The 1991-92 Budget: Perspectives and Issues

Report from the Legislative Analyst's Office to the Joint Legislative Budget Committee

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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 1991 Budget Act and in other legislation. It seeks to accomplish this by (1) providing perspectives on the state's fiscal condition and the budget proposed by the Governor for 1991-92 and (2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement the *Analysis of the 1991-92 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 a broader fiscal overview and discusses significant fiscal and policy issues which either cut across program or agency lines, or do not necessarily fall under the jurisdiction of a single fiscal subcommittee of the Legislature.

The 1991-92 Budget: Perspectives and Issues is divided into four parts:

- Part One, "State Fiscal Picture," provides an overall perspective on the serious fiscal problem currently confronting the Legislature which requires resolution before the start of the coming fiscal year.
- Part Two, "Perspectives on the 1991-92 Budget," provides a brief overview of the economic and demographic forces which will help shape the budget; a review of the revenue projections assumed in the budget and an assessment of their reliability; and a description of the budget's spending plan, including information on the each of the main program areas in the budget (such as K-12 Education, Resources, and Capital Outlay).
- Part Three, "Strategies for Addressing the State's Budgetary Imbalance," offers examples of the various strategies available to the Legislature (such as eliminating tax expenditures, reducing services, and shifting costs to fees) in addressing the current funding gap. It also lists

some considerations on how each type of strategy should be used.

- Part Four, "Major Issues Facing the Legislature," discusses some of the broader issues currently facing the Legislature. Given the state's current fiscal problems, we have included several analyses in key fiscal areas: Proposition 98 and its proposed suspension, county-state relations and the impact of the Governor's "realignment" proposal, the AFDC program and the implications of the Governor's proposal to reduce welfare grant levels, and the community corrections alternative and how it might relieve prison overcrowding and some of the pressure on state prison spending. In addition, Part Four has overview pieces on state infrastructure, the uses of bond proceeds, school restructuring, and the state rail transportation program.

State Fiscal Picture I

Part I

State Fiscal Picture

The Legislature faces an enormous task as it begins its deliberations on the 1991-92 budget. The combination of underlying structural imbalances and a downturn in the California economy has resulted in an estimated two-year budget funding gap of almost $10 billion.

The Governor's Budget seeks to address the budget problem through a combination of proposals to reduce existing state services and increase revenues. It also contains a number of "prevention" proposals aimed at reducing the cost of existing services in future years.

The Governor's plan is but one approach for addressing the budget problem and providing for the state's service needs. This plan has within it much to commend, especially given the adverse fiscal situation facing the state. However, the budget does not fully address the funding gap and also raises concerns regarding its impacts on health and welfare program users, schools, and other affected groups.

Thus, although the Governor's plan provides a reasonable starting point for the Legislature in its deliberations, it is but one of a wide variety of "solutions" available. Ultimately, the Legislature must craft a plan that balances the need for state services with the need to address the state's underlying structural budget problem.

State Fiscal Picture

The presence of underlying structural budget problems and the onset of a national recession have combined to pose extremely difficult challenges for the 1991-92 state budget. The budget plan for the current year, adopted last summer, is now expected to leave the state with a large deficit on June 30, 1991. In addition, projected state revenues for 1991-92 will fall far short of the level needed to both maintain current levels of services and restore the state's reserve fund, absent corrective action.

The *1991-92 Governor's Budget* has as its most basic goal the resolution of the state's fiscal problems. It proposes increases in revenues to help fund state programs as well as reductions in existing state services in order to achieve this goal. It also contains a number of "prevention" proposals which are aimed at reducing the cost of existing services in future years.

The budget provides a reasonable starting point for crafting a solution to the state's fiscal problems. If adopted, the Governor's proposals would go a long way toward addressing the funding gap which the state faces. However, whether the Governor's proposals are the best way to achieve this goal, as opposed to the other policy choices that will be considered in the coming months, is the key question facing state lawmakers in 1991.

In this part, we review the nature of the state's budget funding gap, both in the absence of any corrective action and assuming that the Governor's plan for bridging the gap is adopted. We also summarize the major proposals contained in the budget and examine how they affect different program areas. Finally, we provide our overall assessment of the extent to which the Governor's Budget effectively addresses the budget gap for 1991-92 and beyond.

THE 1991-92 BUDGET PROBLEM

As has been fairly typical in recent years, the 1991-92 Budget must address not only the need to balance revenues and expenditures for the budget year, but also the imbalance that has arisen in the current year. According to the *administration's* calculations, the magnitude of this two-year fiscal problem amounts to \$7 billion. This includes \$1.9 billion to pay off the 1990-91 deficit,

$3.7 billion to cover the difference between "workload budget" expenditures and baseline revenues anticipated for the budget year, and $1.4 billion to replenish the state's reserve fund.

Our analysis suggests, however, that these estimates significantly *understate* the true magnitude of the underlying budget funding gap. Specifically, as shown in Figure 1, our estimate of the total budget funding gap for 1991-92 is $9.9 billion. This consists of $2.1 billion to pay off the 1990-91 deficit, $6.4 billion to fund current levels of services in the budget year, and $1.4 billion to replenish the state's reserve fund. As discussed later, about half of the $2.9 billion by which our funding gap estimate exceeds the administration's estimate translates into a reduction in the General Fund balance as of June 30, 1992.

Figure 1

General Fund Budget Gap
LAO Estimates

(in billions)

1990-91 Budget Deficit		$2.1
1991-92:		
Base Expenditures	$48.1	
Base Revenues	41.7	
Difference		$6.4
Amount to Replenish Reserve		1.4
Two-Year Budget Gap		**$9.9**

Why Do Our Estimates Differ?

Our estimate of the budget funding gap differs from that of the administration for four primary reasons.

Economic Recovery Adjustment. The administration's estimate of 1991-92 General Fund revenues includes a special $1.2 billion "economic recovery adjustment." This adjustment reflects the administration's view that it is appropriate to anticipate certain events which would justify a more optimistic revenue outlook than is implied by its standard economic forecast. We have not included such an adjustment in our own estimates, on

the basis of its relatively low probability and the fact that *the department's standard economic forecast already assumes a recovery at least as strong as the consensus view of state and national economists.*

Proposition 98. Our estimate of 1991-92 Proposition 98 expenditures for K-14 schools is $600 million higher than the administration's estimate. This is because the administration's estimate assumes that the 1990-91 funding level is reduced as proposed in the budget, and because it does not include funding for the restoration payments that would be required in 1991-92 as a result.

Discretionary Colas. Our estimate reflects the increased costs of maintaining current services in programs where cost-of-living adjustments are not required by statute. These adjustments, and certain other similar factors, add approximately $400 million to our estimates.

AFDC Caseloads. Our expenditure estimates for 1990-91 and 1991-92 reflect a higher level of state costs for the AFDC program than is anticipated in the administration's workload budget figures. These estimates are based on recent trends in caseload and unemployment, and indicate that costs will be approximately $300 million higher than the administration projects over the two-year period.

The Gap's Cyclical and Structural Components

Our estimated $9.9 billion budget gap is the result of two fundamental factors.

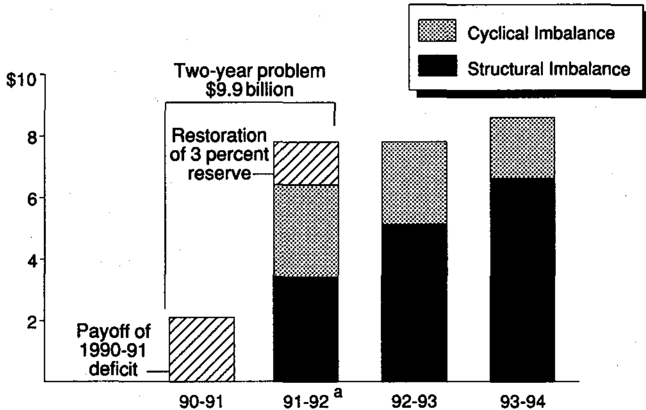
The first of these is the *current economic downturn,* which has the effect of depressing state revenue collections and increasing caseloads in state assistance programs. Because these effects should dissipate gradually over time as the economy recovers, this part of the budget problem is *cyclical* in nature. The budget gap also reflects a substantial *structural* component, in that there is a significant imbalance between revenues and expenditures that would occur even in the absence of an economic downturn. Our estimates indicate that the $6.4 billion gap between revenues and expenditures for the 1991-92 fiscal year is almost equally attributable to these cyclical and structural factors.

Figure 2 shows our estimates of the budget gap, both for 1990-91 and 1991-92 as well as the following two years, including its cyclical and structural components. These estimates do *not* include any of the administration's budget proposals or any other corrective actions. They are based upon the budget's economic forecast for 1991 and 1992, our assumptions about the economic

Figure 2

Components of the State Budget Problem

1990-91 through 1993-94 (in billions)



[a] 1991-92 data reflect the second-year effects of 1990-91 budget actions. These actions reduced expenditures and augmented revenues, thereby making the 1991-92 projected budget imbalance less than it otherwise would have been.

performance that would follow in subsequent years, and our estimates of the revenue and current-services expenditure levels that would be consistent with this outlook.

As this figure indicates, although the economy is assumed to strengthen by 1992, the *cyclical* imbalance still remains a factor in the out years. This is because of the time it takes to return to "normal" revenue levels, given the pace of economic recovery that most forecasters are assuming. *The structural component of the gap, however, is projected to increase substantially over time,* reflecting the continuing imbalance between revenues and expenditures. These underlying trends, which are examined in greater detail in Parts Two and Three of this document, are briefly discussed below.

The Economic Outlook

The Department of Finance's economic forecast assumes that the state will experience a brief and mild downturn, with recovery underway in the last half of 1991. Figure 3 shows the projected growth rates in California personal income and employment that are reflected in this forecast. This forecast also

assumed that a nonmilitary resolution of the Persian Gulf crisis would occur by the spring of 1991, and that interest rates and oil prices will be declining through mid-1991. Beginning in 1992, it is assumed that the economy will return to a more normal pattern, with state personal income growth in the 8-percent range.

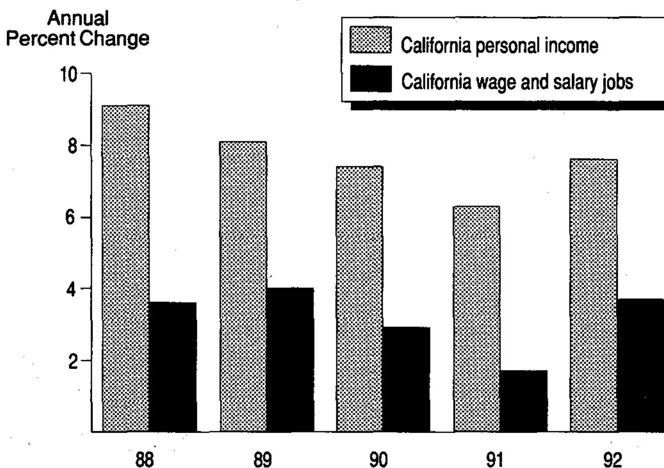
At the time this forecast was prepared, it was generally consistent with the consensus view of economists. Since that time, the situation in the Persian Gulf has obviously changed, however, and most reports on the economy have been fairly negative. Consequently, many economists have revised their projections downward, and the department's forecast for California now is a bit more optimistic than the consensus view.

The Revenue Forecast

As shown in Figure 4, the budget forecasts General Fund revenue growth in 1991-92 totaling $5.3 billion, a 13 percent increase over the current year. This large increase is primarily due to a variety of revenue enhancements proposed in the budget, along with the optimistic $1.2 billion economic recovery adjust-

Figure 3

The DOF Economic Forecast - Brief Downturn Followed by Upturn



Source: 1991-92 Governor's Budget.

Figure 4

Components of General Fund Revenue Growth Anticipated in the 1991-92 Governor's Budget

(in billions)

Baseline Revenue Increase (Standard Economic Forecast)	$1.3
Additional Increase, Assuming Economic Recovery Adjustment	1.2
Accrual Accounting Proposal	1.7
Other Revenue Proposals[a]	0.8
Transfer Proposals	0.3
Total Revenue Growth	$5.3

[a] Includes $400 million in withholding payments and $400 million from elimination or delay of certain tax expenditures.

ment discussed earlier. The underlying rate of growth in revenues in the budget forecast is less than 4 percent when these special factors are excluded, however, reflecting the forecast for generally slow economic growth. Our estimates of revenues beyond the budget year reflect a return to more normal rates of growth in economic activity and underlying tax liabilities. In addition, these out-year figures reflect *none* of the revenue proposals contained in the budget.

Expenditure Growth Trends

Regarding expenditures, our estimates of the budget gap are based on calculations which attempt to measure the cost of providing 1990-91 levels of state services in 1991-92 and beyond. Thus, these calculations do not reflect the effect of the expenditure proposals contained in the Governor's Budget.

In the aggregate, we estimate that the cost of providing 1990-91 service levels amounts to $48.1 billion for 1991-92, an increase of 13 percent over estimated 1990-91 baseline expenditures. Our estimates indicate that these current services funding requirements will increase by 10 percent in both 1992-93 and 1993-94.

The Bottom Line

The state faces a multi-billion dollar funding gap in 1991-92 and beyond, *absent corrective action.* Although about half of the near-term funding gap may be ascribed to cyclical factors, the underlying problem is predominantly structural. The Legislature will need to take dramatic action both to balance the 1991-92 budget and begin to permanently bring state revenues and expenditures into line. The Governor's Budget proposes one set of strategies for partially accomplishing this.

WHAT DOES THE NEW BUDGET PROPOSE?

The *1991-92 Governor's Budget* contains a large number of major proposals to bridge the funding gap. Figure 5 shows that, in the aggregate, these proposals provide $5.4 billion in expenditure reductions and $3.1 billion in revenue enhancements. These proposals, combined with the additional economic recovery revenue adjustment discussed earlier, total $9.7 billion. Thus, these proposals would have the effect of eliminating all but about $200 million of the $9.9 billion funding gap, and would leave the state budget in balance and with a reserve slightly below the 3-percent target. Because the $1.2 billion economic recovery revenue adjustment is unlikely to occur, however, we believe that the Governor's proposals fall significantly short of eliminating the

Figure 5

Budget's Proposed Resolution of the 1991-92 Spending Gap[a]

(in billions)

Program Reductions	$5.0	
Funding Shifts	1.2	
Cost Deferrals	0.1	
Cost Increases	-0.9	
Total, Expenditure Changes		$5.4
Revenue Enhancements	$3.1	
Economic Recovery Adjustment	1.2	
Total, Revenue Changes		$4.3
Total		**$9.7**

[a] Amounts reflect combined effect of 1990-91 and 1991-92 changes.

funding gap. In fact, the state would be left with *no* reserve and a small *deficit* on June 30, 1992. Given the considerable economic uncertainties facing the state today, it is highly desirable that an adequate reserve fund be available. Thus, even if the Legislature approved *all* of the Governor's proposals, additional actions totaling approximately $1.4 billion would be needed to fully bridge the funding gap.

Specific Expenditure Proposals

The predominant themes of the *1991-92 Governor's Budget* have to do with correcting the budget's underlying structural problem and re-orienting certain state programs to focus on *prevention* of the social problems which are in part driving the state's fiscal problems. Toward these ends, the budget proposes the elimination or reduction of several specific state programs and the enhancement or creation of other programs thought to have preventive potential. In general, these program expansions are funded by redirecting resources from other existing programs. For example, in the education area the budget proposes to develop new public school programs to increase prevention-oriented services for children, and proposes that these efforts be funded by redirecting funds from other existing K-12 spending categories (primarily cost-of-living adjustments).

The budget's specific expenditure proposals to balance the budget, as categorized in Figure 5, are as follows:

Program Reductions. The budget proposes $5.0 billion in program funding reductions, including almost $700 million in *current-year* savings, which are primarily due to reductions in Proposition 98-related educational spending. Of the $4.3 billion in *budget-year* savings, $2.0 billion is attributable to our estimate of budget-year Proposition 98-related savings. This is $600 million higher than the administration's $1.4 billion estimate, as discussed earlier. (For a thorough discussion of Proposition 98 and how it affects K-14 funding, please see our piece on Proposition 98 in Part Four of this document.)

Other major program reduction proposals include:

- Suspension of statutory cost-of-living adjustments ($0.4 billion).
- AFDC grant-level reductions ($0.2 billion).
- Reduction of the renters' tax credit ($0.2 billion).
- Reductions in specific higher education support items ($0.2 billion).

The budget also achieves substantial savings through a variety of unallocated reductions in departmental budgets ($0.8 billion).

Funding Shifts. By shifting the responsibility of funding programs to other levels of government or to fees, the budget proposes to achieve savings of $1.2 billion in 1991-92. The major item in this category is the budget's "program realignment" proposal, which would shift existing state responsibilities for funding local mental health and public health programs to county governments. State taxes on alcoholic beverages and automobiles would be increased and dedicated to counties to assist them with these or other responsibilities. The budget also funds a portion of the increased costs of operating the University of California (UC), the California State University, and the Community Colleges by imposing a 20 percent student fee increase.

Cost Deferrals. The budget contains two proposals that would result in the deferral of $125 million of current costs to future years. Specifically, the budget proposes that $55 million of 1991-92 UC expenditures be instead paid for in 1992-93, and that $70 million in current state costs for the Public Employees' Retirement System (PERS) be deferred by accelerating the recognition of 1989-90 actuarial gains. (Subsequent to the introduction of the Governor's Budget, however, the PERS has indicated that there were no gains for 1989-90 and, in fact, the system sustained a loss. As a result, the savings from this proposal would not materialize.)

Partially offsetting these various expenditure reductions is an increase of about $900 million due to an accrual accounting change involving Medi-Cal expenditures.

Proposed Changes By Program Area

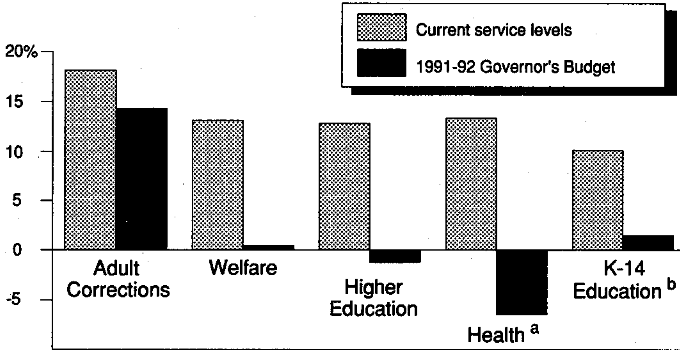
Figure 6 shows how most major program areas fare under the Governor's proposals relative to current services funding requirements. As the figure indicates, adult corrections programs are the most fully funded, while all other major program areas face significant reductions from current state-supported service levels. The level of funding for health programs is reduced dramatically, reflecting primarily the Governor's proposal to shift the state's existing local mental health and public health services funding responsibilities to county governments.

Revenue Enhancements

The $3.1 billion of revenue enhancements proposed by the budget include $300 million of additional revenues for 1990-91 and $2.8 billion of additional revenues for 1991-92. The major

Figure 6

Expenditure Growth Rates by Program Area, Current Service Levels Versus Governor's Budget



[a] Reflects the Governor's program realignment proposal.
[b] *1991-92 Governor's Budget* figure reflects proposed reductions in funding levels for 1990-91 and 1991-92.

changes for 1991-92 are summarized in Figure 7. As this figure shows:

- The bulk of this increased revenue ($1.7 billion) is attributable to a proposed change in state accounting practices, whereby revenue is to be recognized as it is *earned* instead of generally when cash is *received* by the state. Thus, this proposal does not result in an actual increase in the tax liabilities of state taxpayers, and it would have only a small impact in subsequent years.
- The budget also proposes that state income tax withholding requirements be extended to cover independent contractors, estates and trusts, and that withholding requirements be increased as they apply to certain "lump-sum" payments. These proposals would raise about $400 million in 1991-92, only a part of which would be ongoing.
- The state sales tax would be extended to candy, snack foods, newspapers and periodicals to generate about $300 million in additional revenue. This gain would be ongoing.
- The state's health care tax credit, which becomes effective in 1992 under current law, would be delayed until

Figure 7

Revenue Enhancement Proposals in the 1991-92 Governor's Budget

(in millions)

	1991-92 Amount
Accounting Practices	
Accrual Accounting	$1,702
Withholding Proposals	
Independent Contractors	290
Estates/Trusts	42
Lump-Sum Payments	80
Tax Expenditures	
Repeal Sales Tax Exemptions:	
Candy/Snack Foods	200
Newspapers/Periodicals	83
Delay Health Care Tax Credit	97
Other Proposals	
Miscellaneous Changes	345
Total Changes	$2,839

1993. This delay increases 1991-92 revenues by about $100 million.

Figure 8 shows that, as was the case with the revenue changes adopted along with the 1990 Budget Act, the aggregate impact of the changes proposed in the budget would decline over time because of their one-time effects. In the case of the 1991 proposals, however, the one-time effects are particularly dominant. Thus, the budget in effect relies upon revenue changes primarily to address the *cyclical* (versus *structural*) portion of the budget problem, given that the long-term effect of these measures on state revenues is quite limited.

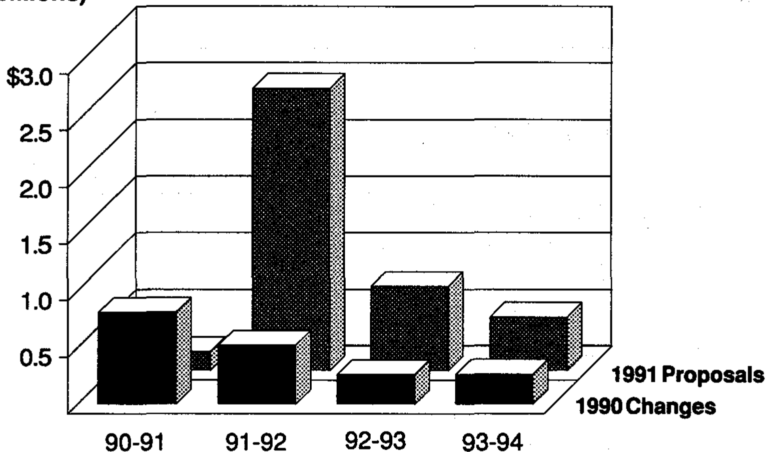
DOES THE BUDGET WORK?

The primary test of the budget plan's effectiveness is the extent to which it can be relied upon to eliminate the budget funding gap in 1991-92 and make significant progress toward

Figure 8

Fiscal Impact of 1990 and 1991 Revenue Adjustments

1990-91 through 1993-94
(in billions)



doing so in subsequent years, while at the same time addressing the basic needs of Californians for public services.

Dealing With the Budget Gap

Figure 9 presents our estimates of the impact of the budget's proposals on the funding gap from 1991-92 through 1993-94.

1991-92. As noted earlier, the budget goes a long way toward addressing the state's two-year funding gap. However, as Figure 9 indicates, *it does not fully eliminate the budget funding gap for the 1991-92 fiscal year, as the state would have a small deficit and no reserve fund as of June 30, 1992.* This is primarily because we do not believe it is prudent to adopt the administration's optimistic premise that an additional $1.2 billion should be added to the revenue forecast. We also have identified several increased costs not addressed by the Governor's Budget, such as the higher costs for public assistance programs stemming from the slowdown in the economy.

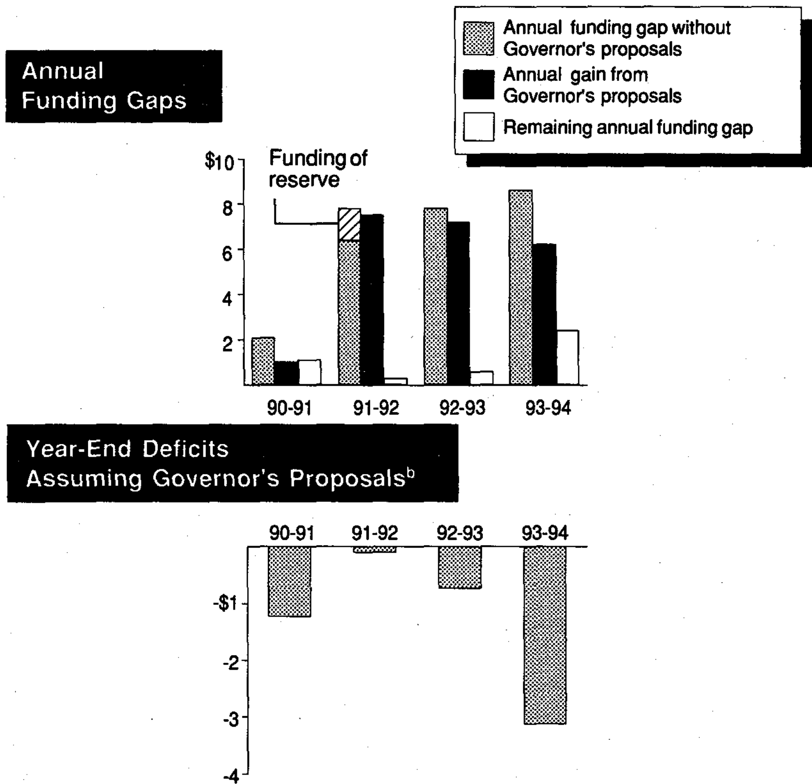
Beyond 1991-92. As Figure 9 indicates, the budget's proposals not only make significant headway toward the elimination of the funding gap in the near term, they also reduce it in the longer term. Figure 9 also indicates, however, that the effectiveness of

the budget proposals is expected to diminish over time, and the underlying budget gap will again become a major problem in the future. In large part, this is attributable to the one-time impacts of the Governor's revenue proposals. However, it also reflects the fact that the budget does not deal fully with the underlying structural problems. For example, fully half of the expenditure savings relied upon in the budget are attributable to Proposition 98 reductions, and these savings will disappear over time as the measure's funding-restoration provisions come into play. Thus, although the budget makes some significant reductions in the

Figure 9

Impact of Governor's Budget Proposals on Budget Funding Gap[a]

1991-92 through 1993-94 (in billions)



[a] Assumes that the $1.2 billion in economic recovery adjustment revenues included in the budget does not materialize.
[b] All years shown end up with zero balance in the reserve fund.

levels of expenditures for state programs in 1991-92, these savings are not sufficient to permanently offset the increased costs of providing services to an ever-expanding population. Figure 9 indicates that, assuming the Governor's proposals are adopted and assuming current service levels, 1993-94 state expenditures would exceed revenues by approximately $2.4 billion, and the year-end deficit would total approximately $3 billion.

Providing State Services

Another major consideration involved in assessing the budget's workability is whether its impact on state-supported services is acceptable. Among other things, the Legislature will need to evaluate the budget's proposal to substantially reduce funding for K-14 schools. Proposed levels of K-14 funding for both 1990-91 and 1991-92 are below the level of funding adopted in the 1990 Budget Act for the 1990-91 fiscal year, and these reductions will result in lower funding levels than would otherwise be the case for several years to come. The Legislature will need to determine the impact that such reductions will have and whether they are acceptable. The same is true for such other major budget proposals as: reductions in welfare grants, shifts of local mental health and public health program responsibilities, reduced renters' tax credits, and funding for higher education.

Other Considerations

In assessing the budget's workability, the Legislature must also consider whether it provides adequate protection from economic and other types of uncertainties that could potentially affect state resources and spending requirements. In this regard, we note that the estimates of state revenues contained in the budget are subject to large dollar errors, even if the budget's economic forecast is basically correct. Given the substantial uncertainty over the course of events in the Middle East and the unknown duration and severity of the current economic downturn, these dollar error margins for revenues are considerably larger than normal.

State spending requirements also are subject to considerable uncertainty over the forecast period. For example, the budget's "prevention" proposals may result in savings beyond those reflected in our estimates, to the extent that they have a strong impact on the social problems they are intended to address. However, the budget also places great reliance on the use of unallocated reductions that may be restored as their negative impacts on state programs become apparent. Thus, there also is

uncertainty as to whether the budget can achieve the level of savings over the long term that is reflected in our estimates of expenditures.

The other major area of uncertainty in our forecast is the potential impact of several lawsuits against the state in such areas as corporate taxation, taxes on automobiles, and indigent aid to counties. The combined impact of these lawsuits, if decided against the state, could exceed $7 billion initially, with substantial ongoing costs thereafter. It is unclear when these impacts would occur, although it appears that it would be primarily after 1991-92.

ARE THERE OTHER OPTIONS?

The plan proposed in the Governor's Budget is but one of a variety of alternative budget strategies available to the Legislature. For example, strategies could be developed that place greater reliance on long-term revenue gains or a different set of reductions in state-supported services. All of these strategies, however, involve difficult decisions and impose burdens on those affected by them. The range of budget strategies available to the Legislature is discussed in Part Three of this document.

It also is important to note that the bulk of state spending is determined by existing federal, constitutional and statutory requirements. Thus, addressing the state's budget problems will necessitate modifying some of these requirements. Although the Legislature has only limited potential to change or limit the impact of federal requirements, it can seek voter approval of state constitutional changes, and it can change existing statutory provisions where it believes that such changes are necessary to effectively manage the state's budget.

The challenge for the Legislature in developing its budget strategy is to make the changes necessary for the state to resolve its underlying budget gap, while still addressing the basic service needs of the population.

CONCLUSION

The Governor's Budget offers *one approach* for addressing the budget problem and providing for the state's public service needs. This plan has much within it to commend, especially given the adverse fiscal situation facing the state budget. However, the Governor's Budget also has certain shortcomings that need to be addressed in order to make it completely workable. Most notable in this regard is that it does not fully address the budget funding gap. The budget also raises concerns regarding its impacts on

health and welfare program users, schools and other affected groups. As with the alternative strategies available to the Legislature, this plan will require the enactment of many pieces of legislation, and raises many important policy issues that will be difficult to resolve.

The Legislature faces an enormous task as it begins its deliberations on the 1991 Budget Bill. It must evaluate a wide range of potential budget strategies and determine their impacts on the achievement of state goals, as well as on the funding gap. Ultimately, it must agree upon a plan that balances the need for state services with the need to address the state's underlying structural budget problem. This structural problem, unless effectively addressed, will only become worse in the future.

Perspectives on the 1991-92 Budget

II

Part II

Perspectives on the 1991-92 Budget

This part provides a discussion of the state's revenues and expenditures in 1991-92 and the assumptions underlying them. The first section of this part describes California's current economic and demographic environment, which affects both revenues and expenditures. The second section presents the outlook for revenues and assesses the reliability of the revenue forecast. The third section summarizes the budget's spending plan, highlighting the major program changes and the factors driving program costs.

The major findings of this part include:

- The California economy is predicted to experience a brief and mild downturn, with recovery beginning by the latter half of 1991. The economic outlook, however, is characterized by considerable uncertainty.
- The state is experiencing rapid population growth, characterized by strong in-migration and shifts in the ethnic and age distributions of the population. These trends have a variety of implications for the state's spending programs.
- Because of the soft economy, underlying revenue growth is projected to be weak. Our assessment of the budget's revenue forecast is that the Legislature should not count on the $1.2 billion in economic recovery adjustment revenues assumed by the administration on top of its

standard revenue forecast. This is because its standard economic forecast already assumes an economic recovery. In addition, the revenue forecast is subject to unusually large error margins, given the uncertainties in the economic forecast.

- The Governor's Budget proposes a General Fund expenditure increase in 1991-92 totaling 3.7 percent. Expenditure growth is significantly below the amount needed to maintain current service levels and reflects several major proposals that reduce spending. These include suspension of Proposition 98, reductions in welfare grant levels, and reduced renters' tax relief payments. In addition, the Governor also proposes a major realignment involving health programs.

California's Economic and Demographic Environment

California's economic performance and the demographic trends occurring in the state are key determinants of both state revenues and expenditures. In the case of expenditures, for example, program needs are affected both by the rate of inflation and program caseloads, and the latter are influenced by such factors as overall population growth, the age characteristics of the population, and the unemployment rate. Likewise, revenues depend on such economic factors as income and job growth in the economy, which in turn are influenced by demographic variables such as the size of the labor force and number of people needing the various goods and services which businesses produce. This section discusses the basic economic and demographic forces operating in California which underlie the revenue and expenditure projections discussed later in this part.

THE CURRENT ECONOMIC CLIMATE

The current economic climate is fairly negative and full of uncertainties. The national economy is in the midst of a recession, and California's economy also has slowed markedly in recent months. The key question at the moment is how deep and lengthy the national recession will be, and to what extent California will share in the downturn.

The National Economy—Recession Has Arrived

The nation's economy weakened steadily throughout 1990, and is now in a recession which began in the latter half of last year. Recent economic data show that retail sales are soft, consumer confidence is weak, car sales and housing starts have fallen, industrial production and corporate profits have declined, business investment is down, manufacturing employment has contracted, and unemployment has been rising. Adding to these problems is the uncertainty regarding the war in the Persian Gulf, including how long it might last and its possible effects on oil prices. Also of concern is the renewed growth in the federal budget deficit and the ongoing foreign trade imbalance.

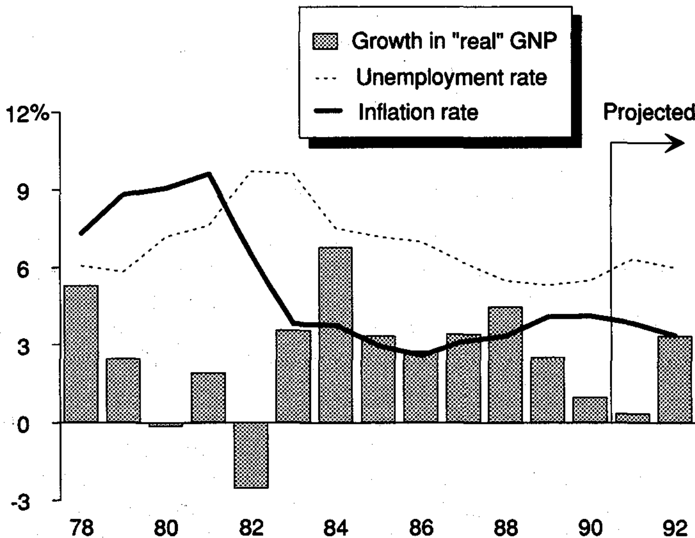
The Forecast—Moderate Downturn Followed by Recovery

Figure 1 shows what the Department of Finance is predicting for the nation's economy. It indicates that a moderate downturn is expected, with growth in "real" Gross National Product (GNP) of only 0.3 percent in 1991. Figure 2 shows the predicted quarterly time pattern of the downturn. It indicates that real GNP growth is expected to be negative in the first quarter of 1991, as it was in the last quarter of 1990. Then, beginning in mid-year 1991, a fairly strong "bounce back" is predicted for several quarters. This is to be followed by a return to sustained economic expansion in 1992, with 3.4 percent GNP growth for 1992 as a whole. Figure 1 shows that the unemployment rate is expected to rise through mid-1991 before turning back down, and inflation is expected to remain modest—around 4 percent. It also indicates that the recession is expected to be much less severe than the economic downturn of the early 1980s.

Figure 1

Trends in Key National Economic Variables

1978 through 1992

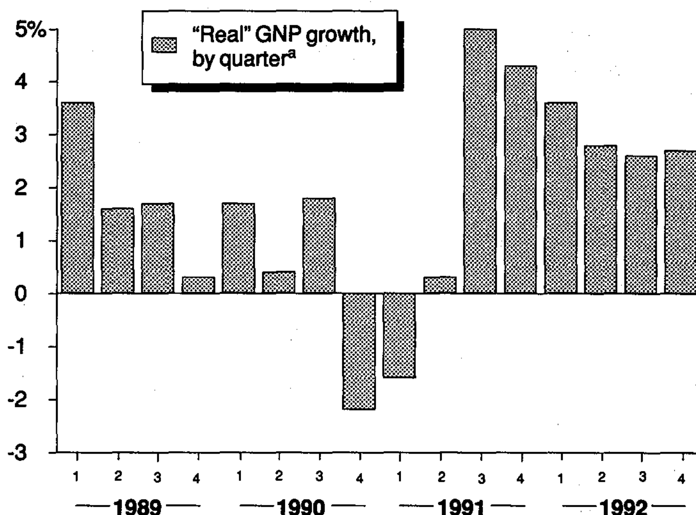


Source: Department of Finance.

Figure 2

The Recession's Projected Pattern

1989 through 1992



[a] Data reflect annualized quarterly rates of change.
Source: Department of Finance.

The California Forecast—Mild Downturn Anticipated

Figure 3 summarizes the department's economic forecast for California in 1991 and 1992, and compares it to the nation's. Like the nation, California is expected to experience a downturn, although the department predicts that the state will outperform the nation. For example, California's 1991 personal income growth is expected to be 6.3 percent versus the nation's 5.2 percent, while its job growth is expected to be 1.7 percent versus the nation's 0.8 percent.

As with the nation, California's downturn is predicted to be less severe than the early 1980's recession. For example, Figure 4 shows that, after adjusting for inflation, the expected slowing in personal income growth in this downturn is not as pronounced as during the previous recession. Likewise, Figure 5 shows that California is expected to at least experience some job growth in 1991, compared to the actual decline that occurred in 1982.

Figure 3

Department of Finance Economic Outlook for California and the Nation

1990 through 1992

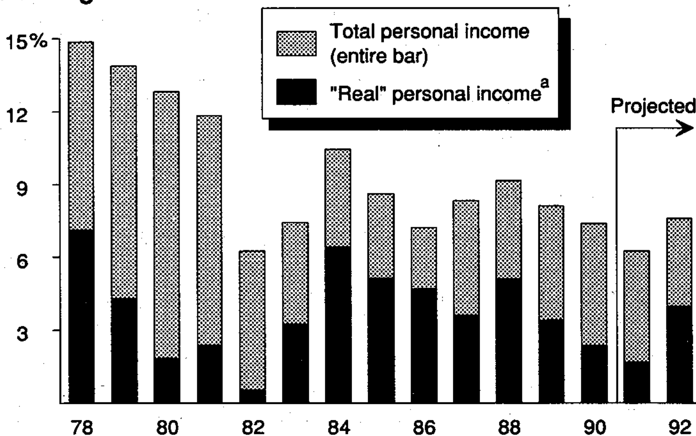
California Economic Indicators	1990 Estimated	1991 Projected	1992 Projected
Percent change in:			
Personal income	7.4%	6.3%	7.6%
Wage and salary employment	2.9	1.7	3.7
Consumer Price Index	5.5	5.0	4.0
Unemployment rate (%)	5.5	6.2	5.6
Residential building permits (thousands)	174	162	212
National Economic Indicators			
Percent change in:			
Real GNP	1.0%	0.3%	3.3%
Personal income	5.9	5.2	6.8
Wage and salary employment	1.8	0.8	2.6
Consumer Price Index	5.4	5.0	3.7
Pre-tax corporate profits	-0.4	-8.7	16.9
Unemployment rate (%)	5.5	6.3	6.0
Prime interest rate (%)	10.0	9.1	9.6
New car sales (millions)	9.5	9.1	9.8
Housing starts (millions)	1.23	1.17	1.42

Source: *1991-92 Governor's Budget* and Department of Finance.

Figure 4

Annual Growth in California Personal Income

1978 through 1992



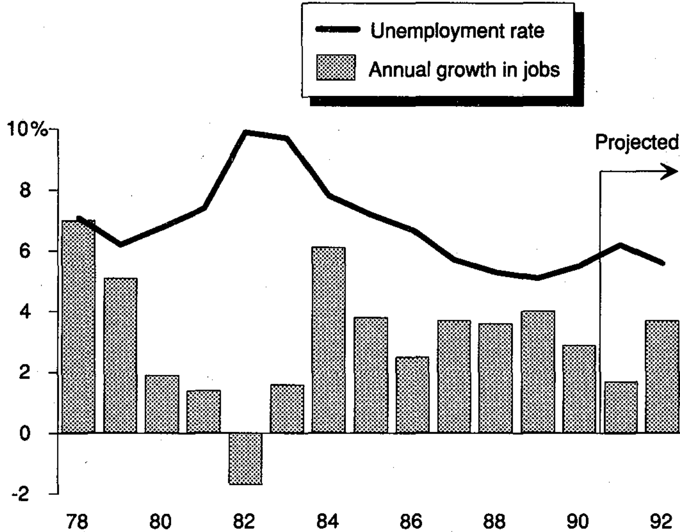
[a] "Real" personal income is defined as total personal income deflated by the GNP consumption expenditures deflator.

Source: Department of Finance. Data are estimated for 1990.

Figure 5

Trends in California's Employment And Unemployment

1978 through 1992



Source: Department of Finance and Employment Development Department. Data are estimated for 1990.

How Reliable Is the Economic Forecast?

Economic forecasts are subject to considerable error. This is especially true in transition periods such as this, when the pace of the economy is changing. As noted in the Governor's Budget, actual economic performance for 1991 and 1992 could end up being significantly different than predicted, especially given the considerable number of concerns and uncertainties in the outlook at this time. Some of these factors are itemized in Figure 6, including the war and California's drought.

At the time the budget was released, the department's economic forecasts for the nation and California both were reasonably consistent with the consensus views of economists. Since that time, however, most reports on the economy have been fairly negative. For example, California's unemployment rate reached 7 percent in January 1991, which was higher than most forecasters (including the department) had been expecting. Given such reports, many forecasters have recently revised their projections downward. As a result, the consensus forecast for the

Figure 6

Concerns and Uncertainties in the Economic Outlook

- ☑ ***War in the Persian Gulf.*** How long will it last, and what will be its effects in such areas as military spending and oil supplies and prices?
- ☑ ***Consumer confidence.*** When will it strengthen from its current low level, and what will be its effects on consumer spending?
- ☑ ***Federal monetary policies.*** Will federal monetary authorities be successful in providing enough credit to help stimulate the economy without setting the stage for a resurgence of inflation?
- ☑ ***California's drought.*** How severe and lengthy will the drought be, and what will be its impacts on agriculture, tourism, construction, and other areas of the economy?
- ☑ ***Federal budget deficit.*** What effects will the growing federal budget deficit have, such as in terms of constraining private sector business investment?
- ☑ ***Foreign trade activity.*** Will the economies of California's major trading partners remain healthy and keep the state's export markets strong?
- ☑ ***Defense spending.*** By how much will planned cutbacks in federal defense spending reduce employment and income in California?
- ☑ ***The housing market.*** What will happen to California housing prices and home sales over the next year, given the softness in the housing market that appeared in 1990?

California economy now is a bit *less optimistic* than the budget's forecast. This is not to say that the budget's economic forecast should not be used for preliminary budget planning purposes. What it does suggest, however, is that the Legislature needs to be especially mindful of the downside risks inherent in the budget's economic forecast. Thus, it will need to closely monitor the economy's performance in the months to come and, depending on what happens, be prepared to use revised estimates of state revenues and expenditures.

CALIFORNIA'S DEMOGRAPHIC ENVIRONMENT

California is in the midst of rapid changes in the size and composition of its population. These changes have many implications for the future course of California's economy and for the

volume and mix of public services that will be needed in the budget year and beyond.

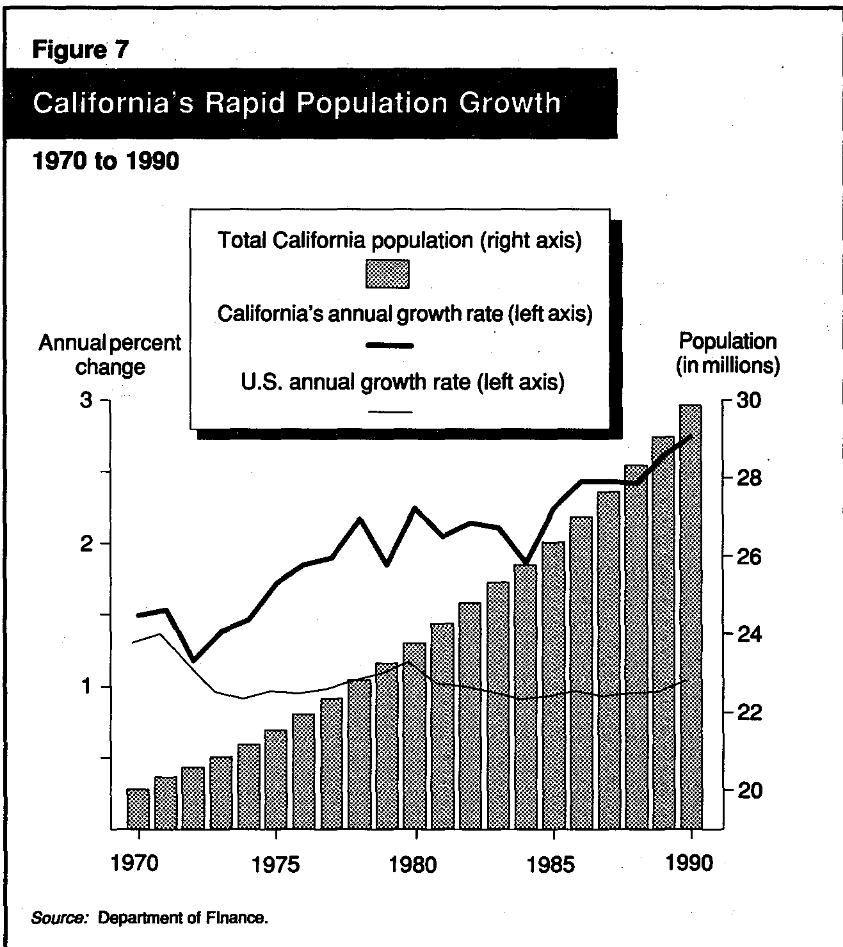
Rapid Population Growth

Figure 7 shows that the state's population has been growing about twice as fast as the nation's population since the late 1970s. Furthermore, the state's population growth rate accelerated after 1985, reaching 2.7 percent in 1990. This is the highest annual growth rate in the past 25 years, and compares to a national population growth rate in 1990 of only 1.1 percent. In numerical terms, California gained almost 800,000 new residents in 1990—a population greater than that of San Francisco.

Figure 7

California's Rapid Population Growth

1970 to 1990



Source: Department of Finance.

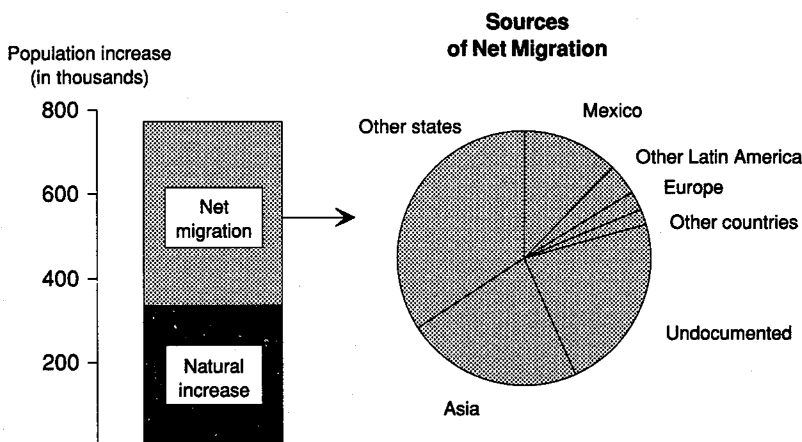
Immigration Spurs Population Growth

There are two sources of population growth: *natural increase*, which is the excess of births over deaths, and *net migration*, which is the difference between the number of people who come to California and the number of people who leave. Figure 8 illustrates the sources of California's population growth in 1989. It shows that more than half of the growth was attributable to net migration, a trend that most demographers expect to continue for at least several more years.

The figure also shows that more than half of the people migrating to California are immigrants from other countries. Mexico is the largest single source of immigrants to California, providing about 50,000 new legal immigrants annually and most of the estimated 100,000 undocumented annual immigrants to the state (these estimates exclude persons already residing in the state who are legalized under the federal Immigration Reform and Control Act of 1986). Asia is the second largest source of immigrants to California—particularly the Philippines, Southeast Asia, China, and Korea. Only about one-third of the people

Figure 8

More Than Half of California's 1989 Population Growth Was From Migration



Source: Legislative Analyst's estimates based on data from the Department of Finance and the U.S. Immigration and Naturalization Service.

who move into California are from other states. Given the above, federal immigration policies, along with the economic and political conditions in other countries, will be important determinants of the rate and composition of California's population growth in the budget year and beyond.

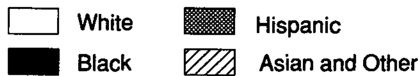
Increasing Ethnic Diversity

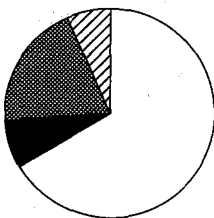
The large number of immigrants and the higher birthrates of many immigrant groups and ethnic minorities in California are rapidly changing the state's ethnic makeup. Figure 9 illustrates the evolution of the state's ethnic composition that has taken place over the last decade and that is projected to occur over the next decade. During this 20-year period, the non-Hispanic white portion of the state's population will shrink from about two-thirds to about one-half, while the black portion of the population will remain essentially constant. In contrast, the Hispanic portion of the population will grow from about one-fifth to close to one-third, and Asians will make up more than one-tenth of California's population by the year 2000. As a result of these trends, California is currently the most ethnically diverse state

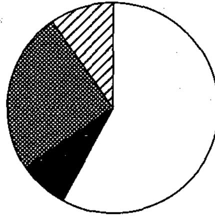
Figure 9

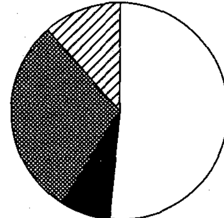
California's Ethnic Makeup is Changing

1980 through 2000









Source: Department of Finance.

in the nation after Hawaii.

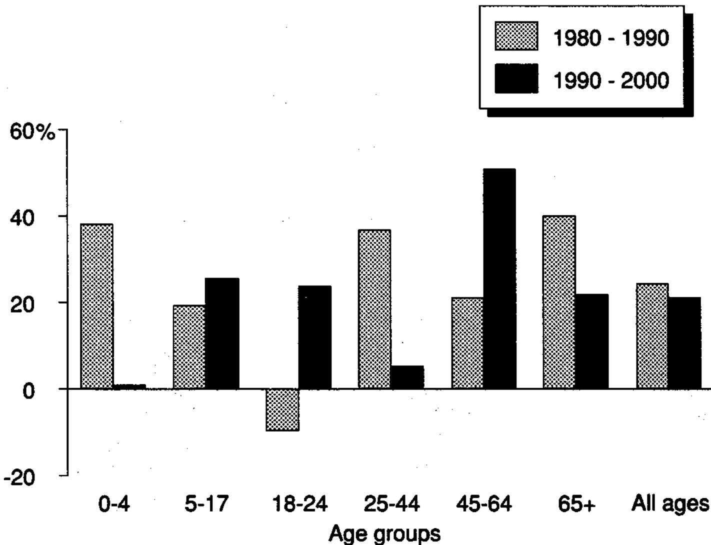
Changes in the Age Distribution of Californians

Rapid changes also are taking place in the age distribution of California's population. As shown in Figure 10, the decade of the 1980s saw rapid growth in the 25 to 44 age group (a key component of the workforce), as the postwar baby boomers matured. The 1980s, however, also saw strong growth among the very young and the elderly portions of the population. Meanwhile, the number of young adults aged 18 to 24 actually declined. During the decade of the 1990s, California's workforce will grow older on average as the baby boomers enter their late 40s and 50s. The decline in the young adult population will reverse, however, and growth in the 18 to 24 age group will provide increasing numbers of entry-level workers and potential college students during the 1990s. Growth in the K-12 school-age population will accelerate, as is already occurring, but the number of preschoolers will

Figure 10

Percent Increase in California's Population By Age Group

1980s versus 1990s



Source: Department of Finance.

change relatively little over the next decade. Although the elderly population will continue to grow in the 1990s, it will do so at a slower pace than during the 1980s.

What Effects Will These Trends Have?

The state's rapidly growing and changing population will have many implications for California, including for its economy and state and local governments. For example:

- Continued population growth will generate increased economic activity, while at the same time imposing additional infrastructure demands on state and local governments.
- Growth in the school age and young adult populations will place greater demands on K-12 and higher education, job training programs, and possibly the criminal justice and correctional systems.
- The rapid changes taking place in the state's ethnic composition will place many public institutions, especially schools, under increased stress as they attempt to serve a public that speaks a multitude of languages, and that has a wide diversity of educational and cultural backgrounds.

The effects of demographic factors on individual state expenditure programs are discussed further in the remainder of Part Two and in Part Three of this document.

Revenues in 1991-92

This section reviews the budget's estimates of state revenues, including our evaluation of the reliability of the revenue forecast. These revenues are divided into two general categories: General Fund revenues and special fund revenues. Figure 1 summarizes the relative size of these revenue categories and their major components. We first discuss the General Fund revenue forecast followed by a discussion of the forecast for special fund revenues.

Figure 1

State Revenues in 1991-92

(in billions)

Total State Revenues $57 billion

General Fund Revenues	
Personal Income Taxes	$20.0
Sales and Use Taxes	16.8
Bank and Corporation Taxes	5.5
All Other	3.5
Total	**$45.8**

Special Fund Revenues	
Motor Vehicle-Related Taxes	$7.3
Tobacco-Related Taxes	0.6
Sales and Use Taxes	0.2
Alcoholic Beverage Taxes	0.2
All Other	3.0
Total	**$11.3**

Source: 1991-92 Governor's Budget.

THE FORECAST FOR GENERAL FUND REVENUES

General Fund revenues account for approximately 80 percent of all state revenue collections. Figure 2 presents the department's forecast for General Fund revenues, by source, for the prior, current, and budget years.

Figure 2 shows that General Fund revenues are expected to total $40.4 billion in 1990-91 and $45.8 billion in 1991-92. Figure

Figure 2

General Fund Revenues

1989-90 through 1991-92
(dollars in millions)[a]

Source of Revenue	Actual 1989-90	Estimated 1990-91	Projected 1991-92	Change 1990-91 to 1991-92	
				Amount	Percent
Taxes:					
Personal income[b]	$16,903	$17,620	$20,034	$2,414	13.7%
Sales and use[c]	13,473	13,830	16,780	2,950	21.3
Bank and corporation[d]	4,927	5,370	5,535	165	3.1
Insurance[e]	1,168	1,270	1,325	55	4.3
Estate, inheritance and gift	389	442	487	45	10.2
Cigarette	153	147	158	11	7.5
Alcoholic beverage	129	127	135	8	6.3
Horse racing	107	111	113	2	1.8
Subtotals, taxes	$37,249	$38,917	$44,567	$5,650	14.5%
Other Sources:					
Interest on investments[f]	$390	$365	$390	$25	6.8%
Transfers[g]	477	590	338	-252	-42.7
Abandoned property[h]	249	218	70	-148	-67.9
Oil and gas revenues[i]	60	67	14	-53	-79.1
Other revenues[j]	325	281	392	111	39.5
Totals, General Fund	$38,750	$40,438	$45,771	$5,333	13.2%

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

[b] Estimates include net downward adjustments of $35 million in 1990-91 and net upward adjustments of $1.8 billion in 1991-92 due to adjustments and augmentations relating to proposals for legislation, changes in accounting methods, the Franchise Tax Board "trigger" reduction, and economic recovery.

[c] Estimates include net upward adjustments of $98 million in 1990-91 and $2.1 billion in 1991-92 due to adjustments and augmentations relating to previously enacted and proposed legislation, changes in accounting methods, the Board of Equalization "trigger" reductions, and economic recovery.

[d] Estimates include net upward adjustments of $435 million in 1990-91 and $233 million in 1991-92 due to adjustments and augmentations relating to legislation and changes in accounting methods.

[e] Estimate includes an upward adjustment of $7 million due to legislation accelerating "retaliatory" tax payments.

[f] Includes gross interest income earnings under the state's external borrowing program, which are partially offset by borrowing costs on the expenditure side of the budget.

[g] Includes transfers from the Disaster Relief Fund of $254 million in 1990-91 and $135 million in 1991-92. These amounts are to reimburse the General Fund for expenditures and revenue losses associated with the Loma Prieta earthquake.

[h] Includes a revenue increase of approximately $137 million in 1990-91 due to Ch 450/90 (SB 57, Lockyer), which shortened the time period from five to three years after which unclaimed property escheats to the state.

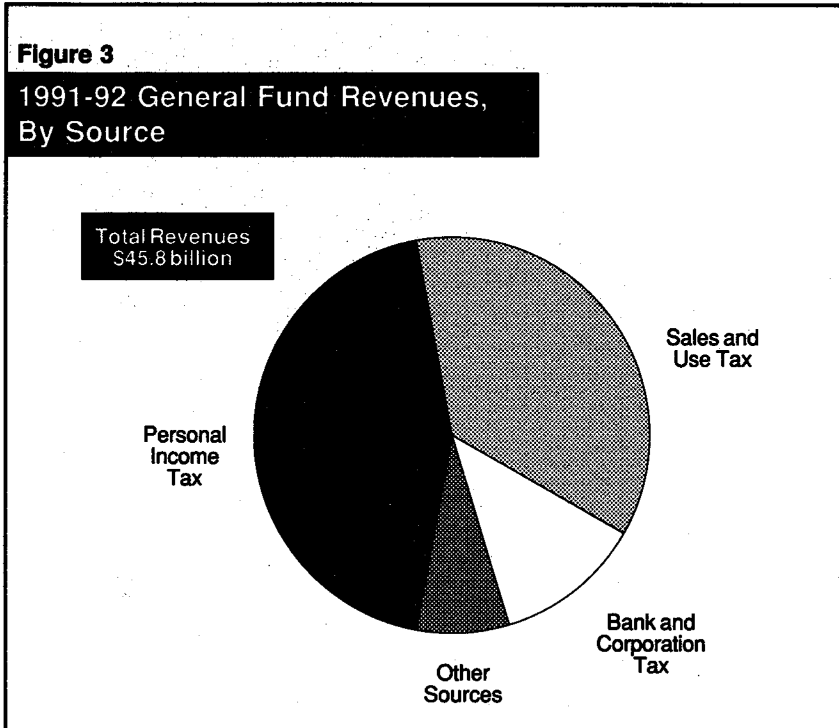
[i] Represents oil and gas revenues from state lands. Excludes royalties allocated to other funds and federal land royalties.

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

3 indicates that over 92 percent of these revenues will come from three large taxes—the personal income tax ($20 billion), the sales and use tax ($16.8 billion), and the bank and corporation tax ($5.5 billion). The remaining 8 percent of General Fund revenues ($3.5 billion) is derived from the insurance tax, interest income from investments, death-related taxes, and various other sources.

Figure 3

1991-92 General Fund Revenues, By Source

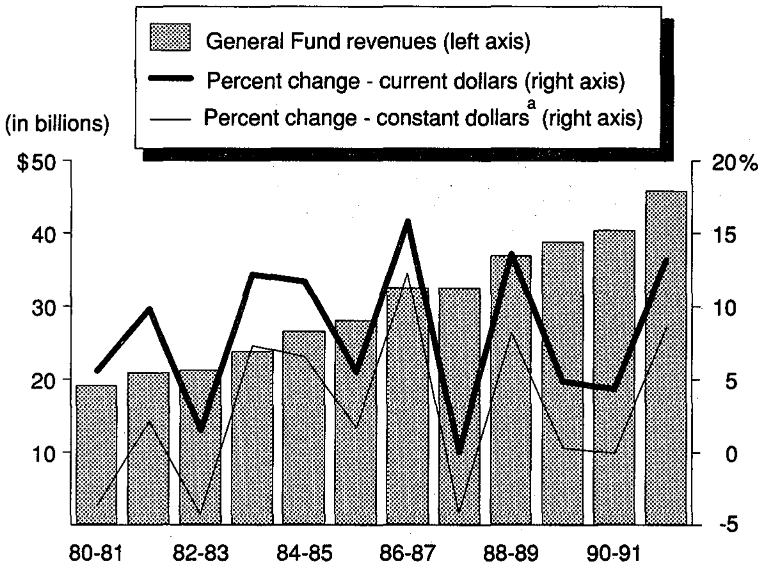


General Fund revenues are expected to grow by approximately 4.4 percent ($1.7 billion) in 1990-91 and 13 percent ($5.3 billion) in 1991-92 (see Figure 2). Figure 4 compares the predicted budget-year revenue growth with prior years, both before and after adjusting for inflation. The apparently strong *revenue* increase contrasts sharply with the department's forecast for sluggish growth in key *economic* variables. For example, the forecast predicts depressed growth rates in 1991 for personal income, taxable sales, and corporate profits, the bases from which the state's major tax revenues are generated.

Figure 4

Annual Growth in General Fund Revenues

1980-81 through 1991-92



[a] Revenue growth adjusted for inflation using the GNP state and local government price deflator.
Source: Governor's Budgets and State Controller's reports.

Revenue Adjustment Proposals Mask Underlying 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* growth in the revenue base. In the budget year, however, the magnitude of the special factors—$4 billion—is several times as large as the $1.3 billion baseline revenue growth which would be generated by the department's economic forecast in the absence of these special adjustments (see Figure 5).

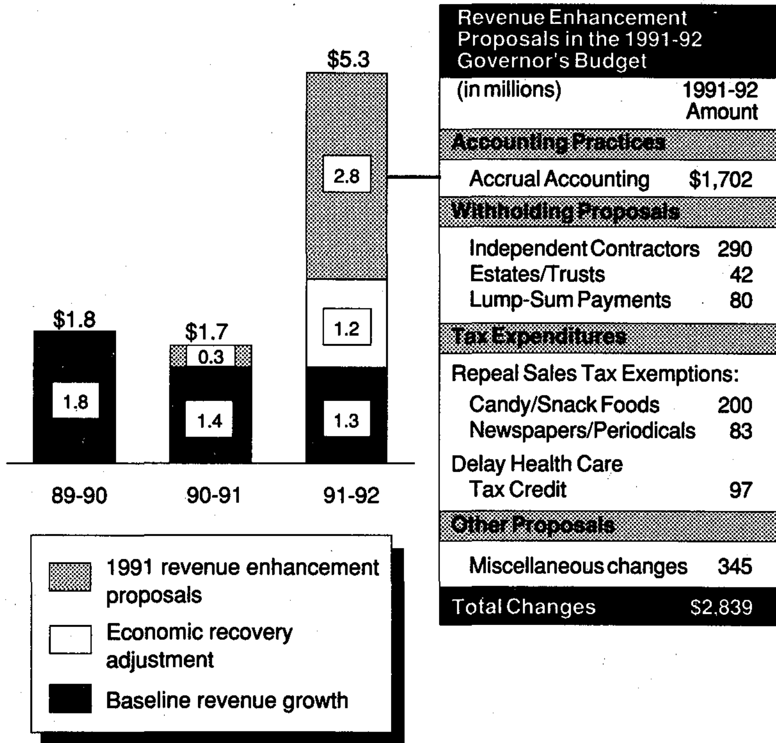
What Are the Revenue Adjustments Proposed in the Budget?

Figure 5 indicates that, of the $5.3 billion revenue growth expected in the budget year, $1.2 billion is attributable to a special economic recovery adjustment, which reflects the administration's view that the state will experience a stronger recovery from the current recession than is reflected in its economic fore-

Figure 5

General Fund Revenue Growth

1989-90 through 1991-92 (in billions)



Revenue Enhancement Proposals in the 1991-92 Governor's Budget (in millions)	1991-92 Amount
Accounting Practices	
Accrual Accounting	$1,702
Withholding Proposals	
Independent Contractors	290
Estates/Trusts	42
Lump-Sum Payments	80
Tax Expenditures	
Repeal Sales Tax Exemptions:	
Candy/Snack Foods	200
Newspapers/Periodicals	83
Delay Health Care Tax Credit	97
Other Proposals	
Miscellaneous changes	345
Total Changes	$2,839

cast. An additional $2.8 billion is due to the administration's revenue enhancement proposals. These proposals include a change in accounting methods, which produces a net gain of $1.7 billion in 1991-92. In addition, the budget proposes legislation which would (1) require withholding on certain kinds of income not presently subject to withholding, (2) eliminate sales tax exemptions on candy and periodicals, (3) delay implementation of a health care tax credit, and (4) enact a number of smaller proposals affecting minor revenues and transfers. This latter group of proposals increases revenue by $1.1 billion in the budget year.

The specific proposals are discussed further below under the individual taxes and in the section on the reliability of the revenue forecast.

How Does Projected Revenue Growth Compare to "Normal" Revenue Growth?

Although revenues *including the proposed augmentations* are expected to grow by 13 percent, baseline revenues excluding these proposals will increase by only 4 percent (or 7 percent if the economic recovery adjustment is included). This 4 percent underlying revenue growth rate is similar to revenue growth experienced in the last two years—3.6 percent in 1990-91 and 4.9 percent in 1989-90

In contrast, General Fund revenues grew at a much higher average rate of 8.2 percent over the last decade. Thus, the underlying revenue trend in 1991-92 is well below average historical levels, consistent with the weakness in the economic forecast.

As shown in Figure 4, General Fund revenues in individual years have grown at widely disparate rates in the past. This is partly because revenue growth rates are heavily influenced by the cyclical nature of economic activity. Lower-than-normal revenue growth periods tend to be associated with economic slowdowns, while greater-than-normal growth periods tend to be associated with economic expansions.

In addition, however, revenue growth rate fluctuations in recent years have been in part due to such factors as federal law changes and their effects on the magnitude and timing of certain types of tax payments, like capital gains taxes. This helps explain the revenue growth volatility shown in Figure 4 for the 1986-87 through 1988-89 period.

INDIVIDUAL GENERAL FUND REVENUE SOURCES

The Forecast for Personal Income Taxes

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, 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. As shown in Figure 2, PIT revenues are projected to total $17.6 billion in 1990-91 (4.2 percent growth) and $20 billion in 1991-92 (14 percent growth).

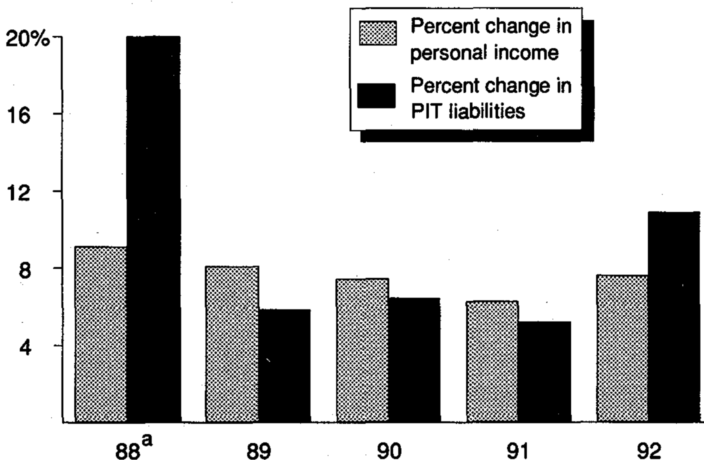
Figure 6 shows recent and expected future growth in PIT liabilities, and indicates that growth is expected to slow in 1991 and then strengthen in 1992, consistent with the projected pattern of economic activity.

As noted earlier, personal income is projected to increase by about 6.3 percent in 1991 and 7.6 percent in 1992, reflecting the department's forecast for a mild downturn followed by recovery. By comparison, personal income tax *liabilities* are expected to

Figure 6

Annual Growth in Personal Income Tax Liabilities and Personal Income

1988 through 1992



[a] Tax liability growth was unusually high in 1988 due to the effects of major changes to the income tax law at the federal level in 1986 and at the state level in 1987.

Source: Department of Finance and Franchise Tax Board. Data shown are on an income-year basis. Liability data shown are preliminary for 1989 and projected for 1990 through 1992.

increase by 5.2 percent in 1991, but by 11 percent in 1992. Although the state's progressive marginal tax bracket structure should enable 1992 tax liabilities to increase slightly faster than personal income growth, the 11 percent growth for 1992 is higher than would be expected from the economic forecast alone. Rather, this strong liability growth is heavily influenced by a 25 percent increase in capital gains in response to the expected economic recovery.

The growth in underlying tax liabilities only partially explains the department's estimate of the 14 percent PIT revenue growth in 1991-92. There are a number of special factors that complete the story. Specifically, the department has augmented its PIT revenue forecast by $1.4 billion for 1991-92, reflecting its proposed legislation and a special "economic recovery adjustment." Proposed legislation to (1) require withholding on payments to independent contractors, supplemental "lump-sum" wage payments, and estates and trusts, and (2) delay implementation of a health care tax credit, are estimated to bring in an additional $454 million in 1991-92. In addition, a proposed accrual accounting adjustment adds $270 million to the 1991-92 revenue forecast. Finally, revenues have been augmented by $700 million (an economic recovery adjustment) on the assumption that the economy will experience a stronger and swifter recovery than predicted in the economic forecast. Without the adjustments for legislation, 1991-92 PIT receipts would be reduced to $19.3 billion, an increase of 9.6 percent over 1990-91. Without the economic recovery adjustment, it would be further reduced to $18.6 billion, bringing the increase down to 5.6 percent.

Capital Gains Forecast Subject to Considerable Uncertainty. Figure 7 presents the historical trend and the department's forecast for capital gains tax liabilities. As this figure indicates, wide year-to-year swings in capital gains have been the norm in recent years. This partly reflects federal and state law changes regarding the tax treatment of capital gains (see below). In its forecast, the department estimates that capital gains liabilities fell by 6 percent in 1990, and projects them to remain flat in 1991 before increasing by 25 percent in 1992.

Capital gains liabilities have been more volatile in the past than other tax liabilities because taxpayers typically have great discretion over when to realize and report their gains. A 1987 change in the state tax treatment of these gains, making them fully taxable, increased their contribution to total revenues. As a result, the state became more "vulnerable" to potential revenue fluctuations caused by the volatility of capital gains taxes.

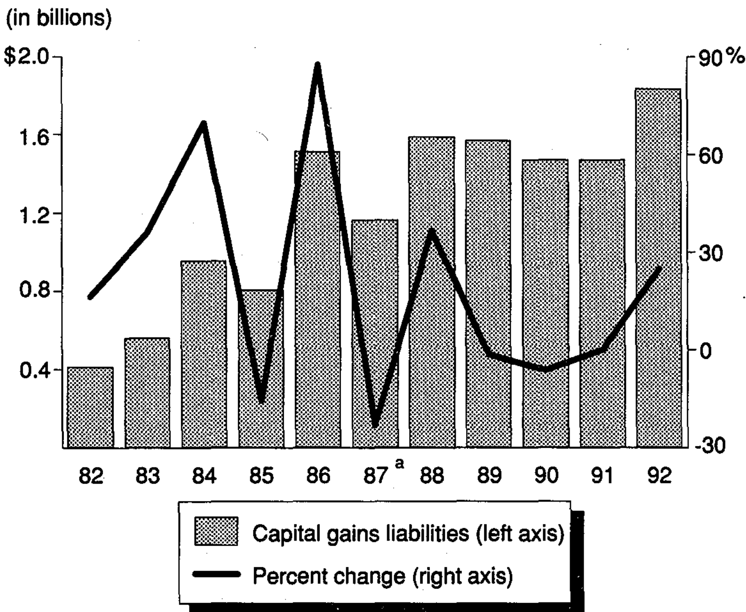
The department's forecast reflects the view that many taxpayers have delayed selling their assets because of uncertainty over the future federal tax treatment of capital gains and other factors such as soft real estate markets and the poor performance of the 1990 stock market. According to this view, the state will realize large increases in capital gains tax revenues as soon as the economy firms up and uncertainty about the federal tax issue disappears. It is this view that explains the department's assumption that capital gains activity will be strongly responsive to the economic recovery in 1992.

Although predicting capital gains is, to a large extent, guesswork, the department's capital gains forecast is a reasonable one and consistent with its economic forecast. It is important to note, however, the historical pattern of volatility in capital gains growth which illustrates the extreme sensitivity of this revenue

Figure 7

Capital Gains Tax Liabilities

1982 through 1992



[a] Federal tax reform and state conformity made capital gains fully taxable effective January 1, 1987.

Source: Department of Finance and Franchise Tax Board.

source to economic conditions. If the economic recovery is not as vigorous as the department forecasts, or is delayed, capital gains could be much weaker. In such a case, revenues from this source easily could vary from the forecast by several hundred million dollars in 1991-92.

The Forecast for Sales and Use Taxes

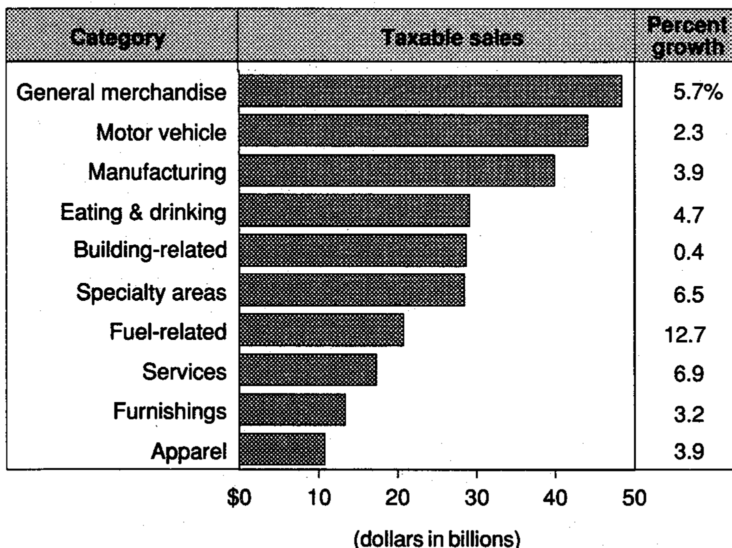
Background. Sales and use taxes are the second largest source of General Fund revenues, comprising about 37 percent of the total. Sales and use taxes are derived from the state's 4.75 percent levy on taxable sales. In addition, sales and use taxes of up to 2.25 percent are levied by local governments and transit districts. A temporary one-quarter-cent state sales tax was in effect from December 1, 1989 through December 31, 1990 to fund earthquake relief.

Taxable Sales Sluggish. The key to forecasting sales tax receipts is projecting the level of taxable sales in California. Figure 8 shows the major categories of taxable sales which comprise this tax base. It indicates that the department expects modest growth in many of the major categories of taxable sales.

Figure 8

Major Categories of Taxable Sales

1991



Fairly slow growth is predicted for those categories that are particularly sensitive to the economy, such as motor vehicles (2.3 percent), manufacturing (3.9 percent), and building-related materials (0.4 percent). The only area of strong predicted growth is in fuel-related sales, reflecting the budget's forecast for higher gasoline prices due to the Persian Gulf conflict.

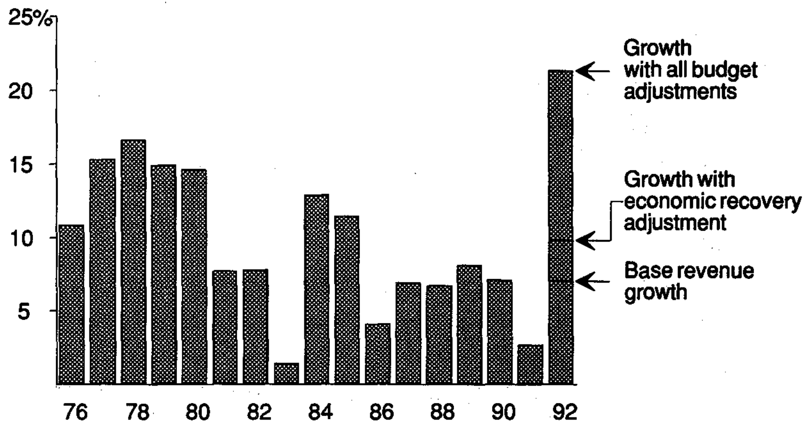
The budget forecasts that total taxable sales will increase by 6.3 percent in 1991 and 8.5 percent in 1992, compared to 4 percent in 1990. These growth rates reflect the department's forecast for a short and mild recession.

Strong Growth in Tax Receipts Due to Special Adjustments. The department expects sales tax revenues to reach $16.8 billion in 1991-92, a gain of 21 percent over the current year. As Figure 9 shows, the strong growth predicted for sales tax receipts is primarily attributable to various budget proposals. These include proposals to eliminate the tax exemptions for candy, snack foods, and periodicals ($283 million), and change accounting methods ($1.2 billion). In addition, the economic recovery adjustment adds $500 million to revenues over and above the amount produced from the projected underlying growth

Figure 9

Annual Growth in State Sales Tax Collections

1975-1976 through 1991-1992[a]



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

Source: Department of Finance. Tax collections data are preliminary for 1989-90 and projected for 1990-91 and 1991-92.

in taxable sales. This projected underlying growth is consistent with the department's economic forecast.

The Forecast for Bank and Corporation Taxes—Stagnation Continues

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 $5.4 billion (9 percent growth) in 1990-91 and $5.5 billion (3.1 percent growth) in 1991-92. As noted below, however, revenue growth in 1991-92 would be negative in the absence of the administration's proposed special adjustments.

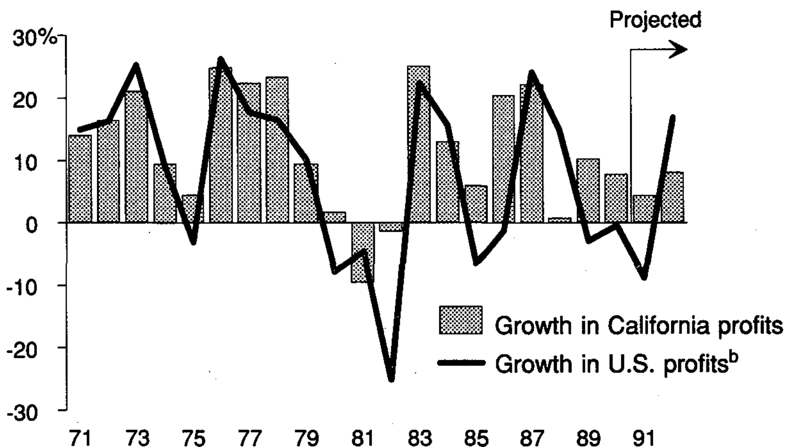
Department Predicts Modest Gains in Corporate Profits. The key to forecasting this tax is to predict the level of California's taxable corporate profits. California profits are related to national profits as well as to factors unique to California.

Figure 10 indicates that the department expects California profits to increase by 4.4 percent in 1991 and by 8.1 percent in

Figure 10

Annual Growth in Taxable Corporate Profits

1971 through 1992[a]



[a] California data for 1989 and 1990 are preliminary estimates by the Department of Finance.

[b] California and U.S. profit data are not strictly comparable in all years due to definitional differences. Data incorporate the effects of various federal and state tax law changes during the 1980s and 1990s which revised the definition of taxable corporate profits.

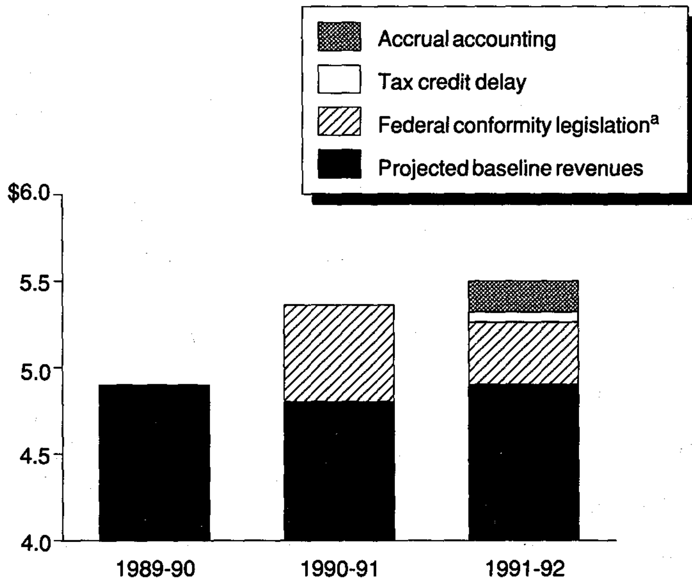
1992. In contrast, U.S. profits are expected to decrease by about 9 percent before rebounding by 17 percent over the same time period. Although there is a high degree of historical correlation between California and U.S. profits, the figure shows that California profits generally tend to be more resistant to economic slowdowns than do U.S. profits. This tendency of California to either match or "out perform" the nation as a whole (in good times as well as bad) is reflected in the department's forecast of California profits for 1989, 1990, and 1991. The higher growth rate estimated for U.S. profits in 1992 in part reflects the recovery from an especially depressed 1991 profit level.

Growth in Corporate Tax Receipts Is Due to Adjustments. Figure 11 shows the projected growth in corporate tax receipts for the prior, current, and budget years. As the figure indicates, projected growth in 1991-92 is due entirely to two proposed adjustments. These are the department's proposals to

Figure 11

Projected Corporate Tax Receipts

1989-90 through 1991-92 (in billions)



[a] Refers to federal conformity legislation enacted by California in 1990.

Source: Department of Finance.

change accounting methods ($180 million) and delay implementation of the health care tax credit for small employers ($55 million). Absent these adjustments, projected bank and corporation tax receipts would actually *decline* by $70 million in 1991-92.

This is the second consecutive year in which all of the projected growth in corporate tax receipts is due to proposed legislation. As Figure 11 shows, current-year growth in this tax is entirely attributable to the estimated revenue gain from "federal conformity" legislation enacted by California in 1990. The estimate of this revenue gain, made at the time this legislation was enacted—$525 million for 1990-91 and $363 million for 1991-92—has not yet been corroborated by actual collections data.

Other General Fund Revenues

Other General Fund revenues are expected to decline by $196 million in the budget year. This 5.4 percent reduction is due to the net effect of many factors. The most important of these are a reduction of $119 million in earthquake-related disaster relief transfers, a decrease of $148 million in revenues from the sale of abandoned property, a $78 million recovery of prior-year Department of Social Services costs from the federal government, an increase of $55 million in insurance tax revenues, and a $53 million decrease in oil and gas revenues. The latter decrease is primarily due to the expected decline of oil prices in the budget year over the current year. The increase in insurance taxes will actually be approximately $50 million more than is reflected in the revenue forecast (resulting in a total 1991-92 increase of $105 million) because the Board of Equalization recently increased the tax rate on 1990 premiums that will be collected in the budget year. This action was taken as a result of a provision in Proposition 103 (November 1988) which allows the state to be compensated for any decrease in revenues which result from the measure.

RELIABILITY OF THE REVENUE FORECAST

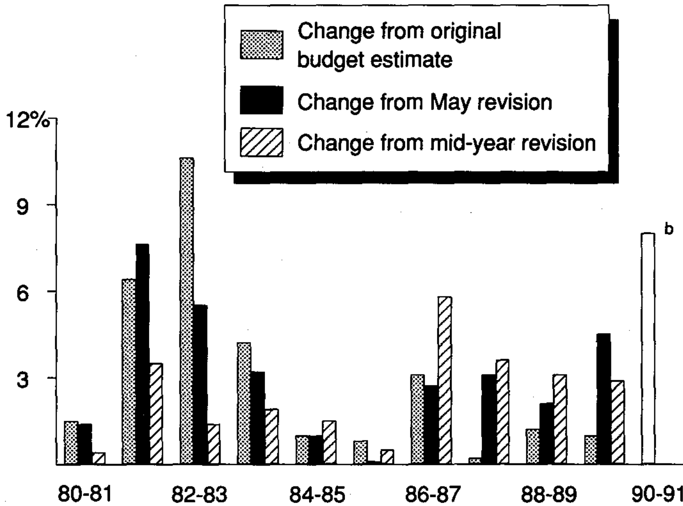
Figure 12 shows the discrepancies between past revenue forecasts—original budget estimates, May revise reestimates, and mid-year reestimates—and final receipts over the past decade. It demonstrates that there are significant margins of error underlying the revenue forecasts, and serves as a reminder that the budget-year forecast is subject to large margins of error as well.

Figure 12 also shows that revenue estimating errors over the past decade were at their largest during the early 1980's reces-

Figure 12

Discrepancies Between Actual and Estimated General Fund Revenues[a]

1980-81 through 1990-91



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

[b] Represents the discrepancy between the original *1990-91 Governor's Budget* forecast and the *1991-92 Governor's Budget* mid-year revision.

sion and subsequent recovery. This illustrates the fact that forecasting is most difficult at the peak or trough of an economic cycle, when economic trends are changing direction. The current period, in which California has moved into a downturn, is just such a case. The discrepancy between the original budget forecast for 1990-91 (made in January 1990) and the current reestimate is 8 percent (after adjustment for noneconomic factors). This discrepancy, due primarily to unexpected weakness in the economy, is significantly greater than those experienced in the past several years. The current downturn also adds to the difficulty in forecasting budget-year revenues, because both the 1990-91 base from which they will grow and the growth pace itself are uncertain. For this reason, the budget-year revenue forecast presents us with the potential for greater error than is the case when the economy is more stable.

What Do These Error Margins Mean in Terms of Revenues? Even small percentage revenue estimating errors can produce large dollar discrepancies between forecasted and actual receipts. For example, a 1 percent error in the budget year would translate into a change of over $450 million. Thus, the "average" error for the previous 10-year period (3.1 percent) would amount to $1.4 billion.

Is the Revenue Forecast Reasonable? Assessing the reasonableness of the budget's revenue projections involves consideration of two main factors: (1) the reliability of the economic forecast on which the revenue forecast depends and (2) the consistency of the revenue projections with the economic forecast from which they are derived. Our analysis of these factors indicates the following:

- ***Economic reliability.*** As discussed in the preceding economic and demographic overview section, the consensus view of economic forecasters has become more negative since December when the economic forecast appearing in the budget was prepared. The consensus view still holds that the recession will be short and mild; however, its estimates of California personal income and employment growth for *both 1991 and 1992* have been adjusted downward so that they are now below those of the department. The net effect of using the less optimistic consensus forecast would be to reduce revenues below the budget forecast by several hundred million dollars.

  It also is important to recognize that the growing severity of the drought is another factor which has become more apparent since the department made its economic forecast. It will, in all likelihood, reduce tax revenues, both through (1) its *direct* negative effect on corporate profits and the income and sales of businesses such as farming operations, fisheries, and recreation-related businesses; and (2) its *indirect* effects on profits and employment in related business such as trucking companies, canneries, and chemical suppliers. It also may affect residential construction negatively. The extent to which revenues are affected by the drought will depend on many factors, including the extent to which farmers can adopt water-conserving technologies, move their operations to areas with adequate water, and convert to drought-resistant crops.

- ***Consistency.*** Our analysis indicates that the department's economic forecast would produce—on net—less revenues than the budget projects. The key difference

between our own estimate and the department's is the $1.2 billion in economic recovery adjustments to personal income taxes and sales taxes. Apart from this factor, however, we believe the budget's revenue forecast is reasonably consistent with the department's economic forecast.

General Conclusion—Estimates Have Significant Downward Potential

Based on the most recent economic information available, it appears that the department's revenue estimates have significant downward potential. Specifically:

- Regarding the economic recovery adjustment, we see no basis for assuming that this $1.2 billion will be realized. Therefore, we recommend that the Legislature disregard this amount for its fiscal planning purposes.
- In addition, revenues could be several hundred million dollars lower if the latest consensus economic forecast proves more accurate than the department's, and if other factors like the drought further depress economic activity. This underscores the need for the state to have an adequate reserve in 1991-92.

April Will Provide Additional Information. During each of the past three years, the budget's revenue projections have been significantly revised in May, following the filing of personal income tax returns in April, and after other major tax payment dates have passed. This year, there again will be important revenue data available in the spring, as well as added information on the economy, which could significantly change the revenue estimates. More information will be available, for example, on the course of the current downturn, the severity of the drought, and the extent to which the budget's assumptions about oil prices are accurate. Depending on what these data show, the revenue estimates for both the current year and budget year may need to be significantly revised in May.

THE FORECAST FOR SPECIAL FUND REVENUES

As shown in Figure 13, special fund revenues are projected to be $9.0 billion in 1990-91 and $11.3 billion in 1991-92. This 27 percent increase is primarily due to administration proposals to (1) revise the motor vehicle depreciation schedule, (2) increase vehicle registration and driver's license fees, and (3) increase alcoholic beverage taxes, as well as the effect of fuel tax increases authorized by Proposition 111 (1990). These increases are

Figure 13

Special Fund Revenues

1989-90 through 1991-92
(dollars in millions) [a]

Source of Revenue	Actual 1989-90	Estimated 1990-91	Projected 1991-92	Change 1990-91 to 1991-92 Amount	Change 1990-91 to 1991-92 Percent
Motor Vehicle Revenues:					
License fees (in lieu)[b]	$2,140	$2,262	$3,225	$963	42.6%
Fuel taxes[c]	1,349	2,018	2,537	519	25.7
Registration, weight and miscellaneous fees[d]	1,162	1,363	1,505	142	10.4
Subtotals, motor vehicle revenues	**$4,651**	**$5,643**	**$7,267**	**$1,624**	**28.8%**
Other Sources:					
Cigarette and tobacco products tax[e]	$634	$609	$644	$35	5.8%
Alcoholic beverage tax	--	--	190	190	-- [f]
Sales and use taxes[g]	445	537	183	-354	-65.9
Interest on investments	202	171	170	-1	0.6
Oil and gas revenues[h]	84	170	149	-21	-12.4
Other	1,687	1,826	2,723	897	59.5
Totals, special funds	**$7,703**	**$8,956**	**$11,326**	**$2,370**	**26.5%**

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

[b] Includes revenues of $781 million in 1991-92 due to a proposed revision of the vehicle license fee depreciation schedule.

[c] Includes revenues of $687 million in 1990-91 and $970 million in 1991-92 due to a tax rate increase under Proposition 111 (June 1990).

[d] Includes revenues of $130 million in 1990-91 and $216 million in 1991-92 due to increased driver's license and vehicle registration fees.

[e] Includes revenues due to Proposition 99 (November 1988) of $569 million in 1989-90, $547 million in 1990-91, and $531 million in 1991-92, and an increase of $53 million due to a revision in the state's accounting methods.

[f] Not a meaningful figure.

[g] Includes revenues of $353 million in 1989-90 and $422 million in 1990-91 due to a temporary one-quarter-cent tax increase enacted by the Legislature in 1989 to fund earthquake relief.

[h] Represents oil and gas revenues 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.

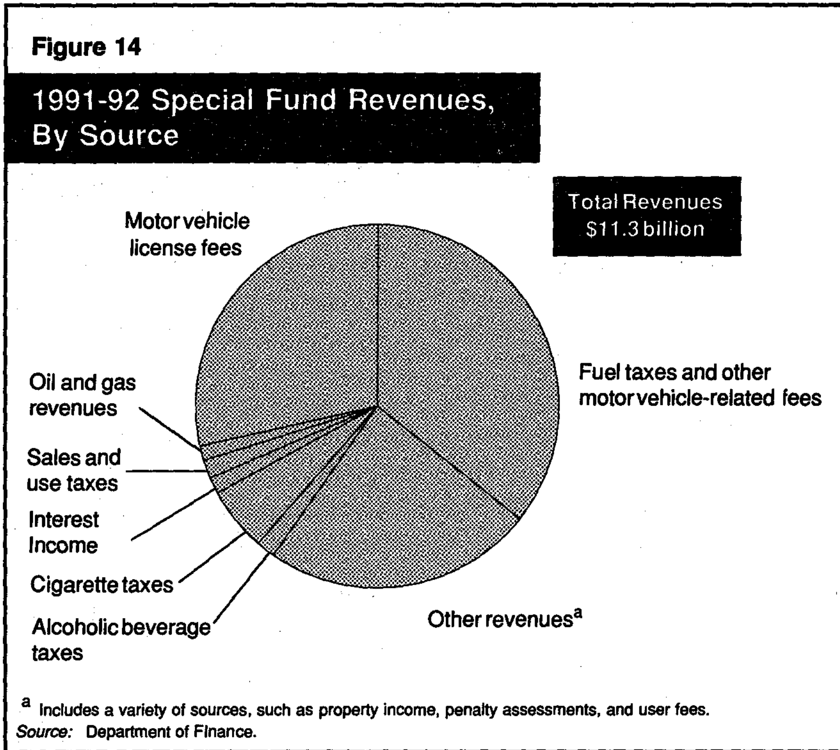


Figure 14

1991-92 Special Fund Revenues, By Source

[a] Includes a variety of sources, such as property income, penalty assessments, and user fees.
Source: Department of Finance.

partially offset by the sunset of the one-quarter-cent earthquake tax implemented to fund disaster relief.

Figure 14 indicates that about two-thirds of all special fund revenues ($7.3 billion) are motor vehicle-related. These sources include vehicle license fees ($3.2 billion), fuel taxes ($2.5 billion), and vehicle registration, weight, and other fees ($1.5 billion). The other one-third of special fund revenues come from tobacco products taxes ($644 million), alcoholic beverage taxes ($190 million), sales and use taxes ($183 million), investment interest ($170 million), oil and gas revenues ($149 million), and a variety of other sources ($2.7 billion).

How Are Special Fund Revenues Used?

Special fund revenues are used for a variety of purposes. Many special fund revenues are dedicated to specific uses. For example:

- Motor vehicle-related revenues are used for various programs, many of which are related to transportation. Over

one-half of these revenues are transferred to local governments for use in a variety of local programs, including street and road maintenance and mass transit purposes. The remainder is used for 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 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 fund capital outlay projects.

Major Increases in Motor Vehicle-Related Fees and Taxes

Motor Vehicle License Fees. Figure 13 shows that motor vehicle license fees are expected to total $2.3 billion in the current year and $3.2 billion in the budget year. The budget proposes to increase vehicle license fees primarily by revising the vehicle license fee depreciation schedule. Under current law, new car values are depreciated over a nine-year period, so their value for tax purposes declines from 85 percent in the first year to 5 percent by the ninth year. The new schedule would establish license fees instead based on 100 percent of purchase price for new vehicles, declining to a minimum of 15 percent over a 10-year period. These changes would increase vehicle license fee revenues by an estimated $781 million in the budget year. The budget proposes that these revenues be allocated to counties as part of its "program realignment" proposal. (For a discussion of this proposal, please see our county-state piece in Part Four of this document).

Vehicle Registration and Driver's License Fees. The department expects vehicle registration and other fees to be $1.4 billion in the current year and $1.5 billion in the budget year. The revenue forecast includes revenues from an administration proposal for legislation to increase vehicle registration fees by $5 and driver's license fees by $2 beginning January 1, 1992. Together, these increases would produce an additional $73 million in 1991-92 to be used for support of the DMV.

Fuel Taxes. Fuel taxes are expected to be $2 billion in the current year and $2.5 billion in the budget year. The forecast

reflects fuel tax increases authorized by Proposition 111 (1990) to be used for transportation purposes. Proposition 111 increased fuel tax rates by 5 cents per gallon, effective August 1, 1990, with an additional 1-cent-per-gallon increase each January 1 thereafter for four years. The department expects these increases to produce $687 million in 1990-91 and $970 million in 1991-92.

Alcoholic Beverage Taxes. The budget forecast includes revenues generated from the administration's proposal to raise taxes on alcoholic beverages. The proposed rates are essentially the same as proposed by Proposition 126 on the November 1990 ballot, which was rejected by the voters. These increases would place the state's tax rates near the national average for all alcoholic beverages, with the exception of wine, for which the state tax rate would remain significantly below the national average.

The department estimates that these rate increases would raise approximately $190 million in additional revenues in the budget year. The administration has proposed to allocate most of these funds (together with the additional vehicle license fees from proposed fee increases) to counties, in lieu of General Fund support for public health services and local mental health programs. The remainder ($17 million) will be used for a program to educate women on the dangers of alcohol and drug abuse during pregnancy.

Tobacco-Related Taxes—Revenue Increase Due to Accrual Adjustment. Special fund revenues from tobacco-related taxes are estimated to be $609 million in 1990-91 and $644 million in 1991-92. Most of these revenues—$547 million in the current year and $578 million in the budget year—are due to Proposition 99, which levied an additional 25-cents-per-pack tax on cigarettes and an "equivalent" amount on other tobacco products, effective January 1, 1989. The remainder represents revenues distributed to local agencies.

An accrual accounting adjustment made by the department has increased the revenue estimate by $53 million for the budget year. Our analysis indicates, however, that these revenues *already* are accounted for on an accrual basis, so the adjustment is inappropriate. In the absence of this adjustment, total 1991-92 revenues from the cigarette tax would have been projected at $591 million ($531 million from Proposition 99), a 3 percent decrease from the current year. This decrease in underlying revenues is due to declining consumption of cigarettes. Because the cigarette tax is assessed on a flat rate-per-pack basis, declining consumption results in an absolute reduction in revenues. Price increases due to a recent federal surtax are expected to

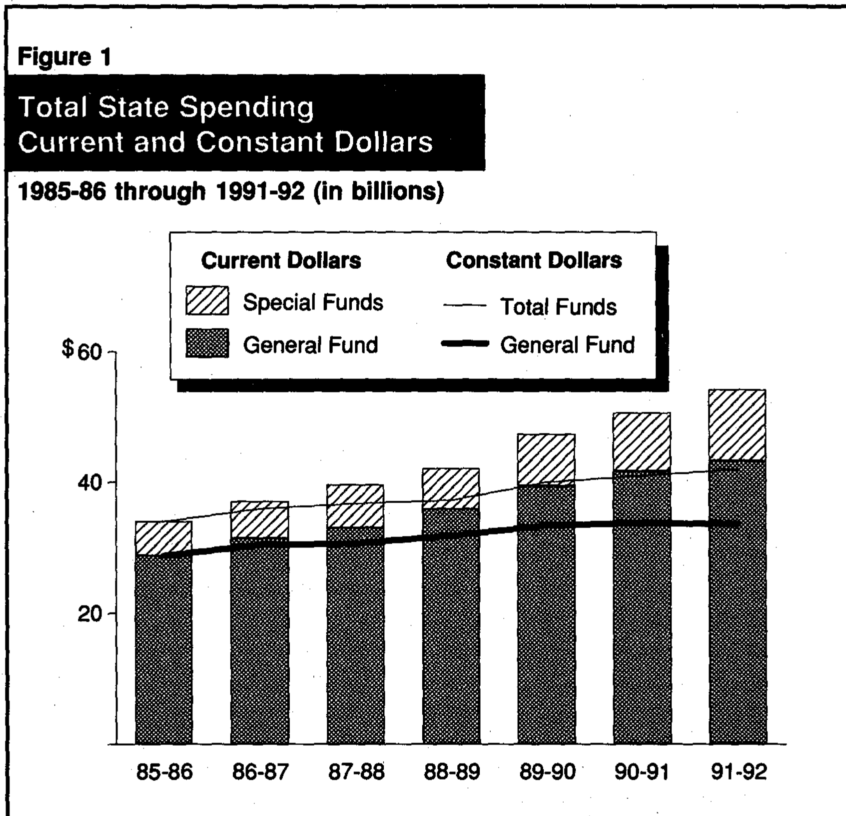
accelerate the trend of declining consumption of cigarettes, resulting in revenue decreases in the budget year.

Oil and Gas Revenues—Reduction Reflects Lower Oil Prices. Figure 13 shows that oil and gas revenues are expected to total $149 million in the budget year. This is a 12 percent ($21 million) reduction from the level in the current year. This reduction is primarily due to the department's expectation that the price of crude oil will remain below the recent high levels experienced immediately after the onset of the Persian Gulf conflict. Lower oil prices reduce both the revenues obtained per barrel from oil produced on state-owned lands, and the volume of oil it is profitable to extract. The amount of oil and gas revenues actually collected could differ significantly from the estimate, however, due to the uncertainty surrounding the war in the Persian Gulf and the potential volatility in oil prices.

Expenditures in 1991-92

The Outlook for State Expenditures

Figure 1 shows state expenditures from 1985-86 through 1991-92 from the General Fund and special funds in both "current dollars" (amounts as they appear in the budget) and "constant dollars" (current dollars adjusted for the effects of inflation). This adjustment relies upon the Gross National Product (GNP) implicit price deflator for state and local government purchases of goods and services. The GNP deflator is a good general measure of the price increases faced by state and local



governments, and allows comparisons of the "purchasing power" of state resource allocations over time.

Figure 1 shows that total state spending (in current dollars) increased from $34 billion in 1985-86 to a proposed level of $54.1 billion in 1991-92. This 1991-92 amount is $3.5 billion, or 6.9 percent, more than estimated total state spending for the 1990-91 fiscal year. The growth since 1985-86 amounts to an average annual increase over the period of 8.0 percent. Figure 1 also shows that, in constant dollars, total state expenditures have grown less rapidly, increasing at an average annual rate of 3.6 percent.

General Fund expenditures are proposed to total $43.3 billion in 1991-92, which is $1.6 billion, or 3.7 percent, more than estimated General Fund expenditures for 1990-91. In contrast, General Fund expenditures grew at an average growth rate of almost 8 percent between 1985-86 and 1990-91. Because we estimate that General Fund expenditures would need to grow by $6.4 billion in 1991-92 in order to maintain current levels of state-supported services, the budget reflects significant reductions in the level of services to be provided.

Special fund expenditures are proposed to total $10.8 billion in 1991-92. This amount is $1.9 billion, or 22 percent, higher than estimated special fund expenditures in 1990-91. This high growth rate reflects the budget's proposed increase in state taxes on vehicles and alcoholic beverages, which would be deposited in state special funds and distributed largely to counties.

State Spending by Program Area

Figure 2 shows the distribution of proposed 1991-92 expenditures from all state funds among different program areas. Both General Fund and state special fund expenditures are reflected in order to provide some perspective on total state spending on different programs. In some program areas (for example, resources), the exclusion of special fund expenditures would not permit a meaningful evaluation of funding and policy changes.

The program area groupings used in Figure 2 differ in three respects from the traditional groupings used in the Governor's Budget. Specifically, the criminal justice category includes spending on both the traditional Youth and Adult Corrections category as well as state expenditures for the judicial system, in order to recognize the linkage between these programs. The general government category includes not only most of the programs that traditionally are shown as general government in the Governor's Budget, but also includes all of the administrative

functions traditionally included in the Legislative, Judicial and Executive; State and Consumer Services; and Business, Transportation, and Housing categories. This provides a better perspective as to the costs of running state government. Finally, the capital outlay category includes all of the direct capital outlay expenditures made from the General Fund and special funds, as well as state general obligation bond debt service, and expenditures associated with lease-payment bonds.

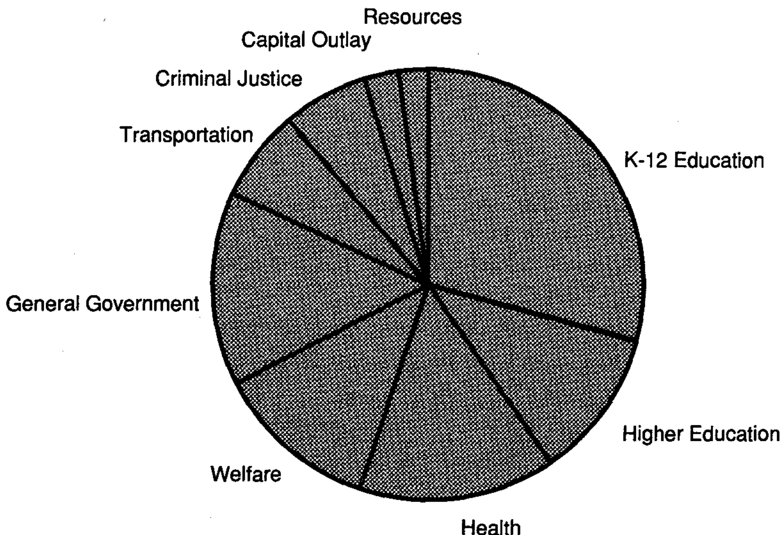
Figure 2 shows that slightly more than 40 percent of all expenditures from state funds is proposed for educational programs, and more than one-quarter for health and welfare programs. The remaining expenditures are in the areas of general government (13 percent), criminal justice (6.4 percent), transportation (7.9 percent), resources (2.0 percent) and capital outlay (2.6 percent).

Figure 3 compares the average annual growth rate for each program area during the 1985-86 through 1991-92 period with the overall rate of growth in expenditures from state funds. It

Figure 2

Total State Spending By Major Program

1991-92



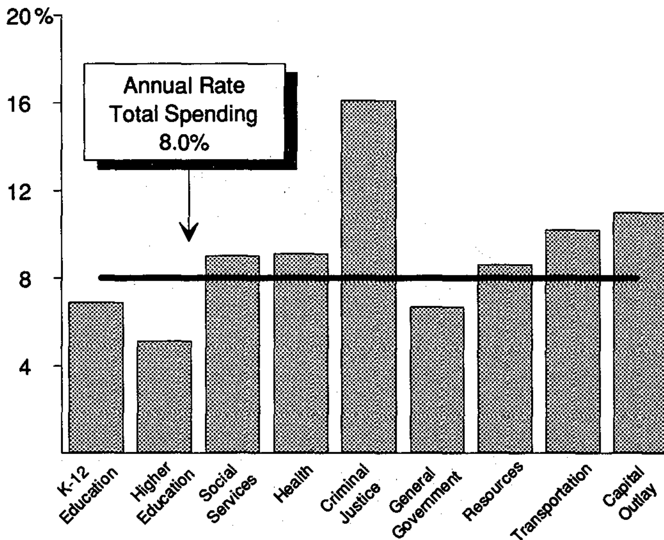
shows that criminal justice, transportation, and capital outlay expenditures have grown significantly faster than the budget as a whole. Taken together, however, these programs represented only 17 percent of state expenditures in 1991-92. By comparison, higher education programs have been growing significantly slower than total spending.

The next part of this section discusses this year's budget from a program area perspective. For each program area, we discuss the proposed level of expenditure for each major program, and the various factors which are "driving" program expenditures. In addition, we discuss the administration's major proposals for reductions in expenditures, as well as the new program initiatives proposed in the budget.

Figure 3

Comparison of Annual Average Growth Rates For Major Program Areas - All State Funds

1985-86 through 1991-92



K-12 EDUCATION

Funding for K-12 education from the General Fund for Proposition 98-eligible programs is proposed to total $15.1 billion, which is equal to approximately 35 percent of General Fund expenditures proposed in the Governor's Budget for 1991-92. (Over 90 percent of total General Fund support for K-12 education counts towards meeting Proposition 98's minimum funding requirements. The primary K-12 program areas which are not counted are contributions to the State Teachers' Retirement Fund, debt service on school facilities aid bonds, privately operated child care programs, and State Department of Education administration.)

The level of funding proposed in the budget represents an increase of $233 million, or 1.6 percent, over the level of K-12 education expenditures estimated for 1990-91. The 1990-91 expenditure level includes the impact of a $450 million reduction in Proposition 98 funding for K-12 schools which resulted from reduced General Fund revenues in the current year. (For a discussion of Proposition 98, please see our piece on this measure in Part Four.)

BUDGET PROPOSAL VERSUS CURRENT SERVICE LEVEL

Figure 4 shows General Fund spending levels for Proposition 98-eligible K-12 education programs for 1989-90 and 1990-91, and compares the budget proposal for 1991-92 with our estimate of the spending required to maintain the 1990-91 current service level in the budget year. For purposes of this analysis, we define current service level as the Proposition 98 "full funding level" that would have been required in the absence of both the $450 million reduction in 1990-91 and the administration's proposal to suspend Proposition 98 in 1991-92.

As the figure indicates, the proposed budget would result in a $1.8 billion (10 percent) reduction in the overall level of funding for K-12 education programs relative to the current services funding level.

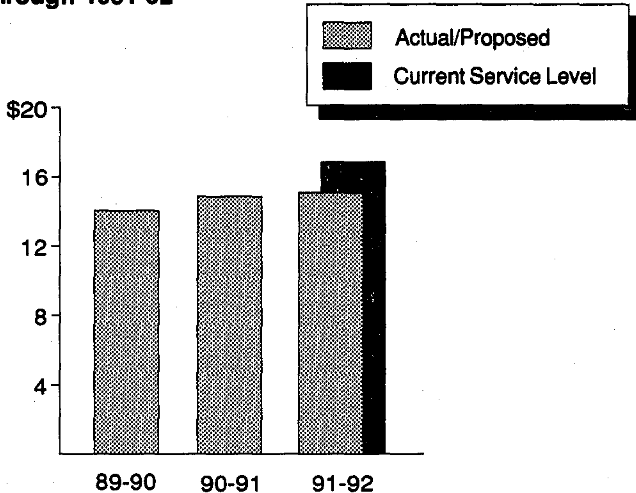
SPENDING BY MAJOR PROGRAM

Figure 5 shows General Fund expenditures for the major K-12 education programs from 1985-86 through 1991-92. The decrease in 1991-92 general-purpose apportionments is due to the Governor's proposals to: (1) not fund a COLA and (2) impose strict attendance accounting procedures.

Figure 4

Growth in K-12 Education Expenditures[a]

General Fund (in billions)
1989-90 through 1991-92



[a] Covers Proposition 98-eligible programs only (over 90 percent of total General Fund expenditures for K-12 education).

FACTORS DRIVING PROGRAM COSTS

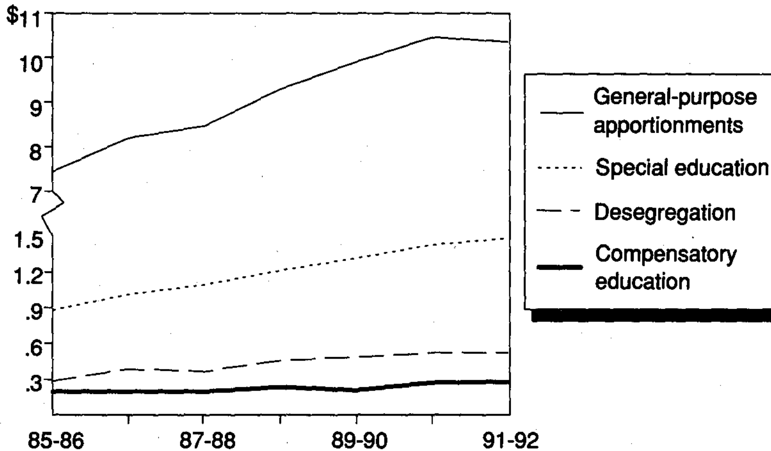
The primary factors driving K-12 education program costs are specified in the California Constitution, as amended by Proposition 98 and Proposition 111. These measures generally require that total funding for K-12 schools and community colleges from state and local sources be no less than the amount provided in the prior year, as adjusted for enrollment growth and growth in California per capita personal income. The measures also provide for the minimum funding requirement to be based on K-14 education's 1986-87 share of General Fund revenues, if this would result in a higher amount, and provide for an automatic reduction to the minimum funding level in years of low General Fund revenue growth.

Under the basic Proposition 98 minimum funding guarantee formula, therefore, the level of General Fund support required for K-12 education is based on three factors: (1) K-12 enrollment growth, (2) per capita personal income growth, and (3) local property tax growth. Other things equal, increases in the first two factors increase the required level of General Fund support,

Figure 5

K-12 Education Expenditures By Major Program

General Fund (in billions)
1985-86 through 1991-92



while increases in local property taxes *reduce* General Fund requirements on a dollar-for-dollar basis.

K-12 Enrollment Growth. The budget estimates K-12 enrollment growth of 4.3 percent, which increases the amount of General Fund support needed in order to maintain current service levels by $871 million.

Per Capita Personal Income Growth. The budget estimates growth in California per capita personal income of 5.3 percent, which increases the amount of General Fund support needed by $1.1 billion.

Property Tax Growth. The budget estimates growth in school district property tax revenues of 9.1 percent, which *decreases* the amount of General Fund support needed by $454 million.

SPECIFIC PROPOSALS IN THE BUDGET

The major thrust of the proposed budget for K-12 education is to significantly reduce the growth in program expenditures.

(As noted above, cuts in K-12 education funding can be accomplished only by suspending Proposition 98.) This is achieved through a variety of proposals, which in the aggregate would result in a funding level that is approximately $1.8 billion less than the amount needed to fund the 1990-91 level of services in these programs.

Cost Reduction Proposals

The major cost-cutting proposals contained in the budget are:

- ***Suspension of statutory K-12 education COLAs ($991 million).*** The budget eliminates funding for all statutory COLAs.
- ***Continuation of current-year funding reductions ($450 million).*** The budget continues in the K-12 funding "base" the reductions made in the current year.
- ***Strict attendance accounting requirements ($250 million).*** The budget reduces funding for school apportionments, on the assumption that strict adherence to current-law attendance accounting requirements will reduce the level of reported ADA by 2 percent.
- ***Suspension of Mentor Teacher Program ($66 million).*** The budget eliminates funding for the Mentor Teacher Program in 1991-92. The administration suggests that, when restored, the program should be restructured to emphasize merit pay.
- ***Elimination of funding for class size reduction ($31 million).*** The budget proposes no funding to continue the process of reducing class sizes, begun in the current year pursuant to Ch 1147/89 (SB 666, Morgan).

New Initiatives

The budget also contains $95 million in new initiatives, as follows:

- ***Preschool expansion ($50 million).*** The budget proposes a five-year program to extend the availability of preschool to all low-income families. The administration also proposes changing staff-to-child ratios for all state-funded programs serving preschool-aged children from 1:8 to 1:10, in order to serve more children.
- ***"Healthy Start" pilot program ($20 million).*** The budget proposes a pilot program to coordinate social services through specified elementary school sites.

- ***Early mental health ($10 million).*** The budget proposes a new program to provide mental health counseling services at elementary schools.
- ***Revised assessment system ($10 million).*** The budget proposes to restore a revised version of the California Assessment Program, allowing the reporting of individual student scores.
- ***Volunteer and mentor corps ($5 million).*** The budget proposes to train local community members as volunteers in schools and mentors for "at-risk" children.

Funding for these initiatives is not included in the Budget Bill, but is instead shown in the Governor's Budget as a General Fund "set-aside" for pending legislation.

HIGHER EDUCATION

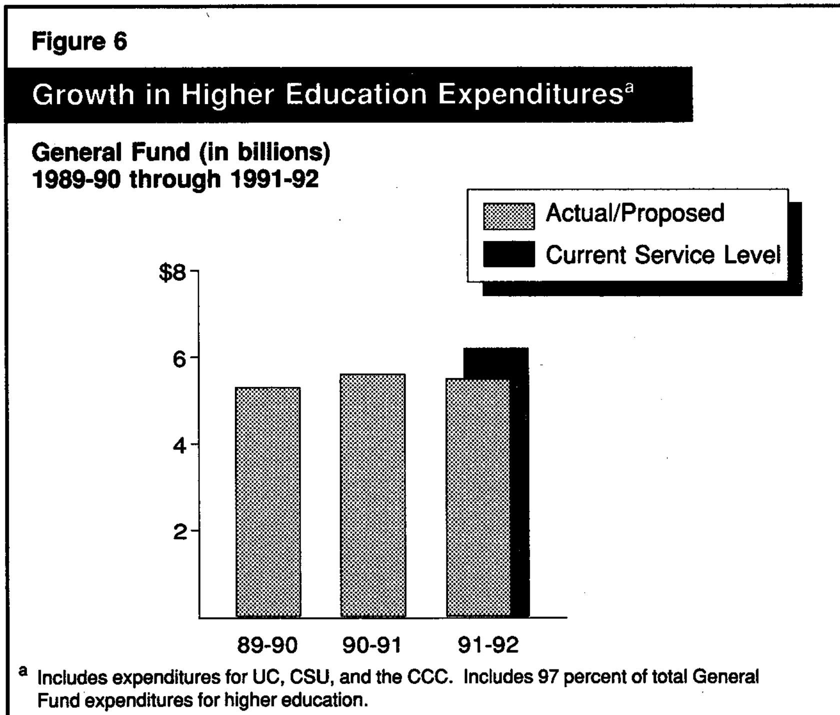
Funding for higher education programs is proposed to total $6.1 billion from all state funds, which is equal to approximately 11 percent of total expenditures proposed in the Governor's Budget for 1991-92. This level represents a decrease of $27 million, or 0.4 percent, from the level of expenditures estimated for 1990-91.

BUDGET PROPOSAL VERSUS CURRENT SERVICE LEVEL

Figure 6 shows combined General Fund spending for the University of California (UC), the California State University (CSU), and the California Community Colleges (CCC) for 1989-90 and 1990-91, and compares the budget proposal for 1991-92 with our estimate of the spending required to maintain the 1990-91 current service level in the budget year. As the figure indicates, the proposed budget would result in significant reductions in the overall level of higher education programs relative to the current services funding level.

Figure 6

Growth in Higher Education Expenditures[a]



[a] Includes expenditures for UC, CSU, and the CCC. Includes 97 percent of total General Fund expenditures for higher education.

SPENDING BY MAJOR PROGRAM

Figure 7 shows General Fund expenditures for the UC, CSU, and the CCC from 1985-86 through 1991-92. It shows that the CCC have experienced a greater rate of growth than the UC or the CSU. This is partially explained by a slightly higher enrollment growth for the CCC and increased funding as the result of Proposition 98. We also note that the UC's somewhat lower rate of growth is explained by reductions in the state's contribution rate for the UC's retirement plan. CSU has experienced the lowest rate of growth.

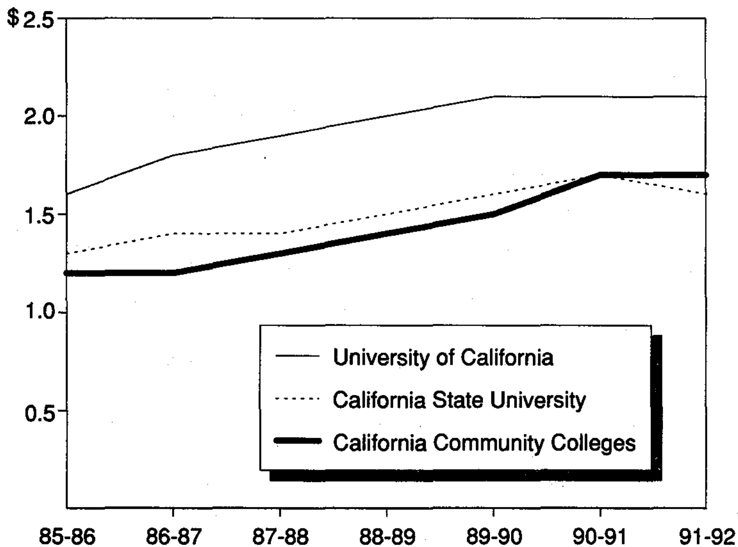
FACTORS DRIVING PROGRAM COSTS

In addition to salary and price increases, two main factors account for expenditure growth in higher education: (1) enrollment growth and (2) Proposition 98. Between 1985-86 and 1991-92, enrollment at UC, CSU, and the CCC increased at annual

Figure 7

Higher Education Expenditures By Segment

General Fund (in billions)
1985-86 through 1991-92



rates of 2.2 percent, 2 percent, and 2.3 percent, respectively. Proposition 98 generally requires that total funding for community colleges and K-12 schools from state and local sources be no less than the amount provided in the prior year, as adjusted for enrollment growth and growth in California per capita personal income. (For a discussion of Proposition 98, please see our piece on this measure in Part Four.)

SPECIFIC PROPOSALS IN THE BUDGET

The major thrust of the proposed budget for higher education is to reduce the growth in program expenditures. This is accomplished through a variety of proposals which, in the aggregate, would result in a funding level that is approximately $764 million less than the amount required to continue funding the 1990-91 level of services in these programs.

Cost Reduction Proposals

Figure 8 shows the $764 million current services level shortfall by segment ($225 million for CCC, $227 million for CSU, and $312 million for UC). As the figure shows, the budget proposes to offset part of the shortfall with (1) additional fee revenue and (2) a $55 million deferral of payments for UC budget-year costs. The budget proposes a 20 percent increase in student fees at all three segments, resulting in additional revenue of $112 million. These actions would reduce the unfunded costs to $597 million ($211 million for CCC, $180 million for CSU, and $206 million for UC). The major cost-cutting proposals to bridge this $597 million gap are:

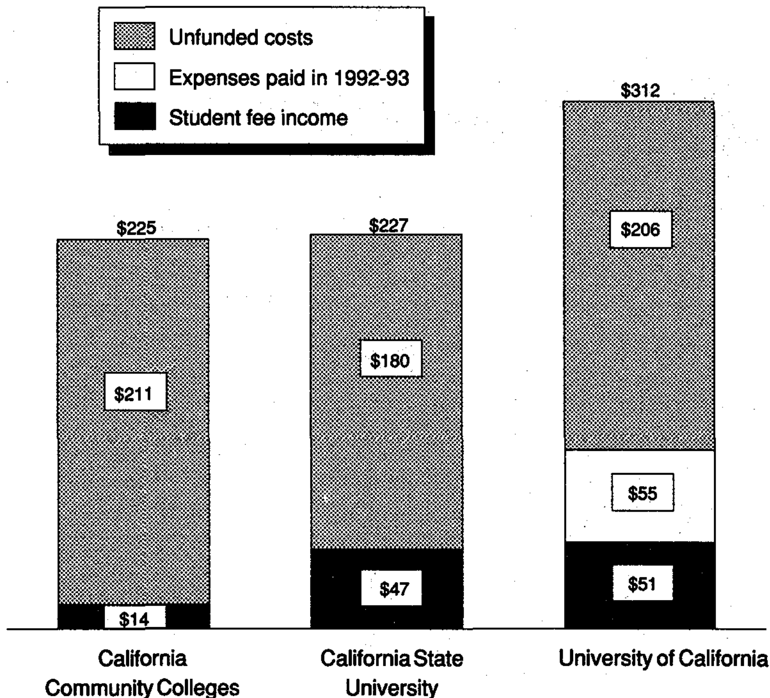
- ***Suspension of Proposition 98 ($225 million).*** The Governor proposes to suspend Proposition 98 in the budget year. We estimate that the CCC would receive an additional $225 million at the Proposition 98 "full funding" level.
- ***Other expenditure reductions ($194 million).*** The budget proposes spending reductions of $99 million for UC and $95 million for CSU. These consist of unallocated reductions and reductions in research, administration, and equipment. As a result of these deductions, some of the activities the budget purports to fund may not be supported. For example, the budget shows that projected budget-year enrollment is fully funded. However, one of the actions the UC and CSU probably will have to take to generate the necessary savings is to hold new faculty positions open, thereby not fully providing for workload increases related to new enrollment.

- ***No salary adjustments ($128 million).*** The budget proposes no salary increases for UC and CSU faculty and staff in 1991-92 ($70 million), and the budget does not fund faculty and staff merit salary adjustments in 1991-92 ($58 million).
- ***No price increases ($28 million).*** The UC and CSU anticipate increased costs of $28 million for a variety of price increases that are not addressed in the budget.
- ***No instructional equipment replacement ($24 million).*** The budget underfunds the normal level of funding for instructional equipment by $24 million, according to the formula traditionally used for this purpose.

Figure 8

Higher Education
Current Service Level Funding Shortfalls

1991-92 (in millions)



SOCIAL SERVICES

Funding for social services programs is proposed to total $6.6 billion, which is approximately 15 percent of General Fund expenditures proposed in the Governor's Budget for 1991-92. This level of expenditures represents an increase of $7 million, or 0.1 percent, over the level of expenditures estimated for 1990-91.

BUDGET PROPOSAL VERSUS CURRENT SERVICE LEVEL

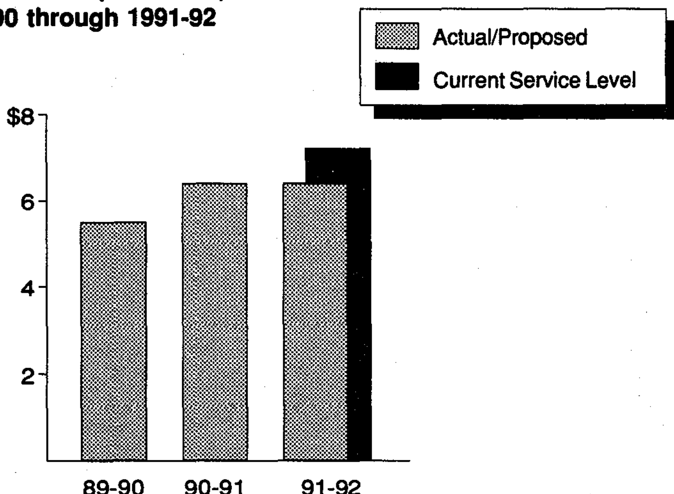
Figure 9 shows the spending levels for major social services programs for 1989-90 and 1990-91, and compares the budget proposal for 1991-92 with our estimate of the spending required to maintain the 1990-91 current service level in the budget year. As the figure indicates, the budget proposes funding that is $831 million, or about 12 percent, less than we estimate would be needed to cover the General Fund share of the costs of providing the current level of services for these programs. This shortfall reflects two major factors:

- ***The budget underestimates AFDC caseloads by about 7 percent.*** The budget includes an estimate of caseloads

Figure 9

Growth in Social Services Expenditures[a]

General Fund (in billions)
1989-90 through 1991-92



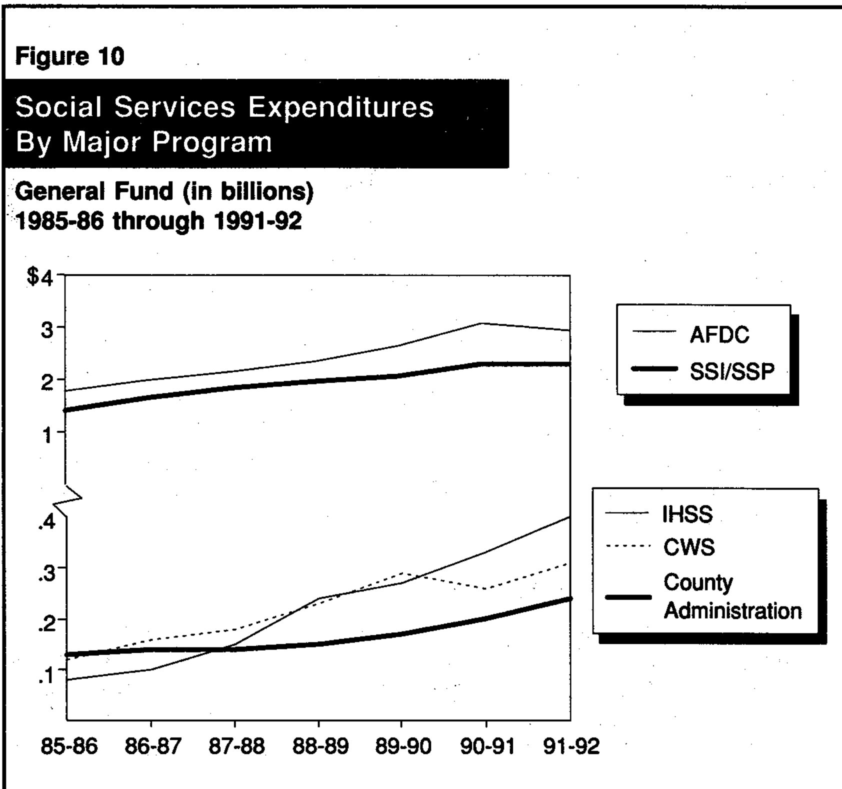
[a] Covers 98 percent of total General Fund expenditures for social services.

that does not reflect the downturn in the state's economy or the most recent trends in actual caseloads. As a result, we estimate that the budget understates the costs of the AFDC program by about $175 million. Since there is a statutory appropriation for AFDC that ensures that all eligible recipients will receive their statutorily determined grants, the actual expenditures in this program are not limited to the amounts provided in the Budget Act.

- ***The budget proposes a variety of statutory changes.*** Most of the $831 million shortfall represents proposed service reductions. We describe the four major proposals to reduce services, totaling $594 million, below.

SPENDING BY MAJOR PROGRAM

Figure 10 shows General Fund expenditures for the five major social services programs. The figure shows that expenditures for AFDC, the largest welfare program, have grown steadily since 1985-86, with especially rapid growth in 1989-90 and 1990-91.



The state's other major welfare program, SSI/SSP, also grew throughout the period displayed, although the rate of growth dropped off substantially in 1990-91. This occurred because the state suspended the statutory SSI/SSP COLA. At the same time, SSI/SSP caseload growth accelerated to 7.4 percent, higher than its historical average rate of 4.5 percent per year. The net effect of the reduction in state COLA costs and the increase in costs due to increased caseloads was an overall General Fund increase of about 4 percent in 1990-91.

In addition, the figure shows that the costs of the Child Welfare Services (CWS) program and the In-Home Supportive Services (IHSS) program grew at extremely high rates since 1985-86. The downturn in CSW costs in 1990-91 is due to the Governor's veto of $55 million from the program. While the veto reduced costs in 1990-91, the figure illustrates that this had little, if any, impact on the ongoing rate of growth in program costs. With respect to the IHSS program, it is important to note that the General Fund costs of this program are growing substantially faster than the program's total costs. For example, in 1991-92, total IHSS costs are projected to increase by 10 percent, while the General Fund cost is anticipated to increase by 20 percent. This occurs because the federal contribution to the program increases only slightly from year to year and county funds are capped at the 1987-88 level. Thus, the General Fund bears a disproportionate share of any cost increases in this program.

FACTORS DRIVING PROGRAM COSTS

Cost increases in social services programs in recent years can be categorized into those costs that are due to caseload increases and those that are due to increases in the average cost per case. For more detailed discussions of the reasons for increases in these programs, please see (1) our piece on the AFDC program in Part Four of this document, (2) our analysis of the SSI/SSP program in the *Analysis of the 1991-92 Budget Bill*, (3) our recent report on the CWS program (*Child Abuse and Neglect in California, A Review of the Child Welfare Services Program,* January 1991), and (4) our analysis of the IHSS program in the *Analysis of the 1990-91 Budget Bill.*

Factors Driving Caseload Increases

All of the major welfare and social services programs are designed to help individuals and families in specific target groups. As the numbers of people in each of these target groups increase, the caseloads of the programs increase as well. More than half of the increased costs of the major social services

programs in recent years is attributable to increased caseloads, whose growth, in turn, has been driven by a variety of factors. Figure 11 highlights some of the major demographic, social, and programmatic factors which influence caseloads in the major social services programs.

Factors Driving Average Costs Per Case

The statutory COLAs for AFDC and SSI/SSP grants are probably the largest single influence on the costs of social services programs. For example, the General Fund costs of the COLAs granted since 1985-86 is about $700 million. This amount would

Figure 11

Major Social Services Programs Factors Affecting Caseload Growth

AFDC

- An increase in women of child-bearing age.
- An increase in the number of births to unwed mothers.
- The increase in two population subgroups—Hispanics and refugees—accounts for some of the AFDC caseload growth, since these groups have in the past had welfare dependency rates that are considerably higher than the rest of the population.
- The different purchasing power of the AFDC grant in different regions of the state (due to variations in regional costs of living).
- The lack of a significant work incentive for recipients and potential recipients.

SSI/SSP

- The growth in the aged portion of the SSI/SSP caseload tracks the increase in the aged population, which has been substantially greater in recent years than the increase in the state's general population.
- Outreach efforts by the federal government.
- The AIDS epidemic has contributed to an increase in the disabled caseload.

IHSS

- Increase in the state's elderly population.
- Improved medical technology, which allows more severely disabled people to remain at home.

CHILD WELFARE SERVICES

- Increase in the known cases of child abuse and neglect.
- A lack of treatment services.

have increased by almost $300 million had the state not suspended the COLAs in 1990-91.

The COLAs that county welfare departments provide their employees are a major reason for increases in the costs per case in the CWS and county administration programs, since both of these programs rely heavily on county staff to serve clients. The 1991-92 budget, for example, includes $24 million to cover the state's share of the costs of COLAs that counties provided their employees in 1990-91.

In the IHSS program, the major determinant of the costs of serving the average case is the state's minimum wage. This is because most IHSS providers are paid at this rate. When the state increased the minimum wage from $3.45 per hour to $4.25 per hour in 1988, the General Fund cost of the IHSS program increased by $60 million, or 42 percent. Another significant factor in the IHSS program is the number of hours of service that counties award to clients. The average rate of growth in hours of service since 1985-86 has been 2.3 percent.

SPECIFIC PROPOSALS IN THE BUDGET

There are no significant proposals to add new services or increase the level of service in the social services budget for 1991-92. As noted above, the budget includes four major proposals to reduce services in this area for total savings of $594 million. In addition, the budget proposes a variety of smaller program reductions, which we describe in detail in the *Analysis of the 1991-92 Budget Bill.* The four major proposals are:

- ***Suspension of statutory welfare COLAs ($321 million General Fund savings).*** Under current law, AFDC recipients would receive a 5.49 percent increase in their grants on July 1, 1991 (for example, the grant to a family of three with no other income would increase from $694 to $732 per month) and SSI/SSP recipients would receive a 5.49 percent increase on January 1, 1992 (for example, the grant to an aged couple would increase from $1,167 to $1,231 per month). This would be the second straight year of suspending the statutory welfare COLAs, with the result that grant levels in 1991-92 would be the same as in 1989-90.
- ***Maximum Aid Payment (MAP) reduction ($193 million General Fund savings).*** The budget proposes to reduce the MAP for AFDC recipients to the 1988 level, a reduction of about 8.8 percent (for example, the MAP for a family of three would be reduced from $694 to $633 per

month). This proposal would affect the 18 percent of recipients who have outside (non-AFDC) income differently than it would affect the 82 percent of recipients with no outside income. Recipients with no outside income would have their grants reduced by the full 8.8 percent reduction in the MAP (because they currently receive the maximum grant). Most recipients who have outside income, however, already receive substantially less than the maximum grant and would not, therefore, experience any reduction in their grant. We discuss this proposal, and other options for reducing AFDC costs in Part Four of this document.

- ***Elimination of the Homeless Assistance Program ($35 million General Fund savings).*** This component of the AFDC program provides special grants for temporary shelter and for permanent housing to families who are homeless or who are about to become homeless.
- ***Foster care rate freeze ($45 million General Fund savings).*** The budget proposes to freeze for one year the monthly rates of reimbursements to foster care group homes and family homes at their 1990-91 levels. Chapter 1294, Statutes of 1989 (SB 370, Presley), created a new rate-setting system for group homes, to be phased in over a three-year period, and provided for a schedule of increases in foster family home rates, with a specialized care rate increase for family homes scheduled for 1991-92. The budget proposal would delay the phasing in of the group home rate schedule and put off the specialized care rate increase for family homes for one year.

HEALTH

Funding for health programs is proposed to total $7.0 billion (all state funds) and $6.4 billion (General Fund) in 1991-92. The General Fund amount is equal to approximately 17 percent of General Fund expenditures proposed in the Governor's Budget for 1991-92. The level of funding from all state funds represents an increase of $346 million, or 4.6 percent, over the level of state-funded expenditures estimated for 1990-91. The level of funding from the General Fund represents a decrease of $376 million, or 5.5 percent, from the level of General Fund expenditures estimated for 1990-91.

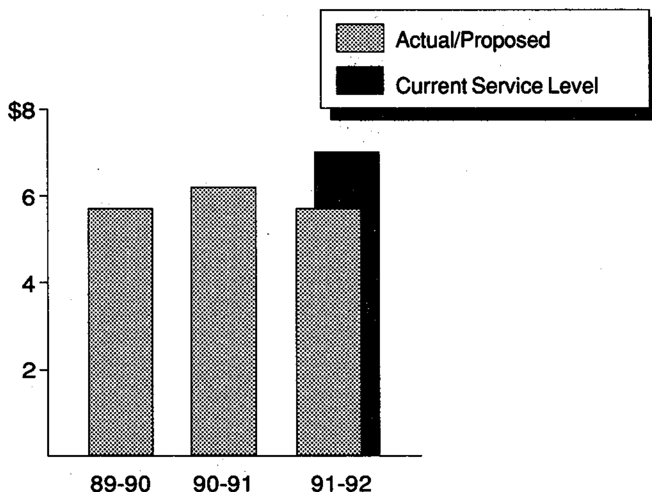
BUDGET PROPOSAL VERSUS CURRENT SERVICE LEVEL

Figure 12 shows General Fund local assistance spending levels for major health services programs for 1989-90 and 1990-91, and compares the budget proposal for 1991-92 with our estimate of the General Fund spending required to maintain the

Figure 12

Growth in Health Services Expenditures[a]

General Fund (in billions)
1989-90 through 1991-92



[a] Includes 78 percent of all state (General Fund and state special funds) expenditures in the health program area in 1991-92. Includes Medi-Cal figures on a cash, not accrual, basis. In addition, 1991-92 proposed funding reflects the administration's proposal to shift various health program responsibilities to counties.

1990-91 current service level in the budget year. These figures exclude approximately $900 million in funding associated with a proposed accrual accounting adjustment, because this proposal has no effect on program service levels. As the figure indicates, the proposed budget would result in significant General Fund reductions in the overall level of local assistance funding for health services programs relative to the current services funding level. This is due in large part to the proposed shift in responsibility to counties for providing mental health and public health services.

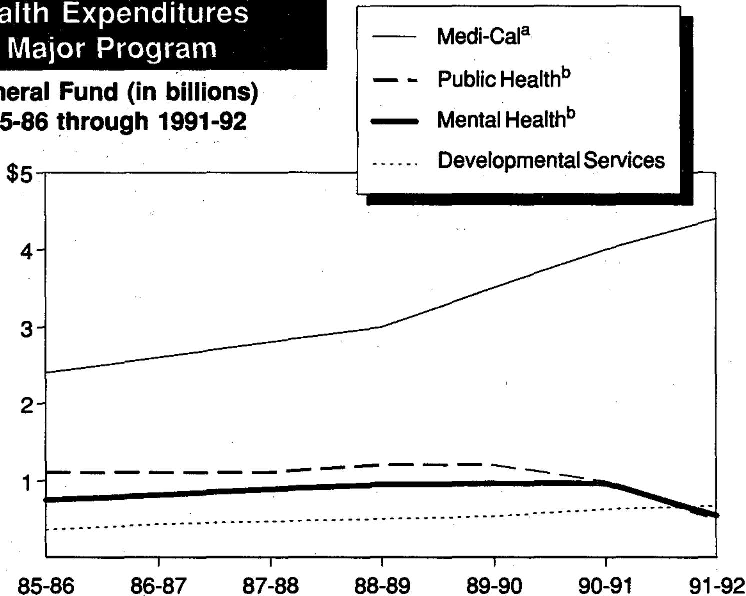
SPENDING BY MAJOR PROGRAM

Figure 13 shows General Fund expenditures for the four major health programs—Medi-Cal local assistance, public health local assistance, and programs administered by the Department of Developmental Services (DDS) and the Department of Mental Health (DMH)—from 1985-86 through 1991-92. As the figure shows, changes in funding for each of the programs has varied substantially over this time period. For example, funding for Medi-Cal and DDS programs has grown by roughly 50 percent

Figure 13

Health Expenditures By Major Program

General Fund (in billions) 1985-86 through 1991-92



[a] Medi-Cal figures are on a cash, not accrual, basis.

[b] 1991-92 expenditures reflect Governor's program realignment proposal.

over this time period. On the other hand, funding for public health and for DMH programs has declined substantially during the same period. These declines relate primarily to (1) reductions enacted in the current year and (2) budget proposals to shift responsibility for the AB 8 County Health Services and most local mental health programs to the counties in 1991-92 (discussed below).

FACTORS DRIVING PROGRAM COSTS

During the period 1985-86 through 1990-91, General Fund support of Medi-Cal, public health, and programs administered by DDS and DMH grew by about $2 billion, or more than 40 percent. This section examines the specific factors responsible for increases in health services costs during this period. These factors are also likely to drive health care expenditures for the next several years.

Demographic Changes. During the period from 1985-86 through 1990-91, funding for Medi-Cal grew by about $1.5 billion (General Fund). Roughly $400 million, or one-quarter, of this increase was due to caseload growth. In particular, two of the major population groups served by Medi-Cal—the elderly and children—have grown faster than the general population as a whole over this period.

Similarly, General Fund support for DDS increased by about $200 million, or over 50 percent, between 1985-86 and 1990-91. Approximately $75 million of this increase appears to be due to caseload growth that is tied to demographic factors.

State Policy Changes. During the period 1985-86 through 1990-91, funding for DMH-administered programs increased by about $200 million, or roughly 25 percent. (As Figure 13 shows, the budget's proposal to shift virtually all local mental health programs to the counties would reverse this growth trend.) Approximately $50 million of the increase has been due to the effect of major state policy changes, such as (1) the establishment of the Conditional Release program for parolees in 1986-87 and (2) the provision of staff for accreditation and other purposes resulting from the department's state hospital initiative in 1984-85.

In addition, about $40 million, or 20 percent, of the growth in DDS funding over the five-year period was due to specific state program changes, such as adding community placement and prevention activities, implementing rate increases through the Alternative Residential Model (ARM), and achieving and maintaining accreditation at the state developmental centers.

For Medi-Cal, the expansion of Medi-Cal coverage beginning in 1988 for pregnancy services to include women in families with incomes of up to 185 percent of the federal poverty level has increased costs by more than $50 million since that time.

New Federal Requirements. Roughly $300 million, or almost 20 percent, of the growth in Medi-Cal funding from 1985-86 through 1990-91 has been related to meeting major new federal requirements.

- The federal Immigration Reform and Control Act (IRCA) and the federal Omnibus Budget Reconciliation Act of 1986 (OBRA 86) require states to provide coverage for certain medical services to newly legalized and undocumented persons.
- The Medicare Catastrophic Coverage Act of 1988 requires Medi-Cal to pay Medicare premiums, coinsurances, and deductibles for people with low incomes and few assets, as specified.
- The federal Family Support Act of 1988 requires Medi-Cal to extend coverage to beneficiaries for up to 12 months after they become ineligible for Aid to Families with Dependent Children (AFDC) due to factors such as increased earnings or increased hours of employment.

Societal Changes. Funding for AIDS programs increased from roughly $2 million to approximately $50 million (General Fund) during the period due to a major social change—the AIDS epidemic. In addition, our field visit observations and discussions with health experts indicate that two other social changes—increases in the number of unmarried teenage women having children and children born to substance-abusing mothers—may have increased pressure for state funding for Medi-Cal and DDS. The funding impact of these changes, however, is not possible to quantify given existing data.

Inflation. Overall, the reimbursement levels and mix of services provided by various health programs are influenced by underlying trends in the costs of medical care. Costs of the major health programs (particularly Medi-Cal) have increased despite cost-containment measures, in part because medical care costs have increased more rapidly than the costs of other goods and services.

SPECIFIC PROPOSALS IN THE BUDGET

While the proposed budget for health services is based upon funding levels required to meet statutorily required caseload and

utilization growth, it actually provides less than the necessary amounts due to the inclusion of unallocated reductions. It also proposes to reduce General Fund costs by (1) shifting major programs to the counties and (2) budgeting copayments or fees for various health services.

The major cost-cutting proposals in the budget are:

- ***Shift funding responsibility for health services and local mental health programs to the counties ($942 million General Fund savings).*** The budget proposes to shift funding responsibility for the AB 8 County Health program and virtually all local mental health programs to the counties. These proposals also transfer a similar amount of revenues to the counties through increased vehicle license fees and alcohol taxes.
- ***Establish fees for regional center services for persons with developmental disabilities ($30 million General Fund revenues).*** The budget proposes enactment of legislation to establish certain regional center fees in order to obtain federal reimbursement for targeted case management at the regional centers administered by the DDS. The budget assumes that the appropriate legislation will be enacted in February 1991. At the time this analysis was prepared, legislation (SB 92, Presley) had in fact been enrolled.
- ***Establish or increase various fees and copayments ($25.7 million General Fund savings).*** The budget proposes to institute beneficiary copayments for Medi-Cal, for a General Fund savings of $21.2 million. Exemptions from copayments would be made for all services to children and long-term care patients, pregnancy-related and emergency services, and services provided in "capitated" systems (such as, for example, health maintenance organizations). As a result of these exemptions, it appears that copayments would be applied primarily to services for the blind and disabled and for primary care services.

The budget proposes to establish an enrollment fee for the California Children's Services and the Genetically Handicapped Persons Program via legislation, for a $2.6 million General Fund savings. The budget also proposes to replace $1.9 million in General Fund support for various genetic disease testing and related programs with (1) Genetic Disease Testing Fund reserves in the budget year and (2) fees in future years.

New Initiatives

The budget contains three major new health proposals for 1991-92:

- ***Shift to accrual accounting for Medi-Cal.*** The budget proposes to shift from cash to accrual accounting in Medi-Cal, for a General Fund cost of $876 million.
- ***Perinatal access.*** The budget proposes to use $90 million from Cigarette and Tobacco Products Surtax funds to establish a perinatal insurance program, to be administered by the Major Risk Medical Insurance Board (MRMIB). The program would provide prenatal care, delivery, and one year of well-baby services to women with incomes between 185 percent and 250 percent of the federal poverty level, with participants sharing premium costs.
- ***Family planning increase.*** The budget proposes to increase funding for family planning services by $10 million, and to target the funds to teenage parents and substance-abusing women. The budget also anticipates $5.1 million in related General Fund savings—$4 million from Medi-Cal and $1.1 million from AFDC.

CRIMINAL JUSTICE

Funding for criminal justice programs is proposed to total $3.5 billion, which is approximately 6.5 percent of all state expenditures proposed in the Governor's Budget for 1991-92. This level of funding represents an increase of $312 million, or 9.9 percent, over the level of expenditures estimated for 1990-91.

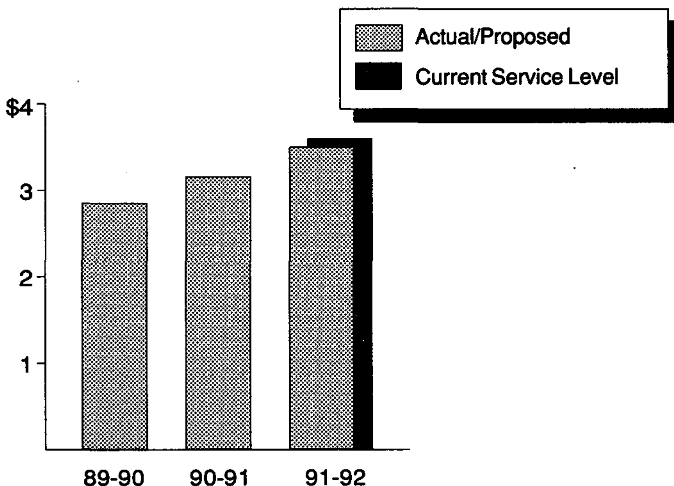
BUDGET PROPOSAL VERSUS CURRENT SERVICE LEVEL

Figure 14 shows spending levels for major criminal justice programs for 1989-90 and 1990-91, and compares the budget proposal for 1991-92 with our estimate of the spending required to maintain the 1990-91 current service level in the budget year. As the figure indicates, the proposed budget would result in minor reductions in the overall level of funding for criminal justice programs relative to the current services funding level.

Figure 14

Growth in Criminal Justice Expenditures

General Fund (in billions)
1989-90 through 1991-92



SPENDING BY MAJOR PROGRAM

Figure 15 shows General Fund expenditures for the three major criminal justice programs—adult corrections, youth corrections, and judicial—from 1985-86 through 1991-92. The figure indicates that: (1) adult corrections has grown steadily and rapidly over the period, (2) youth corrections has remained fairly flat, and (3) the judicial program grew significantly in 1988-89 and 1989-90 due to the implementation of the Trial Court Funding Program.

FACTORS DRIVING PROGRAM COSTS

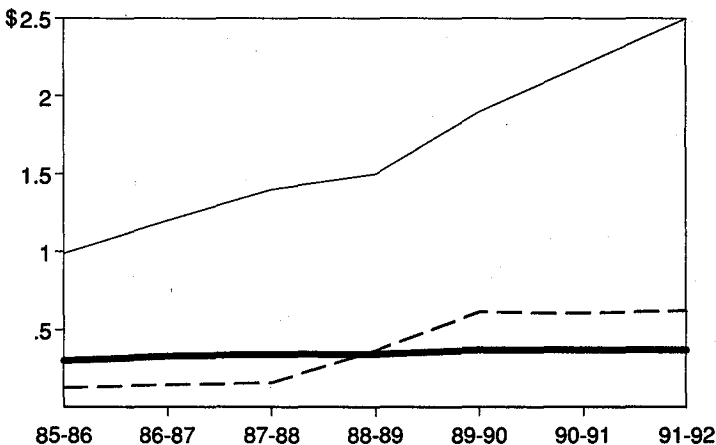
This section examines the specific factors responsible for increases in criminal justice program costs in recent years, which also are likely to drive expenditures for the next several years.

The rising costs of criminal justice programs are directly related to the continuing increase in the state's prison population. The inmate population climbed from 26,768 inmates in 1980-81 to 93,810 in 1989-90, an increase of 250 percent. The

Figure 15

Criminal Justice Expenditures By Major Program

All State Funds (in billions)
1985-86 through 1991-92



Department of Corrections projects that the population will increase further to 173,000 by 1995-96, a rise of 85 percent. These population increases have been due to a variety of factors:

State Policy Changes. The most significant factor has been state policy changes. The Legislature has enacted numerous laws to increase the length of prison sentences since it changed in 1977 the state's sentencing structure from indeterminant sentencing (where the offender's release from prison was largely discretionary) to determinant sentencing (where the offender's length of sentence is set in statute). In addition, there have been numerous measures requiring mandatory prison sentences (as opposed to less costly probation or jail) for specified crimes.

Parole Violation Rates. Another factor driving costs has been the dramatic increase in the number of parolees returned to prison for violation of the terms of their parole (more than half of all parolees are returned to prison). The increase in parole violation rates is due, in part, to discretionary administrative policies of the Department of Corrections.

Local Jail Overcrowding. Overcrowding of county jails has had an indirect effect on the state's criminal justice budgets. This is because many county jails now have court-ordered population caps, and persons who would have otherwise served their terms of incarceration in county jails are now serving terms in state prison.

Higher Cost of New Facilities. Expenditures have also been driven by increasing costs for operation of new prison facilities. The state has been engaged in a massive prison construction program in recent years in an attempt to accommodate the increased inmate population. These new facilities are generally more costly to operate than the state's older prison facilities, as they require higher staffing levels.

SPECIFIC PROPOSALS IN THE BUDGET

The major thrust of the proposed budget for criminal justice programs is to *fully fund most program expenditures*. The budget for 1991-92 proposes increases of $313 million (10 percent), financed almost completely from the General Fund.

The Governor's Budget contains no major policy proposals for criminal justice programs.

GENERAL GOVERNMENT

Funding for general government programs is proposed to total $7.2 billion, which is equal to approximately 13 percent of General Fund and special fund expenditures proposed in the Governor's Budget for 1991-92. This level of expenditures represents an increase of $1.1 billion, or 19 percent, over the level of expenditures estimated for 1990-91. The large increase for 1991-92 is attributable to legislation proposed in the budget which would increase aid to local governments by increasing the level of vehicle license fees distributed to cities and counties. Figure 16 shows the level of spending for general government programs in 1989-90, 1990-91, and 1991-92.

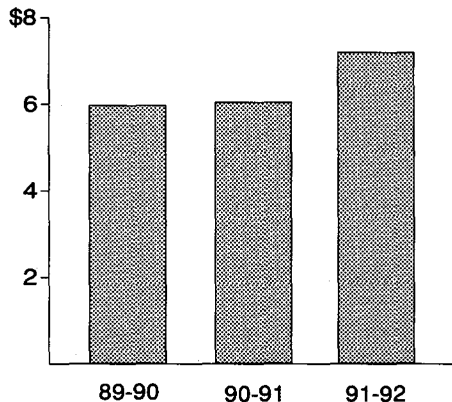
SPENDING BY MAJOR PROGRAM

Figure 17 shows General Fund and special fund expenditures for the four major general government programs from 1985-86 through 1991-92. As these data indicate, the largest general government program is aid to local governments, which is funded primarily by motor vehicle license fees. These revenues are

Figure 16

Growth in General Government Expenditures

All State Funds (in billions)
1989-90 through 1991-92



collected by the state and returned to cities and counties for general purposes according to statutory formulas. As noted above, the sharp budget-year increase is due to the Governor's proposal for increased vehicle license fees. All of the other major programs in this area exhibit relatively stable funding trends over the period indicated.

FACTORS DRIVING PROGRAM COSTS

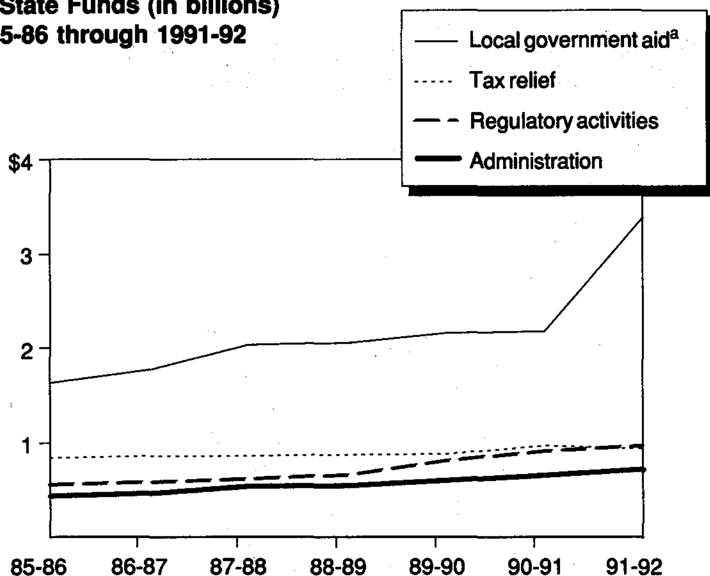
This section examines the specific factors responsible for increases in general government program costs in recent years, which also are likely to drive expenditures for the next several years. These include:

Demographic Changes. The state's increasing population is the primary driver of general government program costs. Cost increases in the state's tax relief programs, for example, are driven by increases in the number of homeowners and renters

Figure 17

General Government Expenditures By Major Program Area

All State Funds (in billions) 1985-86 through 1991-92



[a] Increase in 1991-92 reflects Governor's proposal to raise vehicle license fees and alcohol taxes as part of his realignment plan.

who are eligible to receive these benefits. Local government aid, whose primary funding source is the vehicle license fees paid on each car in the state, is also driven primarily by population increases.

Inflation. General Fund costs for annuitant health benefit premiums are expected to increase by $134 million between 1989-90 and 1991-92, which amounts to an average annual increase of 23 percent. Most of the increase (78 percent) is attributable to the rise in premium costs, reflecting the high current rates of inflation in the health care industry. The remainder is due to increasing numbers of state retirees.

State Policy Changes. State policy changes also have had, and will continue to have, a significant impact on expenditures in this program area. For example, state-mandated local program reimbursements reflect costs that have been incurred as a result of state legislation imposing costs on local government agencies. Another example is the State Board of Equalization's 1990 decision in the *Diaz* case, which expanded the benefits provided to public assistance program beneficiaries under the renters' tax credit program.

SPECIFIC PROPOSALS IN THE BUDGET

The proposed budget for general government programs generally proposes to continue past funding practices in this area. That is, most programs receive funding increases to offset workload increases, and several of the economic development programs receive funding for continued expansion. In many cases, however, these increases are offset by unallocated reductions.

Cost Reduction Proposals

The major cost-cutting proposals contained in the budget are:

- ***Reduction of renters' tax credit ($210 million General Fund savings).*** The budget proposes that legislation be enacted to reduce the level of the state's renters' tax credit. Specifically, the budget proposes that this tax credit be reduced from its present level of $120 for joint returns and $60 for single returns to $70 and $35, respectively.
- ***Forego general salary increases ($108 million General Fund savings).*** The Governor's Budget proposes that no general salary increase be provided to state employees in 1991-92. Based on an anticipated 3.9 percent

increase in the U. S. Consumer Price Index (the index is used in determining current-year salary increases), and assuming that any COLA would have been effective January 1, 1992, we estimate that the proposal would save $108 million (General Fund) in 1991-92 and approximately twice that amount annually thereafter. The ongoing savings assume that the foregone 1991-92 increase is not subsequently restored through collective bargaining agreements.

- ***PERS—Change in amortization period for actuarial gains and losses ($70 million General Fund savings).*** The Governor's Budget proposes to reduce the state's contributions for employee retirement benefits by $127 million ($70 million General Fund) by amortizing the gains anticipated for the 1989-90 fiscal year over a five-year period beginning in 1991-92. The PERS Board of Administration approved a similar amortization period for 1988-89 gains last year, thereby providing annual General Fund retirement contribution savings of $73 million annually until 1994-95.

  Subsequent to the introduction of the Governor's Budget, however, the PERS has determined that there was no gain for 1989-90, and that there will, in fact, be a *loss of $79 million.* As a result, this proposal will not result in the retirement contribution savings that had been anticipated in the budget.

- ***PERS—Increase actuarial interest assumption ($86 million General Fund savings).*** The Governor's Budget proposes to increase from 8.5 percent to 9.5 percent the rate of return on investments (interest assumption) used to calculate the annual funding need for the PERS. This action would effectively lower the state's employer contribution, resulting in projected state savings of $156 million ($86 million General Fund) in 1991-92.

- ***Continue optional status for 18 mandates ($30 million General Fund savings).*** Consistent with action taken in the 1990 Budget Act, 18 existing state-mandated local programs would be made optional for 1991-92. This means that local agencies would not have to comply with their provisions, and the state, therefore, would not be liable for any reimbursements to local agencies.

New Initiatives

The budget proposes to significantly expand local government aid in 1991-92 as part of its "program realignment" package. Under this proposal, state vehicle license fees and alcoholic beverage taxes would be increased, with most of the proceeds earmarked for distribution to county governments. This proposal also calls, however, for the termination of existing state assistance provided to counties for local mental health and public health programs. On balance, the new funding sources would provide about the same level of aid in 1991-92 as the existing subventions.

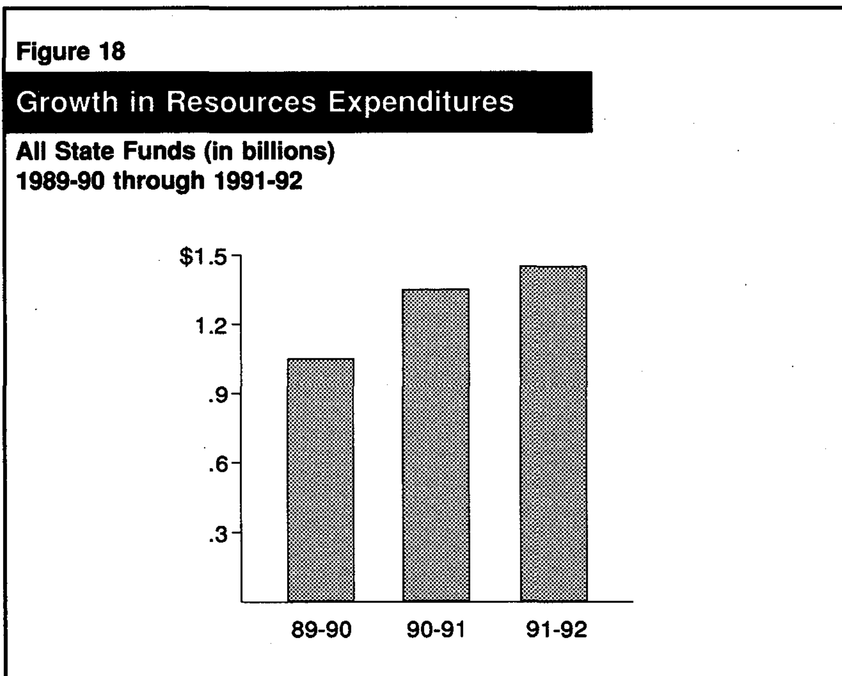
In the economic development area, the budget proposes to expand several programs. These include increased funding of $6.6 million for additional grants provided through the Competitive Technology Program, $1 million for a joint state-federal expansion of the Small Business Development Center Program, and an additional $1 million allocation for export loan guarantees offered by the World Trade Commission.

RESOURCES

Funding for resources programs is proposed to total $1.5 billion from all state funds in 1991-92. This is equal to 2.2 percent of expenditures from all state funds proposed in the Governor's Budget for 1991-92. The General Fund supports about one-third of these programs, or about 1.2 percent of total 1991-92 proposed General Fund expenditures. The remaining two-thirds of state support for resources programs will come from special funds, including the Environmental License Plate Fund, the Motor Vehicle Account, the Public Resources Account (Proposition 99), and funds generated by beverage container recycling fees and fees for support of specific regulatory activities.

BUDGET PROPOSAL

Figure 18 shows spending levels for resources programs for 1989-90 and 1990-91 and proposed spending for 1991-92. As the figure indicates, total spending from all state funds is proposed to increase by 7.5 percent in the budget year. This consists of special fund growth of nearly 20 percent and a General Fund decline of nearly 10 percent.



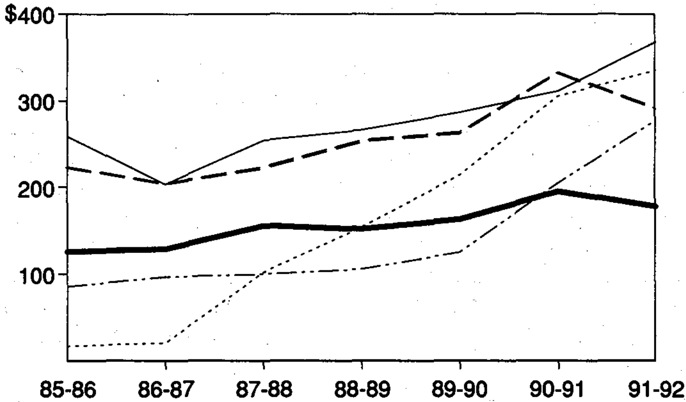
SPENDING BY MAJOR PROGRAM

Figure 19 shows total state spending trends for the four largest state-funded programs within the resources area: the Departments of Conservation (DOC), Forestry and Fire Protection (CDF), and Parks and Recreation (DPR), and the Environmental Affairs Agency boards with responsibility for water quality, air quality, and waste management. As the figure shows, expenditures for CDF, DPR, and all other resources programs have increased modestly over the period. In contrast, spending on the DOC and the environmental boards has increased dramatically, due to higher spending on various environmental regulatory and beverage container recycling programs.

Figure 19

Resources Expenditures By Major Program

All State Funds (in millions)
1985-86 through 1991-92



FACTORS DRIVING PROGRAM COSTS

This section examines the specific factors responsible for increases in resources program costs in recent years, which also are likely to drive expenditures for the next several years.

State Policy Changes and New Environmental Requirements. The most significant increases in expenditures for resources programs have resulted from increases in various environmental regulatory programs. For example, in 1986-87 the DOC implemented a statewide beverage container recycling program; and in 1989-90, the state began to implement a new California Clean Air Act program (Ch 1568/88—AB 2595, Sher). These, and expanded responsibilities for waste management and water quality as a result of new legislative initiatives, explain much of the growth in resources programs over the six-year period. The trend towards greater environmental regulation is likely to continue for some time as California's population growth continues to place increasing pressures on the state's land, air, and water resources.

Drought Conditions and Other Natural Phenomena. Expenditures in the resources area vary depending on the weather and other natural phenomena. For instance, at the time this analysis was prepared (early February), it appeared that the state would be facing a fifth straight year of drought. The primary effect of the continuing drought on the resources budget is to require additional expenditures for emergency wildland fire suppression. Estimated General Fund expenditures in the current year for emergency wildland fire suppression are $83.8 million, which significantly exceeds historical costs (average annual costs for the previous four years were only $30 million). The CDF advises that, even if the state experiences above-average rainfall in the current year and/or 1991-92, the extensive damage to timber caused by the drought thus far makes it unlikely that actual costs would fall below the historical average during this period. A secondary effect of the drought on the resources budget is to require greater spending on restoring fisheries and habitat damaged by the drought.

A second natural phenomenon affecting resources expenditures is the future danger of floods in many areas of the state. The 1991-92 budget includes $53.2 million for flood control, including $42.5 million for subventions to local agencies and $10.7 million in the capital outlay budget for work in the Sacramento area.

SPECIFIC PROPOSALS IN THE BUDGET

The major thrust of the proposed budget for resources programs is "business as usual," despite the state's overall fiscal problems. Where General Fund support has been reduced, it generally has been replaced from other funding sources, including new fees.

Cost Reduction Proposals

The budget includes several proposals to fund programs through fees. First, it proposes to fund some currently General Fund-supported programs in the Air Resources Board from the Motor Vehicle Account, for a General Fund savings of $2.9 million. Second, the budget proposes $4.3 million in increased fees charged by the State Water Resources Control Board. The budget proposes to use additional revenues for new regulatory program staff.

New Initiatives

The budget does not propose any major program initiatives in the resources area. The Budget Summary indicates that the administration intends to submit a proposal to establish a new California Environmental Protection Agency within a year; however, the budget does not contain any details of this proposal.

TRANSPORTATION

Funding for transportation programs is proposed to total $4.3 billion, which is approximately 7.9 percent of expenditures from all state funds proposed in the Governor's Budget for 1991-92. This level of funding represents an increase of $615 million, or 17 percent, over the level of expenditures estimated for 1990-91.

Up until the current year, state funds for transportation programs have been provided almost entirely from state excise taxes on gasoline and diesel fuel, truck weight fees, and vehicle registration and driver's license fees. Only minimal amounts of General Fund money were used for the state's transportation programs. Beginning in 1990-91, as a result of the June 1990 passage of Proposition 108 (the Passenger Rail and Clean Air Act of 1990) and Proposition 116 (the Clean Air and Transportation Improvement Act of 1990), general obligation bond money will be used to fund rail capital outlay projects throughout the state. The interest and principal payments to retire these bonds will come from the General Fund. (The Governor's Budget proposes, however, to pay the current- and budget-year debt service from the Transportation Planning and Development Account.)

OVERVIEW OF TRANSPORTATION BUDGET

Figure 20 shows spending levels for major transportation programs from 1989-90 through 1991-92. As the figure shows, state-funded expenditures for transportation programs have increased steadily since 1989-90. Specifically, expenditures increased by 28 percent from 1989-90 to 1990-91, and are proposed to increase by 16 percent from the current to the budget year.

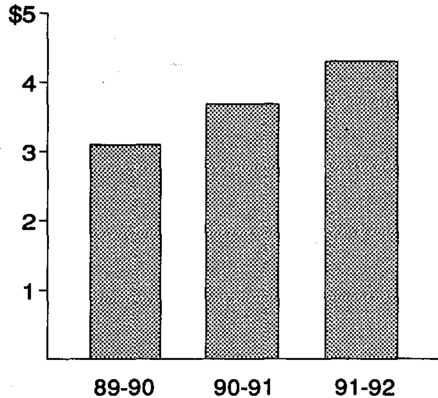
In particular, the budget proposes to:

- Increase Department of Transportation staff operational expenditures by $78 million (5.7 percent) to develop state highway capital outlay projects; earthquake retrofit and restoration projects and projects funded by local sales tax measures; and for various highway maintenance, mass transit, and rail activities.
- Provide about $460 million in state (including general obligation bond) funds for rail capital outlay improvements.
- Increase traffic licensing and enforcement programs by $93 million for 441 additional staff to accommodate workload increases, continued office automation and

Figure 20

Growth in Transportation Expenditures

All State Funds (in billions)
1989-90 through 1991-92



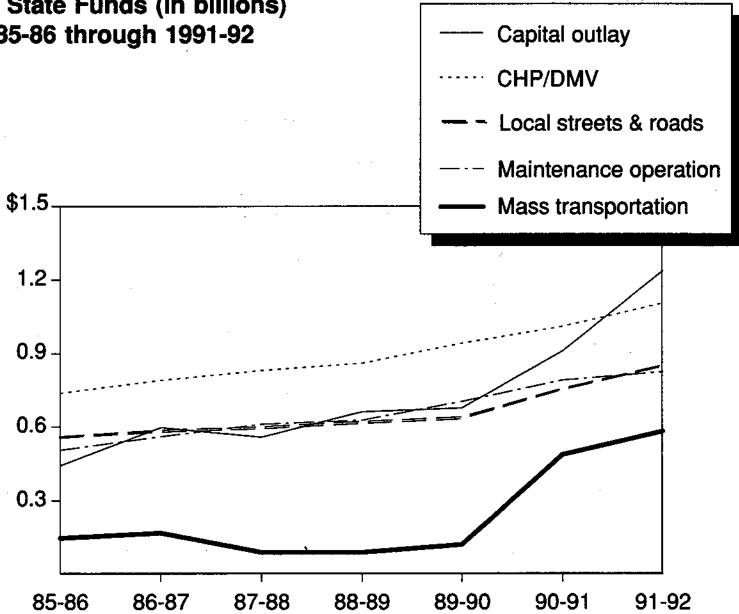
data processing, and to implement new programs mandated by legislation.

- Transfer funds from the Transportation Planning and Development Account to the General Fund to pay debt service costs in the current and budget years for bonds issued pursuant to Propositions 108 and 116.

SPENDING BY MAJOR PROGRAM

Figure 21 shows state-funded expenditures for the five major transportation programs since 1985-86. It indicates that two programs in particular—capital outlay for highways and mass transportation—have increased sharply in the current year. The increase is due to the additional funds made available as a result of the passage of Proposition 108 and Proposition 111 (the Traffic Congestion Relief and Spending Limitation Act of 1990) in June 1990. (Proposition 116, adopted at the same election, also provides bond funds for rail capital improvements. Because these funds are continuously appropriated, they are not reflected in the annual Budget Act.)

The passage of Proposition 111 triggered an increase in the gas tax and truck weight fees beginning in August 1990, provid-



ing increased revenues mainly for highway capital outlay improvement. Because part of the additional gas tax revenues are apportioned to local governments for transportation use, Figure 21 also shows an increase in state-funded expenditures on local streets and roads in the current year. The passage of Propositions 108 and 116 authorizes the state to issue a total of nearly $3 billion in general obligation bonds for rail capital outlay improvement purposes. As a result of expenditures of Proposition 108 bond funds, mass transportation expenditures are expected to experience a threefold increase in the current year. As reflected in the figure, the growth in expenditures for this program is projected to continue into the budget year (an increase of 20 percent).

FACTORS DRIVING PROGRAM COSTS

Expenditures in the transportation programs are affected by the following key factors.

Demographic Changes. Transportation demand increases with growth in population and economic activity. With the increase in the number of drivers and vehicles, there is a correspondingly higher usage of the state's highways and road system. This in turn increases traffic licensing and enforcement activities by the California Highway Patrol and the Department of Motor Vehicles. Similarly, the greater use of the highway and road systems necessitates expansion of the systems and increases maintenance and operations expenditures. Furthermore, a growing population increases demand for new and expanded mass transit services.

State Policy Changes. Up until the current year, transportation activities have been funded on a pay-as-you-go basis. The passage of Proposition 108 and 116 authorizes the state to use general obligation bonds for rail capital outlay expenditures. This policy change has significantly changed the state's role in funding mass transportation rail activities and will allow a sustained higher level of transportation expenditures in future years.

SPECIFIC PROPOSALS IN THE BUDGET

The major thrust of the proposed budget for transportation programs is to continue to improve and expand the state's highway system, increase funding for rail projects, and accommodate workload increases in traffic licensing and enforcement activities.

New Initiatives

The budget contains two proposals for funding of the transportation program.

- First, it proposes to transfer Transportation Planning and Development Account money to the General Fund to pay for the current- and budget-years' debt service costs of bonds issued under Propositions 108 and 116.
- Second, the budget proposes that legislation be enacted to increase vehicle registration fees by $5 (from $23 to $28) and drivers' license fees by $2 (from $10 to $12), in order to raise about $73 million in revenues to the Motor Vehicle Account in the budget year for various traffic licensing and enforcement activities.

CAPITAL OUTLAY

Funding for capital outlay expenditures represents 2.6 percent of expenditures from all state funds (both General Fund and special funds) proposed for 1991-92. These expenditures reflect the state's current costs for capital outlay programs, either through debt service payments or direct appropriation of state funds to purchase assets (that is, "pay-as-you-go" financing). (The funding figure does *not* include the appropriation of bond proceeds, themselves, because they do not represent a direct cost to the state until the bonds are paid off in future years.)

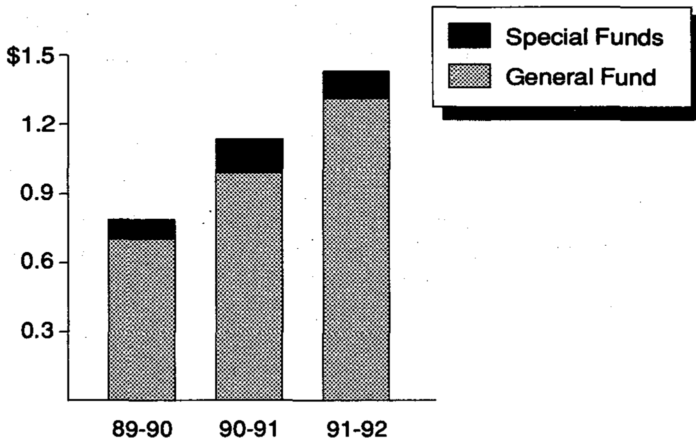
As shown in Figure 22, expenditures for capital outlay programs over the past three years have increased significantly—from $786 million in 1989-90 to over $1.4 billion in 1991-92. This increase is directly attributable to the increase in General Fund debt service payments on bond programs. These expenditures have increased from $691 million in 1989-90 to $1.3 billion in 1991-92.

Expenditures for debt service payments include amounts for both general obligation bonds and lease-payment bonds. With

Figure 22

Growth in Capital Outlay Expenditures

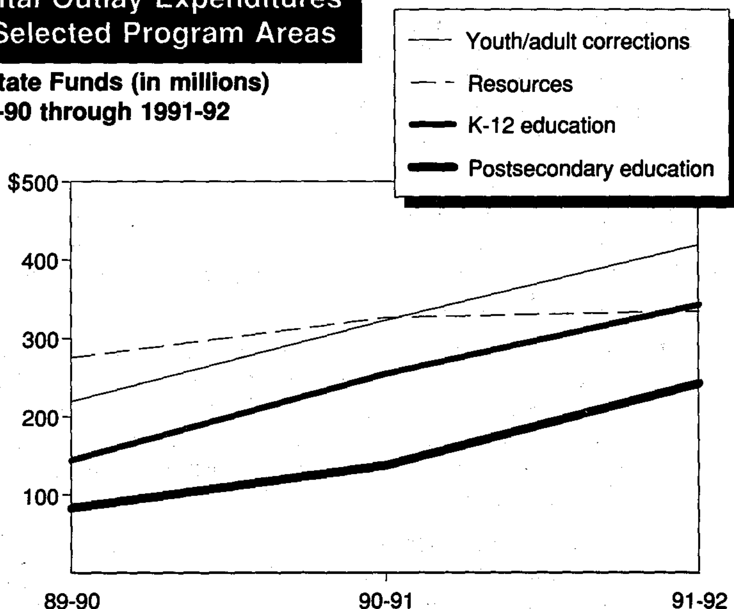
All State Funds (in billions)
1989-90 through 1991-92



lease-payment bonds, the General Fund makes the debt service payments through direct appropriations to the department using the capital asset. These funds are then used to make lease payments to the Public Works Board, which in turn uses them to pay off the bonds. As a percent of debt service payments, expenditures for lease-payment bonds have increased from 7.2 percent in 1989-90 to 16 percent in 1991-92. As we have mentioned on several occasions, lease-payment bonds are more costly than general obligation bonds, and the Legislature should use caution when considering the use of this financing method. (Please see our piece on state infrastructure in Part Four of this document for a more detailed discussion of this issue.)

SPENDING BY MAJOR PROGRAM

The vast majority of annual expenditures for capital outlay (over 90 percent) is in four areas: (1) Youth and Adult Corrections (YAC), (2) K-12 education, (3) higher education, and (4) resources. Figure 23 shows the expenditures in these areas over the past three years. It indicates that, with the exception of the resources area, expenditures have grown steadily and rapidly. Total expenditures are highest in YAC, where in 1991-92 they are



expected to reach $419 million, compared to $219 million in 1989-90.

We note that 28 percent of 1991-92 debt service payment expenditures for YAC and higher education is for lease-payment bonds. This is up from a level of 16 percent in 1989-90. This upward trend will continue in the future as projects financed under this method are completed.

PROPOSED DIRECT APPROPRIATION OF FUNDS FOR CAPITAL OUTLAY

The Governor's Budget proposes appropriations of nearly $564 million for the *acquisition* of capital assets. This includes:

- ***$440 million (or 78 percent of the total) from bond financing.*** This total consists of $107 million in appropriations from general obligation bonds in the areas of YAC, higher education and resources, and $333 million in appropriations from lease-payment bonds for higher education.
- ***$124 million in direct appropriations*** from various special funds ($118 million), such as the Special Account for Capital Outlay (SAFCO), the Motor Vehicle Account, the Cigarette/Tobacco Products Surtax Fund, and from federal funds (over $5 million).

The major emphasis of the Governor's Budget for capital outlay is in the area of higher education. This area receives $385 million, or 68 percent, of the proposed funding. Again this year, the Governor's Budget *does not include any proposals for new prisons.* Apparently, the administration will continue the practice of proposing individual new prisons in a piece-meal fashion through separate legislation.

Failure of General Obligation Bond Measures. The failure of several bond measures on the November 1990 ballot has had a significant effect on the state's ability to address its capital outlay needs. For instance:

- About 55 percent of the capital outlay plan for higher education is proposed for funding in 1991-92. Although upon examination the entire higher education program may not merit funding, much of the program is needed if enrollment growth throughout higher education is to be accommodated.
- Two prisons authorized by the Legislature—at Susanville and Madera—were funded for construction from the prison bond measure that failed in November. Thus,

these prisons, along with other new prisons that would have been financed through this measure, are unable to proceed.

For additional discussion of the implications of the 1990 election on state capital outlays, see our earlier cited piece in Part Four on infrastructure.

OTHER STATEWIDE EXPENDITURE ISSUES

This section discusses certain other expenditure-related features of the budget which are significant from a statewide perspective. These include the unallocated "trigger-related" reductions reflected in budgets of departments funded from the General Fund and the state's appropriations limit.

UNALLOCATED REDUCTIONS

The "Trigger"

Under the provisions of Chapter 458, Statutes of 1990 (AB 2348, Willie Brown), state General Fund appropriations are to be reduced by up to 4 percent when state General Fund revenues are projected to be insufficient to fund the state's "workload budget" expenditure level. This automatic reduction provision is referred to as the "trigger." The determination as to whether the trigger is activated is to be made by the Director of Finance on or before May 21 of each year, subject to certification by the Commission on State Finance of the general accuracy of the calculations involved.

If the Director's estimate of General Fund revenues is more than 0.5 percent *less* than the Director's estimate of workload budget expenditures, then *all* General Fund appropriations for the new fiscal year are to be reduced by the same percentage difference as that between the estimated General Fund workload budget expenditures and estimated General Fund revenues.

Defining a "Workload Budget." Chapter 1209, Statutes of 1990 (AB 756, Isenberg), defines "workload budget" for purposes of making the above determinations. Specifically, Chapter 1209 defines "workload budget" as the budget-year cost of currently authorized services, adjusted for changes in enrollment, caseload, or population. In addition, adjustments are to be made for statutory cost-of-living adjustments, legislation, costs incurred pursuant to constitutional requirements and court/federal mandates, general price increases, merit salary adjustments, and certain other technical factors. On this basis, the Department of Finance calculates the cost of the 1991-92 workload budget to be $46.8 billion, while General Fund revenues (excluding the effect of legislation proposed in the budget) are estimated to be $43.1 billion. Because the difference between these estimated expenditures and revenues is 9.2 percent, the trigger's reduction percentage would be set at the 4 percent maximum.

The statute exempts from these trigger reductions those General Fund appropriations which are required by operation of the State Constitution (for example, Proposition 98-required expenditures, general obligation bond debt service payments, and state subventions for the Homeowners' Property Tax Exemption Program). The total amount of state spending exempted from trigger reductions is approximately $19 billion.

The trigger's reductions apply to all General Fund appropriations as they appear in the Budget Act or as provided for in statute. In the case of four specific programs (such as AFDC), however, the amount of the reduction is limited by Chapter 458 to the *lesser of* the amount of any statutory cost-of-living adjustment required or the amount of the percentage reduction. Finally, to the extent that a funding reduction would require the reduction of a statutory entitlement, Chapter 458 provides general authority (and specific authority for certain programs) to make the reduction.

What the Budget Proposes. The Governor's Budget proposes that the reductions envisioned by the trigger mechanism be made instead through the Budget Bill, by including a specific unallocated reduction in the budgets of most General Fund state agencies and programs. Section 1.2 of the 1991 Budget Bill, as introduced, states that the Budget Bill "incorporates the reductions required by Chapter 458," and provides that no further reductions shall be made to General Fund appropriations on July 1, 1991.

In the context of the overall budget proposed by the administration, the unallocated reductions undermine the budget's claim of funding "population enrollment and caseload growth for all programs." While the budget details appear to reflect this goal, the unallocated reductions mean that the *actual proposed appropriations will be insufficient to achieve it.*

The administration's proposal raises several issues regarding how the Legislature should approach unallocated reductions:

- ***Reductions in statutory entitlements.*** As mentioned earlier, Chapter 458 provides that, if an appropriation for any program is reduced pursuant to its provision, then the level of any payment amount specified in statute may be correspondingly reduced. This authority, however, may not apply if, as the administration proposes, appropriations are instead reduced pursuant to the Budget Bill. In this event, additional legislation would be needed to actually achieve General Fund savings.

- ***Distribution and level of reductions.*** The Governor's approach on unallocated reductions would result in a different distribution (for example, between state operations and local assistance) and level of cuts than under the trigger. These differences generally result from two factors. First, the administration's general approach to determining the unallocated reductions is different than the approach specified in Chapter 458. Second, the administration has made a number of policy choices to *exempt* certain departments or programs from these reductions, or to *reduce* the amount of reduction that would have otherwise applied. However, the exact amount of these differences cannot be known without making assumptions about the level of Budget Act appropriations that would have existed if the statutory trigger mechanism had been used.
- ***The use of unallocated reductions.*** In relying on the use of unallocated reductions to achieve budgetary savings, the Legislature, in effect, delegates sole authority for determining how these reductions will be implemented to the administration. Our review indicates that, in many cases, there is no plan for how these savings are to be achieved. The Legislature will probably have little additional information on the implementation of these reductions as it works its way through the budget process.

STATE APPROPRIATIONS LIMIT

The state's appropriations limit, imposed by Article XIII B of the State Constitution, was significantly changed by Proposition 111 in June 1990. This measure both increased the level of the state's appropriations limit and exempted certain additional types of expenditures from the limit's control. As Figure 24 shows, the Governor's Budget indicates that the state will be $3.6 billion below its limit in 1990-91 and $2 billion below its limit in 1991-92.

Current Year

Last year at this time, the state was projected to be within $143 million of its 1990-91 appropriations limit. The dramatic increase in "room" under the limit—to $3.6 billion—reflects both the decline in anticipated state revenue collections that has occurred since that time and passage of Proposition 111. State tax revenue collections for 1990-91 are now estimated to be approximately $2.4 billion *less* than anticipated in the 1990-91

Figure 24

State Appropriations Limit Estimates Governor's Budget Estimates

1990-91 and 1991-92 (in millions)

	Appropriations Limit	Appropriations Subject to the Limit	Amount Under the Limit
1990-91	$32,161	$28,531	$3,630
1991-92	34,990	32,946	2,044

Governor's Budget. The remaining difference is due to various Proposition 111 changes, which are discussed below.

Proposition 111 Adjustments. Proposition 111 changed the index that the state and local governments use to annually adjust their appropriations limits. Specifically, the measure requires them to use the change in California per capita personal income instead of the lesser of per capita personal income or the change in the U. S. Consumer Price Index. Furthermore, Proposition 111 redefines the population factors for all governmental entities subject to the limit. With regard to the state's limit, the population adjustment is now computed as an average of the changes in statewide population and average daily attendance (ADA) for K-14 schools, weighted to reflect the non-K-14 and K-14 shares of the state's budget. Proposition 111 also allows the state to exclude from the limit calculation appropriations for "qualified capital outlay projects" and for certain emergency expenditures, such as disaster relief. Finally, Proposition 111 allows the state to include all of the increased transportation revenue resulting from its passage as "user fees."

Budget Year

The budget anticipates that the state's appropriations limit for 1991-92 will be set at almost $35 billion, an increase of 8.8 percent over the level estimated for 1990-91. This figure reflects an anticipated increase in per capita personal income of 5.31 percent, and an increase in the weighted average population/ ADA measure of 3.31 percent. Appropriations subject to the limit are estimated to total $32.9 billion, leaving slightly more than $2 billion in "room" under the limit for 1991-92.

The administration's calculation of the appropriations limit, however, is incomplete in several respects.

Capital Outlay Projects. The administration's estimates do not fully account for the additional exempt appropriations allowed by the provisions of Proposition 111. Specifically, that measure allows the state to exclude from the limit all appropriations for "qualified capital outlay" projects. The budget states that this is "still under review," but our analysis suggests that a number of state expenditures should be excluded under this provision. The largest of these is the state's debt service on its lease-payment bonds for higher education and correctional facilities, estimated at $356 million for 1991-92.

Federal Mandates. A 1990 California Supreme Court decision appears to allow the state to treat over $600 million of existing expenditures for various program activities as "federal mandates" which can be *excluded* from the limit calculations.

Shifts of Financial Responsibility. The Constitution requires that, when the responsibility for providing a service is transferred from one level of government to another, or its funding source is transferred from tax revenues to fee revenues, the appropriations limit be adjusted to reflect the transfer. The budget contains several proposals which involve transfers of financial responsibility—almost all of which are *from* state taxes *to* other funding sources—but the appropriations limit calculations do not reflect any downward adjustment on their account. The largest of these proposals involves the transfer of state funding responsibilities for local mental health and public health programs to counties. Additional proposals relevant to this point include the proposed higher education student fee increases, which will offset General Fund support, and fee increases for the adoptions and community care licensing programs. Depending upon how these proposals are ultimately structured, a downward adjustment to the state's appropriations limit of approximately $1 billion may be required.

On balance, the potential adjustments discussed above, as well as a variety of other adjustments, would leave the state with approximately $200 million *less* limit "room" than estimated by the administration.

Strategies for Addressing the State's Budgetary Imbalance

III

Part III

Strategies for Addressing the State's Budgetary Imbalance

As discussed in Parts One and Two of this document, the Legislature faces an enormous task in closing the gap between current service requirements and current estimated resources. The Governor's Budget provides one plan for addressing the shortfall, which includes a specific mix of expenditure reductions and revenue increases. This is only one approach to the problem. There is, in fact, a wide range of budget strategies that the Legislature can use in addressing the budget problem. These strategies fall into two main categories:

- ***Strategies to Increase Revenues.*** These include strategies to: (1) modify or eliminate tax expenditures, (2) expand the tax base, and (3) increase tax rates.
- ***Strategies to Reduce Expenditures.*** These strategies include: (1) service reductions, (2) program investments, (3) improved efficiencies, (4) funding shifts (to fees, local governments, the federal government, and the private sector), and (5) one-time adjustments and deferrals.

Strategies for Addressing the State's Budgetary Imbalance

INTRODUCTION

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

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

BASIC POLICY CHOICES

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

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

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

Constraints on Closing the Gap

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

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

LEGISLATURE CAN CHOOSE FROM A VARIETY OF STRATEGIES

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

Figure 1

Strategies for Addressing the State's Budgetary Imbalance

INCREASING REVENUES

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

REDUCING EXPENDITURES

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

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

One-Time Adjustments and Deferrals

STRATEGIES FOR INCREASING REVENUES

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

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

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

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

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

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

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

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

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

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

STRATEGY: MODIFY/ELIMINATE TAX EXPENDITURES

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

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

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

Eliminate Tax Expenditures With No Clear Current Public Purpose

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

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

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

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

Eliminate Tax Expenditures That Are Ineffective or Not Cost-Effective

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

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

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

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

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

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

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

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

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

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

STRATEGY: EXPAND THE TAX BASE

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

Expanding the Coverage of Taxes

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

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

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

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

Changing the Basis of Taxation

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

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

STRATEGY: INCREASE TAX RATES

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

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

Temporary Tax Increases

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

Permanent Rate Increases

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

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

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

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

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

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

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

STRATEGIES FOR REDUCING EXPENDITURES

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

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

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

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

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

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

STRATEGY: SERVICE REDUCTIONS

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

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

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

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

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

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

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

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

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

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

STRATEGY: PROGRAM INVESTMENTS

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

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

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

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

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

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

STRATEGY: IMPROVED EFFICIENCIES

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

Consolidating Programs

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

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

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

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

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

Restructuring Programs

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

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

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

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

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

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

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

Management Efficiencies

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

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

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

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

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

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

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

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

STRATEGY: FUNDING SHIFTS

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

Shifting to Fees

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

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

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

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

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

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

Shifting Costs to Local Governments

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

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

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

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

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

Shifting Costs to the Federal Government

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

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

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

Shifting Costs to the Private Sector

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

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

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

STRATEGY: ONE-TIME ADJUSTMENTS AND DEFERRALS

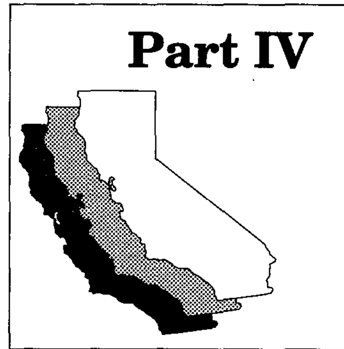
This strategy involves stop-gap measures that, like one-time revenue gains, help the state address the near-term cyclical portion of its current budget shortfall. Deferring expenditures, however, will make balancing *future* budgets even more difficult.

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

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

Major Issues Facing the Legislature

IV



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 proposals in the Governor's Budget, while others are more long-range in nature and will, in all probability, persist for many years beyond 1991.

The issues in this part fall into two general categories:

- The first category is comprised of issues in key program areas that could help the Legislature in addressing its structural fiscal problem. These issues are: (1) Proposition 98 and its proposed suspension, (2) county-state relations and the impact of the Governor's "realignment" proposal, (3) the AFDC program and the implications of the Governor's proposal to reduce welfare grant levels, and (4) the community corrections alternative and how it might relieve prison overcrowding and some of the presure on state prison spending.
- The *second* category consists of other issues involving the state's fiscal planning efforts: (1) state infrastructure, (2) the uses of bond proceeds, (3) school restructuring, and (4) the state rail transportation program.

Proposition 98

How Is the Proposition 98 Minimum Funding Guarantee Determined, and What Are the Consequences of Suspending Proposition 98?

Summary

Proposition 98 provides K-12 schools and community colleges with a constitutionally guaranteed minimum level of funding in 1988-89 and thereafter. Under the provisions of this measure, funding requirements for K-14 education programs are determined using a series of complex calculations based on factors related to both workload-based needs and state revenue availability.

As part of its overall strategy for balancing the budget, the administration proposes to suspend Proposition 98 in 1991-92 and reduce funding for K-14 education programs by $2 billion, relative to levels that would be required in the absence of suspension. One of the major decisions facing the Legislature, therefore, will be whether to suspend Proposition 98 (as proposed by the Governor's Budget).

Our review indicates that, if Proposition 98 is not *suspended, the Legislature will have to cut funding for non-K-14 education programs by $2 billion in addition to the significant reductions already proposed in the budget, raise an equivalent amount in new tax revenues, or use a combination of these two approaches.*

If the Legislature suspends Proposition 98, on the other hand, it need not accept the administration's proposal to reduce funding for K-14 education by $2 billion. Rather, the Legislature could determine the level of funding for K-14 education it deems appropriate. The Legislature would also have much greater flexibility in deciding how to distribute any new General Fund tax revenues in 1991-92.

In addressing the extremely complex problem of crafting a balanced budget for 1991-92, one of the Legislature's major decisions will be whether or not to suspend Proposition 98. In this piece, we describe the important fiscal provisions of this measure, how the Proposition 98 funding levels are determined in the current and budget years, and the consequences both of suspending and of not suspending Proposition 98 in 1991-92.

THE PROVISIONS OF PROPOSITION 98

Proposition 98, the "Classroom Instructional Accountability and Improvement Act of 1988," provides K-12 schools and community colleges with a constitutionally guaranteed minimum level of funding in 1988-89 and thereafter. As amended by Proposition 111 of 1989 and legislative statutes, the fiscal aspects of the measure consist of three major components:

- The minimum funding guarantee.
- Provisions relating to suspension and restoration.
- Provisions relating to the distribution of "excess" revenues (that is, revenues which exceed the state appropriations limit).

These components, described in more detail below, are summarized in Figure 1.

Minimum Funding Guarantee

The core of Proposition 98 is the minimum funding guarantee, which is determined based on one of three so-called "tests."

As originally enacted, Proposition 98 guaranteed K-14 education a level of funding based on the *greater* of:

- ***Test 1--Percent of General Fund Revenues.*** This is defined as the 1986-87 percentage of General Fund tax revenues provided K-14 education—about 40 percent.
- ***Test 2--Maintenance of Prior-Year Service Levels.*** This is defined as the prior-year level of total funding for K-14 education from state and local sources, adjusted for enrollment growth and for inflation.

Under the original provisions of Proposition 98, therefore, K-14 education was always guaranteed a level of funding at least as great as the amount received in the prior year, plus full adjustments for enrollment growth and inflation—irrespective of whether there were sufficient General Fund revenues available to support this level of funding.

Figure 1

Proposition 98 Major Fiscal Provisions

Minimum Funding Guarantee

In *normal* or *high revenue-growth* years, guarantee based on the *greater* of:

- ***Test 1—Percent of General Fund Revenues.*** 1986-87 percentage of General Fund tax revenues for K-14 education—about 40 percent—or
- ***Test 2—Maintenance of Prior-Year Service Levels.*** Prior-year total state and local funding level, adjusted for enrollment growth and growth in California per capita personal income.

In *low revenue-growth* years, guarantee based on:

- ***Test 3—Adjustment Based on Available Revenues.*** Prior-year total funding level, adjusted for enrollment growth and growth in General Fund revenues per capita, plus 0.5 percent of the prior-year level.

Suspension and Restoration

Minimum funding guarantee may be suspended for one year, *for any reason,* through urgency legislation other than the Budget Bill.

- Once guarantee has been suspended, the Legislature may appropriate *any level of funding* for K-14 education.

In years following either suspension or Test 3, the state may be required (depending upon the level of state revenues) to make minimum payments toward restoring K-14 education funding to the level that would have been required had funding not been reduced.

- These payments serve to restore K-14 education funding to pre-reduction levels (as adjusted to maintain service levels); ***there is no requirement that amounts that the state saves as a result of a reduction be repaid.***

"Excess" Revenues

In any year in which General Fund revenues exceed the state appropriations limit, K-14 education receives *one-half* of the excess amount, on a one-time basis (the other half must be returned to taxpayers).

- Unlike the minimum funding guarantee, the excess revenue provision may *not* be suspended.

Partially in response to concerns about this latter prospect, Proposition 111 of 1989 amended Proposition 98 to establish a third "test." Under this test, which is operative only in years in which General Fund revenue growth per capita is more than 0.5 percentage point *below* growth in per capita personal income, the minimum funding guarantee is based on:

- ***Test 3—Adjustment Based on Available Revenues.*** This is defined as the prior-year total level of funding for K-14 education from state and local sources, adjusted for enrollment growth and for growth in General Fund revenues per capita, *plus* 0.5 percent of the prior-year level.

Proposition 111 also added two other key provisions:

- It changed the inflation adjustment under Test 2 to growth in per capita personal income.
- It provides that in no event can Test 3 result in an increase in per-pupil funding that is less than the increase in per capita expenditures for all other General Fund-supported programs. This was intended to ensure that K-14 education is treated no worse, in years of low revenue growth, than are other segments of the state budget.

As the formula indicates, the calculation of the minimum funding guarantee under Test 3 is quite similar to that under Test 2--the only difference is in the inflation index used. Under Test 2, funding is increased based on growth in per capita personal income. Under Test 3, in contrast, funding is increased based on growth in General Fund revenues per capita (a measure of available budget resources), plus a 0.5 percent "bump" (which ensures a smooth transition between Test 2 and Test 3 as revenues decline).

"Spike" Protection. Proposition 111 also added another condition related to the calculation of the minimum funding guarantee: In any year in which the guarantee is determined by Test 1, and the Test 1 funding level exceeds the Test 2 level by more than 1.5 percent of General Fund revenues, the excess amount shall not be considered part of the "base," for purposes of calculating the following year's guarantee. This provision is intended to limit the extent to which a one-time "spike" in General Fund revenues may result in a permanent increase in the Proposition 98 "base."

Suspension and Restoration

Suspension. Proposition 98 provides that the minimum funding guarantee may be suspended for one year, through

urgency legislation, in a bill other than the Budget Bill. The measure gives no additional criteria on the decision to suspend. Consequently, the Legislature may suspend the minimum funding guarantee for *any reason* which meets the general criterion for urgency legislation specified in the California Constitution ("necessary for the immediate preservation of the public peace, health, or safety"). Once the minimum funding guarantee is suspended, which requires a two-thirds vote of each house, the Legislature may appropriate *any level of funding* for K-14 education.

Restoration. In years following a suspension or a Test 3-based reduction, however, the state may have to make specified minimum payments toward restoring K-14 education funding to the level that would have been required had funding not been reduced.

In practice, the process of suspension and restoration works as follows:

- ***Creation of a "maintenance factor."*** In any year in which funding for the minimum guarantee is reduced below the level that would otherwise have been required by either Test 1 or Test 2, a "maintenance factor" is created in an amount equal to the underfunding.
- ***Computation of guarantee.*** In the following year, the minimum funding guarantee is computed using Test 1, 2, or 3 (as appropriate), with the prior year's *actual* (reduced) level of funding as the new "base."
- ***Computation of adjusted maintenance factor.*** The amount of the maintenance factor is increased annually, using the adjustment factors specified in Test 2 (enrollment growth and growth in per capita personal income).
- ***Minimum restoration payment.*** In any year in which General Fund revenue growth per capita exceeds per capita personal income growth, the state must make a minimum restoration payment, equal to one-half of the difference in these growth rates, times total General Fund tax proceeds. In no case, however, is the restoration payment greater than the amount of maintenance factor outstanding. The restoration payment serves to reduce the amount of any maintenance factor outstanding.

It is important to emphasize that, because the restoration payments are on top of a minimum funding guarantee which in each year is based on the actual level of funding received in the prior year, they serve to restore K-14 education funding to a level equal to—but not greater than—the pre-reduction level (as ad-

justed for enrollment growth and inflation). As a result, amounts which the state saves due to a suspension or Test 3-based reduction ***do not have to be repaid.***

"Excess" Revenues

Finally, Proposition 98 provides that, in any year in which General Fund revenues exceed the state appropriations limit, K-14 education shall receive one-half of the excess amount *on a one-time basis*. In other words, these funds do not get built into the "base," for purposes of computing the following year's minimum guarantee. The California Constitution requires that the remaining half of the "excess" revenues be returned to the taxpayers. Unlike the minimum funding guarantee, the excess revenue provision may not be suspended.

DETERMINATION OF PROPOSITION 98 FUNDING LEVELS

As the preceding discussion indicates, the computation of Proposition 98-required funding levels for K-14 education can be quite complex. In this section, we describe in more detail exactly how these funding levels are determined in 1990-91 and 1991-92 under the assumptions contained in the Governor's Budget.

Current-Year Funding Level

When the Legislature passed the 1990-91 budget last July, it approved a total level of state funding for Proposition 98 of $17.1 billion. This amount was based on the assumption that the minimum funding guarantee would be determined by Test 2 (the maintenance of prior year's service levels test). The Governor's Budget indicates that, since that time, estimated 1990-91 General Fund tax revenues have decreased by $2.4 billion. As a result, the basis for computing the minimum funding guarantee has shifted from Test 2 to Test 3.

Figure 2 shows how the decrease in General Fund tax revenues (horizontal axis) affects the determination of state aid requirements under the minimum funding guarantee (vertical axis). (The figure is based on the Governor's Budget estimates of General Fund tax revenues and the Proposition 98 guarantee.) As the figure shows, total General Fund tax revenues for 1990-91 were estimated last July to be $41.4 billion, resulting in a Proposition 98 state aid requirement under Test 2 of $17.1 billion (equal to 41.3 percent of General Fund tax revenues).

Figure 2 also shows that, since that time, the estimated level of current-year General Fund tax revenues has decreased by $2.4 billion. As a result, the basis for computing the minimum funding

guarantee has shifted from Test 2 to Test 3, and the required level of state aid has decreased by approximately $500 million. (Of this amount, the budget proposes to reduce approximately $450 million from funds for K-12 education, and $50 million from community colleges.) According to the budget estimates, the new level of the current-year guarantee is $16.6 billion (equal to 42.6 percent of the revised estimate of General Fund tax revenues).

As these percentages confirm, in any year in which the Proposition 98 guarantee is determined by Test 2, the percentage of General Fund tax revenues represented by the 98 guarantee *exceeds* the 40 percent level required under Test 1. They also indicate, however, that the percentage represented by the minimum guarantee can exceed 40 percent *even in years in which the guarantee is determined by Test 3.*

Budget-Year Funding Level

For 1991-92, the administration proposes to suspend the Proposition 98 minimum funding guarantee, and reduce funding for K-14 education by $2 billion below the level that would otherwise be required in the absence of suspension.

Figure 3 shows the level of funding proposed by the administration in relationship to the Proposition 98 funding guarantee and General Fund tax revenues. The figure shows that, under the Governor's Budget assumptions (including the administration's proposed reduction of 1990-91 Proposition 98 funding levels, as well as its revenue assumptions—see Part I of this document), the minimum funding guarantee would be determined by Test 2. Specifically, the Proposition 98 state aid requirement under Test 2 would be $18.3 billion (equal to 40.8 percent of the total $44.8 billion in General Fund tax revenues).

Figure 3 also shows that the level of funding proposed by the administration for Proposition 98-eligible programs is $16.9 billion (equal to 37.6 percent of General Fund tax revenues) in 1991-92. As the figure shows, this amount is $1.43 billion below the $18.3 billion funding level that would otherwise be required by Test 2.

Finally, the figure shows that, in the absence of suspension, the state would also be required to fully restore $550 million in maintenance factor outstanding (that is, the $500 million current-year maintenance factor, as adjusted for enrollment growth and inflation) created by the shift to Test 3 in 1990-91. The combination of (1) the $1.43 billion reduction below the Test 2 funding level and (2) the $550 million restoration yields the $2 billion total impact related to suspension noted above.

Figure 2

Proposition 98 Funding Guarantee

1990-91 (in billions)

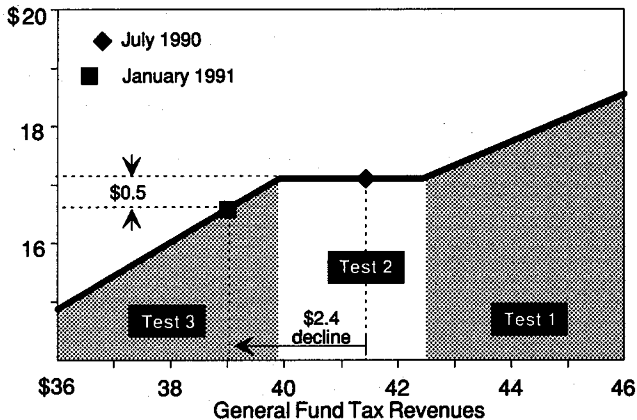
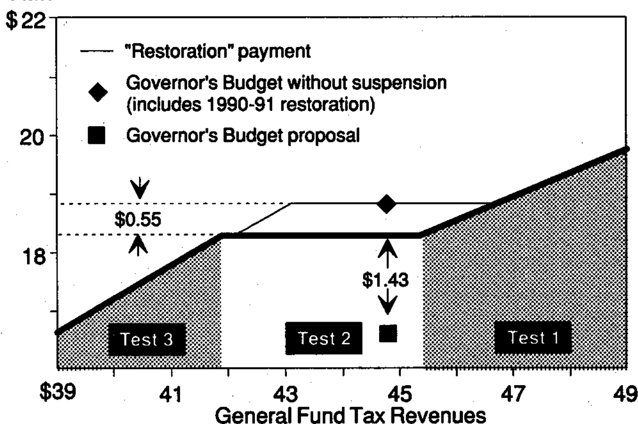


Figure 3

Proposition 98 Funding Guarantee

1991-92 (in billions)



Key Factors Affecting State Aid Requirements

As Figures 2 and 3 show, the level of state funding required for the Proposition 98 minimum funding guarantee can vary, depending upon the level of General Fund revenues. Changes in other factors may also affect the required level of state aid. These impacts are summarized in Figure 4, and are discussed in greater detail below.

Changes in General Fund Revenues. As noted, Figures 2 and 3 show how the required level of Proposition 98-related funding changes, as total General Fund tax revenues change. Specifically, the figures show that:

- ***When the minimum funding guarantee is determined by Test 1,*** K-14 education gains or loses approximately 40 cents for every dollar of tax revenues gained or lost by the General Fund. (This percentage reflects the share of General Fund spending for Proposition 98-eligible purposes in 1986-87—the Test 1 "base year"—and does not vary.)
- ***When the minimum funding guarantee is determined by Test 2,*** the level of Proposition 98 state aid is unaffected by changes in General Fund revenues.
- ***When the minimum funding guarantee is determined by Test 3,*** K-14 education gains or loses more than 40 cents for every dollar of tax revenues gained or lost by the General Fund. (The exact percentage is based on the ratio between total spending for Proposition 98 purposes from state *and local* funds in the prior year and total prior-year General Fund revenues. This ratio—which is 59 percent for 1991-92—varies from year to year.)

Changes in Other Factors. Figures 2 and 3 are only able to show the relationship between the Proposition 98 minimum funding guarantee and General Fund tax revenues, holding constant all other factors affecting the guarantee level. These other factors, shown in Figure 4, and their effects on the minimum funding guarantee are:

- ***Local property tax revenues.*** Increases in the level of local property taxes for schools or community colleges result in dollar-for-dollar *decreases* to the level of state funding required under Test 2 or Test 3. Changes in local property tax revenues have no effect on the level of state funding required under Test 1.
- ***K-12 enrollment.*** Increases in the rate of enrollment growth in K-12 schools result in *increases* in the level of

Figure 4

Impacts on State Aid Requirements of Changes in Key Factors Affecting Proposition 98

Increases in:	Impact on State Aid Under		
	Test 1	Test 2	Test 3
General Fund Revenues	↑	--	↑
Local Property Taxes	--	↓	↓
K-12 Enrollment	--	↑	↑
Per Capita Personal Income	--	↑	--

state funding required under Test 2 or Test 3 for both K-12 schools and community colleges. Changes in enrollment growth have no effect on the level of state funding required under Test 1.

- ***Per capita personal income.*** Increases in the rate of per capita personal income growth result in *increases* in the level of state funding required under Test 2. Changes in per capita personal income growth have no effect on the level of state funding required under Test 1 or Test 3.

Changes in Factors Unlikely to Solve Budget Problem. Although changes in the factors noted above can reduce the level of Proposition 98-required state aid, our review indicates that—absent a major reduction in General Fund revenues below the level assumed in the Governor's Budget—such changes would not reduce the level of the Proposition 98 guarantee to the level of spending proposed by the administration in 1991-92.

We reach this conclusion for two reasons:

First, our analysis indicates that there is *no conceivable combination* of changes in these factors (other than a major reduction in General Fund revenues below the level assumed in the budget) that could cause a Test 3 reduction to occur in 1991-92.

Second, while changes in these factors could cause the guarantee under Test 1 or Test 2 to drop below the level assumed

in the Governor's Budget, it is unlikely that such a drop would significantly reduce the $2.0 billion "gap" between the Proposition 98 "full funding" level and the budget proposal.

CONSEQUENCES OF SUSPENDING PROPOSITION 98

The decision of whether or not to suspend Proposition 98 has major implications for the Legislature's ability to find a solution to the enormous budget problem which it confronts in 1991-92. The decision also has major implications for the ability of school districts to balance their own budgets. In this section, we discuss several important considerations, summarized in Figure 5, which we believe the Legislature should bear in mind in deciding this issue.

What If the Legislature Chooses to Suspend?

As noted, once the minimum funding guarantee is suspended, the Legislature can appropriate funds for K-14 education *at any level*, not just the level proposed by the Governor. Suspension would give the Legislature the ability to distribute funds among all state programs, including K-14 education, *according to its own priorities.*

One-Time Suspension Can Yield Multi-Year Savings. Figure 6 illustrates another important consideration--the *one-time* suspension of Proposition 98 in 1991-92 can yield major General Fund savings for *several years thereafter.* The figure presents our estimates of the level of Proposition 98 funding that would be required during 1991-92 through 1993-94 under the "full funding" (that is, no suspension) alternative (the top line in the figure) versus the Governor's Budget proposal to suspend (the lower, shaded portions of the bars).

Figure 6 also shows that, if the Legislature adopts the budget proposal, the state General Fund will save $2.0 billion in 1991-92, relative to the K-14 education funding level that would be required in the absence of suspension. In 1992-93, we estimate that the minimum funding guarantee would be determined by Test 3. As a result, the General Fund would save an additional $3.1 billion. (This amount is composed of the adjusted maintenance factor from 1991-92, plus an additional reduction in 1992-93 due to the shift to Test 3.) Finally, in 1993-94, we estimate that General Fund revenue growth would be sufficiently strong to require a restoration payment of $1.2 billion. Relative to the funding level that would have been required had Proposition 98 not been suspended in 1991-92, however, the General Fund would save an additional $2.2 billion.

Figure 5

Considerations Relative to Suspension of Proposition 98

IF MINIMUM FUNDING GUARANTEE IS SUSPENDED:

- Once the Proposition 98 minimum funding guarantee is suspended, the Legislature can appropriate funds for K-14 education *at any level.*
  - The Legislature is not bound by the Governor's proposal to reduce funding by $2.0 billion below current-law requirements.
- One-time suspension not only yields major savings in 1991-92, but may also produce *major, multi-year savings* in future years, relative to funding levels that would have been required in the absence of suspension.
  - The amounts saved *do not have to be repaid.*
- Major reductions in funding will result in equivalent losses to school and community college districts, making it difficult for districts to balance their budgets.
  - Some districts may seek emergency loans; others may be forced into bankruptcy in order to break contractual agreements (such as multi-year collective bargaining agreements).

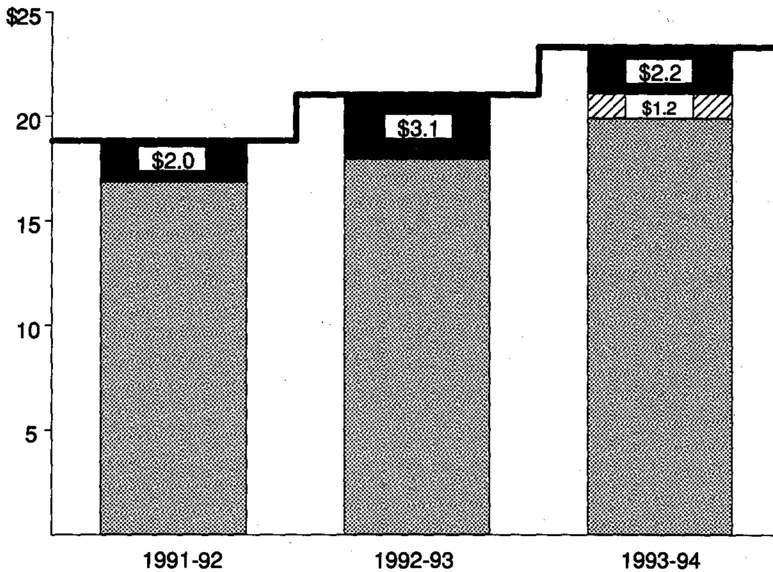
IF MINIMUM FUNDING GUARANTEE IS NOT SUSPENDED:

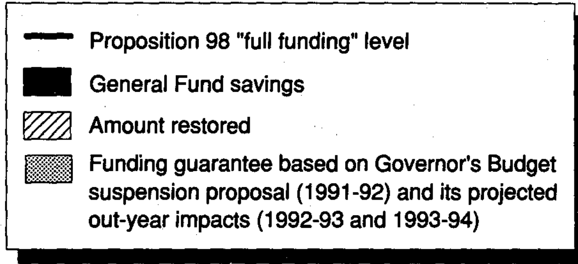
- The Legislature will need to appropriate an additional $2.0 billion to K-14 education above amounts proposed in the Governor's Budget.
  - This amount consists of the $1.43 billion reduction below the "Test 2" funding level, plus $550 million to restore funding reduced due to the current-year shift to "Test 3."
- The Governor's Budget estimates that, with its spending and revenue proposals, there is only $2.1 billion in additional "room" remaining under the state appropriations limit.
- Thus, if the Legislature chooses to address the budget problem by raising revenues, rather than by making further cuts in non-K-14 education programs, *100 percent* of the first $2.0 billion in new revenues would have to be appropriated to K-14 education.
  - Of the next $100 million, K-14 education would be entitled to roughly $40 million (with $60 million available for non-K-14 programs).
  - And, of any revenues raised in excess of $2.1 billion, 50 percent would go to K-14 education and 50 percent would be rebated to taxpayers (with no additional funding available for non-K-14 programs).

Figure 6

One-Time Proposition 98 Suspension Can Yield Major Multi-Year Savings

1991-92 through 1993-94 (in billions)





Source: Legislative Analyst's projections based on Governor's Budget proposal and LAO estimates of 1992-93 and 1993-94 revenues.

In total, therefore, our estimates of the future impact of the Governor's proposal imply that the one-time suspension of Proposition 98 would save the General Fund a total of *$7.3 billion* over three years ($2.0 billion in 1991-92, plus $3.1 billion in 1992-93, plus $2.2 billion in 1993-94).

State Savings Equal School District Losses. These state General Fund savings, of course, translate into equivalent losses to school and community college districts. Because personnel costs typically account for about 80 percent of district expenditures, losses of this magnitude would be difficult to accommodate under the best of circumstances. Such losses will be especially difficult to accommodate, however, for those districts which have entered into multi-year contractual arrangements (such as collective bargaining agreements) with no provisions allowing them to be renegotiated in the event of insufficient revenues. In these cases, major funding losses to school districts will undoubtedly generate pressure for emergency loans from the state and, in extreme cases, could force districts into bankruptcy. If the Legislature chooses to suspend Proposition 98, therefore, it will also need to consider these impacts in deciding on an appropriate level of funding to provide K-14 education.

What If the Legislature Chooses Not to Suspend?

If, on the other hand, the Legislature chooses not to suspend Proposition 98, it will need to appropriate an additional $2 billion in funding to K-14 education above the amount contained in the Governor's Budget.

One option for fully funding Proposition 98 requirements would be to reduce funding for General Fund-supported programs other than K-14 education by an additional $2 billion beyond the significant reductions already contained in the administration's budget proposal.

Another option would be to address the *overall* state budget problem by raising revenues. If this approach were taken:

- Of the first $2 billion in new revenues, 100 percent would have to be appropriated to K-14 education.
- Of the next $100 million, K-14 education would be entitled to roughly 40 percent (because the guarantee at that revenue level would be based on Test 1)—with the remaining $60 million available for non-K-14 education programs.
- Of any revenues raised in excess of $2.1 billion, 50 percent would go to K-14 education and the remaining 50 percent would have to be returned to taxpayers. This is because, at this amount of new revenues, the state would have reached its appropriations limit, which requires this distribution of "excess" revenues.

A third option would be to raise the additional $2 billion for K-14 education from some combination of revenue enhancements and additional spending cuts for non-K-14 education programs. Like the second option, however, this one would, in effect, require that 100 percent of any new revenues raised (up to $2 billion) be devoted to K-14 education.

CONCLUSION

As the preceding analysis indicates, Proposition 98 is an extremely complex measure, under which funding requirements for K-14 education vary depending on a number of factors. The most immediate decision facing the Legislature regarding Proposition 98 is whether to suspend its minimum funding guarantee in 1991-92 in order to deal with the budget's overall funding gap.

Our review indicates that, if Proposition 98 is *not* suspended, the state would have to provide an additional $2 billion in funding for K-14 education programs. This would require cutting funding for non-K-14 education programs by $2 billion *on top of the reductions already proposed in the budget,* raising an equivalent amount in new tax revenues, or a combination of these two approaches.

If, on the other hand, the Legislature suspends Proposition 98, it need not accept the administration's proposal to reduce funding for K-14 education by $2 billion. Rather, the Legislature could determine the level of funding for K-14 education it deems appropriate. The Legislature would also have much greater flexibility in deciding how to distribute any new General Fund tax revenues in 1991-92.

The County-State Partnership

What Adjustments to the County-State "Partnership" Are Needed to Ensure That It Will Best Serve the Needs of the People of California?

Summary

Over the past several years, many of California's counties have experienced increasing financial stress. Despite county reductions in discretionary spending and some state legislative action, our analysis indicates that the problem of county fiscal distress is relatively widespread and is a cause for concern. In addition, there are a number of other problems with the existing county-state partnership that reduce the effectiveness of partnership programs. These problems are of significant concern for the Legislature, as the state has a clear interest in maintaining the fiscal viability of county governments. This is because they not only provide basic municipal services to residences of local unincorporated areas, but also serve all Californians by providing services of statewide interest.

In an attempt to address some of the problems with the existing county-state partnership, the 1991-92 Governor's Budget *proposes to realign the funding responsibility for AB 8 county health services and community mental health programs. Specifically, the state would remove existing state funding for these programs and provide counties with new revenues. Our assessment is that the Governor's proposal would not improve the overall effectiveness of these programs or necessarily improve the fiscal capacity of counties. It would, however, leave the state with additional resources to use to help address its budgetary funding gap.*

While the process of reform is complicated due to the complex nature of the county-state relationship, it is important that the Legislature explore the opportunities for reforming it. We offer a framework that can provide a basis for approaching reform, and discuss various considerations and action steps involved in making changes in the county-state relationship.

Over the past several years, many of California's counties have experienced increasing financial stress. While Butte County is perhaps the most visible example of recent county financial troubles, our analysis indicates that the problem is inherent to the existing arrangement of state and county responsibilities and affects *all counties* to greater or lesser extent. The existing county-state partnership suffers from a variety of structural problems—such as program fragmentation, counter-productive fiscal incentives, and the inappropriate division of responsibilities—that both diminish the effectiveness of these programs and reduce the financial viability of county governments.

Clearly, the State of California also is facing significant fiscal problems, as we outline in Part One of this document. The state's budget funding gap is forcing a reevaluation of state spending priorities, and this will probably mean that less state funding will be available for many state programs operated by counties. As discussed in Part Three, reduced service levels and a shifting of program responsibilities are among the options for addressing the state's budgetary gap. These could have negative consequences for the financial viability of county governments, which is needed to ensure the effective operation of our "partnership" programs. The above concerns have led many to call for a basic overhaul of the county-state relationship in California.

The *1991-92 Governor's Budget* includes one major proposal to change the existing county-state relationship. Specifically, it proposes to replace existing state funding for the community mental health, the AB 8 county health services, and local health services programs with increased county revenues that result from proposed changes in the structure of the Vehicle License Fee (VLF) and an increase in the state's alcoholic beverage taxes. As of this writing, the administration's specific proposal for accomplishing this change has not yet been made available. As a result, it is not clear, for example, whether existing state controls over these programs would also be shifted to counties, or whether the state would continue to exert its influence over program service levels.

This analysis has several purposes:

- First, we examine the existing county-state relationship and assess its underlying problems.

- Second, we identify the basic principles that are important in evaluating the structure of the county-state relationship, as well as proposals to change it.
- Third, we use these principles to evaluate the Governor's proposal to shift funding responsibility for county health and mental health programs to localities.
- Finally, we discuss additional considerations and action steps for the Legislature in approaching reform of the county-state partnership in the future.

WHAT IS THE BASIC COUNTY-STATE PARTNERSHIP IN CALIFORNIA?

This section describes the existing county-state partnership in California and identifies some of the problems with this relationship.

Background—Counties in California

Counties in California play a dual role in providing services to their residents.

First, counties are an administrative arm of the *state* and, as such, are charged with the responsibility to administer a variety of programs. These programs include welfare [such as the Aid to Families with Dependent Children (AFDC) and general assistance programs], indigent health services, social services [such as In-Home Supportive Services (IHSS) and Child Welfare Services (CWS)], community mental health, corrections, and the trial courts.

Second, counties administer a variety of *local* programs. These include some programs of general interest to the state (such as public health and local social services programs) and others of primarily local interest (such as the municipal-type services provided to residents of unincorporated areas, including fire and sheriff services).

Counties pay for local programs and for their share of state-required program costs out of the revenue they have available for general county purposes. County general purpose revenue (GPR) comes from a variety of sources, including the local property tax, state general purpose subventions, and the local sales tax. Due primarily to the constraints imposed by Proposition 13, counties have very limited power to increase GPR.

How Are the Major County-State Partnership Programs Structured?

As noted above, counties administer a variety of state-required programs in partnership with the state. The structure of the partnership varies from program to program, in terms of three basic characteristics:

- ***Who controls decisionmaking?*** The degree of relative decisionmaking control between the state and counties varies considerably among programs. In the case of AFDC, the state and federal governments establish most of the rules that determine eligibility and scope of services, leaving counties with little discretion over service levels. In contrast, counties have more control over the level of services provided in justice programs, mental health, and general assistance. For example, counties can reduce services provided under probation programs by decreasing the level of supervision provided, because the state has few formal requirements in this area.
- ***Who administers the program?*** California's counties are responsible for the day-to-day operation of many programs required by the state. Major examples of county administration of state-required programs include AFDC, general assistance, community mental health, and CWS, as well as the local courts, jails, and probation services. Other programs are administered by the state, such as state mental hospitals and the County Medical Services Program (for participating small counties).
- ***Who pays for the program?*** The county-state partnership programs have widely varying cost-sharing arrangements. For example, the state pays 100 percent of the nonfederal costs for Medi-Cal administration. The state also pays the majority of the costs for AFDC—roughly 93 percent of the nonfederal share of the grant costs and 50 percent of the nonfederal share of administration costs. Conversely, counties pay for 100 percent of the costs of general assistance and most of the costs of probation and operation of local jails.

Figure 1 shows the basic arrangements of funding, control, and administration for the major county-state partnership programs.

Figure 1

County-State Partnership Programs

Program[a]	Description	Policy Control	Administration	Funding
AFDC - Family Group ($3,967 million)	Grants to single-parent families.	Federal and state governments set policy.	County administration, supervised by the state (supervision includes monitoring and oversight).	Federal - 50 percent State - 45 percent County - 5 percent
AFDC - Unemployed parent ($733 million)	Grants to intact families with one unemployed parent	Federal and state governments set policy.	County administration supervised by the state.	Federal AFDC-U program: Federal - 50 percent State - 45 percent County - 5 percent State only AFDC-U program: State - 89 percent County - 11 percent
AFDC - Foster care ($1,013 million)	Payments to foster care providers	Federal and state governments set policy.	County administration, supervised by the state.	Federal Foster Care program: Federal - 50 percent State - 47.5 percent County - 2.5 percent State only Foster Care: State - 95 percent County - 5 percent
AFDC - Child Support Enforcement ($230 million)	Child support collection for AFDC and non-AFDC families	Federal and state governments set policy; counties have discretion in organizing service delivery.	County administration, supervised by the state.	Federal - 66 percent County - 34 percent County costs partially or fully offset by state and federal incentive payments.
General Assistance ($304 million)	Grants to individuals who do not qualify for other grant aid programs	State requires counties to take care of indigents; county sets grant/service level; court actions have influenced level required.	County administration.	Entirely county-funded.

Figure 1—CONTD

Program	Description	Policy Control	Administration	Funding
Child Welfare Services ($473 million)	Services to abused and neglected children and their families	Federal law sets broad guidelines for the program. State law is more stringent and there are fairly stringent state regulations.	County administration, supervised by the state.	Primarily state- and federal-funded.
Community Care Licensing ($50 million)	Licensing of out-of-home nonmedical facilities (i.e., family day care and foster family care)	State sets policy.	Some counties provide services on a contract basis.	Mostly funded through state funds, some federal money.
GAIN/JOBS ($183 million)	Employment and training services	State and federal governments set policy; counties have some discretion to tailor program to suit local needs.	County administration, supervised by the state.	State- and federal-funded.
In-Home Supportive Services (IHSS) ($676 million)	Domestic and personal services to elderly and functionally disabled adults	State sets eligibility criteria. County has some discretion how services are provided.	County administration, supervised by the state.	State and federal governments fund almost all of the program. Total county share is frozen at $19 million. Administration is entirely state-funded through the County Services Block Grant.
Adult Protective Services ($23 million)	Protective social services for elderly and disabled	State requires counties to respond to cases of adult abuse, but sets no service level; counties set service level and mix of services.	County administration, supervised by the state.	State-funded (as part of the County Services Block Grant).
Welfare programs administration ($1,259 million)	Eligibility determination AFDC, Food Stamps, Foster Care, Medi-Cal	Federal and state governments set policy; counties have discretion in organizing service delivery.	County administration, supervised by the state.	Federal - 50 percent State - 25 percent County - 25 percent

Figure 1—CONTD

Program	Description	Policy Control	Administration	Funding
Mental health services: community-based Short-Doyle ($781 million)	Inpatient and outpatient mental health services	Counties develop plans and state reviews plans, but there is little state control over county service delivery.	County administration, supervised by the state.	For Medi-Cal eligible services, 50 percent federal funds and 50 percent state funds. For non-Medi-Cal eligible services, State - 90 percent County - 10 percent (for counties with populations over 125,000); no county match for counties with populations under 125,000. County over-match was $47 million for 1988-89. Hospitals: State - 85 percent County - 15 percent, regardless of county population.
Mental health services: state hospitals ($261 million)	Acute, inpatient mental health services	State sets policy; counties have little or no policy control.	State administration.	State hospitals: State - 85 percent County - 15 percent (for counties with populations over 125,000); for counties with populations less than 125,000, the match requirement is 10 percent.
Mental health services: Institutions for Mental Diseases ($85 million)	Inpatient mental health services	State sets policy.	State contracts with private providers.	Entirely state-funded.
Alcohol and drug programs ($257.4 million, not including county funds)	Alcohol and drug treatment and prevention services	Federal and local governments set most of the policy; state does not have a strong policy role.	County administration supervised by the state.	There are several funding formulas using both state General Fund and federal funds. Counties are required to match General Fund with 10 percent county funds, except for counties with populations less than 100,000.

Figure 1—CONTD

Program	Description	Policy Control	Administration	Funding
Indigent health care ($1.3 billion)	Health services to the medically indigent	Larger counties: Participate in the Medically Indigent Services Program (MISP) with indigent care systems established by the counties; state has little control over eligibility and scope of services. Smaller counties: Generally participate in County Medical Services Program (CMSP) run by the state with state-established eligibility and scope of services.	Generally county administration supervised by the state. CMSP- (providing indigent health care for some clients in participating small counties) is state run.	**MISP:** State provides block grants to counties not participating in CMSP. Most counties supplement with county funds. **CMSP:** State-funded. **Cigarette and Tobacco Products Surtax (C&T) Fund:** State block grants to counties for a variety of health services; some funds must be distributed to private providers. **AB 8-county health services:** Per capita minimum state grant for indigent health care and public health services. Additional funding is generally 50 percent state and 50 percent county (with some county over-match). **State Legalization Impact Assistance Grant (SLIAG):** Federal reimbursements for services provided to newly legalized persons.
Public health programs ($167 million)	Public health services	Counties have significant discretion regarding what services are provided and how they are provided.	County administration, supervised by the state.	AB 8: Per capita minimum state grant for indigent health care and public health services. Additional funding is generally 50 percent state and 50 percent county. Note: does not reflect variety of categorical programs from which some funds flow to county health departments.
Trial court operations ($1.3 billion)	Operation of trial courts (Superior, Municipal and Justice courts)	Service level determined partially by the state and partially by the counties.	County administration, audited by the state.	State funding through the Trial Court Funding Program block grants and payment of judges' salaries (total for 1990-91 - $501 million); local funding from county general revenues and fee collections.
Public defense (at least $260 million)	Defense services, primarily for indigent persons	Service level determined primarily by local governments.	County administration.	County-funded (minor state funding). Greater state funding prior to 1990-91.
Prosecution (at least $360 million)	Prosecution services through the District Attorney	County largely controls policy, but state actions affect local discretion.	County administration.	Primarily county-funded; state provides $30 million for homicide trial reimbursement, training, and various grant programs.

Figure 1—CONTD

Program	Description	Policy Control	Administration	Funding
Incarceration-jails (at least $1.5 billion)	Pre- and post-trial custody services (adult and juvenile)	County has little control over jail population; state and court actions limit discretion.	County administration.	County-funded, with some state reimbursement for specified programs (for example, for counties housing state parole violators).
Incarceration (adults)-state prisons ($2,111 million)	Custody services for adult felons	State sets policy.	State administration.	Entirely state-funded.
Incarceration (juveniles)-youth authority ($350 million)	Custody and rehabilitative services for youthful offenders	State sets policy.	State administration.	Entirely state-funded.
Probation (at least $350 million)	Probation services	State through enactment of criminal punishments; county through supervision policies.	County administration.	Primarily county-funded. State provides some funds through the County Justice System Subvention Program, training programs, and mandate reimbursements.
Jail construction (at least $200 million)	Aid to counties for the cost of jail construction	Service level determined by the counties; county construction plans reviewed by the state Board of Corrections.	Primarily county administration.	Generally: State - 75 percent, County - 25 percent Amount varies substantially from year to year.
Parole (adults) ($205 million)	Community supervision for persons released from state prison	State sets policy.	State administration.	Entirely state-funded.
Parole (youth) ($41 million)	Community supervision for persons released from the Youth Authority	State sets policy.	State administration.	Entirely state-funded.
Police protection ($1,201 million)	Basic county law enforcement	Service level determined primarily by county.	County administration.	Primarily county-funded. State provides about $100 million for special grant programs and training.

[a] Program costs shown are estimated for 1990-91.

WHAT ARE THE PROBLEMS WITH THE CURRENT PARTNERSHIP?

Certainly, the most obvious problem with the county-state relationship in recent years has been the well publicized poor fiscal capacity of county governments. In addition, we have found the existing county-state relationship probably does not ensure that partnership programs are operated as *effectively* as possible. In this section, we discuss the basis for these findings.

County Fiscal Capacity

For purposes of our analysis, we define county fiscal capacity in broad terms—as the ability of a county to meet whatever public service needs may arise in its community with the resources it potentially has available to it. *Fiscal distress* occurs when an imbalance between resources and responsibilities leads a county to have severe difficulty addressing service needs.

Because county flexibility to raise GPR is limited, local service needs must compete with state-required programs for the growth in the existing GPR base. As counties have little (and sometimes no) control over the costs of state-required programs, counties may be unable to prevent these programs from commanding an increasing share of GPR over time. This can lead to a corresponding decline in the amount of GPR available for local services (referred to as local purpose revenues, or LPR), requiring counties to reduce service levels for these programs.

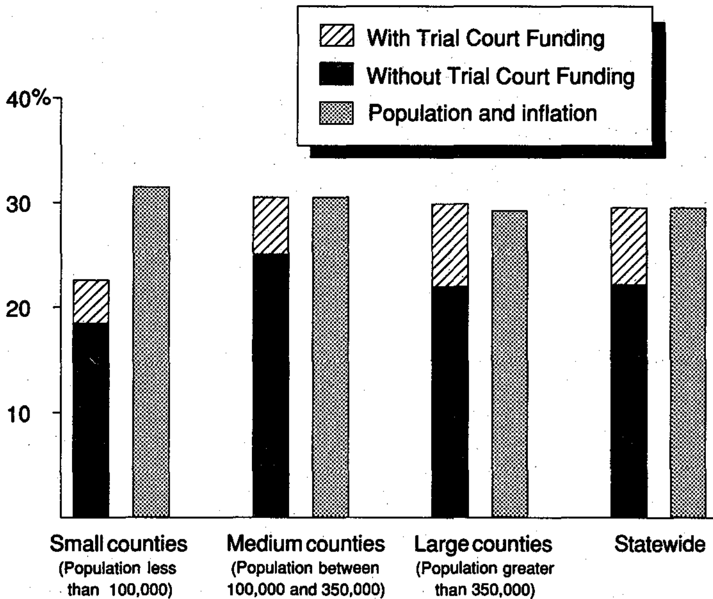
Previous Findings About Capacity. In last year's *Perspectives and Issues*, we presented an analysis of county fiscal capacity for the period 1984-85 through 1987-88. This analysis showed that county fiscal capacity, as measured by the change in LPR, did not keep pace with the growth in the cost of living and population over this period. On a statewide basis, county LPR increased by a nominal 12 percent between 1984-85 and 1987-88, but actually *declined* by 6.5 percent after accounting for inflation and population.

New Data Are Available. Data on county fiscal capacity are now available for the 1988-89 fiscal year. These data show a significant reversal of the prior trend, due to the implementation of the Trial Court Funding Program (TCF). In 1988-89, this program provided half-year state block grants to cover a portion of county costs for court operations. As shown in Figure 2, on a statewide basis, county fiscal capacity *improved* sufficiently to fully restore the 1984-85 level of LPR, after adjustment for inflation and population growth. Our review, however, indicates that this general conclusion does *not* apply in the case of smaller

Figure 2

Percentage Change in Local Purpose Revenue With and Without Trial Court Funding

1984-85 through 1988-89



counties, because of their relatively lower levels of expenditure for court operations.

The advent of TCF clearly took some pressure off county budgets in 1988-89, and because the program expanded to provide full-year funding in 1989-90, our projections indicate further improvement through 1989-90. In addition, in 1989-90 counties began to receive additional funding for indigent health care expenditures from the new tobacco products taxes imposed by Proposition 99. These factors have combined to restore some of the county fiscal capacity that had been eroded in the years since Proposition 13. However, they have not affected the underlying conditions that gave rise to the decline in overall county fiscal capacity to begin with—high rates of growth in state-required program costs and low rates of growth in GPR.

Erosion of Gains Is Likely. Our analysis indicates that, beginning with the 1990-91 fiscal year, several additional factors will begin to erode the gains realized by counties in 1988-89 and 1989-90. First, in 1990-91 the state reduced the level of funding for TCF by $61 million. This reduction appears to have been implemented by counties through a reduction in their expenditures for programs other than court operations.

In addition, other 1990-91 state funding reductions amounting to $369 million occurred in the Medically Indigent Services Program (MISP), the Community Mental Health Program, the CWS Program, and several other programs. These reductions appear to be resulting in increased *county* expenditures for these programs, because many counties have chosen to replace some or all of the state funding reductions with local funds.

In order to help counties absorb these increased costs, the Legislature authorized them to begin charging other local agencies for the costs of certain county-provided services (property tax administration and jail booking), and to levy new taxes in county unincorporated areas. Recent information indicates that most counties will levy the charges, and increased revenue of $220 million is expected from them in 1990-91. This will be insufficient to offset the $430 million in state funding reductions discussed above. Moreover, with respect to these charges, there are a number of significant implementation issues which must be resolved. Until this occurs, it will not be possible to determine the actual amount of revenues counties will receive from these sources. With respect to county adoption of new unincorporated-area taxes, there is no information available yet, but the potential revenue gains are expected to be relatively limited.

Finally, counties will be increasingly affected by recent federal cutbacks in State Legalization Impact Assistance Grants (SLIAG) funding. In 1989-90, the state reduced its funding for the MISP by $100 million, and justified this reduction on the basis of increased funding counties were expected to receive under the SLIAG program. It appears that SLIAG funds actually covered only about 80 percent of this funding reduction for 1989-90 and 1990-91. In addition, the level of SLIAG monies that will be available in 1991-92 is uncertain, and these funds will be unavailable in 1992-93. Thus, it is likely that county costs will increase due to the loss of these funds, or service levels will have to be reduced, beginning in 1992-93.

Local Fiscal Capacity Will Be Weakened. While the lack of current data precludes us from measuring the exact impact of these changes on county LPR, we do see some general trends. Based on the underlying growth rates for state-required program

costs and GPR, we estimate that the gains in county fiscal capacity during 1988-89 and 1989-90 will be temporary. For 1990-91 and beyond, we estimate that county costs for state-required programs will grow significantly faster than GPR—leading to erosions in local fiscal capacity.

Partnership Program Effectiveness

The effectiveness of county-state partnership programs is determined by a variety of factors, including the level of resources committed to them and the nature of the problems that these programs seek to address. In addition, however, they are affected by the way the partnerships for these programs have been *structured.* Program structure leads to reduced effectiveness when it causes decisions to be made that are *inconsistent* with the overall objectives for the program, or precludes actions that would lead to greater effectiveness. Our review has identified several of these structural shortcomings.

Counter-Productive Fiscal Incentives. As an example of this type of shortcoming, we previously have pointed out that the juvenile justice system is structured in such a way that, in many cases, the least effective treatment (the placement of juveniles in Youth Authority facilities) is the least costly alternative available to counties but the most expensive to taxpayers as a whole. (For more information on this issue, please see *The 1989-90 Budget: Perspectives and Issues,* page 319.) In this case, the effectiveness of the program is weakened by the *counter-productive fiscal incentives* inherent in the structure of the program.

Inappropriate Assignment of Responsibilities. The mental health program provides an example of a second type of structural problem that reduces effectiveness. In this case, the state is basically responsible for patients in need of long-term care, while counties take care of shorter-term needs and case management. In some cases, the inability of the state or the county to carry out its part of the program interferes with the overall system's ability to provide the most effective treatment at the least cost. For example, clients no longer in need of long-term care have sometimes been maintained in such facilities because of a shortage of community-based treatment capacity—even though the long-term care is more expensive. Thus, the *current assignment of responsibilities* in mental health programs works against program effectiveness because it imposes artificial barriers to the more efficient allocation of resources.

Failure to Avoid Duplication and Realize Scale Economies. Another example of how the structure of the relationship reduces effectiveness is found in the administration of the AFDC

and Medi-Cal programs. Each of the 58 counties conducts its own eligibility determination, needs assessment, and other administrative functions following general guidelines supplied by the state Departments of Social Services and Health Services. As a result, the counties often duplicate each other's efforts to interpret and implement new state regulations, and the state then expends additional resources to verify the county determinations. If these functions were consolidated at the state or regional level, some of the duplicative effort and verification costs could be eliminated. Further, the state might realize additional savings due to the *economies of scale* offered by consolidation.

Inappropriate Exercise of Administrative Oversight. Finally, a more general type of structural problem occurs across many of the county-state partnership programs, and relates to the state's interest in ensuring that counties run these programs as effectively as possible. Toward this end, the state's oversight activities seek to ensure that the programs are properly targeted, that administrative problems are corrected promptly, and that useful information is available on program performance. The oversight function is carried out generally by requiring counties to submit plans, reports, and case data to the state. However, in some cases the state appears to be making little or no use of this information for its intended purposes. Further, despite the volumes of information collected, there is often little information available at the state level as to who is being served by these programs and at what level. Thus, the *inappropriate exercise of administrative oversight* can reduce program effectiveness by diverting available resources from more productive uses.

These examples are by no means a comprehensive listing of all of the types of structural problems currently characterizing the state's partnership programs. Our review of these programs indicates that structural problems are widespread and significant, and they may fundamentally undermine the overall effectiveness of both state and county government in California.

Summary of Problems

The problems with the existing county-state relationship are generally long-term and structural in nature. They result from the basic structure of the relationship between the state and counties, as well as the revenue constraints imposed by Proposition 13. Given the complexity of factors involved and the diversity of California's counties, it will not be an easy task to find long-term solutions to these problems. Nonetheless, as discussed below, the Legislature should consider individual proposals for program realignment or other measures for addressing county fiscal distress in the context of a comprehensive review of the

county-state relationship. The next section discusses a framework for evaluating proposals to reform county-state relations in California.

A CONCEPTUAL FRAMEWORK: HOW SHOULD THE LEGISLATURE APPROACH MODIFYING THE PARTNERSHIP?

Over the past few years, there has been a growing interest in examining the broad relationships between state and local governments in order to assess whether the existing arrangements for providing services to the public are in need of revision. The term "program realignment" is often used in this context. This is a process for rationalizing (to the extent possible) the *entire county-state system.* This section discusses a framework for approaching this task.

Sorting Out Partnership Responsibilities

The first step in reforming the county-state relationship in California is deciding the extent to which "partnership" programs should be centralized or decentralized in terms of:

- ***Decisionmaking control.*** Should *state* or *local* officials be responsible for establishing service levels, or indeed determining whether a particular service is provided at all?
- ***Funding responsibility.*** Should a program be paid for primarily with state or local resources?
- ***Program administration.*** Who should control day-to-day program operations?
- ***Service delivery.*** Who should actually provide services: State or local government agencies? Private or nonprofit contractors?

Reforming the county-state partnership requires a clear understanding of these responsibilities and the relative capabilities of state and county governments to carry them out. It also requires understanding the fiscal constraints faced by both the state and county governments. Below, we present the basic principles which can guide the Legislature in considering the current and future proposals for reforming the partnership.

Basic Principles of Reform

We have identified six basic analytic principles that are helpful in considering reform of the county-state relationship. Each of these is shown in Figure 3 and discussed below.

Figure 3

Basic Principles of Reform

- ☑ Determine who will exercise program control
- ☑ Link program control and funding
- ☑ Pay attention to incentives
- ☑ Consider cost-effectiveness
- ☑ Address physical capacity
- ☑ Provide for fiscal capacity

Determine Who Will Exercise Program Control. The most important consideration in reforming county-state partnership programs is determining whether the state or the counties should have *primary* responsibility for setting program service levels.

One of the most fundamental requirements for achieving greater effectiveness and efficiency in partnership programs is to ensure that the "right amount" of services are provided. If *too much* is provided, resources are wasted that could have been used more effectively in another way. If *too little* is provided, then the service will not effectively address the problem at which it was directed.

Generally, economists argue that placing program control at the *lowest* level of government possible tends to minimize the potential for over- or under-provision of resources. Figure 4 summarizes four advantages of decentralization—recognition of local diversity, experimentation/innovation, information availability, and citizen access.

Economists also note that, in some cases, state intervention is needed to ensure provision of adequate service levels. There are a number of circumstances where it is appropriate for the state, instead of counties, to determine program requirements. Thus, the assignment of primary control over the setting of

Figure 4

The Advantages of Program Decentralization

Recognition of Local Diversity

If county officials are allowed to establish service levels, they are better able to reflect the service demands of county residents.

Experimentation and Innovation

If a large number of local agencies independently provide a service, it is likely that they each will approach problem solving differently, and in so doing generate more effective and efficient programs.

Information Availability

Given the number and diversity of California's counties, county officials may have better information about local conditions and citizen needs.

Citizen Access

Local control of a program may facilitate citizen access to the decisionmaking process.

program service levels should be based on an *assessment of the need for state intervention*, based on the extent to which the following criteria are true:

- ***Costs or benefits of program operation are not restricted geographically.*** In many cases, the costs or benefits of county action "spill over" into other counties. As a result, under local control a county can end up either paying too little or too much for a service, relative to the benefits it receives. For example, while county public health programs may reduce the threat of communicable disease for *all* state residents, counties may only provide a high enough level of service to address immediate local concerns.
- ***Service level variation will create adverse incentives for migration.*** In this case, local control can lead

to under-provision of services, as communities try to avoid attracting added caseloads due to the migrational impacts of relatively higher benefit levels in public assistance programs. For example, in some counties, general assistance is provided at very limited levels to discourage program usage.

- ***Uniformity is needed to promote state objectives.*** In some cases, the state may see a need to intervene to ensure that certain minimum services are provided for, or to ensure standard treatment under the law. Some types of problems are of a statewide nature and can only be effectively addressed with state control. This is especially true for programs whose purpose is to redistribute income, like AFDC.

Link Program Control and Funding. The government which has primary control over service levels and other program standards normally should also shoulder most, if not all, of the program costs. A strong link between program control and funding ensures that scarce fiscal resources are used in the most effective manner possible. In the absence of such a link, the government paying for the program may be vulnerable to uncontrollable growth in program costs. Moreover, the officials who establish service levels are not directly responsible for program tradeoffs or actual costs to their jurisdiction's taxpayers, so that *accountability* is weakened.

Pay Attention to Incentives. County officials respond to a variety of factors in making decisions about partnership programs, including fiscal incentives that are present in the program context. Some of these incentives are intentionally created by the state for good reasons. For example, sometimes state matching grants are provided which reduce the cost of a particular service from a county's perspective, in order to encourage its local officials to provide a higher level of those services than they would otherwise choose to provide. The state can use this type of incentive when a higher level of service will help to achieve state objectives. In some cases, however, program arrangements can create counter-productive fiscal incentives, encouraging counties to select higher-cost or less-effective program alternatives.

Consider Cost-Effectiveness. The state should consider the cost-effectiveness of alternative program arrangements, including the assignment of responsibility for day-to-day program administration and actual service delivery. Program realignments can offer opportunities to achieve better cost-effectiveness in a variety of ways. For example, in the case of decentralization:

- In some cases, if local officials are given increased discretion over service levels and program operations, they will choose varying approaches to providing services. Some of these program innovations may result in reduced costs or improved program outcomes. In contrast, if the state imposes program standards, there may be less experimentation and innovation, because of the need to have standardized approaches that are consistently applied throughout the state.
- Decentralization also may reduce costs through intergovernmental competition. For example, if one government undertakes cost-reducing measures, other governments may face pressures to undertake similar measures.

In some cases, however, increased centralization can provide benefits. For example, centralization may increase cost-effectiveness if the state government can provide services at a lower cost than counties due to "economies of scale." The state, for instance, might be able to achieve economies in such areas as the development of computer-based information systems that would not be available if each county were to develop its own individual system.

Address Physical Capacity. Some counties may not have the physical resources required to provide certain types of services. For example, small rural counties may not have the public and environmental health technicians needed to ensure adequate protection of public health and safety for residents and visitors. Thus, the state needs to assess their capabilities before decentralizing certain types of state-provided services.

Provide for Fiscal Capacity. In assigning program responsibilities, it is important to ensure that the responsible government (state or local) has adequate fiscal capacity to "take on" a program. For example, if a county has extremely limited fiscal capacity, it may not have the flexibility to make meaningful choices about service levels in discretionary local programs. A partnership system that does not provide for adequate fiscal capacity at both the state and local levels is imbalanced, and this imbalance will eventually undermine the achievement of both state and local goals.

Strategies for Reform

Given these principles, there are many different strategies that can be used to reform the existing county-state relationship, as shown in Figure 5. These include shifting program responsibility and/or revenue capacity from one level of government to another. As shown in Figure 5, there are different ways to

Figure 5

Strategies for Reforming the County-State Relationship

Shift Program Responsibility to Counties

- Provide complete local discretion
- Provide local discretion above mandatory minimum program requirements
- Provide local discretion with state assistance

Shift Program Responsibility to the State

- Completely state-operated
- State-operated with contract providers (may be counties)
- State-operated with local administration and delivery

Allocate Portion of State Revenue Base to Locals

Earmark a share of state revenues commensurate with new program responsibilities. For example:

- Alcohol tax revenue
- General sales tax revenue

Adjust Shared Revenues

- Shift property tax allocations
- Shift vehicle license fee revenue allocations

Provide New Local Revenue Authority

- Property tax override (requires constitutional amendment)
- Other new general or special taxes
- Additional sales tax authority

Provide Other State Grants

- Appropriate general purpose or categorical grants to all counties
- Appropriate fiscal assistance to distressed counties

structure responsibility for partnership programs, depending upon the Legislature's objectives for these programs. The "sorting out" of program responsibilities need not mean total separation of state and local governments; in many cases, they have mutual and compatible interests that can be best served in a *cooperative partnership arrangement* in which both participate but have different roles.

The other strategies shown in Figure 5 basically allow the partnership system to be adjusted to accommodate changes in program responsibility. For example, shifting control of a county program to the state level would increase state costs and lower county costs. This could be offset by reducing the county share of local property taxes and increasing school shares, thereby reducing state expenditures for school apportionments. Such adjustments, however, should be considered in the context of ensuring adequate fiscal capacity at both the state and county levels of government.

We next turn to the Governor's proposal regarding the county-state partnership, and examine its consistency with the basic principles of partnership reform shown in Figure 3.

THE GOVERNOR'S PROGRAM REALIGNMENT PROPOSAL

The *1991-92 Governor's Budget* contains a proposal to transfer the funding responsibility for three existing programs from the state to the counties. Specifically, the proposal would:

- ***Eliminate state General Fund support*** for Short-Doyle local mental health, AB 8 county health services, and the local health services programs, which totals approximately $942 million in the budget year.
- ***Increase county revenues*** by $942 million, through an increase in state-levied alcohol taxes and Vehicle License Fees (VLF).

VLF. Existing law imposes a motor vehicle license fee equal to 2 percent of a vehicle's "market" value. Revenues from the VLF are distributed to cities and counties (according to a statutory formula) after state administrative costs are deducted. (State voters passed a constitutional amendment in 1986 dedicating VLF revenues to cities and counties, in response to several years in which the state used these funds to help balance the state's budget.) Vehicle market values are determined by adjusting the vehicle's *original purchase price* for depreciation, according to a statutory depreciation schedule. The budget proposes to change the existing depreciation schedule, and to revise the definition of original purchase price for newly purchased *used* vehicles. These

changes would raise an estimated $781 million, and almost all of this amount would be allocated entirely to *counties*.

Alcohol Taxes. The budget proposes to raise the state's alcoholic beverage taxes and allocate $173 million of the estimated total increase in revenues ($190 million) to counties. (The remainder would be used to establish a new state drug education program.)

At the time this analysis was prepared, it was not clear (1) how the new revenues would be allocated between individual counties or (2) whether the revenues would be earmarked for local mental health and county health services. These questions have important implications for any assessment of the proposal, as discussed below.

Background—How Do These Programs Work Now?

AB 8. Under current law, the AB 8 (Ch 282/79, Leroy Greene) County Health Services Program provides block grants to counties for funding inpatient care, outpatient care, and public health programs. Most of these funds are used to assist lower-income persons. Each county's allocation is based on a formula consisting of (1) a per capita grant and (2) state sharing funds that must be matched by county funds. This allocation is capped at a maximum amount each year, adjusted annually for inflation and population growth. Counties have discretion as to how to allocate their AB 8 funds between (1) inpatient and outpatient care and (2) public health services, but must agree to maintain overall spending levels as a condition of receiving these funds. This state assistance helps counties meet their underlying obligations to provide health care services for indigent persons and to carry out local public health programs. The state also provides assistance for indigent health care through a number of programs, including the Medically Indigent Services Program (MISP), and the California Healthcare for Indigents Program (CHIP).

Local Health Services. The LHS Program provides public health nursing and environmental health services to 12 counties with populations of less than 40,000 each. The state contracts with these counties for basic preventive health and disease control services provided by state public health nurses and sanitarians. The LHS Program also implements the Public Health Nursing Liaison and Certification Program, which (1) provides general public health nursing consultation to local health departments and (2) receives and processes applications for public health nurse certification in the state.

The LHS Program was statutorily established in recognition of the difficulty that small, rural counties have in (1) attracting and retaining health personnel and (2) providing the variety of public and environmental health services required to ensure community health and safety.

The LHS Program provides the following specific services: sanitation and restaurant inspection, vector and rabies control, child health and family planning activities, communicable disease control, and immunizations. Counties participating in the LHS Program contribute a per capita (55 cents) county match to the state.

Short-Doyle (Community Mental Health Programs). Under the Short-Doyle Act, counties are responsible for planning local mental health programs and providing health services, and the state Department of Mental Health is responsible for overseeing the system. Short-Doyle mental health services are funded primarily from state funds and county matching funds, generally on a 90 percent state and 10 percent county basis. Inpatient hospital services, including state hospital services, generally are funded 85 percent by the state and 15 percent by counties. This state assistance program was created as part of the state's attempt to reduce the number of patients in state hospitals. The high level of state cost-sharing was intended to encourage counties to provide community-based treatment options for state hospital patients, in order to reduce overall system costs and improve effectiveness.

Evaluation of the Governor's Proposal

This section provides our evaluation of the Governor's program realignment proposal. We discuss whether the proposal is consistent with respect to the six basic principles of reform described in the previous section, and identify the likely effects of the proposal on the overall effectiveness of these partnership programs.

Determining Program Control. As described above, efficiency and concerns for maintaining minimum levels of basic services should be the basis for deciding which level of government should control program service levels. State intervention in local mental health and public health programs has been justified on both grounds, due to concern about variation in service levels between counties and access to services. The administration's proposal is at this point ambiguous about the extent of state involvement in these programs that would be present after the funding shift. If the proposal is to *eliminate* state involvement, then the proposal implicitly assumes state

acceptance of service-level variation between counties, including the potential reduction in access by individuals to these services. This may be acceptable to the Legislature if it finds that there is a sufficiently strong local interest in maintaining adequate service levels.

If, on the other hand, the administration's proposal continues the state's present involvement in these programs, then the proposal would not necessarily affect existing levels of service.

Even if the latter is the case, however, an important concern remains. In both of these program areas, there *already* is a substantial variation in service levels across counties. At least some of the existing variance is a reflection of the amount of state funding going to individual counties for these programs. For example, the existing AB 8 program allocations are based on historical spending by counties for inpatient and outpatient care and public health services in 1977-78, adjusted by inflation and population growth. As a result, AB 8 program allocations have not been sensitive to changes in the need for county health services. A similar situation exists with respect to mental health programs where funding levels vary, at least in part, based on when individual counties opted into the original Short-Doyle program. The Governor's current proposal, if allocations are based upon existing state assistance, will essentially "lock in" these inequities, thwarting one of the fundamental reasons for state intervention in the first place—ensuring uniform minimum access to basic services.

Linking Control and Funding. As described above, one of the fundamental principles of reform is that control and funding for a program should be linked. The governmental entity that has responsibility for setting program objectives and service levels in a program should also have primary responsibility for funding the program. Conversely, it can be inefficient and ineffective to vest responsibility for program goals with a government entity that does not pay for the services.

The Governor's proposal is relatively consistent with regard to linking control and funding—if it is implemented without earmarking the new revenues. That is, if the state repeals existing state requirements related to AB 8 and mental health *and* provides the counties with additional general revenues, the counties will have both (1) strong control over service levels and program standards and (2) a large stake in providing them in the most efficient manner, given that they will be responsible for funding them. Conversely, if the state wants to continue to have significant control over program objectives and service levels, then the proposed reliance on *local* revenues as the funding

source reduces the state's accountability for program results. As described earlier, VLF revenues have been clearly designated as a source of funds for local agency purposes by the state's voters.

The Use of Incentives. Incentives should be used to *further* the achievement of overall program objectives, not detract from them. The Governor's proposal poses a number of problems in this area. First, the current division of mental health program responsibilities results in counter-productive fiscal incentives because the prices faced by counties for alternative treatment options do not reflect the overall cost of providing these services. *The Governor's proposal would exacerbate this problem by establishing new counter-productive incentives.* Under the proposal, county costs for the most expensive and institutionalized forms of treatment would continue as at present to be 15 percent of the total costs for state hospitals and zero for treatment provided in Institutions for Mental Diseases (IMDs). In addition, placements in AFDC-FC group homes for children would continue to be available as an entitlement with a 5 percent county match. However, county costs for community-based services, which are less restrictive, generally more cost-effective, and used to prevent institutionalized placements in the first place, could only be provided at 100 percent county cost (versus 10 percent at present). Thus, counties would have a fiscal incentive to choose the most restrictive treatment option, all other things being equal.

Cost-Effectiveness. Program alignment decisions should be made to encourage cost-effective program administration and service delivery. This concept is closely tied to the idea, described above, that it is important to set fiscal incentives so that they encourage the most cost-effective administration and service delivery possible.

To the extent that existing program arrangements restrict local entities from achieving the most cost-effective management at the local level (for example, as the result of forced uniformity by the state in programs even when local conditions vary), then the Governor's proposal might provide some benefit by allowing counties increased flexibility. For example, if the proposed realignment were implemented in a fashion that accorded counties primary program control, then counties might be able to improve the overall cost-effectiveness of their programs through improved targeting of available funds toward the highest local priorities.

In our view, the Governor's proposal would have a limited impact on the cost-effectiveness of county health and mental health programs. It simply does not address the issues which could lead to the achievement of better effectiveness, such as

coordination of state and local program activities, changes in service delivery to achieve economies of scale (such as might come from regional or increased private provision of services), and the incentive issue discussed above.

Physical Capacity. As earlier noted, program alignment should also ensure that the level of government responsible for a program (or a particular part of a program) has the physical capacity to provide the services. For example, as described previously, some counties may not have the physical resources to ensure provision of certain services.

The Governor's proposal makes no direct attempt to ensure that the physical capacity to provide health and mental health services exists at the local level. While significant service delivery systems already exist in many counties, at least several of the smaller counties do not now have the delivery systems needed to ensure provision of medical and mental health services (because they cannot attract and retain providers). Thus, the realignment proposal may undermine the ability of the state and small counties to achieve the overall goals for the programs.

Fiscal Capacity. As discussed earlier, primary control and funding for a program should be vested with the same level of government, and that level of government should have sufficient fiscal capacity to carry out the program effectively. If a governmental entity has the responsibility for funding a program, but does not have the capacity to do so (or lacks the flexibility to improve local fiscal capacity independently), then potential program effectiveness will be compromised.

The effects of the Governor's proposal on county fiscal capacity will depend on whether the new revenues going to counties grow faster or slower than the costs of providing current levels of service in health and mental health programs. For example, to the extent that revenue growth exceeds increases in the costs of the programs, then improved fiscal capacity would occur. In contrast, if revenues grow more slowly than expenditures, fiscal capacity would be reduced.

As regards the Governor's proposal, our analysis indicates that it is unlikely that VLF and alcohol tax revenues will keep pace with the rapid cost increases for providing current levels of service in county health and mental health programs. Specifically:

- ***Revenue growth.*** Although VLF revenues increased relatively quickly during the 1980s, anticipated slower growth in the state's economy (including automobile sales) are likely to slow the rate of growth in VLF

revenues as well. With respect to the alcohol tax, alcohol consumption (and thus revenues from alcohol taxes) is generally on the decline, and is likely to decline further as consumers adjust to the increased prices that result from increasing the tax rates. We estimate that combined revenue from the two sources might grow in the range of 5 percent to 7 percent annually.

- ***Expenditure growth.*** Over the last five years, net county spending for county health and mental health programs (that is, what counties spent after subtracting state aid for those specific purposes) grew on the order of 12 percent to 13 percent annually, and we believe this to be a reasonable proxy for the underlying growth in demand for these services. We have no evidence to suggest that these growth rates are likely to decline over the coming years.

Given the above, growth in the level of program costs required to maintain service levels is likely to be greater than the growth in revenues under the Governor's proposal. This means that *improvements* in county fiscal capacity should not be expected as a result of the Governor's proposal, *except as a result of reductions in the level of services provided by counties*. It should be noted, however, that state General Fund support for these programs has grown relatively slowly (on the order of only 3 percent to 5 percent annually) over the last several years. Thus, the VLF and alcohol tax revenues, while not keeping pace with program costs, may provide a more stable source of funding for these programs than they have had in the past.

Overall Assessment. While the Governor's proposal provides relief from spending pressures at the state level by freeing up $942 million in resources, we find that it is not likely to produce much improvement in the overall effectiveness of the partnership programs involved. With respect to mental health programs, the proposal may actually *reduce* the effectiveness of the existing system. This is because it would establish counterproductive fiscal incentives in the program, as described earlier. With respect to AB 8, it appears that the proposal would have *little* impact on effectiveness. This is because the AB 8 program is only one component of the overall indigent health care system, and improvements depend upon changes in the overall system. With respect to the LHS Program, it appears that the proposal may significantly affect 12 small rural counties' ability to provide public health services. This is because the size and scale of these counties' programs often cannot justify the personnel and resources necessary to ensure that minimum services are provided.

Figure 6

Summary Evaluation of Governor's Proposal

<table>
<tr><th>Realignment Principle</th><th>Mental Health</th><th>AB 8/LHS</th></tr>
<tr><td>Determine program control</td><td colspan="2">- Locals may underprovide these services to the extent that they see the costs as localized but the benefits as widespread. This may occur, since counties cannot restrict migration into the county, and thus may have little control over growth in program costs.</td></tr>
<tr><td>Link control and funding</td><td>+/- If existing mandates are removed, the proposal is relatively consistent with respect to linking control and funding. If mandates are not removed, the proposal is inconsistent.</td><td>+/- While control and funding for public health programs would be made consistent, the proposal would not improve the link between control and funding for the overall indigent care system.</td></tr>
<tr><td>Control of incentives</td><td>- Proposal continues (and may worsen) counter-productive incentives by "reducing the cost" to the counties of the most institutionalized (and costliest) options, while increasing county costs for less intensive, less costly treatments.</td><td>No impact on existing incentives.</td></tr>
<tr><td>Cost-effectiveness</td><td>- Proposal would likely not improve cost-effectiveness of the overall mental health system in the state because of the fiscal incentive for counties to push patients to costlier treatments paid almost entirely by the state.</td><td>No impact on existing cost-effectiveness, other than the potential for minor savings related to changing reporting requirements.</td></tr>
<tr><td>Physical capacity</td><td>No impact on capacity to deliver services.</td><td>No significant impact on capacity to deliver services, except for local public health programs in small counties.</td></tr>
<tr><td>Fiscal capacity</td><td colspan="2">+/- The proposal only improves county fiscal capacity if the new revenues grow more quickly than costs grow, or if service levels are reduced. Since we estimate that new revenue growth will likely not exceed spending pressures, then improved fiscal capacity can only come about through reduced service levels.</td></tr>
</table>

Figure 6 summarizes our basic findings with regard to the Governor's proposal.

STEPS FOR THE FUTURE

Looking beyond the Governor's proposal, what steps, if any, should the Legislature take in the future regarding the county-state partnership?

A Comprehensive Review Is Needed

We believe that a comprehensive review of the entire county-state partnership is needed, given the many problems with the current relationship. Such a review is complicated by the large number of programs that are involved in the partnership and their individual complexities. Nevertheless, we believe that a comprehensive review is merited and that any proposals to reform the current relationship should be developed, if possible, within the larger context of the entire county-state partnership. This offers the best chance for developing a well integrated and consistent set of partnership programs.

What Approach Should Be Followed?

The issue of reforming the partnership should be approached using the general framework and basic principles presented earlier and summarized in Figure 3.

As noted earlier, the most critical step in the whole process is the determination of who will have primary control over the setting of program service levels. In many ways, each of the subsequent steps in the process merely help to facilitate the exercise of this control and ensure that it is exercised effectively.

In actually undertaking this task and applying the partnership framework, there are two more general considerations to keep in mind:

Establish Clear Program Objectives. Many of the existing county-state partnership programs have poorly defined goals and objectives. Having such poorly defined objectives can compromise program effectiveness and reduce accountability. For example, the state requires counties to respond to any report of alleged abuse or neglect of elderly or dependent adults. However, there are no standards for what constitutes an acceptable county response. As a consequence, the level of response varies by county, and has become subject to intervention by the courts.

The Need for Local Fiscal Flexibility. The notion of a shared partnership between the state and counties requires that

adequate fiscal resources be available to each to carry out their responsibilities in providing services, however determined. This, in turn, requires that counties have the ability to select desired service levels and to correspondingly adjust their revenue levels to fund them. In recent years, many counties have faced severe fiscal constraints and have been unable to finance their desired local services. Resolving this problem is an essential aspect of partnership reform.

As a means of resolving the problem, county governments need to have a flexible and reliable discretionary revenue source. This is of vital importance for two reasons. First, a stable and flexible funding source is necessary to ensure the achievement of state and local objectives in partnership programs. This is because local conditions are likely to change over time, and county officials require funding sources adequate to address these changing needs. Second, counties also require adequate fiscal flexibility to respond to citizen preferences for local programs. As general purpose governments, counties need to be responsive to the expressed wishes of local voters. As a result, counties require a discretionary revenue base that local voters can draw upon to fund the programs they desire.

CONCLUSION

As we have described, county-state partnership programs in California are suffering from a variety of problems, including declining local fiscal capacity, program fragmentation, and lack of clear program objectives. These problems are long-term and structural in nature, and need to be addressed in a *comprehensive fashion*. While no process of reform is likely to be easy, following the basic framework presented in this piece can assist the Legislature in beginning the task of reforming the overall county-state relationship.

California's AFDC Program [a]

What Are the Legislature's Options for Controlling Welfare Costs and Reducing Welfare Dependency?

Summary

The Aid to Families with Dependent Children (AFDC) Program provides cash grants to families whose income is not adequate to provide for their basic needs. The principal component of the program—AFDC-Family Group (AFDC-FG)—will cost the state approximately $4.2 billion ($1.9 billion General Fund) in 1990-91.

Despite a relatively strong California economy during most of the 1980s, AFDC-FG caseloads and the welfare "dependency rate" increased significantly over that time. There are various factors that explain these increases, including demographic, societal, and programmatic changes.

Our review indicates that the Legislature has limited options to control AFDC costs other than by reducing grant levels because of the entitlement nature of this program. It does have, however, some ability to change the work incentives inherent in the program. Currently, the AFDC grant structure offers little incentive for recipients to work. In fact, in many cases there are strong disincentives to work. Consequently, in developing legislative options, we focus on policies designed to make it more feasible, or attractive, for actual and potential AFDC recipients to seek and obtain employment and, ultimately, earn enough to leave the welfare rolls.

We identify four options that have the potential for reducing welfare dependency and controlling program costs in the long run: (1) reduce grant levels (as proposed by the Governor), (2) increase the "need standard" above the existing maximum grant, (3) provide medical coverage for the working poor, and (4) increase the number of recipients who receive services through the Greater Avenues for Independence (GAIN) Program. With the exception of the first option, however, all of these options could involve short-term costs to the state.

[a] This analysis was published in February 1991 as a separate Issue Paper.

The *1991-92 Governor's Budget* proposes a significant change in the state's Aid to Families with Dependent Children (AFDC) Program. It proposes to reduce the maximum AFDC grants available while at the same time increasing the incentive for recipients to work. Presumably, the administration's proposal is an attempt to control the program's caseload and the state's welfare "dependency rate," both of which have risen rapidly over the past decade.

In this analysis, we document the recent increases in caseload and welfare dependency in the AFDC-FG Program and identify the factors contributing to this trend. We then examine various options—including the administration's proposal—which are available to the Legislature to help control the program's costs and reduce welfare dependency.

THE AFDC-FG PROGRAM: COST AND CASELOAD TRENDS

The AFDC Program provides cash grants to certain families whose other income, if any, is not adequate to provide for their basic needs. The program consists of three major components, of which AFDC-FG is the largest, accounting for 80 percent of all AFDC cases. Generally, AFDC-FG cases consist of single-parent families, most of which are headed by women. The other major components are AFDC-Unemployed Parent (AFDC-U) and AFDC-Foster Care (AFDC-FC), which account for 11 percent and 8 percent of all AFDC cases, respectively. This analysis focuses exclusively on the AFDC-FG component.

AFDC-FG COSTS INCREASED DURING THE 1980s

In 1980-81, expenditures for the AFDC-FG Program totaled $2.1 billion ($0.9 billion General Fund, $1.1 billion federal funds, and $0.1 billion county funds). By 1990-91, the cost of the program doubled to an estimated $4.2 billion ($1.9 billion General Fund, $2.1 billion federal funds, $0.2 billion county funds). As a percent of all state General Fund expenditures, AFDC-FG increased slightly, from 4.3 percent in 1980-81 to 4.6 percent in 1990-91.

Program costs rose because of cost-of-living adjustments (COLAs) and caseload growth. About 60 percent of the increase in AFDC-FG costs during the 1980s is attributable to increases in grant amounts resulting from COLAs (the COLAs, however, only offset about two-thirds of inflation during this period, as measured by the California Necessities Index). The remaining increase is from caseload growth, which is discussed in detail below.

AFDC-FG CASELOAD INCREASED FASTER THAN THE STATE'S POPULATION

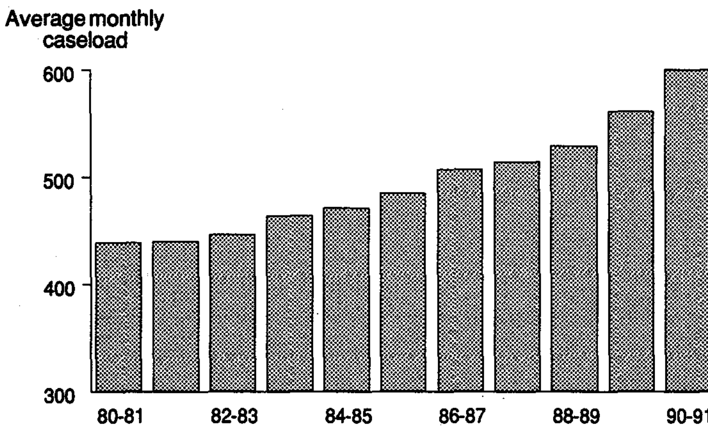
Figure 1 shows that the AFDC-FG Program provided benefits to an average of 439,000 cases each month in 1980-81. The Department of Social Services (DSS) estimates that the average monthly caseload figure for 1990-91 will be 599,600. This is an increase of 37 percent over 1980-81, which reflects average annual growth of 3.2 percent. During this same period, California's population grew by an estimated 2.3 percent per year.

Figure 1 also shows that caseload growth has accelerated significantly in recent years. From 1980-81 to 1985-86, caseloads increased by an annual average growth rate of 2.0 percent. From 1985-86 to 1988-89, caseloads rose by an average annual rate of 2.9 percent. The DSS indicates, however, that caseloads would have increased at a rate of about 4.7 percent annually over this period if two factors had not artificially depressed the caseload level: (1) a short-term drop in the caseload in Los Angeles County due to the implementation of the Immigration Reform and Control Act of 1986 and (2) a diversion of cases to the Refugee Demonstration Project between 1985 and 1989.

Figure 1

AFDC-FG Caseload Has Risen Sharply in the Last Two Years

1980-81 through 1990-91 (in thousands)



Source: Department of Social Services.

The AFDC-FG caseload growth rate in the last two years has been even more dramatic: an increase of 6.1 percent in 1989-90 and an estimated 6.9 percent in 1990-91. The budget projects that the AFDC-FG caseload will continue to grow at this accelerated rate—a 1991-92 increase of 6.0 percent.

Caseload Growth in California Was Higher Than the National Average

One way to place California's caseload growth in perspective is to compare it with trends in other states. During the 1980s, California's caseload increased at a rate three times greater than the national average. Of the 10 largest states, only Texas experienced more rapid caseload growth than California. Besides Texas, only 2 other states, Florida and Ohio, experienced caseload growth on the scale of California, and caseloads actually *decreased* in 5 of the 10 largest states.

CALIFORNIA'S DEPENDENCY RATE HAS RISEN

Not only has the AFDC-FG caseload risen during the 1980s, but so has the state's welfare "dependency rate." This rate is defined as the number of AFDC-FG cases per 10,000 women between the ages of 15 and 44 in the state's population. This is a good indicator of welfare dependency because 75 percent of AFDC-FG cases are headed by women 15 to 44 years of age. (Most of the other cases consist of needy children who live with adult relatives who are not on welfare.) Changes in the dependency rate are significant because they indicate that factors other than population growth are affecting AFDC caseloads.

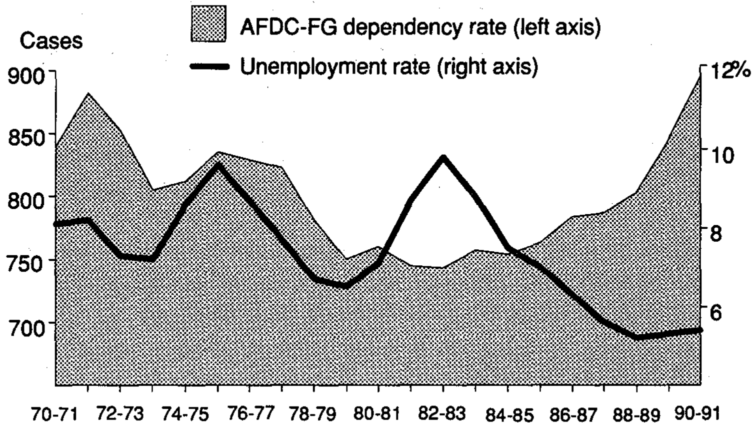
Figure 2 displays changes in California's welfare dependency rate since 1970. It shows that the estimated AFDC-FG dependency rate for 1990-91 is higher than for any other year in this period. The dependency rate has displayed an upward trend since 1982-83, and particularly dramatic growth since 1988-89.

California's dependency rate is high when compared with other states. In 1988 California's rate was 25 percent higher than the national average. Of the 10 largest states, only Michigan, New York, and Ohio had a dependency rate greater than California's. Moreover, between 1983 and 1988 the dependency rate fell in 7 of the 10 largest states, as did the national average. Only California, Ohio, and Texas experienced an increase during that period.

Figure 2

AFDC-FG Dependency Rate Has Risen Significantly in Recent Years[a]

1970-71 through 1990-91 (in thousands)



[a] "Dependency rate" is based on the number of AFDC-FG cases per 10,000 females aged 15-44.

Dependency Rate Has Increased Despite a Decrease in Unemployment

Figure 2 shows that during the 1970s California's welfare dependency rate tracked the state's unemployment rate. Welfare dependency increased during times of high unemployment and dropped off during periods of lower unemployment. As the figure shows, this connection between welfare dependency and the unemployment rate was broken in 1980. Most noticeably, unemployment has declined significantly over the 1980s yet the dependency rate has increased dramatically during that same time. Presumably, the improvement in the economy had some effect in reducing the AFDC caseload, but this effect was outweighed by factors working in the opposite direction.

Length of Time on Aid Has Increased

The dependency rate can increase either because a greater portion of the potentially dependent population is on aid *or* because those who go on aid stay on for longer periods. The available data suggest that at least some portion of the increase

in California's welfare dependency rate has been due to an increase in time on aid. Specifically, surveys of recipients show that, by two measures, the length of time families stay on aid increased during the 1980s:

- The median total number of months on aid—including current and, if any, previous spells on aid—for households receiving AFDC-FG at the time of the survey increased from 32 months in 1981 to 39 months in 1986 (the most recent year for which these data were reported).
- The median length of the current spell on aid also rose, from 22 months in 1981 to 26 months in 1986.

FACTORS CONTRIBUTING TO INCREASING CASELOADS AND DEPENDENCY RATES

There are several factors that help explain the rise in the AFDC-FG caseload and the dependency rate over the past decade. These factors are summarized in Figure 3.

DEMOGRAPHIC FACTORS

Increase in Women of Childbearing Age

As indicated previously, most AFDC-FG cases are headed by women aged 15 to 44. Figure 4 shows the actual and expected growth in this subset of the state's population for the period 1970 to 2010, based on estimates and projections by the Department of Finance (DOF).

Between 1970 and 1980, the state experienced almost 3 percent average annual growth in the population of women aged 15 to 44. In the 1980s, however, the growth rate fell by half as the baby-boom generation aged. During this decade, the number of women of childbearing age rose from 5.7 million to 6.7 million—an 18 percent increase. During this same period, the AFDC-FG caseload increased by 37 percent. Thus, holding all other variables constant, the increase in the population of women in this age group could account for about one-half of the caseload increase.

The DOF's projections indicate that the growth rate of this part of the population will drop even further in the 1990s and in the first decade of the next century. If so, some of the pressure on welfare caseloads should diminish as well.

Figure 3

Factors Contributing to an Increasing AFDC-FG Caseload and Dependency Rate

DEMOGRAPHIC

- ✓ Increase in Number of Women of Childbearing Age
- ✓ Change in Ethnic Composition of State's Population

SOCIETAL

- ✓ Increase in the Proportion of Women Having Children
- ✓ Increase in the Birthrate for Teenagers
- ✓ Increase in Births to Unwed Women
- ✓ Increase in the Cost of Medical Care
- ✓ Shift of Caseload to Low-Cost, High-Unemployment Areas
- ✓ Increase in Nonneedy Relative Caseload

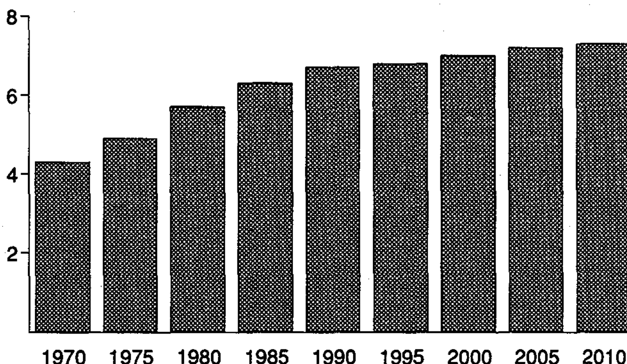
PROGRAMMATIC

- ✓ 1981 Federal Legislation Reducing the Work Incentive

Figure 4

Population Of Females Aged 15-44 In California[a]

1970 through 2010 (in millions)



[a] Projections for 1995 through 2010 are by the Department of Finance.

Change in Ethnic Composition of the State's Population

During the 1980s, the population of California changed significantly to include more members of two groups with higher-than-average welfare dependence: Latinos and refugees. According to the Current Population Survey, the Latino population of the state increased by almost 75 percent between 1980 and 1989, rising from 3.9 million to 6.8 million. The refugee population in the state also surged in this period as California experienced a wave of immigration from Southeast Asia and Eastern Europe. The DOF estimates that California's refugee population (primarily Southeast Asian) nearly tripled between 1980 and 1988, from 175,000 to almost 500,000.

The welfare dependency rate among these two groups—Latinos and refugees—is currently substantially higher than the dependency rate of the general population. In 1990, the AFDC dependency rate for Latino women was 23 percent higher than the rate for all other women. Refugees also have a welfare dependency rate significantly greater than that of the general population. The DSS estimates that nearly half of all refugees in the state are dependent on public assistance. Whether the dependency rate for these groups will remain at these higher levels in the future is unknown.

SOCIETAL FACTORS

Increase in the Proportion of Women Having Children

If an increasingly greater proportion of women have children, a related increase in AFDC caseloads and the dependency rate might be expected. The statewide birth rate rose from 70.4 (births per 1,000 women) in 1980 to 79.9 in 1988, an increase of 14 percent. Since the average family size stayed about the same during the period, this suggests that the increase in the birth rate reflects a trend toward a greater proportion of women having children, rather than an increase in the number of children born to each woman.

Increase in Teenage Birth Rate

The birth rate for teenage mothers increased from 52.5 in 1980 to 59.5 in 1988 (a 13 percent increase). This is noteworthy because teenage mothers are especially prone to welfare dependency. Most of the increase in the teenage birth rate occurred in 1987 and 1988, perhaps helping to explain the escalation of caseload growth that has occurred in recent years.

Increase in Births to Unwed Women

Figure 5 shows that the number of births to unmarried women also increased significantly during the 1980s. Specifically, the number of births to unmarried women grew from 83,373 in 1980 to 152,368 in 1988, an increase of 83 percent. In comparison, the number of births to married women for this same period rose by only 19 percent.

The increase in births to unwed women is significant because unwed mothers tend to have lower incomes and a higher likelihood of going on welfare. For example, according to the most recent AFDC-FG data, over 40 percent of the approved applications are in the "never married" category. In addition, the increase in out-of-wedlock births has been greater during the latter part of the 1980s. This appears to be correlated to the increase in the birth rate among teenage mothers, and adds to the explanation of why overall AFDC-FG caseload increases are higher in the late 1980s than in the early part of the decade.

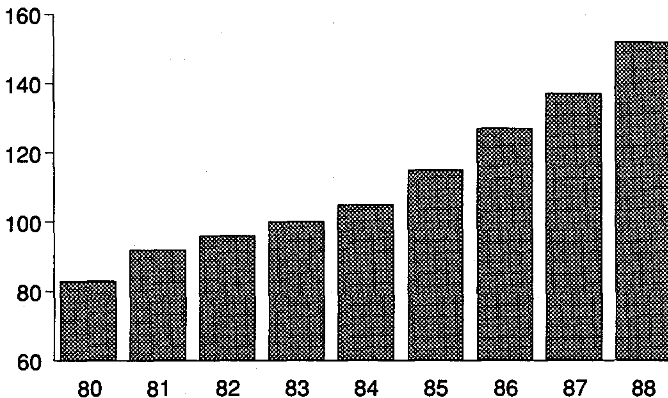
Increase in the Cost of Medical Care

The cost of health care and health insurance could be a significant factor in determining whether someone eligible for

Figure 5

Births to Unwed Mothers in California

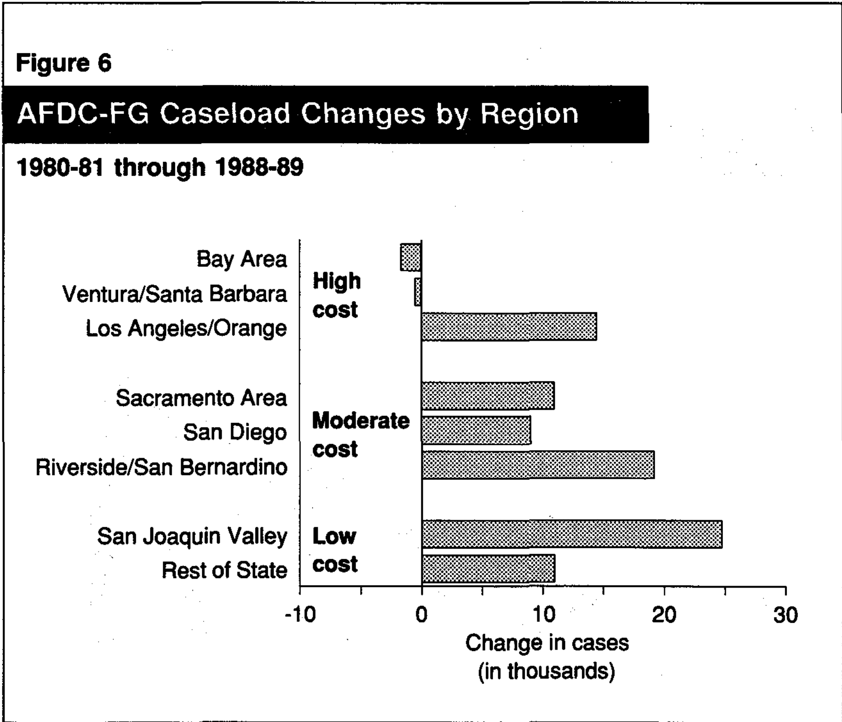
1980 through 1988 (in thousands)



AFDC-FG applies for welfare or seeks employment. This is because AFDC-FG recipients are fully covered under the Medi-Cal Program. The "value" of this Medi-Cal coverage increased significantly during the 1980s, commensurate with the rapid rise in private health insurance costs. Thus, the cost and difficulty of obtaining coverage comparable to Medi-Cal may have contributed to the increase in the caseload.

Shift of Caseload to High Unemployment Areas

Figure 6 shows that during the 1980s, a substantial portion of AFDC-FG caseload growth occurred in the lower-cost areas of the state (basically, counties in the Central Valley and all rural counties). These areas accounted for 41 percent of the total caseload increase even though they accounted for only 14 percent of the state's population during this period. Migration of AFDC-FG recipients from high-cost to low-cost areas of the state is likely to have occurred in order to maximize the purchasing power of the grants, which are the same dollar amount in all 58 counties. This is consistent with anecdotal evidence provided by many county welfare program administrators.



We also note that unemployment has been relatively high in the low-cost areas—an average of 9.7 percent in 1988-89, compared to approximately 4 percent in Bay Area counties and Los Angeles and Orange counties and 5 percent in San Diego County and Sacramento-area counties. If AFDC recipients are in fact migrating to low-cost areas, they may be confronted with fewer job opportunities, thereby making it more likely that they will remain on aid for a longer period of time and contributing to caseload growth in the program. This would also have the effect of increasing the state's welfare dependency rate.

If this is true, it means that the state is—unintentionally—providing an incentive to many recipients to act in a way that *increases* their dependency. One way to reduce this incentive to move is to vary grant levels by region—either by lowering grants in low-cost regions of the state or raising them in high-cost areas. This is currently done by several states.

Increase in Nonneedy Relative Caseload

Another component of the AFDC-FG caseload growth in the 1980s was an increase in the number of cases in which a nonneedy relative acts as the caretaker of a child who is eligible for AFDC. For instance, a child can be placed with nonneedy relatives when the parent is deemed unable to care for the child due to the parent's drug dependency. In these cases, the nonneedy relative receives a grant for the child but not for him or herself. Between 1980 and 1989, the number of these cases in the average month almost tripled, from 15,000 to nearly 44,000.

PROGRAMMATIC FACTORS

1981 Legislation Reduced the Financial Incentives for Recipients to Work

In 1982, California implemented a variety of AFDC rule changes mandated by the federal Omnibus Budget Reconciliation Act of 1981 (OBRA). The major effect of these changes was to significantly reduce the work incentive both to persons *already* on aid and to *potential* recipients (working single parents with incomes near the AFDC grant levels). For instance, prior to OBRA—in 1981—17 percent of AFDC-FG recipients had earned income, which averaged $540 per month. Within one year after the implementation of the OBRA rules, only 5 percent of recipients had earned income and their average monthly earnings had fallen to $295. In 1989, the most recent year for which these data are available, recipients with earned income accounted for 7.6 percent of the AFDC-FG caseload and their average earnings were just $352 per month.

To the extent that the OBRA rule changes reduced the work effort of recipients, they probably contributed to the overall welfare dependency rate increases of the 1980s. This is because recipients who work are substantially more likely to leave welfare than those who do not. For example, surveys conducted in 1988 and 1989 indicate that AFDC-FG recipients who worked were more than twice as likely to leave welfare in a given month than those who did not work.

(For a more complete discussion of the work incentives implicit in the AFDC-FG Program, please see below.)

OPTIONS FOR THE LEGISLATURE

In this section we discuss the Legislature's options for controlling the costs resulting from AFDC caseload growth and for reducing welfare dependency. It is important to note, however, that in the short run the goals of reducing poverty among California's children and of controlling expenditures in the AFDC Program are probably in conflict. Increasing the AFDC grant level, for example, would reduce the number of California families living in poverty, but it would also result in major cost increases to the state. Over the long term, however, it may be possible to work toward both goals by adopting strategies to increase the *nonwelfare* income of poor families and thereby reduce their dependence on welfare.

In this section, we discuss four options for reducing welfare caseloads and the welfare dependency rate in the long run: (1) reduce grant levels to most AFDC recipients (primarily those not working) by lowering the maximum grant below the existing AFDC need standard, as proposed for 1991-92 by the Governor; (2) increase the grants to working recipients by raising the "need standard" above the existing maximum grant; (3) provide medical coverage for the working poor; and (4) increase the number of recipients who receive services through the GAIN Program.

With the exception of the Governor's proposal (Option 1) the options listed above would involve significant *costs* in the *short term*, although each has the *potential* to reduce welfare dependency and thereby generate net *savings* over the *longer term*. In light of the state's current budget problem, it may be difficult for the Legislature to adopt any of these options unless it can find a way to offset these increased costs in the short term.

Because the first two of these options are based, in large part, on the concept of increasing the incentive for AFDC recipients to work, we begin our discussion with an examination of the existing AFDC rules and how they affect a recipient's incentive to work.

THE WORK INCENTIVE IN THE AFDC-FG PROGRAM

Why Is It Important?

Clearly, the state has a strong interest in providing an adequate work incentive in the AFDC-FG Program. Such an incentive not only encourages recipients to minimize their welfare dependency, but also has the potential effect of reducing state costs.

Figure 7 illustrates this latter point. It shows how the AFDC grant level (for a family of three) *decreases* from the *maximum* grant of $694 as a recipient works. As income increases, the state's cost (in the form of grant payments) declines.

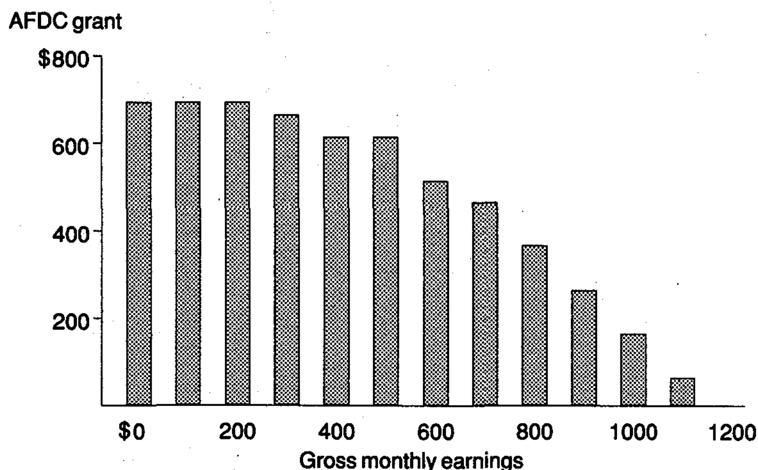
What Are the Work Incentives in the Current Program?

While receiving aid, an AFDC-FG recipient generally must reduce the grant—*on a dollar for dollar basis*—by the amount of any earned income. There are, however, allowances for work-related expenses and the following earned income "disregards:"

- During the first four months of aid, the first $30 and one-third of the remaining earned income are not counted for purposes of reducing the grant.

Figure 7

Grant Reductions Resulting From AFDC-FG Recipients Working[a]



[a] Assumes a family of three with child care expenses.

- During the 5th through 12th months of aid, the first $30 of earned income is not counted.

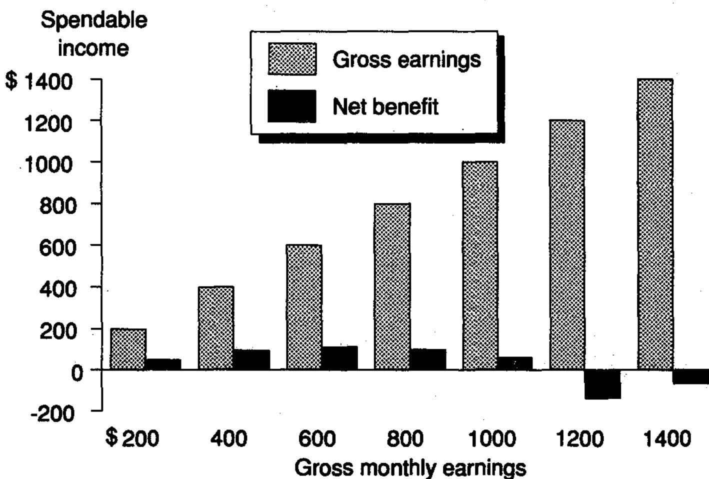
There are many other factors that influence the work-related decisions of AFDC recipients and persons earning income at a level close to the grant levels. For instance, working also affects taxes (including the impact of the federal earned income tax credit) and other benefit programs (such as food stamps).

We have attempted to account for these factors in evaluating the work incentive provided AFDC recipients, as illustrated by Figure 8. The figure shows what a recipient would gain (after accounting for grant reductions, taxes, etc.) from taking a job at various levels of income. For example, a job grossing $800 monthly would result in the recipient being "better off" by about $100. A job paying $1,200 a month, however, would leave the recipient *worse off by $150* (primarily due to the loss of the AFDC grant and food stamps, in conjunction with the continuation of work-related expenses and taxes).

It should be noted that the data in the figure do not reflect the value of Medi-Cal benefits. This is because, for the income range

Figure 8

The Current Work Incentive in the AFDC-FG Program[a]



[a] Assumes a family of three with child care expenses.

shown in Figure 8, families generally are eligible for Medi-Cal coverage whether they are working or not.

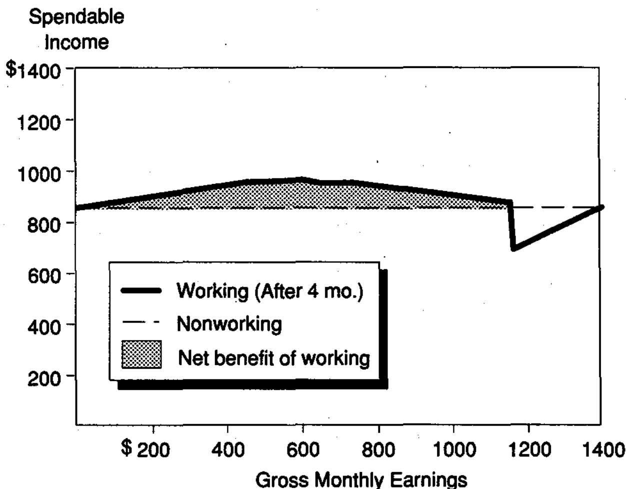
The figure can also be used to show the incentives facing recipients in choosing whether to *increase* their work effort, once employed. For instance, someone currently making $600 and deciding whether to increase earnings to $800 would actually be *worse off*. This can be seen from the fact that the "net benefit" bar becomes *smaller*. This occurs because the additional income is more than offset by grant reductions and taxes.

Figure 9 summarizes the information presented above in a slightly different form, which we will be using later in discussing the options. It shows an AFDC-FG family's "spendable income" (grant and food stamps plus any earned income, adjusted for tax impacts, work-related costs, and expenses such as child care) at various levels of gross monthly earnings. The shaded area between the solid and dashed lines shows the net benefit of working at various income levels.

Figures 8 and 9 present a dramatic picture of the lack of financial incentives to work that characterizes the current program.

Figure 9

Spendable Income for Working and Nonworking AFDC-FG Parents[a]



[a] Assumes a household of three with child care expenses.

At virtually all of the pertinent income levels, *AFDC-FG recipients gain little net dollar benefit—and in many cases come out behind—from going to work or working more.*

It is important to note that this disincentive effect is only of major significance at income levels near the ranges shown in Figures 8 and 9. For example, it is unlikely that the head of a family of three would regard welfare as a significant option if she could find work at $33,300 per year, which was the median income of California households in 1989. The problem, of course, is that many welfare recipients have limited employment prospects beyond entry-level jobs, at least in the short term. Thus, for many recipients and potential recipients, their immediate options involve incomes within the ranges displayed in Figures 8 and 9.

We conclude, therefore, that the fiscal incentives facing a welfare recipient—or potential recipient—have the following adverse effects:

- For individuals who have never been on welfare, the incentives could induce them to go on welfare rather than work.
- For individuals who have worked their way off of welfare, the incentives could induce them to stop working or reduce their level of work and return to the welfare rolls.
- For individuals who are receiving AFDC benefits, the incentives could discourage them from seeking employment or increasing their level of employment.

We do recognize that these findings do not encompass all of the factors that determine whether an AFDC recipient will seek and find employment. For some individuals, the relatively small net benefit of working might be offset by other positive factors associated with working, such as the increased self esteem, potential opportunities for obtaining a better job in the future and the importance of the added income. Other individuals, however, might require a relatively large net benefit from working in order to offset perceived negative factors associated with employment, such as the difficulty of work or the substitution of paid child care for direct parental care. In any case, it appears that there is *relatively little* fiscal incentive for AFDC-eligible parents to work, unless they can earn enough to lift their families well beyond the poverty level.

What Can the State Do to Increase the Work Incentive?

Many of the AFDC grant determination rules that result in the lack of a work incentive, as illustrated in Figures 8 and 9, are

not within the control of the Legislature. For example, the elimination of the "one-third" portion of the "$30 and one-third" disregard after four months is a requirement of *federal* law. *There are, in fact, only two areas in which the state has discretion to change the incentive pattern by altering the manner in which the grants are determined: setting the AFDC "need standard" and setting the AFDC maximum aid payment (MAP).*

Need Standard and Maximum Aid Payment. The need standard—technically referred to as the minimum basic standard of adequate care (MBSAC)—is a schedule, adopted in state law, that reflects each state's determination of the incomes that families of various sizes need to subsist. Many states have need standards that are higher than their MAPs. Thus, they acknowledge in state law that the grants they are willing to provide are not sufficient to support a minimum basic standard of living. Since 1981, California has set its need standard equal to its MAP (except for a slight difference for families of nine or more persons).

The actual grants that working families receive in California are currently determined by subtracting "net nonexempt income" (basically this means earned income less the allowable "disregards") and all unearned income (such as unemployment insurance payments) from the MAP. It would be permissible under federal law, however, (1) to determine these grants by subtracting net nonexempt income from the *need standard,* rather than the MAP, and (2) to set the need standard *higher* than the MAP, either by raising the need standard or reducing the MAP. We examine both of these options below.

OPTION 1—REDUCE THE MAP (GOVERNOR'S PROPOSAL)

As noted above, the only major area of AFDC policy over which the Legislature has discretion under federal law is the setting of the need standard and the MAP. For this reason, the only way to achieve significant savings in the AFDC Program in the *short term* would be to reduce the MAP, either by suspending future COLAs applied to the MAP or by actually reducing it below the current level.

The Governor proposes to (1) reduce the MAP below the existing need standard by an average of 8.8 percent and (2) base actual grants—for those recipients with income—on the need standard. In other words, grants would be determined on the basis of the need standard, but the actual grant could not exceed the new MAP. Figure 10 shows the MAP and need standard for the current and budget years under current law and the Governor's proposal.

The effect of the Governor's proposal generally would be an 8.8 percent reduction in grant levels to *nonworking* AFDC recipients (more specifically, to those who currently have no "net nonexempt income") and a reduction of up to 8.8 percent to some part-time working recipients. Grants to most working recipients would not be reduced because their grants currently are below the proposed MAP.

Figure 10

AFDC MAP and Need Standard Budget Proposal Compared to Current Law

1990-91 and 1991-92

	Current Law MAP and Need Standard[a]		Budget Proposal 1991-92	
Family Size	1990-91	1991-92[b]	MAP	Need Standard
1	$341	$360	$311	$341
2	560	591	511	560
3	694	732	633	694
4	824	869	753	824
5	940	992	859	940

[a] Under current law, the MAP and the need standard are the same for all family sizes except for a slight difference for families of nine or more persons.

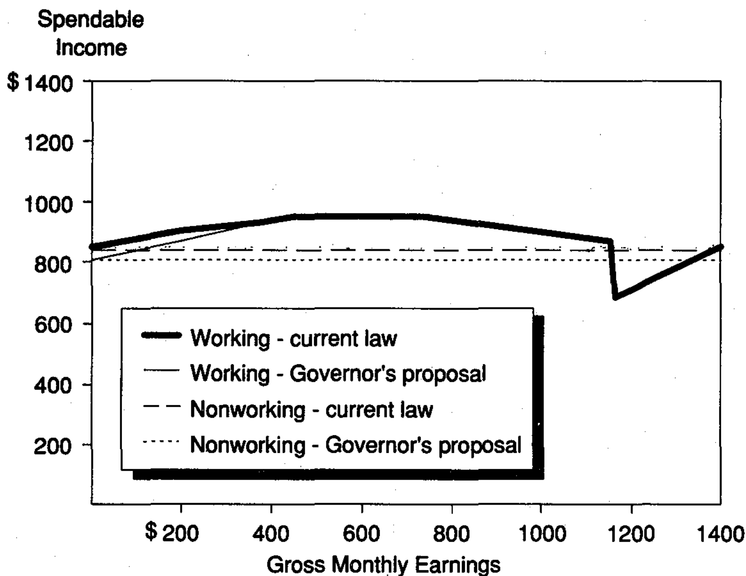
[b] Assumes a 5.49 percent COLA, effective July 1, 1991, based on the estimated change in the California Necessities Index. Current law also provides that this statutory COLA be reduced by up to 4 percentage points if the Commission on State Finance certifies that General Fund revenues are more than 0.5 percent less than the amount needed for a workload budget, as defined.

By reducing grants to nonworking recipients while leaving grants to most working recipients unchanged, the Governor's proposal would increase somewhat the incentive for recipients (and, in effect, potential recipients) to work. The general effect of the proposal is illustrated in Figure 11.

The Governor's proposal reduces "spendable income" to nonworking recipients (the dotted line in Figure 11), which has the effect of increasing the net benefit of working. In our example—a family of three in which a working parent incurs child care expenses—the proposed reduction in the MAP would have no effect on grants allocated to families that have gross earnings exceeding $375 per month. For families with gross earnings of less than $375, grants would be reduced by up to $61. Generally,

Figure 11

Option 1 (Governor's Proposal): Impact of Reduced MAP On AFDC-FG Recipients[a]



[a] Assumes a household of three with child care expenses.

then, the Governor's proposal does increase the work incentive since the dollar gain from working, versus not working, is larger than under current law. It is important to note, however, that it achieves this by allowing recipients to *avoid a loss* in spendable income (by working), rather than to achieve any gain. The overall impact of the proposal on the work incentive would appear to be minimal given the current strong disincentives faced by grant recipients.

Focusing on the impact on nonworking AFDC-FG recipients, grants would be reduced by 8.8 percent, or $61 per month for a family of three, which would be partly offset by an increase of $19 per month in food stamps. Nonworking recipients could offset the proposed MAP reduction by taking a minimum wage job for a few hours a week. On the other hand, for recipients unable to find employment or unable to work for some other reason, a reduction in the MAP would result in a reduction in their spendable income. (Please see our discussion of the fiscal impact of the Governor's proposal in the *Analysis of the 1991-92 Budget Bill.*)

OPTION 2—RAISE THE NEED STANDARD

The Governor's proposal (Option 1) would increase the work incentive by lowering the MAP, thereby reducing the income available to nonworking AFDC recipients. Another approach would be to increase the work incentive by raising the need standard *above* the current MAP. (Both options would also use the need standard, rather than MAP, as the basis for determining the actual grant, up to the level of the MAP.) Figure 12 shows how the implementation of Option 2 would affect the incentive to work.

Figure 12 compares spendable income at the current need standard (heavier solid line) with what the spendable income would be if the need standard were increased to $860 (lighter solid line). We chose this amount as an example because it corresponds to what the need standard would have been if it had received the full statutory COLA in each year since it was created in 1972.

The figure shows that increasing the need standard would increase the work incentive. This increase could be significant for some AFDC recipients. For example, Figure 12 shows that recipients could, by taking a full-time minimum-wage job, increase their spendable incomes by $91 per month (increasing their net benefit of working from $99 to $190 per month) at the higher need standard. To the extent that nonworking recipients respond to the increased incentive, the work experience they gain could significantly enhance their prospects for finding employment at higher wage levels, potentially high enough to carry them beyond the range where they would consider returning to welfare.

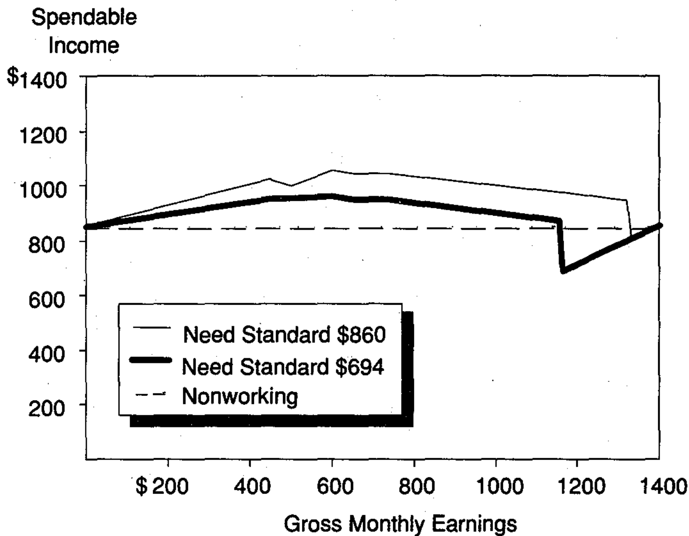
We would note, however, that even with the increased work incentive, many recipients—whether working or not—would *still* receive little net benefit from increasing their earnings, and many would actually *lose* spendable income by increasing their earnings, due to the effect of taxes.

Fiscal Effect of Increasing the Need Standard Above the MAP

The immediate fiscal effect of increasing the need standard would be to *increase* AFDC costs. This is because the increase in the need standard would enable some families, whose income from work currently disqualifies them from receiving a grant, to qualify for a grant. In the near term, these costs could be offset, for instance, by coupling the increase in the need standard with a *reduction* in the MAP. In the long run, however, increasing the need standard could result in net savings, to the extent it

Figure 12

Option 2:
Impact of Increased Need Standard On AFDC-FG Recipients[a]



[a] Assumes a household of three with child care expenses.

increases the incentive to work enough to encourage currently nonworking recipients to work their way off welfare. At present, we have no way of estimating the behavioral response that this option would elicit.

OPTION 3—IMPROVE MEDICAL COVERAGE FOR THE WORKING POOR

As discussed above, the high cost of medical coverage for the working poor (and the related value of such coverage provided to AFDC recipients) has probably contributed to the growth in AFDC-FG caseloads. The Legislature has been considering proposals that would expand medical coverage for all workers. How best to accomplish this end is a complex issue that is beyond the scope of this analysis. It is important to note, however, that if medical coverage were extended to all workers, this could have the effect of reducing the current disincentive for potential AFDC-FG recipients to work.

OPTION 4—EXPAND PARTICIPATION IN THE GAIN PROGRAM

The GAIN Program seeks to reduce welfare costs by moving AFDC recipients into the labor force. Participation in the GAIN Program is mandatory for all AFDC recipients who have children over the age of three, with specified exceptions. Failure to participate can result in the loss of benefits.

Rather than relying on direct financial incentives to encourage recipients to work, the GAIN Program relies on education, training, and helping recipients to find jobs. Based on information presented in Figure 9, GAIN would probably be most successful when it prepares recipients for jobs paying more than $1,400 per month. At this income level and above, the individual is no longer on aid, and there is a positive and rising net benefit from working. (This income level would vary with the worker's family size. Figure 9 relates to the situation of a family of three.)

The effectiveness of the GAIN Program has not yet been determined. Thus, its potential for reducing AFDC costs is unknown. The GAIN legislation required the Department of Social Services (DSS) to contract for a comprehensive evaluation. This evaluation will determine whether the benefits of the GAIN Program (reduced welfare dependency and increased earnings) exceed its costs. It should also shed light on whether making GAIN more "job" oriented, rather than as "education" oriented as it has been to date, would increase its cost-effectiveness. The study is scheduled for completion in November 1992, although preliminary results should be available in October 1991.

The current funding level for the GAIN Program does not allow all eligible recipients to participate. Under the Governor's proposed 1991-92 budget, the program will serve an estimated 208,000 AFDC-FG & U cases, out of about 276,000 who would be served under full funding. One strategy for reducing caseloads and welfare dependency in the long run would be to expand funding for the GAIN Program providing that it is found to be effective. The DSS advises that fully funding the program in 1991-92 so that it could serve all 276,000 potential participants would cost $488 million ($188 million General Fund). This is $159 million ($50 million General Fund) more than is proposed in the budget.

Until the evaluation of the GAIN Program is available, it will not be possible to determine whether increasing program participation would result in long-term savings. Nevertheless, it is important to note that the program is currently the state's only major strategy for reducing long-term welfare dependency.

CONCLUSION

Our analysis of the AFDC program indicates that recipients have relatively little incentive to work. In considering options to control the programs costs, we note that the Legislature's options to alter the work incentives are limited, not only because of fiscal constraints but also because many of the program's grant determination and eligibility rules are set by federal law. There are, however, some state options that would have some effect on increasing the work incentive.

In reviewing the legislative options for controlling AFDC costs and reducing welfare dependency, we find that each has advantages and disadvantages. Generally, efforts to induce welfare recipients to work and nonrecipients to remain off welfare will result in state costs, at least in the short run, or—as in the case of the Governor's proposal—will have an adverse impact on recipients who are unable to find employment in order to compensate for the reductions in their grants.

While it is possible to estimate some of the immediate costs or savings of implementing specific policies based on the options presented in this analysis, we are unable to quantify all of the potential long-term fiscal effects. Information is not available, for example, to project the ability of AFDC recipients to obtain employment or the degree to which they will respond to changes in the work incentives. As a result, we do not have an analytical basis—from a cost-benefit perspective—to recommend that the Legislature adopt any one of these options. We have, however, been able to show how the different options would operate to affect the incentive for AFDC recipients to work. Hopefully, this provides some insight into the potential that these policies have for controlling the program's costs in the long run.

Reviewing these options also may assist the Legislature in evaluating the Governor's budget proposal to reduce the maximum grant below the AFDC need standard—Option 1 in our analysis. We have shown that this proposal would result in immediate savings and, by reducing the grant, would increase the incentive for AFDC recipients to work. As noted above, however, the work incentive itself is very modest; and those recipients who are unable or unwilling to find employment would experience a loss of income.

Community Corrections

Should the Legislature Expand Its Use of "Community Corrections" as a Punishment Alternative?

Summary

Expenditures to support the state's growing prison and parole populations continue to increase at a rapid rate. In addition, the state currently has a limited range of punishment options for many criminal offenders. One potential way to address this growing population in a more effective way is through "community corrections" programs. This approach involves the use of intermediate sanctions as an alternative to state prisons. In evaluating community corrections programs, the Legislature will have to consider the fiscal benefits, public safety issues, and treatment effectiveness of these programs.

There is some evidence indicating that these programs can be more viable corrections alternatives than state prisons in certain cases. However, this evidence is limited, and there is uncertainty about the overall effectiveness of these programs, especially if applied on a large-scale basis. Consequently, the Legislature should take a cautious, evolutionary approach to the expansion of community corrections programs. Specifically, the state should promote small-scale piloting and experimentation with targeted populations, and undertake evaluations of program effectiveness.

The past decade has been one of tremendous growth for the state's prison and parole populations. As a result of this growth, the budget for the Department of Corrections (CDC) has gone from $370 million in 1980-81 to $2.6 billion in 1991-92. As the corrections piece of the budget pie has increased (from 1.8 percent of total General Fund expenditures in 1980-81 to 6.1 percent in 1991-92), the availability of funds for other state priorities has decreased. At the same time, there are many questions concern-

ing whether state prisons are the best place for dealing with certain offenders—especially nonviolent ones.

Given the above, the Legislature has demonstrated an interest in community corrections programs. Generally, these programs provide intermediate sanctions for certain targeted offenders who would otherwise be confined to state prison. The goal of community corrections is to provide more effective treatment and services to offenders, thereby reducing recidivism and state costs.

In this analysis, we: (1) examine the key factors associated with the state's corrections situation; (2) describe California's existing community corrections programs, as well as those of other states; (3) consider questions concerning the viability of community corrections programs; and (4) outline the key issues that must be considered in developing community corrections policies.

BACKGROUND—CALIFORNIA'S CONTINUING CORRECTIONS DILEMMA

In recent years, the Legislature has been faced with a dilemma—unprecedented growth in the state prison population and inadequate facilities to accommodate this population.

Prison Overcrowding Continues to Worsen

Despite the state's massive prison construction program of the past 10 years, prisons are currently operating at 180 percent of capacity. As Figure 1 shows, the CDC projects that prisons will operate at 230 percent of capacity by 1996. Thus, even with the projected addition of another 25,000 beds over the next five years, the state's prison system will be *more* overcrowded by 1996 than it is currently.

The future budgetary implications of these projections are daunting. On an annual basis, it costs roughly $22,000 to support an inmate in a state prison bed. Thus, accommodating the projected prison population growth would result in added costs to the state of roughly $500 million per year in operating expenses and as much as $4 billion in capital outlay costs.

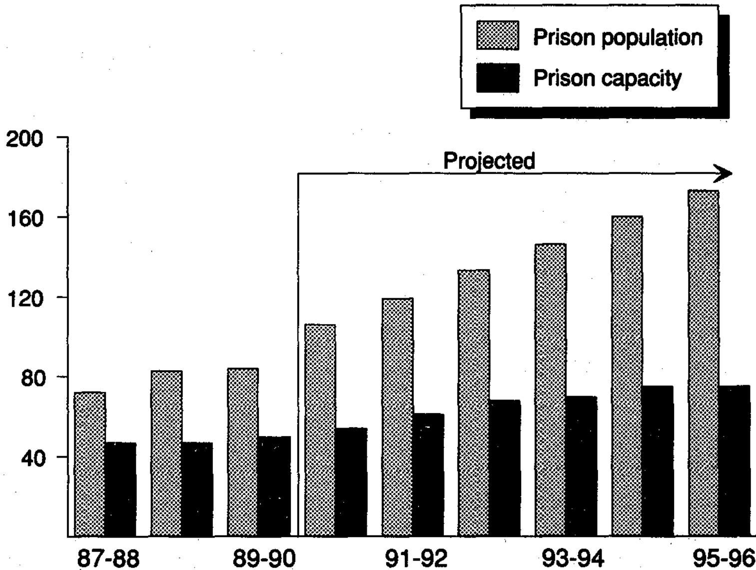
High Parole Revocation Rates—"The Revolving Door"

Many of the inmates currently serving time in prisons are parole violators. Parole violators are inmates who have served their sentences, been released on parole, found in violation of parole, and then returned to prison. California's high parole revocation rate has been one of the driving forces in the state's

Figure 1

Prison Overcrowding Will Worsen[a]

1987-88 through 1995-96 (in thousands)



[a] Based on (1) Department of Corrections prison population projections and (2) projected prison capacity, assuming completion of facilities that are funded.

escalating prison population—the so-called "revolving door" problem. The number of parole violators has grown substantially from about 16,000 in 1985 to over 50,000 in 1990. These parole violators account for up to one-half of the new admissions into state prison.

Most Parolees Return to State Prison. About three-fourths of parolees return to prison while on parole. Parole violators who are returned to custody (PV-RTCs) represent a majority of total revocations. PV-RTCs can be returned to prison for up to one year for technical violations (for example, failure to report to a parole agent) or for new criminal offenses (drug, violent, and property offenses). On the other hand, parole violators with new terms (PV-WNTs) are parolees who, while on parole, are prosecuted and returned to prison for the full sentence of a new crime.

Parole violators are typically committed to prison for a short period of time, but they represent a significant proportion of the prison population—about 34 percent in 1988. The increasing number of short-term inmates presents both a fiscal and programmatic problem for the entire criminal justice system. For instance, the annual costs associated with parole violators who return to prison for technical or drug-use violations—17,000 in 1989-90—is significant. We estimate the state's annual costs to support these additional inmates in state prison to be roughly $100 million.

Drug Use Is a Major Factor. Drug use among parolees is a major factor contributing to the dramatic increase in the number of parole violators returning to prison in recent years. Sixty percent to 80 percent of this population has a history of substance abuse. As a result of a positive drug test or new criminal activity related to their drug use, many substance-abusing parolees are returned to state prison for short periods of time.

Limited Programmatic Options Exist

The state has a limited range of punishment options for nonviolent offenders and parole violators. Generally, at the time of sentencing, a judge can place a nonviolent felon on probation or send the offender to state prison. Once the offender completes a prison term, he or she is placed on parole. If the offender violates conditions of parole, the offender is referred to the Board of Prison Terms (BPT) for parole revocation. At that time, the BPT has only two options: (1) continue a violator's parole or (2) revoke parole and return the parolee to state prison for up to 12 months. Ninety-eight percent of the time, the BPT chooses to send the parolee back to prison. One factor contributing to the prison population problem is the lack of punishment options available to judges and to the BPT. Community corrections programs are one mechanism to increase the punishment options available at the state level.

WHAT IS "COMMUNITY CORRECTIONS"?

Community corrections is *an intermediate sanction that targets offenders who, in the absence of other appropriate sanctions, would otherwise be confined in institutions such as state prisons and local jails.* Community corrections programs provide more services for the offenders (such as drug treatment), with less security staffing and less capital outlay costs. In this piece, we focus on alternative sanctions for certain low-risk persons who would otherwise be confined in a *state prison.* In other words, we limit our discussion to state programs that will likely target nonviolent felon parole violators, inmates who are

sentenced to short prison terms, or inmates who are serving the final months of their terms.

Many community correctional sanctions are served within the community in which the offender committed the offense or in the community in which he or she resides. Programs traditionally considered to be "community corrections" include the use of: community-based residential facilities, house arrest/electronic monitoring, restitution/community service, mandatory drug treatment, and intensive supervision.

What Role Do Local Governments Play?

To date, local governments have played a limited role in California's community corrections programs. However, the role of these entities—especially counties—could expand in the future. Possible roles include providing direct treatment, services, and supervision, or coordination of services provided by private organizations. The local role does not, however, involve incarcerating state inmates in local jails.

Current Community-Based Programs in California

California currently does relatively little in the area of community corrections. Figure 2 summarizes the state's programs, categorizing them into "residential" and "nonresidential" components.

All but one of the state's programs are provided through *secured residential* facilities—generally referred to as the Community-Based Beds (CBB) Program. The CBB Program provides incarceration on a scale smaller than state prison, with treatment and services focused on the nonviolent offender's needs. As Figure 2 indicates, the state's residential programs are limited to just over 3,200 community-based beds in 51 facilities.

The one nonresidential community corrections program—the Substance Abuse Revocation Diversion (SARD) Program—is an intensive supervision pilot program for substance-abusing parolees, operated by the state.

In most cases, the state contracts with private organizations or local correctional agencies to operate community corrections programs. To be placed in one of these programs, an inmate's record must pass a variety of screening criteria. In general, an inmate (1) must not have been convicted of a sexual or violent offense or arson and (2) must not have a history of forced escape, selling drugs for large-scale profits, or serious institutional misconduct.

Figure 2

Current Community Corrections Programs in California

RESIDENTIAL			
Program	Description	Number of Beds	Estimated Annual Cost Per Bed[a]
Return-to-Custody (RTC) (Private, County and/or City) 11 Facilities	Provides parole violators with education and social skills needed to complete parole	1,877	$20,000
Work-Furlough (Private, State) 32 Facilities	Helps inmates with less than 3 months left to serve find jobs and transition back into community	1,087	16,000
Prisoner Mother-Infant (Private) 6 Facilities	Attempts to preserve the bond between the inmate-mother and her child through parenting skills training	114	25,000
Restitution Center (Private) 1 Facility	Encourages the offender to work, as well as accept the responsibility for his/her criminal act	105	17,000
Substance Abuse Treatment Unit (Private) 1 Facility	Provides an alternative placement to prison for parole violators with a substance abuse problem	50	22,000
Total Beds		3,233	

NON-RESIDENTIAL			
Program	Description	Number of Participants	Annual Cost Per Participant
Substance Abuse Revocation Diversion (State) 9 Units	Provides intensive supervision in the community to substance-abusing parolees who are likely to be returned to custody in a state prison for drug violations	1,800	$5,500

[a] Based on Department of Corrections' and Legislative Analyst's estimates.

Recent Legislation Expands the CBB Program. The fastest-growing type of CBB facilities are the return-to-custody facilities that are operated by local governments. As Figure 2 shows, there are 1,877 beds in 11 return-to-custody facilities. The CDC estimates that there will be 2,000 more beds in other facilities by 1992. In addition, the Legislature recently enacted Ch 1594/90 (SB 2000, Presley), which earmarks a total of $15 million from the New Prison Construction Bond Act of 1990 (June) to establish "substance abuse community correctional detention centers." These centers are to be jointly designed and operated by the state and counties.

Community Corrections Options—What Have Other States Done?

The goals and scope of community corrections legislation enacted in other states have varied greatly. Most programs in other states appear to reflect the belief that local governments or private nonprofit organizations are best able to design community corrections programs that fit the needs of the offenders in their community. Some states simply create a mechanism to allow local governments to design a community corrections plan and apply for funding. In contrast, other states are very specific about what programs will be implemented and who is eligible for the programs. The complexity and scope of the community corrections legislation range from initiating a single intensive supervision program, to omnibus legislation creating new sentencing guidelines and a wide variety of community corrections program options. We briefly discuss below some of the characteristics of community corrections programs in other states.

Florida. Florida's 1983 Community Corrections Act created a large-scale house arrest/electronic monitoring program that currently covers about 6,500 offenders. Since local judges are given the authority to place offenders in house arrest programs, a substantial portion (nearly 50 percent) of the program's participants are offenders who otherwise would be on regular probation supervision.

Colorado. Colorado recently implemented a Treatment Alternative to Street Crime (TASC) program for parolees. This is similar to an intensive supervision program for substance-abusing parolees; however, it places more emphasis on improving case management methods and accessing drug treatment services.

Minnesota. Minnesota is generally considered a pioneer of community corrections. Since 1973, Minnesota has provided funding to voluntarily participating local governments to divert

state offenders to community-based residential facilities and, more recently, to house arrest/electronic monitoring programs. It is believed that the success of Minnesota's community corrections program was due, in part, to the phased-in implementation of the county programs.

Kansas. Kansas has generally focused its community corrections efforts on intensive supervision programs. To avoid the expense of new prison construction, Kansas targets about 4,500 low-level felons (such as property offenders) and places them under intensive parole supervision instead of prison.

California Differs From Most Other States. While there are lessons to be learned from other states, the nature of the prison problem in California may be significantly different. For example, California has a greater percentage of violent and substance-abusing inmates than Minnesota or Kansas. Some of the offenders who other states target for their community corrections programs would typically be on probation in California. Thus, it is important to understand that how one state implements community corrections legislation may not translate well to California.

WHAT DO WE KNOW ABOUT COMMUNITY CORRECTIONS?

Although several states have implemented community corrections programs, there is little conclusive information concerning the effects of these programs. For example, although many evaluations of intensive supervision and so-called "halfway house" programs have been completed showing promising results for lower recidivism, few of these evaluations included random assignment of offenders to treatment and control groups. As a result, it is not possible to draw firm conclusions about these programs. Below, we summarize the general information available regarding three aspects of community corrections programs —operational costs, effectiveness in treating offenders, and public safety considerations.

What Does it Cost to Operate These Programs?

Residential Programs. Generally speaking, existing CBB programs are slightly less expensive than a state prison as measured by the average cost of a bed. Most CBB facilities cost the state an average of $18,500 per offender per year, whereas a state prison costs an average of $22,000 per offender per year. The private work-furlough CBB facilities have the lowest cost per year, at approximately $16,000 per offender.

Nonresidential Programs. Intensive or specialized supervision programs such as the CDC's SARD Program cost approximately $5,500 per offender per year. Other nonresidential programs include outpatient drug treatment or specialized case management. The costs of these programs vary depending on the level of services provided, but generally range from $3,500 to $12,000 per offender per year.

A recent U.S. General Accounting Office (GAO) report on intermediate sanctions (such as intensive supervision) concludes that the per capita costs for operating an intermediate sanction is less than operating a prison. However, the GAO report warns that, if the participants are caught committing new offenses while in the intermediate sanction programs, then the additional cost of new prison terms associated with these programs may increase the overall costs of intermediate sanctions above that of a traditional prison bed. This GAO finding illustrates the importance of selecting participants for nonsecured programs who are most likely to successfully complete the intermediate sanction program.

Do Community Corrections Sanctions Provide Effective Treatment?

By far the greatest potential of community corrections programs is the cost savings associated with reductions in overall recidivism rates. To the extent community-based sanctions reduce recidivism, the state would save money in the long run. It is unclear, however, whether these programs actually achieve this end. One reason for this uncertainty is that existing programs rarely track what happens to their participants after they leave, as is the case with CDC's programs. As a result, it is impossible to conclude which of the state's programs, if any, are effective in reducing recidivism. Most studies of effectiveness of residential programs in other states are from the late 1970s and, although offering some positive findings, the methodologies of most of the studies are questionable. There are, however, at least two areas where we have some information on program effectiveness.

Drug Treatment May Reduce Criminal Activity. Mandatory drug treatment programs may be promising as an option for nonviolent offenders. A recent evaluation of drug treatment clients who had formerly been involved in so-called "predatory" crimes (such as robbery, burglary, and larceny) found that clients who remained in drug treatment programs at least 30 days were much less likely to commit crimes, both during and after drug treatment (please see Item 4200 in our 1991-92 *Analysis* for

further discussion of the effectiveness of drug treatment programs).

Research Raises Questions About Effectiveness of Intensive Supervision Programs. Intensive supervision programs include increased supervision of the offender and, in many cases, additional services and treatment. There is little evidence to suggest that increased supervision by parole agents, *in and of itself*, will reduce recidivism or the likelihood of parole violations. For example, a recent study by the RAND Corporation has found that intensive probation supervision alone does not reduce the likelihood of "high-risk" felon probationers to commit crimes. The RAND study focused on intensive supervision probation programs for high-risk offenders in Los Angeles, Ventura, and Contra Costa Counties. The study also found, however, that programs that offered greater access to treatment and services had somewhat lower recidivism rates. Thus, without service availability and clearly defined selection criteria, increased supervision may be of limited effectiveness.

How Do Community Corrections Programs Affect Public Safety?

The potential public safety risk of community corrections programs varies by the structure of the program and the eligibility criteria for program participants. Most CBBs are "secured" *residential* facilities—meaning security personnel are on-site. Consequently, CBBs are unlikely to have much of an effect on public safety. On the other hand, in the case of *nonresidential* intensive supervision programs, the public safety risks are increased, at least in the short run.

This concern emphasizes the importance of selecting low-risk participants to participate in nonresidential programs. Recent research indicates that the selection of participants for these programs is the most important indicator of their success.

WHAT COURSE SHOULD THE LEGISLATURE TAKE ON COMMUNITY CORRECTIONS?

Given the above findings, it is unclear how much community corrections programs can help address the state's overall prison population problem. Nonetheless, we believe that further experimentation with community corrections alternatives is merited, as they can be one of the tools used in addressing the problem. Given the relative inexperience of the CDC in using community correctional programs and the great degree of uncertainty concerning its effectiveness with California's prison population, however, we believe that the best course for the state is an

evolutionary approach—one that promotes voluntary, small-scale pilot projects and experimentation, as well as evaluations of program effectiveness.

Current Efforts Remain Limited. Although the state has begun to expand the existing CBB program, these secure residential facilities represent a very limited range of community corrections programs. While the CBB program was perhaps a reasonable starting point, many CBBs provide limited treatment and services. In addition, the CDC rarely places offenders in CBBs located in the offender's own community. Programs that do not place an emphasis on transitional services (such as substance abuse and job training) are less likely to reduce future rates of recidivism.

KEY ELEMENTS OF A COMMUNITY CORRECTIONS APPROACH

In its approach to community corrections, the Legislature should consider a number of key factors. These are summarized in Figure 3 and discussed below.

Specify Program Goals and Objectives

The first step in approaching community corrections is to clearly specify program goals and objectives. These could include:

- A decline in the parole revocation rate.
- A reduction in correctional operating costs.
- Improved treatment for certain offenders.

These goals should be reasonable and attainable. For example, it would be unreasonable to set as a goal a dramatic decrease in the parole revocation rate (such as cutting the rate in half). A relatively small decrease in the rate might be considered a "success" and would result in savings to the state.

Identify and Target the Eligible Population

The goal of community corrections programs should be to meet the security needs of the community and program needs of the offender. For example, a nonviolent substance-abusing parolee may only need improved case management and an outpatient drug treatment program in order to stay out of prison, and this would not necessarily affect community safety. In contrast, a more violent drug-abusing parolee may need to be placed in a secured residential facility that provides drug treatment programming.

Figure 3

Factors to Consider in Approaching Community Corrections

Specify Program Goals

- ☑ Are the program goals reasonable?
- ☑ Has program "success" been defined clearly?

Identify and Target Program Participants

- ☑ Does the proposed program meet the security and program needs of the targeted offenders?
- ☑ Are there enough offenders to participate in the programs described in the legislation?
- ☑ Are parole violators eligible to participate in the programs?
- ☑ Who is making the placement decisions? Is this likely to increase the number of offenders and, in turn, the costs to the state?

Establish A Funding Mechanism

- ☑ Does the proposed funding mechanism provide incentives for local governments to address a full range of offender needs?

Address Location Decisions

- ☑ Does the proposed legislation create incentives for more urban facilities?

Monitor Program Effectiveness

- ☑ Is a portion of the funding allocated for program evaluations?
- ☑ Does the proposed program evaluation distinguish between motivated participants and effective program treatment?
- ☑ Is the program design flexible enough to incorporate modifications based on future program evaluations?

The CDC has not provided the Legislature with an estimate of the total number of nonviolent state offenders who would be eligible for community corrections programs. There is some question as to the number of nonviolent offenders who would be appropriate for these programs. While probably a small proportion of the total prison population would be involved, even this could translate into thousands of participants.

Avoid "Widening the Net." Many programs in other states have ended up dealing with offenders who would *not* have gone to prison and would have been in a less expensive county probation program. Thus, future legislation must safeguard against this phenomenon. Perhaps a reasonable place to begin is to allow the BPT to place technical and drug-use parole violators into community correctional programs. The BPT could potentially place eligible parole violators in intermediate sanctions, such as residential and nonresidential drug treatment programs, CBBs, or house arrest/electronic monitoring programs.

Establish a Funding Mechanism for Community Corrections

Generally speaking, the funding concerns of local governments related to community corrections fall into two categories. First, many are concerned that future state funding will not keep pace with program costs. Second, many are worried about the state-imposed conditions and standards they would have to adhere to. These concerns stem from the history of California's "probation subsidy" program and recent strained county-state fiscal relations.

Flat-Rate Versus Grant Funding. There are two basic ways for the state to compensate local governments for participating in a particular community corrections program—flat-rate and grant funding. Providing funding for programs at a "flat rate," such as $10,000 per offender, can reduce the incentives for local governments to develop treatment and services according to the individual needs of an offender. This is because programs with costs exceeding the flat rate will be less likely to be provided by local governments. In contrast, the "grant funding" approach would provide funding to local governments based on the merits and costs of their specific grant proposal. Traditionally, under this approach the local government would apply for funding to a state oversight agency to treat a given number of eligible offenders from the local community with a variety of program options.

Address Location Decisions

If the Legislature decides to channel more resources into community corrections, implementation of residential facilities

may be severely hampered by urban siting problems associated with such concerns as public safety.

Other states have experienced siting problems. While Michigan has managed to site facilities in nearly every part of the state, the director of Michigan's correctional agency reported that it took 10 tries for every successful siting. Wisconsin, on the other hand, took a very different approach, and enacted a code that overrides local zoning ordinances. Halfway houses and group homes for mental health are guaranteed the right to locate in every community in Wisconsin.

One strategy that has proven to be partially successful with the CDC's siting of CBBs is to site facilities in light-industry areas. In these areas, it is difficult to distinguish a CBB from other buildings. Most employees in the area are unaware that they work near a correctional facility.

Monitor Program Effectiveness

In order to gauge the effectiveness of community corrections programs in meeting their goals and objectives, it is necessary to carefully monitor and measure their performance. This requires developing meaningful performance measures that correspond to specific program goals. Any community corrections approach should provide adequate funding for well designed program evaluations.

CONCLUSION

In our view, community corrections programs offer the state one additional tool for dealing with its state offender population. Such programs appear to have the potential to reduce state correctional costs and improve the treatment of certain offenders.

There are, however, limits to what these programs can accomplish, especially given uncertainties about their effectiveness. Therefore, while we believe the Legislature should consider increasing its use of community corrections, it should do so in a cautious, evolutionary manner. The general approach should be to promote pilot projects that target specific populations and include evaluations of program effectiveness.

State Infrastructure

How Should the Legislature Address the State's Growing Capital Facility Needs?

Summary

The state is faced with a large and growing need to revitalize and expand its infrastructure. Although it is difficult to estimate with any precision the state's infrastructure needs, it is clear that it is in the tens of billions of dollars. The defeat of various bond measures at the November 1990 statewide election has complicated efforts to address current infrastructure needs and raised concerns over the extent to which bonds can be relied on to meet needs in the future.

Based on the large volume of infrastructure needs and the state's current budgetary situation, we conclude that the state will have to rely heavily on bonds if the state's infrastructure requirements are to be addressed. This will require increasing the proportion of the budget allocated to debt service costs for capital financing. We also continue to believe that the state should rely as much as possible on general obligation bonds, rather than "lease-payment" bonds, in order to minimize General Fund debt service costs.

The above situation underscores the state's need for a statewide multi-year plan that identifies infrastructure needs and the funding requirements for addressing them. Chapter 1435, Statutes of 1990 (SB 1825, Beverly), requires the Department of Finance to prepare a plan and submit it to the Legislature by February 1, 1991. At this writing, the plan had not yet been submitted. Our analysis identifies the information which this document hopefully will provide in order to serve as a blueprint for addressing the state's capital outlay needs. We plan to report to the Legislature once the department's report comes out regarding the extent to which it accomplishes this objective.

During this last decade of the 20th century and into the next century, California will be faced with great demands to revitalize existing infrastructure and develop new infrastructure to meet the dynamic economic and demographic changes occurring in the state. By the term "infrastructure," we mean capital facilities that yield services over many years, such as roads and highways, educational facilities, prisons and jails, utility systems, and parks. During the past several years, the state's existing infrastructure has deteriorated steadily. Some progress has been made in the areas of prisons, education, and recently transportation. The progress in these areas, however, has not kept pace with demands, and little has been done in other areas to meet the state's need for additional infrastructure. This situation must be turned around if the state's infrastructure is to effectively accommodate the state's future needs. Failure in this effort could have a significant negative impact on California's future economic performance and the overall quality of life it can offer its citizens.

In this analysis, we examine some of the major infrastructure-related problems facing the Legislature. These include: (1) identifying the state's infrastructure needs; (2) setting priorities to meet these needs; (3) assessing the state's ability to finance additional bonded indebtedness needed for infrastructure; and (4) establishing a financing plan to carry out the Legislature's priorities, including the extent and timing of future bond measure submittals to the voters.

WHAT ARE THE STATE'S INFRASTRUCTURE NEEDS?

Estimates of Statewide Needs

Any estimates of costs to address the statewide infrastructure problem should be viewed cautiously. On the one hand, the data do not tend to reflect all potential needs due to the incompleteness of the state's capital planning process. This includes the need for various capital expenditures relating to earthquake hazards, some of which became more apparent following the October 1989 Loma Prieta earthquake. On the other hand, infrastructure estimates also may include proposals that, upon close examination, do not actually merit funding. Moreover, definitions of "need" vary greatly from one department to the next.

Regardless of these qualifications, available information indicates that the overall magnitude of the need for improving and expanding the state's infrastructure is very large. For example, in 1984 the Governor's Infrastructure Review Task Force reported that, over the ensuing 10-year period, approximately $29 billion would be needed for deferred maintenance and

Figure 1

Projected Capital Needs for the State and K-12 Education

1991-92 through 1995-96 (in billions)

	Five-Year Total
State/Consumer Affairs	$0.4
Transportation	12.4
Resources	0.7
Health/Welfare	0.2
Youth/Adult Corrections	5.9
Education	19.3
General Government	0.1
TOTAL	$39.0

Source: Legislative Analyst's estimates, based on information from state departments.

$49 billion for new infrastructure. For the most part, state expenditures over the intervening seven years, with few exceptions (most notably prisons, education, and recently transportation), have only served to maintain the status quo and have done little to address the needs identified in the Task Force report. Furthermore, since that report was prepared, California's rapid economic and demographic growth has generated even more infrastructure demands.

Based on planning projections by various state departments, the current magnitude of infrastructure needs for state and K-12 school projects is $39 billion over the next five years. Figure 1 summarizes these projections.

Needs in Specific Program Areas

To illustrate the infrastructure needs of particular programs, we briefly review specific capital outlay requirements in six areas.

K-12 Education. Enrollment in the state's K-12 education system is projected to increase by an average of 210,000 new pupils each year over the next decade (up from projections made one year ago of 140,000 new pupils each year). The State Department of Education (SDE) estimates that school districts will require about $15 billion from state and local funding sources just in the next five years for new school buildings ($12.7 billion), school reconstruction ($1.5 billion), and air conditioning equipment in schools that adopt year-round education programs ($1.2 billion).

The SDE's estimate is based on the assumption that virtually all school districts will build schools which operate on traditional nine-month, rather than year-round, school calendars. In addition, the SDE has assumed that over the five-year period: (1) new school facilities will be needed in order to accommodate 90 percent of the annual growth in enrollment (thus, 10 percent of

the new growth will be housed in existing facilities at no additional cost); (2) 4 percent of all older school buildings will require reconstruction; and (3) air conditioning systems will be needed in one-half of the schools that adopt year-round education programs.

Transportation. The state's current program for transportation contains a total of about $9.5 billion for capital outlay projects to be readied for construction during the period 1991-92 through 1995-96. Of this amount, about $3.3 billion is to complete projects adopted in the 1988 State Transportation Improvement Program (STIP), $4 billion is for projects adopted since 1988, and $2.2 billion is reserved for projects to be identified in later years of this period.

The substantial amount of programming for new projects since the 1988 STIP reflects recent increases in gas taxes and truck weight fees enacted by Ch 105/89 (SB 300, Kopp) and Ch 106/89 (AB 471, Katz) and approved by the voters in June 1990 (Proposition 111). The new programming also reflects voter approval in June 1990 of $1 billion in general obligation bonds for rail projects pursuant to the Passenger Rail and Clean Air Bond Act (Proposition 108). Rail projects programmed during this period, however, are also dependent on voter approval of additional general obligation bond measures of $1 billion each scheduled for the 1992 and 1994 general elections. These amounts do *not* include about $2 billion of projects to be funded under the Clean Air and Transportation Improvement Act of 1990 (Proposition 116) because the schedules for funding these projects have not been determined at this time.

The transportation-related capital programming discussed above does *not* include costs associated with recovery from the Loma Prieta earthquake or of the Seismic Retrofit Program created by Ch 17x/89 (AB 36x, Sher) and Ch 18x/89 (SB 38x, Kopp). The Department of Transportation estimates that the costs of this work will total about $2.6 billion. After deducting federal emergency relief funds expected to be available and state emergency relief funds as proposed in the 1991-92 Governor's Budget, we estimate that there are about $1.5 billion in earthquake and seismic retrofit costs during the 1991-92 through 1995-96 period which, under current law, will need to be funded from resources currently programmed for other transportation capital outlay projects.

Higher Education. Enrollment in the state's three segments of higher education is expected to grow by 30 percent to 50 percent between now and the year 2005. Estimates by the higher education segments indicate that $3.9 billion will be required for capital outlay expenditures over the next five years. (This

estimate does *not* include establishment of any new campuses.) Several billion dollars more will be needed in subsequent years if the state is to accommodate the increased enrollments anticipated by 2005.

Prisons. The Department of Corrections' (CDC) latest five-year plan (April 1990) proposes construction of an additional 51,450 prison beds by 1995 at a cost of about $4.0 billion. Since publication of the five-year plan, however, the department has issued new projections which indicate faster growth in the anticipated inmate population. Based on these latest projections and using the CDC's average per-bed construction cost and its current overcrowding policy, we estimate that new bed construction needs will total $5.0 billion over the five-year period, or $1 billion more than the CDC's April 1990 plan.

State Office Buildings. The Department of General Services' five-year cost estimate for state office buildings is $400 million. However, this figure is understated. This is because the plan does not sufficiently address implementation of the state's Capitol Area Plan goal of accommodating about 90 percent of Sacramento state office space needs in state-owned buildings. This goal was to be attained by 1987. The percentage of state-owned office space in Sacramento, however, has actually decreased from 64 percent in 1977 to 52 percent in 1989, as the state has elected to house more employees in leased space. The department's five-year plan also does not address the future of the Oakland State Office Building, which was damaged in the Loma Prieta earthquake and remains closed.

Seismic Safety of State Buildings and Public School Buildings. Information is incomplete regarding the need to make state buildings more earthquake-resistant. In an important first step, the Office of the State Architect has begun a seismic survey program covering all state-owned buildings, including those of the University of California and the California State University, along with all public school buildings. This effort should result in priority lists and preliminary cost estimates for those buildings that require upgrading to improve earthquake resistance. The issue of seismic safety cuts across most capital outlay program areas and will increase future capital outlay funding needs to an unknown, but significant, extent.

In June 1990, the voters approved a general obligation bond issue that included $250 million to upgrade state-owned buildings (excluding university buildings) that would be unsafe during an earthquake. These funds will only partially address the financing needs in this area.

How Firm Are These Estimates of Infrastructure Needs and Costs?

The infrastructure "needs" described above are not absolute, and can change depending on policy decisions made by the Legislature. In other words, the Legislature could modify current policies in various program areas, the effect of which could be to reduce state infrastructure-related expenditure needs.

For example, in areas where the state finances local infrastructure—such as K-12 schools, community colleges, and county jails—the Legislature could return these funding responsibilities to local agencies. The state could assist local governments to meet their resulting increased financial responsibilities by seeking to eliminate the two-thirds vote requirement on local bond issues (the Governor's Budget proposes this for local jails and schools). Improved local access to this capital outlay funding source would allow the state to institute or increase local matching fund requirements or eliminate state financing altogether.

The Legislature also could adopt policies that encourage more intensive use of existing capital facilities. For example, it could more strongly encourage school districts to use year-round education to reduce the need for construction of new facilities. Increased year-round use of facilities is a strategy that also could be employed at higher education institutions to reduce needs. Other options in this area include (1) deferral of projects that do not directly accommodate enrollment, (2) expansion of existing campuses in lieu of creation of new campuses, and (3) limits on graduate and/or undergraduate enrollment.

Another example involves prisons. Options available to reduce the rate of inmate population growth—and thereby the need to build additional state prisons—include (1) placement of certain nonviolent offenders in community-based facilities (please refer to our piece on Community Corrections in this document) and (2) changes in parole supervision to reduce the number of parole violators returned to prison. Another option to reduce the need for more prisons is the adoption of higher overcrowding ratios for prisons.

Given the above, there is considerable latitude in determining exactly how much infrastructure "needs" to be funded. Even after accounting for this factor, however, there clearly is a large volume of basic infrastructure needs that will require funding.

WHAT OPTIONS EXIST FOR FINANCING INFRASTRUCTURE NEEDS?

As we have discussed in previous analyses, there are three basic ways that the state can meet its infrastructure needs. Specifically, the state can:

- Pay "up front" for facilities through direct appropriations of state revenues.
- Rent, lease, or lease-purchase facilities from private parties through annual rental or lease payments.
- Acquire facilities by borrowing money through issuing bonds that are repaid over time with interest.

The state uses each of these financing methods to some extent at present, but relies most heavily on bonds. Although bond financing is about 25 percent more costly than paying "up-front" for capital facilities (after adjusting for the effects of inflation), the large volume of infrastructure needs that presently exists in conjunction with the state's current tight budgetary situation makes it impossible to rely primarily on direct appropriations. Likewise, rental and leasing markets are simply not available for many of the types of capital facilities that the state requires. As a result, we believe the state will have to continue to rely to a great extent on bonds, if its infrastructure needs are to be addressed.

Issues Raised by the Need to Use More Bonds

As discussed above, the sheer magnitude of the state's infrastructure needs compared to available resources makes continued heavy reliance on bond financing inevitable. This situation raises two issues:

- What is the state's current bonded indebtedness situation, and what does this imply about the ability of the state to issue more bonds and the wisdom of doing so?
- What steps need to be taken to ensure that the most effective possible use of bonds occurs?

STATE BONDED INDEBTEDNESS— WHAT IS OUR CURRENT SITUATION?

Types of Bonds

The State of California uses bonds for many different purposes, ranging from financing public infrastructure like schools, prisons, and parks, to assisting private-sector small businesses and home buyers. The state's bonds generally are classified as

either general obligation bonds or revenue bonds, based on the type of financial resources that are pledged to repay them. Figure 2 summarizes the state's current bond programs that fall into each of these two categories.

General Obligation Bonds. These are bonds whose principal and interest payments (that is, debt service payments) are guaranteed by the full faith and credit of the state's taxing authority. These bonds require voter approval and offer investors a very high degree of security. Repayment of the principal and interest on these bonds comes directly from the General Fund, or is pledged to do so if other resources backing them prove to be insufficient.

Within the classification of general obligation bonds, there are two specific types of bonds that the state issues: self-liquidating and non-self-liquidating bonds. A self-liquidating general obligation bond is one that, although backed by the full faith and credit of the state, has its debt service paid from revenues generated from the project or program that the bonds fund. (An example is veterans' housing bonds, whose debt service is paid from the monthly mortgage payments made by the veterans.) Conversely, a non-self-liquidating general obligation bond is one whose debt service is directly paid for by the state's General Fund.

There are currently about 60 different individual state general obligation bond acts which fall under the 25 general program areas shown in Figure 2. These programs provide funding for a variety of purposes, including water treatment, environmental cleanup, parks, senior citizen centers, school construction, state prisons, county jails, and home purchases.

Revenue Bonds. These are bonds whose debt service payments generally are legally secured only by revenues from the projects that their proceeds finance or from some other restricted source, rather than the state's full taxing power. Examples include bonds used for pollution control facilities, student dormitories, housing mortgages, toll bridges, and water resources development. Generally speaking, revenue bonds do not require voter approval, and are not paid for by the General Fund. The one exception involves so-called General Fund lease-revenue bonds, which the state uses to fund some prison projects and higher education facilities. These bonds do not require voter approval, but their debt service *is* paid for by the General Fund even though they are not general obligation bonds. Specifically, the debt service on the bonds is paid using annual General Fund appropriations made to the occupying state department for "lease" payments on the facility. Thus, we refer to these bonds as lease-payment bonds rather than lease-revenue bonds.

Figure 2

Current State Bond-Funded Programs

General Obligation Bond Programs, by Purpose	State Revenue Bond Programs, by Issuing Agency
Beach, park, recreational facilities	California Alternative Energy Source Financing Authority
Clean water	California Educational Facilities Authority
Community college construction	California Health Facilities Financing Authority
Community parklands	California Housing Finance Authority
County correctional facilities	California Industrial Development Financing Advisory Commission
County jail construction	California National Guard
First-time homebuyers	California Passenger Rail Bond Authority
Harbors	California School Finance Authority
Hazardous substance cleanup	California State University Trustees
Health sciences facilities	California Student Loan Authority
Higher education	California Transportation Commission
Lake Tahoe land acquisition	California Urban Waterfront Area Restoration Financing Authority
State prison construction	Department of Water Resources
Park and recreational facilities	Hasting College of Law
Parklands acquisition and development	State Public Works Board (energy conservation and cogeneration projects)
Recreation, fish, and wildlife	State Public Works Board (general capital outlay projects)
Safe drinking water	University of California Regents
School building aid	Veterans' Revenue Debenture (housing loans)
School building lease-purchase	
Senior centers	
State office buildings	
State, urban, and coastal parks	
Veterans' farm and home loans	
Water conservation and quality	
Water resources development	

Source: California State Treasurer.

Current General Fund Debt Levels

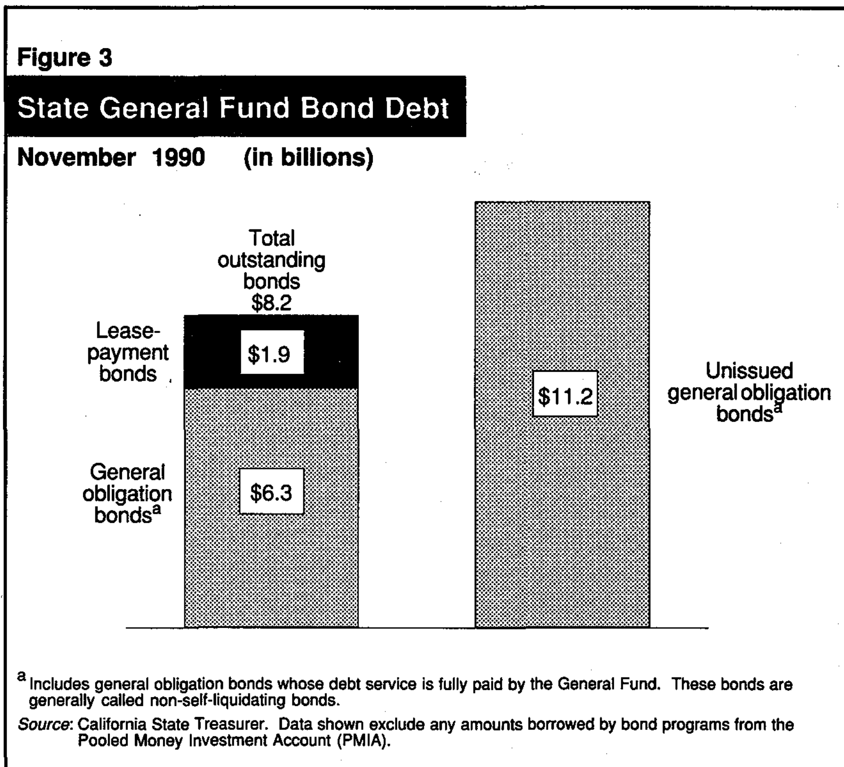
Our primary focus in the remainder of this piece will be on General Fund bonds—that is, non-self-liquidating general obligation bonds and lease-payment bonds—as these are the only bonds that impose direct costs on the state.

Figure 3 shows that, as of November 1990, outstanding General Fund bond debt totaled $8.2 billion. This included $6.3 billion in general obligation bonds and $1.9 billion in lease-payment bonds. In addition, there were $11.2 billion in authorized but unissued general obligation bonds.

Figure 3

State General Fund Bond Debt

November 1990 (in billions)



[a] Includes general obligation bonds whose debt service is fully paid by the General Fund. These bonds are generally called non-self-liquidating bonds.

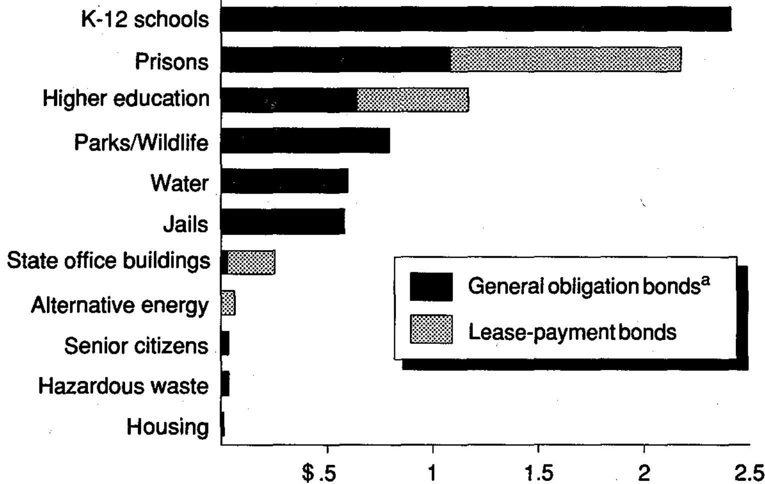
Source: California State Treasurer. Data shown exclude any amounts borrowed by bond programs from the Pooled Money Investment Account (PMIA).

The Mix of Outstanding General Fund Bonds. Figure 4 summarizes how the state's outstanding General Fund bonds are distributed, by purpose and bond type. About 70 percent of the state's total outstanding bonds are for school lease-purchase programs, prisons, and higher education.

Figure 4

Outstanding General Fund Bonds, By Program Area and Type

November 1990 (in billions)



[a] Includes non-self-liquidating general obligation bonds.
Source: California State Treasurer.

What About the Level of Unissued Bonds?

As noted above, as of November 1990, there were $11.2 billion of general obligation bonds that had been authorized by the voters of California but not yet sold. There has been considerable interest in recent years why so many bonds remain unissued. There are several reasons for this.

The Role of PMIA Loans. One of the primary contributors to the current level of unissued bonds has been the federal regulations governing tax-exempt bonds. In order for the general obligation bonds sold by the state to be federally tax-exempt, the state has had to adhere to federal laws regulating bond proceeds. The Federal Tax Reform Act of 1986 generally required that the proceeds from the sale of tax-exempt bonds be spent within six months of the sale. Due to the length of time required to initiate and complete capital projects, the state chose to delay bond sales until the projects were nearing completion. Interim financing

arrangements were used to pay for the projects through the state's Pooled Money Investment Account (PMIA), and then bonds were issued to pay off this interim financing.

These federal requirements were modified in 1990 to generally allow a period of two years for the expenditure of bond proceeds. As a result, the state has been taking steps to accelerate the sale of bonds and eliminate the need for interim financing. Thus, the "built-in" delays in the sale of bonds that resulted from the federal requirements should be less of a factor in the future. At the present time, there are approximately $2.2 billion in outstanding PMIA loans to General Fund bond programs, for which bond sales have been pledged.

Program-Related Factors. Apart from PMIA loans, the level of unissued bonds is dependent upon the interrelationship between two factors: the amount of new bonds authorized by the voters in election years and the amount of bonds sold each year. Only if bonds are sold faster than they are authorized will the level of unissued bonds decline. The amount of bonds sold in any year depends primarily upon the state's readiness to use bond proceeds, including whether it has carried out the activities necessary to proceed with the sales such as the planning of the projects themselves. Generally, once bond programs are prepared to use their proceeds, commitments for bond sales are made.

In recent years, bond sales have increased steadily and are expected to total $3.1 billion in 1990-91. The budget anticipates, however, that bond sales will be $2.5 billion in 1991-92. At this rate of sales, the backlog of unissued bonds would not decline by much in the future, unless the volume of new bond authorizations from subsequent elections was significantly less than that of 1988 and 1990.

The Debt Burden

The increased volume of new bond authorizations and sales in recent years has raised some concerns about whether the state's debt level is "too high," and whether the annual cost of paying off this debt is imposing an excessive financial burden on the state budget and California's taxpayers. Clearly, *if* such conditions exist, additional bond usage could be undesirable.

Is There Too Much Debt Right Now? There is no single correct answer to the question of how much state debt is "too much," since this depends upon one's opinions about what share of the state's financial resources should be devoted to providing public infrastructure, how capital projects should be financed,

and how their costs should be spread over time. However, there are at least two reasons for concluding that California's current debt service is *not* a significant problem at present:

- ***The debt service cost is a relatively small share of state expenditures.*** Although debt servicing costs on General Fund bonds have increased significantly in recent years, they still amount to well under 3 percent of estimated total General Fund expenditures in 1990-91. This is well below the national average for states of between 4 percent and 5 percent.
- ***The state's bond ratings are high.*** As of this writing, California's general obligation bonds have the highest ratings possible by all three of the nation's major bond rating agencies. Generally speaking, a state is not given bond ratings as high as California's if it is perceived as having an excessive debt burden. California was recently (January 1991) placed on "credit-watch" status by one of these bond rating agencies. However, this appears to be related to concern over the state's fiscal condition, not the level of bonded indebtedness. The state's bond ratings themselves have not yet been affected by this change.

It also is important to note that California's debt is used primarily to finance public and private long-term capital assets, not short-lived assets or operating costs. (For a discussion of exceptions to this general rule and our related recommendations, please see our following piece on uses of bond proceeds.) Virtually all of the state's debt-servicing payments essentially represent the public's ongoing costs for using capital assets *currently generating benefits* to them. Economists agree that this type of debt can be economically justified, and is fundamentally different from the federal government's debt, most of which has been incurred simply to finance ongoing operational expenses.

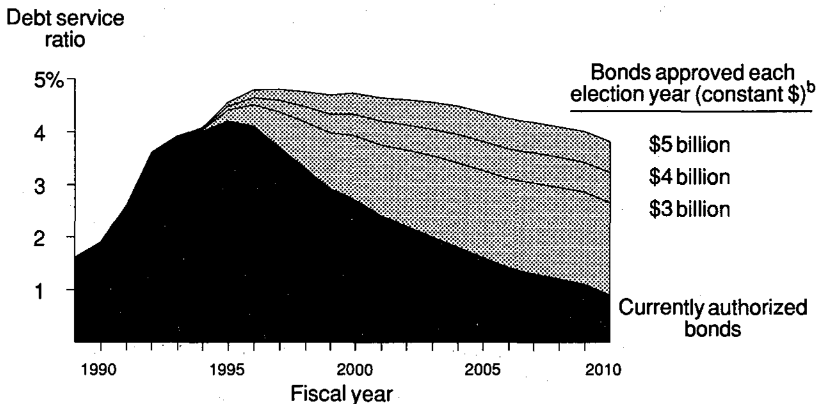
Given the above, there is no evidence that California's current debt burden is excessive or poses any significant fiscal threat at this time. Clearly, this does not mean that the state can afford to issue bonds in limitless amounts or use them indiscriminately in the future. However, it does mean that *there is sufficient "room" for the state to continue issuing bonds in the future for financing its basic long-term capital needs.*

What About the Future Debt Burden? As indicated above, the state has yet to sell about $11 billion in authorized general obligation bonds. Figure 5 shows that, as these bonds are marketed in the coming years, the state's debt service ratio (the ratio of General Fund debt service to General Fund expenditures)

Figure 5

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

1988-89 through 2009-10



[a] Data shown are for fiscal years ending in years specified. The "debt service ratio" represents General Fund costs for paying off non-self-liquidating general obligation bonds and lease-payment bonds, plus net cost of loans prior to bond sales, as a percent of total General Fund expenditures. Projections assume that new and existing-but-unissued bond authorizations are fully marketed within four years and paid off over 20 years at an average interest rate of about 7.5 percent.

[b] Constant 1992 dollars. In current dollars, the dollar amounts shown would grow by about 10 percent for each election year after 1992.

will increase from the current estimated level of 2.6 percent for 1990-91. The figure indicates that the projected debt service ratio will increase to about 4.2 percent in 1994-95, and then decline thereafter, assuming no additional bonds are authorized in future years and given reasonable assumptions regarding the pace at which bonds are sold.

Figure 5 also shows what the state's debt service ratio would be, assuming that various additional amounts of general obligation bonds are approved by the voters and sold in the future. For example, if the voters were to approve an additional $5 billion of general obligation bonds in each future election year (with increases for inflation), the state's debt service ratio would peak at about 4.8 percent in 1996-97 and then begin to decline slowly. Thus, even in this case, the debt service ratio would remain manageable and not exceed the national average.

Should There Be a Limit 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. It is our view that California does *not* need a debt limit. 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 be sought simply to avoid direct spending, the use of a capital outlay planning process (see below) should act as an effective "screening device" to help minimize inappropriate uses of the state's bond authority. Thus, *the key thing for the Legislature to focus on is not how many bonds to issue per se, but rather the trade-off between using state revenues to pay debt service on bonds needed to fund infrastructure, versus using these revenues to support or enhance other state programs.*

Implications of the November 1990 Election

In November 1990 California's voters were asked to approve 14 bond measures authorizing some $5 billion in new bonded indebtedness. Historically, with few exceptions, the voters have approved similar bond measures. This time, however, all but two measures failed—an $800 million measure for K-12 school construction and a $400 million measure for the veterans' farm and home purchase (Cal-Vet) program. The failure of the other 12 bond measures to pass raises concerns over (1) the extent to which general obligation bonds can necessarily be counted on to meet infrastructure needs in the future and (2) how to meet immediate infrastructure needs, given that most of the bond money sought in November 1990 will not be available.

To address the first concern—the availability of bonds in the future—we believe the most important step to be taken is to improve the state's capital outlay planning process (see discussion below). As to the immediate funding problem, the defeat of various bond measures in the November election has created significant funding "gaps" for the 1991-92 fiscal year in areas such as state and local correctional facilities, higher education, and parks. The following is a brief discussion of implications of the funding "gaps" for higher education and state prisons.

Higher Education. California's voters denied a $450 million measure for higher education facilities in November 1990. The capital outlay spending plans of the higher education segments (University of California, California State University, and community colleges) called for $690 million in 1991-92, based

partly on the assumption of passage of this bond measure. Although it may be that, upon examination, not all proposals in the segments' plans would necessarily merit funding, failure of the bond measure definitely limits the state's ability to address the priority needs of these plans. For example, the *1991-92 Governor's Budget* provides only about 55 percent of the funding requested by each segment (the majority of proposed funding is with General Fund lease-payment bonds). Moreover, the capital outlay projects either (1) proposed in the budget or (2) previously approved by the Legislature will require an estimated $650 million to complete. In addition, the spending plans do not include any proposals for new campuses that may be required to accommodate future enrollment growth.

For a more detailed discussion of higher education facility needs, including the funding gaps for financing them, please see our overview of higher education capital outlay in the *Analysis of the 1991-92 Budget Bill.*

Prisons. The defeat of the $450 million bond measure for new prison construction leaves the Department of Corrections (CDC) without adequate funds to complete its proposed program. The CDC's current five-year plan calls for construction of an additional 51,450 prison beds by 1995, at a cost of $4.0 billion. To fund the 1990 portion of the program, the Legislature enacted Ch 981/90 (SB 549, Presley), appropriating $692 million for construction of 14,650 beds. Of this amount, the Legislature appropriated about $280 million from the bond fund that subsequently was denied approval by the voters in November. Thus, the failure of the bond measure leaves the CDC without enough general obligation bonds either to (1) complete all the projects already approved by the Legislature or (2) construct additional prisons in the future.

Lacking significant policy changes, inmate population will continue to grow rapidly and the state, for all practical purposes, will need to spend at least $4 billion by 1994-95 to construct new prisons. Furthermore, the need for new prisons would not end at that point, as similar amounts probably will be needed during the following five-year period. Thus, a significant funding gap will exist unless the Legislature adopts other policy options to reduce this growth and thereby reduce the need for additional prisons.

WHAT STEPS NEED TO BE TAKEN?

In order to address its pressing infrastructure needs and related bond financing needs, we have previously said that the state needs a statewide capital outlay plan to (1) identify and prioritize infrastructure needs and (2) serve as the foundation for

a financing plan to establish the extent and orderly timing of bond authorizations. The Legislature enacted a capital outlay financing plan requirement in 1990 which, hopefully, will accomplish this objective. This section discusses the types of information the Legislature needs to make informed decisions in this area, what the new legislation provides for, and several other issues involving how best to address and finance the state's infrastructure needs.

To date, the state's process for identifying, ranking, and financing its capital outlay needs has been fragmented. The Legislature has received a series of independent five-year plans in most program areas, but there has been no centralized compilation nor ranking of projects across programs to provide a statewide perspective. Moreover, each department has developed its plan in the absence of uniform guidelines regarding the identification of programmatic objectives and the evaluation of programmatic needs. Not only has each plan been developed in isolation from the others, but, once developed, no effective process has existed to bring the plans together to reflect statewide priorities.

As a result of these problems in the planning process, there has been no easy way to identify either (1) the relative priority of various programs and proposals or (2) the financing required to address overall state needs.

What Information Is Needed?

In order to meet the state's infrastructure needs, the Legislature should have a capital outlay plan containing specific information concerning needs, relative priorities, and schedules for implementation and financing individual projects. To be most useful to the Legislature, this information should include for each major program area (such as the University of California, Department of Corrections, etc.) summary presentations identifying:

- Major programmatic objectives.
- How facility needs were assessed and determined within the framework of these programmatic objectives.
- The criteria upon which identified needs were prioritized.
- Anticipated annual operations cost requirements associated with the capital outlay programs.

For each program area, the required major capital outlay projects should be identified by year, by amount of expected expenditure, and by potential funding source. Finally, to provide

a *statewide* perspective, the various plans should be combined with criteria for setting priorities between projects and across program areas, and a plan for financing the identified needs by anticipated manner of funding (i.e., general obligation bonds, General Fund lease-payment bonds, etc.).

New Planning Document Will Hopefully Provide Blueprint for Meeting Needs

Chapter 1435, Statutes of 1990 (SB 1825, Beverly), requires the Director of Finance to prepare a 10-year projection of the state's potential need for financing capital outlay. This report is due to the Legislature by February 1, 1991 and is to be updated annually. At the time this analysis was written, the report had not yet been submitted. Hopefully, this document will include the information necessary to serve as a blueprint for a financing plan. As noted earlier, such a plan is needed to enable the Legislature and the administration to establish appropriate allocation of fiscal resources to meet state infrastructure needs, including when and how many bonds to present to the voters at statewide elections.

As mentioned earlier in this analysis, because of the magnitude of infrastructure funding needs, we believe bond financing must play the key role in any financing scheme. This means that the Legislature will need to request the voters to approve large amounts of additional general obligation bonds in the future.

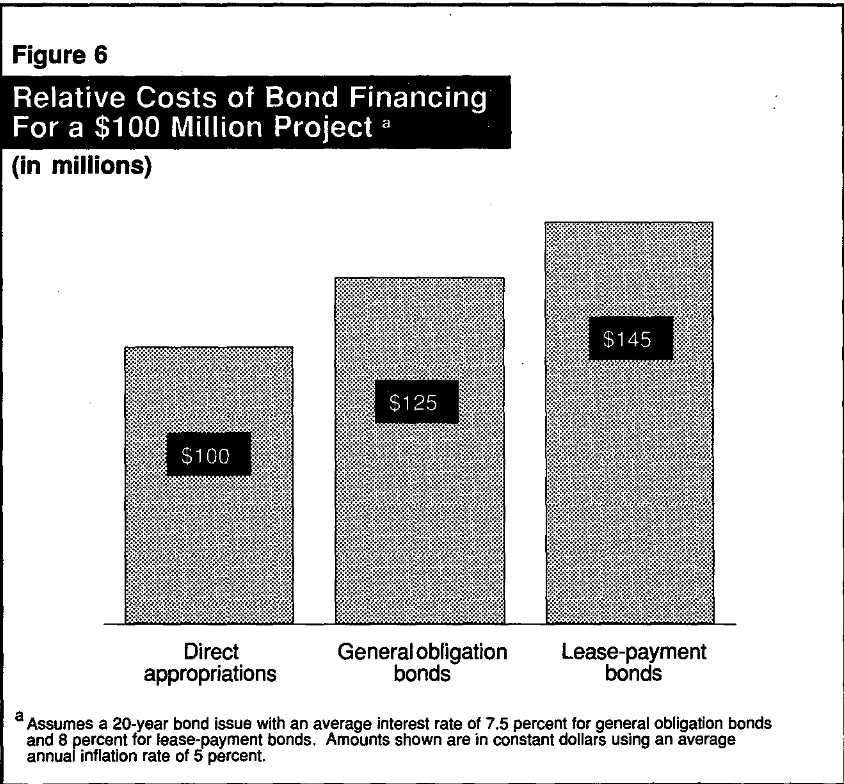
What If the Needed General Obligation Bond Issues Are Not Authorized? The implications of not obtaining additional general obligation bond authorizations are that (1) fewer capital needs can be addressed and/or (2) more costly debt financing means will have to be used—such as General Fund lease-payment bonds.

Under the first case—*addressing fewer capital needs*—the state will be faced with limiting the current objectives of many programs because of the lack of sufficient facilities, even though the Legislature may consider the program objectives a high statewide priority. Failure to adequately fund infrastructure will negatively affect public services in such areas as education, corrections, transportation, environmental quality, and seismic safety. For example, it could result in such problems as an inability to accommodate all qualified students for higher education, court-ordered release of some prisoners, and inadequate sewer and water systems.

The second alternative is that the Legislature could use *more costly financing means* to fund infrastructure and avoid these negative outcomes. As discussed previously, General Fund lease-

payment bonds can be used to finance infrastructure improvements. This funding mechanism does not require voter approval. These bonds, however, are more expensive and therefore increase the state's debt service costs at a faster rate than if general obligation bonds are used. Figure 6 shows that the difference in financing costs using general obligation bonds versus General Fund lease-payment bonds is about 15 percent after adjusting for the effects of inflation. That is, for every $100 million of capital improvements the state would need to pay about $125 million if general obligation bonds are used and $145 million if lease-payment bonds are used. (The costs to pay for the capital improvement are higher under both methods of bond financing than under direct appropriations, because of the interest expenses and other unique costs associated with debt financing.)

Given the fiscal advantages of general obligation bonds over lease-payment bonds, ***we recommend that the Legislature rely to the maximum extent possible on the former when addressing its infrastructure needs through debt financing.*** A capital outlay plan—such as the one required under



Ch 1435/90 (SB 1825, Beverly)—should help the Legislature achieve this end through improved planning, identification of the state's highest priority needs, and scheduling of necessary general obligation bond measures for future ballots.

What Are Some of the Factors That Influence the Amount of Bonds That Will Be Available in the Future? The amount of bonds that will be available in the future for funding infrastructure will depend on such factors as:

- The Legislature's and the administration's overall spending priorities based on assessment of the needs identified in a statewide capital outlay plan.
- The amount and timing of those infrastructure needs identified in the statewide capital outlay plan.
- The Legislature's views on what the acceptable levels of bonded indebtedness and debt service costs are, based on factors such as other spending priorities and credit rating concerns.
- The voters' willingness to approve new general obligation bond authorizations. In this regard, we believe a well developed capital outlay plan that includes an assessment of statewide infrastructure needs and a financial plan to accomplish its elements will help voters look more favorably on future general obligation bond measures.
- The Legislature's willingness to permit more expensive non-voter-approved lease-payment bonds to be used as an alternative to general obligation bonds.

The Plans Must Be Flexible and Regularly Reevaluated. No plan, however well conceived and developed, can anticipate all needs or all future changes in circumstances. This certainly applies to any capital outlay needs and financing plans developed by the state. The Legislature, therefore, should keep this in mind when drafting future bond measures. These measures should give the voters a clear sense of the programs to be funded—*in broad terms*. They should not, however, schedule the permitted appropriation of funds on a specific project-by-project or geographic basis. This scheduling should be done through appropriations in the annual Budget Act. Otherwise, the Legislature will find that it does not have discretion in matching appropriations with changing needs, priorities, and circumstances.

CONCLUSION

The state must improve and expand its infrastructure to address existing deficiencies and to accommodate future demographic and economic growth. Based on recent reports and information from various state departments, it is clear that the state's infrastructure needs over the next several years are easily in the tens of billions of dollars. In view of the magnitude of these costs, the state must identify specific needs, set priorities, and establish a financing plan to carry out the necessary improvements. The state will have to rely heavily on borrowing money through the issuance of bonds, and should try to rely to the maximum extent possible on general obligation bonds rather than "lease-payment" bonds.

In order to address its infrastructure needs effectively, the state needs a multi-year capital outlay plan and a related capital financing plan. Hopefully, the plan presently under preparation by the Department of Finance in response to Ch 1435/90 (SB 1825, Beverly) will include the necessary information to serve as a blueprint for developing a financing plan that will assist in scheduling future bond measure submittals to the voters and help promote their successful passage at statewide elections. We will be reporting to the Legislature once this plan is released regarding its contents and findings.

Uses of State Bond Proceeds

How Can the Legislature Ensure That Proposed Uses of Bond Proceeds Are Consistent With Its Objectives?

Summary

The state is faced with a large and growing need to revitalize and expand its infrastructure. As discussed in the preceding analysis, doing this requires that it rely on bonds as a financing source. As the state continues to increase its use of bonds for capital projects, it becomes ever more important that the bond funds be used in ways that maximize their effectiveness in achieving the state's capital outlay goals. Changes to the state's capital outlay planning process, as we also discuss in the preceding analysis, will improve effectiveness by helping the Legislature to identify its highest priorities for funding. Another means of improving effectiveness is to ensure that specific expenditures of state bond funds for such items as support costs are consistent with the Legislature's overall objectives for the use of bond funds.

Our review indicates that there has been a definite broadening in recent years as to the purposes for which bond proceeds are being used. Although some of these expanded uses of bond proceeds are appropriate, others appear to be inappropriate. There also are other current and potential uses of bond proceeds for nontraditional purposes that may be "eligible" for bond funding from an accounting perspective, but raise fiscal policy questions that should be reviewed by the Legislature. We also believe that the Legislature and the administration need to exercise greater oversight over the use of bond fund proceeds in the future, in order to ensure that the uses of bond funds represent good fiscal policy and are consistent with the provisions of the bond acts.

The Legislature can best address these concerns through the adoption of legislation identifying its specific preferences for the use of bond funds and requiring the provision of better information as to the actual and planned expenditure of bond fund proceeds.

The state's large and growing infrastructure needs will require the expenditure of large sums of money if they are to be successfully addressed. The state's current budgetary situation effectively precludes the use of current revenues to meet any more than a small fraction of these needs, so that the passage of additional bond issues will be required. Bond issues will allow the costs of these needed capital outlay projects to be spread over time, thereby making them more affordable from a budgetary perspective. However, the debt service on these bond issues still represents a sizeable cost to the state, and, as the November 1990 election shows, new bond issues should not be considered an unlimited resource. Thus, it is important that the Legislature attempt to maximize the effectiveness of its available bond resources so that these bond issues deliver as much new infrastructure as possible. It also is important that the state incur the added interest costs of using bonds only for those purposes for which these extra costs can be justified.

In this analysis, we examine four important trends we have identified in the use of state bond funds over the last 10 years. In each case, we provide specific examples from various program areas to illustrate the nature of these trends. In the second section, we provide a discussion of the major issues that the Legislature should consider when deciding whether to approve the appropriation of bond fund monies for various purposes, especially those purposes which are distinguishable from the actual acquisition of capital assets. The third section discusses the need for greater oversight of the actual expenditures made from bond funds.

TRENDS IN THE USE OF BOND FUNDS

The four trends we have identified relating to the use of bond fund proceeds include their use for: bond program administration, a variety of departmental support purposes not involving construction, interest expenses on interim financing, and statewide bond overhead costs incurred by the Treasurer and Controller.

Bond Fund Expenditures for Bond Program Administration

One trend in the state's use of bond funds over the last 10 years has been an increased expenditure of bond funds to support the direct administrative costs of certain bond programs—that is, to pay for the department's costs for managing the program being funded by bond proceeds. The increased usage of bond funds for this purpose appears to have stemmed directly from the increased approval of bond programs requiring departmental administration, rather than any fundamental change in policy.

Bond proceeds have traditionally been used by the Office of Local Assistance (OLA) in the Department of General Services for the administrative costs of the State School Building Aid Program. In 1982, the office also began to administer the State School Building Lease-Purchase Program. In both cases, the OLA received its operating funds from the proceeds of general obligation bonds approved by the voters for school facilities construction. The OLA uses the bond funds to support staff who review and evaluate school district applications for bond funding and who administer the release and distribution of funds to school districts.

The use of bond monies for bond program administration also shows up in other departments after the early 1980s. For example, in 1984-85, the Board of Corrections began to use bond fund monies for bond program administrative expenses, spending a total of $575,000 in that year. For 1990-91, the board expects to spend a total of $2.2 million from bond funds to pay for bond program administrative costs. This includes salaries and related operating expenses of staff who (1) review plans and award grants of bond funds for construction and remodeling of county jail facilities and (2) inspect these facilities once constructed.

Similarly, Proposition 70 specifically allocates $1.6 million to the Wildlife Conservation Board and allows the Department of Parks and Recreation to spend up to $7.4 million for program administration. These monies are primarily used to pay departmental staff to perform general administrative tasks related to the bond program, including planning and development studies, and for grant administration. Some of the bond funds also are used to pay the State Lands Commission for property title searches and ownership verification activities required by Proposition 70. Finally, in the housing area, the Department of Housing and Community Development will have spent a total of almost $13 million by the end of 1991-92 on staff and related expenses to establish and manage a new housing loan program to be funded from bond proceeds.

Bond Fund Expenditures for Departmental Support Purposes Not Involving Construction

Through the early 1980s, the use of bond fund monies for departmental support purposes was largely limited to activities associated with the actual construction of new facilities. These project-specific support costs include financing for departmental planning and construction activities, and for performance of contract administration and construction management. There were certain exceptions to this general policy, however. For

example, the State Water Resources Control Board (SWRCB) has traditionally had specific authorization to use bond funds to pay for a wide variety of support costs, including planning, studies, monitoring, and technical assistance, even in cases where the program support activities are not directly related to a specific project.

Beginning in 1985-86, the general policy described above was expanded to encompass a wider range of expenses related to capital outlay projects, but not involving the actual construction of new facilities. For example, in 1985-86 the Department of Corrections expanded its use of bond funds to include special *repair* programs in *existing* prisons, and legal defense for the department against claims arising from the construction program. In 1987-88, the department began to use prison bond funds for *maintenance* projects associated with *existing* facilities.

The *1990-91 Governor's Budget* proposed to further expand the use of bond fund monies by using them to pay for the *start-up operating costs* of the state's four newest prisons. These proposed expenditures totaled $26.4 million in 1990-91, and reflected costs for such items as inmate laundry, electricity, and staff relocation. The budget also proposed to expand the California Youth Authority's (CYA) use of bond fund monies for program support by allocating a total of $1.2 million from the 1990 Prison Construction Bond Fund (approved on the June 1990 ballot) for start-up costs related to the CYA's newest facility. These start-up costs included expenditures for ward education, recreation, and clothing, housekeeping, and maintenance of structures, grounds, and equipment. The Legislature rejected these proposals, however, choosing to fund these costs instead from direct General Fund appropriations.

The *1991-92 Governor's Budget* generally does not propose to expand the types of purposes for which state bond funds are expended, but does propose that past practices in this area be continued and, in one case, expanded. In the proposed budget for the Department of Corrections, for example, the administration is seeking authority to increase its expenditure of existing bond funds to pay for planning activities associated with proposed new prisons—prisons for which the department has no construction funding at this time. These prisons had been intended to be funded from a bond measure on the November 1990 ballot that was rejected by the voters.

The expansion in the types of expenditures made from bond funds can also be seen in some of the bond programs that have been established by initiatives in recent years. For example, Proposition 70 (the 1988 parks bond) specifically allocates $11

million to the Department of Fish and Game (DFG) for capital purposes other than the traditional "bricks and mortar" type capital facilities. These costs include restoration and enhancement of salmon streams ($10 million) and purchase of marine patrol boats ($1 million). In addition, Proposition 70 allows the DFG to spend $6 million on activities related to wild trout habitat, including program support activities if the department chooses.

Bond Fund Expenditures for Interest on Interim Financing Loans

A third trend we have identified is the state's use of bond fund monies to pay interest charges on interim loans provided to the bond programs. In 1987 the state passed Ch 6/87 (AB 55, Roos), which allows bond fund programs to begin operation before the bonds are actually sold by borrowing money from the state's Pooled Money Investment Account (PMIA). Prior to 1987, the state sold bonds once they were authorized, even if particular projects were not ready to begin construction. The state invested the idle bond proceeds until the funds were needed for project construction. In 1986, however, the federal government passed strict new laws governing the use of tax-exempt bonds. These laws effectively precluded the state from continuing this practice, and the state enacted Chapter 6 to bring state practices into compliance with the new regulations. Under Chapter 6, the state has delayed the sale of bonds until after most of a project's expenditures (funded initially from a PMIA loan) are incurred. As project expenditures are completed, bonds are sold to repay the loans from the PMIA, and thereby refinance the project.

Chapter 6 provided that the interest on these loans would be paid directly from the state's General Fund. In 1988, however, Ch 984/88 (SB 2172, Campbell) revised the law to require that the interest on PMIA loans be paid from the *bond proceeds* (with certain exceptions), instead of the General Fund. This change was made to free up General Fund revenues in the *short term* for other state programs, although it resulted in higher costs to the state in the *long term,* because of the interest charges required to be paid by the General Fund on the outstanding long-term debt.

The total amount of interest on PMIA loans to be paid from bond funds is estimated to be approximately $55 million in 1990-91 and $26 million in 1991-92. These figures are significantly lower than previous estimates, which ranged up to $100 million annually, because of recent changes in federal tax law. These changes allow the state a longer period of time over which the proceeds of a bond sale may be spent without resulting in a penalty, and will in most cases eliminate the need to rely on interim financing in the future. As a result, in 1990 the State Treasurer's Office began to plan for the accelerated sale of bond issues and a

corresponding reduction in the use of interim financing loans. Further, in January 1991 the Treasurer's Office announced its intention to completely phase out the interim financing program.

Bond Fund Expenditures for Statewide Bond Overhead Costs

The final trend is the state's increasing reliance on bond fund monies to cover the statewide overhead costs incurred by the Treasurer and the Controller for managing bond issues. For example, in 1987-88 the administration required these offices to begin charging various bond funds to recover a portion of their costs for management of the state's bond issues. According to the Treasurer's Office, the expenses covered by this new policy arise from the following kinds of activities:

- Administering loans from the PMIA for the purpose of carrying out a program or project that is to be financed by eventually issuing bonds.
- Assuring bond program compliance with federal laws and regulations.
- Providing services related to arbitrage tracking and special financial arrangements for bond sale proceeds.
- Other general administrative costs in the Treasurer's executive office that are related to management of the state's bond issues.

The amount of bond funds expended to reimburse the Treasurer and Controller for the overhead activities described above totaled $747,000 in 1988-89, $2.2 million in 1989-90, $3 million in 1990-91, and is projected to total $3.5 million for 1991-92. In the context of the Treasurer's total costs related to bond fund programs (approximately $6 million in 1990-91), these reimbursements represent a significant portion (50 percent) of the funding for statewide bond-related overhead. Based on our discussions with the Treasurer's Office, it appears that the administration's policy since 1988 has been to fund all new or increased costs related to the management of bond issues from bond funds, while maintaining General Fund support for the remainder of the state's costs in this area.

POLICY ISSUES RAISED BY STATE BOND FUND EXPENDITURE PRACTICES

Over the last 10 years, the state has both increased its overall use of bond funds and, as described above, expanded the type of expenditures made from bond fund monies. These changes are responsible for the large increase in bond fund expenditures

characterized as "state operations" over the last 10 years. These types of expenditures have grown from only $8 million in 1980-81 to an estimated $136 million in 1990-91. As noted earlier, some of this increase reflects the state's overall increase in the use of bond funds for capital projects generally. Some of the increase, however, also reflects changes in state policy regarding the kinds of support, administrative, and overhead costs the state chooses to pay from bond funds.

The trends in bond fund usage we have described above lead us to the conclusion that the Legislature should establish a comprehensive policy to guide decision-makers in allocating the proceeds of bond issues. Such a policy would help ensure the allocation of bond funds in a manner which is consistent with the objectives of the bond acts as well as the Legislature's preferences for the use of these funds.

What Principles Should Guide the Legislature?

In developing a policy to guide the allocation of bond fund monies, the Legislature needs to consider the following three basic issues.

- Are particular uses of bond funds consistent with the provisions of the bond acts approved by the voters?
- Can particular uses of bond funds be considered to be directly related to the acquisition of the capital asset for which the bond issue was approved?
- What are the Legislature's preferences for limiting the extent to which bond funds may be used?

As these issues indicate, there are essentially three steps to the development of an allocation policy for bond proceeds. The first step is to determine whether or not a particular use of bond funds should be *precluded* from further consideration because it is not consistent with the provisions of the bond act. The second step is to determine whether a particular use should be *eligible* for further funding consideration because it either (1) involves construction or (2) otherwise is related to the acquisition of capital assets. The final step is for the Legislature to determine which of the eligible uses *should* actually be funded from bond proceeds, given its fiscal and other policy preferences. The remainder of this section discusses these issues in greater detail.

Consistency With the Bond Acts

The State Constitution (Article XVI, Section 1) restricts the use of bond funds to the specific objects of expenditure that are set

out within the individual bond acts. Individual bond acts typically require or allow specific types of expenditures, and any expenditures that fall within these specifications should be considered to be consistent with the bond acts. In some cases, however, the state has made expenditures of bond funds for activities which are not specifically mentioned in the bond acts. In these cases, the administration has contended that the uses of the bond funds are "reasonably subsumed within the activities contemplated by the voters in approving the bond acts," and thus are consistent with the constitutional restrictions. However, two recent Legislative Counsel opinions call this contention into question.

In the first case, as described earlier, in last year's budget the Department of Corrections proposed to pay for a variety of operating costs from the 1990 New Prison Construction Bond Act (approved at the June 1990 election). That act states that "the moneys in the fund shall be used for the acquisition, construction, renovation, remodeling and deferred maintenance of state youth and adult correctional facilities." The act does not specifically authorize the use of funds for the *operation* of correctional facilities, however. According to a 1989 Legislative Counsel opinion, while some moveable equipment may be legitimately purchased with bond funds, consumable materials or supplies (such as expenditures for laundry or electricity costs) do *not* fall into the authorized categories (acquisition, construction, etc.). On the basis of Legislative Counsel's opinion, these types of support costs would be precluded from bond act funding.

In the second case, a similar situation occurs with respect to the use of bond funds to reimburse the Treasurer and Controller for their costs in managing the state's bond programs. The state's General Obligation Bond Law, which is incorporated by reference into the bond acts, provides that the bond proceeds may be used to pay for the direct costs of bond issuance, such as printing of the bonds and the fees for the bond underwriters and legal counsel. From a capital budgeting perspective, these types of costs are allocable to capital projects and on this basis a case could be made to fund them from bonds. However, we have been advised by the Legislative Counsel that the use of bond funds to pay the state's overhead costs related to bond programs violates the provisions of the bond acts and the State Constitution. As a result, this type of administrative expense also would be precluded from bond act funding, at least as far as the costs associated with already enacted bond measures. The Legislature could choose to include specific authorizations for these types of expenses in future bond acts.

Relation to the Acquisition of Capital Assets

The state has in past years issued both general obligation bonds and revenue bonds funded by the General Fund as a means of increasing its ability to acquire long-lived capital assets. If these assets were to be acquired on a pay-as-you-go basis, the state would face a significant problem in raising the large amount of funds required for the needed capital facilities, given the level of demands already placed on the state budget by ongoing programs. By spreading the cost of these facilities over longer periods of time, bond issues allow the state to make currently needed investments in infrastructure, such as schools and prisons. The annual cost of servicing the debt issues is also easier to accommodate within the budget context, and more closely matches the "consumption" or usage of the benefits that these facilities provide.

It is important to recognize, however, that the bonds are merely a financing tool for acquiring long-lived capital assets. As such, their use should be limited to that purpose, and not expanded to pay for activities that provide only short-term benefits, are not project-specific, or are unrelated to the actual acquisition of a capital facility. Limiting the use of bond funds for these types of expenditures not only makes sense in its own right, but also helps to ensure that the available bond monies will be sufficient to achieve the intended purpose of the bond acts. Thus, we would suggest that the Legislature consider, in determining whether a particular type of expenditure is "eligible" for bond financing, whether that expenditure is *necessary* to the *acquisition* of a *specific* capital asset.

Applying the Eligibility Criterion. Applying this criterion requires a certain amount of judgment. This is because not all types of expenditures fall neatly into a category of "appropriate" or "not appropriate" for bond financing, resulting in there being many "grey" areas. Keeping this in mind, the above criterion generally suggests the following regarding whether different types of expenditures should be considered as eligible candidates for being funded through bonds:

- ***Direct capital costs of acquiring facilities.*** The direct "brick and mortar" type costs of acquiring capital facilities clearly *are* consistent with the above criterion.
- ***Acquisition-related departmental support costs.*** As noted earlier, the state has traditionally funded the project-specific departmental support costs associated with acquisition of capital projects from bond funds. Because these costs are necessary to acquire the specific

capital facilities, they also appear to be *consistent* with the eligibility criterion discussed above.

- ***Other types of departmental support costs.*** Other program support costs, including those relating to capital facilities such as operations and standard maintenance costs at existing prison facilities, would *not* be eligible under the above criterion. Although it is true that maintenance activities can help to extend the useful lives of capital facilities, most are an ongoing basic cost associated with the operation of these facilities. As such, they should be financed from current revenues unless they involve substantial capital expenses and extend a facility's useful life significantly beyond what it normally would be.
- ***Bond program administrative costs and interim financing.*** It is our view that these costs *should* be considered eligible for bond financing because they are necessary to acquire the capital projects. For example, the review of plans for county jails helps to ensure that certain standards of quality are achieved for specific jail facilities, so that the facilities provide the long-term benefits contemplated by the voters in approving the bond acts. Likewise, the costs of interim financing are directly related to the construction phase of a capital project, although they may only be needed in limited situations from now on due to the recent federal law changes discussed earlier.
- ***Statewide bond overhead costs.*** Expenses incurred by the Treasurer and Controller for managing bonds that are clearly allocable to specific projects *would* qualify under this criterion. An example is the cost of writing checks to investors to pay interest on or redeem the bonds used to finance a facility. In contrast, an argument can be made that expenses for the ongoing day-to-day responsibilities inherent to these offices—such as for basic staffing, keeping abreast of financial market developments, maintaining contacts with financial market representatives, and preparing required government reports—would *not* be eligible.

Legislative Preferences for Bond Fund Usage

The final step in the development of a bond fund allocation policy is the determination of the Legislature's fiscal and other policy preferences for the use of bond funds. In other words, even if a proposed expenditure meets the first two conditions in that it

is consistent with the bond act and related to the acquisition of a capital asset, the Legislature may decide not to use bond funds for other reasons. Some of these reasons may include:

- ***Minimizing long-term General Fund cost impacts.*** By limiting the extent to which bond funds are used to finance *all* eligible costs of a capital project, the Legislature can reduce the cost impact of specific projects on future state budgets. For example, the practice of paying the interest on interim financing loans from bond funds results in higher costs to the state in the long run. This is because the General Fund is responsible for ultimately paying off the bonds and thus ends up paying "interest on interest."

- ***Stretching available bond fund resources.*** A great deal of discussion has occurred concerning the possibility that increased reliance on bond financing will result in the state becoming "over-bonded" at some point in the future. Our analysis suggests that the state presently is in no danger of this occurring. However, if the state were to adopt policies limiting the amount of bond issues submitted to the voters during each election year, this could exacerbate the competition which already exists among potential bond authorizations for placement on the ballot. Under these circumstances, limiting the use of bond funds to those types of expenditures *most directly needed* to acquire capital assets could allow a greater number of projects to be undertaken.

In both of these cases, there is a short-term/long-term trade-off to be considered. That is, eligible project costs *not* funded by bond proceeds will have to be funded from current revenues, thereby reducing the amount of current revenues available to fund other state programs. On the other hand, by not funding such costs from bond proceeds, the Legislature avoids debt service costs, thereby freeing up *future* General Fund revenues for future state expenditure needs and/or allowing the available bond resources to permit acquisition of a greater number of capital facilities. Thus, while we have no basic disagreement over the need to incur the types of expenditures we have discussed in the first section of this analysis, we believe that the Legislature should consider whether the use of bond funds to pay for them is consistent with its fiscal policy and other objectives.

Given the above, ***we recommend that the Legislature enact legislation to clearly identify the types of expenditures that it does and does not want to pay for with bond proceeds.*** As noted earlier, at a minimum, legislation is needed

to authorize or specifically prohibit the charging of statewide bond overhead costs to bond funds, because *the existing practice violates state law and the State Constitution.* In addition, the Legislature should determine whether it wishes to limit the extent to which bond proceeds may be used for departmental support, bond program administration, and interim financing, and specify the criteria upon which these determinations shall be made.

OVERSIGHT OF BOND FUND EXPENDITURES

The state's bond activity has grown and become more complex in recent years. However, there has been no concurrent improvement in the systems necessary for adequately tracking and monitoring bond fund expenditures. The Legislature has access to information about bond fund expenditures, largely through the bond fund condition statements presented annually in the Governor's Budget. Yet, despite the growth and increased complexity of the state's bond activities, the fund condition information that the Legislature currently receives is little different from the information it received 10 years ago.

In this context, the bond fund condition information presented is deficient in two ways. First, the information presented is often misleading, because it does not consistently account for all of the charges against a particular bond fund. For example, the fund condition statements in many cases fail to reflect charges for PMIA loan interest and statewide bond-related overhead expenses. Second, in some cases, the Governor's Budget presents no fund condition information at all. Thus, the Legislature does not now have a complete picture as to the availability of bond funds when it is considering how these funds should be allocated for various projects, and the amount of additional bond funds that should be placed before the voters for their approval.

This lack of information regarding the availability of bond monies can have serious financial consequences. For example, the 1986 Community Parklands Act authorized the sale of $100 million in bonds to fund population-based grants for local parks and recreation projects. The act provided for allocation of the entire $100 million to local agencies (with a provision for the payment of a small amount of departmental administrative costs from the bonds). Pursuant to Chapter 984 (as described above), however, that bond fund must also pay the interest on the interim financing it receives from the PMIA. Since the information as to the amount of interest costs that would eventually have to be paid from the bond proceeds was not made available to it, the Legislature made commitments of the bond funds that exceed the amount of money that will eventually be available. Thus, without

an outside source of funds, the department will have to reduce the amounts of individual local assistance grants that already have been awarded and allocated to local agencies in order to pay the PMIA interest costs.

The *1991-92 Governor's Budget* does a better job than previous budgets of accounting for bond fund expenditures. It includes information as to the amount of interim financing charges that will be assessed against most of the affected state bond funds, and, in some cases, has also identified the bond program administrative costs. It still does not, however, identify charges for statewide bond program overhead costs or provide fund condition statements for all state bond funds.

Thus, while the state's bond activity has expanded and grown more complex, the systems needed to track bond fund expenditures have not been adequately improved to meet the increased need for oversight. As the above examples demonstrate, greater legislative and administrative oversight is needed to ensure that the state's bond programs are managed effectively.

Toward this end, ***we recommend the enactment of legislation requiring the inclusion in the Governor's Budget of fund condition statements for all state bond funds, and the inclusion in such statements of all charges that will reduce the amount of such funds available for appropriation by the Legislature.***

CONCLUSION

In conclusion, we recommend that the Legislature consider the issues raised above in making future decisions on what bond fund allocations are desirable and appropriate. Specifically, we recommend that the Legislature enact legislation specifying a policy to guide it in allocating bond funds. This will help to ensure that proposed allocations are consistent with the provisions of the bond acts, that they are necessary for the acquisition of capital assets, and that they are consistent with the Legislature's fiscal policies and other objectives. This legislation also should impose new requirements for the reporting of all bond fund expenditures in the Governor's Budget.

School Restructuring in California

What Is "School Restructuring," and How Can It Potentially Improve Educational Quality?

Summary

Concerns over current levels of educational achievement, combined with perceived limitations of current reform strategies, have resulted in proposals for new approaches to schooling. These new approaches are known collectively as "school restructuring." In practice, the term "restructuring" has been used by various groups to advance different visions of reform. However, boiled down to its essential components, school restructuring involves decentralization of authority and increased collaboration at the local level, in conjunction with enhanced accountability. School restructuring can involve making changes in many different areas, including instruction, school organization, and community relations.

There is some preliminary research which suggests that restructuring can be a useful strategy, especially if guided by strategic planning and focused on improving the content and delivery of a school's curriculum. Restructuring is, however, also subject to numerous "pitfalls," such as teachers not being given adequate release time or necessary training.

The Legislature recently established a statewide demonstration program in school restructuring in order to generate additional evidence on whether educators in California can make restructuring work. Other potential roles for the state include (1) experimenting with large-scale systems of accountability, (2) researching various state actions that would increase local flexibility, and (3) coordinating the state's education policy objectives with the model curriculum frameworks provided to schools.

In 1983, the report of the National Commission on Excellence in Education, *A Nation At Risk*, warned that declining standards in many of the nation's public schools were jeopardizing the country's ability to remain economically competitive. Partly in response to this report, and also due to other factors, many states, including California, adopted a variety of measures aimed at improving the quality of K-12 education. One of the most recent of such measures, Chapter 1556, Statutes of 1990 (SB 1274, Hart), appropriated $6.8 million to begin establishing up to an estimated 350 "restructured schools."

Exactly what is school restructuring? Generally speaking, school restructuring involves decentralization of authority and increased collaboration at the local level, in conjunction with enhanced accountability. In this analysis, we examine the concept of school restructuring. Specifically, we (1) discuss current deficiencies in the performance of the state's school system, (2) explain the various components of school restructuring and how these components could potentially improve educational quality, (3) summarize the research on the effectiveness of this approach, and (4) discuss what the state's future role might be involving restructuring. The purpose of this piece is primarily to describe the concepts associated with restructuring, as opposed to making judgments about their efficacy or specific recommendations about their implementation.

Our analysis of school restructuring is based on an extensive review of the literature, interviews with experts in the field, and direct observation of various schools undergoing the restructuring process.

PROBLEMS WITH CURRENT LEVELS OF ACADEMIC ACHIEVEMENT

In this section, we discuss deficiencies in levels of academic achievement by pupils in the state's school system. Although educational achievement may not be the only goal of the educational system, it is generally regarded as the most important, and so any evaluation of the current system should primarily be based on this factor.

Concerns About Different Skills

California employers, who observe first hand the proficiency levels of high school graduates when hiring for entry-level jobs, report widespread dissatisfaction with the skills possessed by most graduates.

Basic Skills. First, there is continuing concern among employers regarding such basic skills as reading, writing, and

arithmetic. For instance, a recent survey of businesses that was sponsored by the California Business Roundtable found that (1) only an estimated 46 percent of individuals applying for jobs in California demonstrated satisfactory basic skills on written examinations and (2) 59 percent of the businesses surveyed either currently provide or plan to provide remedial instruction in these skills.

Problem-Solving Skills. Second, there is growing concern with the ability of high school graduates to solve complex problems. According to some reports, the U.S. ranks near the *bottom* among industrialized nations on most international tests of math and science ability. By contrast, Japanese, Canadian, English, and Finnish high school graduates score more than four grade-level equivalents ahead of Americans. In addition, the Business Roundtable survey indicates that, in a number of firms, job applicants often do not have the necessary skills to advance in the organization or learn new, complex techniques. Employers view problem-solving skills as especially important because they are increasingly calling upon workers to implement and "debug" new methods of production and service delivery.

Teamwork and Communication Skills. Finally, several reports document that a growing number of companies are demanding workers with skills in teamwork and communication, and, specifically, an ability to use these skills in order to solve problems as part of a group. Many of these companies have "restructured" in order to become more competitive—specifically, by reducing the size and responsibility of middle management and delegating more responsibility to front-line workers. Whereas previously a worker might have had a very narrowly defined role (such as operating a machine), restructured firms often require employees to work with customers, suppliers, and other coworkers in order to customize production, maintain and repair equipment, and find ways to improve production processes. Thus, competency in teamwork and communication is becoming increasingly important for *all* workers, but teaching such skills has not typically been a large part of the curriculum of most schools.

Has the School Reform Movement Helped?

Since the early 1980s, many states—including California—have attempted to improve academic achievement by imposing state requirements on schools (such as increased graduation requirements) or providing schools with financial incentives to operate in a particular way (such as lengthening the school day and year). As such, many of these reforms have reflected a "top-down" approach to school reform (in contrast to the more "bottom-

up" approach in school restructuring, which we will discuss in the next section).

To what extent have these initial reform efforts worked, as measured by improvements in student test scores over time? Our review indicates that, on tests administered to a national sample of students, there has been some modest improvement in basic skills but no improvement in problem-solving abilities over the last eight years.

In California, statewide test scores have been generated through the California Assessment Program (CAP)—which measures both basic skills and some problem-solving abilities. Trends in CAP scores for the last eight years for which data are available are shown in Figure 1. The figure shows that the scores have increased, depending on the grade level in question, by from 3 percent to 5 percent in reading, by about 4 percent in writing, and from 4 percent to 9 percent in mathematics.

Figure 1

Trends in Average Test Scores California Assessment Program

1982-83 and 1989-90

Test		Scores		Change	
Grade	Subject	1982-83	1989-90	Amount	Percent
Grade 3	Reading	263	275	12	4.6%
	Writing	266	277	11	4.1
	Mathematics	267	283	16	6.0
Grade 6	Reading	253	261	8	3.2
	Writing	259	268	9	3.5
	Mathematics	260	270	10	3.8
Grade 8	Reading	250[a]	257	7	2.8
	Writing	250[a]	259[b]	9	3.6
	Mathematics	250[a]	271	21	8.4
Grade 12[c]	Reading	242	248[d]	6	2.5
	Mathematics	236	256[d]	20	8.5

a Scores are for 1983-84, as this was the first year that eighth-graders were tested.
b Score has been adjusted to reflect change in writing exam in 1986-87. Figure is based on 1988-89 data (which is the latest year available).
c Writing tests were not administered to twelfth-graders until 1988-89.
d Figure is based on 1988-89 data (which is the latest year available).

These figures suggest that the reform movement has had *some* effect on student achievement in California. In fact, the scores may understate actual improvement achieved. This is because California has experienced rapid growth in children from groups that currently have the lowest test scores. These include an increasing number of children living in poverty—including children of single mothers—and a growing number of limited-English-proficient students from a wide array of ethnic groups. These demographic changes have tended to partially "mask" the true effects of school reform on test scores.

Nevertheless, concerns about the reform movement remain. First, the amount of improvement that California has achieved to date has been limited. Specifically, the amount of improvement is equivalent to only about one-half to one year of learning in mathematics (depending on the grade level examined) and about one-quarter year in reading. As noted previously, school graduates in many other countries score the equivalent of as much as four grade levels ahead of the United States in some areas.

Second, it is unclear whether the reforms to date will be adequate to deal with the demands placed on the state's school system by the aforementioned demographic changes.

Limitations of Previous Reform Efforts

Why have the reform efforts that California and other states initiated in the early 1980s had only limited success in improving academic achievement?

As mentioned previously, many of these reforms reflected a "top-down" approach to school reform, where the state imposes certain requirements on schools (or provides them with financial incentives to operate in a particular way). Proponents of restructuring argue that a "top-down" approach does not necessarily result in the effective delivery of the curriculum. For instance, requiring that a student take two years of mathematics before graduating does not necessarily address the effectiveness of those courses—such as whether the content of the courses is both sufficiently rigorous and contains instruction in thinking skills.

Although the State Department of Education (SDE) has attempted to improve the quality of instruction by upgrading its "curriculum frameworks," which provide general suggestions on both what schools should teach and how, it is too early to tell whether this move, by itself, will solve these problems.

As an alternative to a "top-down" strategy towards school reform, some analysts have proposed that states adopt more extensive "bottom-up" strategies. California has, in fact, previ-

ously implemented several such programs, such as the School Improvement Program (SIP), which provides schools with funds to plan and implement improvement efforts. These types of programs, however, have not been uniformly used to improve teaching methods or curriculum, and have been criticized for often not resulting in fundamental institutional change, especially at the high school level.

SCHOOL RESTRUCTURING PROPOSED AS AN ALTERNATE APPROACH

Given the above, there is increased interest for states to promote a broad, "bottom-up" strategy, known as "school restructuring." This is a strategy which is intended to create extensive change in the nature of schools.

The concept of school restructuring is modeled, in part, on the restructuring efforts in private industry. This is not to suggest that operating schools is necessarily identical to running a factory or a bank, but only that there are some general principles underlying the operation of any effective organization.

The essence of restructuring is the *decentralization* of power, decisionmaking, and resources in an organization, so that front-line "workers" (students and teachers, in the case of schools) have (1) more input into how the organization functions and (2) a greater flexibility to *collaborate* with one another and with groups outside the organization, in order to achieve the organization's goals. The underlying assumptions are that decentralization and collaboration will unleash the creativity and expertise of such "workers" in finding the best ways of achieving the organization's goals, and will increase workers' commitment to these goals.

Restructuring also involves, however, combining decentralization with greater amounts of *accountability*, where accountability is defined as a mechanism for ensuring that the organization's goals are being met. Thus, when the National Governors' Association called in 1987 for a restructuring of states' educational systems, it described the process as "a good old-fashioned horse trade," where states would exercise less control over schools in return for stronger accountability.

Although many separate parties have called for school restructuring, in practice the term "restructuring" has become used by various groups to advance different visions of reform. For instance, some versions of "restructuring" focus on changing the organization and delivery of instruction (for instance, by encouraging students to *discover*, rather than simply acquire, knowledge); others focus on reforming how schools are governed (for

instance, by involving teachers more in decisionmaking); and still others focus more on altering existing systems of accountability (for instance, by allowing parents and students to choose —based on their personal interests and goals—which school they would like to attend).

These various versions of restructuring, however, are not necessarily mutually exclusive; a school or school district could adopt all or some combination of them. The focus of these various proposals differs, however, because each is attempting to change a different aspect of the existing educational system. For this reason, it may be helpful to think of the concept of restructuring as having different components, all of which support reform of the system. We now turn to describing these various components in more detail.

THE COMPONENTS OF SCHOOL RESTRUCTURING

Figure 2 summarizes the various major components of school restructuring. It shows that the components address two central themes—(1) decentralization and collaboration and (2) accountability. Each of these themes is discussed in more detail below.

Components Related to Increased Decentralization and Collaboration

As discussed above, school restructuring entails decentralizing power and resources, and, as part of this decentralization, allowing individuals greater freedom to collaborate with one another. Educators may move power and resources down to various levels within school systems: (1) from the level of the district to that of the school, (2) from the school to that of the teacher, or (3) from the teacher to that of the student. We begin our discussion of school restructuring by considering what is involved at the most immediate level—the relationship between teacher and student. We then consider how restructuring would work at other levels within schools.

Curriculum and Instruction. In many cases, school curricula emphasize the memorization of factual knowledge over the development of creative and critical thinking. In such cases, students assume a passive role, in which teachers lecture to students or require them to memorize facts from a textbook.

Those who advocate a "restructuring" of curriculum and instructional methods argue that not only does this approach neglect the development of thinking skills, but that it also tends to bore students. As a result, they may acquire only a superficial understanding of the material's content.

Figure 2

Components of School Restructuring

Components Related to Decentralization and Collaboration

- Curriculum and Instruction
- School Organization
- School Governance
- State/District Roles
- Community Outreach

Components Related to Accountability

- Statewide Testing
- School-Community Site Councils
- School Choice
- Teacher-Related Accountability

Proponents of restructuring advocate the use of more "active learning," which requires students to use the knowledge that they have acquired to solve problems or, to some degree, to discover knowledge themselves. Use of more active learning does not necessarily mean that teachers abandon lecturing, but only that they supplement such approaches more often with student activities, such as science experiments, written essays, or group projects. In addition to active learning approaches to problem solving, teachers can specifically use group projects to reinforce teamwork and group communication skills.

The restructuring of curriculum and instructional methods thus reflects the principles of decentralization and collaboration because students (1) take a more active part in exploring ideas and solving problems and (2) are encouraged to collaborate with one another in this process.

Specific strategies that teachers may use in an active learning approach include: (1) interdisciplinary projects, (2) centering the curriculum around themes, and (3) focusing the curriculum on fewer topics that can be explored in greater depth.

School Organization. Some restructuring advocates argue that, in order to better enable teachers to deliver a rigorous curriculum based on active learning, educators must change the way schools are organized. Specifically, supporters of restructuring contend that educators must put in place organizational structures that (1) encourage teachers to experiment and (2) allow teachers to share ideas and insights on useful strategies.

One suggested way to promote such collaboration is to implement teacher mentoring programs. In this type of program, schools designate certain experienced teachers with exemplary skills as mentors, and encourage them to assist other teachers, particularly new teachers. While many states, including California, have previously implemented such programs, restructuring advocates argue that states need to strengthen and expand these programs, such as by linking the mentor role to a well developed career ladder.

Another way that schools—specifically secondary schools—can create organizational structures that foster experimentation and collaboration is to employ teacher teams and block schedules. Under this system, the school divides its faculty into interdisciplinary teams, with each team consisting of from two to six teachers. The school then assigns a particular group of students to one team for a block of time, ranging from two to six hours. During this period, the faculty team is allowed to vary the length of time that it devotes to particular subjects (such as science or English). Schools may also provide these teams with autonomy over the design of curriculum, as well as the type of instructional materials that shall be used. The approach therefore illustrates the dual themes of decentralization and collaboration.

School Governance. School governance relates to how decisions regarding school policies and procedures are made. In many schools, decisions are often made "from above" by either federal or state mandate or district central office administrators. Teachers are often not involved in the decisionmaking process, except perhaps for issues raised during collective bargaining, and school site administrators may only have control over a limited number of decisions. As a result, school staff often lack the flexibility to undertake many types of innovations. (For instance, state credentialing laws might prevent a science instructor from teaching calculus in the context of physics, or district regulations

might prevent a social studies instructor from using literature—rather than textbooks—to teach history.)

Generally, the restructuring of school governance systems involves the decentralization of decisionmaking. The literature on restructuring discusses two types of innovations in this regard: (1) shared decisionmaking, which relates to *how* decisions are made, and (2) school-based management, which relates to *the level* at which they are made.

- ***Shared decisionmaking.*** In shared decisionmaking, decisions are made with the formal input of teachers and, in some instances, parents and community members. Schools may make decisions by a vote of either the school's entire faculty or a representative "site council." At the district level, shared decisionmaking may also operate by involving teacher representatives in the decisionmaking process.
- ***School-based management.*** In school-based management, some decisions formerly made by the state or district are "moved down" to the school level. Although the exact scope of school-based management plans vary, in a comprehensive plan, schools (rather than districts) would be responsible for designing the curriculum, choosing textbooks, budgeting funds, and hiring staff.

Currently, schools in both Chicago and Los Angeles are conducting major efforts in both shared decisionmaking and school-based management.

State/District Roles. Ideally, restructuring requires collaboration not only among teachers but also between schools and higher-level administrators (at both the state and district levels). It is often maintained that the process of educational restructuring requires high-level administrators to act less as regulators of schools and more as "coaches" who assist school personnel--through providing information and advice--in solving problems related to school improvement. While in a restructured school system site personnel would have the *primary* role in generating ideas and solving problems, higher-level administrators would support them in these tasks.

Community Outreach. Just as restructured schools may develop the flexibility to establish new, collaborative roles within a school and with high-level administrators, they also can establish collaborative partnerships with groups and organizations in the community, such as universities, businesses, or health and social service agencies. For instance, a school might actively attempt to train parents on how they can best encourage learn-

ing, or might agree to serve as a "research lab" for professors and students from a local university. Schools could use partnerships with local businesses as a way of enriching an "active learning" curriculum through the development of job internships for students.

Finally, schools could form partnerships with health and social service agencies in order to coordinate the delivery of noneducational services through the schools, so that noneducational problems, such as substance abuse or mental illness, would be less likely to interfere with student learning.

Two national projects—the League of Schools Reaching Out and the Accelerated Schools Project—have combined the use of social and health services with other components of restructuring.

Forms of Accountability in School Restructuring

As noted previously, school accountability involves setting goals and establishing some mechanism to ensure that schools meet these goals. Various forms of accountability differ with respect to *who* is responsible for setting the goals and monitoring school performance. Goals, for instance, can be established and monitored either from "above" (by the state) or, alternatively, from "below" (by students and parents). Top-down accountability is not necessarily inconsistent with the spirit of restructuring, if schools are given considerable authority in implementing general goals. There are, however, different forms of restructuring, depending on the exact nature of the accountability system adopted.

Below we discuss four different forms of accountability that are frequently discussed in the literature on restructuring: (1) statewide testing, (2) school-community site councils, (3) school choice, and (4) teacher-related accountability. Figure 3 summarizes these various forms.

Statewide Testing. The use of formal statewide testing as a means of accountability assumes that some basic goals are set and measured by the state. State and local officials, as well as school personnel, may then evaluate the performance of individual schools or school districts based on the results of these tests. To the extent that school personnel feel that these test scores are important and reliable, they will pay attention to them and attempt to improve their performance where necessary.

With some exceptions, most of the tests that states use are standardized multiple choice exams that measure discrete skills, such as the ability to add numbers. Because schools tend to gear

Figure 3

School Restructuring: Forms of Accountability

- Statewide Testing
  - Performance Testing
  - End-of-Course Exams
  - Rewards and Sanctions
- School-Community Site Councils
- School Choice
- Teacher-Related Accountability
  - Merit Pay
  - Evaluations of Teacher Teams

their curricula to what the state will assess, such narrow tests can lead to a narrow curriculum that focuses solely on a few basic skills at the expense of critical and creative thinking. Some testing agencies (most notably the California State Department of Education) have developed multiple choice tests that measure some thinking skills by including more difficult problems. However, the SDE generally acknowledges that such tests cannot measure the full range of thinking and related "higher-order" skills, such as creativity, writing, teamwork or oral communication.

For this reason, many have called for "restructured" assessment systems that contain an increased number of *performance tests*. In a performance test, a student must perform an activity, such as writing an essay or giving a speech. Performance tests are thus useful not only for measuring a range of educational skills that cannot be measured by traditional tests, but also for generating products that schools may show to policymakers and the general public.

Other types of assessment reforms that are often discussed in the context of restructuring include: (1) the use of state-developed and -mandated final exams and (2) the provision of rewards (such as teacher bonuses or merit grants to schools) and sanctions (such as negative school publicity) based on assessment results.

School-Community Site Councils. Some schools that restructure their governance system by establishing site councils for shared decisionmaking have also chosen a restructured form of accountability. This form of accountability provides that (1) a majority of the individuals on the site council are parents and community members and (2) the site council is authorized to hire and fire the school principal. The school principal (and staff) are then accountable to the members of the site council in addition to the district superintendent and school board; as such, the site council may terminate the school principal if it becomes unhappy with the school's performance.

School Choice. School choice is a model of accountability in which districts allow parents and students to choose which school the student shall attend. This type of accountability is based on the goals of individual students and parents and, if a school fails to meet these goals, the student is free to transfer elsewhere. Proponents assert that, under a choice model, schools that fail to meet the goals of a large number of their students would experience declines in enrollment and be forced to improve.

There are three basic types of choice plans:

- ***Intradistrict choice.*** This type of choice plan is confined to schools within one district. One of the best examples of this approach is the choice plan for middle grade students in New York School District No. 4 in East Harlem, where students can choose to attend any one of 24 specialized schools. Many of these schools were formed by small, autonomous groups of teachers over a 15-year period.
- ***Interdistrict choice.*** In this type of choice plan, students may attend public schools in other districts. The state of Minnesota is currently implementing such a plan.
- ***Public/private choice.*** In this system, students may attend both public and private schools. The City of Milwaukee, Wisconsin is attempting to implement a limited version of such a system.

Advocates of school choice disagree on the best type of plan. Some advocates endorse state-mandated *intra*district choice, but not the other forms of choice, on such grounds as (1) interdistrict choice could be too financially disruptive and could thus undermine district attempts to assist schools in restructuring and (2) public/private choice could possibly result in public support for schools that teach certain religious and political viewpoints. Others argue that only a system that allows students to attend

private schools would create a sufficiently strong incentive to induce the majority of public school districts to improve.

Teacher-Related Accountability. The fourth form of accountability that is often discussed is that directed at evaluating individual teachers or groups of teachers, rather than schools. When only schools are evaluated, an individual teacher can dismiss the cause of poor performance as the fault of administrators or other teachers, and may be reluctant to examine and improve his or her own skills and behaviors unless forced to do so by the school principal. Thus, while the other forms of accountability might result in *some* change among teachers, some argue that a teacher-related accountability system would result in much greater change.

Two major forms of teacher-related accountability that have been suggested are (1) merit pay systems based on teacher performance and (2) in cases where restructuring has led to "teacher teams," the evaluation of the entire team (as opposed to individual teachers).

THE STATUS OF SCHOOL RESTRUCTURING

In this section, we summarize the extent to which schools are engaging in restructuring, and what is known about the effectiveness of this approach.

To What Extent Is Restructuring Occurring?

Based on our review of the literature on restructuring, it appears that some forms of restructuring are fairly widespread. The literature that we reviewed cited over 60 major restructuring projects across the nation that have been implemented by (1) schools in collaboration with state governments, universities, and associations, or (2) large urban school districts, including those in Los Angeles, San Diego, Richmond (California), Chicago, and Rochester. In addition, the SDE has made a concerted attempt over the last several years to restructure curriculum and instructional methods by upgrading its model curriculum frameworks. Moreover, many middle grade schools in California have adopted faculty teams following publication of SDE's report in 1987, *Caught in the Middle.*

Many of these efforts, however, appear focused on only one or two components of restructuring, such as school organization, school-based management, or choice. With a couple of exceptions (such as the efforts in Harlem), we found few, well documented cases of more comprehensive restructuring efforts. While there are several efforts that are designed to produce extensive change in the curriculum, organization, and governance mechanisms of

specific schools, these efforts do not attempt to develop and test broad-based systems of accountability that extend beyond an individual school, such as restructured statewide testing or school choice.

Is Restructuring an Effective Strategy?

Although there is little experience with large-scale, comprehensive restructuring efforts, there is research on the effectiveness of the individual components of restructuring. Figure 4 summarizes the major findings of this research, while Figure 5 lists some of the potential pitfalls.

We draw several conclusions from this information.

First, although there is sufficient preliminary evidence to suggest that certain aspects of restructuring are promising strategies that the state should explore further, *additional research is needed on most of the components of school restructuring in order to conclusively judge the effectiveness of this approach.*

Second, the research indicates a number of things that can potentially go wrong when restructuring approaches are implemented, as detailed in Figure 5. In general, *restructuring does place added demands on teachers, and they must be provided with sufficient release time and training in order to meet these demands.*

Third, there is fairly conclusive evidence that some active learning approaches in the area of curriculum and instruction—such as peer tutoring or the use of group projects—can make a difference in levels of student achievement, if implemented properly. There is also some evidence that the delivery of a challenging curriculum that requires pupils to engage in creative thinking and problem-solving also results in significantly higher levels of student achievement (although researchers disagree as to the exact extent). This finding suggests, although it does not prove, that for the other components of restructuring to have much effect on levels of student achievement, *schools must link them to the effective delivery of a challenging curriculum that is centered on active learning.* For this reason, some researchers have faulted a number of previous attempts to implement school-based management and shared decisionmaking plans because participants in these reforms failed to address issues of curriculum and instruction. Rather, participants more frequently addressed issues such as changing discipline policies or developing parent newsletters. Thus, failure to address curriculum issues may constitute another major pitfall of restructuring.

Figure 4

Summary of Research on School Restructuring: Findings

Components Related to Decentralization and Collaboration

Curriculum and Instruction

Large body of research documents:

- Active learning improves attention, memory, and understanding.
- Group projects can result in improved academic achievement.
- Enrollment in "harder" classes that require more thinking results in higher achievement, even when student ability is held constant.

Organizational Changes

No comprehensive studies. Evidence from 20 German schools using teacher teams found:

- 1% dropped out (compared to 14% nationally).
- 60% qualified for college (compared to 27% nationally).

Governance Changes

Research findings are mixed:

- Several major studies show that high levels of achievement are associated with high levels of (1) school autonomy, (2) staff involvement, (3) a clear focus and sense of mission, and (4) strong principal leadership.
- Other studies show that school-based management councils often shy away from curriculum and budget issues.

Restructured State and District Roles

No formal research exists:

- Several efforts are in progress. The most prominent are occurring in San Diego (district level coaching) and Kentucky, Virginia, and New Mexico (state level coaching).

Figure 4—CONTD

Community Outreach

Evidence very preliminary:

- Test scores in one school in the League of Schools Reaching Out project increased from 3 percent to 10 percent annually for four years. No data are available on other participating schools.

Components Related to Accountability

Performance Testing

Evidence very limited:

- Use of writing assignments across all curriculum areas increased following implementation of California Assessment Program writing assessment.
- Few systematic studies of performance assessment in other areas.

School-Community Site Councils

Research findings discouraging:

- Some studies show that councils often shy away from curriculum and budget issues.

Choice

A moderate body of research exists:

- There are some documented successes. For instance, from 1974 to 1988, district reading scores in Harlem (District No. 4) increased from last place in New York City to about average.
- One major pilot project, conducted in Alum Rock, California, in the mid-1970s, did not result in significantly improved student achievement.

Teacher-Related Accountability

Research very limited:

- No studies available that evaluate relationship to student achievement. One study found that merit pay/career ladders in Texas resulted in decreased cooperation between teachers who were competing for promotions.

Figure 5

Summary of Research on School Restructuring: Potential Pitfalls

Components Related to Decentralization and Collaboration

Curriculum and Instruction

- Teachers may fail to pinpoint what students should learn.
- Teachers may fail to use activities that engage students and keep them busy.
- Teachers may fail to monitor and manage multiple groups of students working on different projects.
- Teachers may fail to develop group facilitation skills among students.
- Teachers may be unwilling to learn--through both training and trial and error--how best to implement instructional innovations (such as peer tutoring).

Organizational Changes

- Schools may fail to combine block schedules with an engaging curriculum or with useful instructional methods.
- Innovations may not last if there is a lack of support for block schedules or career ladders from unions or teachers given new responsibilities.

Governance Changes

- Resources may be diverted from instructional issues to administrative matters (especially if teachers spend large amounts of time out of the classroom or if site councils fail to examine the curriculum).
- Teachers may lack time for meetings.
- Meetings may be conducted ineffectually.
- Site councils may fail to solve school problems due to insufficient authority, resources, ideas, or management expertise.

Restructured State and District Roles

- Administrators may lack expertise in solving particular problems, or be unable to draw individuals with various types of expertise together for this purpose.
- Providing assistance can sometimes be time-consuming and make administrators spread resources "too thin."

Figure 5—CONTD

Community Outreach

- Direct parent involvement can, in some instances, result in placing unreasonable demands and burdens on schools.
- Referring individuals to social service agencies may be time-consuming.

Components Related to Accountability

Performance Testing

- Costs may be high if many students are tested.
- Tests may be unreliable if not properly developed.
- Insufficient incentives may exist for schools to place importance on test results.

Site Councils

- Parents and community members may lack sufficient knowledge of educational procedures and programs to participate meaningfully.
- Parents and community members may, in some instances, place unreasonable demands on schools.

Choice

- Unless students and parents are provided with sufficient information on available options and adequate transportation, some students may not be able to exercise meaningful "choice."
- Students in some instances select a particular school for "noneducational" reasons.
- The supply of "quality" schools may not expand (either because of a lack of excess capacity in existing schools or because there is no mechanism to allow for the formation of new schools). In this situation, enrollment levels in poor-quality schools would probably not decline.
- Low-quality schools that begin losing significant numbers of students as a result of "choice" may not be able to improve unless districts provide the necessary conditions for restructuring (such as school autonomy or adequate teacher training).

Teacher-Related Accountability

- Merit pay may reduce collegiality among teachers.
- Teacher evaluations (for merit pay) may be perceived as unreliable.

Finally, the evidence suggests (but again does not prove) that *schools which base restructuring on "strategic planning" may have more success than those which base it on piecemeal reform.* In strategic planning, the staff members in a school form a vision of what they wish to achieve—including the knowledge and skills that graduating pupils should possess—and then design strategies to achieve these goals. Many of these strategies could involve other aspects of restructuring, and so will tend to be more comprehensive than simply implementing a single innovation such as shared decisionmaking. Research on both effective school restructuring and restructuring efforts in industry suggest that, for strategic planning to be effective, organizations must support change efforts with strong leadership, a consensus among staff on the need for change, and the ability of staff to solve problems and implement innovations in a collaborative fashion.

The Legislature Has Provided for Additional Research

Because most of the research on restructuring is not conclusive, the Legislature initiated the school restructuring demonstration projects pursuant to SB 1274. These projects, which will be operated in individual schools, might include such things as team teaching, extensive use of peer tutoring, or the formation of community-school partnerships. According to the legislation, the purpose of these demonstration projects is to determine whether restructuring is a cost-effective strategy and, if so, under what circumstances. By contrast, the purpose of these programs is *not* necessarily to find one specific model of restructuring to mandate in all districts in the state. This is because an innovation that may work well in one school may not work in another. This argument is consistent with the view that, rather than mandating specific statewide practices, states should encourage schools to choose which innovations to adopt and how to tailor them to their needs. Establishing demonstration projects can further this goal by identifying and showcasing a variety of *general approaches* that schools might find useful.

OTHER POTENTIAL ROLES FOR THE STATE

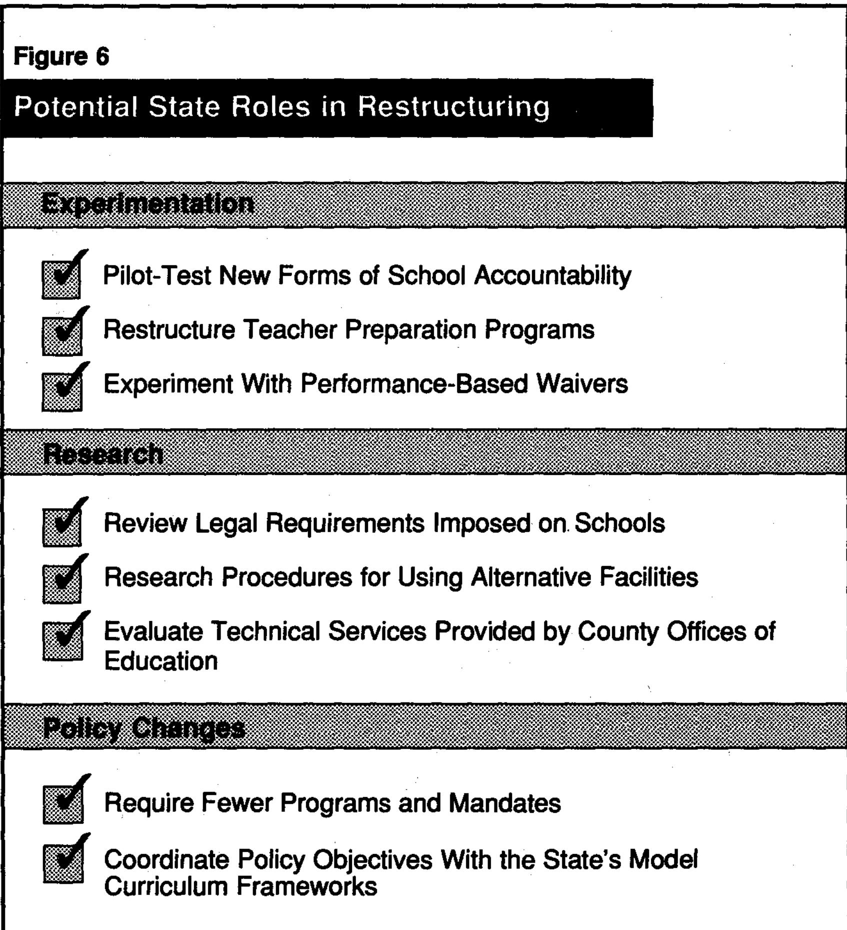
While the demonstration programs established by SB 1274 will generate important information, some significant questions regarding restructuring are likely to remain partially unanswered. In particular, the demonstration programs—which, again, are focused on individual schools—may not tell the Legislature how restructuring would be implemented on a very large scale—for example, throughout large school districts or on a multi-district basis. In addition, there are other roles the state could play in restructuring, generally by providing increased

flexibility to schools in a variety of areas. Figure 6 summarizes these potential state roles, which fall into the general categories of experimentation, research, and policy changes.

Additional Areas for Experimentation

The Legislature could experiment with a number of alternative mechanisms relating to restructuring on a larger scale, including (1) new forms of school accountability, (2) restructuring of teacher preparation programs, and (3) performance-based waivers.

Pilot-Test New Forms of School Accountability. Prior to the current fiscal year, the state evaluated the performance of individual schools through the California Assessment Program (CAP), and made these scores available to the local media in every



community. Almost all 1990-91 funding for CAP, however, was vetoed and so, at the time this analysis was prepared, California lacked any major statewide system of accountability. The Governor' Budget proposes to implement a "revised" statewide testing system, and the Legislature will need to consider to what extent the proposed system should include student performance assessments.

In addition, the Legislature may wish to establish pilot projects in school choice and teacher-related accountability. It is unclear how many of the demonstration projects that the state will fund under SB 1274 will address these alternatives— especially that of school choice—since the measure provides funding to restructure individual *schools*, rather than restructuring on a districtwide or multi-district basis.

Restructure Teacher Preparation Programs. If teachers are to work in a restructured educational environment, they must have training in such areas as (1) utilization of active learning techniques and (2) how to collaborate with other teachers. Colleges of education, however, appear to vary greatly in how well they teach these and other types of related skills. For this reason, a number of reports have called for a "restructuring" of teacher preparation programs, by providing colleges of education with greater autonomy in setting course work requirements. (Currently, the state indirectly sets such requirements to a large extent through credentialing and accreditation laws). Some have proposed that accountability systems should also be strengthened, for instance by publishing "outcome measures" on individual teacher preparation programs, in order to encourage some programs to improve.

Upgrading teacher preparation programs could help promote the restructuring of K-12 schools by producing teachers with the necessary aptitudes for working in such schools. For this reason, the Legislature could implement some additional pilot programs in improving teacher education.

Experiment With Performance-Based Waivers. Currently, the State Board of Education (SBE) grants some school districts waivers from selected provisions of state law, but these waivers are not generally "performance-based." Performance-based waivers exempt schools from certain statutory requirements if the school can obtain a specified level of academic performance within a fixed period of time, for both its general population of students and, if appropriate, among special groups. As an example, the state might grant a waiver to a science teacher on an interdisciplinary faculty team who might wish to teach calcu-

lus, on the condition that the team's students maintain a certain level of performance on tests of mathematical ability.

Although currently school districts can request the SBE to waive the requirements of most sections of the Education Code, there is no guarantee that the board will grant a waiver, especially in areas that may be viewed as controversial or unorthodox. As a result, many school districts are reluctant to seek such waivers. In order to experiment with performance-based waivers, the Legislature could direct the SDE, as staff to the board, to experiment with performance-based waivers and to evaluate the results.

Additional Areas for Research

We have also identified a number of areas where the state may wish to conduct additional research in order to design specific options for providing school districts with greater flexibility and technical assistance.

Review Legal Requirements Imposed on Schools. In order to provide schools with greater local discretion, the Legislature could direct the SDE to convene a task force to review the various legal requirements that the state has imposed on schools. Those requirements that appear to no longer serve any useful purpose could be eliminated.

Another purpose of such a task force could be to identify and clarify common areas of confusion regarding where schools and school districts *currently have flexibility*. Often, school districts have areas of flexibility of which they are not aware. Staff at the SDE report, for instance, that requirements which some districts thought were mandated by the state were actually local rules that evolved through collective bargaining.

Research Procedures for Using Alternative Facilities. Many restructured schools that use block schedules need physical space that can accommodate both large lectures (to 60 or more students) and small group discussions. Most schools are designed, however, simply to accommodate class groupings of 30 students each. Some restructuring experts have proposed that the state enact legislation to make it easier for schools to rent or lease public and private buildings, so that schools can have access to more flexibly designed space. To ensure that these buildings are earthquake-safe, the state currently requires schools to comply with extensive facility utilization requirements. The Legislature could direct the appropriate state agencies to review these requirements to determine if they can be streamlined,

while at the same time maintaining adequate protection for the state's children.

Evaluate Technical Services Provided by County Offices of Education. One restructuring-related role that the state already performs is to provide school staff with technical assistance to better enable them to solve local problems in a collaborative fashion. Such technical assistance often takes the form of help with strategic planning, where schools seek to identify local needs, set goals, and develop strategies for achieving these goals.

Because of the large number of schools in California, it is not feasible for the SDE to provide technical assistance directly to most schools or school districts; rather, the state relies on county offices of education to provide the majority of this technical assistance. The capacity of county offices to serve this function, however, varies widely. Some county offices are adept at providing help with strategic planning, while others are not. Although the county offices have developed a common "menu of services" in an attempt to achieve a degree of standardization, it is unclear to what degree these services are consistently and adequately delivered.

For this reason, the Legislature could direct the SDE to evaluate the capacity of county offices to provide schools assistance with strategic planning and other services supportive of restructuring.

Potential Policy Changes

If the Legislature wishes to promote educational restructuring, it could consider policy changes to increase schools' flexibility by (1) requiring fewer programs and mandates and (2) seeking to further state policy objectives instead through the state's model curriculum frameworks.

Require Fewer Programs and Mandates. Every year, the Legislature enacts a number of additional programs and mandates that further certain policy goals. For instance, there are programs designed to increase students' awareness of environmental issues, to decrease drug use, and to promote civic responsibility. Most such programs contain rules and regulations on how program funds may be spent, and thus reflect a "rules-based approach" to public policy.

One problem with such an approach is that school teachers and administrators become inundated with limited-purpose programs and initiatives. As a result, teachers often attempt to cover a large number of subjects in a short period of time,

resulting in superficial treatment of the material. Some studies, in fact, indicate that curricula in most schools in the United States lack "depth" when compared to the curricula taught in most other industrialized countries.

For this reason, some have argued that the Legislature should refrain from adding programs and initiatives to an already overcrowded school agenda. On the other hand, it can be argued that it is the Legislature's responsibility to set and further societal goals, and that it would be an abdication of legislative responsibility not to require schools to address current issues.

Coordinate Policy Objectives with the State's Model Curriculum Frameworks. There is, however, a middle ground. Specifically, the Legislature could seek to identify and further certain high-priority goals through the state's system of model curriculum frameworks.

These frameworks, which were developed by the SDE, consist of somewhat detailed *goals* regarding the knowledge and skills that students should learn. The frameworks do not, however, precisely specify how schools should organize and present the curriculum. Nor are schools required to use the frameworks, although the state's testing system is aligned with the frameworks at the secondary level. Figure 7 presents a few examples of the goals that are reflected in the frameworks, using the framework for middle grade science for purposes of illustration.

The Legislature could proceed to integrate legislative goals with the model frameworks in the following manner:

- ***First,*** the Legislature could adopt a general policy not to require additional activities in areas which are already addressed by the frameworks (recognizing in advance that some exceptions may be warranted).
- ***Second,*** the Legislature could direct the SDE to strengthen the frameworks where it finds them to be inadequate.
- ***Third,*** the Legislature could direct the SDE to develop an interdisciplinary resource document that would assist schools in addressing legislative goals and other various curricular goals simultaneously. This document would contain examples of promising interdisciplinary learning activities, such as how instruction on topics such as AIDS could be combined with instruction on mathematical probabilities or civics.
- ***Finally,*** in selected cases where schools still appear to be failing to achieve framework goals of particular importance to the Legislature, it could direct the SDE to modify

Figure 7

Examples of Goals From State Curriculum Framework: Middle Grade Science

Category	Examples
Examples of Major Curriculum Goals	• Students should understand the nature of science. • Students should understand the principles underlying energy.
Examples of Specific Content Goals	• Students should understand the principles underlying such phenomena as boiling water or insulation. • Students should understand that farmers have increased agricultural productivity through the selective breeding of animals and plants.
Examples of Behavioral Goals	• Students should be able to observe, compare, categorize, and make inferences.
Examples of Suggestions to Teachers	• Teachers should center instruction around themes, such as energy, evolution, change, and stability. • Teachers should use active learning.

existing statewide exams so as to (1) signal to schools that those goals are important and (2) monitor school performance accordingly.

Advantages of this Coordination Approach. Pursuing statewide legislative goals through the model curriculum frameworks would reflect the spirit of school restructuring because, rather than prescribing a specific manner for achieving a goal, the state would allow teachers the freedom to create a variety of solutions for achieving the goal. This approach potentially has two major advantages:

- ***Local creativity enhances effectiveness.*** By furthering local creativity, schools would be likely to discover a number of effective solutions, all tailored to the school's individual needs. For instance, some schools might wish to promote civic responsibility by requiring students to engage in community service, while others might find interviews with community leaders on specified social problems to be more effective.
- ***Coordination decreases educational fragmentation.*** To the extent that schools could pursue broad goals through the regular academic instruction offered in core subjects such as history or science, additional specialized programs would be unnecessary. Varied program requirements and funding sources often discourage schools from using interdisciplinary projects to address multiple goals simultaneously.

SUMMARY

The term "restructuring" is an umbrella concept, encompassing a wide array of proposed changes in the educational process. As such, it means many different things to different people. There are, however, three broad themes that tend to run throughout restructuring reforms: decentralization, collaboration, and accountability.

To date, there is very little evidence that documents the benefits of restructuring proposals. The research information that is available suggests, however, that reforms have the potential to improve educational performance, especially when they are: (1) accompanied by strategic planning by the schools and (2) focused on the delivery of a quality curriculum. Restructuring proposals, however, are also subject to numerous pitfalls, such as teachers not being given adequate release time or training.

While the state is already encouraging schools to experiment with restructuring, there are other roles the state could play as well. For example, the state could: (1) experiment on a broader-based scale (for example, on a multi-district basis), (2) research various state actions that would increase local flexibility (such as in the areas of legal requirements and facilities regulations), and (3) coordinate better the state's educational policy objectives with the model curriculum frameworks currently provided to schools.

State Rail Program

What Major Issues Does the Legislature Face in Implementing the State's New Rail Program?

Summary

Propositions 108 and 116 provide a total of nearly $3 billion in bond funds for rail capital outlay, thereby greatly expanding the state's rail program. With this increase in funding, the state has gone from providing limited financial assistance for local rail projects to providing major funding in support of a strategy of statewide expansion and improvement of the state's rail network. The Legislature needs to clarify the state's expanded role vis-a-vis this statewide rail system. To this end, we recommend legislation to further define the state's role, including a requirement to develop a long-term rail plan to guide development of the overall statewide rail system.

In the near term, the Legislature will want to consider two other issues involving the state's expanded rail program. First, the Legislature needs to address a lack of coordination in the implementation of the Propositions 108 and 116 rail programs, particularly relating to rail project evaluation and database management. Second, the Legislature needs to address the subject of the two additional rail bond measures scheduled to be placed before the voters in November of 1992 and 1994.

In 1989, the Legislature enacted several measures that significantly redefined the state's role in rail transportation. In enacting these measures, the Legislature provided some new funding for expanded rail systems, sought to encourage better coordination between land use and transportation decisions (including rail transportation decisions), and allowed transit and local street projects to compete with state highway projects for state funding.

In June 1990, the voters approved Proposition 108—*The Passenger Rail and Clean Air Bond Act of 1990*—placed on the ballot by Ch 108/89 (AB 973, Costa). At the same election, voters also approved Proposition 116—*The Clean Air and Transportation Improvement Act of 1990*—placed on the ballot through the initiative process. Both measures authorize the state to issue general obligation bonds, which significantly expand the amount of state funds available for rail capital outlay projects.

In this analysis, we (1) provide background on the state's existing rail system, how rail systems have been financed up until 1990, and the key features of the new rail programs financed by bond funds; (2) review the state's role in the planning, development, and implementation of the state's rail system; (3) discuss the coordination of the state's rail capital outlay programs; and (4) review issues related to two future rail bond measures scheduled for the November 1992 and 1994 elections.

THE STATE'S PASSENGER RAIL SYSTEM AND ITS FUNDING

Types of Rail Systems

The passenger rail transportation system in California includes two major components—intercity rail, and commuter and urban rail.

Intercity Rail. This system primarily serves business or recreational travelers going between cities in California and to other parts of the country. The system is entirely Amtrak-related. (Amtrak is the national rail system.) Five of the state's Amtrak lines are completely federally supported, while the state contributes partial support for two lines: the *San Diegans* (which run from San Diego to Santa Barbara) and the *San Joaquins* (which run from Bakersfield to Oakland).

Commuter and Urban Rail. Commuter rail generally offers frequent service during commute hours to serve commuters, and urban rail provides regular service throughout the day, generally within an urban or metropolitan area.

The only major *commuter service* in the state is the Peninsula Commute Rail Service (Caltrain) from San Francisco to San Jose. The state currently funds most of this service, although full support of the service will shift to a local agency by July 1993. In addition, other commuter services are in various stages of planning by local agencies throughout the state.

In general, *urban rail services* are provided by local transportation agencies. Existing urban rail services include:

- The San Francisco Bay Area Rapid Transit (BART) system.
- The San Francisco Municipal Railway.
- The Sacramento Light Rail System.
- The Santa Clara County Light Rail System.
- The Los Angeles Metro Blue Line (Long Beach—Los Angeles).
- The San Diego Trolley.

In addition, some system expansions are currently under construction, including the Los Angeles Metro Red Line and Green Line, the San Francisco Municipal Railway, and the San Diego Trolley.

Funding for Rail Comes Mainly From Nonstate Sources

As noted above, intercity rail service has been primarily funded by Amtrak, with partial support from the state. In the case of commuter and urban rail (with the exception of Caltrain), both capital outlay and operating costs have traditionally been funded primarily from nonstate (local and federal) sources. Specifically:

- Local sources include fare revenues, funds generated by local sales taxes dedicated to transportation purposes (including funds under the Transportation Development Act), and a variety of other sources.
- The federal Urban Mass Transportation Administration (UMTA) also provides capital and operating support for commuter and urban rail services. (Because UMTA capital funds flow directly to the local agencies, the state has virtually no influence in the distribution of these funds.)

The primary role played by the state in funding commuter and urban rail has been to provide annual capital grants for rail projects.

As an example of the relative importance of these three sources in funding commuter and urban rail, in 1988-89 nearly 100 percent of BART operating funds came from local sources. Local and federal funds provided about 87 percent of capital funds, and state sources made up the remaining 13 percent.

Bond Measures Expand State Funding of Rail Capital Program

Until 1990, the state's rail capital outlay program was provided under the Transit Capital Improvement (TCI) program. While annual amounts have varied, state funding for the program was about $100 million in 1989-90. These funds are mainly from state sales taxes on motor vehicle fuels and from state gas tax revenues.

The passage of Propositions 108 and 116 provides a major infusion of state funds to expand the state rail capital outlay program. Additionally, the increase in the state gas tax triggered by the passage of Proposition 111 (*The Traffic Congestion Relief and Spending Limitation Act of 1990*) in June 1990 will increase funds available for the annual TCI program. Figure 1 summarizes the three program components that comprise the current state rail capital outlay program—Proposition 108, Proposition 116, and the TCI program components.

Proposition 108. Assembly Bill 973 legislatively authorized three general obligation bond measures of $1 billion each to be voted on by the voters. Proposition 108, adopted in June 1990, was the first of these three measures. The other two are scheduled to be voted on in the November 1992 and 1994 elections. If all three measures are adopted, there will be a total of $3 billion available for rail capital improvements. The California Transportation Commission (CTC) assumed the passage of the two remaining $1 billion bond measures authorized in AB 973 in developing the seven-year 1990 State Transportation Improvement Program (STIP). Thus, it programmed the full $3 billion in rail projects for construction during the period 1990-91 through 1996-97.

Proposition 116. Proposition 116 authorizes the state to issue nearly $2 billion in general obligation bonds, mostly for rail projects in specific geographic areas. However, bond money also is authorized for other types of projects, such as capital improvements to ferry and bicycle facilities. Unlike Proposition 108-funded projects, Proposition 116-funded projects do not have to be included in the STIP.

State Program Will Be Part of at Least $10 Billion in Rail Investment

If the additional two AB 973 bond measures are approved by voters in 1992 and 1994, the state's bond funding for rail projects will total about $5 billion. When matching funds are included, the total investment of federal, state, and local funds in rail projects envisioned by these measures would be *at least* $10 billion over the next 10-plus years, and likely would be more.

Figure 1

Components of State Rail Capital Outlay Program

Proposition 108

- Provides for $1 billion in state general obligation bonds to be appropriated by the Legislature. (Additional bond authorizations for $1 billion each are scheduled for the November 1992 and 1994 elections.)
- All projects must be programmed in the State Transportation Improvement Program (STIP).
- At least 15 percent of these funds are for intercity rail projects, with no local match requirement. Caltrans designs and manages projects.
- The remaining funds—up to 85 percent—are for commuter and urban rail transit projects, with a dollar-for-dollar local match required. Local transportation agencies design and construct projects.

Proposition 116

- Provides for nearly $2 billion in state general obligation bonds, continuously appropriated to the California Transportation Commission (CTC).
- Specifies funding amounts for projects in specific geographic areas, with a dollar-for-dollar local, federal or private matching requirement on some projects.
- CTC administers the program, and reviews and approves grant applications.

TCI Program

- Provides grants to local entities which are appropriated annually by the Legislature (over $100 million in 1989-90).
- Program is funded mainly from sales taxes on motor vehicle fuels and state gas tax revenues.

To provide a better sense of the magnitude of this investment, it is helpful to compare it to prior investments or investments currently under way that involve rail transportation. For example:

- The 18.5-mile Sacramento Light Rail system cost about $180 million to build.
- The existing 71.5-mile BART system would cost about $6.5 billion in current dollars to construct.
- The 17.4-mile Los Angeles Metro Rail Red Line (subway) system currently under construction is projected to cost $4 billion.

Figure 2 shows the projects that are programmed in the 1990 STIP from Proposition 108 and the projects specified in Proposition 116, along with the amount of state funding for each. As the figure shows, about 89 percent of Proposition 116 funds will be available for rail projects (58 percent for commuter and urban rail and 31 percent for intercity rail), while Proposition 108 funds will be used entirely for rail projects. The figure also shows that, in most projects and regions shown, funds are planned to be available from both propositions.

THE STATE'S ROLE IN RAIL TRANSPORTATION

State Role to Date Has Been Limited

In addition to the state's *funding* role for rail projects discussed above, the state also has had responsibilities in the areas of planning, development, and implementation of the statewide rail system. However, prior to 1990 these roles were limited.

System Planning. The state's role in the planning of rail services has mainly been focused on intercity and commuter rail service. Current law requires the California Department of Transportation (Caltrans) to prepare biennially a five-year Rail Passenger Development Plan that examines intercity and commuter rail service in the state, including operating and capital costs for existing and proposed services. Since 1985, the Legislature has also authorized studies in four rail corridors to develop plans to initiate or improve intercity or commuter rail service. The corridors studied are: Los Angeles-San Diego, Santa Barbara County-Los Angeles, Los Angeles-Fresno-San Francisco Bay Area-Sacramento, and San Francisco Bay Area-Sacramento-Auburn.

System Development and Implementation. The state's role in developing and funding intercity rail projects has basically

Figure 2

Propositions 108 and 116 Projects

(dollars in millions)

System	Proposition 108[a]	Proposition 116
COMMUTER & URBAN RAIL		
L.A. Basin:		
• L.A. Metro Red Line	$95	$80[b]
• L.A. County light rail	350	--[c]
• Valley transit project	495	--[c]
• Southern CA commuter rail	581	177[b]
Subtotals—L.A. Basin	***($1,521)***	***($406)[d]***
San Diego County light rail and commuter rail	$345	$77
S.F. Municipal Railway	180	35
Santa Clara County light rail	88	47[d]
BART	202	108[d]
Caltrain	60[e]	190[f]
Sacramento light rail	154	100[d]
City of Irvine Guideway	--	125
Miscellaneous	--	60
Totals - Commuter & Urban Rail	***($2,550)***	***($1,148)***
Percent of grand total	***(85%)***	***(58%)***
INTERCITY RAIL		
L.A.—San Diego	$61	$202[g]
Santa Barbara—L.A.	36	81[g]
L.A.—Bay Area—Sacramento	99	140
Auburn—Sacramento—Oakland—San Jose	22	85
S.F.—Eureka	7	10
Rolling stock & maintenance facilities	225	100
Totals - Intercity Rail	***($450)***	***($618)***
Percent of grand total	***(15%)***	***(31%)***
OTHER NONRAIL		
Rural-county, bicycle, ferry, grade separations	--	$203
Miscellaneous	--	21
Totals - Other	***(--)***	***($224)***
Percent of grand total	***(--)***	***(11%)***
GRAND TOTALS	$3,000	$1,990
	100%	100%

[a] The 1990 STIP programmed $3 billion—$1 billion from Proposition 108 and $1 billion each from similar, scheduled bond measures in 1992 and 1994.
[b] Minimum amount specified in measure.
[c] A specific amount is not allocated for this project.
[d] Allocated to a county transportation agency for expenditure within that county. Most likely will be expended on project(s) listed.
[e] Includes interconnection of Caltrain to BART and Muni Metro.
[f] Includes $17 million that could be used on projects in Monterey County.
[g] Includes commuter rail.

been limited to the expansion of passenger service provided by Amtrak. With regard to commuter service, the state's role has been limited to the operation of Caltrain under contract with the Southern Pacific Transportation Company. Under current law, Caltrans is required to transfer operation of that service to a local agency by July 1992. In addition, full funding of the service will shift to the local agency by July 1993.

Recent Legislation Has Changed the State's Role

The approval by voters of Propositions 108 and 116 modified the state's role in statewide rail programs. With the substantial increase in state bond funding for rail programs provided by these measures, the state has gone from providing limited financial assistance for essentially local rail projects to providing major funding in support of a strategy of statewide expansion and improvement of the overall rail network.

The state's role in planning and promoting coordination of a statewide rail system also has been broadened. Chapter 106, Statutes of 1989 (AB 471, Katz), requires the CTC to adopt guidelines to ensure that intercity, commuter, and urban rail projects funded under the AB 973 bond program provide for an efficient system of rail services in the state. Thus, the state will not only grant local assistance on a project-by-project basis, but also will be concerned with how projects fit into an overall statewide system.

In addition, Proposition 116 makes the state responsible for promoting standardization in the state's rail system by requiring the state to develop specifications for standardized rail equipment. Proposition 116 also specifies that $100 million in reserved rolling stock funds can only be used on equipment that conforms with the standardized specifications.

Should the State's Role Be Further Defined?

The Legislature will need to continue to review the implementation of the state rail program and consider whether the state's role should be further expanded or redefined. Such a reexamination is important because:

- Rail has assumed a much more prominent position as a *state-level* strategy for addressing transportation demands.
- With the major expansion of rail systems, issues of interregional and intermodal planning and coordination are likely to take on greater importance. Because the

state has a broader perspective, these are appropriate issues for the state to address.

- With increased funding, the state now has a much greater stake in the success of statewide rail programs and greater ability to influence overall rail system development.

Figure 3 summarizes five key concerns related to ensuring development of an effective overall rail system, and potential actions the state could take in these areas, consistent with its newly expanded role in the statewide rail program. These actions range from broad policy level actions, such as development of a long-range statewide rail system plan, to activities related more to implementation, such as providing for consolidated financial data on projects. In considering which of these actions to take, the Legislature will need to further consider what is the appropriate role for the state, versus local governments, in the overall development of the state's rail system.

The potential actions the state can take in each of the areas shown in Figure 3 are discussed below.

Planning. While local and regional agencies currently maintain short-term (five-year) plans for local rail systems and the state develops a five-year plan for intercity and commuter rail service, there is no statewide long-term *system plan* to: (1) set out the objectives for the overall rail program, (2) define the relationship between rail policies and other state policies (such as land use and air quality), and (3) define the role of the rail system within the overall transportation network in order to guide system development. Without such a plan, the state cannot determine the relative priorities in rail projects and make decisions regarding funding of the system. As there currently is no requirement for such a plan, legislation would be needed to provide for one.

The Legislature could also choose to provide direction and oversight in the overall acquisition of rights-of-way. Chapter 1039, Statutes of 1989 (SB 1562, Presley), initiated the first step towards a rights-of-way preservation plan by requiring an inventory of rights-of-way. A well coordinated plan to acquire or develop rights-of-way could facilitate local agencies' development of rail projects, and potentially help in negotiations for rights-of-way acquisition.

Assessing Economic Merit. To date, the CTC and Caltrans have not reviewed individual rail projects, prior to their inclusion in the 1990 STIP, to ensure that they merit state funding based on an analysis of the expected benefits and costs of those projects.

Figure 3

Potential State Actions in Rail System Development

Planning

- Develop a statewide rail system plan to guide rail system development.
- Develop a related statewide rights-of-way acquisition plan.

Assessing Economic Merit

- Ensure that the expected benefits of rail projects are greater than their costs, thereby justifying public investment in the projects.

Coordinating

- Promote coordinated development of projects on an interregional basis.
- Ensure coordination between rail systems and other passenger transportation modes.
- Encourage coordination of operating policies.
- Coordinate rights-of-way negotiations statewide to ensure that rights-of-way valuation is conducted consistently and that negotiations are carried out in a manner most advantageous to the state.

Financing

- Ensure that agencies have provided for adequate funding of rail operations prior to approval of state funding for construction.
- Ensure that financial plans for projects programmed for state funding are reasonable and, in aggregate, do not oversubscribe federal, state or local funds.
- Provide for consolidated financial data on all proposed projects.

Promoting Efficiency

- Encourage joint procurements, shared maintenance facilities, and similar measures among rail operators to economize on overall system costs.

It is essential that such reviews be conducted. The Legislature could require such assessments through legislation, including specifying the various factors that should be taken into account in them.

Coordinating. The linkage of a rail system interregionally, as well as the system's linkage with other modes of transportation, such as bus transit, is essential in order that the state's investment in the rail system works most efficiently. Coordination among systems may relate not only to the physical characteristics of the systems, but could also include coordination of policies and procedures among operators to encourage greater systemwide use. For example, this might include improved intersystem transfer policies or creation of regional or statewide uniform rail passes.

Coordination in these areas may be achieved most effectively by the state because of the broader perspective needed for this function. The Legislature could enact legislation to specify the responsibilities of Caltrans, the CTC, and other state and regional agencies in addressing coordination issues.

Financing. In order to carry out an effective program for financing rail projects, the state will need to review project financial plans. In our view, two kinds of financial reviews should be done. First, the state should review individual projects in terms of their capital funding plans and cash flow projections. In addition, the state should review system operating plans to ensure that agencies have adequately provided for funding of system operations. Caltrans performs this kind of review on a regular basis for TCI projects.

Second, a financial review of all projects applying for funds should be performed to ensure that the program, *as a whole,* does not make unreasonable assumptions about available funds, including state, federal, local, and private funds. For example, although an *individual project* may make a reasonable assumption about the potential level of federal funding available, the program *as a whole* may assume an unreasonably high level of total potential federal funds. This problem could be addressed by the use of consolidated financial reviews for projects. The Legislature could enact legislation to require the above reviews.

Promoting Efficiency. The Legislature could also consider actions to encourage efficiency in the overall rail system, such as measures to encourage joint procurements and shared maintenance facilities. The Legislature could direct state and local agencies to report on options available in the overall development of the rail system to achieve such efficiencies.

Given the above, we believe that there are a variety of steps the Legislature could take to ensure that the state develops an efficient and effective rail system. As a first step, ***we recommend that the Legislature enact legislation further defining the state's role involving rail transportation.*** Specifically, we recommend that the legislation:

- Require development of a long-term rail plan to guide development of the state's overall rail system.
- Require review of the economic merits and financial plans for projects.
- Specify the responsibility of Caltrans, the CTC, and other state and regional agencies in the areas of project review and system coordination.

COORDINATION BETWEEN RAIL PROGRAMS NEEDS IMPROVEMENT

The CTC administers Proposition 116, while Proposition 108 and the TCI program are the joint responsibility of the CTC and Caltrans. This arrangement makes coordinating these program components inherently complicated.

While both agencies indicate that program coordination is important and have taken some steps in this direction, for the most part, they still have to determine how coordination will be accomplished in implementing the three components of the state rail program. In particular, our review shows that two areas—project evaluation and database management systems—definitely need better coordination.

Project Evaluation

Figure 4 summarizes the project evaluation process for each program component. As the figure shows, projects will be evaluated differently in each case. These differences, however, are *not* the result of statutory requirements. For instance, TCI projects that will be funded in 1991-92 have been reviewed by Caltrans according to CTC policy. Proposition 108 commuter and urban rail projects were not reviewed by either the CTC or Caltrans prior to their inclusion in the 1990 STIP (for a further discussion see the 1991-92 *Analysis*, Item 2660). Finally, the CTC tentatively plans for Proposition 116 projects to be reviewed by private consultants.

Figure 4

Rail Capital Outlay Project Evaluation Process

	Proposition 108	Proposition 116	TCI Program
Program requirements	• CTC and Caltrans review projects according to program guidelines prior to inclusion in STIP. • Projects must first be nominated by regional transportation agencies or Caltrans.	• CTC reviews grant applications according to Proposition 116 guidelines. • CTC can contract with Caltrans for application review.	• Caltrans reviews projects according to CTC policy and makes recommendations to the CTC.
Actual process used for project evaluation	• $2.5 billion in commuter and urban rail transit projects were programmed in 1990 without prior review by either CTC or Caltrans. • Caltrans plans to perform project review at time local agency requests funds.	• CTC tentatively plans to use private consultants to review projects.	• Caltrans reviews projects according to CTC policy, and makes project recommendation to CTC.

Database Management Systems

Currently, the only comprehensive database system for tracking TCI projects is Caltrans' accounting system. However, the system does not function adequately to provide information on the status of projects. For example, the system is not capable of providing automated reporting on a particular (local) agency's projects that have received funds over a number of years. Such reports must be created manually.

Caltrans recognizes the deficiency of the current system, but nonetheless intends to use the same database system, with some improvements, for Proposition 108 projects. Additionally, it is not clear whether projects funded with Proposition 116 funds will be tracked using the same database.

Lack of Coordination Could Be Detrimental

A lack of coordination between program components in terms of project evaluation and database management could have the following negative effects:

- ***Duplicative review.*** The same project applying for different sources of funds may be reviewed twice—once by the CTC and once by Caltrans—resulting in duplication of review at the state level. At the same time, duplicative reviews create a cumbersome process for local agencies applying for funds.
- ***Inconsistent project assessment.*** Because projects may be evaluated by different agencies, they may be assessed based on nonuniform application of evaluation guidelines—even where guidelines across program components are the same. This could result in inconsistent project rankings for funding purposes.
- ***Lack of consistent project information.*** At present, it is not clear whether the state will develop a uniform database management system for all three program components. Absent such a system, it will be difficult to (1) make funding decisions based on complete information, (2) track a project's use of multiple state fund sources, and (3) obtain comprehensive program information.

How Can Coordination Be Improved?

Given the above, it is clear that there needs to be improved coordination between the state's rail programs. In the 1991-92 *Analysis*, we have recommended that the CTC report at budget hearings on its plans for the administration of Proposition 116,

and that the CTC and Caltrans report at budget hearings on issues related to the review of Proposition 108 projects (please see 1991-92 *Analysis*, Items 2600 and 2660). At that time, the Legislature could also examine the issue of coordination of rail project evaluations.

In addition, ***we recommend that the Legislature enact legislation directing the CTC to delegate to Caltrans the review of all Proposition 116 projects, and allow Caltrans, in turn, to contract with consultants where necessary to perform project evaluation.*** This would ensure that the same agency applies a consistent set of criteria for project reviews and would eliminate duplication of work. It would also be consistent with the intent of Proposition 116, which allows the CTC to contract with Caltrans for that work.

In order that there is a sound database to provide necessary management and financial information regarding rail projects, ***we also recommend that the Legislature direct Caltrans and the CTC to jointly establish a comprehensive database for this purpose, and to utilize the same database for the evaluation and tracking of all rail capital outlay projects receiving state funds.***

SCHEDULED BOND MEASURES WARRANT FURTHER REVIEW

As noted earlier, AB 973 places before the voters two general obligation bond measures of $1 billion each for rail capital outlay at the November 1992 and 1994 elections. During 1991-92, the Legislature will need to review the amount and timing of these measures in light of three developments that occurred subsequent to the enactment of AB 973.

- Voters approved Proposition 116, thereby increasing current state rail funds available to $3 billion. If voters approve both the additional AB 973 measures, state funds available will increase to almost $5 billion.
- The Legislature enacted Ch 1435/90 (SB 1825, Beverly), requiring the Director of Finance to report annually, beginning February 1, 1991, on projected state needs for financing *all* types of major capital outlay projects (including rail projects) over a 10-year period.
- Voters rejected 12 of 14 general obligation bond measures on the November 1990 ballot, thereby raising concerns over the amount of general obligation bonds that can be counted on to be approved and available to meet infrastructure needs.

Voter rejection of most bond measures in November 1990 makes the review of statewide capital outlay financing plans mandated by Chapter 1435 even more urgent to aid the Legislature and the administration in deciding when and how many bonds to present to voters at future statewide elections. (Please see our piece on state infrastructure elsewhere in this part.)

The amount of state funding needed over the next 10 to 20 years for rail projects will depend on the Legislature's *long-term* plans for rail development in California. However, in the *near term,* as the Legislature considers which bond measures to place before voters in 1992 and 1994, it will need to review the projects to be funded from the rail bonds currently scheduled for November 1992 and 1994, alongside all other types of capital outlay projects.

What Should the Legislature's Review Focus On?

The Legislature's review should consider three issues related to the *amount* and *timing* of the two additional bond measures.

First, the Legislature should consider the *merits* of the projects to be funded from the $3 billion in bond funds currently authorized and the merits of the additional projects which would be funded under the larger $5 billion program. As in the case of all governmental projects, whether financed with or without bonds, these rail projects should be undertaken only if their benefits exceed their costs.

Second, the Legislature will need to decide the *relative priority* of rail capital outlay projects versus other statewide capital outlay projects to be funded from general obligation bonds.

Third, as regards the *timing* of the rail bond measures, the Legislature should consider whether Caltrans and local agencies will have projects ready in time to use bond funds promptly, once the bonds are approved by the voters, and whether a series of smaller bond authorizations may be adequate to maintain project schedules.

Basic Information Is Needed

In order to arrive at a decision on the AB 973 bond measures, the Legislature will need additional information from Caltrans and the CTC. In particular, the Legislature will need to know which projects are to be funded from the scheduled bond measures, why each project merits funding, and when those projects are expected to require funding.

As discussed in further detail in the 1991-92 *Analysis* (please see Item 2660), $2.5 billion in commuter and urban rail projects were not reviewed by Caltrans or the CTC prior to being adopted in the 1990 STIP. Additionally, the CTC has not yet determined which projects will be funded under Proposition 116. Consequently, the Legislature does not have the information it will need to review the amount and timing of the AB 973 bond measures currently scheduled for the 1992 and 1994 ballots. In order that the Legislature can effectively review the AB 973 measures, ***we recommend that the CTC develop this information and report to the Legislature no later than August 1, 1991 on (1) the projects scheduled to be funded from currently authorized bond funds, and projects proposed for funding from the additional AB 973 bond measures; (2) why each project merits funding; (3) the total proposed funding by source for each project; and (4) the CTC's best assessment of when bond funds will be needed.***

SUMMARY AND CONCLUSIONS

Passage of Propositions 108 and 116 have created major new state rail programs. The Legislature will face several important issues in implementing these new programs.

Further Definition of State's Role. The Legislature will need to consider what further changes in, or definition of, the state's role in development of the state's rail system may be appropriate. In our view, there are several actions the Legislature should take in this regard.

We recommend that the Legislature enact legislation to:

- ***Require development of a long-term rail plan to guide development of the overall rail system.***
- ***Require review of the merits and financial plans for projects.***
- ***Specify the responsibilities of Caltrans, the CTC, and other agencies in the areas of project review and system coordination.***

Rail Program Coordination. The Legislature will also need to address problems in the implementation of the new rail programs by Caltrans and the CTC. In particular, we believe that improvements in project evaluation and database management systems are needed.

We recommend that the Legislature enact legislation directing the CTC to delegate to Caltrans the review of all

Proposition 116 projects. This would promote greater consistency in implementation of Proposition 116 and other state rail programs.

We also recommend that the Legislature direct Caltrans and the CTC to jointly establish a comprehensive database to adequately support the rail programs.

Review of Bond Measures. The Legislature will need to review the amount and timing of the rail bond measures currently scheduled by AB 973 for the November 1992 and 1994 ballots. This is needed to ensure that the projects to be funded have merit, are of high state priority, and will be ready for funding once bond funding is authorized by the voters. To carry out this review, the Legislature will need additional information.

Therefore, we recommend that the CTC report to the Legislature by August 1, 1991 on projects scheduled to be funded from the AB 973 bond measures and the Proposition 116 program, why each project merits funding, the total proposed funding by source for each project, and an assessment of when funding will be required.

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