-hour course. These educational requirements make the budget year a critical time period for providing adult educational services in order to ensure that all newly legalized persons have the opportunity to convert to permanent residency status.

The Administration's Proposal for the Use of SLIAG Funds

As discussed above, the IRCA appropriates $4 billion to reimburse state and local governments for the costs of health, welfare, and education expenses incurred in assisting newly legalized persons. These monies, minus the federal costs of Medi-Cal, Supplemental Security Income/State Supplementary Program (SSI/SSP), and food stamps that are provided to eligible persons (known as the federal offset), will be allocated to states based on a specified formula.

Five-Year Expenditure Plan. Table 1 displays the amount of SLIAG funds estimated to be available to California and the expenditures of these funds from 1987-88 through 1991-92 as proposed in the Governor's Budget. These estimates were compiled by the Health and Welfare Agency (HWA), which has been designated the lead agency for IRCA implementation. Of the total funds available to the states (after adjusting for the federal offset), the agency estimates that approximately 58 percent will be allocated to California, for a total of $1.8 billion over the four-year period. This amount is $64 million *higher* than the amount estimated last year, based on the state's latest application for funding to the federal government.

Although the IRCA allocates funds to states over a four-year period, the Governor's Budget proposes to spend these funds over a five-year period, from 1987-88 through 1991-92. Federal regulations allow states to carry over SLIAG funds from year to year. Consequently, by carrying surpluses over each year, the budget proposes to make sufficient funds available to support program costs in the fifth year, 1991-92.

Substantially Revised Expenditure Plan. The five-year expenditure plan shown in Table 1 has been substantially revised from the plan presented to the Legislature last year as well as the plan ultimately included in the 1988 Budget Act. According to the HWA, the revisions have resulted because of revised estimates of program utilization in the prior and current fiscal years and because of the revised estimate of the total funds that will be available to the state.

In conjunction with the revised five-year expenditure plan, the Director of Finance notified the Legislature on January 19, 1989 of his intent to substantially revise the expenditure plan for the current year from the one approved by the Legislature in Control Section 23.50 of the 1988 Budget Act. The control section provides limited authority to the

Table 1
Federal SLIAG Funds
Availability and Proposed Expenditures
1987-88 through 1991-92
(dollars in millions) [a]

	State Fiscal Year					
	1987-88	*1988-89*	*1989-90*	*1990-91*	*1991-92*	*Total*
Funds available						
Federal allocation to California [b]	$427.8	$423.2	$416.5	$425.8	$106.1	$1,799.4
Carryover from previous year	—	286.0	393.4	257.6	284.3	n/a
Totals, funds available	$427.8	$709.2	$809.9	$683.4	$390.4	$1,799.4
Proposed expenditures						
Public assistance						
Health:						
Medically Indigent Services program	$68.4	$130.6	$238.9	$238.9	$238.9	$915.6
Medi-Cal	6.3	22.6	46.6	56.9	61.7	194.0
Primary care clinics	10.0	11.6	23.1	23.1	23.1	91.0
County medical services	—	4.9	18.0	18.0	18.0	58.8
California Children's Services	0.6	1.6	2.5	2.5	2.5	9.6
Subtotals, health	($85.3)	($171.2)	($329.0)	($339.4)	($344.1)	($1,269.0)
Mental health	—	$3.0	$3.0	$3.0	$3.0	$12.0
Welfare:						
General assistance	0.1	1.1	4.7	5.7	5.7	17.3
Foster care	—	2.6	2.7	2.3	2.1	9.6
AFDC-FG&U	0.1	0.5	2.1	5.1	5.2	13.0
SSI/SSP	0.1	1.5	2.9	3.7	3.1	11.4
Food stamps	0.1	0.5	0.7	0.7	0.7	2.7
IHSS	—	0.1	0.2	0.2	0.2	0.7
Subtotals, welfare	($0.4)	($6.2)	($13.2)	($17.7)	($17.0)	($54.6)
Housing	—	$2.5	$4.0	$4.0	$4.0	$14.6
Administration, public assistance	0.2	5.6	5.0	3.8	3.8	18.4
Totals, public assistance	$85.9	$188.5	$354.3	$367.9	$371.9	$1,368.6
Education						
Adult education	$30.0	$100.0	$180.0	$20.0	$10.0	$340.0
K-12 supplemental	4.2	2.8	1.4	—	—	8.4
Administration, education	0.1	1.8	2.3	1.0	0.5	5.7
Totals, education	$34.3	$104.6	$183.7	$21.0	$10.5	$354.1
Public health						
Health:						
TB/leprosy control	$5.0	$8.1	$0.6	$0.5	$0.3	$14.5
IRCA subvention	8.6	3.5	6.6	3.4	2.2	24.3
Sexually transmitted diseases	4.0	1.7	1.0	0.5	—	7.2
Laboratory support	—	0.3	—	—	—	0.3
Immunizations	0.6	0.5	0.2	0.1	0.1	1.5
Perinatal services	1.3	2.8	1.1	1.2	1.2	7.6
Family planning	1.0	3.2	1.6	1.7	1.7	9.2
Child health and disability prevention	0.7	—	—	—	—	0.7
Adolescent family life	0.2	0.5	1.0	1.1	1.1	3.9
Administration, public health	0.3	2.1	2.1	1.7	1.4	7.5
Totals, public health	$21.6	$22.7	$14.3	$10.2	$8.0	$76.7
Grand totals, proposed expenditures	$141.9	$315.8	$552.3	$399.1	$390.4	$1,799.4
Carryover to subsequent year	286.0	393.4	257.6	284.3	—	—

[a] Source: 1989-90 Governor's Budget. Details may not add to totals due to rounding.
[b] Based on estimates by the Health and Welfare Agency.

Director to move funds between the items scheduled in the section after notifying the Legislature of his intent to do so. Table 2 shows the revised expenditure plans for the current year compared to the 1988 Budget Act and for the budget year compared to the original expenditure plan included in the 1988-89 Governor's Budget. As the table shows, the administration proposes to reduce the amount of SLIAG funds allocated to welfare programs by 90 percent and substantially increase the amounts for medically indigent services and education programs.

Few Claims in the Current Year. As indicated above, the primary reasons the administration proposes to revise the SLIAG expenditure plan is to reflect its revised estimates of program utilization. In fact, at the time this analysis was prepared, *many programs had not spent any of their SLIAG funds.* Specifically:

- ***Health.*** The Department of Health Services advises that it is still processing claims for 1987-88 and has processed *no claims* for the current year in the county medical services and medically indigent services programs and less than $100,000 in claims in the Medi-Cal program. The department expects to begin processing 1988-89 claims for county health services beginning in March 1989. In addition, the Department of Mental Health has yet to process any claims in the current year.
- ***Welfare.*** The Department of Social Services advises that it has received *no claims* for SLIAG funds for welfare programs in the current year, including General Assistance, Aid to Families with Dependent Children, and SSI/SSP.
- ***Housing.*** The Department of Housing and Community Development (HCD) advises that it has not established a mechanism to determine which program recipients are eligible for SLIAG reimbursement. Consequently, the department has not processed any claims.

The reasons for the lack of claims are not clear. The HWA, however, advises that there are probably two reasons for the lack of health and welfare claims. First, the agency believes that the newly legalized population is a working population (although often in low-paying jobs) that can provide basic food, clothing, and shelter needs for themselves and their families. Second, the agency believes that many have a fear of government assistance programs, heightened by the fear of disqualification from legalization on "public charge" grounds. This is because under IRCA if newly legalized persons are found to have been a "public charge" (that is, receiving welfare or health benefits during specified periods), they may have difficulty qualifying for permanent residency. This fear may keep many newly legalized persons from seeking assistance through these programs.

Table 2
Federal SLIAG Funds
Changes in Expenditure Plans
1988-89 and 1989-90
(dollars in millions) [a]

	1988-89			1989-90		
	Original Plan (1988 Budget Act)	*Revised Plan (1989-90 Budget)*	*Percent Change*	*Original Plan (1988-89 Budget)*	*Revised Plan (1989-90 Budget)*	*Percent Change*
Public assistance						
Health:						
Medically Indigent Services program	$67.6	$130.6	93.2%	$94.0	$238.9	154.1%
Medi-Cal	26.9	22.6	−16.0	47.5	46.6	−1.9
Primary care clinics	11.6	11.6	—	14.7	23.1	57.1
County medical services	4.9	4.9	—	6.7	18.0	168.7
California Children's Services	1.7	1.6	−5.9	1.7	2.5	47.1
Subtotals, health	($112.7)	($171.2)	(51.9%)	($164.6)	($329.0)	(99.9%)
Mental health	$3.0	$3.0	—	—	$3.0	— [b]
Welfare:						
General assistance	41.4	1.1	−97.3%	$88.1	4.7	−94.7%
Foster care	2.5	2.5	—	2.7	2.7	—
AFDC—FG&U	7.4	0.5	−93.2	14.3	2.1	−85.3
SSI/SSP	12.9	1.5	−88.4	21.4	2.9	−86.4
Food stamps	0.3	0.5	66.7	0.3	0.7	133.3
IHSS	0.2	0.1	−50.0	—	0.2	— [b]
Subtotals, welfare	($64.7)	($6.2)	(−90.4%)	($126.8)	($13.2)	(−89.6%)
Housing	$2.5	$2.5	—	—	$4.0	— [b]
Administration, public assistance	4.1	5.6	36.6%	$3.5	5.0	42.9%
Totals, public assistance	$187.0	$188.5	0.8%	$294.9	$354.3	20.1%
Education						
Adult education	$80.0	$100.0	25.0%	$110.0	$180.0	63.6%
K-12 supplemental	2.8	2.8	—	1.4	1.4	—
Administration, education	1.3	1.8	38.5	1.7	2.3	35.3
Totals, education	$84.1	$104.6	24.4%	$113.1	$183.7	62.4%
Public health						
Health:						
TB/Leprosy control	$8.1	$8.1	—	$1.5	$0.6	−60.0%
IRCA subvention	3.5	3.5	—	1.2	6.6	450.0
Sexually transmitted diseases	1.7	1.7	—	—	1.0	— [b]
Laboratory support	0.3	0.3	—	—	—	—
Immunizations	0.5	0.5	—	0.1	0.2	100.0
Perinatal services	2.8	2.8	—	2.3	1.1	−52.2
Family planning	3.2	3.2	—	3.2	1.6	−50.0
Child health and disability prevention	—	—	—	—	—	—
Adolescent family life	0.5	0.5	—	0.5	1.0	100.0
Administration, public health	1.0	2.1	110.0%	0.6	2.1	250.0
Totals, public health	$21.6	$22.7	5.1%	$9.4	$14.3	52.1%
Grand totals, expenditures	$292.7	$315.8	7.9%	$417.4	$552.3	32.3%

[a] Details may not add to totals due to rounding.
[b] Not a meaningful figure.

Education Claims. As of December 31, 1988, the State Department of Education had spent approximately $34 million, or about 43 percent, of its current-year appropriation of $80 million for adult education. As Table 2 shows, the administration proposes to allocate an additional $20 million for adult education in the current year in anticipation of additional claims being processed during the year. The HWA indicates that newly legalized persons appear to be seeking adult education services in advance of when they have to apply to INS for permanent residency status and appear to be staying in ESL and civics classes beyond the minimum number of instructional hours that INS requires.

Issues for Legislative Consideration

Our analysis indicates that the administration's proposed expenditure plan for SLIAG presents the Legislature with a number of questions and issues to consider. Specifically:

Questionable Estimates. Many of the estimates used to develop the five-year plan are questionable. Given the lack of actual claims in the current year and the very limited data available, many of the estimates are little more than educated guesses.

SLIAG Is a Temporary Funding Source. Much of what is proposed in the expenditure plan will fund *existing*, rather than *new*, programs and services. That is, SLIAG funds are proposed to *replace existing General Fund expenditures*. This has a serious drawback. When SLIAG funds are exhausted in 1991-92, the General Fund monies that they replaced will likely have been committed to other uses.

Uncertainty at the Federal Level. President Reagan's budget for federal fiscal year 1990 proposed a 30 percent reduction in SLIAG funding. According to the HWA, if such a reduction is enacted (which would require Congress to rescind its prior appropriation), California could lose $174 million in its estimated remaining SLIAG funding.

Data Collection. The SLIAG expenditure plan in the Governor's Budget has changed substantially from the plan submitted to the Legislature last year. In large measure, this is because so little data were available last year with which to estimate program costs. Given the lack of claims in the current year, we believe the estimating problem is likely to persist in the budget year. This is partially due to the difficulty in (1) determining what services newly legalized persons need from state and local governments and (2) identifying which costs are eligible for SLIAG funding.

Other Services Could Be Funded with SLIAG Funds. Although the budget proposes to support many different programs with SLIAG funds, our analysis indicates that the Legislature could elect to support IRCA-related costs incurred in other programs. These programs include various environmental health programs in the Department of Health Services and substance abuse programs in the Department of Alcohol and Drug Programs.

We discuss a number of these issues in our *Analysis of the 1989-90 Budget Bill*. Specifically, in the analysis of the Department of Health Services (Item 4260), we review the policy issues regarding the Governor's proposal to substantially increase SLIAG funding for the Medically Indigent Services program. We also address questions regarding the estimates for the perinatal, adolescent family life, and California Children's Services programs, and we discuss a court injunction that limits the department's ability to claim SLIAG funds for some Medi-Cal services. In the analysis of the State Department of Education (Item 6110), we address policy questions regarding the administration's proposals to target SLIAG funding to critical educational services.

State Child Care Services

What Options Are Available to the Legislature for Better Targeting Existing Child Care Funds to Those Most in Need?

Summary

- *Currently, 13 state agencies administer 49 child care programs funded at approximately $747 million—$614 million from the General Fund and $133 million from federal funds. In addition, federal agencies administer four programs funded at an estimated $623 million in 1988-89.*
- *The two programs which provide almost three-fourths of state funding for child care are: (1) the subsidized Child Development program administered by the State Department of Education and (2) the child care tax credit program administered by the Franchise Tax Board.*
- *The Legislature has three major options for modifying child care programs in order to expand the number of low-income children served: (1) modify existing staff to children ratios (which we recommend enactment of legislation to achieve); (2) change the mix of programs currently provided; and (3) raise family fee levels.*
- *The current child care tax credit provides benefits primarily to middle- and high-income families. The Legislature has three primary options for modifying the credit to better target state child care resources: (1) phase out or reduce the credit for families with higher incomes; (2) make the credit refundable; or (3) repeal the credit.*

The Legislature faces important decisions regarding how to target available child care funds to those most in need of affordable care. For instance, with regard to the two existing state programs that provide the majority of funding for child care and related services:

- Should the state-subsidized child development programs administered by the State Department of Education (SDE) be modified as the Legislature considers whether or not to extend the programs beyond their scheduled June 30, 1989 sunset date?
- How can the state child care tax credit administered by the Franchise Tax Board (FTB) be modified to better target subsidies to those most in need of this assistance?

In addition, to the extent that the federal government enacts one or more of the child care programs that are currently being considered in Congress (including those that provide services directly and those that provide tax credits), the Legislature may also need to address issues related to these programs' implementation.

To assist the Legislature in determining how to target existing state resources to those most in need of child care, this analysis first provides background information on the cost and affordability of child care in California. We then discuss existing state and federal child care programs. Finally, we examine options available to the Legislature for better targeting state funds to those most in need of affordable child care.

What Types of Child Care Are Available in the State?

There is a wide diversity of child care programs available in California, both in terms of the services provided and in the role the state plays in monitoring and funding them. There are part-day and full-day programs, summer and year-round programs, and programs targeted to specific groups (such as the disabled, children of teenage parents, and abused and neglected children). Some programs receive state or federal funds (we identify these programs in a subsequent section) and some do not.

Generally, all child care programs are required to be licensed by the Department of Social Services (DSS), except for the following which are specifically exempted: (1) programs where child care providers care only for their children and the children of one other family in the provider's home, (2) care provided to children in their own homes, (3) programs, such as after-school recreational programs, in which activities are provided only on a drop-in basis, and (4) programs operated by school districts in which all staff employed are regular district employees and all children served are students enrolled in the district. In addition to the licensed and license-exempt providers, there are an unknown—but presumably large—number of unlicensed child care arrangements.

All the programs vary considerably in cost, though the greatest variation probably occurs in license-exempt care. For example, some license-exempt care, such as care by relatives, may be provided free. Other types, such as care for one family's children in their own home, may be more expensive than many other forms of child care.

There is almost no information available on the cost of *non*licensed (that is, license-exempt and unlicensed) child care; thus, our analysis in the next section deals only with licensed child care. This is not to imply that parents only use licensed care. Clearly, this is not the case. In fact, many child care experts estimate that the number of children enrolled in nonlicensed programs may *equal or exceed* the number of children enrolled in licensed programs.

Is Child Care Affordable?

There is evidence to support a common perception about child care—that many families in which both parents (or the single parent) work cannot afford to purchase child care at private market rates. Child care policy experts estimate that families can usually afford to pay approximately 10 percent of their incomes for child care services. Table 1 shows the percentage of family income (at various income levels) needed in 1986-87 to purchase licensed child care (at the state's median market rate) in centers or family day care homes *for one child.* (Child care centers are generally licensed to care for more than 12 children and are usually operated at sites other than families' primary residences. Family day care homes are generally licensed to care for up to either six or 12 children and are usually operated in families' primary residences.)

Table 1
Portion of Family Income Needed to Pay Average Child Care Costs 1986-87

Type of Child Care	Annual Costs[a]	Family Income: Selected Percentages of State Median Income—$33,200				
		50.0%	84.0%	100.0%	120.0%	180.0%
Infant Care:						
Child Care Center	$4,194	25.3%	15.0%	12.6%	10.5%	7.0%
Family Day Care	3,298	19.9	11.8	9.9	8.3	5.5
Preschool Care:						
Child Care Center	3,130	18.9	11.2	9.4	7.9	5.2
Family Day Care	3,149	19.0	11.3	9.5	7.9	5.3

[a] The annual costs are the median rates charged statewide by child care providers (simple average of all providers, not weighted by the number of children served). The costs include both subsidized and nonsubsidized funding rates.

Source: California Child Care Resource and Referral Network, *California Inventory of Child Care Facilities,* February 1987 with June 1988 update, San Francisco, California. The statewide median income ($33,200 in 1986-87) was obtained from the Department of Finance.

Using 10 percent of income as a measure of affordability, the table shows that families earning the state median income—$33,200 in 1986-87—could afford to pay for licensed child care, unless they needed child care for infants or for children with special needs (because care for these children is often more expensive that other types of care), or they had more than one child needing child care.

The table also shows that families with incomes at 84 percent of the state median—$27,888 in 1986-87—paid, on average, between 11 percent and 15 percent of their incomes for licensed child care in that year, unless they received subsidies. In general, the children from families with incomes *below* this level are eligible for subsidized child development programs administered by the SDE. Many of the children who are eligible for the child development programs, however, are not served by them. (We discuss the potential unmet demand for the programs in a subsequent section.) While the child care arrangements for an unknown number of the children from these low-income families may be subsidized through employers, nonprofit organizations, and local governments, it is likely that many families in this income range either (1) pay the full cost of child care or (2) obtain child care informally at less cost.

Families with incomes of 50 percent of the state median—$16,600 in 1986-87—paid between 19 percent to 25 percent of their incomes for licensed care in that year—a proportion that generally made such care unaffordable for this group, unless they received subsidies. While many of these families were probably eligible to receive Aid to Families with Dependent Children (AFDC), there are no data on the number of these families that received child care through AFDC or the Greater Avenues for Independence (GAIN) program. Among other things, GAIN provides child care to AFDC recipients so that they may work or receive job training.

The next section discusses programs in California that receive state and/or federal funds to provide affordable child care to low-income families, as well as other child care and related programs.

STATE CHILD CARE PROGRAMS

Our review indicates that 16 agencies (13 state agencies and three federal agencies) administer 53 separate programs that provide child care and related services in California. Chart 1 identifies these agencies (and their acronyms, which are used in Table 2).

Chart 1

State and Federal Agencies That Provide Child Care and Related Services in California

STATE AGENCIES	
California Community Colleges	CCC
California Department of Corrections	CDC
California State University	CSU
Department of Developmental Services	DDS
Department of Housing and Community Development	HCD
Department of Motor Vehicles	DMV
Department of Personnel Administration	DPA
Department of Social Services	DSS
Department of Transportation	Caltrans
Employment Development Department	EDD
Franchise Tax Board	FTB
State Department of Education	SDE
State Water Resources Control Board	SWRCB

FEDERAL AGENCIES	
Internal Revenue Service	IRS
Department of Education	DOE
Department of Housing and Urban Development	HUD

Chart 2 shows the percentage of funds administered by state agencies in the current year (total of $747 million) that are provided for the major types of child care. As the chart indicates, 48 percent of these funds is used to support child care for low-income families, 17 percent provides support for child care expenses through tax benefit programs, 17 percent is targeted to particular groups of children (such as those who are disabled, abused and neglected, or the children of high school or college students), and 18 percent is used to support services related to child care (such as capital outlay, state administration of child care programs, and child care referral programs for parents.)

Chart 2

Child Care Funds Administered by State Agencies By Type of Program 1988-89

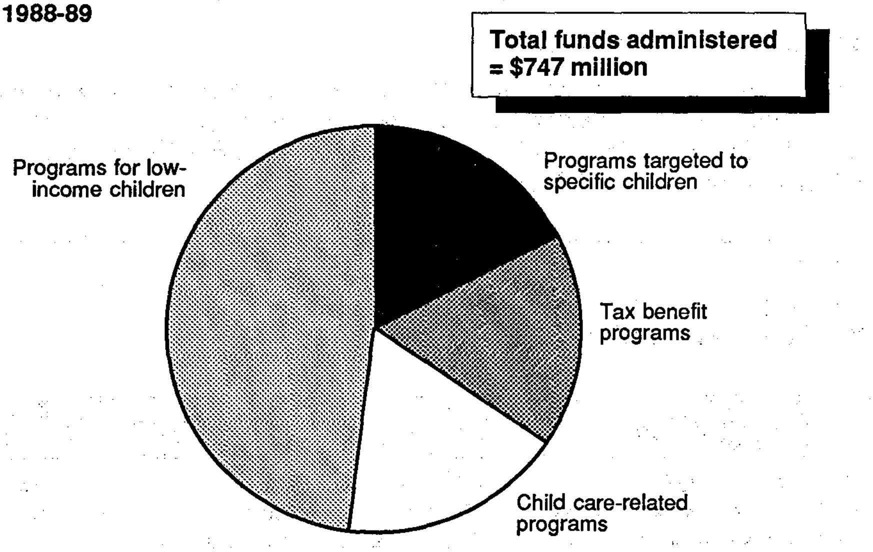


Table 2 lists all the state and federal child care programs operating in California that we were able to identify. The chart provides for each program summary information on eligibility requirements, caseloads, and current-year estimated costs. All the identified programs were funded at a total of $1.4 billion in the current year. The General Fund financed about $614 million (45 percent) of these expenditures and the federal government funded about $756 million (55 percent).

The table displays separately the expenditures of the federal government where the state plays no administrative or policy role. Generally, the programs provide child care and related services through grants or tax credits. While the Legislature cannot directly influence these programs, it may wish to take these expenditures into account when making decisions about the amount of state funds to provide for child care services.

Due to lack of available data, Table 2 excludes programs supported by one-time federal grants not allocated by state agencies, and programs provided through local governments, school districts, private nonprofit agencies and employers, *unless the programs are funded through the state and federal funds we identify.* For example, many school districts operate subsidized child care programs for school-age children. If a district's program is funded through the SDE, it is included in Table 2; if it is funded through general district revenues, it is not included.

Below we discuss in greater detail the two programs that provide the majority of state funding for child care.

Child Development Programs

The SDE administers nine programs which provide direct child care services and nine programs (including two one-time programs) which provide child care services indirectly. In 1988-89, the ongoing child development programs are budgeted at $337.0 million ($334.3 million from the General Fund and $2.7 million from federal funds). The major direct service programs serve families (including AFDC recipients) earning less than 84 percent of the state median income (adjusted for family size), in which both parents or the single parent is in the labor force. Other direct service programs are targeted at specific groups, such as abused and neglected children, migrant children, or the children of teenage parents. The indirect service programs primarily fund capital outlay, child care referrals to parents, training for providers, and special projects.

The direct service programs provided services, usually on a sliding fee scale, to approximately 110,000 children in 1985-86 (the last year for which detailed enrollment data are available). Almost two-thirds of these children were from families headed by single women. Most of the children served were aged 3 through 5 (61 percent), and 98 percent were under 11 years of age. Almost all children (93 percent) were enrolled in child care centers, which are usually licensed to care for more than 12 children.

Our review indicates that the 55,000 children from low-income working families served in 1985-86 through SDE child development programs represent anywhere from 12 percent to 26 percent of the demand for

Table 2

Programs In California That Provide Child Care and Related Services[a]

1988-89 (dollars in thousands)

PROGRAMS[b]	TARGET GROUP	ESTIMATED NUMBER OF CHILDREN SERVED 1988-89	ESTIMATED 1988-89			COMMENTS
			STATE	FEDERAL	TOTAL[c]	
PROGRAMS FOR LOW-INCOME CHILDREN						
General child care (SDE)	Standard[d]	52,453	$208,576	—	$208,576	
Child care for GAIN[e] participants (DSS)	Children of GAIN participants	—[f]	25,931	$4,027	29,958	
State Preschool (SDE)	Low-income, ages 3-5	21,241	35,529[g]	—	35,529[g]	Programs operate part-day only.
Alternative Payment (SDE)	Standard[d]	5,881	33,315	—	33,315	
Dependant Care Disregard (DSS)	Employed AFDC[h] recipients; primarily female heads of households	—[f]	9,794[i]	10,649[i]	20,443[i]	In effect, increases AFDC benefits for employed AFDC recipients with specified child care costs.
Extended day (Latchkey) care (SDE)	Standard[d], ages 5-14	14,953	16,111	—	16,111	Requires participation by nonsubsidized children.
Migrant child care (SDE)	Standard[d], migrant children	2,330	7,326	2,140	9,466	
Child care for employed GAIN participants/transitional child care (DSS)	Children of employed GAIN participants	—[f]	1,776	—	1,766	Provides 90 days of child care for GAIN participants beginning the day they become employed.
Child care for JTPA[j] participants (EDD)	Children of parents receiving training through JTPA	—[f]	—	—[f]	—[f]	Local Service Delivery Areas can spend up to 15 percent of their grants for child care and other support services for JTPA participants.
SUBTOTALS		(96,858)	($338,358)	($16,816)	($355,164)	
PROGRAMS TARGETED TO SPECIFIC CHILDREN						
PROGRAMS FOR CHILDREN OF COLLEGE STUDENTS:						
Child care centers (CSU)	Priority: low-income students, students, faculty and staff, public.	—[f]	$190	—	$190	Funding shown here is divided equally among the 18 campuses (of 19) with child care centers. Total licensed capacity in 1987-88 was 1,197 spaces.

Child care centers (CCC)	Primarily children of students	—[f]	—[f]	—	—[f]	An unknown amount of district funds support centers at 86 of the 106 campuses. Centers served 12,823 children in 1987-88.
Cooperative Agencies Resources for Education (CARE) (CCC)	Children of students on AFDC[h]. Priority: children under age 6.	—[f]	700	—	700	In 1988-89, 39 of the 106 campuses participated. About 50 percent of the total CARE funds support financial assistance for child care.
Campus children's centers (SDE)	Standard[d], primarily campus students	3,775	6,459	—	6,459	
Campus Child Care Tax Bailout (SDE)	Specified community college campus child care centers.	—[f]	4,191	—	4,191	
SUBTOTALS		(3,775)	($11,540)	(—)	($11,540)	
PROGRAMS FOR CHILDREN OF SCHOOL-AGED PARENTS:						
Vocational education—Carl Perkins funds Title II, part A, single-parent (SDE)	Children of school-aged parents	—[f]	—	$8,000	$8,000	50 percent of program funds targeted to low-income areas.
School-Age Parenting and Infant Development (SDE)	Parents enrolled in secondary school and their children	1,300	$6,941	—	6,941	
SUBTOTALS		(1,300)	($6,941)	($8,000)	($14,941)	
PROGRAMS FOR ABUSED AND NEGLECTED CHILDREN:						
Protective Services (SDE)	Abused, neglected or exploited children	2,307	$1,069	—	$1,069	These children also receive first priority for enrollment in other SDE child development programs.
Child Abuse Prevention Program (Ch 1398/82) (DSS)	Abused, neglected or at risk children and families regardless of income	—[f]	—[f]	—	—[f]	An unknown number of counties choose to provide child care as part of this program.
Out-Of-Home Respite Care (DSS)	Abused, neglected or at risk children	—[f]	—[f]	—	—[f]	Respite care is an allowable service in the Child Welfare Services program; an unknown number of counties provide such care.
SUBTOTALS		(2,307)	($1,069)	(—)	($1,069)	

PROGRAMS[b]	TARGET GROUP	ESTIMATED NUMBER OF CHILDREN SERVED 1988-89	ESTIMATED 1988-89 STATE	FEDERAL	TOTAL[c]	COMMENTS
PROGRAMS FOR DISABLED CHILDREN:						
Preschool and infant development (DDS)	Infants 0-36 months (1) identified by regional center as at risk or developmentally disabled and (2) required to receive services in their IDPs[k]	—[f]	$4,200	—	$4,200	5,800 children are eligible.
Day care, recreation and other development programs (DDS)	Regional center clients required to receive such services in their IDPs[k]	—[f]	300	—	300	Estimate based on percentage of children under age 14. 24,000 children are eligible.
Respite (DDS)	Regional center clients required to receive such services in their IDPs[k]	—[f]	1,300	—	1,300	Estimate based on percentage of children under age 14. 24,000 children are eligible.
Severely Handicapped (SDE)	Disabled children in the San Francisco Bay area	197	740	—	740	An additional number of disabled children are served in other SDE-administered child development programs.
Special education infant/preschool program (SDE)	Handicapped children ages 0-5	15,000	81,000	$13,000	94,000	Excludes funds for individual instruction and other designated services.
SUBTOTALS		(15,197)	($87,540)	($13,000)	($100,540)	
PROGRAMS THAT GIVE PRIORITY TO CHILDREN OF STATE EMPLOYEES:						
State Employee Child Care Program (DPA)	Children of state employees	—[f]	$350	—	$350	Provides grants to state employee groups to develop child care services.
Child care center—Sacramento (FTB)	Preschool aged children; Priority given to children of FTB employees	60	36	—	36	Funding covers the program's fixed costs, such as rent.
State developmental centers (SCDs) on-site child care (DDS)	Children of state employees and community members	380	—[f]	—	—[f]	Five of the seven SDCs have child care centers. SDCs may subsidize centers in exchange for priority or reduced-rate child care services for SDC employees.
Child care center—Sacramento (DMV)	Ages 2-6, open to state employees and the public in the Sacramento area. Priority: (1) DMV employees, (2) state employees, and (3) the public.	54	88	—	88	The DMV center building is state-owned; thus, no funds are spent on rent. Budget includes a maintenance and rent subsidy.

DOT TOT child day care center—Sacramento (Caltrans)	Ages infant-5; open to Caltrans staff and other state employees in the Sacramento area. Priority: (1) Caltrans; (2) state employees.	60	—[f]	—	—[f]	The benefit to the state in terms of increased employee productivity is considered when determining the center's rent.
Child care center—Sacramento (SWRCB)	Priority given to children of state employees	60	14	—	14	Center is located in a state building and pays rent to the state at a subsidized rate.
Child care center—Vacaville (CDC)	Priority given to children of CDC employees	—[f]	—[f]	—	—[f]	Center is located at a correctional facility. Subsidized rent of $1 per year charged.
SUBTOTALS		(614)	($488)	(—)	($488)	
PROGRAMS THAT PROVIDE OTHER CHILD CARE SERVICES:						
Centerforce Inmate Visitation Program (CDC)	Children of inmates	—[f]	$79	—	$79	Provides child care while spouses visit inmates. Funds will pay for 23,808 service contacts (defined as one child care meeting regardless of length) in 1988-89.
School desegregation—child care component (SDE)	Children enrolled in specified school desegregation programs	360	510[l]	—	510[l]	Child care provided as an incentive for minority and white families to participate in desegregation plans at targeted schools.
SUBTOTALS		(360)	($589)	(—)	($589)	
TAX BENEFIT PROGRAMS						
Tax credit for child and dependent care (FTB)	Tax-filers claiming child care expenses	950,000[m]	$121,000	—	$121,000	Allows taxpayers to deduct a portion of their child care expenses from their taxable income.
Dependent care assistance program (FTB)	Employees of participating employers	—[f]	8,000	—	8,000	Authorizes employees to place up to $5,000 of their pre-tax income in a child care expense fund.
SUBTOTALS		(950,000)	($129,000)	(—)	($129,000)	
CHILD CARE RELATED PROGRAMS						
PROGRAMS FOR CAPITAL OUTLAY:						
Child care capital outlay (SDE)	Subsidized child care programs	—	—	$19,700	$19,700	Established by Ch 1140/85 and Ch 1026/85 for portable facilities and loans. One-time funds totalled $44 million. Remaining amount will be allocated in 1988-89.

PROGRAMS[b]	TARGET GROUP	ESTIMATED NUMBER OF CHILDREN SERVED 1988-89	ESTIMATED 1988-89 STATE	FEDERAL	TOTAL[c]	COMMENTS
Child care centers capital outlay (CCC)	Community college child care programs	—	110	—	110	One-time equipment funds for a new child care center at Mendocino Community College.
SUBTOTALS		(—)	($110)	($19,700)	($19,810)	
OTHER RELATED PROGRAMS:						
Resource and Referral (SDE)	Parents, regardless of income	—	$7,636	—	$7,636	Provides child care referrals and information to parents and child care providers.
Preschool Scholarship Incentive Program (SDE)	Prospective preschool teachers	—	288	—	288	Provides Early Childhood Education scholarships to those working in the SDE-administered child development programs.
Special projects (carryover) (SDE)	Providers of child care and related services	—	3,895	—	3,895	Funds allocated but not spent in previous years (carryover funds) are used for special projects and child care.
California Child Care Initiative (SDE)	Potential child care providers	—	250	—	250	Primarily funds recruitment and training of new child care providers. Private funds also provide $1 million.
Before and after school program incentives (SDE)	Potential providers of school-age child care	—	—	$336	336	One-time start-up grants.
School age child care (SDE)	Potential providers of school-age child care	—	—	259	259	One-time start-up grants.
Self-care projects (DSS)	Latchkey children, regardless of income	—[n]	253	—	253	Three projects, each with a phone hot-line system, provide training on after-school self-care.
State administration of child development programs (SDE)	Providers of SDE-administered child development programs	—	4,607	—	4,607	Funds used to administer and monitor child development programs serving about 110,000 children.
State administration of child care licensing (DSS)	All licensed child care facilities	—	15,576	—	15,576	Funds are used to license and monitor child care providers. Total licensed capacity of providers is 746,864 in 1988-89.
Special allowance for rent (SDE)	Certain subsidized child care programs	—	441	—	441	Provides rent subsidies.

Community Development Block Grant—Small Cities (HCD)	Low-income families	—[f]	—	68	68	Can be used for operating expenses and capital outlay.
Child Care Food Program (SDE)	Low-income children in preschool and child care programs	—[f]	5,100	74,970	80,070	Provides subsidies for meals and snacks.
Subtotals		(—)	($38,046)	($75,633)	($113,679)	
PROGRAMS FUNDED AND ADMINISTERED BY THE FEDERAL GOVERNMENT						
Tax credit for child and dependant care (IRS)	Tax-filers claiming child care expenses	—[o]	—	$500,000[p]	$500,000[p]	Allows taxpayers to deduct a portion of their child care expenses from their taxable income.
Head Start (DOE)	Low-income, ages 3-5	34,000	—	98,200	98,200	Part-day only.
Dependant care assistance program (IRS)	Employees of participating employers	—[f]	—	25,000[q]	25,000[q]	Authorizes employees to place up to $5,000 of their pre-tax income in a child care expense fund.
Community Development Block Grant—Entitlement Program (HUD)	Low-income families	—[f]	—	—[f]	—[f]	Funds (probably less than $9 million) are generally used for capital outlay.
SUBTOTALS		(34,000)	(—)	($623,200)	($623,200)	
TOTALS		1,104,411	$613,681	$756,349	$1,370,020	

[a] This table does not provide an unduplicated count of services provided because such information is not available. The table most likely underestimates the total amount of state resources provided for child care services, because data are generally not available on the extent to which state agencies, institutions of higher education, and school districts provide in-kind resources (such as facility space and administrative services) for child care programs. The table also underestimates the total amount of resources used to care for the children identified because such information is not available. Specifically, most programs charge parent fees and some programs may receive funding from other sources.

[b] Agency acronyms were identified previously in Chart 1. The programs provide direct child care services unless noted otherwise.

[c] Details may not add to totals due to rounding.

[d] Children served must meet at least one standard eligibility criterion and one standard need criterion as follows: Eligibility: (1) child is actually or potentially abused, neglected, exploited, or homeless; (2) the family receives public assistance; or (3) income is not greater than 84 percent of state median income, based on family size. Need: (1) parents are employed, seeking employment, or in training; (2) parents or child have a medical or psychiatric special need and need child care; or (3) the child is actually or potentially abused, neglected, exploited or homeless.

[e] GAIN: Greater Avenues for Independence.

[f] Figures not available.

[g] The State Preschool and Preschool Scholarship Incentive programs are not budgeted separately. Separate funding estimates are based on SDE information.

[h] AFDC: Aid to Families with Dependent Children.

[i] Does not include GAIN or the effects of federal welfare reform.

[j] JTPA: Job Training Partnership Act.

[k] An Individual Development Plan (IDP) is developed for all regional center clients to determine their individual service needs.

[l] The state expenditure is an estimate of the portion of the budgets for Los Angeles and San Diego programs which is reimbursed by the state.

[m] Estimated number of children served assumes one child per filer.

[n] Although the number of children served is currently unknown, estimates will be contained in the DSS forthcoming report, "Year Two Report on Effectiveness and Cost Effectiveness of AB 1562."

[o] The estimated number of children served was reflected previously for the state tax credit; it is not included here to avoid a known duplication.

[p] Estimate for federal tax credit revenue loss derived by multiplying the U.S. Congressional Joint Committee on Taxation estimate for national revenue loss ($4 billion), by 12.5 percent, an estimate of the proportion of the credits claimed by Californians.

[q] Estimate for federal dependent care revenue loss derived by multiplying the U.S. Congressional Committee on Taxation estimate for national revenue loss ($200 million), by 12.5 percent, an estimate of the proportion of the exclusion which relates to California taxpayers.

subsidized care. Thus, the potential unmet demand for subsidized care for low-income working families in that year ranged from about 155,000 to 405,000 children. Our estimate assumes *current subsidy rates and eligibility standards* and includes adjustments to reflect the fact that many families would use informal child care arrangements (such as care by relatives) even if subsidized care were available. (The effect of these adjustments *may* be to understate the potential "unmet demand" for these programs. We discuss this issue in greater detail in our report, *The Child Development Program: A Sunset Review*, Report No. 89-5, February 1989).

It is not possible to estimate *total* demand for subsidized child care, because data are not available on the demand for child care for specific groups, such as abused and neglected children and the children of high school students.

Child Care Tax Credit

The Franchise Tax Board (FTB) estimates that the tax credit for child and dependent care expenses will result in General Fund revenue losses of about $121 million in 1988-89. This tax credit allows taxpayers to claim a tax credit for a portion of the "out-of-pocket" expenses they incur in providing care for their children, and for certain other dependents who are disabled. The credit may only be claimed by persons who incur the eligible expenses because they are working or looking for work. Child care costs are eligible for the credit whether or not the child care provider receiving payments is licensed. The credit is nonrefundable, and unused credit amounts may not be carried forward into succeeding tax years.

The allowable *state* credit amount equals 30 percent of the taxpayer's corresponding *federal* child care credit. The current federal credit ranges from 20 percent to 30 percent of qualifying expenses, depending on a taxpayer's adjusted gross income (AGI). The federal credit is equal to 30 percent of qualifying expenses for taxpayers with AGIs of $10,000 or less. The credit amount is then reduced by one percentage point for each $2,000 of AGI income over $10,000, until it decreases to 20 percent for taxpayers with AGIs greater than $28,000. The maximum amount of qualifying expenses to which the federal credit may be applied is $2,400 if one qualifying child is involved, and $4,800 if two or more children are eligible.

Thus, the maximum federal credit ranges from $480 to $720 annually for taxpayers with one eligible child, and from $960 to $1,440 for taxpayers with two or more eligible children. The corresponding maximum state credit is equal to 30 percent of these amounts, or $144 to $216 for one child, and $288 to $432 for two or more children. However, California's tax rate structure is designed so that taxpayers with AGIs low enough to generate the maximum credit amounts generally do *not* have a large enough tax liability to realize the full benefit of the credit. As a result, the effective maximum credit a taxpayer with one child can receive is generally $166, while the effective maximum credit for taxpayers with two or more children is generally $302.

As mentioned, the child care tax credit program provides tax relief to individuals who obtain child care services in order to be able to work or look for jobs. By partially tying the amount of the credit to the taxpayer's AGI, both state and federal law attempt to provide greater tax relief to low-income taxpayers. In addition to providing tax relief, the credit also generally provides an incentive for increased labor force participation by increasing the potential after-tax incomes of eligible taxpayers. At the same time, the tax credit has a structural bias against married couples with one earner, as the program provides no benefits to a parent who elects to stay at home with his or her children.

In the next section, we discuss the Legislature's options for better targeting funds provided through these two child care programs.

POLICY OPTIONS FOR THE LEGISLATURE

The Legislature has several options both for better targeting existing state funds to those most in need of affordable child care and for expanding child care programs to meet more demand. In general, these options involve policy—rather than analytical—decisions about the state's role in providing various types of child care. Thus, we have no analytical basis for making recommendations on *most* of these issues. Rather, we point out the potential trade-offs that exist within the various options.

In the discussion which follows, we limit our review to areas in which data are available to illustrate the possible trade-offs that would occur if various policies were adopted. Specifically, we discuss the following options for the SDE-administered Child Development program:

- Modify existing staff to children ratios;
- Change the mix of programs currently provided; and
- Raise family fee levels.

We also discuss the following options for the FTB-administered tax credit program:

- Phase out or reduce the credit for families with higher incomes;
- Make the credit refundable; or
- Repeal the credit.

Generally, the options discussed below are not mutually exclusive. Thus, the Legislature may consider adopting more than one of the policies we review.

Modify Existing Staff to Children Ratios for Preschool-Aged Children in Child Development Programs

We recommend the enactment of legislation to phase in a change in staff to child ratios for preschool-aged children served through subsidized child development programs from 1:8 to 1:10, on an enrollment basis. A 1:10 ratio would maintain high-quality programs while still providing a richer staff to child ratio than that required by the Department of Social Services for nonsubsidized child care programs. This change would result in annual savings of up to $19 million, which could be used to serve up to 4,300 additional children.

Most subsidized child development programs must maintain higher adult to child ratios than nonsubsidized programs. For example, nonsubsidized programs are required by DSS licensing standards to place one adult in charge of no more than 12 preschoolers, for a 1:12 staff ratio. The SDE, however, requires that subsidized programs meet a 1:8 staff ratio for this age group.

Historically, subsidized programs have been required to meet higher staff ratio requirements because they serve low-income children and children with special needs, such as abused and neglected children. Based on the results of the comprehensive National Day Care Study, however, we find that current staff ratios for preschool children enrolled in subsidized care could be liberalized, while still maintaining high-quality programs. The higher ratio would still be richer than the ratio required by the DSS for nonsubsidized child care programs. Further, the 1:10 ratio would equal or be stricter than those used in 44 of the other 49 states. (This issue is discussed in much greater detail in our recently issued report, *The Child Development Program: A Sunset Review.*)

Recommendation. Accordingly, we recommend the enactment of legislation to change staff ratios for children aged 3 to 5 from 1:8 to 1:10, on an enrollment basis. We further recommend that (1) the staff ratio change be phased in, to allow child care providers to adjust to the changes through normal staff attrition or reassignment and (2) the SDE be required to capture the savings resulting from implementation of the new staff ratios. We estimate that full implementation of this recommendation would result in General Fund savings of up to $19 million annually, which could be used to serve up to 4,300 additional children.

Target Savings to Specific Areas. Historically, the Legislature has almost always acted to use savings in subsidized child care programs to provide additional child care services (rather than have the monies revert to the General Fund). In addition, the Legislature most recently has required certain child care funds to be distributed to each of the state's counties based on need. *To the extent the Legislature wishes to maintain these practices*, we recommend that it give priority to allocating the savings (of up to $19 million annually from the General Fund) available through modification of existing staff ratios for subsidized child care programs to counties that are relatively underserved by child development funds.

Change the Mix of Child Development Programs Currently Provided

Another option for the Legislature is to change the relative funding amounts provided to two existing child development programs administered by the SDE. These programs—the Alternative Payment (AP) program and the General Child Care program—serve primarily the children of low-income parents who are working or receiving job training. The programs are somewhat different in structure, cost, and program content.

In the current year, the AP program is budgeted $33.3 million and the General Child Care program is budgeted $208.6 million. In 1985-86, the AP program provided services to approximately 8,500 children and the General Child Care program served approximately 52,000 children.

The Alternative Payment Program. The AP program allows each parent to choose the type of child care to be provided, as long as it is either licensed or license-exempt. The program then reimburses the child care program selected by the parent. (Thus, it is often referred to as a "vendor-voucher" program.) The local AP agencies determine each child's eligibility, refer the parents to available child care spaces, and provide social services to parents and children as needed. An existing supply of licensed and/or license-exempt child care is necessary in order for an AP program to be effective, since the program does not create new child care spaces directly.

In 1987-88, it cost approximately $4,000 to serve one child for a year in the AP program. Of this amount, approximately $1,000 (or 25 percent) went to AP agencies, and about $3,000 (or 75 percent) went directly to child care providers.

The child care providers reimbursed through the AP program that are not license-exempt must have staff to children ratios of at least 1:12. While this is the minimum staff ratio that providers must meet, there are no data available on the *average* standards met by providers.

The General Child Care Program. The General Child Care program provides services to children directly, primarily in child care centers (which are generally licensed for more than 12 children). Typically, the SDE contracts with each center to provide child care for a specified number of children.

The centers funded through the program are required to meet the SDE's standards. Thus, for preschool-aged children, the centers must have staff to children ratios of at least 1:8 and must use teachers that have completed roughly a two-year college degree course in Early Childhood Education. Finally, the centers are subject to the SDE's periodic quality review process, which assesses the extent to which they provide developmentally appropriate and high-quality care to children.

In 1987-88, it cost approximately $4,850 to serve one child for a year in the General Child Care program. Of this amount, about $250 to $750 (5 percent to 15 percent) was used to pay for administrative costs and the remainder—$4,100 to $4,600 (85 percent to 95 percent)—was used to provide direct child care services.

Conclusion. Currently, the AP program is less costly (by about $850 per year for each child served) than the General Child Care program. There are no data comparing the average quality levels of each type of program.

Given existing cost differences between the programs, approximately 440 additional children could be served each year for every $10 million that was shifted from General Child Care to the AP program. (If the Legislature first adopted our previous recommendation to modify staff to children ratios for children aged 3 through 5 and then shifted monies to the AP program, the number of additional preschool-aged children that would be served would be lower—about 190. This is because about half of the current price difference between General Child Care and the AP program for this age group is attributable to the costs of maintaining different staff ratios.)

Based on our discussions with the SDE, we find that there are many areas of the state where either the AP program or the General Child Care program could operate effectively. In some instances, however, one program or the other may better meet the needs of particular areas. For example, the AP program may be particularly suited to some rural areas, where the number of children eligible for subsidized care might be too low to support the General Child Care program, which generally provides funding for several children in one child care center. On the other hand, the General Child Care program may be more appropriate in areas where it is sometimes difficult for AP programs to operate—that is, in some urban low-income areas that do not have much existing licensed or license-exempt child care.

Raise Family Fee Levels for Child Development Programs

Currently, most families served through the Child Development program are required to pay fees on a sliding fee schedule. The SDE indicates that approximately $10 million in fees are collected each year. Many families pay no fees, usually because (1) their incomes are below 50 percent of the state median income (the income level at which families begin to pay fees), or (2) their children are enrolled in programs that do not charge any fees (such as the State Preschool program). The SDE requires that family fees be used primarily to provide additional children with subsidized child care services.

There are several options for raising family fees that the Legislature may wish to consider (each $1 million raised could be used to serve up to 230 additional children):

- ***Increase fees for all families by some flat amount,*** such as 10 percent or 15 percent. Each 10 percent general fee increase would yield approximately $1 million annually in additional revenues.
- ***Raise fees for families that earn higher incomes,*** such as those who earn at least 70 percent or 80 percent of the statewide median income. Unfortunately, the SDE does not collect information that is detailed enough to determine the amount that would be raised by selectively increasing fees.
- ***Charge a minimum fee for each child.*** Currently, families that earn less than 50 percent of the statewide median income ($12,599 for a family of three in the current year) are not charged any fees. The SDE estimates that there were ***at a minimum*** 19,500 children from such families enrolled in subsidized child care in 1985-86. Based on enrollment levels in that year, charging the current minimum fee level (about $120 per year or $10 per month) for these children would yield at least $2.3 million in additional fee revenues.
- ***Charge fees for children enrolled in the programs that do not currently require fee payments.*** Several child development programs are free to all participants. These programs are: State Preschool, the School-Age Parenting and Infant Development (SAPID) program (which serves the children of high school students), the Severely Handicapped program, and the Protective Services program (which primarily serves abused or neglected children). In 1985-86, approximately 25,000 children were enrolled in these programs. Assuming that at least one-half of the children came from families with incomes high enough to pay the minimum fee, charging the current minimum fee level for children enrolled in these programs would yield at least $1.5 million in additional revenues.
- ***Charge fees for siblings.*** Currently, families with more than one child enrolled in a subsidized child development program pay a fee only for one child. According to the SDE, there were approximately 17,360 children with at least one brother or sister also enrolled in subsidized care in 1985-86. Approximately 7,000 of these children would have been required to pay fees in that year (because their family incomes were sufficiently high), if they had not been exempt because they were the siblings of other enrolled children. Based on 1985-86 sibling enrollment levels, charging the current minimum fee

level for each sibling would yield approximately $840,000 in additional fee revenues. Charging fees at levels higher than the current minimum fee level would, of course, generate additional revenues to the extent that siblings remain enrolled in subsidized programs.

All of these options would increase the *total* number of children served in child development programs (assuming the additional fee revenues were used to expand the existing program). However, because some families might not be able to afford to pay higher fees, the options also could result in some *currently served* children dropping out of the program.

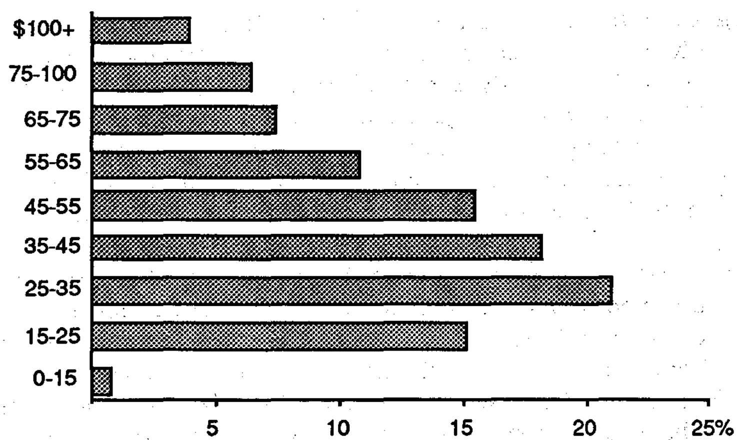
Change the Tax Credit for Child and Dependent Care Expenses

Who Is Using California's Child Care Credit? According to preliminary data from the FTB, taxpayers claimed nearly $110 million in child and dependent care credits for 1987. The board estimates that this revenue loss will increase to $121 million in the current year and $133 million by 1989-90. Chart 3 illustrates the percentage distribution of 1987 child care credits by taxpayer AGI. As the chart demonstrates, approximately 84 percent of these credit amounts benefited taxpayers with AGIs greater than $25,000, while less than 1 percent of the credits benefited taxpayers with AGIs less than $15,000.

Chart 3

1987 State Child Care Credit Distribution By Adjusted Gross Income Range

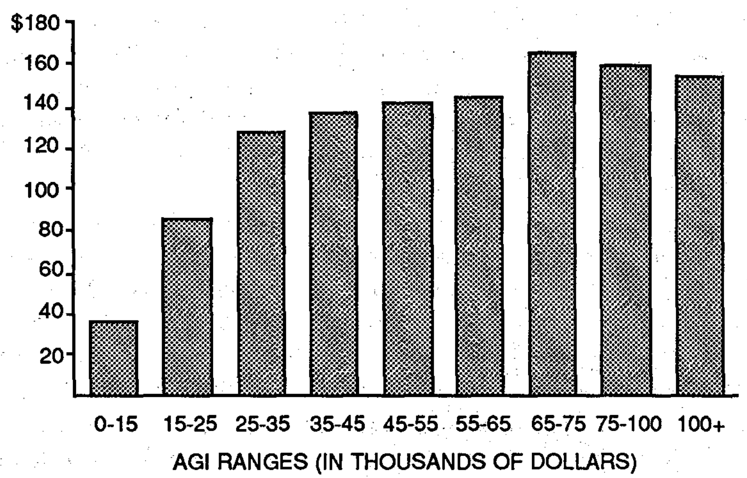
(dollars in thousands)



The average credit amount used by taxpayers in different income ranges is displayed in Chart 4. The chart illustrates that the average credit amount used by taxpayers tends to increase with income, despite the provisions of the credit which decrease the maximum allowable credit as income rises. For example, the average credit for taxpayers with AGIs of $15,000 to $25,000 is $87, while the average credit for taxpayers in the $65,000 to $75,000 AGI range is $166. This is primarily the result of: (1) the tendency for taxpayer expenditures on child care services to increase with income and (2) the limited ability of taxpayers in lower income ranges to make use of their available credits (for instance, taxpayers with AGIs less than $16,000 essentially receive no benefit from this program because they generally do not have a tax liability to claim the credit against.)

Chart 4

Average 1987 Child Care Credit Per Taxpayer By Adjusted Gross Income (AGI) Range



Is the Child Care Credit "Targeted" Appropriately? The child care credit provides tax relief to taxpayers who use child care services because they are working or looking for work. However, *over half the tax benefits provided by this program are used by taxpayers with AGIs greater than $40,000 (which corresponds roughly to 120 percent of the statewide median income). In addition, the average benefit provided by this program is greatest for taxpayers with AGIs greater than $65,000 (which* *is roughly equal to 180 percent of the statewide median income)*. As Table 1 (shown earlier) suggests, many of these taxpayers can afford child care without state subsidies.

This distribution of credit resources may not be consistent with the Legislature's policy intentions. Currently, the state's credit program is tied directly to the federal child care credit. The federal credit program provides, over a limited income range, that the maximum allowable credit decreases as income rises. Tying the state credit to a program structured in this way suggests that legislative intent is *not* to provide a tax relief program where the average benefit level provided tends to increase with income.

Accordingly, the Legislature may wish to consider three basic options for modifying this General Fund program. These options are (1) phase out the credit over a specified income range, (2) make the credit refundable, or (3) repeal the credit.

Phase Out the Credit. Phasing out the credit could enable the Legislature to direct this program's resources towards a taxpayer group with lower average income. For instance, if the child care credit were phased out for taxpayers with AGIs of $35,000 (which roughly corresponds with the state's median income) to $45,000, the state would realize annual revenue gains of approximately $60 million. These additional revenues could be used to finance new or existing direct expenditure child care programs, to increase the credit amount for taxpayers below the specified phase out level, or to fund other direct expenditure programs of higher legislative priority.

However, phasing out the credit will leave the basic structure of this program intact. As has been discussed, the basic structure of the credit limits the program's ability to assist low-income individuals. Low-income taxpayers can only receive assistance from this program to the extent they generate a tax liability. As noted above, taxpayers with AGIs less than approximately $16,000 receive no benefit from the credit.

Make the Credit Refundable. Alternatively, the provisions of the program could be altered to make the tax credit refundable. Allowing a refundable child care credit would provide assistance to taxpayers in lower AGI ranges, regardless of their income tax liability. The FTB estimates that making the current child care credit refundable would require an appropriation in the range of $8 million annually. It should be noted that any appropriation made for credit refunds would be subject to the state's constitutional appropriations limit.

However, even making the credit refundable does not eliminate potential "cash flow" problems for low-income individuals. For taxpayers with minimal monthly cash resources, an annual refund related to monthly child care expenses which have *already been incurred* may be of little assistance. These taxpayers simply may be unable to afford the "up front" costs of child care, while awaiting annual reimbursement for a portion of these expenses. In addition, making the credit refundable creates certain compliance problems for the FTB, and thus would require additional FTB enforcement expenditures.

Repeal the Credit. The current distribution of benefits provided by the child care credit is skewed significantly toward taxpayers with AGIs above the state median. As described above, the option of phasing out the credit has significant limitations in its ability to effectively shift this benefit distribution towards low-income individuals. Moreover, making the credit refundable enhances the program's capacity to assist lower-income taxpayers, but it also has certain inefficiencies in addressing the problems of these taxpayers. Therefore, the most efficient policy option for the Legislature may be to repeal the child care tax credit program and devote the resources generated to direct expenditure programs.

For example, the revenues generated by repeal could be dedicated to SDE's Child Development program or to increasing the number of months of transitional child care provided to GAIN participants. Devoting these resources to existing direct expenditure programs could improve significantly the targeting of these General Fund resources, minimize concerns regarding the cash resources of low-income individuals, and take advantage of program administration efforts which are already in place. Again, however, converting the tax credit to a direct expenditure could involve a significant increase in expenditures which are subject to the state's constitutional appropriations limit.

Summary

Many families in which both parents (or the single parent) work—particularly those earning less than 84 percent of the state median income—cannot afford to purchase licensed child care at market rates. While the state subsidizes care for a significant portion of these low-income families, a large unserved population remains. Our review of the state's two primary child care programs indicates that the Legislature has several options for modifying both programs to (1) better target state funds to those most in need of affordable child care and (2) expand child care programs to meet demand.

Substance-Exposed Infants

What Are the Problems Associated with Pregnant Women Abusing Alcohol and Drugs? What Options Are Available to the Legislature for Addressing Them?

Summary

- *Maternal substance abuse results in a variety of different direct and indirect medical and social problems, including low birthweight, prematurity, congenital deformities, and risk of child abuse.*
- *There are no comprehensive data on the prevalence of infant substance exposure, but it appears to be a significant and increasing proportion of all births.*
- *Infant substance exposure appears to result in high costs to a number of state and local programs, including Medi-Cal, child welfare services, developmental programs, and special education programs.*
- *There are a number of issues raised by the current configuration of services: (1) resources are concentrated on addressing the results of the problem rather than preventing it, (2) there are limited drug treatment slots available to pregnant women, (3) programs fail to provide outreach or consistent methods of identification and case management, (4) licensing requirements make it difficult to place certain substance-exposed children in foster care, and (5) substance abuse reporting requirements by health care providers are unclear.*
- *To help the Legislature address these concerns, we make several recommendations on how to improve existing services to substance-abusing pregnant women and substance-exposed children. In general, we recommend that the Legislature give priority to options that prevent maternal substance abuse and its effects.*

There have been many reports from medical and social service providers and others regarding the increasing numbers of women who abuse alcohol and drugs during their pregnancies and the problems that result with their substance-exposed infants. The reports indicate that these women and their babies are placing burdens on existing services and resulting in long-term costs to society.

In this analysis, we outline (1) what we know about pregnant substance abusers and their infants, (2) how available state programs serve them, (3) issues raised by the existing service system, and (4) options available to the Legislature for better serving these populations.

In preparing this analysis, we found no statewide consistent data on either substance-abusing pregnant women or substance-exposed infants. To better understand the prevalence of, and the problems related to, substance abuse during pregnancy, we visited a number of counties and local providers. As a result, our analysis relies on county- or hospital-specific data and anecdotal reports from service providers.

BACKGROUND

Maternal Substance Abuse Causes Harm to Infants

When women use alcohol or illicit drugs while they are pregnant (or breast-feeding), their infants may develop a variety of short- and long-term medical, developmental, and behavioral problems. The short-term problems include prematurity, low birthweight, strokes, irritability, and withdrawal symptoms. The longer-term problems include mental retardation, congenital disorders and deformities, growth retardation, hyperactivity, poor motor coordination, and speech and language difficulties. In addition, substance-exposed infants are at significantly increased risk of dying from Sudden Infant Death Syndrome and AIDS. The specific effect of the exposure on the infant depends on a variety of factors, including: what kind of substance the woman used, when during her pregnancy she used it, and how much—if any—prenatal care she received.

These medical and developmental problems may result directly from exposure to the substance or may be indirectly related. For example, many substance-abusing women receive insufficient prenatal care and have poor nutrition. These factors contribute to prematurity. In addition, a woman's intravenous (IV) drug use may lead to infection with HIV (the virus that causes AIDS), which in turn can be passed on to the infant.

A woman's substance abuse can result in social problems for infants, as well as medical and developmental problems. Specifically, data on substance-exposed children who are enrolled in regional center prevention programs funded by the Department of Developmental Services (DDS) indicate that substance-exposed infants frequently have psychological and social problems, including poor attachment with a parent and family histories of abuse or neglect.

In some cases, the medical problems may result in social problems. For example, a substance-exposed infant's medical problems may make the infant extremely irritable and difficult to care for. This, in turn, may lead to poor attachment, abuse, or neglect.

Prevalence of Substance Exposure Among Infants

There are no comprehensive data available on the prevalence of substance exposure among infants. However, the Department of Health Services (DHS) and the Department of Alcohol and Drug Programs (DADP) estimate the prevalence of substance exposure as follows:

- ***Drugs.*** The DHS estimates that 2 percent to 5 percent of all newborn infants—or between 10,000 and 25,000 in California in 1987-88—are exposed to illicit drugs. In August 1988, the DHS estimated that an average of 13 percent of all infants admitted to neonatal intensive care units statewide were drug-exposed.
- ***Alcohol.*** The DADP estimates that approximately 4,500 infants are born annually in California with either Fetal Alcohol Syndrome (FAS) or Fetal Alcohol Effects (FAE), medical and developmental conditions that are directly related to alcohol abuse. FAS and FAE occur in as many as 69 percent of infants born to mothers who were heavy drinkers during pregnancy.

There are at least three reasons why these prevalence estimates may be low. First, hospitals may be underreporting the number of drug-exposed infants because they do not universally screen all mothers and all infants. For example, when the University of California Davis (UCD) Medical Center tested only those women in labor it believed were at high risk for drug abuse, it reported that 11 percent of the women tested had positive drug screens. Once the center initiated *universal* screening, the level jumped to 22 percent.

Second, hospitals rarely test for alcohol abuse. They generally rely on the infant's physical appearance as an indication that the mother has been using alcohol. Thus, only the most severe cases of exposure, the ones that result in FAS or FAE, come to the attention of hospital personnel.

Third, because available data on infant substance exposure tends to be limited to those infants requiring special care, it does not reflect the number of infants born to substance-abusing mothers who did not come to the attention of medical authorities through their care in neonatal intensive care units (NICUs) or elsewhere. Research suggests that even though these infants may appear normal at birth, they may be developmentally delayed and may require special education or other services in later years.

The Prevalence of Substance Exposure Among Infants Appears to be Increasing

Without comprehensive data on substance exposure among infants, it is impossible to provide a complete picture of the problem. However, some county health facilities and child welfare programs have maintained data which show that the prevalence of substance exposure is increasing. To some degree, these data may reflect a growing awareness of the problem by health care providers, as well as increasing prevalence.

Data from Health Facilities. Some county hospitals have documented increases in the prevalence of substance abuse among pregnant women and substance exposure among infants whom they serve. For example:

- Harbor-UCLA Medical Center reports that it found cocaine intoxication among 6 of every 10,000 live births in 1983 compared with 231 of every 10,000 live births in 1987.
- Alameda County's Highland Hospital reports that among mothers delivering at the facility, the proportion that admitted to drug use during pregnancy jumped from between 2 percent and 3 percent in 1985 to 12 percent in 1987.
- San Francisco General Hospital reports that the number of substance-exposed infants delivered at its facility jumped from 50 in 1983 to 240 during 1987.

Data from County Child Welfare Services Programs. The following data reflect the extent to which substance-exposed infants and children constitute an increasing proportion of children referred to county Child Welfare Services (CWS) programs due to a suspicion of abuse and neglect:

- Los Angeles County Health Department's Child Abuse Prevention program reports that the number of neonatal withdrawal incidents reported to it as suspected abuse increased from 538 in 1985 to 1,335 in 1987, an increase of 148 percent over two years.
- CWS programs in San Francisco, Sacramento, and Orange Counties report significant increases in the number of substance-exposed infants taken into protective custody. Most dramatically, Sacramento County reports that between the first calendar quarter of 1987 and the first calendar quarter of 1988, the number of substance-exposed infants taken into protective custody increased from 35 per month to 115 per month.

Data on Foster Care Placements. The Department of Social Services (DSS) does not collect data on the number of substance-exposed infants who are placed in foster care. However, the Orange County Social Services Agency estimates that approximately one-fifth of the children in its foster care program were substance-exposed as infants. Each of the three counties we spoke with—Sacramento, San Francisco, and Orange—indicated that substance-exposed children constitute an increasing proportion of those who are placed in foster care.

WHAT IS THE IMPACT OF MATERNAL SUBSTANCE ABUSE ON STATE AND LOCAL SERVICES?

Substance abuse among pregnant women and substance exposure among infants have a significant impact on a number of state programs. The largest impacts in terms of costs are probably on health care services (Medi-Cal, California Children's Services, and county health services), child welfare services, developmental services, and special education programs. While there are limited data on the fiscal effect on these programs, we summarize the available information below.

Impact on Health Care Services

The Medi-Cal, California Children's Services (CCS), and county health services programs pay for health care services to pregnant substance abusers and their infants. Medi-Cal pays for a wide variety of medical care services for low-income persons, including those medical services needed by pregnant women and their infants. The CCS program pays for medical treatment and therapy services needed by children with specified medical conditions. County health services programs pay for public health and medical care services, including medical care provided to persons who are not eligible for other state programs.

Hospital Services for Women. Because substance-abusing pregnant women are reluctant to seek services during their pregnancies, they more frequently show up in emergency rooms to deliver their babies having had little or no prenatal care. This makes a woman's delivery far more risky and thus more difficult and expensive for the hospital she chooses for her delivery and subsequent care. The higher costs that may result from these deliveries may be borne by Medi-Cal, CCS, or counties. Table 1 shows data from four hospitals, which indicate that in all four facilities, substance-abusing women were at least twice as likely to receive insufficient prenatal care than all women delivering in those facilities.

Table 1
Pregnant Substance Abusers Avoid Seeking Prenatal Care
Percentage of Women Delivering with Insufficient or No Prenatal Care in 1987

Hospital	*Substance-Abusing Women*	*All Women*
Highland Hospital (Alameda County)	60%	37%
Martin Luther King–Drew Medical Center (Los Angeles County)	90	33
UCD Medical Center (Sacramento County)	60	23
San Francisco General Hospital	55	12

Health Care Costs for Infants. Women who receive little or no prenatal care are more likely to give birth to infants who are premature, low-birthweight, and have other medical problems. In August 1988, the DHS estimated that an average of 13 percent of all infants admitted to NICUs statewide were drug-exposed. The DHS estimates that the additional *annual* health care costs of these drug-exposed infants is *$178 million*. Approximately three-quarters of these costs are paid by the Medi-Cal and CCS programs. These infants may also require costly ongoing medical care through these programs.

Impact on Developmental Programs

The extent to which drug-exposed infants will eventually develop developmental disabilities is unknown. However, FAS is among the top three known causes of mental retardation (and the only one that is totally preventable). The DADP reports that the *annual* costs associated with caring for persons born with FAS are approximately $214 million. Of these costs, only $2 million is attributed to infants born in any year while the remainder is attributed to the ongoing costs of children and adults born in previous years.

To the extent that drug-exposed infants later manifest developmental disabilities, state costs for case management and other support services provided by regional centers and state developmental centers can be considerable. Specifically, total costs for caring for the average client in the state developmental centers are $70,000 annually. The average cost incurred for each regional center community client is $5,500 annually.

Impact on Child Welfare Services Programs

County CWS programs respond to allegations of child abuse and neglect, deliver time-limited services to abused children and their families, and provide case management services to children in foster care.

Substance-exposed infants may be referred to county CWS programs in two ways. First, medical or social services providers may identify an infant at birth (or shortly thereafter) as being substance-exposed and report the infant to CWS as in danger of being abused. Second, the infant or child may be reported later to CWS because he or she is suspected of being abused. In either case, CWS evaluates the family situation. The infant or child may be left in the care of the family (sometimes on the condition that the family use certain services, such as drug treatment), be placed in protective custody (such as an emergency shelter or foster care), or be recommended for adoptive placement.

To the extent that county CWS programs either (1) investigate allegations of child abuse and neglect due to substance exposure that otherwise would not have been reported or (2) place a substance-exposed child into foster care, program costs are substantially increased. Specifically, the average cost to county CWS programs in responding to and investigating each allegation of child abuse and neglect, and providing time-limited services to abused children and their families, is over $11,000 annually per child. In addition, the average cost of foster care placement is over $13,000 annually.

Impact on Special Education Services

Research suggests that substance-exposed children may exhibit behavioral and learning difficulties. However, the State Department of Education (SDE) does not maintain data on the number of children served in special education programs who were substance-exposed at birth. Furthermore, none of the representatives of the three Special Education Local Plan Areas (SELPAs) we spoke with could estimate the number or proportion of their pupils who were substance-exposed at birth. Because school districts do not track these children, we do not know the extent to which substance-exposed children differ from other children with respect to their needs for special education services.

The state pays for special education services needed from infancy through age 22. With the exception of services needed by infants, SELPAs are capped at the number of children they can serve. The additional cost of providing special education services to a substance-exposed infant or child who would not otherwise enroll in these programs ranges from \$2,100 to \$6,900 annually. In SELPAs that have reached their caps, a substance-exposed child with a severe handicap might displace another child with a less severe handicap. In these instances, the costs of serving a substance-exposed child would be less.

WHAT PROGRAMS ARE AVAILABLE FOR SERVING SUBSTANCE-ABUSING WOMEN AND THEIR CHILDREN?

Programs Generally Serving Substance-Abusing Women and Their Children

Our review indicates that the state does not currently administer any programs *exclusively* addressing the needs of pregnant substance abusers or substance-exposed infants. The 1989-90 Governor's Budget proposes increases to address some of the problems related to maternal substance exposure. For a detailed analysis of the administration's specific proposals, please see the *Analysis of the 1989-90 Budget Bill,* Items 4200, 4260, and 5180.

However, the state administers a number of programs that serve substance-abusing women and their children along with other women and their children. We discuss three types of programs below.

Prenatal Care and Case Management Programs. In addition to Medi-Cal, the DHS administers four programs designed to provide perinatal care—including nutrition counseling, case management, and other support services—to low-income women.

The Comprehensive Perinatal Services (CPS) and Prenatal Care Guidance programs are available to Medi-Cal-eligible women, the Community-Based Perinatal Services (CBPS) program is available to other low-income women, and the Adolescent Family Life program (AFLP) is available to pregnant and parenting teens. The DHS could not tell us the extent to which these programs are serving pregnant substance abusers.

Drug and Alcohol Treatment Programs. The state provides block grant funds to counties for alcohol and drug treatment programs. Counties may use these funds to provide a wide array of alcohol, methadone, and drug-free treatment programs—in both outpatient and residential settings—to members of the general public having problems with substance abuse. Generally, counties use these publicly funded treatment slots for low-income persons. Persons with private insurance covering substance abuse treatment often seek treatment from other providers.

The DADP does not keep data on the number of pregnant women served in county drug and alcohol treatment programs. However, our visits with these treatment programs indicate that they find it difficult to serve pregnant women because they believe they cannot deliver the special services these women require (for instance, coordination with prenatal care). County drug and alcohol administrators indicate that this sometimes results in pregnant women not receiving drug and alcohol treatment.

High-Risk Infant Follow-Up Programs. The DHS High-Risk Infant Follow-Up (HRIF) and the DDS prevention programs follow infants who are at high risk of developmental disability or delay to ensure they are receiving needed medical and social services. Substance-exposed infants who are also premature, low-birthweight, or have other problems may be eligible for these programs.

Both the HRIF and DDS prevention programs report that substance-exposed infants are an increasing proportion of their program caseloads. The HRIF program reports that substance-exposed infants represented about 7 percent of infants it followed in 1986 and almost 10 percent in 1987. The proportion of infants served in the DDS prevention program who are substance-exposed has increased from 10 percent in 1985-86 to 20 percent in 1987-88.

Local Programs Designed Specifically for Substance-Abusing Women and Their Infants

Local agencies have developed a variety of approaches to serve the comprehensive needs of pregnant substance abusers and their infants. We briefly summarize a few of these local programs below:

Comprehensive Programs. San Francisco and Los Angeles Counties use funds they receive from the DADP to support the delivery of comprehensive services (including prenatal care, drug abuse treatment and parenting education) to pregnant drug abusers and their infants. After two years of providing these services, these programs report some success. Specifically, San Francisco County reports that about three-fourths of the births to program participants were drug-free. Los Angeles

County reports that the program has significantly lowered the incidence of complications at birth, increased birthweight, and reduced the length of stay in NICUs. These results appear especially promising in view of the DADP estimate that only about one-third of persons normally receiving drug treatment remain drug-free six months after treatment.

Outreach and Referral Programs. Alameda County has established a case management program for all identified substance-abusing mothers delivering at Highland Hospital. The county Child Health and Disability Prevention (CHDP) program visits the family at home within 10 days of delivery and follows the infant for one year. The county reports that the percentage of substance-abusing mothers consistently bringing their children in for medical care increased from 10 percent to 67 percent within six months after it implemented the program.

Jail Health Programs. In order to deliver comprehensive prenatal care and substance abuse treatment services to pregnant substance abusers who are incarcerated, Alameda County coordinated services provided separately through Highland Hospital, the county jail, and alcohol and drugs programs from 1985 through 1988. These services are now administered through one agency—the private contractor responsible for delivering health services to jail inmates. County staff estimate that approximately 50 percent of the pregnant women they begin seeing in jail continue to receive services from the agency after being released.

Foster Care Programs. A number of counties have tried to increase the foster care placement options for substance-exposed infants. For example:

- The San Francisco County Department of Social Services combines CWS funds, Aid to Families with Dependent Children-Foster Care (AFDC-FC) funds, and charitable contributions in order to encourage foster parents to accept substance-exposed infants with special needs. San Francisco uses these funds to provide monthly care rates that are up to $1,400 more per child per month than the basic statewide foster family home rate. Once these infants are placed in the foster homes, the foster parents receive additional support services, such as respite care.
- The Orange County Social Services Agency uses AFDC-FC and CWS funds to operate a foster care program for children with special medical needs, 80 percent of whom are substance-exposed. The local welfare department conducts outreach, establishes reporting protocols with local hospitals, locates and trains foster parents, and refers infants to other appropriate programs, including regional center programs.

"Incentive" Programs. Butte County has recently begun to provide mothers of identified substance-exposed infants with a choice: be prosecuted for using illegal drugs or enter a program that includes probation, health, mental health, and social services. If the mother chooses to enter the program, she is allowed to maintain custody of her child as long as the the county CWS program does not believe that the infant is at risk of abuse or neglect. Probation staff also follow her case to determine whether or not she returns to drug use. County staff could not provide us with data on (1) the number of substance-abusing mothers for whom prosecution is necessary due to their refusal to enter available treatment or (2) the program's success.

Coordination and Data Collection Programs. Recently, San Francisco County declared the increasing prevalence of substance-exposed infants to be a "public health emergency," thereby making the county eligible for special state funding for one-time county projects. The DHS awarded the county a one-time grant in order to assist it in (1) coordinating services, (2) collecting data to assist it in defining its problem, and (3) developing protocols for identifying, assessing, treating, and referring substance-exposed infants.

Education Programs. Los Angeles Unified School District established a pilot project in March 1988 in order to identify effective educational strategies for preschoolers and kindergartners who were substance-exposed at birth. The children selected for this pilot must meet two specific criteria: (1) cognitive abilities within the average range and (2) no medical/developmental complications or abnormalities. The project has not yet reached any conclusive findings.

WHAT IS THE IDEAL SYSTEM FOR SERVING SUBSTANCE-ABUSING PREGNANT WOMEN AND THEIR INFANTS?

National experts, the providers we met with, and available research indicate that the most effective way to address the complex needs of these populations is through a comprehensive and multidisciplinary system of service delivery and case management. Specifically, an "ideal" system would include:

- Outreach and preventive education.
- Early identification of pregnant substance abusers.
- Interagency case management of pregnant substance abusers and their substance-exposed infants to ensure they receive available services.
- Uniform screening protocols for substance exposure in labor and delivery in order to provide quality maternity care and to identify infants at risk.
- Consistent reporting of substance-exposed infants to local CWS staff in order to determine whether or not the infant is at risk for abuse.
- Family education, parenting services, and other support services.

- Referral to half-way houses or other residential substance abuse treatment programs.
- Training for foster care families who accept substance-exposed infants.

In order to identify problems with the existing system and recommend ways to improve it, in the following sections we compare the components contained in this "ideal" service system to the existing system.

WHAT ISSUES ARE RAISED REGARDING THE WAY SERVICES ARE CURRENTLY DELIVERED?

Existing Resources Are Concentrated at Addressing the Results of the Problem and Not at Prevention

Existing state and local programs tend to treat the *results* of maternal substance abuse and its effect on infants, whether the results are incarceration, hospitalization, family separation, or developmental and educational delay. Relatively fewer public resources are invested earlier in the delivery process when outreach, prevention, education, and rehabilitation can reduce likely dependence on government resources.

Even though preventing many of these women from using drugs and alcohol while they are pregnant is not an easy task, some limited data from local programs suggest that comprehensive prenatal and substance abuse programs can be successful in reducing a woman's substance use during her pregnancy and, thus, significantly improve the health of her infant at birth. As a result, even if the mother abuses drugs or alcohol again, remaining "clean" during pregnancy will lessen the chances that the infant will require additional long-term health and other services.

Limited Drug Treatment Slots for Pregnant Substance Abusers

Based on our visits to several counties, it appears that pregnant women and women with children are frequently unable to find drug treatment slots. This problem appears especially acute in rural areas and for users of drugs like cocaine. For example, we were repeatedly told of women who want to get off drugs while they are pregnant or are ordered by the court to enter drug treatment as a condition of releasing their children from protective custody, but who cannot find a program to accept them. If these women do not get treatment, they are in danger of having a substance-exposed infant or losing their children to protective custody.

The number of slots available for IV drug users may increase as a result of the availability of new federal funds. However, we do not know the extent to which these funds will be used for pregnant women.

Programs Neither Systematically Provide Outreach Nor Adequately Serve Pregnant Substance Abusers

Outreach. Only one state program of which we are aware (Prenatal Care Guidance) provides funds specifically for outreach activities to pregnant women. The DHS could not tell us the extent to which counties use their outreach funds specifically for substance-abusing women. Few of the local providers we visited conduct these activities on their own. Our review indicates that outreach activities are very important for this population because they are reluctant to seek services on their own.

Identification. Our review indicates that local prenatal care, substance abuse treatment, and corrections programs do not consistently identify pregnant substance abusers. For example, prenatal care providers we visited and spoke with in San Francisco, Fresno, Alameda, Sacramento, and Los Angeles Counties differ in (1) the type and extent of questions asked of women to determine substance abuse during pregnancy, (2) what substances they screen for, and (3) if and when they will use a urine toxicology test to verify substance use among women they suspect use illegal substances.

In addition, of the 16 drug treatment providers we visited in four counties (Mendocino, San Francisco, Los Angeles, and San Joaquin), we found that only a few of the drug treatment programs routinely ask if a woman is pregnant when she comes in for treatment. We also found differences in the way county corrections staff seek to identify if a woman is pregnant and/or a substance abuser. A significant proportion of women arrested or incarcerated are substance abusers of child-bearing age.

Referral and Case Management. We found a lack of consistent referral and follow-up among local programs serving substance-abusing pregnant women and their infants. For example, only two of the four county jails we contacted—Alameda and Contra Costa—make formal efforts to link pregnant women to county health services upon their release. Of the 16 drug treatment programs we visited, only the three programs designed specifically for pregnant substance abusers consistently referred women to prenatal care providers and followed up to ensure that they kept their appointments.

We found similar inconsistencies in (1) medical providers' procedures for reporting substance-exposed infants to child welfare and regional center prevention programs and (2) acceptance of these infants by regional centers.

Licensing Requirements Make it Difficult to Place Certain Substance-Exposed Children in Foster Care

Current law and DSS licensing regulations prohibit foster family homes from providing more than incidental medical services to children in their care (with the exception of in-home medical services for ventilator-dependent children). "Incidental" services do not include the special medical needs that substance-exposed children may have. Therefore, the practical effect of the existing licensing requirements is to prevent placing children with special medical needs, including many substance-exposed children, in foster care.

The DHS indicates that it has secured two federal waivers that permit using Medi-Cal funds to pay for support services for foster families who keep children with special medical needs at home, thereby avoiding more costly institutional care. This funding source cannot be used, however, as long as the current licensing requirements related to incidental medical services are in place.

Uncertainty about Testing for and Reporting Substance Abuse and Exposure May Impair the Delivery of Comprehensive Services

We found that providers have different understandings about which mothers and infants they can test or report and under what justification. For example, public and private hospitals in Los Angeles County have developed written protocols regarding who they can test for substance abuse and under what conditions. However, the UCD Medical Center routinely tests *all* women delivering at its facility.

Similarly, current law makes no mention of infant substance exposure as a reason to report a child being abused or in danger of being abused. As a result, some hospitals report substance-exposed infants to county CWS programs and others do not because they are unsure whether current law requires them to do so.

WHAT OPTIONS ARE AVAILABLE TO THE LEGISLATURE FOR BETTER SERVING THESE WOMEN AND THEIR CHILDREN?

Our review indicates that the Legislature has several options for improving the delivery of services to pregnant substance abusers and their substance-exposed infants. Of the available options, some involve *increasing* the resources allocated to these populations; while others target, coordinate, and remove barriers from *existing* resources in order to enhance the delivery of comprehensive services. In general, we recommend that the Legislature give priority to those options which will increase the delivery of services aimed at preventing substance abuse and its effects.

More Information Needed on Maternal Substance Abuse

We recommend that the Legislature adopt supplemental report language that directs the DADP and the DHS to improve the information available regarding substance-abusing pregnant women and substance-exposed infants. We further recommend that the DHS report

to the fiscal committees during budget hearings on the costs, benefits, and possible funding sources for obtaining information from a one-time survey of hospital births.

Our review of the problems associated with maternal substance abuse was severely limited by the lack of comprehensive data. There are, however, at least two ways to improve the information available on substance-abusing pregnant women and their infants. First, the state could require drug treatment providers that receive state funding to request information on pregnancy status and to include this with the information it currently reports to the DADP. Second, the DHS could obtain additional information on substance-exposed infants by conducting a one-time survey of all hospital births in order to better estimate the extent of the problem. The DHS recently contracted for a similar study in order to gain more information about the extent to which women delivering in California received prenatal care. Also, we believe that federal funds might be available to fund this type of study.

Obtaining better information about maternal substance abuse and infant substance exposure would make it easier for the Legislature to address the problems we discuss in this analysis. Accordingly, we recommend the adoption of the following supplemental report language:

1. Item 4200-001-001. The department shall require all drug treatment providers who report through the California Drug Abuse Data System (CALDADS) to include information on pregnancy status of women served in their programs.
2. Item 4260-001-001. The department shall conduct a one-time sample survey of hospital births in order to determine the extent of maternal substance abuse and infant substance exposure.

We further recommend that the DHS report to the fiscal committees during budget hearings on the costs and benefits of such a survey, as well as possible funding sources.

Clarifying Infant Substance Exposure Reporting Would Improve Treatment of Substance-Exposed Infants

We recommend enactment of legislation that would clarify whether substance exposure is a reportable condition that places an infant in danger of abuse and neglect.

Our review indicates that different hospitals have different policies for reporting substance-exposed infants to county CWS programs for evaluation. Some of the hospital staff we spoke with felt that reporting all substance-exposed infants to CWS programs is the best way to ensure the safety of these children because CWS is the appropriate program to monitor these children and their families after they leave the hospital. Other providers, however, were concerned that a policy of reporting all substance-exposed infants to CWS could result in more women delivering at home, rather than at a hospital, thereby placing the infants at higher risk during delivery.

In general, the Legislature has *not* left the question of which children should be reported to county CWS programs to the discretion of those involved. For example, health care professionals are *required* to report injuries that they have reason to believe could have been the result of abuse. Once the injury is reported, local CWS programs and the courts decide whether to monitor the family, provide services, take the child into foster care, or dismiss the case. In the case of substance exposure, existing law is unclear as to whether exposure itself is reportable as placing a child in danger of being abused, which is why different hospitals have different policies regarding reporting these cases.

We have no analytical basis for determining whether substance exposure in itself puts a child in danger of being abused. This is a policy question that the Legislature will have to decide based on the advice it receives from health care professionals and child abuse experts regarding what is in the best interests of substance-exposed children. In our view, however, there should be a consistent statewide policy on this issue. This is because the current uncertainty regarding what the law requires in these cases (1) exposes health care providers to prosecution if they wrongfully fail to report a substance-exposed infant and (2) provides an incentive for substance-abusing pregnant women to "shop around" for hospitals that do not consistently report substance exposure. We therefore recommend the enactment of legislation to clarify whether substance exposure is reportable.

Standardized Reporting and Screening Protocols Could Reduce Problems Related to Substance Abuse During Pregnancy

We recommend that the DHS submit to the fiscal committees, prior to budget hearings, a plan for developing model protocols for prenatal screening and testing for substance use and exposure.

Our review indicates that health and social service providers have practices for screening or testing pregnant women or infants for substance use, or referring them to other services, that vary widely in their effectiveness. For example, prenatal care providers may not ask appropriate questions to best elicit information from pregnant women about their substance use during pregnancy. Not having this information makes it difficult for providers to most effectively handle the woman's or infant's problems related to substance abuse.

We believe that the DHS should provide guidance to providers regarding the most effective screening, testing, and referral practices so that (1) substance-abusing women are provided effective pregnancy-related care and (2) substance-exposed infants are provided appropriate health and social services. To make this information directly usable to providers, we recommend that the DHS do this by issuing model protocols. These protocols should be developed in conjunction with medical and social service providers.

Accordingly, we recommend that the DHS submit to the fiscal committees, prior to budget hearings, a plan for developing model screening, testing and referral protocols related to substance-abusing women and substance-exposed infants. The plan should include an estimate of costs for developing the protocols and a discussion of funding options.

Changing Licensing Restrictions Would Facilitate Placement of Substance-Exposed Infants in Foster Care Homes

We recommend approval of the administration's proposal to amend current law to allow foster families to provide treatment for infants with specialized care needs. (Please see the **Analysis of the 1989-90 Budget Bill,** ***Item 4200, for our additional recommendations regarding this proposal.)***

Our review indicates that current law restricting foster families from providing more than incidental medical treatment for infants may impede placement of substance-exposed infants in foster family homes. In the budget, the administration proposes to fund four pilot projects to encourage care of substance-exposed children in foster family homes rather than in more expensive settings. As part of this proposal, the administration indicates that it will seek legislation that would amend current law to allow foster families to provide treatment for infants with specialized care needs. Relaxing this restriction would also allow the DHS to use state and federal Medi-Cal funds to pay for needed support services.

We recommend approval of this proposal, although we have additional recommendations regarding the expenditure of funds. Please see the *Analysis*, Item 4200, for a more detailed explanation of this proposal.

Ensuring Drug Treatment to Substance-Abusing Pregnant Women May Reduce the Number of Substance-Exposed Infants

We recommend that the Legislature adopt Budget Bill language requiring the DADP to require drug and alcohol treatment providers to (1) ask women whether they are pregnant and (2) give priority to pregnant women.

Our visits with local drug and alcohol treatment providers indicated that they have different policies for identifying and giving priority treatment to pregnant women. Our review suggests that requiring drug and alcohol treatment providers to (1) ask all women seeking services whether they are pregnant and (2) give pregnant women priority for receiving services could reduce the number of substance-exposed infants.

For these reasons, we recommend that the Legislature adopt Budget Bill language in Item 4200-101-001 requiring the DADP to require all programs receiving DADP funds to give priority to pregnant women. The following language is consistent with this recommendation:

> The Department of Alcohol and Drug Programs shall require all local drug and alcohol treatment providers to (1) ask women whether they are pregnant and (2) give priority to pregnant women in providing treatment services.

The Legislature Should Provide Additional Treatment Slots, Case Management, and Outreach Services for Substance-Abusing Pregnant Women

We recommend approval of the administration's proposals to (1) provide additional drug and alcohol treatment slots for pregnant women and (2) provide additional case management services. (Please see the **Analysis of the 1989-90 Budget Bill,** ***Items 4200 and 4260, for our additional recommendations regarding this proposal.)***

Our review indicates that there are insufficient outreach, substance abuse treatment, and case management resources available for pregnant substance-abusing women. In the budget, the administration has a number of specific proposals designed to provide additional resources for case management and treatment services. In general, we recommend approval of these proposals. However, we have additional recommendations regarding the specific expenditure of these funds. For our more detailed analysis, please see the *Analysis*, Items 4200 and 4260.

State Programs for Older Californians

What Guidelines Can the Legislature Follow When Allocating Funds for Senior Programs?

Summary

- *The continued rapid growth of the elderly population will affect the demand for state programs. The fastest growing age subgroup in the next decade, those 85 and over, is the elderly group most likely to use state services. However, older people belong to a variety of subgroups, with differences in financial, health, and marital status, as well as in ethnicity and age.*
- *The poverty rate for elderly Californians has declined substantially since 1970. Older Californians have a lower rate of poverty than national figures for the elderly or the general population. However, poverty levels are disproportionately high for certain groups, most notably women, minorities, and those living alone.*
- *Most elderly people are relatively healthy and free of any major disability, although the incidence of disability rises with advancing age.*
- *The Governor's Budget proposes expenditures for senior programs of $4 billion from all funding sources in 1989-90, with 83 percent of the total for income support (primarily Supplemental Security Income/State Supplementary Program (SSI/SSP)) and health services (primarily Medi-Cal) to low-income elderly persons.*
- *In recent years, many issues regarding "unmet need" for senior programs have been brought to the Legislature's attention. Our review of three of these programs indicates that the term "unmet need" can have several meanings. It also indicates that filling the unmet need for these programs would involve major fiscal and/or program trade-offs.*
- *Our review of senior programs suggests several guidelines for legislative planning: (1) give high priority to services targeted at subgroups of the elderly most in need of government services, (2) give priority to funding programs in underserved areas, (3) set clear program goals to reflect spending priorities, and (4) minimize program duplication and encourage local cooperation.*

The rapid growth of the elderly population continues to be one of the most important demographic changes affecting California. In 1980, there were 2.4 million Californians 65 years of age and over, or approximately 10 percent, of the state's total population. The Department of Finance

(DOF) estimates that by the year 2000, the number of older Californians will increase by 157 percent, to 6.2 million, or 12 percent of the state's total population.

In this section, we provide a profile of California's older population and the state's expenditures for senior programs, present an overview of "unmet need" for three selected programs, and suggest guidelines for legislative decisionmaking in responding to the increasing demand for senior services.

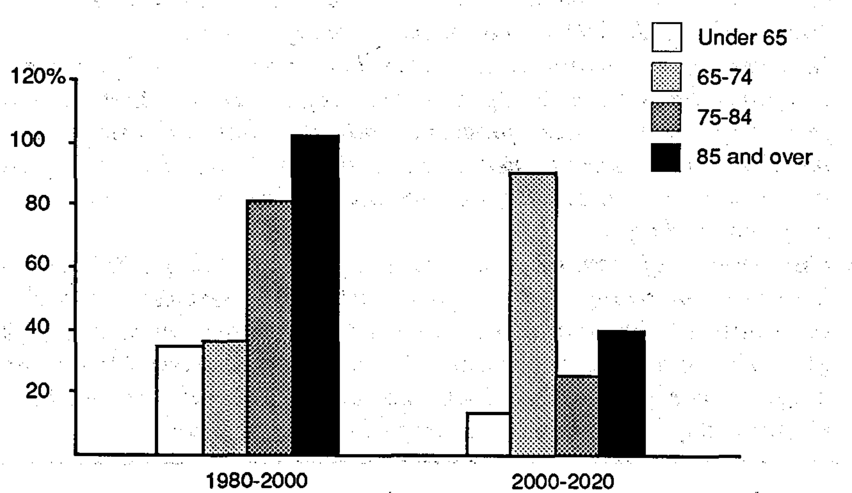
Profile of Older Californians

Older Californians belong to a variety of subgroups, with a range of differences with respect to age, sex, income, health status, marital status, and ethnicity. An understanding of these subgroups can help the Legislature in setting priorities for state services and programs.

Age. Chart 1 displays the DOF's projection of population growth for four different age groups over the periods 1980 to 2000 and 2000 to 2020. The chart illustrates that between 1980 and the year 2000 there will be significant growth in the age 75 and over population. Then during the period 2000 to 2020, the fastest growing age category will be the 65-74 age group, as the "baby boom" generation reaches old age.

Chart 1

Percentage Growth in California's Population By Age Group
1980-2000 and 2000-2020



Sex. As the population ages, the ratio of men to women declines. In the 60-64 age group, for example, men represent 47 percent of the total, but the number of men declines to *29 percent* of persons age 85 and over. Thus, given the increase in the over-85 age group anticipated over the two decades, women will make up an increasing percentage of the aged population.

Financial Status. As Table 1 shows, the percent of older persons whose incomes are below the poverty level in California has declined dramatically since 1970. Between 1970 and 1980, the percent of older Californians below the poverty level, as defined by the U.S. Bureau of the Census, declined from 18.2 percent to 8.3 percent, and has declined further—to 6.1 percent—in this decade.

Table 1
Percent of Population Below Poverty Line

	California			*Nation* [a]		
	1970	*1980*	*1988* [b]	*1970*	*1980*	*1988*
All persons	11.1%	11.4%	12.4%	12.6%	13.0%	14.4%
Persons 65+	18.2	8.3	6.1	24.5	15.7	12.4

[a] Source: U.S. Census Bureau.
[b] Source: California State Census Data Center, from the U.S. Census Bureau Current Population Survey.

Table 1 also compares the poverty rates in California with those for the nation as a whole. It shows that for all time periods shown, the poverty rates in California were lower than for the nation as a whole. In addition, the table indicates that the 1988 poverty rate for older persons in California was significantly lower than the poverty rates for the general population in California and the nation.

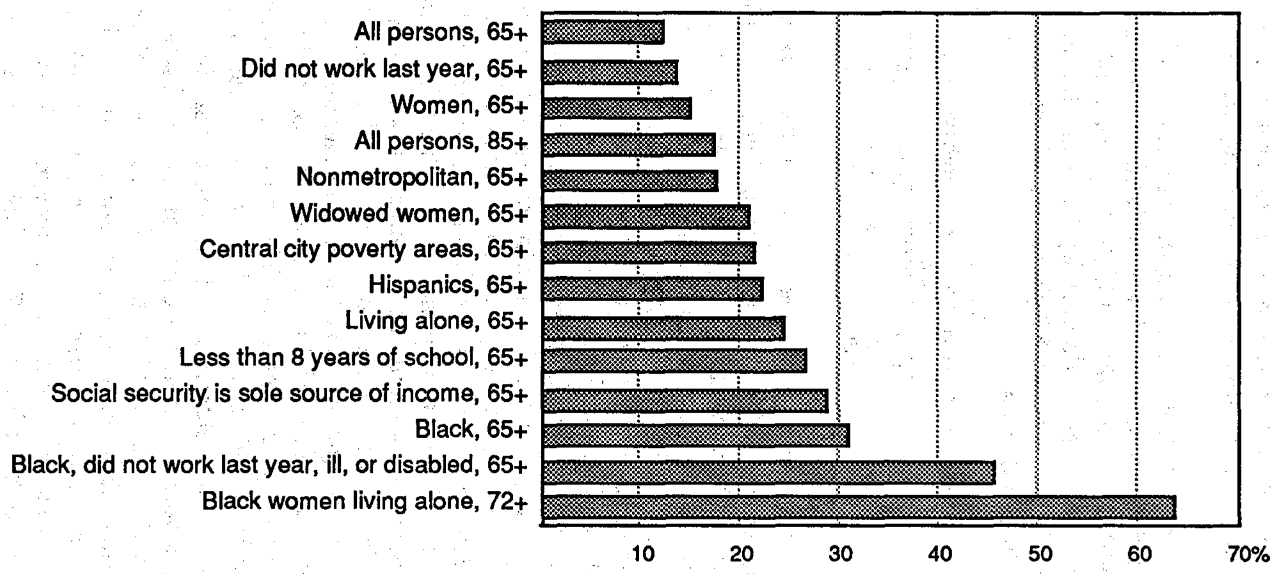
Although the percent of all elderly persons below poverty has declined since the 1970s, poverty levels are disproportionately high for certain groups of older people, most notably, women, minorities, and those living alone. Chart 2 illustrates these large differences among elderly subgroups in the incidence of poverty nationally. The chart shows that, among all people over age 65, 12 percent had incomes below the poverty level. The other categories shown on the chart are all subgroups of the over 65 population. For example, the chart shows that among those over age 65, individuals who did not work in the previous year had a slightly higher incidence of poverty (14 percent). The subgroups shown in the chart overlap, because an individual may fit into more than one category.

Health Status. Most elderly people are relatively healthy and free of any major disability. National studies of major disability among the elderly—defined as daily inability to perform some or all of personal care activities (eating, bathing, dressing, toileting, and mobility)—have estimated that approximately 22 percent of persons over 65 are disabled. The incidence of disability rises with advancing age—14 percent of those aged 65-74, 28 percent of those between 75 and 84, and 58 percent of those over age 85 are disabled. These studies have also shown that the prevalence of disability and illness is disproportionately high among the poorer elderly population.

Chart 2

Percent of Elderly People Below the Poverty Level By Selected Characteristics[a]

1986



[a] Source: U.S. Senate Special Committee on Aging in Conjunction with the American Association of Retired Persons, Federal Council on the Aging, and the U.S. Administration on Aging, *Aging America: Trends and Projections*, 1987-88 edition (based on data from the U.S. Bureau of the Census).

The elderly are the heaviest users of health care services. Individuals over 65 represent 25 percent of hospital discharges, and 86 percent of all patients in nursing facilities, even though they represent only 11 percent of the total population. In addition, they account for 25 percent of all Medi-Cal expenditures, even though they represent only 13 percent of all Medi-Cal eligibles.

The U.S. Bureau of Labor Statistics reports that out-of-pocket health care costs represent 3 percent of income for individuals under 25, 4 percent for individuals between 35 and 44, 9 percent for those between 65 and 74, and 12 percent of the incomes of persons over 75.

Marital Status. Because there are so many more elderly women than men, men are more likely to be married in old age than women. While 70 percent of men over age 75 are married and only 22 percent are widowed, only 24 percent of women over 75 are married and 67 percent are widowed. The California Department of Aging (CDA) estimates that 19 percent of Californians over the age of 60 live alone.

Ethnicity. California's elderly population will become increasingly nonwhite, reflecting the state's changing racial and ethnic make up. The U.S. Census Bureau estimates that in 1988 California's 65 and over population was 82 percent white, 5 percent black, 9 percent Hispanic, and 5 percent Asians and others. The DOF estimates that by the year 2020, the 65 and over population will be 60 percent white, 4 percent black, 20 percent Hispanic, and 16 percent Asian and others.

STATE PROGRAMS SERVING OLDER CALIFORNIANS

In California, 18 state agencies currently administer 40 separate programs that provide services and benefits to older individuals. These agencies are displayed in Chart 3. (The chart also shows the acronyms for these agencies, which are used in Chart 4, below.)

Chart 4 lists state programs for seniors and provides summary information on their eligibility requirements, caseloads, and costs in the current and budget years. The chart shows that the budget proposes to spend $4 billion on these programs in 1989-90, which represents approximately 6 percent of total state spending (General Fund, federal funds, special funds). The General Fund will finance about $2 billion, or 50 percent, of expenditures for senior programs, and the federal government will fund $1.9 billion, or 48 percent. The remaining $100 million, or 2 percent, is supported by state special funds or local funds. (Expenditures from local funds are included in the totals columns, but are not separately displayed in the chart.)

Chart 3

State Agencies That Provide Services and Benefits to Older Californians[a]

Income Support	
Department of Social Services	DSS
Franchise Tax Board	FTB
Department of Economic Opportunity	DEO

Health Services	
Department of Health Services	DHS
California Department of Aging	CDA

Employment, Supportive Social, and Other Services	
Department of Rehabilitation	DOR
Department of Housing and Community Development	HCD
Employment Development Department	EDD
Department of Transportation	Caltrans
Department of Justice	DOJ
State Department of Education	SDE
Department of Veterans Affairs	DVA

Discount Programs	
Department of Food and Agriculture	DFA
California State University	CSU
Department of Consumer Affairs	DCA
Department of Motor Vehicles	DMV
Department of Parks and Recreaction	DPR
Department of Fish and Game	DFG

The budget-year total represents an increase of $123 million, or 3.2 percent, above estimated current-year spending levels. The increase is primarily due to (1) an $83 million increase in SSI/SSP costs related to increased caseloads and the full-year costs of state and federal cost-of-living adjustments (COLAs), which took effect on January 1, 1989, and (2) a $49 million increase in Medi-Cal costs due in part to long-term care rate increases granted in 1988-89, projected caseload increases, and increased costs of Medicare premiums (for seniors who are eligible for Medi-Cal, the state covers the costs of the Medicare part B premium so that the recipient can receive Medicare coverage for such nonhospital costs as doctor's office visits).

The chart groups senior programs into the following three categories, based on the programs' eligibility criteria:

- ***Programs Available to Low-Income Seniors.*** These programs account for 93 percent of all spending on seniors.
- ***Programs Available to All Seniors.*** These programs account for approximately 4 percent of all spending on seniors.
- ***Programs That Have No Age Requirement, But Which Predominantly Serve Seniors.*** These programs represent 3 percent of all state spending on older Californians.

Table 2 summarizes expenditures for senior programs by the type of benefit or service provided. As the table indicates, income support programs and health services programs account for $3.4 billion, or 83 percent, of expenditures for the benefits and services that the state will provide to older individuals in 1989-90.

Table 2
Summary of Services Available to Older Californians by Program Type 1988-89 and 1989-90 (dollars in millions)

	1988-89			1989-90		
	State	*Federal*	*Total* [a]	*State*	*Federal*	*Total* [a]
Type of program or service						
Income support	$957	$746	$1,702	$974	$817	$1,787
Health services	763	747	1,522	786	772	1,568
Supportive social services	195	282	555	190	284	551
Employment	—	14	14	—	11	11
Other services	77	14	105	75	15	104
Discount programs	2	—	2	2	—	2
Totals [b]	$1,993	$1,804	$3,900	$2,027	$1,898	$4,023

[a] Local expenditures are not shown separately, but are included in the totals.
[b] Detail may not add to totals due to rounding.

Who is Served by These Programs?

Chart 4 groups programs for older Californians primarily according to their age and/or income eligibility criteria. As the chart also shows, however, there are a wide variety of state programs designed to serve different subgroups of the elderly. Below, we discuss three categories of programs for the elderly; and where client profile data are available, further identify the elderly subgroups served by the programs in each category.

Programs for the Well Elderly. Some programs designed to provide entertainment, community involvement, or disease prevention focus services primarily on older people who are in relatively good health. These programs include: Preventive Health Care for the Aging, employment services, the Volunteer Service Credit and Foster Grandparents programs, and some of the adult education courses for the elderly.

Programs for the Disabled Elderly. A number of senior programs are targeted at elderly persons with restricted "self-care" abilities. These are often referred to as long-term care programs. Table 3 shows a selected list of programs for the disabled and the participation, by sex and age, in these programs. The table shows that women and the very old generally have the highest participation rates in these programs.

Chart 4

Programs Available to Older Californians By Eligibility Type

1988-89 and 1989-90 (dollars in thousands)

	Services Provided	Requirement to Qualify	Estimated Number of Clients 1988-89	1988-89 State	1988-89 Federal	1988-89 Total[a]	1989-90 State	1989-90 Federal	1989-90 Total[a]
PROGRAMS AVAILABLE TO LOW-INCOME SENIORS									
INCOME SUPPORT									
Supplemental Security Income/State Supplementary Program (DSS)	Cash grants	Age 65 with (1) limited resources and (2) "countable" income that does not exceed the maximum grant	399,081	$926,757	$728,167	$1,654,924	$938,720	$799,651	$1,738,371
Senior Citizens Property Tax Assessment Program (FTB)	Annual grant based on property tax equivalent	Renter age 62 or older and low-income (less than $12,000) or disabled (all ages)	180,000	17,560	—	17,560	18,600	—	18,600
Senior Citizens Property Tax Assistance (FTB)	Direct reimbursements for portion of property taxes	Age 62 or older, or disabled; must own and occupy home; income less than $12,000	51,000	4,040	—	4,040	4,300	—	4,300
Senior Citizens Property Tax Deferral (FTB)	Postponement of property tax payments	Age 62 or older; must own and occupy residence; income less than $24,000	9,735	7,500	—	7,500	7,600	—	7,600
Foster Grandparents program (CDA)	Stipends for seniors who provide supportive services to children with special needs	Age 60 or older and income less than the poverty level	152 volunteers	366	7	373	366	7	373
Senior Companion program (CDA)	Stipends for seniors who provide supportive services to adults with special needs	Age 60 and older and income less than the poverty level	113 volunteers	319	4	343	319	4	343
HEALTH SERVICES									
Medi-Cal (DHS)[b]	Inpatient/outpatient acute medical services, long-term care, ancillary health services	Age 65 and older, and public assistance recipients or meet age, disability, and income requirements	400,900 (average per month)	$747,243	$747,243	$1,494,486	$771,539	$771,539	$1,543,078

Multipurpose Senior Services Program (CDA)	Case management to link clients to various health and social services	Age 65 or older, Medi-Cal eligible and certifiable for placement in nursing homes	8,941	10,659	—[c]	21,037	10,515	—[c]	20,749
SUPPORTIVE SOCIAL SERVICES									
Brown Bag (CDA)	Foodstuffs distributed to older persons	Age 60 or older and SSI/SSP eligible	37,551	723	—	723	723	—	723
In-Home Supportive Services (DSS)	Domestic and nonmedical services provided at home	SSI/SSP eligible	91,663	172,956	208,311	394,941	168,181	209,106	390,961
EMPLOYMENT									
Senior Community Employment Services (CDA)	Subsidized part-time jobs	Age 55 or older and income less than 125 percent of poverty level	1,048	—	5,120	5,120	—	5,175	5,175
DISCOUNT PROGRAMS									
Golden Bear Passes (DPR)	Reduce price on annual state park pass	Age 65 and older and below specified income level	3,700	150	—	150	185	—	185
Discount Fishing Licenses (DFG)	Reduced price on fishing license	Age 65 and older and receiving SSI/SSP or with specified income	17,801	298	—	298	311	—	311
SUBTOTALS, PROGRAMS	**AVAILABLE TO LOW-INCOME SENIORS**			$1,888,571	$1,688,852	$3,601,495	$1,921,359	$1,785,482	$3,730,769
PROGRAMS AVAILABLE TO ALL SENIORS									
HEALTH SERVICES									
Preventive Health Care for Aging (DHS)	RNs provide health appraisals, counseling, referrals, education	Older adults (age 55 and older) in congregate settings who are well	20,643	$1,303	—	$2,606	$527	—	$1,054
SUPPORTIVE SOCIAL SERVICES									
Nutrition (CDA)	Meals provided at community centers or delivered at home	Age 60 or older (and spouses regardless of age)	259,762	12,301	$49,448	100,617	11,970	$49,676	100,514
Supportive Services and Centers (CDA)	Include in-home, transportation, and case management services	Age 60 or older	882,810	2,904	24,672	53,007	2,904	24,775	53,008

	Services Provided	Requirement to Qualify	Estimated Number of Clients 1988-89	1988-89 State	1988-89 Federal	1988-89 Total[a]	1989-90 State	1989-90 Federal	1989-90 Total[a]
EMPLOYMENT									
Job Training Partnership Act/Older Workers (EDD)	Employment and training services	Age 55 and older	Unknown	—	9,123[d]	9,123	—	5,433	5,433
OTHER SERVICES									
Senior Citizens' Shared Housing (HCD)	Grants to nonprofit entities to assist seniors in finding a roommate	Age 60 or older	Unknown	500	—	500	—	—	—
Volunteer Service Credit program (CDA)[e]	Service credits for seniors who provide supportive services to other seniors	Age 60 or older	4,250	50	—	50	50	—	50
Mobilehome Park Assistance Program (HCD)	Technical assistance/loans to residents who wish to buy their mobilehome park	Age 60 or older	566	5,595	—	5,595	1,836	—	1,836
Health Insurance Counseling and Advocacy program (CDA)	Assistance in understanding coverage and provided through Medicare and private insurance	Medicare beneficiaries	80,000	—	—	1,544	—	—	2,646
DISCOUNT PROGRAMS[e]									
Golden State Senior Discount program (DCA/CDA)	Cards issued for purchase of discounted goods and services from volunteer merchants	Age 60 or older	75,000	84	—	84	87	—	87
California Exposition and State Fair (DFA)	Reduced State Fair admission	Seniors	25,858	26	—	26	30	—	30
California State University (CSU)	Student fee waivers	Age 60 or older	1,500	800	—	800	820	—	820

Identification cards (DMV)	Reduced price and extended period of validity on identification cards	Age 62 or older	89,200	444	—	444	456	—	456
SUBTOTALS, PROGRAMS AVAILABLE TO ALL SENIORS				$24,007	$83,243	$174,396	$18,680	$79,884	$165,934
PROGRAMS PREDOMINATELY SERVING SENIORS									
INCOME SUPPORT									
Low-Income Weatherization program (DEO)[f]	Low-cost home weatherization	Income less than 150 percent of poverty level	Unknown	—	$4,030	$4,030	$4,030	$4,030	$3,563
Low-Income Home Energy Assistance program (DEO)[f]	Heating assistance grants	Income less than 150 percent of poverty level	Unknown	—	11,354	11,354	—	11,354	11,354
Emergency Crisis Intervention program (DEO)[f]	Emergency assistance to households unable to pay utility bills	Income less than 130 percent of poverty level	Unknown	—	2,362	2,362	—	2,362	2,362
HEALTH SERVICES									
Alzheimer's Research, Diagnostic, and Treatment centers (DHS)	Research, diagnostic, and treatment services provided to patients and families	Symptoms or indications of Alzheimer's disease	Unknown	$3,564	—	3,564	3,564	—	3,546
Adult Day Health Care (CDA)[g]	Health and social services provided in nonresidential centers	Frail elderly and other disabled adults	3,538	111	—	111	—	—	—
SUPPORTIVE SOCIAL SERVICES									
Alzheimer's Day Care-Resource Centers (CDA)	Supportive services provided to patients and caregivers	Symptoms of Alzheimer's disease or related disorders	1,116	1,550	—	1,550	1,550	—	1,550
Linkages (CDA)	Case management to link clients to various social services	Adults who are not certifiable for placement in nursing homes	4,126	3,900	—	3,900	3,900	—	3,900
Respite Care program (CDA)	Referral of clients and families to respite care providers	Health of caregiver at risk; client at risk of institutionalization	770	60	—	60	30	—	30
Senior Self-Reliance program (DOR)	Assistance in overcoming barriers to mobility	Age 55 or older with limited visual acuity	Unknown	102	—	102	102	—	102

				1988-89			1989-90		
	Services Provided	Requirement to Qualify	Estimated Number of Clients 1988-89	State	Federal	Total[a]	State	Federal	Total[a]
Counselor/Teacher program (DOR)	Mobility orientation and other habilitation services	Client of DOR	Unknown	283	—	283	236	—	285
OTHER SERVICES									
Urban Mass Transportation Act 16b(2) program (Caltrans)[h]	Capital assistance to private nonprofit agencies to purchase specialized vehicles	Elderly and/or handicapped	Unknown	486	2,794	3,280	488	2,777	3,265
Adult Protective Services (DSS)	Investigation and prevention of abuse/neglect of elders	Not applicable	Unknown	17,230	—	21,767	16,654	—	21,009
Prevention of Crimes Against the Elderly (DOJ)	Information and technical assistance	Not applicable	Unknown	1,099	—	1,099	900	—	900
Adult Education Courses for the Elderly (SDE)	Educational courses	Elgibility criteria established by local officials	173,577	27,000	—	27,000	29,000	—	29,000
California Veterans Home (DVA)	Residential nursing and medical services	Veteran and qualifying resident	1,345	24,659	11,086	43,717	26,247	11,807	45,524
SUBTOTALS, PROGRAMS PREDOMINATELY SERVING SENIORS				$80,044	$31,626	$124,179	$86,701	$32,330	$126,390
TOTALS, ALL PROGRAMS				$1,992,622	$1,803,721	$3,900,070	$2,026,740	$1,897,696	$4,023,093

[a] Local expenditures not shown separately, but are included in the totals.
[b] Figures do not include amounts for recipients age 65 or older who receive aid to the blind or disabled.
[c] Federal funds totaling $10.4 million in 1987-88 and $10.3 million in 1988-89 are included in Medi-Cal figures.
[d] Includes $3.7 million in federal funds carried over from prior fiscal years.
[e] Estimated revenue loss, assuming older persons receiving discounts otherwise would have purchased full priced services (except for the Golden State program).
[f] Expenditures for clients age 60 or older. Budget year figures for the Weatherization program do not include $5.3 million in federal funds that can be drawn at any time between 1989-90 and 1991-92.
[g] Except for $111,000 in start-up grants, the amounts expended on this program ($13.8 million in 1987-88 and $15.7 million in 1988-89) are included in Medi-Cal figures.
h Figures include amounts for handicapped as well as elderly.

Table 3
Selected Programs Serving the Disabled
Participation by Sex and Age
1987-88

Program	*Men*	*Women*	*Under Age 65*	*Age 65-74*	*Age 75+*
Multipurpose Senior Services Program....	23%	77%	0%	31%	69%
Linkages..................................	31	69	31	22	47
Adult Day Health Care......................	30	70	22	25	53
Alzheimer's Day Care......................	37	63	12	25	63
In-Home Supportive Services..............	29	71	33	39 [a]	28 [a]
Nursing facilities..........................	25	75	13	15	72

[a] These figures are for slightly different age categories.

The profile of clients in two of these programs, In-Home Supportive Services (IHSS) and Medi-Cal, illustrates the subgroups of the elderly that are most likely to use long-term care services. As Chart 4 indicates, the budget proposes almost $2 billion for these two programs ($390 million for IHSS and $1.5 billion for Medi-Cal), or 48 percent of total expenditures for senior programs. Of the total amount proposed for Medi-Cal, $831 million, or 55 percent, is for nursing facility care for persons age 65 and over.

Table 3 shows that three-quarters of nursing facility residents are women and nearly three-quarters are over 75 years old. In addition, national studies have shown that widows and widowers, whites, and persons with few children are disproportionately represented among nursing facility residents. Table 3 also shows that women are the majority of IHSS recipients. The Department of Social Services (DSS) data on IHSS further show that 76 percent of the recipients do not have a spouse available to provide care and that 48 percent are minorities.

Although nursing facility costs represent over half of all Medi-Cal expenditures for the elderly, only 2.9 percent of California's population 65 and over is in nursing facilities, as compared to the national average of 5 percent. This may be attributable to several factors including (1) the limited number of nursing facility beds available in the state, (2) California's relatively heavy use of nonmedical residential care facilities, and (3) the availability of alternative community services in California, most notably IHSS.

California's low nursing facility utilization rate may demonstrate that, in many cases, the programs shown on Table 3 are *alternatives* for each other. Thus, the availability or lack of one service can have an impact on the demand and utilization of other services.

While for some individuals the programs in Table 3 may serve as alternatives to each other, other individuals may need the services of several of the programs. For example, the Multipurpose Senior Services Program (MSSP) provides a multidisciplinary assessment of its clients to help them remain at home. The assessment often calls for the individual to receive IHSS services and to participate in an Adult Day Health Care (ADHC) program. In addition to receiving other long-term care services, the same MSSP client could receive meals and transportation through an Older Americans Act provider, medical coverage through Medi-Cal, and cash assistance through SSI/SSP.

Currently, programs within and across departments are unable to report on all the services that individual clients receive. The lack of unduplicated client data makes it difficult to identify the various packages of services that different subgroups of the elderly population may require, or the total number of individuals currently being served by the programs.

Finally, Table 3 illustrates that most of the programs that serve the disabled elderly also serve a younger disabled client population. In the future, the Legislature will be faced with the increasing demands of a growing number of individuals under 65 with similar disabilities and service needs. Two major factors in this regard are (1) improvements in medical technology that prolong the lives of persons of all ages with chronic diseases or disabilities and (2) the increasing number of persons with AIDS who may require long-term care services. Although this section focuses on senior programs, it is important to remember that many of the programs that serve seniors have a broader pool of potential recipients, and changes in the under 65 population will also affect the demand for the programs.

Older Americans Act (OAA) Programs. Chart 4 includes expenditures for two programs—nutrition ($101 million) and supportive services and centers ($53 million)—which are funded by the OAA. Enacted in 1965, the OAA provides funding for a range of services for persons 60 and over. The OAA prohibits the use of a means test for these programs but requires that they be targeted at persons in greatest social and economic need.

The CDA, based on federal guidelines, defines individuals as having the greatest social need if they have at least two of the following characteristics: a language/communication barrier, a handicap, they live alone, or they are 75 or over. Individuals are classified as having greatest economic need if their incomes are at or below the SSI/SSP grant levels.

Although available to any person over 60, the programs currently serve primarily those in greatest social or economic need. The CDA reports that in 1987-88, 47 percent of participants in congregate nutrition programs (meals served at a nutrition site) met the criterion of greatest economic need, and 27 percent met the criterion for greatest social need. Of the CDA's clients who received home-delivered meals, 54 percent were categorized as being in greatest economic need and 64 percent were categorized as being in greatest social need (the two percentages exceed 100 percent because some people are counted in both categories). In the supportive services and centers category, 54 percent of transportation recipients were in greatest economic need and 53 percent were in greatest social need. Among in-home service recipients, 44 percent were in greatest economic need and 58 percent were in greatest social need.

WHAT IS THE "UNMET NEED" FOR SENIOR PROGRAMS?

The Legislature has focused greater attention in recent years on the "unmet needs" of the elderly population. "Unmet need" has also been a concern at the federal level. For example, the 1987 amendments to the OAA require the U.S. Commissioner on Aging to submit to Congress by September 30, 1989, the *national* unmet need for all OAA programs. The CDA is required to submit data on California's unmet needs by June 30, 1989.

Obviously, decisionmakers need information on the needs of the elderly population in order to design senior services and programs and to guide them in allocating resources to and among the various programs. Assessments of "unmet need" are potentially useful in both respects. There are, however, two significant problems that arise in assessing unmet need. First, the term "need" itself is subjective. Specifically, a service that one policymaker regards as a necessity may not be seen in the same light by a policymaker with a different set of priorities.

Second, the available data on seniors and on their use of existing services are limited. As Table 3 illustrates, many of these programs serve clients within the same subgroups. A person could choose one or more of several services to meet his or her needs. For example, an elderly disabled person could use ADHC and/or IHSS. Estimates of unmet need for any one program are, therefore, limited by the lack of data on how older people use services, or what the trade-offs are between programs.

To help bring the question of unmet need into sharper focus for the Legislature, we have selected three programs for further review: one entitlement program—the IHSS program—and two programs that are currently available only in certain parts of the state—the ADHC and the Alzheimer's Day Care Resource Centers (ADCRC) programs.

The In-Home Supportive Services (IHSS) Program

The IHSS program is an entitlement program—that is, any individual in the state is entitled to receive program benefits if he or she meets the eligibility criteria. These criteria consist of income and resource criteria (the individual must be "poor" enough to qualify for SSI/SSP) and need criteria (the individual must be aged, blind, or disabled and be assessed by a county social worker as needing the care provided by the program to remain safely at home). Like other entitlement programs for the elderly—such as the SSI/SSP, Medi-Cal, and property tax assistance programs—the availability of IHSS is *not* limited by the appropriation levels in the budget.

Thus, at one level the program could be considered to have *no* unmet needs, as all eligible persons who seek these services are provided them. Even though IHSS is an entitlement program, the Legislature is still frequently confronted with issues regarding unmet need for IHSS, which usually fall into one or more of the following categories.

Administrative Issues. The IHSS program is administered by 58 different counties. There are, consequently, practical differences with respect to how each county assesses need and makes arrangements to deliver services. These differences can have a significant effect on the level of service actually provided to recipients. For example, the average IHSS hours per case in 1988-89 ranges from a high of 116 to a low of 22, depending on the county. Individuals in low-hour counties could argue that they have unmet needs because their county is providing fewer hours than they might get in another county.

Cost Control Issues. Benefit levels in the IHSS program have been partially influenced by the Legislature's decision to control program costs. Currently, the major cost control measure in the IHSS program is the statutory limit on the number of hours per month that an individual can receive (283 hours for severely impaired and 195 hours for non-severely impaired clients). The DSS estimates that 1.2 percent of IHSS recipients, or approximately 16,000 recipients in 1988-89, have been assessed by county social workers as needing more hours than the statutory limit allows. Therefore, the limit on hours results in "unmet needs" for some recipients.

The 1989-90 Budget proposes a $64 million General Fund savings due to proposed new IHSS cost control measures that could have a significant impact on the extent to which the program meets the needs of recipients. We discuss the proposed new cost control measures in more detail in our *Analysis of the 1989-90 Budget Bill* (please see Item 5180-151-001).

Eligibility Issues. Under the current IHSS program, it is possible for an older person to "need" IHSS services but not receive them. Specifically, the existing IHSS eligibility criteria target services at individuals who are poor enough to qualify for SSI/SSP. People with more income than SSI/SSP recipients can receive the services, but they are required to pay for them out of their own pockets, at least until they "spend down" their incomes to welfare levels. Thus, individuals may have "unmet needs" because they require IHSS services to remain safely at home, yet the income and resource limits are too low for them to qualify for the services without charge.

Program Flexibility Issues. The IHSS program provides assistance to recipients with the goal of helping them to remain safely at home. Some individuals may receive IHSS hours when some other kind of service that the IHSS program cannot provide could meet their needs. For example, a person who has difficulty walking can receive IHSS hours for shopping and meal preparation. However, under current IHSS guidelines, the program cannot purchase a walker or wheelchair ramp to help the recipient perform these tasks more independently, and thereby reduce the amount of IHSS hours needed. Individuals who want to be more independent could have "unmet needs" because, under current law, the IHSS program does not have the flexibility to purchase the needed equipment.

Program Awareness Issues. Finally, the Legislature often hears of individuals who need IHSS and who meet the eligibility requirements of the program, but who do not receive services because they are not aware that the services are available.

The Legislature has a great deal of flexibility in how it addresses each of the kinds of unmet needs issues that arise with respect to the IHSS program. Unlike many entitlement programs, there are few federal constraints on how the Legislature can structure the IHSS program. On the other hand, dealing with any of these unmet need issues would involve major fiscal or programmatic trade-offs. For example, the Legislature could eliminate the statutory limit on the maximum hours of service that individual recipients can receive, but to do so would either entail major new costs or the implementation of an alternative cost control mechanism. Similarly, the Legislature could raise the IHSS income and resource limits so that individuals with higher incomes could receive IHSS, but to do so would also entail major new costs. Raising the financial need standard for IHSS would also raise the issue of increasing similar limits for SSI/SSP and Medi-Cal eligibility.

The Adult Day Health Care (ADHC) Program

The ADHC program provides health, therapeutic, and social support services to persons 18 and over whose disability places them at risk of institutionalization. There are 63 ADHC centers in 24 counties, and we estimate that the average center serves approximately 70 elderly and 20 nonelderly clients per month. ADHC is a Medi-Cal benefit for eligible beneficiaries and the CDA estimates that almost two-thirds of ADHC clients are Medi-Cal recipients. The remainder are private clients who pay on a sliding fee basis. Currently, only private nonprofit organizations can be licensed as ADHC centers and receive Medi-Cal funding.

Since ADHC is available in only 24 counties and to only a limited extent in those counties, it is reasonable to assume that there is an "unmet need" for this service. That is, if the service were available statewide, more people would use it. One way to estimate this need is by using research estimates which have shown that (1) 5 percent of those over age 65 and *not in nursing facilities* are disabled enough to qualify for ADHC and (2) in communities where ADHC is available, 25 percent of those eligible would actually use the service, while the remaining 75 percent would use other alternatives such as in-home services or family caregivers. Applying these figures to California's elderly population, we estimate that 37,000 individuals who are not now in nursing facilities would use ADHC if it were available statewide. This represents an increase of 33,000 clients over the number currently served by ADHC centers. In addition, some unknown portion of the state's nursing facility population would also probably use ADHC centers if more were available.

Assuming a caseload of 70 elderly clients per center, the state would need 530 centers to serve 37,000 elderly ADHC clients. Thus, according to this methodology, *it would take an increase of at least 467 centers, or roughly 700 percent, to provide enough slots for all potential elderly ADHC users in the state.*

In the past, the Legislature has encouraged the opening of new centers by providing one-time "start-up" grants of up to $50,000 per center. One way to meet the "unmet need" for ADHC identified above would be to provide more of these start-up grants. Using this approach, it would cost up to $23 million General Fund to create 467 new centers.

In addition to the start-up costs, the expanded ADHC capacity would result in potential ongoing costs to the Medi-Cal program. For example, if the new centers served 11 percent Medi-Cal clients (the approximate ratio of Medi-Cal beneficiaries in California's over-65, nonnursing facility population), the costs of their care to the Medi-Cal program, assuming the current rate of reimbursement, would be about $22 million ($11 million General Fund) annually.

These costs, however, would be offset to an unknown extent by savings associated with increased ADHC use. First, it could reduce costs for IHSS, Medi-Cal (for services such as hospitalization and home health services), and other community services now being used by these clients. Second, to the extent that the increase resulted in an overall reduction in nursing facility use by all Medi-Cal clients, the Medi-Cal program would experience savings. This is because the Medi-Cal rate for nursing homes is more than the rate for ADHC. However, the current demand for nursing facility beds outstrips the supply in California. It would therefore take a substantial increase in ADHC use to reduce the actual Medi-Cal use of nursing facility beds in the state.

Given the magnitude of the "unmet need" for ADHC, it is important to consider why there are currently so few centers in California. One explanation may be that providers are discouraged from starting new centers because the fees that they receive are low, relative to their operating costs. Thus, in addition to the option of providing more start-up grants, the Legislature has two options for increasing the supply of ADHC: (1) increase the Medi-Cal rate (which would result in new General Fund costs) and (2) review the existing ADHC licensing requirements in order to identify ways of reducing providers' costs.

Alzheimer's Day Care Resource Centers (ADCRCs)

ADCRCs offer a day program of nursing, activities, and supervision to persons who are suffering from moderate to severe Alzheimer's disease or a related dementia disorder such as Parkinson's disease. The CDA advises that 26 ADCRCs will serve approximately 1,500 clients in 1989-90. These centers receive annual General Fund grants of approximately $60,000 and are required to provide a 25 percent match from county, Area Agency on Aging (AAA), or other local funds. In addition to state and local resources, the centers receive some of their funding from revenues generated by a fee, which is based on a sliding scale tied to client income.

National estimates on the prevalence of dementia vary. In the past, the CDA has used the estimate of the Congressional Office of Technology Assessment (OTA) that severe dementia affects 1 percent of those age 65 to 74, 7 percent age 75 to 84, and 25 percent over the age of 85. In addition, the OTA estimates that there are one to three persons with moderate dementia for every person with severe dementia.

Using a conservative estimate of a one-to-one ratio for moderate to severe dementia, we estimate that in 1988, up to 300,000 persons 65 and over are eligible for the ADCRC program. Assuming the same 25 percent utilization rate that we applied for ADHCs, this would mean that approximately 75,000 persons might use ADCRCs if these centers were available statewide. To serve a clientele of this magnitude would require approximately 1,300 new centers. At the current General Fund cost of $60,000 per center, *this would result in a new ongoing General Fund cost of $78 million per year.* Increasing the number of ADCRCs could also reduce costs for alternative services (such as IHSS and ADHCs) to the extent that individuals choose ADCRCs over those programs. Nevertheless, our analysis indicates that it would require a major new General Fund commitment to expand the ADCRC program statewide.

WHAT GUIDELINES SHOULD GOVERN LEGISLATIVE DECISIONMAKING?

In developing a strategy for responding to the increasing demands for services for the elderly, there is no "right" or "best" approach. The strategy selected by the Legislature will depend on its spending priorities, available state resources, and policy decisions about the types of programs and benefits to provide for older people. Our review of programs for seniors, however, suggests that there are several guidelines which deserve high priority in the Legislature's planning process.

Give High Priority to Funding Services Targeted at Elderly Subgroups Most in Need of Government Services. Older people are members of a variety of subgroups, each with different needs, rather than a homogeneous population, all with the same needs. To a large extent, the Legislature's priorities for serving these subgroups are reflected in the way existing programs are set up. That is, most of the money the state now spends on seniors goes to serve the poorest and the most disabled. In directing resources to programs for seniors, the Legislature may have to further target limited state resources on the most needy subgroups. For example, our review of senior nutrition programs shows that a higher percent of home-delivered meals participants are in "greatest economic need" (54 percent) than those served at a congregate nutrition site (47 percent). In addition, home delivered meal participants are homebound by reason of illness or disability, or are otherwise isolated. Moreover, 64 percent of home-delivered meal recipients are in "greatest social need," compared to 27 percent in the congregate program. Therefore, in allocating resources for senior nutrition, the Legislature may wish to give priority to the home-delivered meals program because it is targeted at one of the neediest subgroups of the elderly population.

Give Priority to Funding Programs in Underserved Areas. The Legislature has established a number of programs for seniors in recent years, particularly in the area of long-term care, that are not available statewide. Given the limited resources available for increasing the availability of these programs, we think the Legislature should consider expanding first into underserved areas that have demonstrated needs but that currently have few programs or have not benefitted from the recent expansion of long-term care programs.

One way that the Legislature could accomplish the goal of expanding services to underserved areas would be to establish funding criteria for programs that are flexible enough to permit the selection of communities with few existing programs. Currently, new applicants are often required to show that they have previous experience in providing the service, or that there are services available in their communities that will enhance their ability to respond to client needs. While these requirements are intended to ensure program quality, they also have the unintended effect of limiting the ability of providers in underserved areas, who are likely to have limited program experience and few available community services to submit successful applications.

Evaluate Program Goals. There are a variety of goals that may be appropriate for senior services—preventing institutional placement, promoting independence, assisting family caregivers, reducing poverty, or preventing illness. The particular goal of a program can significantly affect its costs and its ability to meet needs.

Under current law, for example, the IHSS program currently has a stated goal of keeping individuals "safe" in their own homes. For this reason, IHSS provides domestic and personal care services to recipients who are not at risk of nursing facility placement. If, however, the IHSS program's goal were to prevent or delay institutional placement, the program would probably not serve most of these clients at all. Instead, it would offer a relatively high level of services, potentially including hours above the current maximum, to a reduced recipient population—those at risk of being placed in a nursing facility—to prevent their institutionalization. Alternatively, if the goal were to promote independence, it might provide services such as walkers or wheelchair ramps that are currently not available. We think it is important for the Legislature to evaluate the cost implications and client impacts of alternative goals for senior programs.

Minimize Program Duplication and Encourage Local Cooperation. Current programs within and across departments are unable to report an unduplicated count of the clients they serve or to identify all the services that individuals receive. This lack of program data makes it impossible to determine the extent to which current programs duplicate and overlap each other. Nevertheless, it is clear that a number of local agencies—county welfare departments, AAAs, Medi-Cal field offices, long-term care programs, and private agencies—provide services to the same clients. Each program incurs costs to keep client records, report to state departments, perform assessments of client needs, and monitor the services provided. To minimize the potential for duplication and inefficiency that exists when so many agencies serve the same or similar individuals, the Legislature could require local agencies to consolidate administrative functions, or it could provide funding incentives to encourage local agencies to work together or to consolidate.

In addition, in order to better identify overlap and duplication, the Legislature could encourage the CDA to improve its data collection systems. We discuss the department's data collection systems in more detail in our *Analysis of the 1989-90 Budget Bill* (please see Item 4170).

CONCLUSION

For purposes of determining the demand for senior programs, the elderly should be viewed as members of a variety of subgroups, some of which may not require government assistance. Currently, the majority of state spending for older people is on income support and health services primarily for the elderly poor.

Departments that currently serve the elderly cannot provide an unduplicated client count of their clientele across programs, and there is limited information about patterns of service utilization by this population group. Using current program definitions, eligibility criteria, and demographic data, it is possible to estimate the potential demand for some programs that serve the elderly. However, these estimates do not account for the individual choices and preferences that would ultimately determine how clients would use the services.

There are two significant problems that arise in assessing unmet need for senior services for purposes of legislative decisionmaking. First, "need" is a subjective term meaning different things to different policymakers. Second, existing data on program use is limited. Therefore, the Legislature may wish to allocate resources for senior programs using priority guidelines, and to continually review existing programs and eligibility criteria to ensure that programs serve priority subgroups of the elderly in the most cost-effective manner.

Insurance Reform

What Effects Will Proposition 103 Have on Buyers and Sellers of Automobile Insurance in California?

Summary

- *Proposition 103, which the voters approved in November 1988, provides for insurance premium rate rollbacks, the approval of future rate increases, and measures intended to make California's insurance industry more competitive. While the measure affects auto, fire and liability insurance, this analysis focuses solely on auto insurance because it is the largest segment affected by the measure.*
- *The insurance industry's current problems are traceable to a variety of factors. Consequently, there is no one simple solution to them.*
- *The effects of Proposition 103 on buyers and sellers of insurance are difficult to predict, and will not be known until the measure becomes fully implemented and operational.*
- *The most important determinants of Proposition 103's effects will be how regulatory decisions are made, and whether the insurance industry's premium rates have been due to excessively high profits or simply the high costs of providing insurance coverage. If regulatory decisions under Proposition 103 take proper consideration of economic factors, and the rate review process itself is not overly burdensome, the measure could help ensure that rates are consistent with the underlying costs of providing insurance coverage.*
- *The insurance industry has certain competitive elements, such as many firms and ease of entry into the business. However, little reliable data exist as to whether or not the insurance industry's current profits are excessive. This is due both to data limitations and disagreements about how to measure such profits.*
- *In order for the rate regulation process to work properly and create a minimum of economic inefficiencies and distortions, it is imperative that the immediate and longer-term regulatory decisions relating to premium rate rollbacks and future premium increases be based on such factors as actual costs and reasonable rates of return on investment.*
- *Standards must immediately be established both for measuring the profitability of individual firms, allocating their costs to different lines of insurance, and designating what level of profitability is "acceptable" for the purpose of approving premium increase requests. The Legislature should closely monitor this process to ensure that it is done properly.*

- *Regardless of whether or not the industry's premium rates and profits are excessive, much of its current problems appear related to the rising underlying costs of providing insurance coverage. Proposition 103 does not address this factor, and, to do so, other approaches will be needed. There are a number of different options which the Legislature can consider for influencing costs.*

INTRODUCTION

On November 8, 1988 California voters approved Proposition 103, one of five different insurance reform measures that were on the statewide ballot. Proposition 103 provides for significant reductions in premium rates for certain types of insurance (auto, fire and liability) and makes various changes regarding how the insurance industry is to be regulated in California. The primary impetus behind passage of the measure appears to have been the rapid rise in insurance premium rates in recent years, combined with uncertainty as to whether these premium increases are fully justifiable on the basis of the actual costs of providing insurance coverage.

The full implications of Proposition 103 for buyers and sellers of insurance in California are not yet known, and will only become apparent over time, after its provisions are fully implemented. Nevertheless, many questions have already been raised regarding what the likely effects of the measure will be. This analysis discusses the various possible outcomes which might occur under Proposition 103 and the factors that will influence exactly which ones ultimately prevail. The analysis focuses on private automobile liability and property-damage insurance coverage, because it is the largest segment affected by Proposition 103 and the segment which has received the most attention from both the Legislature and the public.

WHAT DOES PROPOSITION 103 DO?

Table 1 summarizes the provisions of Proposition 103. Four types of provisions are especially significant.

Premium Rate Rollbacks. Proposition 103 requires that premium rates for all policies written or renewed after November 8, 1988 be *reduced by 20 percent* from the levels in effect as of November 8, 1987 (one year prior to the election). Premium rates are then frozen until November 8, 1989, at which time *a further 20 percent rate reduction* is required for "good drivers." The measure allows individual insurance companies to file for a full or partial exemption from the rate rollbacks if they are threatened by "insolvency" (a term which the measure does not specifically define).

Table 1
Provisions of Proposition 103 [a]

Category	*Key Provisions*
Rate changes:	
Initial rollback	• 20% below rates in effect on November 8, 1987 for all policies written or renewed after November 8, 1988
Additional changes	• Rate freeze until November 8, 1989 • Additional 20% reduction in auto insurance rates for all "good drivers" beginning November 8, 1989
Rate regulation:	
Filing and justification	• Effective November 8, 1989, prior review and approval of all rate changes • Justification for all rate changes
Basis for rate	• Rates must reflect investment earnings • No consideration given to "competitive conditions"
Factors for establishing rate classes	• Primary consideration given to driving record and miles driven • Secondary consideration given to years of driving experience and other factors as determined by commissioner
Antitrust	• Removes current exemption from antitrust and unfair business practice laws
Consumer Assistance	• Establishes a nonprofit corporation to assist consumers and intervene in rate proceedings • Requires Department of Insurance to provide comparative rate information for consumers upon request
Other Features	• Permits sale of insurance by state-chartered banks • Permits discounts and rebates by insurance agents • Requires election of Insurance Commissioner • Increases gross premiums tax and regulatory assessments to offset administrative costs and state revenue losses due to insurance rate reductions

[a] These provisions generally apply to all lines of insurance covered by Proposition 103 (including auto, fire and liability).

Rate Regulation. Prior to Proposition 103, insurance companies were not required to file rate changes with the Insurance Commissioner. The Commissioner, however, had the authority to investigate rate changes and require modifications in rates if they were found to be unjustified. (This authority, however, was seldom exercised.) In contrast, Proposition 103 establishes a *prior approval* process whereby any premium rate change must be filed with the Department of Insurance and cannot go into effect until approved by the Commissioner. All proposed rate changes that exceed 7 percent for personal lines and 15 percent for commercial lines *must* be reviewed by the Commissioner. The Commissioner can *choose* whether or not to review smaller rate changes. If the Commissioner declines to undertake this review, these rate changes automatically go into effect after 60 days.

Antitrust and Unfair Business Practices. Proposition 103 eliminates exemption of the insurance industry to the state's antitrust and unfair business practices (such as price discrimination) laws. Removing these exemptions allows the Attorney General to pursue investigations and bring civil or criminal prosecutions where violations of law are found.

Other Measures to Enhance Competition. Proposition 103 removed several provisions that may have restricted competition between insurance companies. These provisions include (1) restrictions on group insurance, (2) prohibitions on agent commission rebates, and (3) restrictions on entry into the insurance business by commercial banks. Additionally, Proposition 103 requires the Department of Insurance to make available to consumers premium rate comparisons. These provisions are intended to improve the performance of the insurance industry by enhancing competition.

Proposition 103 also provides for election of the California Insurance Commissioner and establishment of nonprofit consumer-intervenor groups.

THE EFFECTS OF PROPOSITION 103—WHAT ARE THE KEY ISSUES?

Many different questions have been raised regarding the possible effects that Proposition 103, once fully implemented, will have on the buyers and sellers of insurance in California. The most frequently asked questions are:

- What will happen to insurance premium rates?
- How will the measure affect the ability of Californians to obtain insurance coverage?
- What will the measure do to the ability of insurance companies to operate profitably in California (including the industry's competitiveness, profitability, and, ultimately, its overall financial health)?

How the Regulatory Process Functions Will Be Critical. As noted earlier, complete answers to these questions will only become apparent once Proposition 103 has been fully implemented and its effects have had time to surface. One thing, however, is clear—the final outcome will depend, to a large degree, on *how the regulatory process established by Proposition 103 functions*, including the specific criteria that will be used to make decisions regarding premium rates. That is, the effects of Proposition 103 on California buyers and sellers of insurance will depend on how the performance of the insurance industry under the rate regulation authority of Proposition 103 differs from how the industry has performed in the past. Proposition 103's effects also will depend on the impacts of the measure's pro-competitive enforcement powers—antitrust investigations and prosecutions under the unfair business practice laws.

Given this, we next review what is known about the insurance industry's characteristics and past performance, followed by a discussion of the different types of outcomes that could result under Proposition 103, depending on exactly the how the regulatory process works.

CHARACTERISTICS AND PAST PERFORMANCE OF THE INSURANCE INDUSTRY

The key issues of interest here are—*Why have insurance rates been increasing so rapidly in recent years, and why has it become hard to obtain affordable insurance coverage in certain areas of the state?* Two main explanations have been suggested. The first is that the insurance industry has simply been responding to such factors as increased numbers of claims and higher settlement costs. The second is that the insurance industry itself is uncompetitive, and has been charging higher rates in order to earn excessive profits. In considering these theories, the basic question to ask is: *To what extent has California's insurance industry been performing in a competitive fashion in recent years?*

Why Does the Degree of Competitiveness Matter?

It is important to ask whether the insurance industry is "competitive" because price levels in competitive industries generally are not out of line with costs, nor do firms earn excessive profits over the long term. In contrast, "noncompetitive" industries often are able to earn excessive profits and charge consumers higher prices than their costs alone can justify. Thus, for example, if the insurance industry *has* in the past been competitive in its pricing and profitability, Proposition 103's rate rollbacks would not be sustainable in the long run and could cause significant disruptions in the short run, including cutbacks in insurance availability. If, on the other hand, the industry *has not* been performing competitively, then these rollbacks could be absorbed from excess profits and sustained in the long run. (Even in this event, however, there could be near-term disruptions as firms adjust to this new environment.)

Is the Insurance Industry Competitive?

Considerable disagreement exists regarding whether insurance premiums and profits generally are greater than those which a competitive environment would produce. Past studies examining this issue seem to suggest that, at least on a *broad industry-wide basis*, the profits earned on private automobile insurance lines of coverage have not been excessive compared either to other financial or to manufacturing industries. However, only a couple of these studies have focused specifically on the profits of California auto insurance companies during the mid- to late-1980s. Thus, at present, the evidence is not very conclusive as to exactly how profitable insurance companies are, including whether their profits are "excessive" compared to those which a competitive environment would produce.

Measuring Profitability Poses Problems. The main reason for this disagreement involves the problem of measuring insurance company profits, including obtaining the necessary data and determining the precise methodology for calculating profits. The earnings of insurance companies are the net result of two factors: (1) their net underwriting profits or losses and (2) the investment income from the reserve balances they maintain. Depending upon the accounting assumptions used to treat this investment income, a variety of different profit measures can be computed, and no consensus appears to exist regarding which measure is correct as an indicator of overall competitiveness.

What Do Other Indicators of Competitiveness Show? Given the problems of relying on profit data to determine if the insurance industry is performing competitively, an alternative approach is to ask whether the general structure of the industry is suggestive of a competitive environment. This involves looking at factors which economists have found usually correlate with competitive markets, such as the number of firms competing in an industry and the ability of new firms to successfully enter the industry. Our analysis indicates that:

- ***Many Insurance Firms Compete With One Another.*** Currently, there are about 300 firms that compete against one another in California selling automobile insurance, 54 of which each have sales exceeding $20 million. Table 2 lists the market share and total premiums earned for the 30 largest companies selling private auto insurance in California. While it is true that eight firms account for nearly two-thirds of all insurance sales, other measures of market share indicate levels of market concentration lower than federal antitrust authorities usually consider as being potentially anticompetitive.
- ***New Firms Constantly Enter the Market.*** Over the 10-year period 1977 through 1987, 106 companies entered the private passenger automobile insurance market in California, whereas 89 left the market. Thus, the number of competing firms actually has increased somewhat over time.

Conclusion—Competitive Elements Are Present. The available data suggest that certain competitive elements are at work in California's insurance industry. Given this, *it is not at all clear that California's high insurance rates are due to an uncompetitive insurance industry that charges too much and earns excessive profits.*

What Other Factors Might Be Causing Insurance-Related Problems?

To the extent that uncompetitive performance is not the main cause behind high and rising insurance premiums and difficulties in obtaining insurance coverage in certain regions of the state, the main alternative explanation for these problems is that they primarily reflect *the increasing costs of providing insurance coverage to consumers.* If this is true, insurance companies are simply "passing through" to consumers the increased costs of providing insurance and are no different from the

Table 2
30 Largest Private Automobile Insurers in California Market Share in 1977, 1982 and 1987

Company[a]	Total Premiums 1987 (in millions)	Market Share 1977	1982	1987
State Farm Mutual	$1,427.1	15.8%	16.7%	15.4%
Farmers Insurance Exchange	893.7	9.9	11.5	9.6
CSAA Inter-Exchange Bureau	863.0	7.8	8.8	9.3
Allstate Insurance	851.8	10.2	10.3	9.2
Auto Club of Southern California	767.9	11.5	11.8	8.3
Twentieth Century Insurance	446.5	1.2	2.4	4.8
Mid-Century Insurance	322.0	3.6	2.8	3.5
Mercury Casualty	242.7	2.0	1.1	2.6
USAA	230.4	2.1	2.4	2.5
State Farm Fire & Casualty	157.3	1.1	0.8	1.7
Government Employees Insurance	120.6	1.2	1.1	1.3
Safeco Insurance of America	105.7	1.6	1.5	1.1
Progressive Casualty Insurance	103.8	0.1	0.6	1.1
New York Underwriters	88.6	0.0	0.0	1.0
California Casualty Indemnity Exchange	86.1	1.0	0.9	0.9
Century-National	85.0	0.5	0.5	0.9
West American Insurance	74.3	1.1	1.2	0.8
Liberty Mutual Fire	73.5	0.7	0.7	0.8
Nationwide Mutual	66.4	0.1	0.2	0.7
Aetna Casualty & Surety	64.7	1.5	0.6	0.7
USAA Casualty Insurance	64.5	0.2	0.3	0.7
Mercury Insurance	62.7	0.0	0.1	0.7
Calfarm Insurance	57.9	0.6	0.5	0.6
Allstate Indemnity	56.4	0.3	0.1	0.6
California Casualty Insurance	54.8	0.6	0.6	0.6
Progressive Specialty Insurance	54.3	0.0	0.1	0.6
Dairyland Insurance	50.3	0.2	0.5	0.5
Colonial Penn Insurance	49.5	0.7	0.6	0.5
Financial Indemnity	47.8	0.4	0.3	0.5
All West Insurance	46.1	0.0	0.3	0.5

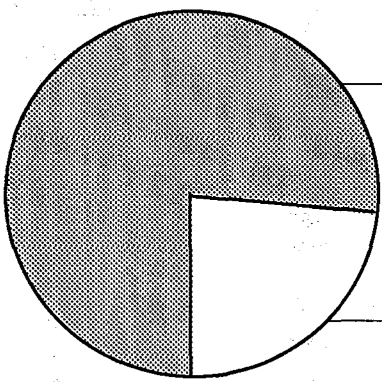
[a] Certain companies in the list have common ownership.
Source: *Underwriter's Report, Annual Statistical Edition* (1978, 1983, and 1988).

sellers of other goods who incorporate their costs into the prices they charge their customers. This, in turn, would imply that the "solution" to problems like high premium rates is not to regulate rates in hopes of lowering them, *but rather to try to reduce the underlying cost pressures that insurers face.*

What Types of Costs Do Insurers Face? Chart 1 summarizes the major cost components of providing automobile coverage. (These data represent average costs for the insurance market generally. Significant cost differences for providing insurance to consumers exist between urban and rural areas, within urban areas themselves and from company to company.) Chart 1 indicates that:

Chart 1

Where The Insurance Dollar Goes[a]



Claims-Related Expenses	
Type	**Share**
Collision and comprehensive	20%
Property damage liability	13
Wage loss and other economic damages	10
Medical costs	9
Plaintiff attorneys	8
Company attorneys	6
Pain and suffering	5
Other claims-handling expenses	6
Total	77%

Other Expenses	
Type	**Share**
Commissions and selling expenses	13%
General expenses and surplus (or profits)	6
Taxes and license fees	3
Dividends to policy holders	1
Total	23%

[a] Source: Insurance Information Institute. These estimates include both premiums and investment earnings based on 1986 revenues and costs.

- About 77 percent of each dollar of premium and investment income is either directly or indirectly associated with paying insurance claims.
- Of the remaining 23 percent, 13 percent is for insurance commissions and selling expenses, 6 percent is for general expenses and surplus (surplus represents the funds available to the company to support expansion), 3 percent is for taxes and license fees, and 1 percent is for dividends to policyholders.

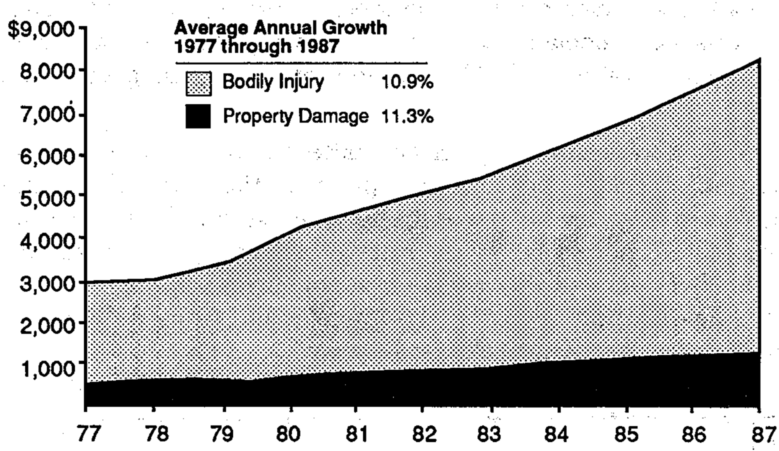
Thus, most of the gross income earned by insurers goes for paying claims, marketing insurance products, and paying general business expenses. It is only natural that premium rates will reflect increases in these and other cost components.

What Has Been Happening to Costs? The evidence indicates that many of the cost components of providing automobile insurance coverage *have been experiencing significant increases in recent years.* This certainly comes as no surprise to anyone who has recently visited an automobile body shop to have collision damage repaired, or spent time in a hospital to receive medical treatment for accident-related bodily injuries. Charts 2 and 3 show the statewide trend of average loss payments by major loss category paid by insurance companies from 1977 through 1987. The different loss measures shown all indicate that rates have grown in excess of 10 percent annually over the last 10 years.

Chart 2

Bodily Injury and Property Damage Average Cost per Claim for Cars in California

1977 through 1987[a]

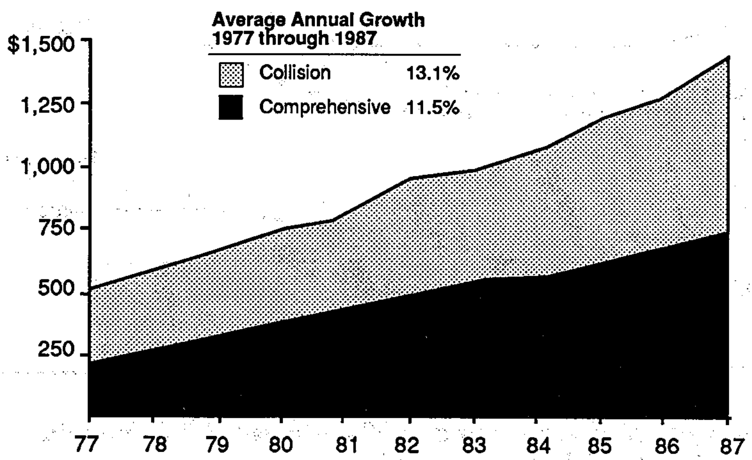


[a] Source: Fast Track Monitoring System, National Association of Independent Insurers.

Chart 3

Comprehensive and Collision Damage Average Cost per Claim for Cars in California

1977 through 1987[a]



[a] Source: Fast Track Monitoring System, National Association of Independent Insurers.

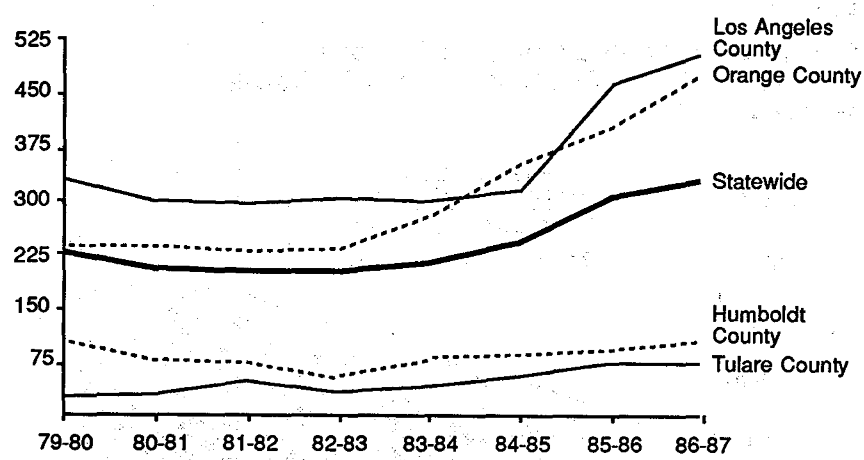
California Has Especially High Costs. Insurance industry data indicate that California has higher insurance premiums than all but a few states. This appears to be the combined effect of a variety of factors, including: (1) the relatively high percentage of the population that lives in urban areas, (2) congested freeways in large urban areas, (3) relatively more small cars (which can result in more severe injuries), (4) relatively more sports and specialty cars (which have higher repair bills), (5) higher litigation rates, and (6) relatively high and rising vehicle theft rates.

California also exhibits significant differences in claims costs and frequencies of claims for different parts of the state. For example, average claim costs are 98 percent above the statewide average in Los Angeles and 17 percent below the statewide average for Sacramento. In addition, Chart 4 shows that accident victims with injuries are far more likely to litigate claims in court in Los Angeles and Orange Counties than in rural areas such as Humboldt and Tulare Counties.

Chart 4

Automobile-Related Lawsuit Rates Statewide and Selected Counties

1979-80 through 1986-87 (lawsuits per 100,000 population)



What Has Been Happening to Premiums? Rising premiums have accompanied the industry's costs of providing insurance coverage. This can be seen by looking at premium data (available from an industry rating bureau) for several large California insurers over the period 1980 through 1988. Although these data have significant shortcomings, they seem to suggest that premium rate increases during this period *generally* were in line with claims cost increases. These data also show significant differences in premium rates between rural and urban areas of the state (for example, rates in central Los Angeles were about three times as high as in Humboldt County in 1988).

Conclusion—Costs Are a Key Factor. Given the significant rates of increase in insurance cost components in recent years and the increased propensity for claims to be filed, it is reasonable to conclude that high and rising costs of providing insurance coverage are key contributors to the problems of high premium rates and restricted availability of insurance in certain geographic areas. This, in turn, suggests that addressing these problems requires devising means of reducing these costs or at least slowing their increase in the future. Given that many different factors affect the cost to insurers of providing automobile insurance coverage, a variety of approaches will be needed.

Summary Regarding Industry Performance

The insurance industry has a relatively small number of firms accounting for a majority of sales and undoubtedly has certain other attributes suggesting potential performance problems. However, it also appears to have a market structure which is consistent with a reasonable degree of competition. It also is the case that the costs of providing insurance coverage seem to have increased significantly in recent years, due to factors like rising automobile repair costs, medical expenses, and liability claims and settlements. Thus, while competitive shortcomings may explain part of California's current insurance-related problems, it seems doubtful that these problems can be addressed without also dealing with the fundamental underlying cost problem—namely, *insurance coverage is becoming increasingly expensive to provide.*

THE IMPACTS OF PROPOSITION 103 ON INSURANCE BUYERS AND SELLERS

As noted earlier, the key questions regarding how Proposition 103 will affect buyers and sellers of insurance relate to how its basic provisions will affect insurance premium rates, availability of insurance coverage, and the ability of insurers to operate profitably in the state. As discussed below, these effects will depend primarily on three factors:

- The extent to which the industry has already been performing in a *reasonably competitive manner*, minimizing costs and earning adequate profits.
- The degree to which the *underlying costs* of providing insurance will be reduced by the measure's provisions.

- The exact manner in which *regulatory decisions* regarding premium rates and other factors are made once Proposition 103 is fully operational.

What Will Be the Effects of the Premium Rate Rollbacks?

Several basic outcomes are possible regarding the rate rollbacks. For example:

- One possibility is that the rollbacks will result in *permanently reduced premium rates with no adverse effects on consumers.* This would occur, however, *only* if insurers have consistently been earning excessive profits that are not justified by their costs.
- Alternatively, if premium rates have generally reflected the increased costs of providing insurance (as opposed to simply reflecting industry attempts to earn excessively high profits), *the rollbacks may not result in permanently reduced premiums without some other types of offsetting adjustments, such as stricter underwriting standards.* Under this second scenario, insurers initially might be able to absorb at least some of these rollbacks by reducing their reserves; however, this would only be a temporary solution, and probably could not finance rollbacks of the 15 percent to 40 percent range that might be required (the actual size of the rollback for any given company depends on that company's specific premium history since November 8, 1987). Thus, some insurers might request full or partial exemption from the rollbacks during the "rate freeze" period, while others eventually would have to request permission to raise their rates back up into alignment with their costs. In either case, *the industry would experience near-term disruptions.*

Which Outcome Will Prevail? The actual outcome probably will be somewhere in between these two cases. Given the data problems involved, it is not possible to predict exactly what the final outcome will be and how it might differ from company to company. It must be remembered, however, that even economically justifiable upward premium-rate adjustments under the second scenario will occur only if the regulatory process permits them. Failure to do so would force the industry to compensate somehow for undercharging customers, such as through tighter underwriting standards or the exclusion of certain types of coverage altogether. *In order to avoid such distortions, it will be imperative that the immediate and longer-term regulatory decisions relating to the premium rate rollbacks be based on such factors as actual costs and reasonable rates of return on investment.*

A typical example of where the regulatory process regarding rate rollbacks may encounter a problem involves Proposition 103's provision that insurers may seek relief from the rollbacks on the grounds of being "substantially threatened with insolvency." While the measure does not define this term, it is commonly understood to imply severe financial difficulty. Premium rates, however, should be set not at a level that forestalls "insolvency," but rather one which allows insurers to both cover their costs and earn an adequate profit margin over the long term. Thus, although the rollbacks may not make a particular insurer immediately vulnerable to "insolvency," they may preclude its long-term economic viability. The regulatory process will somehow have to deal with what Proposition 103 literally provides and what actually makes sense from an economic perspective.

What Will Be the Effects of Ongoing Rate Regulation?

One can never say how regulation will work until it actually is tried. However, the actual history of how rate regulation has worked in different industries—especially industries that exhibit some competitive characteristics—*is not very impressive.* The reasons for this are varied. In some cases, regulators have not correctly understood the basic economic forces affecting an industry, and therefore have set rates that are either too high (thereby causing excessive profits and harm to consumers) or too low (thereby destroying the economic health of the industry). In other cases, regulatory decisions have shown biases, either in favor of consumers or the industry being regulated. This has resulted in such problems as reduced industry innovation and subsidies to certain categories of consumers at the expense of others. This history does not imply that rate regulation under Proposition 103 cannot be effective and consistent with competitive performance. It does, however, emphasize that ***if regulation is to "work," it must be neither pro-industry nor pro-consumer. It must proceed from neutral ground and focus on the underlying economic realities of the insurance industry.***

Exactly How Will Rates Be Set? One issue that will have to be confronted immediately is the specific criteria which should be used for approving and disapproving premium rate increases. For example, Proposition 103 states that, in reviewing rate requests, "no consideration shall be given to the degree of competition." Exactly how this provision is interpreted and rate requests are evaluated in relation to it remains to be seen. If rates do not take into account "competition," there could be a potential conflict with the measure's antitrust provisions.

Steps That Need to be Taken. *Before Proposition 103's rate regulation process can begin, we believe that several difficult tasks must be undertaken and completed.* Specifically:

- ***Standards for Measuring Profits.*** Accounting standards must be developed for measuring the profits of insurers, since this should be the single most important criterion used in approving rate requests.

Standards are also needed for reporting costs, allocating operating costs between lines of insurance, and allocating both assets in reserves and general overhead among lines of insurance and between states.

- ***Determination of Acceptable Profit Rates.*** Once profits are defined and measured, an "acceptable" level of profits must be identified which can serve as the standard for justifying the approval of rate requests.

Developing these standards involves difficult and complex decisions. However, the rate regulation process is unlikely to succeed without these standards. There are several alternative approaches that can be taken to develop the required standards, such as (1) administrative proceedings at the Department of Insurance or (2) enactment of legislation. Regardless of the specific approach used, however, *it is imperative that these standards be correctly developed. Thus, the Legislature should closely monitor implementation of the regulatory process to ensure that this happens.*

The Effects of Other Provisions

The other, generally pro-competitive, features of Proposition 103 *clearly offer opportunities for improving the functioning of local insurance markets.* For example:

- Making the industry subject to the same business practice statutes as other businesses should provide both the public and the state Attorney General with incentives to pursue allegations of anticompetitive behavior or unfair business practices (including discriminatory underwriting practices).
- Removing other restraints on competition could have some positive effects on industry performance. For example, those with group coverage could be in a better position to bargain with insurers, and entry by banks could stimulate additional competition within the industry.
- Providing comparative premium-rate data to consumers upon request should make comparison shopping less costly and place greater pressure on insurers to reduce premium costs due to rate competition.

Summary Regarding Effects of Proposition 103—Only Time Will Tell

Given the above, *it is impossible to predict exactly what will be the full range of effects of Proposition 103 on the buyers and sellers of insurance in California. This will be known only after the measure is fully implemented and operational.* Certain provisions in the measure that tend to increase competition clearly will benefit consumers. The effect of rate regulation on premium rates and insurance availability, however, is much less certain and will depend in large part upon the way in which regulatory decisions are made.

One thing, however, does seem clear—*the insurance industry's current problems are traceable not just to one but to a variety of different factors. Consequently, there is no one simple solution to them. If* regulatory decisions under Proposition 103 take proper consideration of economic factors and the rate review process itself is not overly burdensome, the measure could help ensure that premium rates are consistent with the underlying costs of providing insurance coverage. However, Proposition 103 does not directly address the industry's other difficulties, especially the underlying problem of the rising costs of providing insurance coverage—a problem which seems to be at the center of the industry's difficulties. *In order to deal with this very fundamental issue, other steps and approaches are needed.*

Given that many different factors affect the cost to insurers of providing automobile insurance coverage, there are a variety of different approaches that can be explored for influencing costs. Some of the possible options include: (1) reviewing the underwriting practices of insurers, (2) antitrust and unfair business practices enforcement actions, (3) improved reporting of consumer complaints and complaint resolution, (4) no-fault insurance, and (5) modification of the collateral source rule. The combined use of these and other approaches offers the greatest potential for influencing the costs of providing automobile insurance coverage.

Local Mental Health Programs

What is the Status of the State's Local Mental Health Systems? What Options Does the Legislature Have for Improving It?

Summary

- *Our review of the state's local mental health system reveals a patchwork of services established over time in response to perceived needs for services and available funding sources.*
- *Total expenditures (all funds) for "Short-Doyle" mental health services kept up with inflation and population growth between 1980-81 and 1986-87—the most recent year for which expenditure data are available. Our review indicates that these expenditures have kept up with population growth and inflation primarily because county and federal Medicaid funding have grown.*
- *General Fund appropriations for "Short-Doyle" services, however, have not kept up with inflation and population growth since 1980-81. Specifically, if appropriations had been adjusted for inflation and population growth since 1980-81, the appropriation in 1988-89 would have been $630 million, or $132 million more.*
- *The amount of county funds (match and "overmatch") devoted to mental health services increased from $8.4 million in 1980-81 to $102 million in 1986-87. This growth is partially due to changes in matching requirements.*
- *There are no data available that allow the Legislature to review whether counties use funding allocated to them in the most effective and efficient manner.*
- *The Legislature has augmented local mental health services with categorical funding and through pilot programs. We discuss three other approaches to restructuring the local mental health system: (1) open-ended entitlement, (2) case management entitlement, and (3) funding increases based on inflation and population growth.*

During the last few years, the Legislature has considered numerous requests for additional funding for mental health services provided under the Short-Doyle Act. For example, during legislative hearings on the 1988-89 budget, a coalition of various mental health advocacy groups requested that the Legislature provide $229 million in additional funds for Short-Doyle mental health services. In addition, over the past several years, counties have reported severe program constraints because funding increases have not been sufficient to accommodate rising costs and the growing numbers of persons in need of mental health services.

In this analysis, we (1) provide background on the current Short-Doyle mental health system, (2) review non-Short-Doyle mental health programs, (3) review expenditure and appropriation data for Short-Doyle mental health services, (4) identify issues raised by these data, and (5) provide options for system reform.

Background

Until 1957, California coped with mentally disabled people by placing them in one of 11 state hospitals for indeterminate periods of time with little or no treatment. This was similar to practices in other states.

Consistent with a national trend for deinstitutionalizing the mentally disabled, in 1957 the Legislature significantly reformed the mental health system by passing the Short-Doyle Act. The intent of the Short-Doyle Act was to create a cost-effective alternative to state hospitalization by encouraging counties, under state guidance, to initiate or expand community mental health services. The state provided funds to offset 50 percent of county costs. At that time, it was estimated that 17 percent of the state hospital population could be treated at the local level at a savings to the state.

In 1968 the Legislature again enacted major legislation that (1) established the civil commitment process for patients (the Lanterman-Petris-Short Act) and (2) revised the Short-Doyle Act. This legislation is the basis for the current Short-Doyle system.

The Lanterman-Petris-Short (LPS) Act. The LPS Act provides the legal basis for treating patients in the mental health system. It authorizes commitment for the evaluation and involuntary treatment of persons with mental disorders who are dangerous to themselves or to others, or who are gravely disabled. The act contains procedural safeguards to protect individuals from erroneous commitment. The act represents the state's effort to strike an appropriate balance among treatment needs, individuals' rights, and public safety.

Short-Doyle Act Amendments. In order to assist counties in providing services under the LPS Act, the Legislature also amended the Short-Doyle Act. The amendments required the counties to share responsibility for delivering mental health services and established new funding ratios so that approximately 85 percent to 90 percent of Short-Doyle mental health costs would be funded by the state.

In addition to the Short-Doyle and LPS Acts, there have been other significant events that have shaped the development of local mental health programs:

- 1955-60—Major advancements occurred in the development and use of psychotropic medications to alleviate some of the symptoms of mental illness, allowing more individuals to be treated in the community.
- 1962—Amendments to the Social Security Act allowed mentally disabled persons who had been previously employed to receive social security payments. These payments made it possible for many mentally disabled persons to live in community board and care facilities.
- 1964—The federal Community Mental Health Centers Construction Act stimulated the construction of public and private mental health treatment centers for the specific purpose of utilizing community centers as an alternative to state hospitalization.
- 1965—The Medicare and Medicaid programs were established, making federal funding available to pay for mental health services for persons meeting the eligibility requirements.
- 1974—The Supplemental Security Income/State Supplementary Program (SSI/SSP) allowed indigent mentally disabled persons to receive grants. These amendments allowed additional mentally disabled persons to live in community facilities.

How the Short-Doyle System Works Today

Under the Short-Doyle Act, counties are responsible for planning local mental health programs and providing services, and the state Department of Mental Health (DMH) is responsible for overseeing the system. It requires state and county agencies to fulfill their respective responsibilities in consultation with statutory advisory groups.

All persons in the state are eligible to receive Short-Doyle services. Counties generally provide mental health services to individuals based on the severity and acuity of the person's mental illness. For example, an individual suffering from a severe depressive suicidal episode would take precedence over an individual in need of counseling due to job stress.

State Responsibilities. The Short-Doyle Act requires the DMH to provide leadership in administering, planning, developing, financing, and overseeing local mental health services. The DMH also operates state hospitals that care for the most severely disabled county clients. Specifically, DMH responsibilities include:

- Providing treatment and care for mentally ill persons placed by counties in the state hospitals under the LPS Act.
- Reviewing and approving county mental health service plans.
- Allocating state General Fund appropriations to counties according to specified sharing ratios.
- Assuring that county programs meet specified standards.

- Establishing, monitoring, and evaluating statewide research and prevention programs.

County Responsibilities. Counties are responsible for establishing and maintaining a community-based mental health system. Counties provide services through programs they operate, programs operated by private providers, and state-operated hospitals. The type and amount of services provided to an individual depends on his or her level of mental disability. Services include:

- ***24-hour care*** in local facilities or state hospitals.
- ***Day treatment care***—a range of services that assist individuals with daily living and other skills that help them avoid inpatient care.
- ***Outpatient care***—short- or long-term counseling for individuals who are acutely and/or chronically mentally ill.
- ***Outreach***—services designed to bring special population groups into mental health treatment and to make human services agencies aware of available mental health services.
- ***Continuing care*** for the chronically mentally ill. These services include conservatorships and case management, which supplement direct services.

In addition, counties are responsible for:

- Submitting a county Short-Doyle plan for DMH approval. The plan identifies (1) the county's budget for mental health services and funding sources, (2) the types of mental health services to be offered, (3) the estimated number of persons to be served, and (4) the priority populations to be served.
- Operating a quality assurance (QA) system that covers all county-operated and contracted mental health facilities and programs. QA systems are designed to promote and maintain efficient, effective, and appropriate mental health services.
- Meeting specified program standards.

Funding Arrangements for Short-Doyle Services

Short-Doyle mental health services are funded primarily from state funds (General Fund) and county matching funds. Inpatient hospital services, including state hospital services, generally are funded 85 percent state/15 percent county. Other services generally are funded 90 percent state/10 percent county.

Counties are responsible for managing their programs to ensure that expenditures of state funds do not exceed the amount allocated to the county by the state. Counties do not control state funds appropriated for their state hospital patients. Instead, counties are allocated a specific number of state hospital bed-days for use by their county clients.

Short-Doyle mental health services are supported from a variety of other funding sources as well, including federal grants, county overmatch, fees collected from patients who are able to pay them, payments made on behalf of particular clients—for example, by Medicare, Medi-Cal, and insurance—and other sources.

Table 1 provides an overview of spending for Short-Doyle programs in 1986-87, the most recent year for which actual expenditure data are available. The table shows that the General Fund accounts for 68 percent of all funding for Short-Doyle mental health services, with counties contributing approximately 11 percent through the required match and any "overmatch."

Table 1
Short-Doyle Mental Health Services Expenditures by Funding Source 1986-87 (dollars in millions)

	Local Programs	*State Hospitals*	*Total*	*Percent of Total*
General Fund	$472.1	$190.2	$662.3	67.9%
County match	42.9	26.8	69.8	7.2
County "overmatch"	32.3	—	32.3	3.3
Federal Medi-Cal	75.8	10.6	86.4	8.9
Medicare	21.9	3.7	25.6	2.6
Other sources	79.2	19.3	98.5	10.1
Totals	$724.2	$250.7	$974.9	100.0%

Allocations to Counties. The level of state funding allocated to counties varies greatly. For example, in 1986-87, General Fund per-capita allocations to counties ranged from $31 in San Francisco to $12 in Orange County. The variation is due in large part to when the county chose to begin participating in the Short-Doyle system. That is, counties that opted into the program earlier have more funding per capita compared to counties that started later.

In recent years, General Fund augmentations to county mental health programs have been allocated to achieve a more equitable allocation of resources among counties. To do this, the DMH has chosen a model that assigns equal weight to (1) a county's total population and (2) the number of residents in the county receiving AFDC and SSI/SSP payments. Therefore, a county with 10 percent of the state's population and 20 percent of its "poverty" population would be entitled to 15 percent of the funds.

As with allocations of General Fund monies, the allocations of state hospital bed-days are based on historical utilization patterns.

Categorical Funding. During the last few years, the Legislature has appropriated funds to serve particular populations with special needs. These "categorical" funds are allocated to counties in the same way as other funds; that is, counties must provide a 10 percent match. Specifically, these funds are allocated to counties for:

- Homeless persons.
- Children receiving special education.
- Residential care rate supplements.
- Community residential treatment programs.
- Programs to divert mentally disabled persons from placement in jail.
- Specified priority populations such as mentally ill requiring secure facilities, juvenile sex offenders, the elderly and veterans.

Non-Short-Doyle Mental Health Programs

Only a portion of the mental health services available in the state are provided through the Short-Doyle system. In order to place the Short-Doyle system in context with other services, we have identified other mental health programs and funding sources below:

- The DMH is responsible for providing treatment for individuals who are committed by the judicial system. This care is provided in the state hospitals and in community programs. In 1988-89, $141 million was allocated from the General Fund to serve these individuals.
- Institutions for Mental Diseases (IMDs) are skilled nursing facilities with special mental health treatment programs. IMDs are funded through a combination of General Fund, SSI/SSP reimbursements, and third-party revenues. In 1988-89 there were 3,400 IMD beds statewide at a total cost of $65 million ($55 million General Fund). Before 1987-88, IMD services were funded by Medi-Cal.
- Board and care homes for the mentally ill are paid for primarily through SSI/SSP funds.
- Private mental health treatment services are paid through Medi-Cal, Medicare, and private insurance.
- The DMH contracts directly with providers for services in three programs: (1) the Brain-Damaged Adult program ($5.3 million General Fund in 1988-89), (2) AIDS-related services ($1.5 million General Fund in 1988-89), and (3) primary prevention programs ($954,000 from the Primary Prevention Fund in 1988-89).

Even though these programs and funding sources are not considered to be part of the Short-Doyle system, county Short-Doyle programs may depend on their availability. For example, counties frequently place clients in IMDs and Medi-Cal-funded skilled nursing facilities.

Short-Doyle and Other Mental Health Programs—A Fragmented System

Our review of California's current array of mental health programs indicates that, since 1968, these programs have been patched together in response to perceived service needs and availability of funding. This has resulted in a fragmented system where it is not clear which level of government has overall responsibility. For example, although the Short-Doyle Act placed primary responsibility with the counties to plan local mental health priorities, categorical funding has been added over time for specific populations. These augmentations were made in response to a perception that counties were not able to meet all the mental health service needs of their communities. In another example, the availability of federal funds for Medi-Cal services has resulted in the provision of a large volume of services outside the purview of county Short-Doyle systems.

Spending Trends—Short-Doyle Programs

We examined a number of different measures of the level of resources devoted to Short-Doyle mental health services to determine whether these resources have kept pace with population growth and inflation. In this section, we discuss the following specific measures: expenditures from all funds, General Fund expenditures, General Fund appropriations for local programs, General Fund appropriations for state hospitals, and state hospital bed-days. The most recent *actual expenditure* data is for 1986-87. The most recent *actual appropriation* data is for 1988-89.

We chose 1980-81 as the base year for comparison because it was the first year after Proposition 13 in which programs were relatively stable. However, there is no analytical way to determine what the most appropriate base year would be. This is because our review indicates that there has not been any particular year which could be used as a "model" for the most appropriate level of expenditures.

Base Year Selection Affects Fiscal Analysis. In fact, conclusions regarding whether resources have kept pace with inflation and population growth vary significantly depending on the base year chosen. For example, total General Fund expenditures for local programs and county clients in state hospitals were $662 million in 1986-87. Expenditures would have been $698 million if they had been based on 1980-81 expenditures adjusted for inflation and population growth. Thus, spending in 1986-87 was $36 million *lower* than adjusted 1980-81 spending. These results vary depending on the base year. Spending in 1986-87 was $26 million *higher* than adjusted 1978-79 spending and $72 million *higher* than adjusted 1982-83 spending.

Expenditures From All Funds. Chart 1 shows that total expenditures from *all funds* in 1985-86 and 1986-87—the most recent years for which data are available—exceeded what these amounts would have been had they been increased by inflation and population growth since 1980-81. "All funds" include General Fund, all county funds (both match and overmatch), federal Medicaid and Medicare, and other sources, such as patient insurance and fees. Total expenditures were $975 million in 1986-87. If expenditures had been adjusted for inflation and population growth each year since 1980-81, the expenditures in 1986-87 would have been $882 million, or $93 million less.

In contrast, Chart 2 shows that total *General Fund* expenditures (combined local programs and state hospitals) were lower than adjusted 1980-81 expenditures in all of the fiscal years since 1980-81 for which data are available. The discrepancy between actual 1986-87 expenditures and adjusted 1980-81 expenditures was $36 million, or approximately 5 percent of actual General Fund expenditures.

County and Medicaid Funds Maintain Programs. The difference between expenditures from all funds and General Fund expenditures is a result of counties increasing sources of funding other than the General Fund in order to maintain Short-Doyle programs. The two largest increases have been in county funds and federal Medicaid funds. County funds (match and overmatch) devoted to mental health services increased from $8.4 million in 1980-81 to $102 million in 1986-87. One reason for the growth of county funds devoted to mental health services is changes in match requirements. In 1980-81, counties were required to provide a match for hospital services, while in 1986-87, counties were required to provide a match for both local programs and hospital services. Federal Medicaid funds have increased from $46 million to $86 million over the same period.

General Fund Appropriations for Local Programs. Chart 3 shows General Fund appropriations for local programs from 1980-81 through 1988-89, compared to 1980-81 appropriations adjusted for inflation and population growth.

The data indicate that General Fund appropriations have been considerably below 1980-81 appropriations adjusted for inflation and population growth. General Fund appropriations for local programs totaled $498 million in 1988-89. *If appropriations had been adjusted for inflation and population growth since 1980-81, the appropriation in 1988-89 would have been $630 million, or $132 million more.* Actual 1988-89 appropriations for local programs were 79 percent of adjusted 1980-81 appropriations.

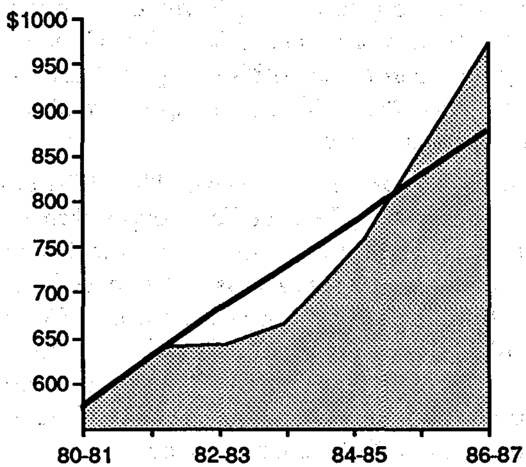
General Fund Appropriations for County Clients in State Hospitals. Chart 4 shows General Fund appropriations for county clients in state hospitals from 1980-81 through 1988-89, compared to 1980-81 appropriations adjusted for inflation and population growth.

Similar to General Fund appropriations for local programs, the data indicate that General Fund appropriations for county clients in state

Chart 1

Total Expenditures for Short-Doyle Mental Health Services

1980-81 through 1986-87 (dollars in millions)



Year	*Actual As a Percent of Adjusted*
1980-81	--
1981-82	101%
1982-83	95
1983-84	92
1984-85	96
1985-86	104
1986-87	111

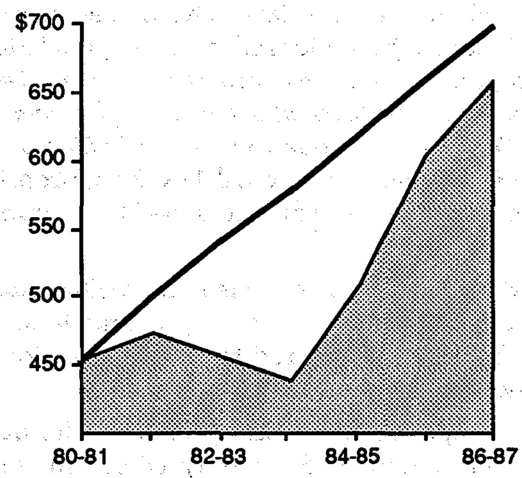
Actual expenditures

1980-81 expenditures adjusted for inflation and population growth

Chart 2

General Fund Expenditures for Short-Doyle Mental Health Services

1980-81 through 1986-87 (dollars in millions)



Year	*Actual As a Percent of Adjusted*
1980-81	--
1981-82	95%
1982-83	85
1983-84	76
1984-85	82
1985-86	92
1986-87	95

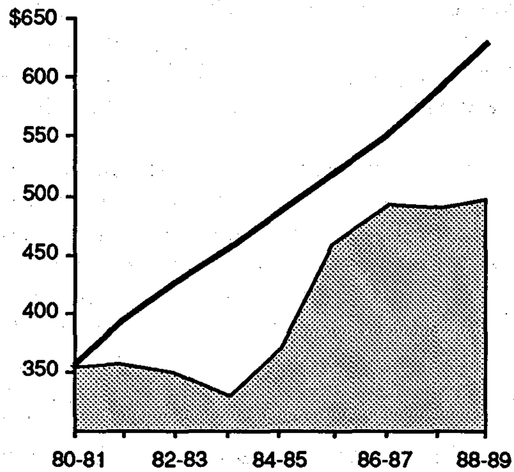
Actual expenditures

1980-81 expenditures adjusted for inflation and population growth

Chart 3

General Fund Appropriations for County Mental Health Programs

1980-81 through 1988-89 (dollars in millions)



Year	Actual As a Percent of Adjusted
1980-81	--
1981-82	91%
1982-83	82
1983-84	72
1984-85	77
1985-86	89
1986-87	90
1987-88 (Est.)	83
1988-89 (Prop.)	79

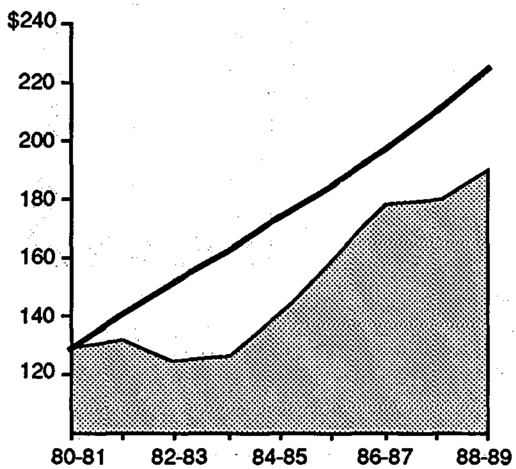
Actual appropriations

1980-81 appropriations adjusted for inflation and population growth

Chart 4

General Fund Appropriations for County Clients in State Hospitals

1980-81 through 1988-89 (dollars in millions)



Year	Actual As a Percent of Adjusted
1980-81	--
1981-82	94%
1982-83	82
1983-84	78
1984-85	82
1985-86	86
1986-87	91
1987-88 (Est.)	86
1988-89 (Prop.)	85

Actual appropriations

1980-81 appropriations adjusted for inflation and population growth hospitals have been below 1980-81 appropriations adjusted for inflation and population growth. General Fund appropriations for county clients in state hospitals were $191 million in 1988-89. *If appropriations had been adjusted for inflation and population growth since 1980-81, the appropriation in 1988-89 would have been $225 million, or $34 million more.*

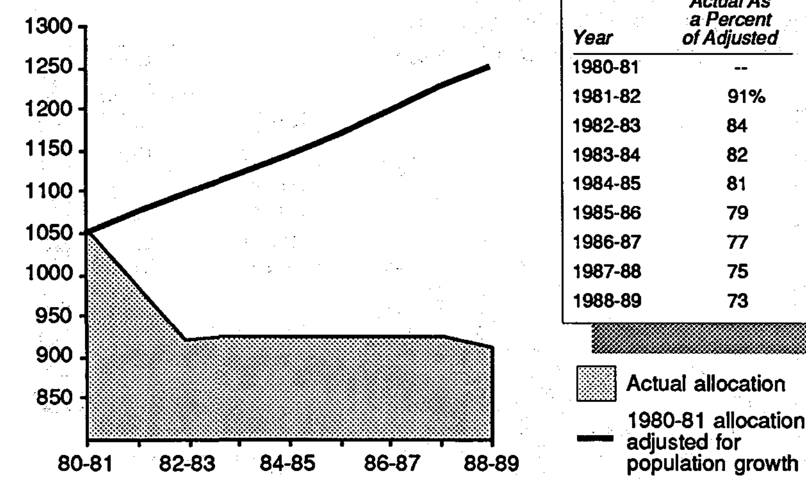
The General Fund appropriation for county clients in state hospitals has not lagged as far behind the adjusted 1980-81 appropriation as the General Fund appropriation for local programs. In 1988-89 the appropriation for county clients in state hospitals was 85 percent of the adjusted 1980-81 appropriation.

State Hospital Bed-Days. Chart 5 shows actual state hospital bed-days allocated for county clients since 1980-81, and the number adjusted annually for growth in the state's population. These data indicate that the number of state hospital bed-days for county clients declined sharply in 1981-82 and 1982-83, and have remained relatively constant since then. The sharp decline was due to agreements in which some counties reduced their use of state hospital bed-days in exchange for additional local assistance funds. State hospital bed-days have remained relatively constant since 1982-83 due to budgetary controls. Specifically, the state, through the Budget Act and administrative actions, has encouraged

Chart 5

State Hospital Bed-Days Allocated to County Clients

1980-81 through 1988-89 (bed-days in thousands)



Year	Actual As a Percent of Adjusted
1980-81	--
1981-82	91%
1982-83	84
1983-84	82
1984-85	81
1985-86	79
1986-87	77
1987-88	75
1988-89	73

counties not to use more than the number of state hospital days allocated to them. Counties that exceed their allocations of state hospital days risk having to pay for the excess use themselves.

State hospital bed-days have remained constant during a period of rapid cost increases (shown in Chart 4). The increased costs are due primarily to adding treatment positions in the state hospitals in order to achieve accreditation from the Joint Commission on the Accreditation of Hospitals.

Conclusions. Our review of these data indicates that:

- Total expenditures in 1986-87 exceeded 1980-81 expenditures adjusted for inflation and population growth. Our review indicates that these expenditures have kept up with population growth and inflation primarily because county and federal Medicaid funding have grown.
- General Fund expenditures have lagged behind adjusted expenditures since 1980-81 in every year for which data are available.
- General Fund appropriations in 1988-89 for both county programs and county clients in state hospitals were lower than 1980-81 appropriations adjusted for inflation and population growth.
- Although appropriations for county clients in state hospitals have gone up, the number of bed-days allocated to counties have declined. The decrease in bed-days is due to state policies encouraging the use of community programs instead of state hospitals. The appropriations have increased due to enhancing the number of treatment positions in order to meet accreditation standards.

Our conclusions regarding whether the Short-Doyle mental health system is underfunded relative to previous years and the level of underfunding is limited by the difficulty of determining an appropriate base year.

There are no data available that allow the Legislature to review whether counties use the funding allocated to them in the most efficient and effective manner. Although the DMH collects data from counties on the types of services provided, the number of persons served, and the costs of specific services provided, the data are not comparable between counties and the information does not measure the effectiveness of treatment provided to the mentally ill.

Access to Mental Health Services

In our examination of Short-Doyle mental health services, we attempted to evaluate "access" to mental health services. By this, we generally mean the availability of services to meet needs. Based on our visits to various counties over a period of several years, we conclude that there are significant problems with access to mental health services in some areas. For example, we observed overcrowding in psychiatric emergency room waiting areas resulting from a lack of available beds for placement of patients. According to mental health providers, the lack of beds has also resulted in releasing many patients without sufficient treatment to prevent additional episodes.

The situation appears to be getting worse; in the current year, due to budget constraints, the counties of Monterey, El Dorado, and San Diego all implemented significant cutbacks in the amount of outpatient service they would be able to provide. In addition, all counties that we visited reported increased waiting times for services. For example, waits of four to six weeks for outpatient services are not uncommon. These lengthy waiting times can potentially discourage individuals needing mental health services from seeking services. They can also increase county costs. This is because without services, some individuals' crises may be exacerbated to the point that they require more costly inpatient services.

How Has the Legislature Responded to Concerns About Local Mental Health Services?

In the past, the Legislature has utilized two strategies for enhancing Short-Doyle mental health services given the constraints of inadequate data: establishing categorical programs and pilot programs.

Categorical Programs. Categorical programs target services and funding to specific mentally ill populations, such as children. The majority of categorical programs were developed and funded in 1985-86. The largest categorical program is a $20 million program for treatment and support services for homeless mentally ill persons.

Categorical programs are attractive because they target specific populations with specific levels of funding. However, categorical programs also have the effect of preempting county responsibility for identifying treatment and funding priorities as required by the Short-Doyle Act. In doing so, *categorical program funding has contributed to the fragmented nature of the mental health system.*

Pilot Programs. Chapter 982, Statutes of 1988 (AB 3777, Wright), established two four-year pilot programs to test how communities can more effectively and economically coordinate a comprehensive array of services for the seriously mentally ill. The pilot programs are designed to provide more structure and accountability in the provision of mental health treatment and support services.

As part of the pilot programs, the state and contractors are developing methods for measuring client outcomes, services, and costs. The development of these methods should assist the Legislature in answering some of the unanswered questions about the adequacy of services provided to individuals, and whether services can be targeted or managed more effectively. However, the lessons from the pilot programs may not apply to other communities if they have a different mix of currently available services. Moreover, it could take up to six years before definitive conclusions may be reached regarding the statewide feasibility of expanding the pilot.

What Other Options Does the Legislature Have for Restructuring the Short-Doyle System?

Categorical programs and pilot programs are two approaches the Legislature has used in the past for improving the Short-Doyle mental health system. The Legislature has a number of other options for restructuring the system as well. These options include:

- ***Existing system with funding increases and, possibly, improved county accountability.*** Under this approach, the current system would remain intact but counties would receive consistent funding increases to account for population growth and inflation. In conjunction with funding increases, the Legislature could also impose standards and data collection requirements on county mental health services in order to measure access to and costs of services. Also in conjunction with funding increases, the Legislature could make the system less fragmented by giving counties responsibility for all services affecting county clients—including IMD services and services that are currently mandated through categorical programs. This approach is likely to be the least expensive of the three, depending on the level of funding provided. It would not address "unmet need" in the same way that an entitlement program would.
- ***A case management entitlement system***, similar to the Department of Developmental Services regional center system. Like the Medi-Cal model, the state would issue regulations, establish a benefit package, and provide funding based on caseload and cost increases. This approach, however, would require that a case manager be assigned to each individual entering the system to ensure that the individual (1) has access to all treatment and services necessary and (2) is utilizing the services according to a comprehensive treatment and support services plan. Counties or regional entities and private providers would supply case management, treatment, and services. The costs of this system would depend on the package of services offered and the number of eligible clients. This system is likely to be very expensive. In addition, this approach would limit the Legislature's fiscal flexibility in the annual budget process.
- ***An open-ended entitlement system***, similar to the Medi-Cal program. The state would establish a specified set of benefits to all persons meeting eligibility criteria, and fund the system based on caseload and cost increases. Counties would determine eligibility and

could provide services as well. Depending on the eligibility criteria and information system established, this system could potentially address the problems of unmet need and accountability. We have no basis for estimating the fiscal impact of providing services under this option, as this would depend on the benefit package provided and how many persons utilize the services. However, this option is also likely to be very expensive because it allows service utilization with little control once an individual is determined eligible for services. In so doing, it also would limit the Legislature's fiscal flexibility.

In our view, whatever approach the Legislature wishes to take, *it must first decide the following*:

- What level of control should the state exert over county mental health programs and expenditures? For example, should the state attempt to ensure statewide consistency in access to mental health services?
- Who should bear the costs of providing mental health services?
- How much is the state willing to pay for mental health services?

Placement Options for Youthful Offenders

How Can the State and Counties Provide Services to Youthful Offenders in a More Cost-Effective and Beneficial Way?

Summary

- *In the current year, the average daily population of youths who have been removed from home under the authority of the juvenile court and placed in county facilities, foster care, or the Department of the Youth Authority will be about 23,600.*
- *Although juvenile arrest rates and the juvenile population have been declining over the past five years, the number of juveniles placed in these facilities has grown dramatically. This increase is due to both increasing admissions and longer stays. As a result, California has the highest juvenile custody rate of any state in the nation for county and state facilities combined.*
- *Probation departments and the juvenile courts have rather limited options for the treatment of wards. The majority of wards either stay at home with limited supervision by probation departments, or they are removed from home and placed in 24-hour care facilities.*
- *The current funding arrangements provide fiscal incentives for counties to place wards in particular facilities based on the state and county* ***share*** *of costs, rather than on the treatment needs of the ward and the* ***total*** *cost of the placement.*
- *The Legislature can address these problems through development of treatment alternatives (such as placement prevention services, special foster family homes, and day treatment programs), and changes in the existing funding arrangements for treatment services.*

According to the U.S. Department of Justice, California has the highest juvenile custody rate in the nation. As a result, the state and counties pay almost $600 million a year to place youthful offenders in various 24-hour facilities (camps, juvenile halls, institutions, and foster care arrangements). It may be, however, that alternative placement options could be made available, which could improve services to these offenders and provide incentives for more cost-effective care.

In this analysis we first discuss the characteristics of youthful offenders and the treatment options available to them in the juvenile justice system at the local and state levels. We then examine the pressures that lead counties to rely on state support for the juvenile justice system. Finally, we outline several options the Legislature may wish to consider to help counties address the needs of juveniles and to reduce the costs to the state.

THE JUVENILE JUSTICE SYSTEM

Minors who become wards of the court include both "status offenders" (such as truants, runaways, or "incorrigibles"), who engage in activities that are prohibited for juveniles only, as well as youths who have violated laws that also apply to adults. Generally, youths who fall into either of these categories are between the ages of 8 and 18. Once a youth has been detained and made a ward of the juvenile court, a determination is made by the court, upon the recommendation of the probation department, as to the treatment needs of the person. The ultimate goal is to provide the ward with the treatment necessary to enable the ward to function in society and avoid a return to the juvenile or criminal justice systems. Generally, the treatment of choice is to maintain the ward at home. If however, the court determines that a specific type of placement outside of the ward's home is necessary, the probation department is required to place the ward in the least restrictive and most family-like setting available.

For wards in out-of-home placement, the probation departments are charged with the additional responsibility of reunifying the ward with his or her family or preparing the ward for independent living. The decision to attempt family reunification depends on the age and abilities of the ward, as well as the stability of the family.

Placement Options

When dealing with youthful offenders, probation departments have a choice of offering a youth "informal probation," which does not involve a court decision or bringing a youth before the juvenile court for a determination regarding treatment. Chart 1 shows that about one-quarter of all juveniles appearing in court are either placed on informal probation or are dismissed by the court.

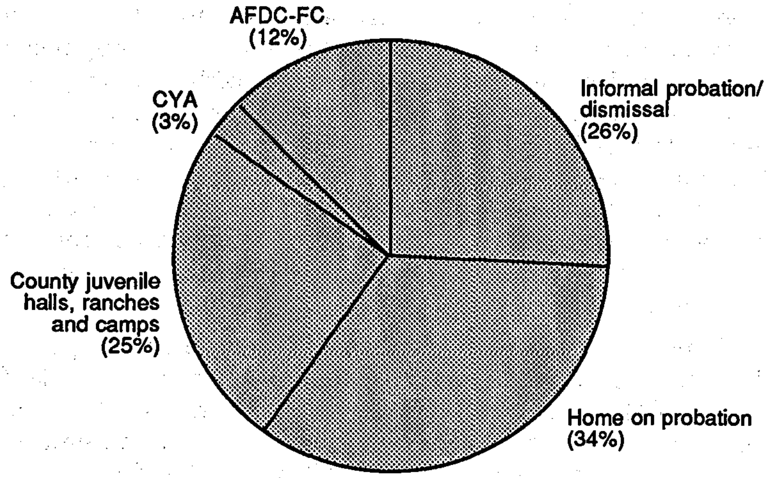
In general, counties have four basic choices for the treatment of those youths whom the juvenile court declares as wards.

Placement Back at Home. In about one-third of juvenile cases, a ward is placed on probation at home. While on probation, he or she may be periodically contacted by probation officers and may receive court-ordered services (such as counseling) or be required to perform community service. This option is generally for the youngest, least serious offenders with little or no history of delinquent behavior. Frequently, these wards will have spent some short amount of time waiting in juvenile hall for a hearing and disposition of their case. In the remaining cases, the ward is removed from home and one of the following "out-of-home" placements is made.

Chart 1

Dispositions of Juvenile Offenders

November 1987



Commitment to a Juvenile Hall, Ranch, or Camp. In about a fourth of all cases, wards are committed to a county facility. All counties are required by law to operate juvenile halls or contract for bed space in the hall of a neighboring county. Juvenile halls are locked facilities that are normally used for short-term detention of about two to three days prior to a hearing, and for commitments of around 30 to 60 days. Because juvenile halls are intended to be short-term placements, the treatment services that are available usually are oriented to crisis intervention. Services usually include some type of mental health counseling, drug and alcohol programs, and suicide prevention. A ward is expected to attend school at the hall. According to a recent Youth Authority study, the average length-of-stay in a juvenile hall is 19 days.

County ranches and camps are used for longer-term placements —about five months on average—for the most serious offenders that a county serves at the local level. Ranches and camps frequently are not locked facilities but are located at some distance from the community. Currently, 19 counties operate ranches or camps. These facilities provide education and some vocational services, as well as treatment programs including drug and alcohol counseling and family counseling.

Foster Care Placements. In about 12 percent of the juvenile court decisions, wards are placed in foster care under the Aid to Families with Dependent Children-Foster Care program (AFDC-FC). These are usually group homes, which can range in size from six beds to over 100 beds, but some placements are also made in family homes (less than six beds). The group home placements mostly are used for the sociological, psychological, or psychiatric treatment of the ward. The group homes are *not* locked facilities and are usually located within a neighborhood setting, rather than in a more remote location as are ranches and camps. As with the other placement options, education is required for all wards age 18 or under. Treatment programs in various group homes usually last from 12 to 18 months. They tend to provide a spectrum of services, from individual and group counseling to psychiatric attention and medication. The variety of services offered to a ward is often greater than in placements in a county facility.

Commitments to the Youth Authority. In only about 3 percent of juvenile court dispositions are wards committed to the California Youth Authority (CYA). Many local officials consider the CYA to be the placement of last resort for juvenile court wards. Two-thirds of the juveniles who are committed to the CYA for the first time have previously been in placement somewhere else in the juvenile justice system. The CYA is the most secure setting available for a ward and also has the longest length-of-stay—an average of 20.5 months. The wards in the CYA receive educational and vocational training based on their age and abilities. Specialized counseling programs are available to a limited number of wards committed for certain types of offenses or having particular problems. Wards in placement in the CYA have service needs that range from remedial education to psychiatric treatment. CYA wards are older on average than wards in other placements, and generally have had a more extensive and/or more serious record of delinquent behavior than other wards.

Characteristics of Wards in Out-of-Home Placement

Table 1 shows selected characteristics of wards in out-of-home placements within the state's juvenile justice system. The data show that most of the wards who have been removed from home are in their mid to late teenage years, have had previous contact with the juvenile justice system, and have been in placement before. The table also shows that juveniles are involved most frequently in property crimes, and that drug- and alcohol-related offenses are also prevalent. Juveniles who committed violent crimes are represented in larger proportions as the security of the placement increases.

Table 1
Characteristics of Juvenile Court Wards by Type of Out-of-Home Placement
1987

		County Facilities		CYA
	AFDC-FC	Juvenile Halls	Ranches and Camps	First Commitments
Average age (years)	15.0	16.1	15.7	17.2
Ethnicity:				
White	55%	34%	26%	28%
Black	25	30	36	36
Hispanic	16	32	34	31
Asian	2	4	4	1
Other	2	—[a]	—[a]	4
Sex:				
Male	63%	—[a]	93%	95%
Female	37	—[a]	7	5
Education (average grade level)	—[a]	—[a]	9.0	6.7
Primary commitment offense:				
Violent	8%	—[b]	22%	36%
Property	53	—[b]	33	44
Drug/alcohol	39	—[b]	16	14
Other (includes probation violation)	—[a]	—[b]	29[c]	6
Length-of-stay (months)	15.1	0.6	4.8	20.5
One or more prior offenses	—[a]	77%	71%	87%
One or more prior out-of-home placements	68%	—[a]	48	69

[a] Data not available.
[b] Included in "Ranches and Camps" population.
[c] According to the CYA Local Needs Assessment Study, 18 percent of camp population consists of probation violators.

According to information provided by several county probation departments to the Health and Welfare Agency's Out-of-Home Care Task Force, wards of the court tend to have many common characteristics. These include substance abuse problems, emotional/psychological problems, undeveloped social skills, learning disorders, average to low IQ, poor school attendance, a history of running away, parents with emotional or drug and alcohol problems, and parents who are neglectful and unable to provide adequate care and control for the minor.

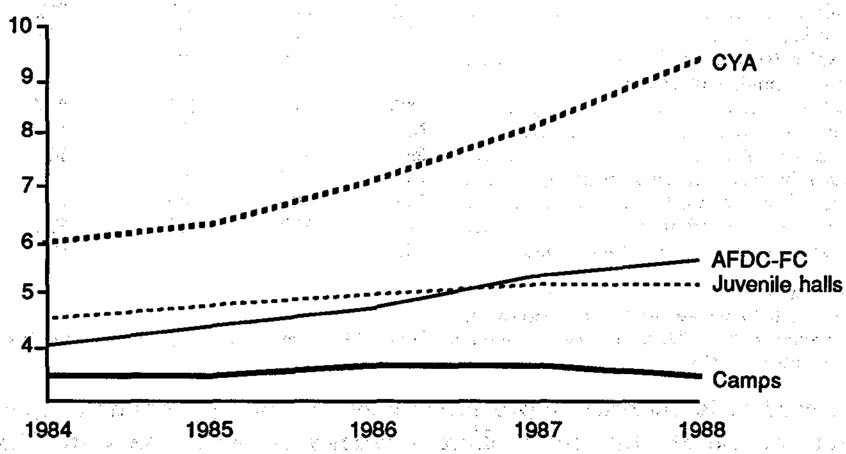
Also, it is not uncommon for a ward at one time to have been a "dependent" of the court due to parental abuse, neglect, or exploitation. In fact, information gathered by the Out-of-Home Care Task Force and our own interviews indicates that wards tend to be similar to dependents of the court with regard to their psychological health, educational achievements, and family situations. These similarities are important to be aware of in determining the needs and providing for the treatment of wards.

The Number of Wards Placed in Facilities

Chart 2 illustrates the average daily population between 1984 and 1988 for each of the out-of-home placement options, with the county commitments broken out between juvenile halls and camps/ranches. The chart shows that juvenile hall populations have increased slightly during that time, while the camp population has been relatively stable. The AFDC-FC population, however, has increased by about 38 percent. The CYA population also has increased steadily over the period, growing by about 58 percent.

Chart 2

Average Daily Population of Juvenile Facilities
1984 through 1988 (in thousands)



The figures mentioned above regarding placement decisions and the information in Chart 2 demonstrate how important length-of-stay is in determining the average daily population of a program. Although commitments to the CYA occur very infrequently compared to other placements (3 percent), the population of the CYA is much higher. This is due to the length of time a ward stays in CYA facilities (an average of 20.5 months). The average length-of-stay in a CYA institution has increased by 5.7 months, or 39 percent, since 1982-83. The same point can be made about AFDC-FC placements. Since 1983, the average length-of-stay in foster care has grown by about 18 percent.

The increasing length-of-stay is a result of policy decisions regarding how to address juvenile delinquency, rather than a result of an increase in the number or seriousness of juvenile crimes. For example, the juvenile arrest *rate* has declined by nearly 12 percent since 1980, according to information prepared by the CYA. More specifically, the rate of felony arrests of juveniles has declined by about 18 percent, while the rate for misdemeanors has declined 8.4 percent. The *number* of arrests also has declined over the same period, as arrests for violent crimes have decreased 27 percent, and arrests for property crimes have decreased by 29 percent. These decreases in arrest rates and the number of arrests are in direct contrast to the growing population and the increasing length-of- stay in juvenile facilities. According to a recent CYA study, *there is no correlation between juvenile arrest rates and juvenile incarceration rates.* Instead, the rate of incarceration in a particular county is dependent on the policies of that county regarding the use of custody as a treatment for youthful offenders.

The Cost of Providing Out-of-Home Placements

Table 2 shows our estimate of the average daily and annual cost of treating wards under the out-of-home placement options. We estimate that in the current year the state, counties, and federal government will spend over $600 million in California to maintain the youthful offenders who are placed outside of their homes in state, county, or private facilities. The table shows that counties provide most of the funding for juvenile halls and camps, while the state provides most of the funding for the AFDC-FC program and the CYA. The General Fund will provide about $373 million, primarily for wards in AFDC-FC placement and in the CYA. The counties will provide about $210 million for wards placed in county facilities as well as for the county shares of the AFDC-FC and CYA placements. The federal government provides funding only for the

Table 2
Placement Costs in the Juvenile Justice System
1988-89
(dollars in millions)[a,b]

	County Facilities		*AFDC-FC*			
	Juvenile Halls	*Ranches and Camps*	*Family Homes*	*Group Homes*	*Youth Authority*	*Totals*
Average Daily Population	5,148	3,467	714	4,907	9,400[c]	23,636
Average Daily Cost	$77	$56	$15	$84	$67	$69
Annual Funding:						
General Fund	—	$14.6[d]	$3.2	$126.5	$229.1	$373.4
County Funds	$144.3	56.2	0.2	6.5	2.4	209.6
Federal Funds	—	—	0.5	18.8	—	19.3
Totals	$144.3	$70.8	$3.9	$151.8	$231.5	$602.3

[a] Costs in table do not include overhead costs associated with county or state departments.
[b] "Average Daily Cost" in actual dollars, not in millions.
[c] Includes 1,110 juveniles convicted in criminal court, and sentenced to the the Department of Corrections but housed in the Youth Authority.
[d] County Justice System Subvention.
Sources: LAO estimates based on information provided by the Youth Authority, the Department of Social Services, and county probation departments.

AFDC-FC program (about $19 million). All of these cost figures *understate* the full costs of these programs because they do not include administrative or overhead costs that are associated with the state or county departments that administer these programs. A comparison of the full costs of the programs was not possible due to the unavailability of data for several of the placement options.

Table 2 also shows the wide variance in the cost per day per ward for these out-of-home placements. The AFDC-FC program has both the lowest daily cost option—$15 per day in a foster *family* home—and the highest daily cost option—almost $84 per day in a *group* home. The relatively low per ward cost in the CYA is due to the fact that its population is at 150 percent of the institutions' capacities. Based on cost data provided by the department, the average cost per ward would be about $82 per day if the department were operating at about 100 percent capacity.

SYSTEM DEFICIENCIES

Our review of the placement process for juvenile offenders indicates that the juvenile justice system suffers from two basic problems. First, probation departments and the juvenile court have rather limited options regarding the treatment of wards of the court. Second, the manner in which the state and counties fund these options provides fiscal incentives for the counties to place wards in particular facilities.

Treatment Options Are Limited

Our review of the current system of services provided to youthful offenders indicates that it is polarized between providing little or no service to wards at home and providing intensive services in a residential setting—that is, the 24-hour care provided by all of the out-of-home placement options. Generally, there is not a continuum of services available to match the variations among wards. According to many juvenile justice professionals, a continuum of services would better serve the goal of preventing the removal of wards from their homes. For example, during our interviews several juvenile court judges expressed the belief that they often must remove a ward from home for placement in a residential program because there are no nonresidential treatment options available, rather than because that is the most appropriate treatment for the ward. This situation may account for the unusually high proportion of wards removed from home. Specifically, according to the U.S. Department of Justice, California's admissions to juvenile facilities account for 25 percent of admissions *nationwide*, although the state has only about 10 percent of the nation's juvenile population.

Table 3 shows a continuum of services—from preplacement services to intensive parole supervision—that probation departments indicate would be desirable to provide to wards. These services, however, are not generally available in most counties. If they were, it is likely that some of the wards who are removed from home and placed in residential care instead could be maintained less expensively at home.

Table 3
Treatment Services Not Generally Available to Juvenile Court Wards

Service	*Purpose*	*Wards Eligible*
Placement prevention	Provide supervision and diversion programs in order to avoid removal from home.	Less serious offenders with stable families.
Day Treatment	Provide education and training during the day to wards who otherwise would have to be placed out-of-home.	Nonviolent wards with stable families who need a structured program but not residential care.
Mental Health Residential Facilities	Diagnosis, stabilization, and psychological/psychiatric treatment.	Mentally disturbed or emotionally disabled wards who cannot be maintained at home.
Secure Treatment Facilities	Secure setting for treatment instead of custody.	Runaways and violent or self-destructive wards who need close supervision.
Emancipation Programs	Provide job training and life skills to prepare wards to live independently.	Wards on or nearing parole who will not be reunified with their families.
Intensive Parole Supervision	Provide extra supervision in order to encourage good behavior and avoid re-incarceration.	Wards on parole who are at-risk of parole revocation.

Thus, the provision of a broader range of services to wards has the potential of improving the treatment services provided to wards (by better targeting treatments to individual needs) and saving money (by substituting less expensive nonresidential care for out-of-home placements). Currently, however, there are no incentives to develop a diversity of programs and services. Within the existing structure of state-supported residential programs, there is little flexibility for counties to develop specific programs for wards who have specialized treatment needs. Moreover, most counties have relatively limited discretionary income available to pay for these or other services.

The lack of treatment options also results in other negative consequences for the juvenile justice system:

High Level of Out-of-County Placements. According to various probation officials we interviewed, a shortage of service and treatment options within a county often leads to out-of-county placements, especially in the foster care system. If a county does not have a program for particular types of wards within its boundaries, probation departments will make efforts to place the ward wherever an appropriate program exists. This could mean placement in the next county, across the state, or even out of state. Table 4 shows the number of wards placed in foster care both in and out of their county of residence in a sample of 10 counties. It indicates, for instance, that in March 1988 Sacramento County placed 80 of its wards within the county and 74 outside of its boundaries, while accepting 190 placements from other counties.

Table 4
Location of Ward Placements in Foster Care for 10 Selected Counties
March 1988

County	*Placements of County Residents: In County of Residence*	*Placements of County Residents: Out-of-County*	*Placements of Other Counties' Residents*
Alameda	39	323	67
Contra Costa	37	140	62
Imperial	1	25	2
Los Angeles	834	245	219
Riverside	74	132	215
Sacramento	80	74	190
San Bernardino	138	236	225
San Mateo	12	65	13
Stanislaus	29	71	62
Ventura	29	14	28
Statewide	2,139	2,922 [a]	2,552 [a]

[a] Statewide totals for wards placed out-of-county do not equal those placed from other counties because the location of some wards was not available. Also, "Out-of-County" includes 167 wards placed out-of-state.

Although out-of-county placements sometimes may offer the most appropriate program for a ward, they also present several problems for the placing counties and for the wards. First, the cost to place a ward outside his or her county of residence is higher to the placing county, due to additional transportation costs and staff time involved with visits to the ward. In addition, efforts to reunify the family are hindered by out-of-county placements, as visits with family and family treatment are more difficult when the ward is placed far from home. Also, paroling a ward back into the community is made more difficult as the ward has been removed from the community's educational and employment resources.

Overcrowding Juvenile Halls. A lack of placement options has also contributed to overcrowding of county juvenile halls. Table 5 illustrates the magnitude of the overcrowding problem experienced by those seven counties with the highest incidence of overcrowding.

Table 5
Overcrowding in Juvenile Halls
January 1987 through December 1987

		Degree of Overcrowding[b]	
County[a]	*Total Days of Overcrowding*	*Number of Juveniles*	*Percentage*
Imperial	185	13	43.3%
Kern	281	91	65.9
Los Angeles:			
Central Juvenile Hall	365	344	63.8
Los Padrinos Hall	365	192	47.9
San Fernando Hall	365	155	56.0
Madera	79	11	36.7
Riverside:			
Juvenile Hall	346	51	32.5
Indio Hall	222	22	44.0
San Diego	356	151	68.9
Tulare	190	22	36.7

[a] Counties with highest incidence of overcrowding.
[b] Shows the largest number of juveniles by which any daily population exceeded the hall capacity and the percent by which capacity was exceeded.

Overcrowding of juvenile halls is the result of two main factors. First, there is a large number of wards *waiting* for placement in another facility. According to the CYA's Statewide Needs Assessment study, 27 percent of the wards currently in juvenile halls are waiting placement in either a foster care placement (14 percent), another county facility (10 percent), or the CYA (3 percent). Although specific data are not available, many county officials have indicated that the length of time a ward spends waiting for placement has been increasing steadily over the past few years as the number of wards incarcerated has increased.

Second, there have been increases in the number of wards *committed* to juvenile halls for terms of about 30 to 90 days. The problem with this situation is that commitments to the juvenile halls generally conflict with the original intent and design for the halls as very short-term "holding tanks." The amount of space, the construction of the facilities, and the programs in place in many juvenile halls typically are not suited for wards to stay for any extended period of time. Because of the lack of placement alternatives, however, juvenile halls are being pressed into a service for which they usually are not equipped.

According to probation department staff, juvenile court judges, and the CYA's study, juvenile halls often are used as a placement option because of the limited space available in the treatment programs. Counties are required by law to operate juvenile halls or contract for bed space in a juvenile hall. This expense is fully funded by the counties. Some county officials we interviewed suggest that once a county pays for the operation of a juvenile hall, there are often few resources left to probation departments for funding "discretionary" programs.

Counties Have Incentives to Use State-Funded Programs

Under the current funding arrangements, the state pays most of the costs of AFDC-FC and CYA placements, and the counties pay most of the costs of placements in county facilities. More specifically:

- ***AFDC-FC Program.*** The state pays 95 percent (with the counties paying the remaining 5 percent) of wards' placement costs in about three-fourths of all foster care placements. In the remaining cases, usually involving wards from low-income families, the federal government pays for 50 percent of the placement costs, the state 47.5 percent, and the counties 2.5 percent.
- ***CYA.*** Commitments to the CYA are funded almost entirely by the state, although the counties reimburse the state $25 per month per ward (about 1 percent of the cost).
- ***County Facilities.*** The counties currently provide virtually all the support for county camps, ranches, and other local programs that are alternatives to AFDC-FC and the CYA. The Governor's Budget proposes to *eliminate* the $37 million that currently is provided by the state for support of local programs and facilities.

This funding arrangement creates fiscal incentives for counties to rely on state-funded programs, rather than their own local programs and facilities. For example, these incentives may explain why admissions of wards to the AFDC-FC programs increased 43 percent from 1984 to 1988, while during this same period juvenile hall and camp populations increased an average of 10 percent. Another, rather unusual example of the counties turning to state-funded programs is the recent conversion of two county camps into AFDC-FC group homes. As a result of this conversion, these camps—which were previously funded entirely by the counties—are now funded almost entirely by the state.

Although the incentives are for counties to place wards in the more expensive state-funded programs, these placements may not necessarily meet the needs of the ward. For instance, a *less intensive* program than is provided at the CYA may be adequate for some wards charged with property crimes.

By funding the largest share of the most expensive residential programs, and only residential programs, the state is providing fiscal incentives for counties to place wards in state-supported residential care even when some wards could be maintained in less expensive county facilities or nonresidential programs. In other words, counties have no fiscal incentives to control these costs or to seek alternatives to these state-funded out-of-home placements. Conversely, by not sharing in the cost of local programs and placement facilities, the state strengthens the incentive for counties to use foster care and the CYA instead of county programs and facilities.

LEGISLATIVE OPTIONS FOR PROVIDING MORE COST-EFFECTIVE AND BENEFICIAL SERVICES TO JUVENILE OFFENDERS

In our judgment, the Legislature could create incentives for counties to develop a continuum of local placement and treatment options for wards of the juvenile court and also eliminate any fiscal incentives that counties have to place wards inappropriately in state-supported residential care.

In this section we offer several options—grouped under the categories of "AFDC-Foster Care" and the "County Justice System Subvention Program"—for the Legislature to consider as a means to accomplish these ends. Although many of the problems we have discussed and the options we are presenting apply to children who are *dependents* of the juvenile court as well as to youths who are *wards* of the court, we have focused this analysis only on wards because of the cross-cutting issues involved by their placement in the foster care system and CYA, as well as in county operated facilities.

A. AFDC-Foster Care

We estimate that the state will spend almost $127 million from the General Fund in the current year for an average daily population of about 4,900 wards in group homes in the AFDC-FC program. The state has a great fiscal incentive to find alternatives to the current level of use of foster care. By developing a continuum of alternative services for wards and eliminating or lessening the fiscal incentives that counties have to rely on state-supported residential care, *the Legislature can provide for more appropriate services to wards while controlling state costs for the AFDC-FC program.*

Development of Alternatives to Group Home Placements

The Department of Social Services is currently administering a pilot project authorized by Ch 105/88 (AB 558—Hannigan) for juvenile court *dependents*. The program provides state funds for services to dependents placed at home as an alternative to foster care, while at the same time increasing the counties' incentives to use successful alternatives.

Given the high level of use of the foster care program by *wards*, a pilot program of this type for juvenile offenders might be useful. If the Legislature chose to provide a similar program for wards, it would require an investment of General Fund money to provide services specifically to wards who otherwise would be placed in a foster care group home. To the extent that the programs were successful, however, the General Fund could realize savings from the first day of the program's operation. (This assumes that the services precluded the need for a foster care placement and were less expensive than foster care group homes.) If the cost of the alternatives were the same as the cost of foster care, the pilot program would have no net impact on General Fund costs. On the other hand, if foster care caseloads were not reduced through the use of alternative services, the General Fund would incur higher costs without realizing any savings.

The counties, however, could be provided with incentives to use these alternatives if they shared some portion of the savings realized through the pilot projects. Because each county's juvenile court (typically relying heavily on probation department recommendations) would be making the placement decisions, counties could also share in the risk assumed by the state in funding these pilots. The counties could do so by providing some portion of the support for the pilots in the event that the projects did not result in reducing the state's costs for the foster care program.

Many local officials and program providers that we interviewed discussed specific programs that could be developed and funded through a pilot project. The following is a discussion of two of the more frequently mentioned alternative programs.

Enriched Foster Family Homes and Small Family Homes. Currently, the vast majority of wards placed in foster care are placed into group homes. Wards are placed in these facilities because of the ability of the staff to deal with the various problems associated with specific wards. There are, however, wards who are placed in foster family and small family homes. These facilities house no more than six minors at a time and the environment is more family-like than in a group home. Wards placed in foster family or small family homes usually do not receive the number and type of services as those wards in group homes. As noted above, these homes are reimbursed at a much lower rate than the group homes ($450 a month versus $2,500 a month).

If foster family homes were "enriched" to provide a higher level of service to the wards (for example, counseling and education assistance) and the foster parents (for example, respite care and special training), it is likely that some of the wards now in group homes could be maintained in foster family homes. For these enriched homes to provide a higher level of service than regular foster homes, they would either have to receive a higher rate of reimbursement, with the expectation that they would use these additional funds to purchase services, or they would have to receive additional services from the county or a private agency. However, in order for this option to result in a net reduction in General Fund costs, the costs of the additional services would have to be less than the difference between the existing group homes and family home rates. This should be possible because foster family and small family homes do not incur the staff and administrative costs incurred by group homes.

Nonresidential Placements. Another option for a pilot project would be to provide services on a *less than 24-hour basis.* These "nonresidential" placements currently are funded for a small number of wards by county probation departments when wards need a level of service that is higher than that provided by regular probation supervision and when the wards have families that are stable enough to maintain them at home. This option is generally known as "day treatment." The basic goal of day treatment programs is to keep a ward occupied with school, vocational education, counseling, or similar activities for eight to ten hours a day. The programs attempt to remove wards from undesirable pressure of peers and neighborhoods while providing services to wards and their families.

Elimination of the Counties' Incentives to Use State-Supported Residential Care

Under the juvenile justice system, counties are legally responsible for the care and supervision of wards of the court (unless they are placed in the CYA) and for making recommendations to the juvenile courts regarding the decisions for placement. Under the current funding arrangement, however, the counties making the placement recommendations do not have to take into consideration the true costs of the different options. For example, the *total* cost of county facilities and programs is much *less* than foster care group home placement, but the costs to the counties of these local options is much *greater* than the cost of foster care because the local facilities are funded almost entirely by the counties. Conversely, foster care placements are the *most* expensive placement options available, but are one of the *least* expensive options available to counties.

The fact that probation departments make placement recommendations without having to address the true cost of the placements creates the fiscal incentive for counties to place wards into foster care rather than in a county-funded program. Historically, the decision of the state to fund most of the foster care costs was based more on county financing issues, rather than on the issue of which ward placements should be preferred over others. The issue of what is the most appropriate treatment setting for wards has been overshadowed by fiscal choices.

In our judgment, a significant adjustment to the current cost sharing ratios is necessary to provide more rational incentives to counties in making placement decisions. In addressing the issue of fiscal incentives and cost sharing, the Legislature would have to carefully construct the share of cost borne by counties and the state to ensure that effective care was provided to wards in the most efficient manner.

B. County Justice System Subvention Program

The CYA's major local assistance program is the County Justice System Subvention Program (CJSSP). Through this program the Legislature encourages county probation departments to develop programs that are alternatives to CYA commitments. Below, we examine options to more effectively use these funds by developing local programs that will reduce the number of wards committed to the CYA or provide more cost-effective care.

Improved Targeting of CJSSP Funds

Under the CJSSP, the Legislature provides annual General Fund block grants to counties to assist in their funding of the juvenile justice system. In the current year, $67.3 million is budgeted for this purpose. The Governor's Budget for 1989-90 proposes to eliminate $37 million of this amount, and fund the remaining $30 million from the Restitution Fund. The $30 million appropriation would pay for a state-mandated local program involving specific incarceration practices for youthful offenders.

In the current year these funds are *supposed to* be used by the counties to develop and maintain: (1) programs designed to avoid commitment of persons to the Department of Corrections or the CYA; (2) programs for wards who are committed to a county facility; (3) programs for the prevention of delinquency by minors who are not currently wards of the court; (4) programs for home supervision and non-secure facilities and shelter care facilities for minors; and (5) necessary administrative expenses associated with the block grants. According to a study conducted in 1982, the funds provided through the CJSSP at that time did *not* result in the development of new programs or the expansion of existing programs designed to provide the services mentioned above. Instead, the major result was to provide funds needed for the continuation of existing levels of service for both juveniles and adults at the local level in light of the decline in county revenues brought on by Proposition 13. According to CYA staff, this situation remains the same today—the current CJSSP block grants provide funding for the basic services offered by county probation departments.

Despite the way CJSSP funds *have been* used, they *could be* better targeted to achieve one of their intended purposes of reducing CYA commitments. Funds provided to county probation departments or county facilities for local alternatives to the CYA could result in net savings to the state to the extent that: (1) the counties can maintain their current number of camp beds and do not have to rely on the CYA; (2) any new or expanded programs reduce the number of wards committed to the CYA; and (3) the total cost to the state per ward is less in the local programs than in the CYA.

Although the success of the local programs cannot be guaranteed, the Legislature could take steps to assure that CYA commitments are reduced or limited and that any funding provided does not simply result in an increase in the number of wards removed from home due to the availability of new program space. These steps could include (1) placing some limits on the number and/or type of wards committed to the CYA, and (2) increasing the counties' share of the cost of wards in the CYA to an amount over the currently required $25 per ward per month. This is the amount that was established by law in 1947 when the annual cost of a ward in the CYA was $1,900.

As noted earlier, the current cost of placing a ward in a county camp or ranch is about $11 per day, or $4,000 per year, *less than* in the CYA. Based on CYA cost data, this difference will grow to about $9,500 annually when and if the CYA realizes its goal of reducing overcrowding to 109 percent of capacity by 1992-93. Therefore, if it were deemed necessary to develop programs that were more intensive and more expensive than *existing* county camp programs in order to avoid CYA commitments, the Legislature could provide an amount that is substantially less than the CYA costs but still greater than county camp costs. The shorter length-of-stay in county facilities would also help keep down the total costs of such programs. Under these circumstances, the state would realize a net savings.

Development of Local Probation Programs Would Create a Continuum of Treatment Options

Targeted CJSSP funds also could be used to develop alternative programs. Many individuals and sources have recommended that the state and counties develop a complete continuum of services for wards in order to: (1) reduce delinquent behavior; (2) avoid removing wards from home when appropriate; and (3) reduce recidivism. This has been the subject of study for many organizations such as the CYA, county probation departments, and advocate groups. The following is a discussion of two programs recommended by juvenile justice professionals and other organizations and individuals who have an interest in attaining these goals.

Placement Prevention Services. Currently, most juvenile court decisions result in removal of wards from home. Increased intensive probation services such as counseling, vocational training, and parenting/family skills training could be used to maintain more wards at home. It is the opinion of the probation professionals that we interviewed that if these wards were given more intensive supervision while at home, many of them could avoid a subsequent return to court and removal from home. Placement prevention services are an alternative to placement in a county facility that could be funded through the CJSSP mechanism described above. These are also alternatives to placement in foster care and could potentially avoid eventual CYA commitment.

Independent Living and Parole Programs. The number of wards currently in placement who have been placed previously make up a substantial portion of the current out-of-home population. Table 1 shows that over two-thirds of the AFDC-FC placements and the CYA first commitments have experienced some type of out-of-home placement before. Also, 17 percent of the current CYA population is comprised of wards returned to the CYA institutions for parole violations.

Program providers and juvenile justice professionals indicate that this situation illustrates a need for stronger parole and probation programs at the state and county level. Independent living or "aftercare" programs could be developed to increase wards' chances of success after release from incarceration or placement. These programs could be funded in the same way as the AFDC-FC related options discussed earlier or as alternatives to incarceration in the CYA discussed above. Currently, there is about $2 million available from the federal Independent Living Program administered by the State Department of Social Services for these programs. The Legislature may wish to consider targeting these funds to address the needs of specific groups of delinquent youths. Funds spent on programs intended to improve wards' chances of success on parole would be a good investment to the extent that they reduced placement costs associated with wards who violate their parole and are returned to an institution or other placement facility.

Summary

The current methods of treating juvenile offenders are limited, and the current funding arrangements for out-of-home placements do not encourage cost-effective treatments. As a result, wards are not always provided with the best possible treatment, and the state and counties often pay more than is necessary. The Legislature, however, can provide incentives to the counties to use alternatives to the current system as a way of addressing both these concerns.

Trial Court Funding and County Finances

What Effect Will the Trial Court Funding Program Have On the Fiscal Condition of California's Counties?

Summary

- *The Trial Court Funding Program provides fiscal relief to counties by allowing them to use state funding to replace county general fund support for the courts. This frees up general fund revenues, which may be used either to augment court services or to increase funding for other county programs.*
- *Counties will receive $433 million in funding during the first full year of the program. However, the net increase in revenues available for general purposes will be only $400 million because counties are required to (1) forego previously existing state funding; and (2) shift revenues to "no- and low-" property tax cities.*
- *To the extent that counties use a portion of the "freed-up" general fund revenues to augment court services, less funding will be available to address county needs in other areas. Based on county /court agreements reported to date, it appears that **at least** 25 percent of the "freed-up" revenues, and probably more, will be used to increase court services, leaving **at most** 75 percent of the funding for other purposes.*
- *If 75 percent of the revenues "freed-up" by trial court funding were available for general purposes in 1989-90, counties would experience about a 3.5 percent increase in discretionary revenues. However, because the amount of funding provided does not necessarily reflect individual county fiscal conditions, some counties may still experience difficulties meeting service needs in the budget year.*
- *The assistance provided under the Trial Court Funding program could be offset to some extent by other proposals in the 1989-90 Governor's Budget that would have a negative impact on the fiscal condition of counties.*
- *In the long run, trial court funding is not likely to eliminate county fiscal problems because it does not address the basic structural problem faced by counties: limited growth in revenues and more-rapid cost increases in state-required programs.*
- *The counties' lack of fiscal control is likely to (1) limit their responsiveness to local service requirements; (2) exacerbate unmet needs in state-required programs such as health and corrections; (3) unduly influence land use decisions; and (4) hamper their ability to provide the infrastructure needed to accommodate California's growing population.*

In the final days of last session, the Legislature enacted the Brown-Presley Trial Court Funding Act (Ch 945/88). This act generally provides state funding for the trial courts in the form of block grants to counties for court judgeships, commissioners and referees. In addition, the act provides funding for municipal and justice court judges' salaries. The Legislature also enacted Chapter 944, Statutes of 1988, which provides state funding to implement the program during the second half of 1988-89.

The purpose of the Trial Court Funding Program (TCF) is twofold. First, the program seeks to enhance county trial court services by making available an increased level of funding for the Judiciary. Second, the measure attempts to provide some level of fiscal relief to counties by relieving them of a portion of their responsibility for funding trial court services.

In *The 1987-88 Budget: Perspectives and Issues* (please see p. 245), we described the increasing fiscal pressures counties have experienced since the passage of Proposition 13. We pointed out that levels of service in programs of state concern varied locally, and that there were unmet needs in many programs. The Trial Court Funding Program allows counties to substitute state funding for a portion of the local revenues currently used to support the courts, and to divert the local revenues to address unmet needs in other county programs. As such, trial court funding represents the most substantial fiscal relief measure provided to counties since 1979.

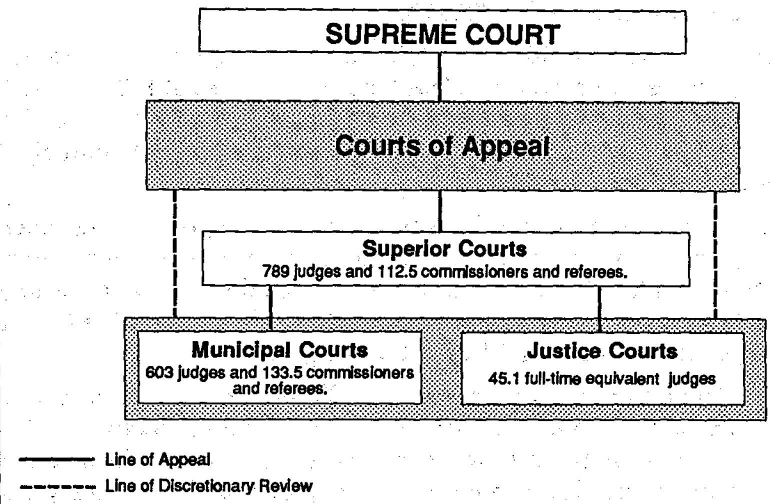
In this piece, we examine the potential effect of TCF on the fiscal condition of California's counties. We identify the magnitude of the relief counties are likely to receive from this measure, and assess the potential impact of these increased revenues on county fiscal conditions.

Background: The Trial Court Funding Program

The state's court system is defined in the California Constitution, and consists of four separate levels of jurisdiction, as shown in Chart 1. The Supreme Court and the courts of appeal comprise the appellate courts, and the superior courts, municipal courts, and justice courts comprise the state's trial court system. A portion of the trial court workload (for example, certain arbitration cases or minor violations) is processed by commissioners or referees, rather than judges.

Chart 1

California Court System[a]



[a] Source: Administrative Office of the Courts. Total number of judicial positions as of December 30, 1988, assuming full participation in Trial Court Funding.

Prior Funding Arrangements. Traditionally, the state has had the sole responsibility for funding the operations of the Supreme Court and the courts of appeal. Counties have funded most of the operations of the trial court system, using both court-generated revenues such as fees and fines and county general funds. Over the years, the state has provided assistance to counties for financing of the trial court system. Prior to the passage of TCF, this assistance consisted primarily of funding for a portion of superior court judges' salaries, an annual block grant for certain superior court judgeships, partial payment of certain health and retirement benefits, and payments to reimburse counties for state-mandated programs affecting the operation of the trial courts. In 1987-88, the state's involvement in the funding of local court operations totaled $107 million.

Description of the Trial Court Funding Program. The Brown-Presley Trial Court Funding Act substantially increases the state's support for the trial court system. This act provides funding, at county option, in the form of a block grant for each superior, municipal, and justice court judgeship, and for each superior and municipal court commissioner or referee.

The Judicial Council estimates that on average counties pay more than $500,000 per year for each judicial position, including the costs of court staff salaries, operating expenses, and county overhead. The block grant amount, $212,000 in 1988-89, roughly corresponds to these costs, *net* of the county share of court-related revenues (for example, traffic and parking violation fees). The grant will increase annually commensurate with the cost-of-living increases received by state employees in the prior year, beginning with a 6 percent adjustment for 1989-90. In the budget year, the block grant amount will be $224,720.

In addition, the act provides for block grants of higher amounts for specified judgeships authorized by Chapter 1211, Statutes of 1987 (SB 709, Lockyer). These payments will begin in 1989. The act also provides for the state to assume approximately 90 percent of the costs of municipal and justice court judges' salaries.

In order to receive these funds, counties must forego existing block grants for superior court judgeships. Counties also must waive reimbursement for state-mandated local programs for the trial courts, and for any state-mandated local program for which a claim had not been filed prior to the chapter date of the Trial Court Funding Act.

In addition to providing funding for TCF, Chapter 944 requires certain counties to shift a portion of their property tax revenues to cities which currently receive no share or a low share of these revenues. These cities generally are guaranteed a minimum of 7 percent of the property tax revenues within their boundaries. This shift in revenues from the counties to the cities will be phased in over a seven-year period, beginning in 1989-90. Cities in Mono and Ventura Counties will receive a smaller percentage, phased in over a shorter time period.

The Trial Court Funding Act includes two provisions that are designed to ensure that counties maintain or increase the level of funding devoted to the trial courts. First, the act requires counties to maintain the same level of annual funding appropriated for the courts in 1989-90, increased by a factor for inflation. Second, the act requires the superior and municipal court justices to sign the resolution of intent to participate in the program each year. The provision for judicial "sign-off" is designed to ensure that judges have a voice in the allocation of funds received under the program.

Impact on County Finances. The Trial Court Funding Program will affect county finances in two basic ways. First, counties can use TCF to *increase* the overall level of funding provided for trial courts in order to improve services, reduce backlogs, or address other outstanding needs. Second, counties can use the funding to *replace* county general fund support for the courts. For example, a county could replace up to $212,000 of its general fund support for each position with state funding, and use the "freed-up" general fund revenues for other county purposes. Similarly, counties could replace the general fund revenues currently used to pay municipal court and justice court judges' salaries with state funds, and divert the county funds for other purposes.

How Much Relief Will Counties Receive?

A total of 56 counties (all except Madera and Santa Barbara Counties) opted into TCF in 1988-89. The Department of Finance estimates that these counties will receive about $200 million for the first one-half year of funding. The Governor's Budget estimates that counties will receive $433 million under the Trial Court Funding program in 1989-90, assuming that all 58 counties participate. (As discussed in Item 0450 of the *Analysis* (please see p. 24), the Legislature will not know until March 1 how many counties will opt into the program for 1989-90.)

Our analysis indicates, however, that TCF will "free-up" about $400 million in county revenues, as shown in Chart 2. First, the requirement that counties forego judicial block grants and waive reimbursement for the costs of certain court-related mandates reduces the net benefits from the measure by approximately $26 million in 1989-90. Second, the required shift of property tax revenues to "no-and-low" property tax cities will reduce the benefits received by the 16 counties required to make this shift. While this shift in revenues is relatively minor in 1989-90 (probably less than $5 million), it will increase substantially over the phase-in period. We do not have sufficient information to determine the precise amount of revenue to be shifted from counties to cities, but we estimate that this amount will be in the range of $100 million by 1997-98.

Chart 2

Effect of Trial Court Funding on County General Fund Revenues

1989-90[a]

		Effect on Revenues in 1989-90 (dollars in millions)
+	State provides judicial block grants	$386
	State pays municipal and justice court judges' salaries	47
−	Counties relinquish existing judicial block grants	-14
	Counties waive reimbursement for court-related mandates	-12
	Sixteeen counties shift property tax revenues to "no-and-low" tax cities	Up to 5
=	Counties spend remainder on:	$400
	• Increased court expenditures	(At least 100)
	• Increased spending on other programs	(Up to 300)

[a] Source: Legislative Analyst estimates.

How Will Counties Use the Revenues "Freed-Up" By TCF? It is too early yet to determine the split of funding between increased court expenditures and other county programs. Because judicial "sign-off" is required to participate in the program, judges and county supervisors in each county are expected to come to a formal agreement over the allocation of revenues "freed-up" by TCF. Our review of county/court agreements reported by 27 counties suggests that there will be substantial variation in the amount of funding allocated for increased court expenditures versus other programs.

In a number of counties, the agreements provide for large increases in spending on the courts and court-related programs. For example, in 1989-90, Los Angeles County has agreed to provide $38 million (29 percent) of its net TCF monies to *increase* trial court services, and an additional $45 million (35 percent) to increase other court-related programs. Of the $30 million San Diego County expects to be freed-up in 1989-90, the county has agreed to use approximately $18 million (60 percent) to increase spending on the courts and court-related programs. Kern County is planning to spend almost 50 percent of the revenues freed-up in 1988-89 to augment court services (the county has not yet opted in for 1989-90).

Other counties plan to use a relatively large share of their freed-up revenues for programs other than the courts. For example, in 1988-89, Alameda County plans to use about 90 percent of the freed-up revenues for general purposes. Merced County has a tentative agreement for 1989-90 which would allow the county to use about 84 percent of the revenues for programs other than the courts. Many of the smaller counties have not earmarked the funding for any purpose, and plan to determine the use of the funds during their 1989-90 budget debates.

Our review of county/court agreements and our discussions with county officials indicate that it is reasonable to assume that *at least* 25 percent of freed-up revenues, and probably more than this amount, will be used to increase trial court expenditures on a statewide basis. Thus, counties are likely to use *at most* 75 percent of the freed-up revenues for general purposes (rather than increased court spending).

Impact on County Budgets

Assuming that counties are able to spend 75 percent of the revenues freed-up by TCF on programs other than the courts, they could increase spending in other program areas by about $300 million in the first full year of the program (1989-90). Comparing this to our estimate of county general purpose revenues in 1989-90, this represents an increase of about 3.5 percent in their general purpose revenue base. While this appears at first glance to be a small relative change, it is equivalent in magnitude to about *50 percent* of the increase in county general fund revenues expected to occur in 1989-90. Thus, Trial Court Funding will result in a substantial "bump" in the revenues available for general purposes.

County Gains Reduced by Budget Proposals. Our analysis indicates, however, that the impact of TCF on county budgets would be offset to some extent in 1989-90 by reductions in other local assistance programs proposed in the 1989-90 *Governor's Budget.* These include:

- ***Mandate Repeal Proposal.*** The administration proposes to repeal 27 mandated programs in lieu of providing reimbursements estimated at $43.5 million for 1989-90. The budget indicates that if the Legislature rejects this proposal, the Governor will reduce state assistance to counties by a corresponding amount.
- ***In-Home Supportive Services.*** The Governor proposes to reduce funding for the In-Home Supportive Services (IHSS) program by approximately $64 million in 1989-90. This would be accomplished by placing a cap on the average number of hours per case in each county and by limiting the reimbursement rate paid to service providers. It may not be possible for the state to save money in the long run by limiting the rate of reimbursement to providers. This is because it is possible that the rate will not attract enough providers to cover all of the hours of service needed by recipients. In this event, the state would either have to raise the rate, or allow recipients to go without needed services. In the latter case, some counties might respond by providing increased rates at county expense.
- ***Medically Indigent Services Program.*** The budget proposes to replace $359 million in General Fund support for the Medically Indigent Services Program (MISP) with Proposition 99 revenues ($331 million) and federal State Legalization Impact Assistance Grant (SLIAG) funds ($100 million). Although this proposal is intended to *increase* overall funding levels for this program, it is likely to have a negative impact on counties over time, for three reasons. First, counties are likely to experience difficulty claiming SLIAG funding due to the reluctance of program participants to document their immigrant status. As a consequence, they may find it necessary to replace this support with county general fund revenues. Second, SLIAG funding expires in 1991-92, and the cigarette and tobacco tax revenues provided by Proposition 99 are a declining revenue source. Thus, there is some likelihood that counties will be required to take on an ever-larger share of funding for the program over time. Third, although statewide the budget proposal may result in an increased level of funding for indigent health care, some counties are expected to experience net revenue *losses,* due to

differences in the existing and proposed funding allocation formulas for MISP, Proposition 99 and SLIAG.

TCF DOES NOT SOLVE LONG-TERM COUNTY FISCAL PROBLEM

While TCF will provide fiscal relief to counties, our analysis indicates that it is unlikely in the long term to eliminate the fiscal problems experienced by counties, for two reasons. First, because the amount of funding provided is not targeted to take into account variations in local fiscal health, some counties are likely to experience continuing difficulty meeting local service demands. Second, TCF is unlikely to solve the fundamental fiscal problem faced by counties: the disparity between growth in uncontrollable costs and growth in general purpose revenues.

Variations in County Fiscal Conditions and TCF Relief

As noted earlier, counties could receive up to $300 million statewide under TCF for general purposes. Although this is a significant revenue increase, the actual impact will vary between the counties. This is because there will be substantial variations in the amount of TCF received by each county, just as there are substantial variations in local fiscal conditions.

As discussed above, the amount of trial court funding provided to counties depends on the number of judicial positions in each county's trial courts. Although this number would tend to reflect local demands on the courts, it may bear little relationship to local fiscal conditions. Thus, the amount provided is unlikely to reflect other cost pressures experienced by the counties or their varying abilities to raise revenues locally. Because trial court funding is not targeted to take into account individual county fiscal conditions, some counties may find that the funding provided closes the gap between revenues and service demands, while in other counties it will make a less significant contribution.

Information is not available at this point to assess the program's effect on each county's budget. However, a number of counties in which the bulk of the "freed-up" revenues will be used for county general purposes report that they nevertheless expect to have difficulties balancing their budgets in 1989-90. For example, Merced County expects that an additional $5 million would be required to maintain current service levels, even after taking into account trial court funding. San Francisco County expects a substantial funding shortfall in 1989-90, and Yolo County has reported a current services shortfall of approximately $2 million for next year. Other counties report that the freed-up revenues provided by trial court funding will not cover their increased costs of operating county hospitals or jails. Thus, although trial court funding provides a substantial amount of funding statewide, the program is unlikely to eliminate each county's fiscal troubles.

Structural Budget Problem Will Erode Gains

As we described in *The 1987-88 Budget: Perspectives and Issues,* counties have experienced rapid growth in expenditures for state-required programs and more moderate growth in county revenues. As a consequence, counties have found it increasingly difficult to fund both the programs required by state law and the traditional programs desired by their citizens. Table 1 presents estimates of the level of revenues available to counties for general purposes between 1985-86 and 1987-88, the most recent years for which data are available. In addition, the table shows the growth of county expenditures for certain programs required by state law. Comparison of the two growth rates gives an indication of whether or not the amount of funds "left over" for local needs is expanding or contracting.

Table 1
County General Purpose Revenues and Expenditures for State-Required Programs [a]
1985-86 through 1987-88
(dollars in millions)

	1985-86	*1986-87*	*1987-88*	*Percent Change 1985-86 to 1987-88*
General purpose revenues	$6,497	$6,803	$7,321	12.7%
Expenditures				
State-required programs:				
Health and welfare	919	996	1,100	19.6
Trial courts	909	1,001	1,092	20.2
Jails	674	762	837	24.3
Subtotals	($2,502)	($2,759)	($3,029)	(21.1%)
All other programs	$3,995	$4,044	$4,292	7.4%
Real per-capita spending on all other programs [b]	$152	$146	$145	−4.0%

[a] Source: Legislative Analyst estimates. Detail may not add to totals due to rounding.
[b] Actual dollars.

Table 1 indicates that growth in county general purpose revenues has not kept pace with growth in county costs for certain state-required programs over the past few years. Between 1985-86 and 1987-88, county general purpose revenues increased by almost 13 percent. During the same period, county costs for state-required programs grew by a total of 21 percent. As Table 1 shows, the relatively high growth in state-required program costs means that the revenues available for other program requirements are limited. In fact, county per-capita expenditures on discretionary programs adjusted for inflation *declined* 4 percent during this period.

In the long run, our review indicates that the structural problem experienced by counties will continue, for two reasons: (1) counties do not have control over any major independent revenue source; and (2) counties have difficulty controlling the growth in costs for state-required programs such as health, welfare and jails. These factors are discussed in more detail below.

Revenue Growth Limited. Prior to Proposition 13, counties could increase the property tax rate to raise the revenues needed to fund both the programs desired by their citizens and the services required by state law. Under Proposition 13, however, counties do not have control over any major independent financing source. Therefore, as service needs increase, counties have difficulty generating the funds required to address these needs.

The Legislature has taken actions in recent years to increase the level of funding available to counties; however, these actions appear to have had a limited impact on county revenues. For example, Chapter 1257, Statutes of 1987 (AB 999, Farr), allows counties with populations under 350,000 to increase their sales tax by one-half cent, with voter approval, for general purposes. While 16 counties have proposed sales tax increases under this law, only *one* of these measures has passed. Because voters are seemingly reluctant to approve a new or increased sales tax for general purposes, this revenue authority has had a limited effect on county fiscal conditions. Moreover, this option is not available to larger counties, many of which are also experiencing fiscal difficulties.

In addition, the Legislature enacted Chapter 1286, Statutes of 1987 (AB 650, Costa). This act provided counties a one-time block grant of $113.7 million in 1987-88. In 1988-89 and subsequent years, Chapter 1286 provides funding to stabilize the percentage of county general purpose revenues which must be expended for the county share of costs associated with four state programs (mental health, AFDC, IHSS and food stamps). Specifically, if a county's ratio of costs for the four programs to its general purpose revenue is higher in a particular year than it was in 1981-82, the state will provide increased assistance to offset the difference. Chapter 1286 limits the amount appropriated for these purposes to $15 million per year. Initial estimates by the Department of Finance, however, indicate that this amount will not be adequate to fully stabilize county spending on these programs in 1989-90. Thus, while Chapter 1286 provides some relief to the most distressed counties, its impact on their basic structural problems is limited.

Health Service Costs. Welfare and Institutions Code Section 17000 requires counties to be the "provider of last resort" with regard to indigent health care. The state helps the counties fulfill this responsibility through (1) the Medically Indigent Services Program, and (2) provision of matching funds under the County Health Services program (AB 8).

In recent years, the counties have shouldered an increasing share of funding for indigent health care services. County funding for the health services "safety net" was $334 million in 1987-88, an increase of 30 percent over 1985-86. Counties will feel pressure to increase expenditures for health care services in the future, due to a number of factors. These include capital needs for health-related facilities, increasing reliance on costly trauma systems, and the growing burden of the AIDS crisis. In addition, recent court cases have required counties to increase their health services costs (for example, by providing dental and prenatal services to indigents).

Public Assistance Costs. County costs for public assistance in 1987-88 were $650 million, an increase of 14 percent over 1985-86. This was due, in part, to actions by the courts and the state which expanded county responsibilities to provide for the poor. For instance, through General Assistance programs, counties provide aid to individuals who do not qualify for benefits under AFDC. In recent years, the courts have systematically increased county expenditures under this program. For example, recent court decisions have required some counties to match AFDC benefit levels, and have prohibited the use of a permanent address requirement in determining eligibility.

Counties also are likely to experience future increases in other public assistance program costs. For example, county officials report that they have recently experienced dramatic increases in demand for their Adult Protective Services (APS), which responds to reports of dependent adult or elder abuse. Counties expect additional program cost increases in the future due to the aging of California's population and to increased social awareness of the problem of adult abuse.

County Jail Costs. Counties traditionally have funded both the construction and operating costs of county jail systems. In recent years, county jail populations have increased dramatically, due to such factors as population growth, higher incarceration rates and increased lengths of stay. The average daily population in county jails went from 44,106 in 1984 to 60,802 in 1987, an increase of 38 percent, resulting in jail overcrowding in many counties. The Board of Corrections reports that, in 1987-88, 95 percent of all prisoners housed in county jails were detained in overcrowded facilities. In many counties, the courts have responded to these problems by imposing jail population caps. As a consequence, counties face increasing costs for both construction and operation of county jails.

Since 1981, the voters have approved four bond measures providing a total of $1.4 billion to counties for jail construction. These increases in jail capacity have resulted in increased county costs for jail operation. Between 1985-86 and 1987-88, county costs for jail operations increased approximately $160 million, or 24 percent.

Benefits of TCF Erode Over Time. In sum, county costs for certain programs have grown at a faster pace than county revenues, and are likely to continue this trend in the future. The Trial Court Funding Program does not eliminate this problem because the funding is unlikely to keep pace with the cost increases faced by counties. County costs for state-required programs recently have increased at a rate of about 10 percent per year. The grants provided under TCF will grow at a much slower rate—the annual increase in state employee salaries. Therefore, it is likely that the benefits of TCF will erode over time.

Implications of County Fiscal Distress

Given the disparate growth rates between county revenues and state-required programs, counties probably will continue to spend an increasing share of the local dollar on state-required services. This basic lack of local fiscal control has several consequences:

- Counties lack the flexibility to respond to local needs in discretionary services. In response to diminished local revenues, many counties recently have curtailed spending on a variety of services. Counties report having closed libraries and park facilities, discontinued recreational programs, and reduced hours in county offices.
- As mentioned in our discussion of accommodating growth in California (please see p. 97), the need to increase local revenues may have an undue influence on local land use decisions. Because counties receive a relatively high amount of revenues from industrial and commercial development, they have an incentive to encourage growth of this type in unincorporated areas of the county, even in cases where such land uses produce other adverse impacts.
- The counties' struggle with conflicting priorities has resulted in service levels in major programs varying tremendously from county-to-county. For example, in response to fiscal pressures, some counties appear to have restricted growth in probation services, despite the high growth in the probation population. This has generally led to increasing probation officer caseloads, and in many counties has led to the elimination of direct supervision of persons placed on probation. In addition, as we discussed in *The 1988-89 Budget: Perspectives and Issues* (please see p. 93), there appear to be growing unmet health services needs in many counties. The significant variation in these program service levels has been a concern to the Legislature.
- The counties' revenue constraints may hamper their ability to respond to future infrastructure needs. Many counties have responded to funding shortfalls by delaying investment in infrastructure projects such as road construction or maintenance. As we point out in our earlier discussion of growth management, and in our recent report, *A Perspective On The California Economy*, adequate investment in transportation systems, waste management systems and other infrastructure projects is vitally necessary to ensure that

California can accommodate its rapidly growing population. Much of the responsibility for providing this type of infrastructure falls to counties, who may have trouble funding such projects.

Conclusion

The Trial Court Funding Program represents the most significant county relief measure enacted since 1979. This program provides counties badly needed assistance by freeing up general purpose revenues that would otherwise be spent on the courts. However, because the amount of relief provided does not necessarily reflect variations in county fiscal conditions, some counties are likely to experience continuing difficulties accommodating current demands. Moreover, in the long term, the relief provided by TCF is likely to erode as increases in the costs of health services, public assistance and corrections exceed county revenue growth.

The Electrical Generation Industry in the 1990s

Should the Legislature Reconsider the Way it Regulates the Electrical Generation Market?

Summary

- *The electric utility industry performs three basic functions: generation of electricity, long distance transmission and local distribution. Most utilities provide all three functions within exclusive service areas, and have been heavily regulated by the state as "natural monopolies."*
- *In recent years, federal laws designed to encourage nonutility electrical generating capacity, along with technological and other changes have shown the potential viability of a competitive electricity generation market.*
- *In light of these changes, we recommend that the Legislature undertake a thorough review of the state's regulation of electricity generation, with the objective of encouraging the development of a competitive market.*
- *Specific elements of this review could include: (1) moving from capacity bidding to market pricing of electricity, (2) considering limiting future utility ownership of generating capacity, (3) addressing the transmission access problem, (4) considering phasing out Energy Commission siting functions, and (5) changing the nature of the Energy Commission's electricity forecasts.*

In 1978, the federal Public Utilities Regulatory Policy Act—known as PURPA—was enacted to encourage utility rate reforms and to require utilities to buy electricity at fair prices from small power producers. PURPA helped trigger a significant transformation of the electricity generation market in California from a utility-based system driven by larger generation facilities to a more diversified system that allows for smaller facilities and greater opportunities for nonutility power producers. Despite the changes in the industry, the state still approaches the economic regulation of utilities in much the same way that it always has. The Legislature, in looking to the 1990s, should reexamine its current regulatory structure in order to accommodate these new economic realities.

In this analysis, we provide background on the electrical generation industry in the state, examine the state regulation of the industry, and offer several steps the Legislature could take to move the state toward an alternative way of regulating the industry in the 1990s and beyond.

PROFILE OF THE CALIFORNIA ELECTRICITY GENERATION MARKET

There are three basic stages in the production and distribution of electricity. These are (1) generation of electricity (such as natural gas-fired, or hydro power plants), (2) large volume, long distance transportation of electricity from generating plants to local markets ("bulk power" transmission), and (3) retail distribution of electricity to customers within local markets (local power lines, meters, and utility service). Most utilities are "vertically integrated," meaning that they are involved in two or more stages of production.

There are basically two types of utilities providing these services; (1) investor-owned utilities (IOUs), such as Pacific Gas & Electric (PG&E); and (2) publicly owned utilities (POUs), which are composed of municipal utility districts (such as Sacramento Municipal Utility District), utility departments of local governments (such as Los Angeles Department of Water and Power) and rural electric cooperatives. All utilities have exclusive franchises to operate at the local distribution level.

Prior to the early 1960s, California IOUs were largely self-sufficient and imported power only from Hoover Dam on the Colorado River. The POUs primarily bought power from the IOUs or produced small quantities of hydro power. The bulk power transmission system within California originally was used primarily by the IOUs to facilitate sales to POUs and to trade power between adjacent utilities to compensate for differences in peak power needs and generating plant outages. Over time, bulk power transmission capacity was constructed to allow for the purchase of electricity from both the Pacific northwest and the southwest. These and other links created what has become an eleven state regional bulk transport system for moving electricity throughout the entire western United States.

Recent Changes in the Production of Power

PURPA created a market for *non*utility power producers (known collectively as small power producers or "PURPA facilities") by requiring utilities to purchase electricity produced by these companies. At about this same time, another type of nonutility producer—known as independent power producers (IPPs)—also began to sell power from their plants to utilities. IPPs differ from the small power producers and utilities in that they build larger, non-PURPA facilities and are not as heavily regulated as utilities.

In response to these nonutility power producers, IOUs began to establish unregulated subsidiaries (for example, Mission Electric owned by Southern California Edison) and joint ventures with engineering firms (for example, PG&E's joint venture with Bechtel Corporation) to build unregulated generating plants, sometimes within their own retail franchise area. There also have been proposals to spin off existing regulated generating capacity into separate unregulated companies.

In addition to the impact of nonutility producers on the market, there were other forces at work changing the electricity generation market. For instance, the oil cost and availability problems in the 1970s precipitated research into and development of new generation technologies—such as new ways of burning coal, wind and solar power, and cogeneration. Additionally, forecasts of rapid electricity demand growth were replaced in the late 1970s by far more modest demand forecasts. Also important in shaping the market in the 1980s were cost overruns for and environmental concerns about large utility-owned power plants (primarily nuclear, coal- and oil-fired), which led to marked reluctance by utilities—both IOUs and POUs—to build such plants.

Other institutional changes shaping today's market include: (1) joint powers agreements by POUs to spread the construction and operating costs of powerplants or transmission lines; (2) consortiums of IOU's and POUs to build bulk power transmission projects; and (3) regional power pools to coordinate bulk power transfers between utilities and assure reliability of the transmission system.

Electricity Generation Market Today

The electrical generation industry is large and diverse. Peak electricity demand in California could reach more than 51,000 megawatts (MW) in 1989, based on preliminary staff estimates used to prepare the California Energy Commission's (CEC) *1988 Electricity Report* (draft). The peak demand represents the highest instantaneous demand measured in the state. Most of the time demand is below this level; however, utilities must have resources available to meet this instantaneous demand or the system could fail, leading to black outs. Alternatively, the utilities would have to implement selective curtailments to ration available capacity. Electricity to meet this demand is provided by a mix of generating facilities that include hydro, nuclear, oil-fired, gas-fired, wind, geothermal, biomass and solar.

The demand for electricity in California is met from a variety of sources:

- ***Utility Generators.*** Table 1 provides summary information about the ownership of generating capacity by utilities and certain public agencies within California. While the five major utilities dominate the generation market, it is clear that there are many producers who participate.

Table 1
Utility and Public Agency Generating Capacity (megawatts)

Utility	*Thermal Capacity* [a]	*Hydroelectric Capacity* [b]	*Total*
Anaheim Municipal Utility District (MUD)	235	—	235
Azusa MUD	2	—	2
Banning MUD	2	—	2
Burbank MUD	306	—	306
City of Santa Clara MUD [c]	245	5	250
Calaveras County Water District	—	2	2
City and County of San Francisco	—	274	274
Colton MUD	2	—	2
Department of Water Resources	266	206	472
East Bay MUD	—	8	8
Glendale MUD	260	—	260
Los Angeles Department of Water and Power	5,176	1,273	6,449
Merced Irrigation District	—	79	79
Metropolitan Water District of Southern California	—	72	72
Modesto Irrigation District [c]	184	45	229
Nevada Irrigation District	—	73	73
Northern California Power Agency	229	—	229
Oakdale and Southern San Joaquin Irrigation District	—	77	77
Oroville-Wyandotte Irrigation District	—	90	90
Pasadena MUD	293	15	308
Pacific Gas & Electric	11,124	3,661	14,785
Placer County Water District	—	227	227
Redding MUD [c]	22	1	23
Riverside MUD	172	—	172
Southern California Edison	14,473	1,143	15,616
San Diego Gas & Electric	2,798	—	2,798
Sacramento MUD	986	659	1,645
Solano Irrigation District	—	7	7
Turlock Irrigation District	48	111	159
U.S. Bureau of Reclamation	—	1,006	1,006
Vernon MUD	33	—	33
Yuba County Water Agency	—	286	286
Totals	36,856 [d]	9,320	46,176 [e]

[a] These include oil-, coal-, and gas-fired plants and nuclear and geothermal facilities.
[b] Capacity estimates are those developed by CEC staff and represent electricity generating capacity available during relatively dry hydro years.
[c] Includes entitlements to capacity from a New Mexico plant (San Juan 4) that these MUDs are not currently able to import to their service areas.
[d] Of this total about 5,000 MW represents long-term entitlements to power from or ownership in plants located outside California, primarily in the Southwest.
[e] Total is not adjusted for transmission system and other losses.
Source: *Draft Staff Electricity Supply Planning Assumptions Report*, California Energy Commission (February 2, 1988).

- ***Nonutility Generating Capacity.*** Table 2 provides an overview of *non*utility generating capacity available to California utilities. The plants shown generally are operating under PURPA contracts. Together, these plants represent capacity of about 5,300 MW. These plants are owned and operated by a wide variety of independent energy companies, manufacturers and food processors, and unregulated subsidiaries of utility holding companies.

Table 2
Nonutility Generating Projects By Region and Type of Plant (megawatts)

Type of Plant	*Region* *No. California*	*So. California*	*Total*
Cogeneration	1,201	2,093	3,294
Biomass	124	14	138
Landfill/digestor gas	37	73	110
Wind	643	614	1,257
Small Hydro	101	107	208
Solar	7	112	119
Geothermal	81	131	212
Municipal solid waste	—	10	10
Totals	2,194	3,154	5,348 [a]

[a] Of this total, about 2,010 MW is subject to California Energy Commission siting review.
Source: *Draft Staff Electricity Supply Planning Assumptions Report*, California Energy Commission (February 2, 1988).

- ***Utility Company Power Purchase Contracts.*** In addition to generating plants, both IOUs and POUs in California purchase large quantities of power from *out-of-state* utilities and federal marketing agencies (including Bonneville Power Administration and US Bureau of Reclamation, Colorado River projects). These contracts represent the equivalent of about 4,100 MW of capacity.

Not only is there a large, diverse number of generating sources, but they currently provide a considerable amount of excess generating capacity. We estimate this statewide excess capacity to be about 4,500 MWs. While the CEC estimates that electricity demand in California will grow at about 2.1 percent annually through 1999, the commission also projects that most of this growth can be accommodated by existing generating plants, purchase contracts and planned conservation and load management programs. Hence, the commission expects that relatively few *new* plants will have to be built over the next 10 years to accommodate expected demand growth.

While these estimates are reasonable, there are some cautionary notes:

- ***Demand Forecast Uncertainties.*** Current CEC forecasts show *increased* projected demand growth rates for the first time in many years. If growth rates are higher than projected, then the excess capacity would dissipate more rapidly than currently is expected.
- ***Diversity Among Regions.*** Statewide estimates of overcapacity mask diversity among individual local utility service areas. For example, while it is unlikely that PG&E would need additional capacity until well into the 1990s, San Diego Gas & Electric *currently* has little excess capacity.

- ***Environmental Regulation on Plant Closures.*** Overall capacity totals also mask potential powerplant closures that could occur as a result of recent state Clean Air Act amendments (Ch 1568/88—AB 2595, Sher). The act gives air quality districts additional authority to require the retrofitting of certain oil- and gas-fired plants with the best available pollution control technology. Given the expense of retrofitting, many of these old plants could be forced to close within the next few years. Current estimates are that somewhat over 700 MW could be eliminated by these requirements.

Importance of the Bulk Power Transmission System to the Generation Market

As noted above, the bulk power transport system serves several important functions. It: (1) allows electricity to be transported long distances from large generating plants to consumers, (2) helps utilities trade power to balance short-run supply and demand and meet backup power needs, and (3) is used by nonutility producers of electricity to transport the power they produce to the utilities with whom they contract.

Any large system that includes many sources of electricity generation requires considerable technical coordination in order to move electricity efficiently to local distribution companies. Historically, the utility companies that owned transmission capacity provided this coordination function. As utilities began to purchase electricity from sources located farther from their service areas, they found they had to develop more formal arrangements to coordinate the transmission system. In some regions of the country, all electricity that moves across the bulk power transmission system is controlled from a central agency created by the utilities to provide that function. While similar institutions have developed in the west, western utilities have retained more control over electricity sales that involve the use of their transmission capacity.

The Federal Energy Regulatory Commission (FERC) currently is engaged in a two-year marketing experiment that involves most of the major western utilities and federal power marketing agencies. The objective of the experiment is to determine the feasibility of a competitive market in wholesale electricity. In essence, FERC is trying to develop information about (1) the ability of utilities and electricity producers to buy and sell power using prices that reflect short-run changes in supply and demand (these prices are known as "spot prices"), and (2) the ability of coordinating agencies to set prices for transmission services and oversee the reliability of the bulk power transmission system.

THE REGULATION OF THE ELECTRICITY GENERATION INDUSTRY

Currently, California's electric utility industry is heavily regulated. In this section we examine the basis for this regulation, review the public agencies involved in regulating the electric industry, and analyze how changes in the industry are undermining the historical basis for regulation.

Why Regulate the Electric Generation Market?

Economic regulation is that set of policies adopted by government to control and oversee the structure and conduct of an industry for the benefit of all segments of society. Such regulation can involve the approval of prices, the control of entry of firms into the market, and the setting of other market conditions. Generally, economic regulation of an entire industry (like power production) is necessary only in cases of "market failure." In the case of the electric utility industry, regulation has been justified on two main bases:

- ***Natural Monopoly.*** Some have argued that the appropriate size of an efficient utility is so large that a market would only allow for one or at most a few firms. This argument also assumes that the industry is subject to substantial economies of scale and that barriers to entry at this stage are large. Thus, vertically integrated firms already in the industry could resort to various strategies to either prevent entry or drive out less advantaged competitors. The result would be an industry with few firms and the ability to reduce output and raise prices relative to a competitive market.
- ***Quality of Service.*** Because of the nature of bulk power transmission and local distribution systems, there are many technical requirements that power plants must meet in order to maintain the integrity of the system. These include the ability to maintain technical specifications and balance demand and supply virtually instantaneously. Together, these are known as reliability requirements. Some argue that these requirements would be difficult or impossible to meet in a competitive market. In effect, they argue that vertically integrated, monopoly firms are needed to protect and maintain control over the system.

While regulation can compensate for these failures, it is widely accepted that regulation also imposes costs on society. These costs include: (1) the expense of the regulatory process, (2) inefficiencies in the use of capital and other inputs to the production of services, and (3) inefficiencies due to retail prices that do not reflect true costs.

Current Regulatory Process

Currently, California's utilities are regulated primarily by three state and federal agencies:

- *CEC.* The California Energy Commission's regulatory responsibilities include: (1) creating state energy plans, (2) certifying most thermal power plant construction, (3) determining long-term electricity demand and supply, (4) developing energy efficiency standards for buildings, and (5) fostering new, less oil-dependent and more environmentally sound energy sources.
- *PUC.* The California Public Utilities Commission is involved in the day-to-day regulation of investor owned utilities. The PUC has no authority over POUs (except to the extent it serves as the lead agency for California Environmental Quality Act oversight of transmission line projects that involve both IOUs and POUs as partners). The regulatory activities of the PUC include (1) setting rates paid by IOU customers, (2) auditing the performance of companies, (3) determining the prudency of IOU investments (including generating facilities) and power purchase contracts, and (4) investigating industry conditions for the purposes of developing regulatory policy.
- *FERC.* The Federal Energy Regulatory Commission has regulatory authority over: (1) wholesale pricing of interstate electric power sales, (2) certification of need for interstate transmission line projects, (3) setting rates for, and conditions of access to, interstate bulk transmission of wholesale power, and (4) rulemaking pursuant to implementation of PURPA.

Publicly owned utilities receive general policy guidance from the Legislature; however, they are not directly regulated at the state level. Rather, they are regulated either by locally elected boards or by the local government of which they are a part.

The PUC's Role in PURPA Implementation. To implement PURPA in California, the PUC developed a series of four contracts (known as "interim standard offers") that small power producers could use when negotiating with utilities for power purchase agreements. Certain of these contracts provided very lucrative long-term pricing for the electricity these small power producers sold to utilities, as electricity prices were based on historically high natural gas prices. A stampede to obtain utility contracts ensued, and up to 15,000 MW of capacity (representing almost *one-third* of current peak demand) were committed to long-term contracts before the PUC terminated these interim standard offers. Of these contracts, however, about 10,000 MW are not currently under development and should expire by April 1990.

The PUC, in a series of proceedings lasting several years, modified both the contracts and the contracting procedures in an attempt to eliminate future excess capacity problems caused, in part, by initial PURPA implementation. Additionally, the PUC's intent is to enhance the prospects for development of a more efficient, competitive electricity generating market. The approach chosen by the PUC was to develop a biennial bidding program to allocate estimated capacity needs among *all* parties—utilities and nonutilities—interested in supplying generating capacity. The amount of capacity open for bidding would be determined by CEC demand and supply forecasts published in its biennial *Electricity Report*. The bidding program would have three basic parts:

- Utility development of a proposed plant which would establish the price at which the utility could produce electricity. This proposal would, in effect, establish a *ceiling* price that other bidders would have to beat.
- Selection of winning bidders using both an auction and evaluation of certain "nonprice" criteria (potentially including such factors as fuels diversity goals, and state employment effects).
- Negotiations between the utility and the winning bidders to develop a final contract.

Changes in the Industry

The existing utility industry structure primarily is the result of past regulatory policies that favor vertically integrated, monopoly utilities. Since the early 1970s, significant changes have occurred at all stages of production, but especially in the electrical generation stage. Our review of the available evidence calls into question the current bases for regulating the electrical generation industry.

Economies of Scale. Some recent studies suggest that smaller power plants can be as efficient as larger plants. This means that cost-effective power can in fact be generated by a wide variety of producers. Some of the factors influencing smaller plant size include reduced demand growth, environmental and other regulatory concerns regarding larger plants, financial commitment and construction lead times for larger plants, and technological change.

Entry. Experience with PURPA has shown that a nonutility power producer industry can develop. Because this entry largely was the result of lucrative contract opportunities, it is difficult to assess prospects for entry under more competitive conditions. There are signs, however, that entry could occur *without* the subsidies included in the PURPA contracts. These include the existence of: (1) an industry with proven technology, (2) capital markets that now understand these investments, and (3) entrepreneurs and managers with experience in this business.

Quality of Service. Vertically integrated utilities defend their structure by arguing the need to coordinate and protect the reliability of the bulk transmission system and the local distribution systems. Typically, these arguments are based on technical engineering considerations related to the design and control of the bulk power transmission segment of the industry. Again, however, there is evidence providing support for a generating market that is more competitive and that has less direct ownership of power plants by utilities. These factors include (1) development of computer controls and monitoring technology, (2) improved analytical understanding of bulk transmission system operations, (3) knowledge about the operation of tightly coordinated systems elsewhere in the country and, (4) better understanding of how the use of sales contracts between power producers and utilities could substitute for internal company transactions.

In light of these changes, regulatory agencies both at the federal and state levels are reviewing their regulatory policies for electricity generation. In particular, FERC is considering several proposed rulemakings that together could result in reduced regulation for *non*utility power producers. In addition, the PUC is finishing rules to govern the capacity bidding program mentioned earlier and has undertaken other reviews of existing regulatory processes. The potential for a more competitive electricity generation market also is recognized by the CEC in its draft *1988 Electricity Report.*

ALTERNATIVE APPROACH TO THE ELECTRICAL GENERATION MARKET

We recommend that the Legislature undertake a thorough review of the state's regulation of the electric utility industry, and consider ways to make regulatory policy consistent with the more competitive environment.

As discussed earlier, the electric utility industry is regulated as a natural monopoly. But perceptions about the industry among observers and participants are changing, especially with regard to electricity generation. The Legislature and state agencies have also recognized the need to reconsider the state's regulatory role in this area. Chapter 495, Statutes of 1986 (SB 1970, Rosenthal) required the CEC and PUC to review—among other things—the state's regulation of the industry. In their report *Joint CEC/CPUC Hearings on Excess Electrical Generating Capacity* (known as the SB 1970 report), the PUC and CEC recommend that the Legislature establish a blue ribbon panel to review existing energy and electric utility regulatory policies. Legislation has been introduced in the current session (SCR 7, Rosenthal), which calls for a Joint Committee on Energy Regulation and the Environment to review energy regulatory policy.

These calls for review of California's energy policy development and regulatory processes are consistent with our findings. We therefore recommend that the Legislature undertake a complete review of utility regulation with the objective of considering ways to make regulatory policy consistent with the increased scope for competition in the utility industry.

If the Legislature undertakes such a review, we believe there are several key areas to consider and resolve. These general policy areas should be considered in relation to the goal of enhancing the prospects for competition. The goal of increased competition would not conflict with the continued need for environmental and safety regulation.

Move Beyond Bidding to Competition

As discussed earlier, the PUC has developed bidding rules which offer the opportunity to increase the market share of nonutility power producers. There are potential problems with bidding, however, that could result in continued utility domination of generating capacity and de-facto return to existing regulatory procedures. These problems include: (1) unnecessarily limiting the pool of bidders through stringent prequalification requirements; (2) potential conflicts of interest arising if utilities are allowed to both administer auctions and submit bids; and (3) complex and protracted negotiations if bid evaluators consider "nonprice" elements of bids (for example, fuels diversity or employment effects).

These concerns have been expressed by the nonutility producers and other observers, and would appear to have some merit. As a way of addressing these concerns, the Legislature and PUC may want to consider the following approaches.

Use Bidding Only in the Near Term. The PUC should use bidding only as the next step on the path toward more open competition in the electricity generation market. Therefore, during the time bidding is used, every effort should be made to keep the pool of bidders *as large as possible.* This could be accomplished by: (1) eliminating prequalification requirements (the likelihood that electricity shortfalls would result from failure of a bidder to perform are minimal), (2) selecting winners only on the basis of price (there are usually other, more appropriate forums for resolving nonprice issues) and (3) monitoring negotiations and bids to prevent utilities or bidders from engaging in activities that might subvert the intent of the bidding proceedings.

Move to Market Pricing. Ultimately, the PUC's bidding process could be phased out and replaced with market pricing of power and contracting by producers *directly* with utilities and other users (with PUC intervention limited to normal "prudency reviews"). Such a market would include both short-term sales of electricity (the spot market) and a mix of short-, medium- and long-term contracts for other sales of power.

The spot market and access to many buyers (both utilities and large retail customers) with whom contracts could be negotiated would serve to police the market.

Address the Issue of Utility Generating Capacity

Due in part to past regulatory activity, utilities currently are the main sources of generating capacity in the state. All current utility investment in power plants are in the "rate base," which means that the utility is virtually guaranteed of receiving an adequate return on investment over the life of the plant (through charges to consumers).

In a competitive generation market, however, the investment risk would be borne by power plant *producers*, not consumers. In order to move toward a competitive market, there must be a level playing field for all players—utilities and nonutilities. Therefore, the Legislature will have to address the issue of how to handle *future* utility power plant proposals.

One way to create a level playing field would be to limit the utilities to their *current* rate base plant capacity (with the possible exception of small specialized plants used to meet peak demand). Over time, both growing electricity demand and the closing of old utility-owned plants would cause the remaining utility-owned capacity to become a comparatively small part of the total electricity required by the utilities to meet customer needs. At this point, utilities would have to rely on the market to obtain electricity at the best available price.

Currently, utilities are allowed to establish unregulated subsidiaries to build generating facilities and sell power to the market (including the "parent" utility company). If this practice continues, consideration should be given to placing some restrictions on subsidiaries, such as: (1) allowing them to negotiate contracts only with utilities other than the parent, or (2) limiting subsidiaries to sales in the spot market. These relatively minor restrictions, combined with diligent antitrust oversight, would significantly increase the prospects for a competitive market in electricity generation.

Address the "Transmission Access" Problem

Many observers who advocate deregulation of electricity generation argue that the so-called "transmission access" problem must first be resolved. This problem, in basic terms, is that most of the transmission network is owned and controlled by IOUs and that these utilities don't want to provide transport services to their competitors. The utilities argue that unlimited access to the system would result in negative effects on small customers and on system reliability.

The access problem ultimately will have to be resolved in order to have a competitive generating industry. It is not clear, however, that transmission access is an *immediate* problem. For instance, PURPA already requires utilities to provide transmission services for contracted power. In addition, demand is growing at a moderate rate and existing proposals for expansion of the bulk transport system could remove the most significant current capacity constraints. Furthermore, system reliability concerns could be mitigated by having all power producers meet specified bulk transmission system requirements.

Over the long run, however, there will have to be solutions to various transmission problems: (1) lack of utility incentives to sell transmission services to nonutility power producers (who compete with the utility's generation plants), (2) monopoly power resulting from ownership of "bottleneck" transmission lines and (3) public health and visual impact issues that cause resistance to the construction of new transmission lines.

Of these problems, the lack of utility incentives and monopoly power are the most important in the context of creating a competitive electricity generation market. There are, however, ways to mitigate these problems. For instance, a utility's incentive to favor its own generation capacity could change if it finds itself going to the spot market (as described above) for substantial amounts of power. Additionally, FERC is considering alternatives to achieve more open access in recent regulatory decisions and proposed rulemakings. If utilities continue to resist access or use bottlenecks to exploit their monopoly power, the Legislature could consider more forceful remedies, including requiring mandatory access, requiring stricter regulation, encouraging construction of competing transmission lines or requiring divestiture of bottleneck transmission lines. While public health and visual impact issues must also be resolved, these issues exist independently of the degree of regulation of the electrical generation market.

Consider Phasing Out Energy Commission's Needs Assessments

The California Energy Commission was established in 1973 and given various energy planning, technology development, building standards development, electricity forecasting and power plant siting responsibilities. The CEC also has a role in the regulation of electricity generation because it is charged with siting most thermal power plants. This siting process includes both an environmental assessment and a "needs" assessment. The environmental assessment determines whether the proposed plant meets the California Environmental Quality Act requirements and the needs assessment determines whether the plant is necessary in order to meet the commission's forecasted electricity demand. The latter was designed to protect customers from having to pay for unneeded power plants.

A competitive electricity generating market, however, would eliminate the necessity for the CEC's needs assessments process. This is because in a competitive industry the power producers—not consumers—would bear the risk of their investment decisions. As market pricing would provide the signals to investors regarding whether to undertake power plant investments, the CEC would no longer need to become involved in those decisions.

Change the Purpose of the Energy Commission's Electricity Forecasts

The CEC is required to publish a biennial *Electricity Report* that includes multi-year forecasts of electricity demand and supply. Currently, these forecasts are used primarily to determine how much electrical generation capacity is needed in designated planning areas, and whether a specific plant proposal should be certified as "needed." Developing these forecasts is an involved regulatory process that includes written and oral testimony by many interested parties, each with competing economic interests. It is both a labor- and time-intensive process (the CEC has up to 80 personnel working on forecasting and needs assessment activities at various times during the biennial cycle) and usually results in compromises regarding the specific demand and supply forecasts published for each planning area.

If electricity generation were deregulated, the CEC would no longer have to do needs assessments as part of its power plant siting responsibilities, as individual power producers would do their own assessments of need. Thus, the CEC would no longer have to engage in the current regulatory process for developing its forecasts.

Given the commission's continuing role in statewide energy policy formation, some type of electricity forecasting capability would still be desirable. However, the capability needed to support the development of general energy policy would be very different from the needs of the existing complex regulatory process and would require many fewer personnel and other commission resources. Additionally, forecasts that are done independently of other forecasters and which are not the result of a regulatory process or negotiated compromises would be more likely to provide useful information to investors and policymakers.

Summary

The electrical generation market has changed considerably in recent years and will continue to evolve in the future. It is important for the state to adapt its regulatory oversight of the electric generation industry to comport with this new environment. The Legislature has several steps which it can consider and act on now in order to move the industry toward a more competitive market in the 1990s.

Implementation of Proposition 98

What Are the Proposition 98 Implementation Issues Facing the Legislature in the Coming Year?

Summary

- *The Governor's Budget proposes to fund the Classroom Instructional Improvement and Accountability Act—Proposition 98—at a level of $116 million in 1988-89 and approximately $400 million in 1989-90.*
- *The implementation of this act and the allocation of funding for its purposes will be subject to legislative determination.*
- *There are several issues that the Legislature should address in implementing legislation, including: (1) the allocation of funds to education programs; (2) the definition of "enrollment"; (3) the definition of the "excess revenue" cap; and (4) the allocation of excess revenue.*
- *There are other issues the Legislature may wish to consider, including: (1) How should the General Fund percentage be calculated? (2) What should be included in the General Fund revenue base? (3) How should discretionary ADA be calculated? (4) How should the minimum funding level be determined in a year after the funding requirement has been waived? (5) Should there be sanctions imposed on districts that spend their Proposition 98 funds on unauthorized programs?*
- *We recommend that the Legislature wait until the May revision of the 1989-90 Budget Bill before appropriating any funds for Proposition 98.*

In November 1988, the voters of the state passed Proposition 98, the "Classroom Instructional Improvement and Accountability Act," which significantly changes the manner in which K-12 schools and community colleges will be funded in the future. The discussion which follows outlines the provisions of Proposition 98 and their fiscal effects, and discusses important implementation issues facing the Legislature.

THE PROVISIONS OF PROPOSITION 98 AND THEIR FISCAL EFFECTS

Proposition 98 has three main provisions: K-14 funding, school accountability, and a prudent state reserve.

K-14 Funding

The primary purpose of Proposition 98 is to increase state funding for K-12 schools and the community colleges. It contains two mechanisms to accomplish this goal: the "minimum funding level" provision and the "distribution of excess revenues" provision.

Minimum Funding Level. Starting in 1988-89, Proposition 98 requires the state to annually provide a minimum level of funding for public schools and community colleges. The measure specifies two methods for determining what the minimum funding level should be and requires the state to use the method that results in the *larger* amount:

- The first method requires the state to ensure that the percentage of state General Fund revenue that is allocated to public schools and community colleges is not less than the percentage that was allocated to them in 1986-87.
- The second method requires the state to ensure that public schools and community colleges receive from state and local tax revenues the same total amount of funds received from these sources in the prior year, adjusted for changes in inflation and increases in enrollment.

Our analysis indicates that the cost of this initiative in 1988-89 will be determined by the first of these options, as General Fund revenues have grown more rapidly in the last two years than inflation and enrollment increases. The actual cost, however, will depend upon the final level of General Fund revenues and the interpretation of which revenues should be counted in the calculation base.

Our November 1988 ballot analysis of Proposition 98 estimated current-year costs at $215 million. This figure was based on revenue estimates made last July when the budget was adopted. Revenue estimates in the Governor's Budget, however, are *lower* than they were last summer. As a result, our estimates of Proposition 98 costs in the current year also have been lowered—to $174 million. This figure will continue to be adjusted as revenue estimates change during the remainder of this fiscal year.

Based on the advice of the Legislative Counsel's Office, we used a broad interpretation of the revenue base—one that counts all General Fund revenues, including transfers and nontax revenues—when we developed our estimates for this measure. This definition was used because the affected section of Article XIIIB of the State Constitution refers not only to tax proceeds, which are subject to limitation, but also to other proceeds. We have consistently used this interpretation in all of our fiscal estimates of this measure.

The Department of Finance, however, is using a narrower definition of the Proposition 98 revenue base—one that *excludes* nontax revenues. The department's methodology, which is compared to ours in Chart 1, results in a slightly *higher* percentage of General Fund revenues dedicated to K-14 funding, which is then applied to a significantly *lower* 1988-89

General Fund revenue base. As a result, the Governor's Budget reflects a cost estimate for the current fiscal year of $116 million, or $58 million less than our estimate of $174 million.

Chart 1

Comparison of the K-14 Education Funding Requirements of Proposition 98

1988-89 (in thousands)

	SOURCE	1986-87 K-14 Funding		1986-87 General Fund Revenue		Required K-14 Percentage
1	LAO	$12,715,087	÷	$32,535,200	=	39.081%
	DOF	12,703,047	÷	31,673,000	=	40.107
Difference		$12,040		$862,200		-1.026%

		Required K-14 Percentage		1988-89 General Fund Revenue		1988-89 Proposition 98 K-14 Funding Requirement
2	LAO	39.081%	x	$36,001,960	=	$14,069,926
	DOF	40.107	x	34,930,000	=	14,009,375
Difference		-1.026%		$1,071,960		$60,551

		1988-89 Proposition 98 K-14 Funding Requirement		1988-89 K-14 Funding		Additonal Amount Required
3	LAO	$14,069,926	–	$13,896,084	=	$173,848
	DOF	14,009,375	–	13,893,150	=	116,225
Difference		$60,551		$2,934		$57,623

In 1989-90, we estimate that the cost of the minimum funding level will be about $465 million, as compared with the Governor's Budget estimate of about $400 million. Both estimates assume that the first formula option—maintaining the 1986-87 level of General Fund support—will be used. Again, our difference regarding the calculation of the revenue base (the nontax revenues issue) leads to the difference in the cost estimates.

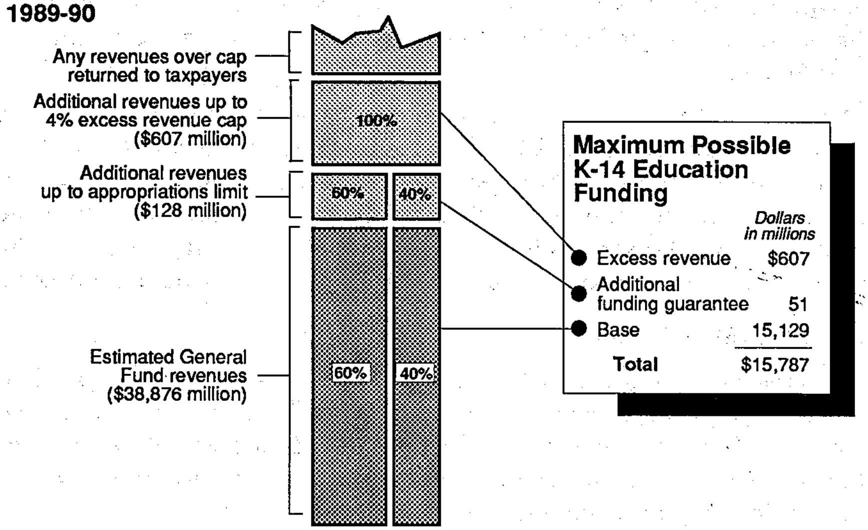
Revenues in Excess of Limit. The initiative also requires that all or part of any General Fund revenues (in an amount equal to 4 percent of the minimum funding level) in excess of the state's appropriations limit be allocated to public schools and community colleges until such time as the state meets or exceeds specified goals in (1) per-pupil expenditures and (2) average class sizes. This allocation of so-called "excess revenues" would be in *addition* to any state appropriation required to maintain the minimum funding level. The excess revenues also would be added to the minimum funding level and rolled into the base. *As a result, they would become a permanent part of the minimum funding level that would need to be maintained in subsequent years and most likely would have a compounding effect on the share of the state's budget that would be* *dedicated to K-14 education.* While the Governor's Budget shows the state being slightly under its limit in both the current and budget years, small improvements in the revenue forecast would result in excess revenues in either year.

Additional Revenues Benefit K-14 Education. Any such additional state revenues would greatly benefit K-14 education. Specifically, as shown in Chart 2, *if* additional revenues were to materialize in 1989-90, K-14 education would first receive 40 percent of any amount up to the state's appropriations limit (a maximum of $51 million based on the Governor's Budget estimate of $128 million remaining in the state's appropriations limit). K-14 education would then be entitled to *all* of any remaining "excess revenues" up to the 4 percent "revenue cap" discussed previously, or approximately $607 million. Thus, in total, K-14 education would receive $658 million (approximately 90 percent) of the first $735 million in additional state revenues. Finally, any additional revenues above the cap level would be rebated to taxpayers.

Chart 2

Disposition of Any Additional General Fund Revenues Under Proposition 98[a]

1989-90



[a] Source: Legislative Analyst estimates based on *Governor's Budget.*

School Accountability Report Cards

Proposition 98 requires the Superintendent of Public Instruction to appoint and consult with a task force to (1) develop a model School Accountability Report Card and (2) present it by March 1, 1989 to the

State Board of Education for adoption. The measure provides that a majority of the task force members shall be teachers, with the remaining members composed of school administrators, parents, school board members, classified employees, and educational research specialists.

The model report card would contain information on a variety of school conditions, including, but not limited to:

- Student achievement,
- Dropout rates,
- Expenditures per student and services funded,
- Class sizes,
- Assignments of teachers outside their subject areas,
- Textbook quality,
- Student services,
- School safety,
- Teacher evaluation and staff development,
- Classroom discipline, and
- Instructional quality.

The measure requires each public elementary, high school, and unified school district to issue an annual School Accountability Report Card for each of its schools, beginning in 1989-90. The measure provides that, at a minimum, each report card must contain information on the conditions noted above.

We estimate that it will cost school districts from $2 million to $7 million annually, beginning in 1989-90, to prepare and distribute the School Accountability Report Cards required by Proposition 98. This is based on an estimated cost of between $250 and $1,000 per school for each of the approximately 7,000 schools in the state. Actual costs will depend on the amount of information that schools already collect on school conditions.

The Prudent State Reserve

Proposition 98 requires that "the Legislature shall establish a prudent state reserve fund in such amount as it shall deem reasonable and necessary." Because the initiative does not specify the size of the reserve, and since the Legislature already maintains a reserve, this provision will have no direct impact on current practices.

ISSUES RELATED TO THE IMPLEMENTATION OF PROPOSITION 98

We have identified two groups of issues that will need to be addressed by the Legislature in implementing Proposition 98. In the first group, we include issues that *should* be addressed in implementing legislation. In the second group, we include issues which most likely will confront the Legislature and which would be *desirable* to resolve.

Issues That Should be Addressed by the Legislature

1. Allocation of Funds. The Legislature will need to decide how to spend the additional Proposition 98 funds for both the current and budget years. There are two broad ways in which these funds could be allocated. First, they could be allocated as *general purpose revenue*, which districts could spend as they see fit. Second, they could be *targeted* to specific programs.

An unrestricted allocation could be accomplished in several different ways: on the basis of enrollment, through a revenue limit equalization formula, or for a cost-of-living adjustment to general-purpose school apportionments. Each of these funding mechanisms would result in a different distribution of funds among districts. For example, an allocation on the basis of enrollment would result in each district receiving the same amount per pupil. A revenue limit equalization formula, on the other hand, would result in different amounts per pupil, depending on each district's own revenue limit in relation to the state average. In each case, however, local districts would decide how to use the funds.

Targeted allocations could be used for (1) establishing new programs, (2) expanding existing programs, or (3) subsidizing local costs for existing programs. In the first two cases, the funds would result in an increased level of service through new or expanded programs. Subsidizing local costs for existing programs would be similar to an unrestricted allocation, except that it would guarantee a certain level of state funding for the targeted programs. For example, the state could provide funds to fully support the cost of home-to-school transportation. This would ensure full funding of transportation, while supplanting local funds that are currently used for this purpose. The local funds could then be used for any other purpose determined by the local districts.

1988-89. The Governor's Budget would spend $116 million in current-year Proposition 98 monies by allocating $77 million to fund estimated current-year K-12 funding deficiencies and $39 million to a K-12 Proposition 98 reserve. The reserve would be disbursed to school districts at the end of the current fiscal year, according to criteria that presumably would be determined by the Legislature and the administration. The Governor's Budget proposes *no Proposition 98 funding for community colleges* in the current year.

1989-90. The Governor's Budget proposes to allocate approximately $400 million for Proposition 98-related expenditures in the budget year as follows:

- $230 million for an education reserve ($220 million for K-12 schools and $10 million for community colleges),
- $110 million for class size reduction in grades 1-3 and 9-12,

- $30 million for year-round school incentive payments,
- $17 million for drug education, and
- $15 million for funding discretionary growth in special education programs.

The budget proposes to use the education reserve first to fund any K-14 education deficiencies that may occur. Any balances that remain after deficiencies have been funded would be disbursed at the end of the fiscal year in accordance with as-yet-undetermined criteria. We note that in the absence of Proposition 98, these funds would have been available for *any* legislative purpose, including K-14 education.

2. ***Defining Enrollment.*** Another issue that needs to be addressed in legislation to implement Proposition 98 is the definition of enrollment. The initiative requires that school district and community college enrollment data be used to compute minimum funding requirements and to allocate any "excess revenues" in the event they are available. Enrollment is defined by the initiative as:

- Average daily attendance (ADA) in K-12 schools,
- ADA equivalents for K-12 services not counted in ADA, and
- Full-time equivalent (FTE) students in community colleges.

The implementing legislation should include formulas for computing ADA equivalents for services not currently counted in ADA, such as summer school programs and enrollment in the state special schools.

In addition, because community college enrollment is currently measured by ADA, legislation to implement Proposition 98 would need to include a formula for converting ADA to FTE students. The conversion to FTE will also be needed to make interstate funding comparisons required by the act, as all other states measure their community college enrollment in terms of FTE.

3. ***The "Excess Revenue" Cap.*** A third issue to be addressed is the definition of the excess revenue cap. As noted, the initiative requires that K-12 schools and community colleges be allocated specified excess revenues "up to a maximum of four percent (4%) of the total amount required pursuant to Section 8(b)." Section 8(b) specifies the amount required to achieve the minimum funding level discussed previously. This amount is *only* provided from state General Fund revenues. Consequently, the determination of any excess funding is *only* a function of those revenues. We estimate that 4 percent of 1989-90 General Fund expenditures for K-14 education is approximately $607 million.

Others have suggested that the reference in Section 8(b) to "monies to be applied by the state" includes local property revenues, since (pursuant to state law) these revenues are also applied to the support of K-14 education. According to this position, the maximum amount of excess revenue that must be allocated to K-14 education would be equal to 4 percent of the total of state General Fund *plus local property tax* support—approximately $803 million in 1989-90. In our view, local property tax revenues are *not* part of "the monies to be applied by the state" that are addressed in Section 8(b).

4. Identification and Allocation of "Excess Revenue." Finally, the Legislature will need to address the issue of the identification and allocation of excess revenue. The initiative requires the *automatic* allocation of excess revenues by the State Controller to schools for specified purposes. It does not, however, indicate *when* the allocation should take place. To implement this provision, the Legislature will need to determine when it can be known how much (if any) excess revenue is available. To accomplish this, it should consider establishing a procedure and timetable that would govern (1) the certification of the availability of excess revenues by the Director of Finance to the Controller and (2) the allocation of excess revenues by the Controller. This same procedure should contain a mechanism for the Director of Finance, the Superintendent of Public Instruction, and the Chancellor of the California Community Colleges to certify to the Controller if and when the allocation of excess revenues is no longer required because the goals for per-pupil expenditures and class sizes have been met.

Issues that May Confront the Legislature

1. Calculation of the General Fund Percentage. One of the two guaranteed minimum funding levels established by Proposition 98 for K-14 education is based on the percentage of General Fund revenue that was provided for this purpose in 1986-87. Specifically, Section 8(b)(1) of the initiative refers to:

> The amount which, as a percentage of the State General Fund revenues which may be appropriated pursuant to Article XIIIB, equals the percentage of such state General Fund revenues appropriated for school districts and community college districts, respectively, in fiscal year 1986-87.

Because of this section's reference to "the percentage" (singular), we have based our cost estimate on the calculation of a single percentage encompassing both school district and community college funding.

The State Department of Education (SDE), however, has prepared a cost estimate which uses separate percentages for school districts and community colleges. This interpretation could imply a substantial difference in the required allocation of the K-14 funds. Specifically, the SDE's approach might require that *all* of the current-year Proposition 98 funds be allocated to K-12 education, with *none* allocated to community colleges. This is because, when calculated separately, the percentage of General Fund revenue that has been appropriated to community colleges in the current year is already greater than the percentage that they received in 1986-87. Under the single percentage methodology, the Legislature would have discretion in determining the allocation of funds between K-12 schools and community colleges.

2. Defining the General Fund Revenue Base. As discussed earlier, another difference of interpretation involves the question of whether General Fund revenues which may be appropriated pursuant to Article XIIIB include those revenues which are not considered to be "proceeds of taxes." According to the proponents of this view, because only revenues which are tax proceeds must be appropriated subject to the appropriations limit, only tax proceeds are appropriated pursuant to Article XIIIB.

The Legislative Counsel, however, has issued an opinion which concludes that all state revenues are "revenues received" as that term is used in Section 2 of Article XIIIB (the section which requires the return of excess revenues), and concludes that nontax state revenues "may be appropriated in compliance with Article XIIIB without limitation." On this basis, Counsel advises that nontax revenues should be included in the General Fund revenue base, and our estimate reflects this position. The Legislature may wish to clarify this point in statute by providing a definition of the General Fund revenue base.

3. Discretionary ADA. In elementary and secondary schools, enrollment increases or decreases are a natural consequence of changes in the school-aged population. However, enrollment increases in community colleges and in some programs operated by K-12 school districts are discretionary. In other words, annual changes in enrollment are subject to state and/or local policy decisions. For example, the state controls enrollment growth in community colleges so that it does not exceed the percentage increase in California's adult population. Similarly, enrollment increases in some school district programs, such as supplemental summer school or Regional Occupational Programs, are controlled by the state.

The average daily attendance (ADA) funding mechanism in Proposition 98 contains a fiscal incentive for the state to limit *discretionary* ADA growth in these controllable programs. This is because, in future years, Proposition 98 will require the maintenance of *total* funding per ADA—an amount that is generally much greater than the actual average cost per ADA (or ADA-equivalent) of these discretionary programs. For example, the supplemental summer school program is currently funded at the rate of $1,274 per ADA-equivalent. Each new unit of summer school ADA under Proposition 98, however, will generate a funding requirement of about $3,400 per ADA—the average rate of *total* state and local funding per ADA. In other words, Proposition 98 requires that funding per ADA for some programs exceed the cost and current funding rate per ADA of those programs. This situation could generate an incentive to limit or eliminate discretionary ADA growth in these less-costly programs.

If the Legislature wishes to address this situation, it could redefine the overall Proposition 98 ADA base by measuring the broadest possible range of instructional services in terms of ADA-equivalents, such that the cost per ADA-equivalent is roughly the same for all programs.

An alternative method for avoiding the incentive to limit growth in discretionary programs would be to eliminate the ADA in such programs from the calculation of the minimum funding requirement. Although the initiative requires that *all* ADA be used, it also gives the Legislature the authority to change its provisions in order to "further its purposes." Arguably, changing the definition of ADA that must be used in calculating the minimum funding requirement could be seen as furthering the intent of the initiative if it eliminated undesirable consequences while having little or no fiscal impact.

4. Determining the Minimum Funding Level in a Year After the Requirement Has Been Waived. The initiative allows the Legislature to waive the minimum funding level requirement with urgency legislation (other than the Budget Act). It does not indicate, however, how the required funding level should be computed in a year following the year in which such a waiver has been enacted. Specifically, the question is whether the funding level should be computed on the basis of the prior year's *actual* funding level or on what the prior year's funding level *would have been* if the requirement had not been waived. The latter course would provide greater revenue to K-14 education, with a correspondingly greater cost to the state.

5. Sanctions. While the initiative requires that excess revenues be spent for specified purposes, it does not impose any sanctions on districts that spend them on unauthorized programs. The Legislature may wish to impose such sanctions.

CONCLUSION

The Governor's Budget contains $116 million in the current fiscal year and approximately $400 million in 1989-90 in new K-14 funding related to the adoption of Proposition 98. The expenditure of these funds will be determined by legislatively approved appropriations (see Item 6110-198-001 in the *Analysis* for a detailed discussion of expenditure options).

We caution that there are several reasons why the Legislature should not rush to appropriate these funds. First, given the funding formula approved by the voters, the current-year and budget-year Proposition 98 cost estimates will continue to change as the year progresses. Specifically, a General Fund revenue change affects the measure's cost because of the requirement to provide a specified percentage of General Fund revenue for K-14 education. For example, a $100 million increase or decrease in General Fund revenue would result in a $39 million increase or decrease in the initiative's cost.

Second, before allocating any 1988-89 Proposition 98 monies, the Legislature should first address funding of current-year K-14 deficiencies. To do otherwise could result in the state providing districts with funds in excess of the Proposition 98 funding requirement.

Because of the possibility of unforeseen changes in both General Fund revenue and K-14 deficiency requirements, *we recommend that the Legislature wait until the May revision of the 1989-90 Budget Bill before appropriating any funds for Proposition 98.* This would allow a response to the initiative based on the most current information regarding current-year revenues and K-14 funding requirements. It would also give the Legislature time to consider the implementation issues which we have raised above.

State Accounting Practices

Do the Accounting Changes Reflected in the Governor's Budget Help to Improve the Accuracy of California's Financial Statements?

Summary

- *The Governor's Budget reflects two changes in the way the state's General Fund condition normally has been reported by the Department of Finance. These changes have the effect of increasing the amount of funds that the department reports as uncommitted and available for appropriation in 1987-88, 1988-89 and 1989-90.*
- *On this basis, the budget indicates that the state did not end 1987-88 in a deficit position, as has been reported by the State Controller.*
- *The changes raise the question of whether they contribute to a more accurate presentation of the state's financial condition. Our review of these changes indicates that they do not, because they lead to an overstatement of the amount of funds which are uncommitted and available for appropriation.*
- *For this reason, the adoption of these changes by the department raises concerns about potential confusion among users of the state's financial data, given that the department's figures will differ from the State Controller's reports and those of the Auditor General. The Legislature may wish to consider whether a specific procedure for the implementation of changes to the state's accounting system is warranted.*

The 1989-90 Governor's Budget reflects two changes in the state's traditional method of accounting for state General Fund expenditures and obligations. These changes have the effect of increasing the amount of money that is considered to be "left over" after the state's obligations are accounted for, and therefore increase the amount considered to be available for appropriation by the Legislature. As a result of these changes, the administration reports that the state did not end 1987-88 in deficit, as reported by the State Controller. According to the administration's figures, the state actually had almost $4 million left in the Special Fund for Economic Uncertainties (SFEU) on June 30, 1988. The accounting changes reflected in the budget also affect the state's reported financial condition for 1988-89 and 1989-90.

This section examines the administration's accounting changes and their consistency with the state's policy of "moving towards" conformity with "Generally Accepted Accounting Principles" (GAAP). We also discuss the method by which the administration will implement these changes and the effect they will have on the state's official financial statements. Finally, we present some concerns relating to these changes.

What Changes Are Reflected in the Budget?

The traditional method of reporting the General Fund's financial condition is referred to as the "Legal/Budgetary Basis" of accounting, and reflects both statutory requirements and traditional practices. The Governor's Budget reflects the following two changes in the traditional method:

- ***It treats goods and services ordered but not received as a*** **reserve** ***rather than an*** **expenditure,** so that they are counted as money "left over" at year end rather than money which has already been expended. Under existing accounting practices, these transactions are treated as an obligation of the state when entered into and recorded as an expenditure charged against the year in which the goods and services are ordered. The administration instead has subtracted these amounts from its General Fund expenditure total, and set up a "reserve for liquidation of encumbrances" to reflect the state's liability for these payments. This change is represented by the administration as necessary to continue the implementation of 1984 legislation requiring the conformance of the state's accounting system to GAAP (Ch 1286/84—AB 3372, Stirling).
- ***It eliminates the reserve for outstanding but unspent appropriations,*** so that they are not considered in determining how much money is available for new commitments. Traditionally, the budget has shown how much of the funds left over at year's end already has been committed by the Legislature for various purposes. This practice ensures that these existing commitments are taken account of in determining what level of uncommitted resources is available for allocation through the budget process. The budget contains no discussion of the rationale for this change.

Are the Changes Consistent With GAAP?

Chapter 1286 declares the Legislature's intent that the state's accounting systems be amended to conform to "Generally Accepted Accounting Principles" (GAAP). This legislation did not establish a specific time frame or set out the order in which actions necessary to bring the state into conformance would occur. It did, however, anticipate that the state's accounting and budgeting systems would eventually be brought into conformity through the gradual adoption of changes by the Department of Finance (DOF) and the State Controller's Office (SCO). A task force consisting of representatives of DOF, SCO, and the state Auditor General's Office has the responsibility for developing recommended changes in accounting policy to the administration. This group, whose current focus is on developing a system of accounting for fixed assets, did not play a role in the administration's decision to adopt the accounting changes reflected in the budget.

What Is GAAP? GAAP is a set of uniform minimum standards for financial accounting and reporting. The application of these standards to governmental entities is governed by regulations issued by the Governmental Accounting Standards Board (GASB). The adoption of these standards is premised on the idea that fair, accurate and *consistent* disclosure of an entity's financial condition will improve its financial management, and allow interested parties to make informed judgments about the entity's ability to carry out its financial responsibilities. Where the accounting standards for private entities focus on net earnings, the focus of the governmental standards is on amounts available for appropriation.

In general terms, the GAAP standards require that all assets and liabilities be fairly disclosed in governmental financial statements. One of the themes embodied in these standards is that revenues should be recorded when they are "earned," and expenditures should be recorded in the year in which the goods and services they purchase are actually "consumed." Another theme is that the financial statements should disclose all obligations which have not otherwise been recorded by establishing a reserve or designation of funds in the amount necessary to satisfy these obligations when they ultimately come due.

The state is currently required by federal law, as a condition of receiving federal grants-in-aid, to prepare a GAAP-based statement of financial condition covering all state funds. This statement is prepared by the Auditor General, in conjunction with the SCO, by "adjusting" the SCO's "Legal/Budgetary Basis" financial statements for the major differences in accounting treatments.

First Change Is Consistent With GAAP. The administration is correct in its assertion that the change in the treatment of goods and services which have been ordered but not received is consistent with the GAAP standards. In preparing the annual GAAP-based financial statement, the Auditor General reduces General Fund expenditures by the amount which has been "encumbered" for goods and services not yet received and indicates that a portion of the fund balance will be needed to satisfy these commitments. Thus, if done correctly, this change would have no impact on the amount of funds left over and available for appropriation, but would lead to a more accurate reflection of expenditure levels for the 1987-88 fiscal year. The Auditor General's Office advises that this adjustment will amount to $241 million for the General Fund in 1987-88, or $10 million less than reflected in the budget.

While the change reflected in the budget is theoretically consistent with GAAP standards, it has *not* been consistently applied. Specifically, the budget has not extended this treatment to funds other than the General Fund, nor is the reserve established to liquidate these encumbrances adequate to fund the full amount of the encumbrances. The administration reduced the amount of this reserve by $80 million to reflect its plan for the cancellation of outstanding encumbrances. Our review of the amounts outstanding indicates that it will not be possible to save the full $80 million, as most of the encumbrances in question have already been liquidated.

Further evidence of the budget's inconsistent application of the GAAP "consumption" standard can be found in the administration's proposed treatment of 1989-90 Medi-Cal expenditures. Under existing state law, the Medi-Cal program must be accounted for on a "cash basis." This means that expenditures are recorded whenever checks are issued for services rendered, as opposed to when the services are actually "consumed." This has the effect of artificially reducing the level of state expenditures. The budget actually proposes to make the accounting for this program even less reflective of its current activity. Specifically, the administration intends to delay the date when the last batch of 1989-90 checks are written, from June until July, so that these expenditures will not be recorded until 1990-91.

Second Change Inconsistent. The second change reflected in the budget is not consistent with GAAP standards. GAAP requires that appropriations which are outstanding at year end but which have not yet been expended be shown as a "reservation" of the ending fund balance. In other words, GAAP requires that, in presenting the amount of funds left over at year end, the statements should indicate how much of these leftover funds have already been appropriated for expenditure. The administration's figures indicate that almost $4 million was left over in the SFEU on June 30, 1988, whereas in fact the state was approximately $200 million short of the amount needed to fund the outstanding appropriations and obligations.

What Impact Do the Changes Have on the General Fund Condition?

As noted earlier, the administration's accounting changes have the impact of increasing the amount of funds which is reported to be available for appropriation. Table 1 shows how the accounting changes affect the reported General Fund condition for the prior, current and budget years.

Table 1
Impact of Accounting Changes on Reported General Fund Condition 1987-88 through 1989-90 (dollars in millions)

	1987-88 Actual	*1988-89 Estimated*	*1989-90 Proposed*
Uncommitted funds per Governor's Budget	$4	$3	$870
Less:			
Amount needed to fully fund 1987-88 encumbrances	−80	−80	−80
Amount needed to fund outstanding appropriations[a]	−117	−43	−30
Other SCO corrections[b]	−7	−6	−6
Amount needed/available to fund commitments[a]	−$200	−$126	$754

[a] Source: Legislative Analyst's Office estimates based on Governor's Budget.
[b] Reflects SCO adjustments to reconciliation items shown in Schedule 7 of the Governor's Budget.

As shown in Table 1, the state's General Fund condition would be less favorable without the accounting changes reflected in the Governor's Budget. Specifically, it shows that the General Fund had more commitments outstanding than it had funds available to pay them in the current and prior years. The table also shows that there is less money available for allocation to the SFEU in 1989-90. Even if the administration were to actually "save" a large portion of the $80 million it expects from the cancellation of 1987-88 encumbrances, this would not be sufficient to fund the remaining outstanding commitments shown in Table 1.

What Concerns Do the Changes Raise?

Our review of the accounting changes proposed in the budget indicates that they raise several issues for the Legislature to consider.

Whose Numbers Are Right? In adopting the changes described above, the administration has offered an alternative view of the state's financial condition to that reported by the State Controller. Given that there is also the GAAP-basis statement prepared by the Auditor General to meet federal requirements, this means that the state now has three different official reports as to the state's financial condition.

Although state law provides that the Department of Finance shall design and maintain the state's accounting system, and that the Controller's accounts shall conform to the administration's system, the law does not give the administration the authority to revise the system on a *retroactive* basis. In fact, the administration advises that it does not intend to make *any* changes in the accounting system. Rather, the Department of Finance will annually "estimate" the amount of the change for purposes of the Governor's Budget, and the agencies will still report as expenditures their obligations to pay for goods and services not yet received. Thus, there will be no change in the information reported to the State Controller, and the Controller will still show these encumbrances as expenditures for purposes of the "Legal/Budgetary Basis" financial statements.

In our view, there should be a one-to-one correspondence between the system used by the Legislature and the executive branch for budgeting and planning purposes and the system used by the Controller to report the actual performance of state agencies in carrying out the expenditure plan contained in the budget. To do otherwise leads to confusion among users of the state's financial data.

How Should Changes to the System Be Made? The changes made in the budget were not announced in advance, and the department does not intend to revise the state's accounting systems to effect the change. Rather, it will be accomplished through an annual "ad hoc" adjustment to the statewide General Fund expenditure totals.

Further, the changes do not enhance the state's long-term efforts to bring about full conformity with GAAP standards. This is because to the extent that the administration continues to adopt GAAP-related changes which *improve* the reported fund balance, it will subsequently be more difficult to adopt those remaining changes which will *adversely affect* the fund balance, such as the accrual of liability for services rendered under the Medi-Cal program.

The Legislature may wish to consider whether a specific procedure for the adoption of changes in the state's accounting practices is warranted. Such a procedure could provide for a more considered and consistent application of accounting system changes. Given the state's policy of moving towards greater conformity with the GAAP standards, it would appear to be appropriate for the Legislature to require that the administration justify proposed changes on this basis *prior* to their implementation. The Legislature may also wish to solicit input on these changes from the State Controller, the Auditor General, and other interested parties.

Will These Changes Promote Investor Confidence? As noted earlier, one of the objectives of financial reporting is to provide fair and accurate disclosure of the state's financial condition. As noted above, the administration has chosen to implement these changes in an inconsistent and unsystematic fashion. For this reason, we are concerned that observers may not obtain the most realistic view of the state's financial condition.

Conclusion

The goal of any accounting system should be to give the Legislature and the executive branch the most realistic assessment of the amount of funds received and expended, and the amount that remains available for appropriation by the Legislature. Recent changes incorporated into the

Governor's Budget do not enhance the accuracy of the reported financial information. Thus, they increase the state's risk of overcommitting its available resources, and highlight the need for the Legislature to consider how changes to the state's accounting system should be made in the future.

Retiree COLAs

How Can the Legislature Best Provide Cost-of-Living Adjustments for PERS And STRS Retirees?

Summary

- *Every year the Legislature faces pressure to improve COLAs for members of the State Teachers' Retirement System (STRS) and the Public Employees' Retirement System (PERS).*
- *The current systems for providing COLAs have the following shortcomings: (1) neither the providers nor the recipients know what level of benefits will be paid each year; (2) benefits are not being paid for as they accrue; (3) the costs are not paid for by the employers and employees (in the case of STRS); (4) the costs of the COLAs are not readily apparent (in the case of PERS); and (5) the COLA mechanism could distort administrative decision making (in the case of PERS).*
- *Our review indicates that a better COLA mechanism would have the following characteristics: (1) the amount of income maintenance would be certain and known in advance; (2) the funding mechanism would be straightforward and easily understood; (3) COLAs would be prefunded by contributions; and (4) the costs would be paid by employers and employees.*
- *In order to improve the current COLA mechanisms, we recommend that the Legislature incorporate enhanced inflation protection within the systems' basic benefit structures. For STRS, this could be accomplished through the development of alternative benefit packages from which school districts and teachers could choose.*

Virtually every year, the Legislature faces numerous requests to improve cost-of-living adjustments (COLAs) for retired members of the two largest state retirement systems, the Public Employees' Retirement System (PERS) and the State Teachers' Retirement System (STRS). In response to these requests, the Legislature has established several programs—cumulatively costing hundreds of millions of dollars annually—which enhance the basic COLAs provided by both systems as a part of their overall benefit structures. While these enhancements have improved the purchasing power of retirees, they have not addressed—and in some regards, actually worsened—the basic problems with the state's approach to providing COLAs.

In this analysis, we describe PERS' and STRS' current methods of providing retiree COLAs and the problems with them. We then offer criteria for designing more desirable COLA provisions and offer specific recommendations on how to implement such mechanisms.

Background

The PERS and STRS provide guaranteed monthly retirement payments to thousands of former state workers and teachers. If these payments were not adjusted annually, however, inflation would reduce the real purchasing power of the benefits. Prior to the late 1960s, purchasing power erosion was not a significant concern, as inflation was very low. Since that time, high periods of inflation have greatly affected the buying power of the benefits paid by the system.

In response, the Legislature has enacted three general categories of COLAs for PERS and STRS members:

- ***"Basic" COLAs.*** Basic COLAs provide annual increases (of up to a certain percentage) to a retiree's monthly allowance to help counteract the impact of inflation. These basic COLAs are *guaranteed* to members, and as such, are an integral part of the benefit structure. The cost of the COLA is calculated into the basic contribution rate paid by employers and employees, and prefunded over the working lives of the employees.
- ***Ad Hoc COLAs.*** Ad hoc COLAs are one-time adjustments to the retirement allowances of certain groups of retirees (for example, those retiring before 1971) whose benefits have been especially affected by inflation. Once granted, they become part of the base allowance, restoring value lost due to *past* inflation. They do not, however, address the need for additional COLA protection against *future* inflation.
- ***Supplemental COLAs.*** Supplemental COLAs are *nonguaranteed*, year-to-year increases in benefit allowances. They are provided *contingent on* the availability of funding (for example, from a legislative appropriation of funds), and do not increase the "base" allowance. They provide increases over and above the basic and ad hoc COLAs to those retirees whose total benefit payments (including COLAs) fall below a specified percentage of original purchasing power.

The Legislature has used all three types of COLAs to maintain retiree purchasing power. In the following sections, we examine the COLAs provided by each system and discuss the problems associated with each.

COLAS PROVIDED TO STRS RETIREES

The Legislature granted STRS retirees two ad hoc COLAs, one in 1967 and the other in 1972, before adding a basic 2 percent (uncompounded) annual adjustment to all retiree benefits in 1972. In response to the impact of higher inflation after that time, the Legislature provided three additional ad hoc increases in 1976, 1978 and 1980 to assist certain groups of longtime retirees.

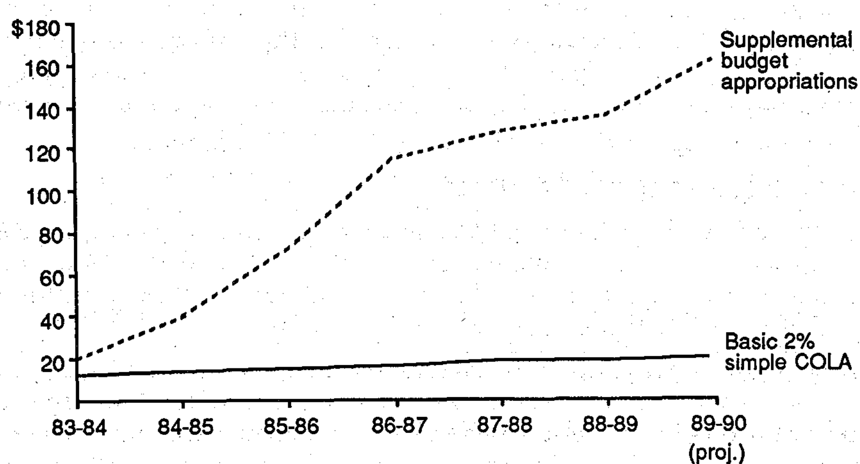
Then, in 1983 the Legislature authorized a supplemental COLA, funded by a *discretionary* annual budget appropriation. The stated intent of this COLA is to increase the purchasing power of all retiree benefits to 75 percent, with appropriated funds going first to assist retirees who have been most affected by inflation. The Legislature, however, is not *required* to provide that amount, and in practice has never provided more than 68.2 percent to retired teachers.

Chart 1 shows the magnitude of STRS COLAs provided from the basic 2 percent COLA and the supplemental budget appropriations since 1983-84. It illustrates two main points. First, by far the greatest portion of inflation protection has been provided through annual budget appropriations for the supplemental COLA. In 1988-89, the budget will provide $132.6 million, compared with only $19 million from the basic COLA. Second, the chart shows that the amount provided through the supplemental COLA has grown dramatically since its inception in 1983-84, increasing almost 600 percent during that period. The chart does not include data on ad hoc COLAs (as the numbers are not available from STRS) or on an additional supplemental COLA established in 1983 which

Chart 1

State Teachers' Retirement System Cost-of-Living Adjustments

1983-84 through 1989-90 (dollars in millions)



provides a relatively small amount of funds each year. At present, the funds provided through all of the system's COLAs provide purchasing power protection of *at least* 68 percent for all retirees.

Problems With Current System

Our review of the existing method of providing inflation protection to STRS retirees indicates the following problems:

Supplemental COLA Payments Are Uncertain From Year to Year. The Legislature annually determines whether and to what extent it funds supplemental COLAs. Because this COLA is paid from the General Fund, it must compete with other legislative programs and priorities. Moreover, the Legislature's ability to fund these COLAs can vary from year to year, depending on such factors as the General Fund revenue condition or the state's position relative to its appropriations limit. Consequently, the Legislature cannot know in advance how much money will be available for COLA payments, and retired teachers cannot know what level of purchasing power they will receive.

Benefits Are Not Being Paid As They Accrue. Through the annual budget appropriation for the supplemental COLA, the Legislature is, in effect, providing benefits associated with services rendered in *past* years. Consequently, the costs of the COLA are not being paid as they accrue. This failure to link benefits and costs: (1) shifts costs forward to future generations of workers, and (2) results in higher payments in the future (due to the foregone interest on contributions).

Those Most Directly Affected — School Districts and School Teachers — Have No Responsibility For, Nor Any Choice In, the COLAs Provided. Each year, the state makes the decision as to the level of the supplemental COLAs and pays the costs for this inflation protection. Thus, the parties *directly* involved in this important employee compensation issue—the school districts and teachers—have no direct responsibility for, nor any choice in, the COLAs ultimately provided.

COLAS PROVIDED TO PERS RETIREES

PERS added a basic 2 percent COLA to its retirement benefit in 1968. In response to the high inflation of the late 1960s and the 1970s, the Legislature granted numerous ad hoc COLAs between 1974 and 1979 in an effort to maintain the value of retiree benefits.

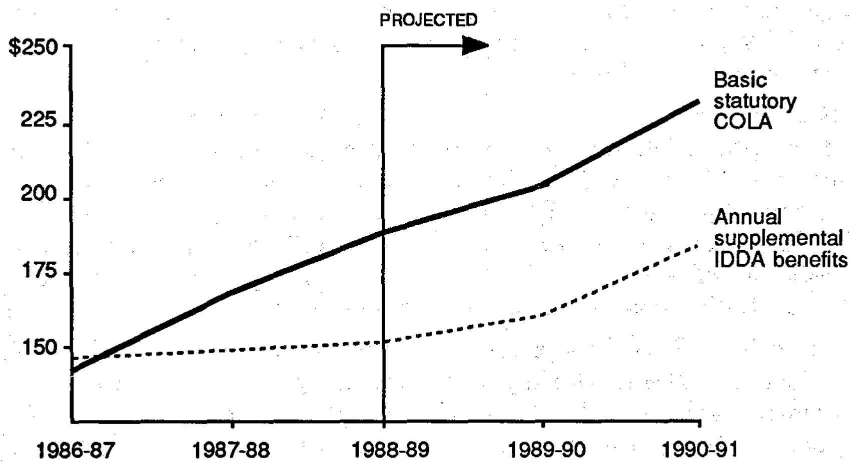
In 1982 the Legislature first established a supplemental COLA program, with payments *contingent upon* the availability of funds in a special account — the Investment Dividend Disbursement Account (IDDA). Under IDDA, PERS provides retirees with the greater of either a 10 percent annual increase or an increase sufficient to provide them with up to 75 percent of original purchasing power. In 1988, Chapter 1356 (SB 275, Russell) increased the maximum possible IDDA benefit to allow *up to 80* percent of original purchasing power protection.

Chart 2 shows the magnitudes of the basic and supplemental COLAs provided since 1986-87, with projections through 1990-91. It indicates that in the current year, retirees will receive increases of $188 million from the basic 2 percent COLA and $152 million from the supplemental IDDA COLA. (Numbers were not available for the ad hoc COLAs, but they provide a much smaller level of benefits.)

Chart 2

Public Employees' Retirement System Cost-of-Living Adjustments

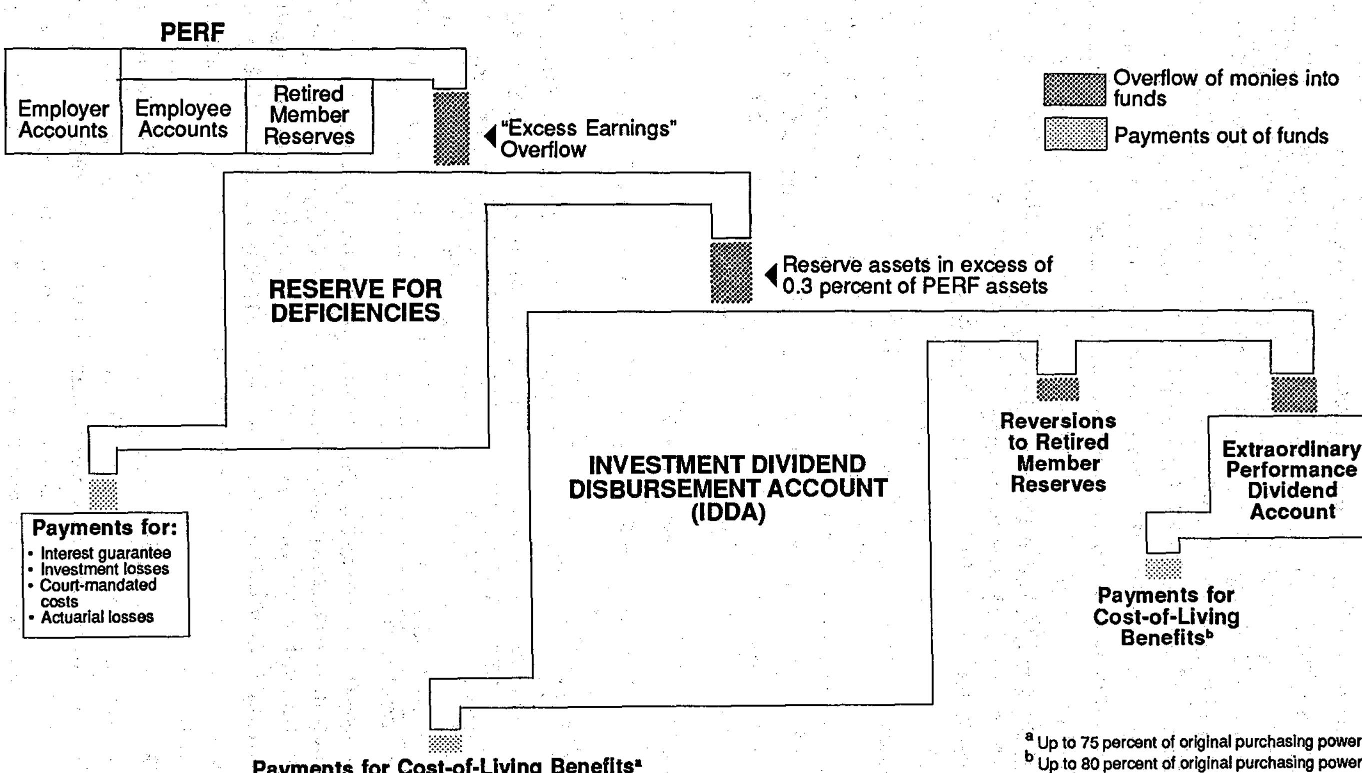
1986-87 through 1990-91 (dollars in millions)



As Chart 2 shows, PERS provides a significant portion of inflation protection through the supplemental "IDDA" benefits. This COLA works through a complex series of accounts and fund transfers, which are summarized graphically in Chart 3 and briefly described below.

Chart 3

Cashflows To Provide IDDA Benefits



[a] Up to 75 percent of original purchasing power.
[b] Up to 80 percent of original purchasing power.

How the IDDA Works. Assets within the Public Employees' Retirement Fund (PERF) are divided into three accounts: (1) employer accounts, which contain all employer contributions along with all interest earned on these contributions; (2) employee accounts, consisting of all employee contributions and their interest earnings (currently credited at an annual rate of 8.5 percent); and (3) retired member reserves, also credited at an 8.5 percent annual rate.

Any earnings on employee accounts and retired member reserves above the 8.5 percent crediting rate are deposited in the Reserve for Deficiencies — up to a maximum of 0.3 percent of total system assets (approximately $194 million in 1988-89). Funds above this maximum flow out of the reserve and into the IDDA, which is used to pay annual COLAs to retirees (to the extent that the funds are available).

The amount which may be retained in IDDA is limited to the total of the previous four years' worth of IDDA benefit payments. Funds in excess of this total (up to an amount equal to the previous year's IDDA benefit payments) then revert to retired member reserves. Any remaining funds flow into the Extraordinary Performance Dividend Account (EPDA), and are used to further supplement retiree incomes up to 80 percent of their original purchasing power.

Problems With PERS' Current System

Our analysis indicates that the PERS COLA structure has the following problems.

The System is Designed in Such a Way That the Costs Are Not Apparent to Those Paying Them. Because the IDDA system is so complex, the costs of these COLAs are not obvious to either the employers or the employees. A more straightforward mechanism would fund COLAs directly, thereby facilitating legislative decision-making on retirement and compensation issues.

Benefits Are Not Being Paid As They Accrue. As with the STRS COLA mechanism, IDDA provides benefits associated with prior years' services. Excess earnings on the accounts of *current* employees are used to pay increased benefits to those already retired. As described above, the failure to pay the cost of benefits as they accrue shifts costs to future generations.

The Source of Funds ("Excess Earnings") is Unstable Over Time. The basic source of funding for IDDA benefits is the amount of "excess earnings" from the retirement fund. In order to continue paying these COLAs, the retirement fund must continue to earn a rate of return greater than the 8.5 percent actuarial crediting rate. By definition, however, the actuarial rate is an *average* return over the long run, meaning that returns of *less than* 8.5 percent would be expected about half the time.

In the years since IDDA was implemented, the PERS retirement fund has experienced an annual rate of return in excess of the actuarial crediting rate by approximately 3 percent per year. As Table 1 shows, earnings since 1985-86 have received a significant boost from capital gains. Capital gains have increased significantly in the past two years but PERS' consultant does not expect them to continue at the current high levels.

Table 1
PERS Investment Earnings
1982-83 through 1987-88

	Earnings from Interest and Dividends	*Earnings from Realized Capital Gains*	*Total Earnings*
1982-83	9.93%	1.39%	11.32%
1983-84	9.94	1.45	11.39
1984-85	10.12	0.81	10.93
1985-86	9.63	2.35	11.98
1986-87	8.81	3.13	11.94
1987-88	7.97	3.82	11.79

Furthermore, earnings from interest and dividends have been falling in recent years, and they could continue at or below their current rate over the next decade. Therefore, once South African divestment is complete and realized capital gains fall, the fund could well return *less than* the 8.5 percent crediting rate. If that happens, IDDA benefit payments would begin to draw from the accumulated reserves within the IDDA account. If the rate of return remains below 8.5 percent long enough for IDDA payments to deplete the reserves, the board will have to discontinue making COLA payments.

As with STRS, then, there is no certainty that monies will be available to fund IDDA benefits in the future, at least at the 75 percent level to which current retirees have become accustomed. Thus, while IDDA was created with the intent to provide a specified level of purchasing power, neither the Legislature nor the retiree can plan with certainty on this level of benefit payments.

The IDDA Funding Mechanism Could Distort Administrative Decision-Making. Although IDDA benefits are only available to the extent that excess earnings exist in the IDDA fund, the amounts in those accounts are in fact actually determined by certain key decisions made by the PERS Retirement Board. Because board decisions affect the amount of funds in the accounts, the IDDA funding mechanism could distort administrative decision-making.

One of the board's decisions that affects the amount of funds in IDDA is the actuarial crediting rate. The actuarial crediting rate is an important determinant of the magnitude of funds that flow into the Reserve For Deficiencies (and from there into the IDDA). Set by the PERS Board of Administration, the actuarial crediting rate is one of the many assumptions necessary to calculate employers' annual contributions. This rate is based on actuarial studies and is supposed to reflect the long-run, average rate of return on assets. If the system should lack sufficient funds in IDDA to pay for annual COLAs, however, *reducing* the long-term crediting rate would produce additional funds flowing to the account.

The actuarial crediting rate is only one example of a variable which could be used to affect the amount of funds in IDDA. Although there is no evidence that the board has made such decisions, a more straightforward COLA mechanism would be independent of such administrative decisions.

HOW CAN THE LEGISLATURE BETTER PROVIDE RETIREE COLAS

Given these problems, the Legislature may wish to consider how it can more effectively provide improved purchasing power for its retirees. Our analysis indicates that a COLA mechanism for retirees should have the following characteristics:

- ***The Amount of Income Maintenance Should Be Certain and Known in Advance.*** In order to help retirees and employers plan for their financial futures, it is important that COLAs are known in advance. Neither the STRS nor PERS COLAs meet this criterion.
- ***The Funding Mechanisms Should Be Straightforward.*** A COLA mechanism should be designed so that the costs are apparent to those paying for them. As described above, the PERS COLA is so complex that it is unclear to many who bears the costs of financing the benefits.
- ***COLAs Should Be Prefunded.*** All retirement benefits *except* for supplemental and ad hoc COLAs are funded by employer and employee contributions so that the full expected cost is paid for *by the time the employee retires.* This approach is called prefunding, and it ensures that retiree benefits are paid for over the working lives of those retirees. If COLAs are viewed as part of the basic retirement package, they should be prefunded in the same way. In other words, they should be paid over the employee's working life through employer and employee contributions. The amount of contributions necessary to finance such benefits can be estimated using actuarial cost assumptions in the same way such contributions are set for other retirement benefits. In contrast, the STRS and PERS supplemental COLAs are—by definition—"pay-as-you-go" benefits.

- ***COLAs Should Be Paid For By the Employer and the Employee.*** As part of the retirement benefit that provides income to employees when they retire, COLAs are a valuable part of the employee's compensation package (along with salary, health benefits, and other benefits). Consequently, sound fiscal policy would indicate that the costs of these benefits should be borne by the employer and employee. Currently, the cost of the STRS supplemental COLA is borne by the state.

Recommendations for Improving the Current COLA Mechanism

The Legislature has stated its intent that PERS and STRS retirees should have their purchasing power protected. The level at which to provide inflation protection is a basic policy decision for the Legislature, and depends on such factors as: costs, the adequacy of the basic retirement allowance, whether retirees have social security and/or health care coverage, and the financial needs of a retiree over time. If, however, the Legislature decides that it wants to provide a certain level of enhanced protection, we recommend that it provide those benefits in the same way it provides all other retirement benefits: they should be an integral part of the basic benefit plan (like the basic 2 percent COLAs). Such a COLA would have all of the desirable characteristics discussed above:

- The benefit would be guaranteed and known in advance;
- The costs, which would be reflected in contribution rates, would be apparent to all;
- Costs would be prefunded, assuring that liabilities were paid over the member's working life; and
- The benefit would be paid for by the employer and employee. Accordingly, we make the following recommendations specific to each system.

STRS

We recommend that the Legislature enact optional STRS benefit packages which include enhanced purchasing power protection.

Technically, it would be relatively easy for STRS to provide enhanced inflation protection within its basic benefit structure. The problem is that the state would be fiscally liable for the entire costs of these benefits, due to constitutional mandate provisions. In order to relieve the state of a cost which properly should reside at the local level (that is, with school districts and teachers), we recommend that the Legislature provide optional alternatives to the existing benefit package which would provide enhanced purchasing power protection. These alternative packages could take many forms, including: (1) the current STRS benefit structure, enhanced by different COLA "add-ons," or (2) modified benefit structures that would reduce other benefits in order to provide enhanced COLAs at little or no added cost.

If local districts opted to elect these alternatives, they would pay the costs of the enhanced benefits. These costs could be paid at the district expense, by teachers, or through a negotiated sharing arrangement between the two. The cost of providing improved inflation protection, would depend upon the COLA selected. For example, a district electing to provide a 3.5 percent COLA (compounded) would pay an additional 3.36 percent of its payroll (approximately). Similarly, the cost of providing 75 percent protection would be about 5.5 percent of payroll.

What About Current Retirees? Even if the Legislature were able to shift to the local level the costs of providing enhanced COLAs for current and future teachers, it would probably have to continue paying the cost of any supplemental COLAs for current retirees. Thus, an annual Budget Act appropriation may be necessary for some time.

Governor's Proposal. In the 1989-90 Budget, the Governor proposes a major change in the way the state pays for STRS' enhanced COLAs. We review the proposal in detail in the *Analysis* (please see Item 1920-111), and conclude that the proposal creates more problems than it solves.

PERS

We recommend that the Legislature replace the current mechanism for providing supplemental COLAs with one that is incorporated into the basic benefit structure.

The current problems with PERS' COLA mechanisms also could be addressed by incorporating enhanced inflation protection into the basic benefit structure. As mentioned above, this could be accomplished in two basic ways. First, the benefit could be provided on top of the existing structure, which would increase the ongoing cost of funding retirement benefits. These costs, however, could be shared between employer and employees. Furthermore, these costs would be *in lieu* of the IDDA costs now borne by the state. Second, PERS could reduce other benefits to offset the cost of an enhanced COLA, thereby resulting in no *net* costs. For example, reducing the basic monthly benefit would "free up" funds that could be used to maintain purchasing power during the member's later retirement years.

Given that either method would address the current problems with the PERS COLA mechanism, we recommend that the Legislature replace the current inflation protection method with one that is part of the basic benefit. The particular method to be selected is a policy call for the Legislature.

Summary

Our analysis indicates that there are several problems with the way STRS and PERS provide inflation protection to their retirees. Given the current COLA mechanisms, the Legislature is faced with demands to fund enhanced inflation protection on a year-to-year basis. *If* the Legislature wishes to provide improved COLAs to these retirees, we recommend that it do so by incorporating inflation protection into the systems' basic benefit structures. In making this policy decision, the Legislature should carefully consider the *commitment* involved, as any defined benefit tends to "lock in" certain costs for many years.

14—78860

State Retiree Health Benefits

What Options Does the Legislature Have for Providing and Funding Health Benefits for Retired State Employees?

Summary

- *In 1988-89, the state's post-retirement health benefit program will provide benefits to about 69,000 retired state employees, at a cost of over $140 million.*
- *Over the last 10 years, state costs for retiree health benefits have increased annually by an average of over 20 percent, and it is likely that these costs will continue to grow rapidly in the future.*
- *There are several major problems with the current "pay-as-you-go" retirees' health benefit program. First, while the Legislature has never explicitly committed to a given level of benefits, it may have implicitly obligated itself to fund future benefits. This implicit commitment could result in state liabilities which are open-ended and which are not paid for as they accrue. Finally, the current program does not closely link benefits with years of service and age of retirement.*
- *We recommend that the Legislature decide explicitly in law what it is committing to for retiree health care. Then, after the commitment is clearly defined, the costs of providing these benefits for future employees should be paid as they accrue.*

In the current year, the state will pay over $140 million toward the costs of state retiree health benefits. In future years, these costs are expected to rise substantially. While, in general, the state has not explicitly guaranteed retirees the right to a certain benefit level, it may be bound to provide benefits in the future to all current employees and retirees. Therefore, given the major financial obligations entailed in any commitment—implicit or explicit—to provide retiree health benefits, the Legislature should carefully consider what benefits it will provide in the future and how they will be funded.

In this analysis, we review (1) the operation of the existing retirees' health benefits program, (2) problems with the program, and (3) different options available to the Legislature for providing and funding health benefits for state retirees.

Background

The state began providing health benefits for active and retired state employees in 1962 under the Public Employees' Medical and Hospital Care Act (PEMHCA). This program is administered by the Public

Employees' Retirement System (PERS), which also offers its health benefit plans to employees of local public agencies. In 1988-89 the program will provide health benefits to about 69,000 retired state employees, at an estimated state cost of over $140 million.

How Do State Employees Qualify for Retiree Health Benefits? In general, state employees qualify for retiree health benefits if they: (1) retire within 120 days of leaving state service, (2) are enrolled in a state-sponsored health plan at the time of retirement, and (3) complete a specified number of years of state employment. Employees hired prior to January 1, 1985 qualify for 100 percent of the state's monthly premium contribution after five years of state service. Employees hired after January 1, 1985 qualify for 50 percent of the state's premium contribution after five years of service. This increases 10 percent annually until employees are eligible for 100 percent of the state's contribution after 10 years. Under new collective bargaining agreements, *represented* employees hired after January 1, 1989 will qualify for 50 percent of the state's contribution for retiree health benefits after 10 years of service, increasing gradually to 100 percent after 20 years of state service.

In addition, the state provides health benefit coverage to the qualified dependents of retirees. Survivors of retirees are allowed to continue to receive health benefit coverage.

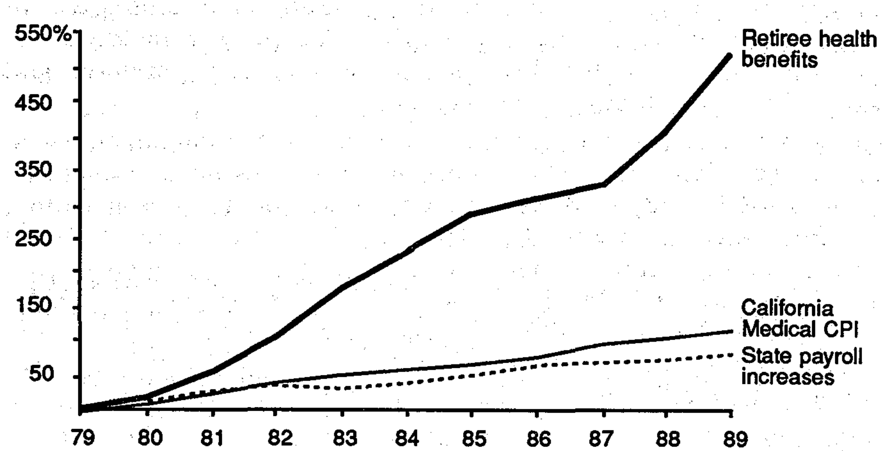
What Health Benefits Do State Retirees Receive? Retirees under the age of 65 receive the same comprehensive health benefit coverage as active employees. Retirees over the age of 65 enroll in Supplement to Medicare plans (retirees not eligible for the federal Medicare program remain in active employee health plans). The PERS' Supplement to Medicare plans are designed to pay for costs not covered by Medicare (such as copayments and deductibles), as well as provide additional services not available under Medicare (such as enhanced prescription drug and vision care coverage). In general, the state pays the entire cost of the premium for this coverage.

Historical Costs of the Program. In the current year, the state will spend about $140 million for health benefits for retired state employees. As Chart 1 shows, the state's cost for retiree health benefits has grown rapidly over the past decade, outpacing both the increase in the medical inflation index and the state payroll. During that time, retiree health costs have increased by an average of 20 percent annually.

Chart 1

State Retiree Health Benefits Historical Cost Trends

1978-79 through 1988-89 (cumulative percent increase)[a]



[a] Data are for fiscal years ending in year shown.

The increasing costs of the retiree health benefit program are the result of: (1) premium increases and (2) growth in the retiree population.

Premium increases in the health care industry have been driven by the increasing costs of medical services, increased utilization of health services, and other factors such as advances in medical technology. Premium rates in retiree health programs are also influenced by the fact that, in general, as people grow older they have higher health care costs. For example, PERS has reported that the costs of claims for enrollees over the age of 45 are 21 percent higher than for those under the age of 45.

The retiree health benefit program also has experienced significant enrollment growth, which has contributed to the high rate of cost increases. Since 1980 the number of retired state employees covered by the program has grown from 46,700 to 68,500, an increase of 47 percent. In 1980, retired employees represented about 25 percent of total state health plan enrollment, whereas today they represent about 28 percent.

The combined effect of increased premiums and enrollment can be significant. For example, the Governor's Budget proposes to increase state support for retirees' health costs by $31 million in the budget year, a 22 percent increase. Of this projected growth, one-fourth is due to increased enrollment and three-fourths to premium increases.

Future Costs of the Program. Our review indicates that the cost of the retiree health benefit program is likely to continue its high rate of growth, due to increasing premiums and enrollment. The trends that have driven premium rate increases in the past are likely to continue in the future. Among the most important of these trends are the increasing costs of medical services and increased health care utilization. In addition, the number of state retirees will continue to grow rapidly in the future due in part to the demographics of the state workforce and increased life expectancies of retirees.

If, in fact, the past trends of the health benefits program were to continue into the future, then the state's expenditures for employee compensation would be greatly affected. For instance, Chart 2 shows that if recent trends continued through 1997-98:

- Total health benefit costs (active and retirees) would surpass retirement/social security as the second most costly item in the state's total compensation expenditures (second only to salaries), and
- The cost of health benefits for retirees would increase from 23 percent to 31 percent of the state's total expenditures for health benefits.

These trends are even more pronounced in the 2007-08 data.

Problems with the Current Retiree Health Benefits Program

Our review of the state's existing health benefits program indicates that it has four main problems.

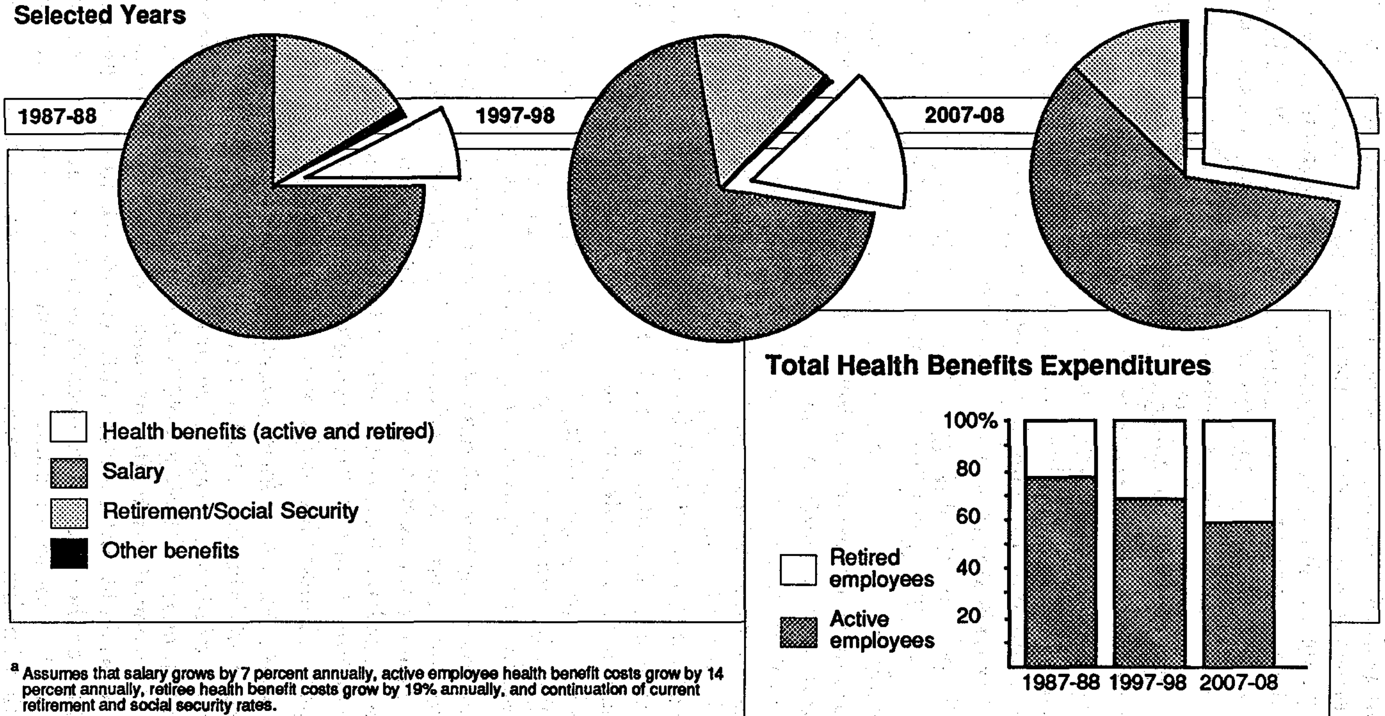
State's Commitment on Retiree Health Benefits Is Unclear. As noted above, under PEMCHA retirees receive the same benefits as current employees. It's unclear, however, what sort of commitment—if any—this statutory provision implies about *future* benefits. For instance, can the Legislature change PEMHCA to modify the health benefits and/or the state contribution paid toward those benefits with regard to current *retirees?* Furthermore, is the Legislature "locked in" on providing future retiree benefits to current *employees?*

Generally, the Legislature has not *explicitly* committed itself to the provision of future health benefits. This may explain why retiree health benefits are supported on a "pay-as-you-go" basis through an annual Budget Act appropriation. On the other hand, Legislative Counsel advises that past legislative actions—such as the statutory linkage between employees and retirees, and the state's funding of benefits at a high level for a long period of time—may have created a contractual commitment to future retirees.

Chart 2

Health Benefit Costs' Growing Share of the Employee Compensation Pie Assuming Past Trends Continue in the Future[a]

Selected Years



[a] Assumes that salary grows by 7 percent annually, active employee health benefit costs grow by 14 percent annually, retiree health benefit costs grow by 19% annually, and continuation of current retirement and social security rates.

Any implicit commitments that have been made to current active and retired state employees, and those that will be made to new employees hired under current collective bargaining agreements, may limit the choices available to future Legislatures and will affect generations of taxpayers to come. For this reason, it is critical that the Legislature clearly define its future commitments to provide state retiree health benefits.

If the state is in fact obligated to provide some level of future health benefits, there are three additional problems with the current program.

State May Be Committed to Fund Current Level of Benefits. Since the state now pays for almost 100 percent of retirees' premium costs, the state could have a commitment to fund future cost increases in the retiree health program. As we described above, the cost of this program could continue to rise at very high rates. For the foreseeable future, the Legislature may have little choice but to pay the entire additional cost each year.

Commitment to Provide Retiree Health Benefits Not Paid for When Benefits Are Earned. As noted previously, the current health benefits program is funded on a pay-as-you-go basis. That is, the employer and employee have not contributed funds during the employee's period of employment for the costs of providing health benefits during retirement. As a result, the state must annually appropriate funds for these costs. If the state is committed to paying retiree health benefits, it would be fiscally prudent to prefund the costs in a manner similar to retirement benefits. Prefunding ensures that: (1) future taxpayers will not be required to support costs that are incurred today and (2) the state will have sufficient funds available to fund these costs when they "come due."

The state may face a large fiscal bill for the past, implicit commitments made to state employees. That is, if an employee's right to retiree health benefits vests in some form even *before* the employee retires, then the state *already* has incurred a liability for the retiree health benefit costs of current employees. In 1984 a private consulting firm estimated the state's unfunded liability for health benefits to be about *$4.5 billion.*

Benefits Have Not Been Closely Linked to Service. In the past, the retiree health benefits received by state employees have not been linked to years of service or age of retirement. For example, employees hired before January 1, 1985 generally qualify for 100 percent of the state's premium contribution after five years of state service. Thus, an employee who worked for the state for only five years and retired at age 55 would qualify for the same retiree health benefits as an employee who worked for the state for 25 years and retired at age 65. Consequently, there is little relationship between a person's years of service and age at retirement, and the health costs incurred by that person in retirement.

In recent years the linkage between years of state service and benefits has improved. As noted earlier, employees hired after January 1, 1985 have longer vesting periods and the state's contribution toward retiree premiums increases with years of service. Despite these significant improvements, however, benefits are not as closely linked with years of service as is the case with retirement benefits and there is no linkage with age of retirement.

What Options Does the Legislature Have for the Future?

Because of implicit commitments made to state employees in the past, the Legislature may have limited choices in the payment of retiree health benefits to current retirees, and perhaps even to current employees. Regardless of what level of retiree benefits the Legislature believes to be reasonable, it should be careful to clearly define the nature of the commitment with regard to *future employees.*

For instance, at one extreme the Legislature could decide not to guarantee *any* future retiree health benefits. It could use the existing Budget Act mechanism to fund whatever portion of retiree premium costs it could afford—or felt was appropriate to pay—in that year. To do this, however, it would have to amend PEMHCA to "unlink" current and retiree health benefits and clearly specify that employees, upon retirement, had no "right" to any particular benefit program or state contribution rate.

This approach, however, appears to be contrary to the Legislature's desire to provide employees with some security as to their health benefits in retirement. Accordingly, we offer two general alternatives to current practice which provide such benefits while at the same time addressing the problems raised above.

Defined Benefit Plan. The Legislature could provide retirees with a *defined health benefit* plan. This would be similar to the current program in which retirees are provided a certain level or general package of benefits. The plan, however, would have the characteristics of a retirement plan, in that benefit costs would be prefunded (through actuarially determined rates, paid for by both employer and employee) and benefits would be linked closely to years of service and age of retirement. Thus, by committing to such a specific benefit plan, the Legislature would address three of the four problems noted above.

It would not, however, necessarily resolve the problem of an open-ended commitment. If, as with existing retirement systems, the employer were the "payor of last resort," the Legislature would not know with much certainty the future fiscal liability it was incurring. As described above, the future costs of retiree health care are difficult to predict because inflation in medical services is difficult to estimate, the patterns of health service utilization are changing, and any changes in federal Medicare policies would significantly affect state costs for retiree health care. Any and all unexpected cost increases would be borne by the state.

There are, however, a couple of ways to limit the state's fiscal commitment under a defined benefit plan:

- The Legislature could specify in statute that the state and employees share the risk for future cost increases. For example, contribution rate changes could be paid half by the employer and half by the employee.
- For represented employees, the state could collectively bargain with employees over the amount of the total cost that would be contributed by the state. This would ensure that the state and its employees begin to explicitly recognize the trade-offs inherent in funding retiree health benefits (a form of *deferred* income) versus *current* income (salaries and current benefits).

In any case, the Legislature needs to be very careful in committing to specific terms of a defined benefit plan. Because of the long-term fiscal involvement inherent in such plans, the Legislature should try to maximize its flexibility with regard to both its annual contribution rate and year-to-year adjustments in the benefit package.

If the Legislature decides to commit to a specific defined benefit plan, it probably would have to apply only to *future* employees. This is not only because the cost of prefunding current benefits to active employees is very high (estimated by one consulting firm to be $240 million annually). Having the plan apply only to new employees also would be the easiest way for the Legislature to "start fresh" with its explicit commitment on health benefits.

Defined Contribution Plan. Another alternative available to the Legislature is to provide retirees with a defined monetary contribution towards the purchase of retiree health benefits. This defined contribution plan could work similarly to existing private-sector retirement plans. For instance, the state would contribute a given amount—which could be matched by the employee—which then would be set aside in a fund to earn interest. At the time of retirement, the retiree would maintain enrollment in one of the state's group plans and use the accumulated monies in the fund to offset health premium costs over his or her retirement period.

A defined contribution plan would address all of the major problems associated with the current program:

- The state's commitment would be clearly defined.

- The state's financial commitment would be *closed-ended,* as future state contributions would *not* be contingent on factors beyond its control (such as medical inflation and Medicare changes).
- Benefits would be paid as they are earned. The state would make contributions over the working life of employees. (Also, under a defined contribution plan, the state would never incur an "unfunded liability" as there is no "vesting" or commitment to specific benefits.)
- Benefits would be closely linked with service, as employees would receive state contributions for each year worked; and the later an employee retired, the further his/her plan dollars would go in paying premium costs.

Providing retirees with a defined contribution plan would also work well within a flexible benefits approach to employee compensation. In a flexible benefits plan the state would bargain over the *total* amount of employee compensation while giving employees a wide choice of different ways to spend their compensation dollars. For example, an employee could trade-off some current salary or retiree health benefit coverage in return for other benefits, such as a long-term care insurance policy. This approach would increase the state's ability to control total compensation costs, while giving employees more choice in determining the mix of benefits that will best meet their needs.

The main disadvantage to a defined contribution plan is that it leaves retirees more at risk for future cost increases in the program. While employees could match the state's annual contributions in order to cover a certain amount of expected retirement health costs, as retirees they would have to pay for any unexpected cost increases from their own resources.

Summary

If past trends continue, the cost of retiree health benefits will rise dramatically in future years. With regard to current employees and retirees, it's unclear the extent to which the state can affect these costs. With regard to future employees, it is vital that the Legislature decide *explicitly* in law what it is committing to for annuitant health care. Then, after the commitment to provide retiree health benefits is clearly defined, the state should pay the costs of providing these benefits for future employees as they accrue.

Implementation of the PERS-CARE Health Plan

Will PERS-CARE Be an Affordable Health Plan Option for State Employees in the Future?

Summary

- *The PERS Health Benefits Program offers health benefit coverage to employees of the state and various local public agencies. Total enrollment, including employee dependents, was about 660,000 as of July 1988. In 1987-88 total premium costs were about $578 million.*
- *In recent years the program has experienced rapidly increasing premiums. Fee-for-service plans have been one of the factors driving premium increases, as these plans are far more expensive than Health Maintenance Organization (HMO) plans.*
- *To help contain premium increases, PERS consolidated its existing fee-for-service plans into a new program called PERS-CARE, a self-funded state-run plan which contains various cost containment features.*
- *PERS-CARE faces significant obstacles to controlling future cost increases, as the plan has a much older membership and the basic fee-for-service structure of the plan does not provide strong incentives to control costs. Because these factors are not easily remedied, it is uncertain whether PERS-CARE will be an affordable health plan option in the future.*
- *To assist the Legislature in monitoring the progress of the PERS-CARE health plan and to provide PERS with information that will help it manage the plan (and all other plans), we recommend the enactment of legislation requiring the PERS Health Benefits Program to develop a comprehensive management information system.*

In recent years, the Public Employees' Retirement System (PERS) Health Benefits Program has experienced rapidly increasing premium costs. One of the driving forces behind the cost increases has been high premium rates in its fee-for-service plans. To help address this problem, PERS recently chose to consolidate the fee-for-service plans into one major plan, called PERS-CARE. PERS-CARE is self-funded by the state, and contains various cost containment features.

In this analysis, we (1) describe the state's health benefits program, (2) evaluate recent cost patterns which led to the creation of PERS-CARE, and (3) evaluate whether PERS-CARE will be successful in controlling these increases.

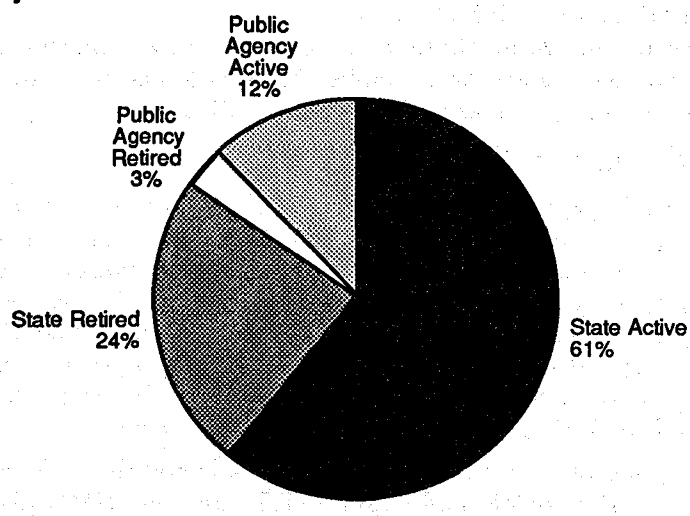
The State's Health Benefits Program

The state provides health benefit coverage to its active and retired state employees under the Public Employees' Medical and Hospital Care Act. This program, which is administered by PERS, also provides health benefit coverage to employees of various local public agencies. The PERS health benefits program is large, covering about 280,000 current and retired state and public agency employees (as of July 1988). Total enrollment, including employee dependents, is 660,000. In 1987-88 total premium costs were about $578 million.

Chart 1 shows the composition of the plan. It indicates that almost three-fourths of enrollees are "active" employees, and one-fourth are retired. It also shows that 85 percent of enrollees are state members, compared with 15 percent local members.

Chart 1

PERS Health Benefits Program Enrollment[a]
As of July 1988



[a] Figures do not include dependents of employees.

In recent years, the number of retirees and public agency members has grown significantly. In 1973, retirees represented 19 percent of the plan, while in 1988 they represented over 27 percent. Since 1980, the number of retirees has increased by 25,000, or 51 percent. Public agency enrollment has grown even faster, increasing from about 20,000 employees in 1983, to over 40,000 in 1988. These employees represent over 400 different public agencies.

The PERS Health Benefits Program offers over 30 health plan options to employees. The options fall in the following categories:

- ***Fee-For-Service/Preferred Provider Plans.*** In a fee-for-service plan an insurer agrees to pay specified percentages of medical services bills. The employee has virtually unlimited access to these services, and may choose the doctor of his or her choice. A preferred provider option includes incentives for employees to use a preselected group of health care providers who have agreed to provide their services at a discount. Prior to PERS-CARE, the major fee-for-service plans were operated by Blue Cross, Blue Shield and Cal-West.
- ***Health Maintenance Organizations (HMOs).*** HMOs generally follow one of three models: (1) staff model, in which services are provided by the HMO's own in-house staff; (2) group practice model, in which services are provided through a medical group; or (3) an independent practice association, in which an HMO provides services through contracts with independent medical providers. In many cases, HMOs provide health care service for a per-person prepaid fee. Normally, the employee is covered only for treatment prescribed by an HMO doctor.
- ***Association Plans.*** These plans are derived from specific collective-bargaining negotiations. Membership is confined to a limited group of employees, such as highway patrol officers.

Why Was PERS-CARE Created?

PERS-CARE was created primarily to help control the cost of the PERS fee-for-service health plan option. In the past, these fee-for-service options have been more expensive than other plans offered by PERS, and recently their cost has increased at a high rate. In 1987-88, for instance, fee-for-service costs increased by nearly 20 percent, while HMO costs increased by 4.8 percent. In the current year, premium costs for the fee-for-service plans are projected to increase by over 31 percent, compared to HMO premium increases of 7.5 percent.

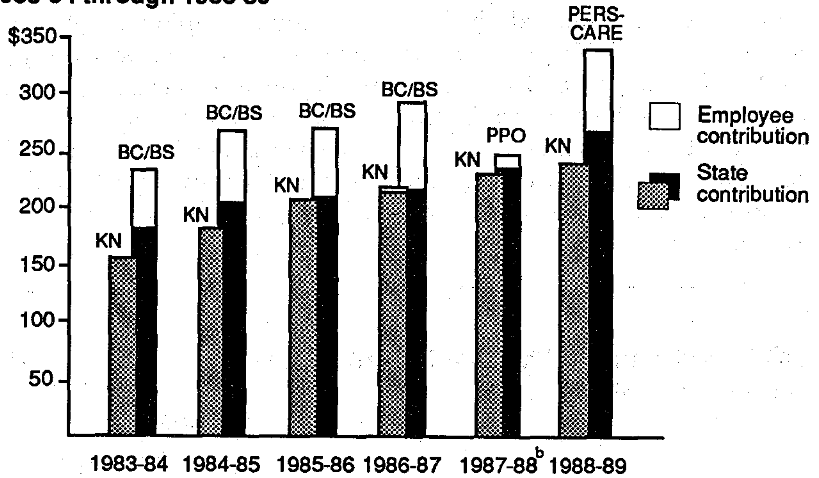
Chart 2 shows recent premium costs of selected fee-for-service plans (Blue Cross/Blue Shield and PERS-CARE), and one HMO plan (Kaiser North).

The chart shows that the fee-for-service plans cost considerably more, and require employees to contribute toward the premium costs. In contrast, employees in the HMO plan generally have not had to incur any out-of-pocket premium costs. The plans shown are representative of the health benefits program as a whole, as fee-for-service plans are significantly more expensive for the state and employees than HMOs.

The high cost of the fee-for-service plans has affected the state health benefits program by (1) increasing its overall costs, (2) increasing the state's contribution toward these costs, and (3) causing enrollments to shift from fee-for-service options to HMOs.

Chart 2

Trends in Premium Rates
Selected Fee-for-Service and HMO Plans[a]
1983-84 through 1988-89



[a] Data represent monthly premium of a basic plan at the family rate. KN = Kaiser North (HMO); BC/BS = Blue Cross/Blue Shield (Fee-for-Service); PPO = Blue Shield Preferred Provider Organization.
[b] Excludes Blue Cross Prudent Buyer Plan.

Increase in Overall Costs. Due in part to the cost of its fee-for-service plans, the PERS Health Benefits Program has experienced rapidly increasing premium costs in recent years. This in turn has led to increasing costs for the employers who participate in the program. For example, between 1979-80 and 1987-88 the state *per-employee* premium cost has risen annually by an average of nearly 12 percent and *total* state premium costs increased annually by an average of almost 16 percent. These increases compare to an annual average increase of 6.8 percent for the state payroll, and an annual average increase of 8.6 percent for the cost of medical services (California medical inflation index) over the same time period.

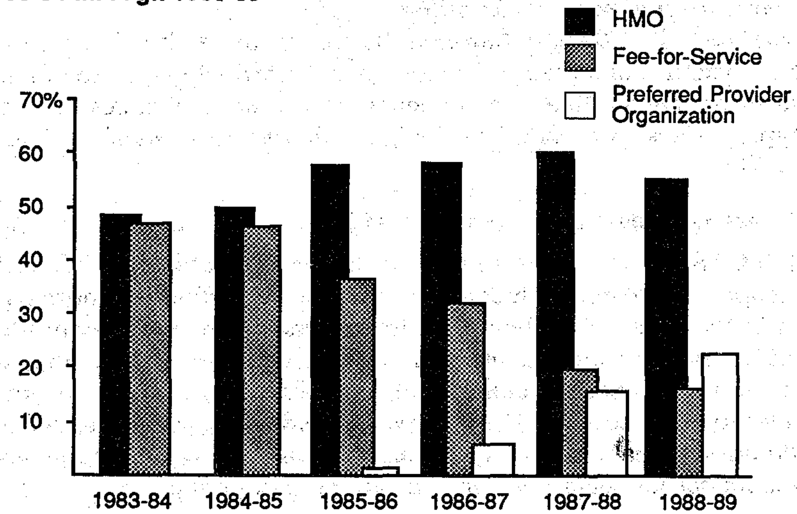
Increase in State Costs. The high premium costs of the fee-for-service plans have also had a substantial effect on what the state contributes toward premium costs. The state's contribution for its employees is based on an *average* of the premiums of the four plans with the largest enrollment (which has always included at least one fee-for-service plan). Consequently, the high premium cost of the fee-for-service plans (one of the top four) raises the state contribution for *all* plans.

Enrollment Shifts. As the employee premium cost of the fee-for-service plans has increased, employees have shifted to less expensive HMO plans. Chart 3 illustrates the changing enrollment patterns in the state's program since 1983-84. It shows that enrollment in fee-for-service plans has dropped from almost half of the total in 1983-84 to about 15 percent today. In general, it is the younger employee who shifts enrollment to an HMO plan because they are less able, on average, to afford the higher premium cost in fee-for-service plans. Also, older employees are reluctant to change to an HMO because they are accustomed to traditional fee-for-service plans, and may have long-standing relationships with particular medical care providers. In addition, some retirees live out-of-state and thus, have no alternative to a fee-for-service plan.

Chart 3

PERS Enrollment by Type of Health Plan[a]

1983-84 through 1988-89



[a] Excludes association plans.

The PERS-CARE Strategy. In order to stabilize premium increases and enrollment patterns, PERS, on January 1, 1989, consolidated the Blue Cross, Blue Shield, and Cal-Western fee-for-service plans into PERS-CARE, a self-funded fee-for-service plan with a preferred provider option. PERS had previously obtained legislative approval for the self-funding of the plan in Ch 1129/87 (SB 908, McCorquodale). PERS-CARE includes a utilization review component, and some minor plan design changes. These changes were based on a 1984 study provided by William

M. Mercer, a private consulting firm. Mercer recommended in the study a number of cost-containment measures, most of which were incorporated into PERS-CARE (estimated savings are based on 1984 premiums):

- ***Consolidation and Self-funding.*** Mercer recommended consolidating the fee-for-service plans into one major plan, which would then be self-funded by the state. By self-funding the plan, the state, and not an insurance company, retains the risk of paying the cost of claims which have been incurred. Self-funding should reduce costs because premium taxes and risk charges are eliminated, and the state retains investment earnings on contributions. *Estimated annual savings: $9.5 million.*
- ***Utilization Review.*** This is a cost containment feature which attempts to reduce the use of health care believed to be unnecessary or inappropriate. *Estimated annual savings: $8 million.*
- ***Preferred Provider Networks.*** Preferred provider networks offer incentives for employees to use a limited group of health care providers who agree to provide their services at a discount. *Estimated annual savings: $3 million.*
- ***Various Plan Design Changes.*** These strategies involve changing the structure of a plan to encourage the more efficient use of health services. Deductibles, copayments, and benefit changes are some typical ways to accomplish this goal. *Estimated annual savings: $4 million.*

What Does the Future Hold for PERS-CARE?

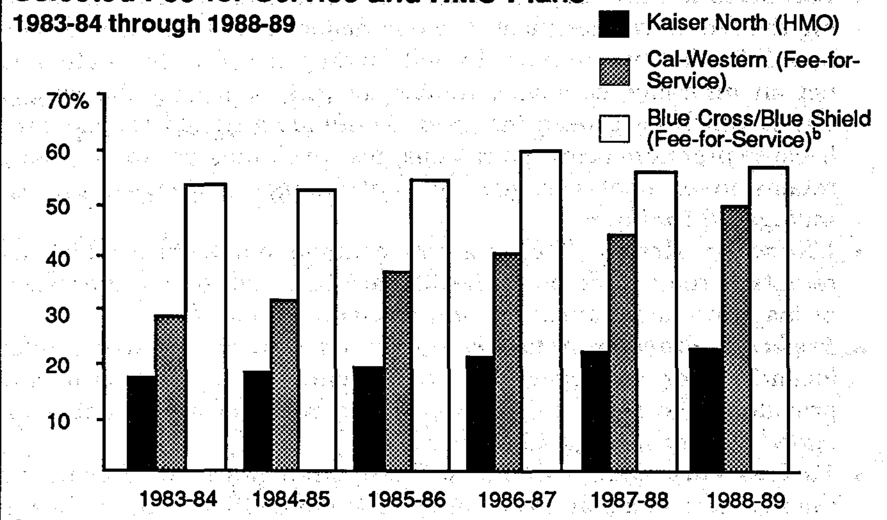
PERS-CARE is currently the most expensive health plan offered to state employees. Whether it can continue to be an affordable health plan option in the future will depend on its success in achieving savings from consolidation, self-funding, utilization review, preferred provider networks, and plan design changes. Yet PERS-CARE faces two major obstacles to its success: (1) the increasingly older age of the PERS-CARE enrollment will make cost containment difficult, and (2) the basic design of a fee-for-service plan does not encourage cost containment.

Demographics of PERS-CARE Will Continue to Make Cost Containment Difficult. A review of enrollment data indicates that the fee-for-service plans in PERS historically have attracted an older population than have the other plans. Chart 4 shows the percent of retired employees in representative fee-for-service and HMO plans since 1983-84. It shows that the fee-for-service plans have attracted a much higher percentage of retirees (currently about half of total enrollment). In general, as a person ages their medical costs increase because they tend to make greater use of health care services. Because fee-for-service plans have had a significantly older enrollment than the HMO plans, this is one important factor that explains the higher cost of their premiums.

Chart 4

Percent Retired Employees for Selected Fee-for-Service and HMO Plans[a]

1983-84 through 1988-89



[a] Includes Basic and Supplemental Plan enrollment.
[b] For 1987-88 and 1988-89 Blue Shield-PPO only.

Recent information indicates that this trend has grown worse in the PERS-CARE plan. In September of each year, PERS has a one-month open enrollment period during which employees are allowed to change from one health plan to another. Results of enrollment changes as of January 1989 indicate that the plan has lost over 11,800 enrollees, or 13 percent of its membership. More importantly, the loss in membership has been among active, and, therefore, younger employees. The plan lost 12,600 active enrollees, or 25 percent of its active enrollment, while it gained about 800 retired enrollees, an increase of about 1.9 percent in its retired enrollment. These trends indicate that the demographics of the plan will continue to be an obstacle to containing premium increases.

Structure of Fee-for-Service System Makes Cost Containment Difficult. Another reason that the fee-for-service plans have higher costs than HMOs relates to the basic structure of the plans. The fee-for-service system does not give doctors and hospitals strong incentives to contain costs. In fact, there is a financial incentive in a fee-for-service plan for health care providers to give a patient more expensive care, which in turn results in higher premium costs.

In general, HMOs have both an incentive and a greater ability to contain costs. In many cases, HMOs are paid a per-person prepaid fee which gives the HMO an incentive to contain costs. HMOs also have more control over their health care providers (who in some cases are the employees of the HMO), which gives them more ability to achieve savings.

While the utilization review, preferred provider option, and plan design features incorporated in PERS-CARE are intended to make it a more cost-efficient delivery system, it is unclear to us that they will be enough to make PERS-CARE a financially affordable alternative to HMOs—especially for active employees. Given these concerns, the Legislature should monitor carefully the progress of the PERS-CARE health plan.

Monitoring the PERS-CARE Health Plan

We recommend the enactment of legislation requiring the Public Employees' Retirement System Health Benefits Program to develop a comprehensive management information system and to report annually to the Legislature on health plan expenditures.

In its 1984 report, Mercer stressed that PERS should "manage" its health care expenditures by developing appropriate analytical data. To accomplish this, Mercer recommended that PERS develop a comprehensive management information system. The data supplied by such a system would allow the Legislature to monitor the progress of PERS-CARE and give PERS information on expenditure patterns that would allow it to determine how the efficiency of the health benefits program could be improved. This information is also vital for *PERS* to assess the effectiveness of the cost containment efforts it has implemented in the PERS-CARE plan.

To be most useful to the Legislature and PERS, however, the management information system should cover *every* plan within the health benefits program in order to be used for comparative purposes both between health plans within the program, as well as comparisons with regional or national trends. Data could be collected on the following major expenditure categories:

- Place of service (for example, hospital, physician, office, independent lab);
- Type of service (for example, surgery, other physician care, mental health, drugs);
- Five-year age categories, by sex, and employee and dependent status; and
- Major geographic areas (for example, Los Angeles, bay area, Sacramento).

Once gathered, the information would be analyzed by PERS and used to evaluate trends, identify problems, and project future experience patterns.

To date, PERS has not fully implemented a management information system. Therefore, it does not have much of the analytical information needed to ensure the efficient operation of the health benefits program. Before implementation of such a system can take place, PERS will require a long lead time (perhaps as much as a year) to negotiate with health plan carriers over obtaining the basic data necessary for a management information system. Therefore, it is important that action be taken as soon as possible so that the process of developing a management information system can begin.

In addition, given the high cost of PERS-CARE, it is important that the Legislature closely monitor the progress of the plan in the near future. Information developed under the management information system should be shared with the Legislature to allow for proper legislative oversight. To accomplish this, PERS could report annually on its findings, and on corrective action being taken to improve the efficiency of the health benefits program.

Accordingly, we recommend the enactment of legislation requiring the PERS Health Benefits Program to develop a comprehensive management information system and to report annually to the Legislature on the following major expenditure categories: (1) place of service, (2) type of service, (3) five-year age categories, by sex, and employee and dependent status, and (4) major geographic areas. Health plan carriers should have the basic data necessary for the implementation of a management information system already available. PERS currently has existing cost containment reporting requirements which could be adapted to include this information.

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