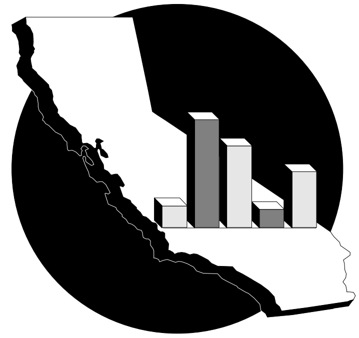


STATE FISCAL PICTURE

The 1994-95 Governor's Budget recognizes that the two-year budget plan adopted last June has been undermined by the continuing stubborn state recession. Faced with an $8 billion budget funding gap for 1993-94, the Legislature and Governor adopted a two-year plan to achieve a balanced budget in 1994-95. That plan now is $4.9 billion out of balance based on the state's current revenue and spending trends identified in the 1994-95 Governor's Budget.

The success of the Governor's 1994-95 Budget proposal hinges on actions at the federal level to approve a multibillion dollar increase in federal funds and on a favorable decision by the U.S. Supreme Court in a pending case affecting state tax revenues. This represents a highly risky strategy that could result in a multibillion dollar budget hole if the federal government or the Court fail to live up to the budget's expectations. Furthermore, the budget presents the Legislature with a difficult timing problem because it must adopt the state budget before Congress completes action on the federal budget.

The proposal continues the same spending priorities that have characterized the state's budget for the past several years. K-12 school funding and corrections spending receive high priority, while the budget proposes $800 million of spending reductions in health and welfare programs. The budget proposes no tax increases.

Perhaps the most important policy proposal in the budget is one that has no net fiscal effect in 1994-95. This is the Governor's plan for restructuring the state/county fiscal relationship, which is intended to give counties a significant cost share in the health and welfare programs that they administer in order to provide appropriate incentives to make those programs more efficient and effective.

In this part, we assess the state's current fiscal outlook and evaluate the Governor's response to the situation. We also examine the implications of the 1995-96 outlook on possible budget strategies for 1994-95.

THE 1994-95 BUDGET PROBLEM

Two-Year Plan Unravels

The budget plan adopted last June was intended to pay off prior-year deficits over a two-year period. Although this meant that the 1993-94 budget was not balanced, the plan indicated that, by the end of 1994-95, the state would have a small surplus of about $100 million. As has consistently been the case in recent years, this plan assumed that economic recovery was imminent and it would improve the state's revenue outlook. Once again, however, the Governor's Budget reflects a lowering of expectations in this area. As a result, the budget plan adopted last summer will not restore the state's fiscal balance by 1994-95, and significant budgetary adjustments must be made.

The Economic Outlook

The administration's forecast for the California economy now assumes that the state's economic recession will extend well into 1994, with only a moderate recovery in 1995. Thus, the current budget forecast is significantly more pessimistic than the forecast underlying last summer's budget plan, which assumed a late-1993 turning point and a stronger recovery.

The more pessimistic outlook for the California economy relates in part to federal budget changes that have taken place since last summer. Additional cuts in projected military spending will reduce defense procurement contracts in California, continuing the steep decline since the late 1980s. In addition, the third round of base closures was overwhelmingly directed at California military installations. High-income taxpayers, who represent an above-national-average share of California residents, will also be subject to significantly higher federal income taxes, which will reduce consumer spending and investment in California to some extent. The changed outlook also reflects an increased recognition of the structural changes that are occurring in the state's economy. Continued housing price declines have dampened construction activity and reduced consumer spending. Also, California is relatively dependent upon exports, and sales to foreign trading partners continue to be dampened by weak foreign economies.

California has not participated to date in the national economic recovery. Nonfarm payroll employment has fallen nearly 7 percent since its peak in May 1990, and shows no signs of turning up in the immediate future. The critical question for economic forecasters is exactly when these California employment losses will bottom out. The Governor's Budget assumes that will occur in late 1994.

The Revenue Forecast

Because the state's economy has generally not performed as well as was expected last May, current-year revenues are estimated to be somewhat weaker than projected when the 1993-94 budget was enacted. General Fund revenues and transfers are now estimated to be $880 million (2 percent) below the budget estimates (that is, revenues will be approximately $39.7 billion).

The outlook for 1994-95 has become significantly more pessimistic, however, relative to the forecast made last summer. Excluding proposed policy changes and revenue from a court decision assumed in the Governor's Budget, 1994-95 revenues are approximately $1.8 billion lower than previously forecast. On this basis, baseline revenue growth in 1994-95 is only $833 million, or 2.1 percent.

Budget Plan Falls Out of Balance

Partially due to the state's continued economic misfortune, the state's two-year budget plan adopted in June now has fallen far out of balance. Figure 1 compares the June 1993 budget estimates for 1993-94 and 1994-95 with the January 1994 estimates just released in the *1994-95 Governor's Budget*, adjusted to exclude the spending and revenue changes that are now proposed by the budget. Thus, the January estimates shown in Figure 1 incorporate the administration's latest revenue forecast and caseload projections. The budget plan adopted in June sought to reduce the General Fund deficit from $2.8 billion in 1992-93 to $540 million by the end of 1993-94 and to achieve budgetary balance in 1994-95, ending the year with a small reserve of $100 million. As the figure shows, however, absent corrective action, the state's General Fund now faces a $4.9 billion deficit in 1994-95 that is attributable both to the revenue shortfalls discussed above and to spending increases.

Spending Increases Add to Budget Problem. As shown in Figure 1, our analysis indicates that spending is expected to increase by $2.3 billion over the two-year period covered by the budget plan. For 1993-94, this projection reflects current estimates of costs in major program areas, exclusive of solutions proposed in the budget. The 1994-95 baseline spending estimate shown in Figure 1 recognizes both increasing caseloads and the increasing costs of providing state services, except where existing law or policy requires otherwise. For example, our baseline estimate provides no increase in per-pupil K-12 education funding or in welfare grants. Our baseline includes funding increases to offset one-time savings in 1993-94 (such as the gain from adopting cash accounting for debt service), and it includes additional costs or savings associated with the full-year impact of changes that were in place for only a portion of 1993-94 (such as annualization of employee pay increases).

Figure 1

Two-Year Budget Plan Falls Out of Balance
Change in General Fund Estimates[a]
January 1994 versus June 1993

(In Millions)

	1993-94			1994-95		
	June	January	Change	June	January	Change
Prior-year balance	-$2,233	-$2,289		-$130	-$2,073	
Revenues and transfers	40,623	39,743	-$880	42,418	40,576	-$1,842
Total resources available	$38,390	$37,454		$42,288	$38,503	
Expenditures	$38,520	$39,527	$1,007	$41,778	$43,041	$1,263
Ending balance	-$130	-$2,073		$510	-$4,538	
Reserve	**-$540**	**-$2,466**		**$100**	**-$4,930**	
Other obligations	$410	$393		$410	$393	

[a] Excludes Governor's proposed budget solutions and restructuring proposal.

Several factors account for the increases in anticipated spending levels. The state's weak economy has reduced property tax receipts allocated to K-14 schools, and increased state spending will be needed to backfill these shortfalls in order to maintain per-pupil funding. In addition, county governments have implemented the property tax shift to schools adopted as part of the 1993-94 budget plan in a manner that reduces the amount shifted to the schools and in turn increases the state's liabilities (the budget proposes legislation to correct this prob lem). Together, these property tax shortfalls increase baseline spending by about $600 million over the two-year period.

A shortfall in previously expected federal funds accounts for $480 million of the spending increase. Specifically, the June budget plan included an annual savings of $240 million from federal funding to cover the state share of Medi-Cal costs for undocumented immigrants, but those funds were not approved by Congress. The remainder of the increase in the spending baseline primarily is due to a variety of shortfalls in savings anticipated from other actions in the June budget plan and some relatively minor caseload increases.

1994-95 Budget Gap: $4.9 Billion

Over the two-year period, we estimate that baseline General Fund revenues have declined by $2.7 billion and that baseline spending has increased by $2.3 billion compared with the June budget plan. Taking into account the $100 million reserve in the June budget plan, these changes would result in a 1994-95 year-end deficit of $4.9 billion if no corrective action is taken (please see Figure 1). This amount represents the two-year budget gap that now faces the state. Figure 2 illustrates the components of the budget gap. The $4.9 billion gap consists of the estimated carryover deficit from 1993-94 (almost $2.5 billion) and a $2.4 billion operating shortfall between baseline spending and estimated revenue in 1994-95.

Figure 2

1994-95 Budget Gap[a]

(In Billions)

Pay off deficit from 1993-94		$2.5
1994-95 baseline spending	$43.0	
1994-95 baseline revenue[b]	-40.6	
Operating shortfall		$2.4
Budget Gap		**$4.9**

[a] Excludes Governor's Budget proposals.

[b] Based on administration's revenue forecast.

While the state's weak economy constrains revenue growth, baseline expenditures increase by $3.5 billion, or 8.9 percent, in 1994-95 compared with the current year. Two programs account for more than half of the baseline spending increase—Medi-Cal health services and Proposition 98 education funding. Medi-Cal baseline spending increases by $1.1 billion in 1994-95 because of the expected continued rapid growth in caseload and costs and to replace expiring federal funds. Proposition 98 funding also increases by over $1 billion in order to maintain per-pupil funding levels, in part because of a $600 million net impact from Proposition 98 loans in the current year.

THE GOVERNOR'S BUDGET PROPOSAL

Figure 3 shows the Governor's proposed amounts of spending and revenue for 1993-94 and 1994-95 and the resulting General Fund condition. (These estimates differ from those printed in the Governor's

Figure 3

Governor's Budget General Fund Condition 1993-94 and 1994-95

(Dollars in Millions)

		1994-95			
	1993-94	As Proposed[a]	Percent Change	Adjusted for Restructuring[b]	Percent Change
Prior-year balance	-$2,289	-$1,893		-$1,893	
Revenues and transfers	**39,743**	**41,334**	**4.0%**	**43,105**	**8.5%**
Total resources available	$37,454	$39,441		$41,212	
Expenditures	**$39,347**	**$38,788**	**-1.4%**	**$40,559**	**3.1%**
Fund balance	-$1,893	$653		$653	
Reserve	**-$2,286**	**$260**		**$260**	
Other obligations	393	393		393	

[a] Includes post-budget adjustments to revenue totals.

[b] Includes $1.8 billion of General Fund revenues and expenditures that are shifted to local governments under the Governor's restructuring proposal.

Budget because they incorporate the administration's post-budget release adjustments for additional federal fund recoveries and tax reduction proposals. They also differ in that they present the annual budget deficits in line with traditional state accounting practices.)

As shown in the figure, General Fund revenues are expected to increase by 4 percent from the current year, while spending is expected to fall by 1.4 percent. However, this comparison includes the effect of transferring $1.8 billion of General Fund revenues and costs to local governments under the Governor's state/county restructuring proposal. In order to facilitate comparisons between the two years, the figure also shows the 1994-95 General Fund condition adjusted to add back the revenues and costs shifted to local governments under the state/county restructuring proposal. This adjustment has no effect on the projected General Fund balance because it is fiscally neutral as presented. On this adjusted basis, proposed General Fund revenues increase by 8.5 percent (largely due to the assumed federal funds and a state victory in the *Barclays* court case) and proposed spending increases by 3.1 percent in 1994-95 compared with 1993-94. As presented, the budget would result in a modest reserve of $260 million at the end of 1994-95.

How the Budget Addresses the Spending Gap

Figure 4 shows how the budget proposes to address the $4.9 billion budget gap that we identified above (and also create a reserve of $260 million). As shown in the figure, most of the budget gap ($3.5 billion) is filled by shifting costs to other levels of government. In contrast with last year's budget proposal, which primarily relied on shifting costs to local governments, the current budget proposal primarily relies on shifting costs to the federal government to gain $3.1 billion of budget solutions. Of this amount, $2.3 billion represents the Governor's request for federal funding of the state's education, health care, and incarceration costs related to undocumented immigrants. The other major increase in federal funding ($600 million) would result from increasing the federal match in the state's major health and welfare programs from the current 50 percent to 54.4 percent, based on one of several alternatives recommended by the U.S. General Accounting Office (GAO). Both of these budget proposals would require action by Congress and the President.

Cost shifts to local governments would provide a net $385 million of solutions, primarily through legislation to revise the 1993-94 property tax shift. This legislation would effectively reverse property tax allocation method changes adopted by county governments which have increased the state's liabilities for K-12 schools.

Program funding reductions account for $1 billion of savings. The largest savings come from proposed grant reductions for Aid to Families with Dependent Children (AFDC) and related welfare reform proposals. The budget also includes substantial savings from the elimination of certain Medi-Cal optional benefits (health services that are not required by federal law) and the elimination of funding for prenatal services for undocumented immigrant women.

Figure 4

Governor's Proposed Resolution Of the 1994-95 Budget Gap[a]

(In Billions)	
Shifts to other levels of government	**$3.5**
Federal Government:	
Reimbursements for costs of undocumented immigrants	$2.3
Increased refugee funding	0.1
Raise federal health and welfare match to 54.4%	0.6
Other funding changes in IHSS and SSI/SSP programs	0.1
Subtotal	($3.1)
Local Government:	
Revise prior property tax shift to schools	$0.4
Subtotal	($0.4)
Program reductions	**$1.0**
Welfare—AFDC grant reductions and reforms	0.5
Medi-Cal: eliminate optional benefits and prenatal services for undocumented persons	0.3
Reduce management positions	0.1
Other General Fund reductions	0.3
Shift special fund monies to General Fund programs	0.1
Program augmentations, including Community Colleges, AIM, Student Aid, and Cal-Learn	-0.2
Cost deferrals	**$0.1**
Shift flood control costs to bonds	0.1
Increased resources	**$0.5**
Assumed victory in *Barclays* case	0.6
New tax credit	-0.1
Total solutions[b]	**$5.2**
Establish 1994-95 General Fund reserve	-0.3
Budget gap solutions	**$4.9**

[a] Figures reflect both 1993-94 and 1994-95 effects.

[b] Details do not add to totals due to rounding.

The budget assumes that the state will be victorious in the *Barclays* and *Colgate* cases now before the U.S. Supreme Court, which challenge California's past unitary tax treatment of corporate income from national and worldwide operations. A favorable decision would allow collection of approximately $600 million of disputed tax assessments in 1994-95. The budget also proposes a new tax credit for low and moderate income taxpayers, which has an expected revenue loss of $95 million in 1994-95.

MAJOR BUDGET PROPOSALS

Governor's State/County Restructuring Proposal

The budget proposes a major shift of program responsibilities and funding from the state to the counties. As detailed in Figure 5, about $3.2 billion in existing state costs for health and welfare programs would be shifted to counties, in exchange for higher allocations of local property tax revenues, an additional shift of state sales taxes, and greater state support for local trial courts. The budget proposal also would significantly revise the 1991 realignment program, essentially consolidating its funding structure to accommodate the new program and funding shifts.

Figure 5

Governor's State/County Restructuring Plan 1994-95

(In Millions)	
State Resources Shifted to Counties	
Shift state sales tax revenues	$1,409
Shift school property taxes to counties (state backfills school losses)	1,140
Increase state trial court block grants	386
Return trial court fines and forfeiture revenues	296
Return mental health patient revenues	15
Total	**$3,246**
State Costs Shifted to Counties	
Establish county share of Medi-Cal costs	$1,353
Increase county share of AFDC costs	1,147
Shift IHSS program to counties	364
Shift foster care program to counties	324
Shift most drug and alcohol programs to counties	62
Eliminate county services block grant	16
Total	**$3,267**

Under the proposal, county governments' share of the nonfederal portion of costs of the AFDC program would be raised from 5 percent to 50 percent. They also would be required to pay a new 11.51 percent share of total costs under the Medi-Cal program. In addition, they would assume complete financial responsibility for the Foster Care, In-Home Supportive Services (IHSS), and most Alcohol and Drug programs.

These changes are intended to increase the financial incentives of counties to make program investments and operating decisions in ways that improve program performance. To the extent that program performance improvements reduce program costs, counties would be entitled to use the savings for other local purposes. To the extent that program costs increase, counties would be at risk for the additional expenditures. The proposal also would increase county flexibility to make program decisions in these and other program areas, although no specifics are provided. Because the proposal assumes the receipt of additional federal funds and the proposed AFDC grant savings, it is fiscally neutral only to the extent these funds and savings actually are realized.

In Part Five, we discuss the Governor's restructuring proposal more fully and offer some potential refinements to deal with the concerns we raise.

Increased Federal Funds

Figure 6 details the major components of the $3.1 billion of increased federal funding sought in the budget. Reimbursement of state costs that the Department of Finance attributes to undocumented immigrants accounts for $2.3 billion of the total, and the largest share of that amount is $1.7 billion for the estimated cost of K-12 education for students who are undocumented immigrants. The budget treats this $1.7 billion as an addition to General Fund revenues, rather than as an offset to General Fund spending. The budget also treats the $300 million sought as reimbursement for incarceration costs of undocumented felons as a General Fund revenue, rather than using it to reduce General Fund support for corrections. In contrast, the budget reduces General Fund support for Medi-Cal to reflect the $300 million in federal funds sought to cover state costs of federally required Medi-Cal services to undocumented immigrants.

As discussed earlier, the budget assumes that Congress and the President will adopt one of the options that the U.S. General Accounting Office (GAO) has recommended to revise the formula that determines the share of cost that the federal government pays each state for Medicaid (Medi-Cal in California), including many services provided by the In-Home Supportive Services (IHSS) program in California, and for AFDC. This change would save almost $600 million in General Fund costs in 1994-95, based on implementation on October 1, 1994. Most of these savings would be in the Medi-Cal program.

Figure 6

Major Federal Funding Proposals In the 1994-95 Governor's Budget

(In Millions)

Costs for Undocumented Immigrants	
Reimburse state for K-12 education costs of undocumented children	$1,700
Pay full cost of Medi-Cal services to undocumented persons	300
Reimburse state for incarceration of undocumented felons	300
Subtotal	($2,300)
Other Proposals	
Increase federal match for health and welfare from 50 percent to 54.4 percent	
Medi-Cal	$408
AFDC	170
IHSS/Personal Care	15
Subtotal	($593)
Fund 36 months of health and welfare benefits for refugees	111
Expand coverage of IHSS/Personal Care services	46
Eliminate federal administrative charge for SSI/SSP program	43
Total	**$3,093**

The budget also assumes other federal actions that would save the state a total of $200 million. The actions include funding up to 36 months of benefits to refugees, expanding Medicaid eligibility to include IHSS services provided by a parent or spouse, and eliminating the charge that Congress imposed on states as part of last year's federal budget agreement for administering state supplemental grants to the aged, blind, and disabled under the SSI/SSP program.

Health and Welfare

AFDC Proposals. The budget proposes legislation to enact various AFDC grant reductions and welfare reforms similar to proposals that the administration has put forward in previous budgets. These actions include a 10 percent grant reduction effective July 1, 1994, an additional 15 percent grant reduction after six months on aid, and a two-year time limit for aid to able-bodied adults. The budget estimates $460 million in General Fund savings from these actions in 1994-95.

Medi-Cal Optional Benefits. The budget again proposes to eliminate certain optional benefits that California provides under the Medi-Cal program. The benefits that would be eliminated include adult dental care, psychology, and podiatry for a net General Fund savings of $154 million in 1994-95.

Prenatal Services. The budget proposes to eliminate funding for a state-only program of prenatal services to undocumented immigrant women, effective February 1, 1994. This would reduce General Fund spending by $14 million in 1993-94 and by $92 million in 1994-95. Undocumented women would remain eligible for federally required emergency and obstetric services under Medi-Cal. The budget indicates that $59 million of these savings will be used to expand the Access for Infants and Mothers (AIM) program that provides subsidized health coverage for pregnant women and infants with family incomes between 200 percent and 250 percent of the poverty level and who do not qualify for Medi-Cal.

Proposition 98 Funding

The budget does not propose any major policy changes to Proposition 98 funding for K-12 schools and community colleges. Spending per K-12 pupil would be maintained at the current level, which results in spending exceeding the minimum guarantee. Unlike past years, the budget does not propose any Proposition 98 loans or recaptures, so that 1994-95 budget expenditures reflect the actual amount of Proposition 98 funding that schools and community colleges will receive in 1994-95.

New Bond Proposals

The Governor has indicated his support for $5.1 billion of general obligation bonds for the June or November ballots. (He has also proposed $1.1 billion in new lease-payment bonds for prisons.) These proposals include $1.6 billion for K-12 school construction; $1.4 billion for prisons and a variety of public safety projects, including assistance for local flood control projects that the state has budgeted on a pay-as-you-go basis previously; $1 billion in rail bonds (already scheduled for the November ballot); $900 million for higher education facilities; and $200 million to fund a state infrastructure bank that would assist local governments. These proposals would be in addition to $2.2 billion in other bond measures already placed on the ballot by initiative and prior legislative action.

Tax Reduction Proposals

The budget proposes legislation which would reduce income taxes for moderate-income individuals and newly established businesses. For individuals, the administration proposes to provide a nonrefundable income tax credit of $25 to most single taxpayers earning less than $25,000 per year. Most married couples earning less than $40,000 per year would be eligible for a $50 credit. Because the credit is not refundable, however, those persons with incomes too low to have a state tax liability would not benefit from the credit. These credits would result in annual revenue losses to the General Fund of approximately $95 million, beginning in 1994-95.

The administration also proposes to provide tax credits to businesses which are established and begin operations during the next two years. These businesses would receive a refundable credit of $1,000 for each new full-time job they create. Eligible businesses would receive the credit for up to two years following the date they begin operations. This proposal would result in annual revenue losses of approximately $50 million for four years, beginning in 1995-96.

State Administration

State Agency Consolidations. The budget proposes several changes that would reorganize, consolidate, or potentially eliminate existing state agencies. Among these are a consolidation of existing commissions and authorities in the State Treasurer's Office. Some of these would be consolidated within a new Revenue Bond Financing Authority, while in other cases their functions would be assigned to other state agencies or eliminated. Two new state agencies are referenced in the budget: a Department of Energy and Conservation to absorb the functions of the existing Energy Commission, State Lands Commission, and Department of Conservation, and a Department of Waste Management to take over the functions of the existing Integrated Waste Management Board. The specifics of the administration's reorganization plan were not included in the budget.

Flattening State Agencies. The budget proposes to reduce the number of managers and supervisors in state agencies by 10 percent by the end of 1994-95. This proposal is intended to improve the responsiveness and efficiency of state government agencies. The budget anticipates savings of $150 million (all funds) in 1994-95 from this reduction, but the budget did not include specific departmental proposals.

BUDGET'S BALANCING ACT IS PRECARIOUS

The Governor's Budget proposal involves major uncertainties and faces significant threats that easily could throw the budget several billion dollars out of balance.

Budget Balance Hinges on Actions by Others

Most of the budget solutions proposed by the Governor ultimately lie outside the control of the Legislature. All of the $3.1 billion of assumed additional federal funding requires action by Congress and the President, and most of the savings attributed to AFDC grant reductions and limitations will require federal law changes or waivers. The additional revenue assumed from a victory in *Barclays* relies on a future Supreme Court decision. We estimate that less than $1.5 billion of the $5.2 billion of proposed budget solutions can be accomplished directly by the Legislature.

Timing of Economic Recovery Uncertain

The economic forecast on which the budget is based once again assumes that the end of the state's recession is imminent, with a slow recovery beginning in late 1994. Our own economic forecast, presented later in this volume, shows the state's job losses continuing through the middle of 1995. Our estimate of General Fund revenues over the two-year period covered by the budget is about $1.2 billion less than the administration's estimate.

Earthquake Puts Additional Strain on Budget

The Northridge earthquake places a major unanticipated fiscal burden on the state. Initial estimates placed the damage in the tens of billions, including damage to public facilities and infrastructure as well as damage to private property. In addition, there will be significant losses of income to many businesses and their employees that have been adversely affected by the earthquake. Fortunately, the federal government will cover most of the governmental costs of emergency assistance and repairs. However, the state's share of these costs still will amount to at least hundreds of millions of dollars and could exceed a billion dollars, given the magnitude of the damage and losses.

Pending Lawsuits Threaten Budget

While the budget assumes a $600 million gain from a victory in *Barclays*, an adverse decision in that case could also require the state to refund $2.1 billion of past tax collections, according to a preliminary estimate by the Franchise Tax Board. Such a result would reduce the anticipated ending balance by $2.7 billion in 1994-95. In addition, two other court cases could have substantial negative budget impacts by 1994-95.

In the first court case—*California Teachers' Association v. Gould*—a recent Superior Court decision appears to relieve K-12 schools and community colleges from repaying $1.8 billion of state Proposition 98 "prepayment" loans. These loans were to be repaid as offsets against the state's future Proposition 98 funding requirements. If this decision (which is not yet in writing) is upheld, it could require the state to show these loans, which currently are carried off-budget, as on-budget expenditures, which would worsen the stated General Fund condition by $1.8 billion. Furthermore, it appears that the decision could increase the state's ongoing Proposition 98 obligations by hundreds of millions of dollars annually because the loans would be rolled into the schools' permanent funding base.

In the second court case, *Orthopedic Hospital v. Kizer*, Medi-Cal providers contend that the state's payments for hospital outpatient services are too low and constrain access to care, in violation of federal law. The court has found that the current rates are arbitrary and has ordered the Department of Health Services to review its rate-setting methodology and report its findings in April 1994. We believe that the potential cost of increasing provider rates could easily be in the range of several hundred million dollars annually, in part because a decision to increase reimbursement rates for outpatient services provided *in hospitals* would effectively require a similar increase for *all* outpatient services.

THE OUTLOOK FOR 1995-96

The economic forecast on which the budget is based projects a resumption of modest job growth in California by the end of 1994. If the budget's economic forecast is accurate, we estimate that revenue growth would pick up in 1995-96, so that baseline revenues would increase by 4.6 percent. Whether this projected improvement in the state's economy next year is sufficient to pull the state out of its fiscal crisis depends upon the expected rate of growth for state spending.

In order to examine the 1995-96 outlook, we have extended our baseline spending projection to that year. This projection does not provide any basis for an optimistic outlook, because baseline spending grows almost twice as fast as revenues. As a result, the baseline operating deficit in 1995-96 would be $4.1 billion—significantly larger than our estimate of the baseline operating deficit of $2.4 billion in 1994-95. Continued rapid growth in costs for Medi-Cal and corrections are a major reason for the large baseline spending increase. The other major reason for the fiscal deterioration is the need to replace roughly $1 billion of temporary budget savings and revenues. These expiring budget solutions include the deferral of the state's PERS retirement contribution, the suspension of the renters' tax credit, and the expiration of the temporary 10 percent and 11 percent top personal income tax brackets.

DOES THE BUDGET WORK?

If the federal government, the courts, and the economy fulfill all of the budget's expectations, the state would regain fiscal balance in 1994-95 and (if this fulfillment is ongoing) remain in balance through 1995-96. However, we believe that it is much more likely that events will fall short of these expectations. In that event, the Legislature will once again face a multibillion dollar hole in the budget early in the 1994-95 fiscal year, at a point in time when it is difficult to make modifications. This would result, once again, in a large carry-over deficit to be dealt with in the next fiscal year.

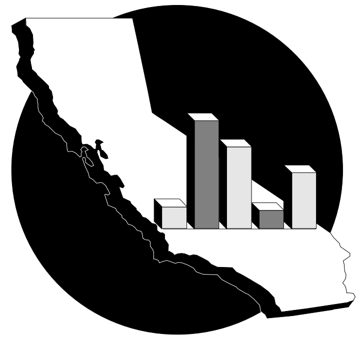
As discussed above, the outlook past 1994-95 indicates that the state's ongoing shortfall between revenues and spending will worsen, even with a modest recovery in place. This situation requires a budget strategy that looks beyond 1994-95 and achieves ongoing and growing savings over the next several years. We offer the following guidelines for the Legislature to use in developing a long-term budget strategy:

- One-time savings actions can buy time to implement ongoing savings; they should not be adopted as a substitute for them.
- Actions that produce significant future savings should be adopted even if they yield little or no savings in 1994-95, because the need for future savings will grow.
- Similarly, actions which result in significant future costs should be avoided.
- Existing laws that end savings, reduce revenues, or restore spending during the next few years should be reviewed.

- Federal health care reform efforts should be closely monitored since Medi-Cal cost increases are a major factor driving state spending growth. The Legislature should encourage Congress and the President to adopt reforms that help to bring the state's Medi-Cal costs under control.
- Efforts should be made to evaluate potential savings in corrections' programs that will reduce the rapid growth in those costs and focus resources on protecting the public from violent crime.

CONCLUSION

As we have discussed above, the state's economy has continued to undermine the Legislature's and the Governor's best efforts to bring the ongoing fiscal crisis under control. We do not expect this situation to be reversed in the near future, as it is unlikely that an improved economic outlook will prevent the need for significant and painful reductions in state spending. Rather, the use of optimistic expectations for the budget would be likely to merely defer the day of reckoning and make the reductions ultimately required all the more severe. The Legislature's best strategy is to focus on putting into place the types of changes that will produce the long-run savings that are needed.



PERSPECTIVES ON THE ECONOMY

Much of the blame for the state's continuing budget shortfalls over the past three years can be placed on the dismal performance of the California economy. The substantial population increases of recent years have maintained constant upward pressure on demands for state services. At the same time, declining employment levels, lower real per capita incomes, and falling property values have limited the ability of the state's major revenue sources to meet these demands. Despite substantial gains in the national economy over the past year, economic activity in most regions of California continues to decline or stagnate. The key questions at this point are:

- When will the California recession end?
- How quickly will employment and income grow thereafter?

CONTRASTING RECENT TRENDS FOR THE STATE AND NATION

The national economy is continuing to recover from the recession that officially ended in the spring of 1991. The interest-sensitive sectors, in particular, have done extremely well over the past seven months. For example, the housing market has accelerated, consumer confidence has rebounded, retail spending has strengthened and the labor market has consistently improved. Overall, current indicators at the national level unambiguously point toward continued economic recovery with low interest rates and low inflation.

The California economy, on the other hand, has stabilized in some areas, but has shown few signs of even the beginnings of a significant recovery. Total nonfarm employment in the state continues to stagnate or drift downward, and the state's unemployment rate remains one of the highest in the nation. Although existing home sales have increased steadily over the past six months, home prices are still falling and construction activity remains very weak. Overall, there is little evidence that the interest-sensitive sectors of the California economy are about to begin the kind of robust cyclical recovery that is needed to offset weaknesses in other sectors of the economy.

National Expansion Still on Course

The national economy, as measured by real Gross Domestic Product (GDP), grew at an estimated annual rate of 5.9 percent in the fourth quarter of 1993, its highest rate since the first quarter of 1987. Much of the recent growth in the national economy can be credited to an improving housing sector that has spilled over into new furniture and appliance sales, helping to boost retail activity and construction-related manufacturing. For instance, existing home sales in 1993 were 7.9 percent above the previous year, driven by low interest rates and resurging consumer confidence. Housing starts climbed 7.1 percent last year to their highest level in four years.

The nation's labor market also shows clear signs of continuing improvement, although there is still weakness in the manufacturing and construction sectors. The national unemployment rate fell to a three-year low of 6.4 percent in December, reflecting the addition of 183,000 new nonfarm jobs, most of them in service industries.

Consumer confidence at the national level climbed to 83.2 percent in January 1994, nearly 25 percentage points above its June 1993 low of 56 percent. This increase helped to bring about a 6.2 percent increase in retail sales for all of 1993, the largest yearly rise since 1989. Improved consumer confidence and retail sales are crucial to a sustained economic recovery because consumer spending accounts for two-thirds of the nation's total economic activity.

Continued low inflation is also a positive sign for sustained growth at the national level. The consumer price index increased by only 2.7 percent for all of 1993, the lowest rise in seven years. Subtracting out the volatile food and energy components, the “core” rate of inflation increased by only 3.2 percent in 1993, its best annual performance in over 20 years.

California Economy Falling Farther Behind

Based on the Department of Finance (DOF) revised payroll employment series, California has lost a total of 868,000 jobs since May of 1990. Over 60 percent of the job losses were in the high-wage manufacturing and construction sectors. These losses resulted from slowdowns in residential and nonresidential building activity, ongoing corporate downsizing and restructuring to meet increased foreign competition, and an acceleration of defense cutbacks and base closures. Unlike previous recessions, California has also lost a large number of jobs in the trade, finance, insurance and real estate sectors.

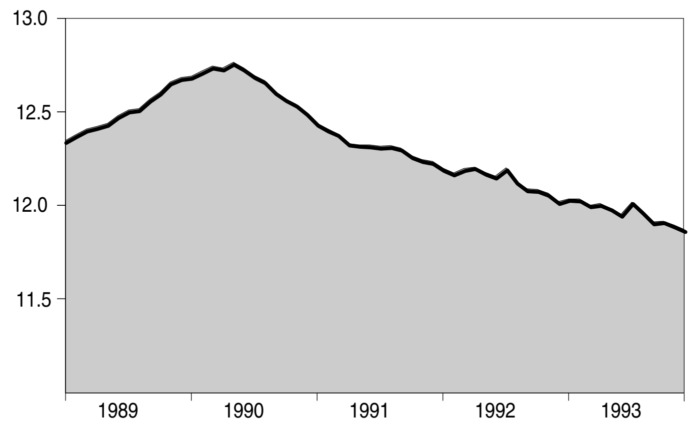
In the past six to twelve months, there has been very little hard evidence that the state economy is poised to begin a significant recovery any time in the near future. In fact, good news is hard to find.

Employment Continues to Fall. From December of 1992 to December of 1993, total payroll employment in California dropped by over 150,000 jobs, as shown in Figure 1. The California unemployment rate, which is based on a separate household survey of all civilian employees and labor force participants, was 8.7 percent last December, one of the highest in the nation, and 2.3 percentage points above the U.S. unemployment rate.

Figure 1

California Nonagricultural Employment 1989 Through 1993

(In Millions)

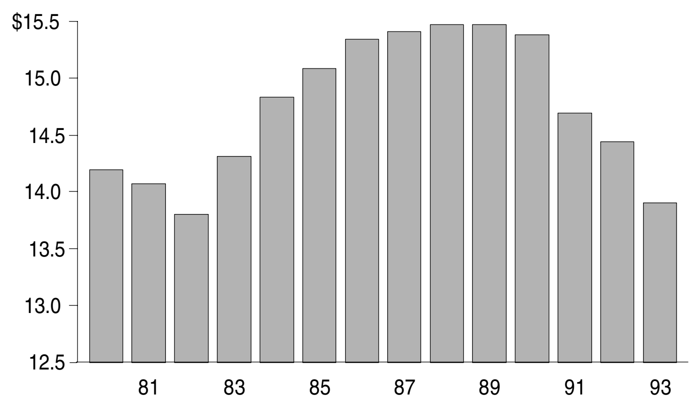


Income Growth Lags U.S. As shown in Figure 2, the level of real per capita income in California has fallen nearly 10 percent during the state's current recession. Over the same period, real per capita income nationally has increased slightly. Although real income levels in the state should begin rising again as the job market and wage rates improve over the next couple of years, California is likely to continue losing ground relative to the nation largely because of the state's declining share of high-wage manufacturing jobs, its faster growing service sector, and the fact that its rapid population growth exceeds the growth in employment potential.

Figure 2

California Real Per Capita Personal Income 1980 Through 1993

(In Thousands)

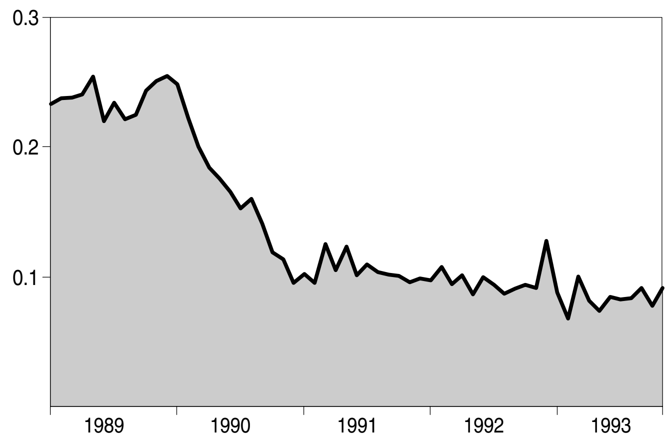


Home Building Slump Continuing. As shown in Figure 3, total housing permits issued in the state have fallen dramatically—by over 65 percent—from their peak in late 1989 to their current level of around 85 thousand units. In addition, the median price of an existing home in California has dropped over 11 percent since its May 1991 peak and is still falling from month to month. Low mortgage interest rates contributed to a moderate increase in home resale activity in the last half of 1993, but this buyer interest has not been translated into increased home building.

Figure 3

California Housing Permits 1989 Through 1993

(In Millions)



Nonresidential Construction Still Sliding. Construction activity in this sector has declined steadily since the beginning of 1990, as shown in Figure 4. Over these past four years, the total volume of nonresidential construction, measured in constant 1987 dollars, has fallen roughly 50 percent. The overbuilding of retail and office space during the 1980s, defense cutbacks, and the severe slowdown in manufacturing activity are primarily responsible for the continued weakness in this sector.

New Vehicle Registrations Flattening Out. After falling by over 20 percent from their 1989 levels, new vehicle registrations appear to have stabilized during 1993. This more positive situation generally reflects a combination of factors, including low interest rates, small price increases for new cars, and the increasing need to replace aging vehicles.

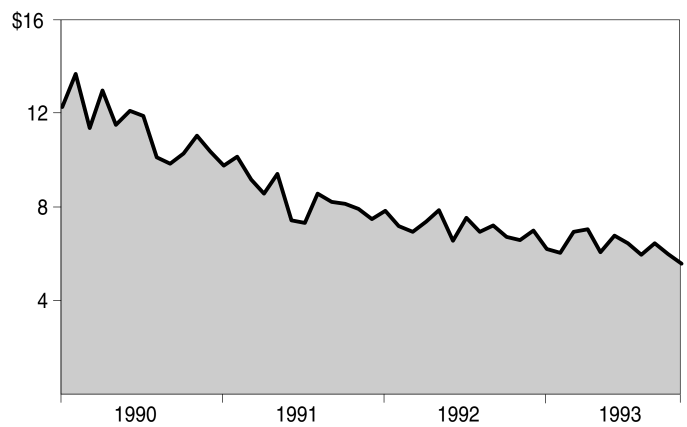
THE GOVERNOR'S BUDGET FORECAST

The DOF's economic forecast assumes the national economy will continue to expand in 1994 and 1995, although at a somewhat slower rate than the pace set in the final months of 1993. The DOF forecast for California, on the other hand, assumes continuing defense spending cuts and military base closures will generate only a small employment turnaround later this year.

Figure 4

Nonresidential Permit Valuations 1990 Through 1993

(In Billions of 1987 Dollars)



The DOF National Outlook—Continued Moderate Expansion

The DOF forecast for the national economy is generally consistent with the consensus view of other national forecasters. Growth in real GDP is expected to moderate from an annual rate of 5.9 percent in the fourth quarter of 1993 to a more sustainable 3 percent average in 1994. This lower growth rate assumes some slowing in retail sales early this year as consumers postpone new purchases to allow income to catch up with late-1993 spending increases. It also reflects the impact of federal tax increases for high-income taxpayers enacted as part of the Clinton Administration's 1993 deficit reduction package. These retroactive tax increases will reduce spendable incomes in 1994 both because of higher payments due on 1993 tax returns and because of the increased withholding and estimated tax payments that take effect this year.

The Department of Finance forecast for 1995 projects real GDP at the national level to continue in the 3 percent range. This assumes recoveries in

Europe and Japan will provide an extra boost to the U.S. economy, and that consumer spending, after slowing somewhat this year, will pick up modestly. Inflation and interest rates, which declined to record low levels during the recession and early recovery periods, will drift upward through 1995, as recoveries in other industrial economies put upward pressure on commodity prices. The Federal Reserve is expected to react to increased inflationary pressures by raising interest rates.

The DOF California Forecast—
Defense Cuts Limit Growth of State Economy

The Department of Finance holds "huge cuts" in defense spending primarily responsible for California's massive job losses since 1990, and considers them to be the main obstacle to an economic recovery in the state. The principal question posed by the department's forecast is "...when and whether other elements in the state's economy can muster sufficient strength to overcome the continuing drag of defense cuts."

Figure 5 compares the growth rates for California nonagricultural employment and personal income projected by the Department of Finance in 1994 and 1995 to those of other forecasters. As shown in this figure, the DOF's forecast of aggregate economic growth in the state over the next two years, as measured by employment and income, falls generally in the middle of the range of these forecasts. Apart from relatively minor differences in growth rates, these forecasters all call for continued employment *declines* this year (in the range of 0.2 percent to 1.1 percent) followed by, at best, a weak recovery in 1995. Although these forecasts all project declines in state nonfarm employment in 1994, this represents a significant *relative* improvement in the state's economy when compared to much larger employment declines in the previous three years.

Figure 5

Comparison of California Economic Forecasts 1994 and 1995

	1994		1995	
	Employment	Personal Income	Employment	Personal Income
Department of Finance	-0.6%	4.0%	0.7%	5.0%
UCLA Business Forecasting Project	-0.2	3.6	1.3	3.4
Western Blue Chip Economic Forecast	-0.2	4.3	NA	NA
Commission on State Finance	-0.7	4.6	1.1	5.1

The Department of Finance identifies some "bright spots" in its California forecast which it states may be sufficient this year to offset the continued drop in defense outlays. These include: an upturn in housing related to lower mortgage interest rates; stronger gains in the state's healthy tourism, entertainment and recreation industries; and improved foreign trade. On the *negative* side, the department indicates that military base closings could be a renewed source of weakness next year. Three bases are scheduled to close in 1995, representing a loss of over 32,000 civilian and military jobs. The department also anticipates further declines in aerospace and electronics, continuation of corporate restructuring and downsizing efforts, and slow gains in retail and wholesale trade.

No Immunity From Effects of Health Plan. Although the DOF budget forecast does *not* take into account the Clinton Administration's proposed national health plan, the department does state that the plan, as currently specified, could have a "significant dampening effect" on the California economy. However, we note that the Clinton plan does not require state implementation in 1995-96, and its economic effects could be positive or negative, depending upon the specifics of the legislation. (Please see our policy brief on National Health Insurance Reform.)

THE LAO FORECAST

In this section, we provide our forecast of the California economy, both in the near-term and future prospects.

Figure 6 compares the Legislative Analyst's forecasts for selected economic variables to the DOF forecasts for 1994 and 1995. Our U.S. forecast assumptions are for slightly stronger real gross domestic product (GDP) growth in 1994—3.0 percent versus 2.8 percent—and somewhat weaker GDP growth in 1995—3.0 percent compared to 3.4 percent. The chief downside risks to this forecast are much weaker foreign recoveries, principally in Germany and Japan. Other risks at the national level include prospects for further federal deficit reduction and steeper defense cuts.

California Economy Remains Weak Through 1995

The LAO California economic forecast projects somewhat weaker growth in both 1994 and 1995 than contained in the DOF forecast. For example, we assume that total nonagricultural employment in the state, which fell by 1.5 percent in 1993, will decline by another 1.1 percent in 1994 and will remain virtually flat in 1995. This compares to the department's forecast of a 0.6 percent employment decline in 1994, followed by a 0.7 percent *increase* in employment in 1995.

Figure 6

Comparison of Selected Forecast Data 1994 and 1995

	1994		1995	
	DOF	LAO	DOF	LAO
United States[a]				
Real GDP (%change)	2.8	3.0	3.4	3.0
Personal income (% change)	5.4	6.5	5.9	6.9
Nonagricultural employment (% change)	1.5	2.1	2.1	2.4
Unemployment rate (%)	6.6	6.4	6.2	6.3
Consumer price index (% change)	2.9	2.9	3.6	3.2
California				
Personal income (% change)	4.0	3.6	5.0	4.3
Nonagricultural employment (000)	11,902	11,830	11,987	11,827
Percent change	-0.6	-1.1	0.7	0.0
Unemployment rate (%)	9.6	9.3	9.5	9.5
Housing permits (000)	102	98	124	126
Percent change	19.6	15.3	21.4	28.2
Corporate profits before taxes (billions)	47.1	44.0	50.3	45.8
Percent change	2.8	-2.0	6.8	4.2
New vehicle registrations (000)	1,262	1,231	1,280	1,259
Percent change	1.3	-1.1	1.4	2.2
Total taxable sales (billions)	276.9	279.0	286.6	289.6
Percent change	1.8	2.6	3.5	3.8
Consumer price index (% change)	2.7	2.7	3.8	2.8

[a] The Legislative Analyst's Office U.S. forecast is based on the WEFA Group's December 1993 standard U.S. forecast.

Figure 7 compares the employment forecasts of the Department of Finance and the Legislative Analyst's Office. As shown in this table, our forecast assumes that employment in mining, manufacturing, trade and government will continue to decline through 1995. Although these areas of weakness should be offset by modest recoveries in other sectors of employment, primarily construction and services, we do not expect any significant increases in total nonagricultural employment until the end of this two-year forecast period.

Figure 7

Comparison of California Employment Forecasts (Percent Change)

	Share of Jobs[a]	1994		1995	
		DOF	LAO	DOF	LAO
Total Nonagricultural Employment	100.0%	-0.6	-1.1	0.7	0.0
Mining	0.3	-1.9	-5.4	1.6	-3.0
Construction	3.8	-0.9	-0.3	4.6	2.8
Manufacturing	15.0	-2.4	-4.4	0.5	-2.4
Aerospace	(1.9)	-13.9	-15.5	-11.1	-10.8
Electronics	(2.5)	-1.0	-3.5	2.5	-0.9
Transportation/Utilities	5.0	-1.0	-0.9	0.3	0.9
Trade	23.2	-0.9	-1.8	1.3	-0.2
Finance, Insurance, Real Estate	6.5	0.5	0.0	0.8	0.8
Services	28.8	1.2	0.8	1.8	1.4
Government	17.3	-1.6	-1.1	-2.4	-1.3
Federal Civilian	2.7	-4.2	-4.6	-6.1	-4.3
State & Local	14.6	-1.1	-0.5	-1.7	-0.8
Unemployment Rate (%)		9.6	9.3	9.5	9.5

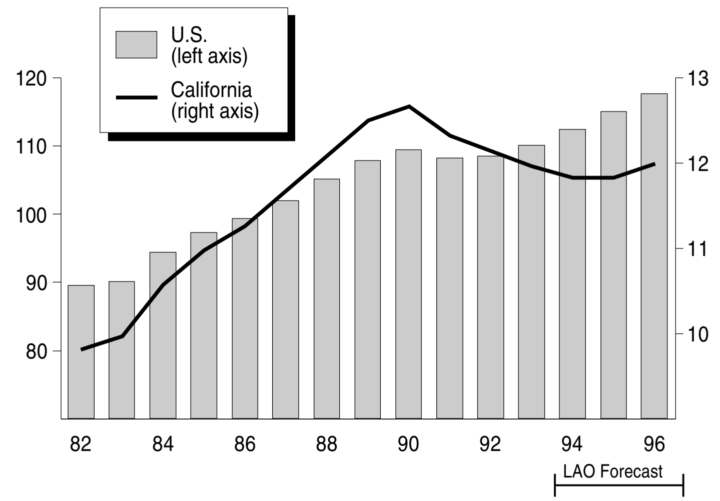
[a] Detail does not add to total due to rounding.

No Rebound Until Late 1995 or Early 1996. Overall, we believe that the DOF forecast for the California economy is consistent with its assumptions that (1) manufacturing employment will level off this year and turn upward in 1995, and (2) home building activity and construction employment will begin a slight recovery this year and grow at a significantly faster pace in 1995. As reflected in our forecast, however, we believe there is at least an *equal possibility* that defense cuts, weak exports, foreign competition and additional restructuring could lead to *continuing* declines in the state's manufacturing sector over the next two to three years. There also is a significant risk that persistently falling home prices, combined with weak job growth and low confidence levels, will delay a significant housing turnaround until early 1995. Under these conditions, residential construction activity may not be strong enough to offset continued weaknesses in the manufacturing and nonresidential construction sectors until the second half of 1995. Under these assumptions, as shown in Figure 8, our forecast indicates that no significant economic growth would occur until late 1995 or early 1996.

Figure 8

Total Nonagricultural Employment Forecast 1982 Through 1996

(In Millions)



Manufacturing Employment Continues to Decline. Slow or declining manufacturing employment growth has been a major source of structural weakness in the California economy. Employment in the manufacturing sector, as a percent of total nonagricultural employment in the state, dropped from nearly 21 percent in 1979 to 15 percent in 1993, and our long-term projections indicate it could drop to 13 percent by the year 2000. Much of this decline reflects trends that are occurring nationally, including fierce global competition, the increasing use of labor-saving equipment, and widespread corporate downsizing and restructuring. These factors have been compounded in California by disproportionately large defense cut-backs in the state, relatively high property values and wage costs, and at least the perception of a more onerous "business climate." Figure 9 compares historical and projected California and U.S. manufacturing employment.

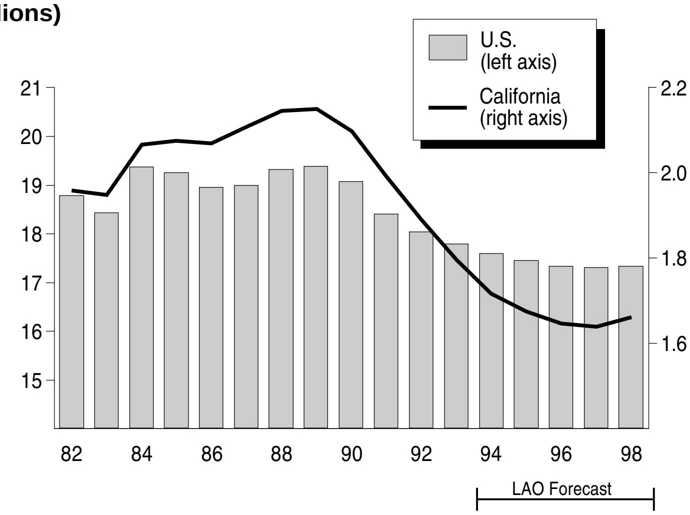
Our forecasts indicate that total manufacturing employment in California could continue to decline through at least the end of 1996. Defense-related aerospace and electronics industries are the principal areas of weakness within the manufacturing sector. Manufacturing employment is not expected to begin a significant recovery either in California or nationally until

1997 and beyond, when it is assumed defense cutbacks will have largely run their course.

Figure 9

U.S. and California Manufacturing Employment Forecast 1982 Through 1998

(In Millions)



Nonresidential Construction Activity Remains Weak. Nonresidential construction activity in California has been either flat or declining since 1986, largely reflecting the overbuilt office and retail markets, cutbacks by defense contractors, and declining employment in the manufacturing sector. As shown in Figure 10, our forecast assumes that total nonresidential construction volume will increase only nominally this year (by a mere 0.3 percent) and by a slightly healthier pace in 1995. The lackluster outlook reflects continued declines in office and retail construction activity offset by some growth in the market for industrial buildings.

Housing Market Key to Short-Term Recovery. Given the potential for continuing structural weakness in California's manufacturing sector, the best chance for a near-term economic recovery in the state is a significant cyclical rebound in new home construction (as expected by DOF). This, in turn, would spur growth in construction employment, building material sales, real estate and financial services, and other building-related activities. Although record-low mortgage rates are expected to lead to some gradual improvement in the state's home building sector this year, particularly in the lower-priced entry level market, we believe a significant cyclical recovery in the California housing market is unlikely to occur until home prices stabilize and begin to at least keep pace with inflation. As discussed earlier, recent data indicate that median home prices statewide, and particularly in southern California, are still falling from month to month. We expect this trend to continue until California's home prices, which were pushed to record highs by speculative buying in the late 1980's, return to more sustainable levels relative to home prices nationally.

Figure 10

Inflation-Adjusted Residential and Nonresidential Permit Valuations 1982 Through 1996

(In Millions)

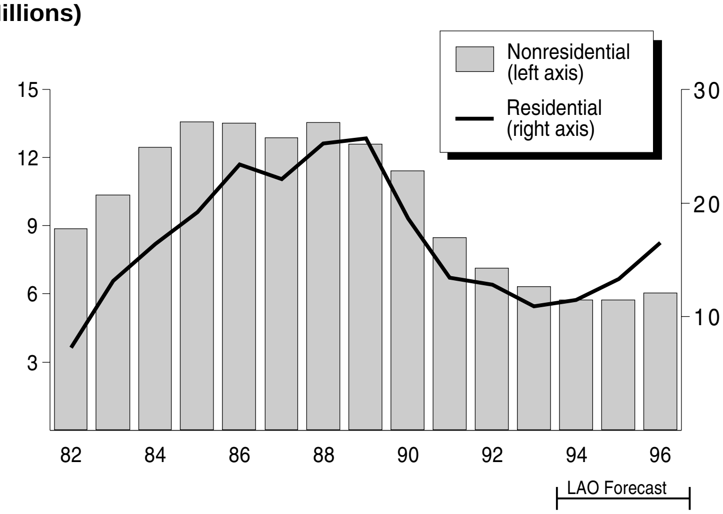
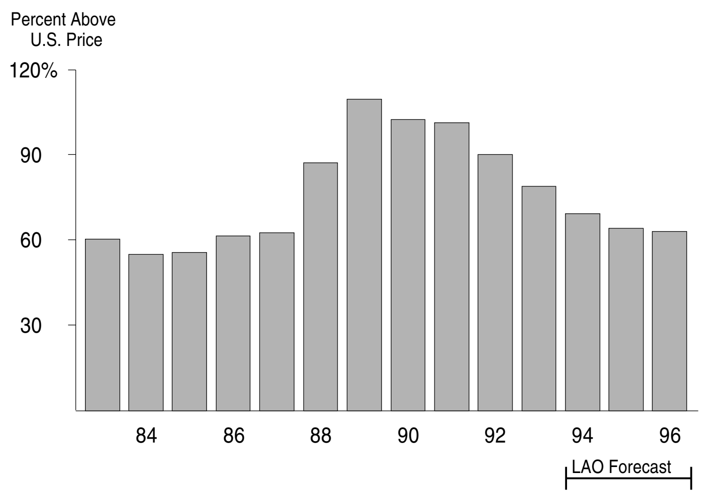


Figure 11 shows the relationship of the median home price in California to the median home price nationally. Between 1980 and 1987, California homeowners paid a relatively stable "premium" for living in the state, averaging about 60 percent above the national median home price. In just two years of skyrocketing prices, however, this premium jumped to its peak level of 110 percent in 1989. In other words, a median-priced home in California cost more than twice as much as the median-priced home for the nation as a whole. As a result of a significant decline in California home prices beginning in 1990, this premium has fallen to around 80 percent in 1993. We assume home prices in California will continue falling through the end of 1994, until they are more in line with their historical relationship to national home prices. Beginning in early 1995, moderately rising home prices in California—combined with more affordable price levels, low mortgage rates, stabilized employment levels, and rising real incomes—are expected to spur a significant upturn in the single-family home building sector. The resulting rebound in construction and related activities should be sufficient to offset continuing weakness in the manufacturing and nonresidential construction sectors, and precipitate some growth in the broader California labor market beginning in the second half of 1995.

Figure 11

California Home Price "Premium" 1983 Through 1996

(In Billions)



The Northridge Earthquake—Significant Downside Risks?

The 6.6 magnitude earthquake that struck the Northridge area of Los Angeles County in January undoubtedly will have a significant impact on the state's economy over at least the next several years. Estimates of the total damage to homes, freeways, commercial structures and other property in southern California currently range in the tens of billions of dollars, which would make the quake one of the most expensive natural disasters in the history of this country. Because of the difficulties in identifying and measuring all of the divergent economic effects of a disaster of this magnitude, we have not attempted to quantify the impact of the earthquake on our forecasts of the California economy. On balance, however, we believe it is likely the quake could add significantly to the *downside* risks of both the administration's and our economic forecasts for California. Although the extensive rebuilding program will provide an immediate boost to southern California's construction industry and construction-related businesses, this could be more than offset by transportation and trade disruptions, commuting logjams, declines in tourism, and other fallout from the quake. The most likely negative regional impacts are increased unemployment, lower incomes and retail sales, and reduced property values.

The potential risk to our statewide forecast over the course of the two-year period is for significantly weaker service and trade employment—partially offset by higher construction-related employment—and lower levels of *new* construction activity. Statewide economic growth also would be dampened to the extent funds to cover uninsured earthquake losses come from increased state taxes or private sector resources that would otherwise be available for consumption and investment spending.

An important concern over the *longer run* is how much the earthquake could further damage the image of the Los Angeles area, which has been battered repeatedly by a series of major disasters in recent years. The key question is whether the *cumulative* effects of these disasters will have a lasting impact on the ability of the Los Angeles area to attract new businesses, investment capital, home buyers, tourists, and skilled employees. Over the long run, however, it is unlikely that the Northridge earthquake, by itself, will significantly alter the direction of economic growth in the region and the state.

The Longer Term Outlook—
Brighter Prospects Ahead for California?

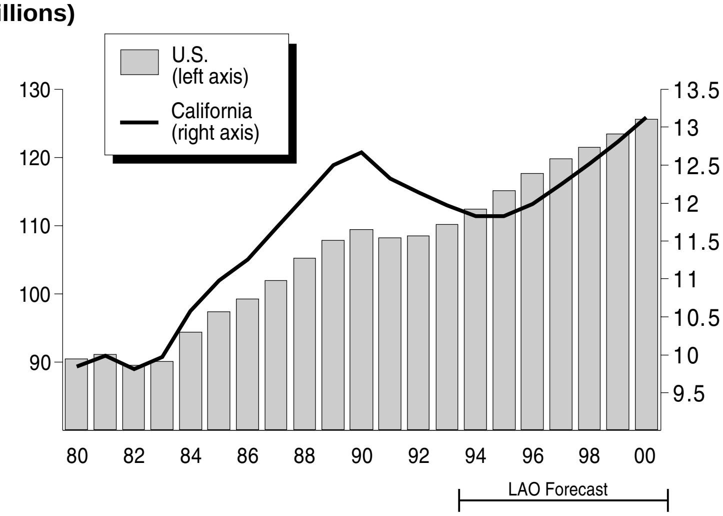
Figure 12 compares our California and national forecasts of total nonagricultural employment through the end of the decade. After a period of stabilization and weak growth over the next couple of years, the California economy should start showing some significant strength as we enter the latter half of the decade, with total payroll employment growing in the 2 percent to 2.5 percent range each year and real personal income increasing by over 3 percent annually. Even at these growth rates, it will take five to six years for the *level* of total California nonagricultural employment to regain its 1990 prerecession peak. In contrast, employment at the national level has already surpassed its prerecession peak.

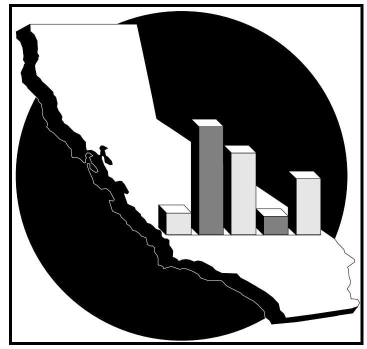
This long-term outlook assumes (1) a substantial pickup in residential and nonresidential construction activity beginning in 1996, as California home prices resume a moderate upward trend and excess retail and office space is absorbed, and (2) a turnaround in manufacturing employment beginning around 1997, reflecting the end of defense cutbacks and corporate restructuring.

Figure 12

Long-Term Outlook
California and U.S. Nonagricultural Employment
1982 Through 2000

(In Millions)





PERSPECTIVES ON STATE REVENUES

The revenues of state government in California are generally divided into two broad groups: General Fund revenues and special fund revenues. General Fund revenues can be used for a wide variety of government expenditures, while special fund revenues are usually earmarked for relatively specific purposes. Examples of special fund revenues include funds from cigarette and tobacco products taxes, which fund certain health-related programs, and hunting and fishing permit fees, which are allocated to outdoor recreation programs. The largest single category of special fund revenues involves motor vehicles and transportation.

Figure 1 gives a broad overview of the major revenue sources that support General Fund and special fund expenditures, as outlined in the *1994-95 Governor's Budget*. General Fund revenues are currently projected by the Department of Finance (DOF) to total $41.3 billion, and special fund revenues are expected to be $15.2 billion. (The General Fund amount reflects two adjustments announced by the administration following the release of the Governor's Budget. In addition, we have included in the special fund totals $1.5 billion of state sales tax revenues which will accrue to the Local Public Safety Fund that are not reflected in the Governor's Budget.)

General Fund revenues are expected to support 73 percent of the proposed $55.6 billion total 1994-95 spending plan. This is a decline from the 78 percent share these revenues represented in fiscal year 1992-93, in part due to the continuing slow growth of General Fund revenues relative to special fund revenues, but primarily because of past and proposed shifts of revenues from the General Fund to special fund accounts.

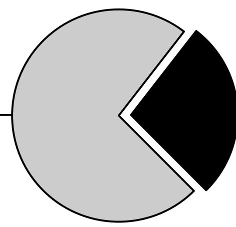
Figure 1

State Revenues in 1994-95[a]

(In Billions)

General Fund Revenues		Special Fund Revenues	
Personal Income Taxes	$18.5	Motor Vehicle-Related Taxes	$7.3
Sales and Use Taxes	12.8	Sales and Use Taxes[b]	4.5
Bank and Corporation Taxes	5.1	Tobacco-Related Taxes	0.5
All Other	4.9	All Other	2.9
Total	**$41.3**	**Total**	**$15.2**

Total State Revenues $56.5 Billion

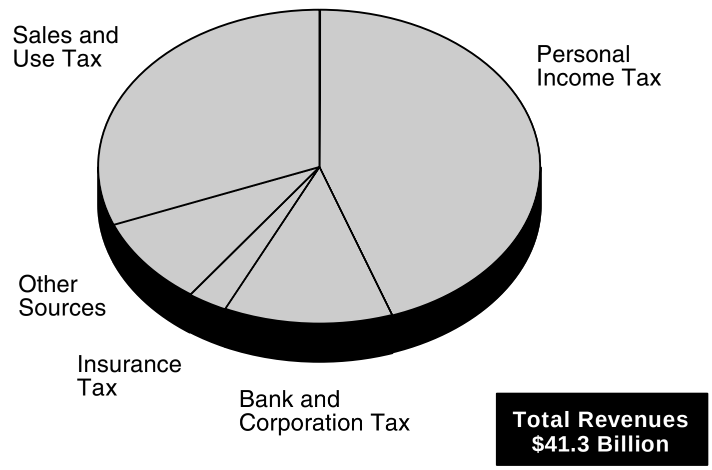


[a] Reflects post-budget adjustments.

[b] Includes $1.5 billion of state sales tax revenues allocated to Local Public Safety Fund which are not included in Governor's Budget totals.

Figure 2

1994-95 General Fund Revenues by Source



OVERVIEW OF THE BUDGET'S GENERAL FUND REVENUE FORECAST

Figure 2 shows that the bulk of General Fund revenues are raised from three sources. The largest of these is the state's personal income tax (PIT), which is projected to generate 45 percent of General Fund revenues. The sales and use tax accounts for 31 percent, while the bank and corporation tax's share is 12 percent. Thus, these three taxes alone account for 88 percent of total General Fund revenues.

Figure 3 summarizes the administration's forecasts for General Fund revenues by major source for 1992-93 through 1994-95. This figure highlights several important trends. First, growth in PIT revenues

Figure 3

General Fund Revenues[a]
1992-93 Through 1994-95

(In Millions)

Source of Revenue	Actual 1992-93	Estimated 1993-94	Proposed 1994-95	Change From 1993-94 Amount	Change From 1993-94 Percent
Taxes					
Personal income	$17,232	$17,535	$18,490	$955	5.4%
Sales and use[b]	15,042	13,748	12,762	-986	-7.2
Bank and corporation	4,724	4,765	5,115	350	7.3
Insurance	1,188	1,219	1,205	-14	-1.1
Estate, inheritance, and gift	466	468	496	28	6.0
Alcoholic beverage	292	279	277	-2	-0.7
Cigarette and tobacco products	173	179	171	-8	-4.5
Horse racing	75	74	70	-4	-5.4
Subtotals	($39,192)	($38,267)	($38,586)	($319)	(0.8%)
Other Sources					
Interest on investments	$228	$181	$185	$4	2.2%
Transfers and loans	697	565	138	-427	-75.6
Abandoned property	196	118	118	—	—
Other revenues	633	612	307	-305	-49.8
Federal cost recoveries	—	—	2,000	2,000	NA
Subtotals	($1,754)	($1,476)	($2,748)	($1,272)	(86.2%)
Totals	**$40,946**	**$39,743**	**$41,334**	**$1,591**	**4.0%**

[a] Reflects post-budget adjustments.

[b] General Fund sales and use taxes in 1993-94 are reduced due to shift of funds to Local Public Safety Fund (Proposition 172) and in 1994-95 due to Governor's state-county restructuring proposal.

continues to be sluggish, reflecting the weakness of the California economy. Second, major declines in the General Fund share of state sales taxes continue to offset gains from other sources (see below). Finally, most of the state's minor revenue sources are falling because of such factors as the state's weak economy, changing consumption patterns (for example, declining cigarette and alcoholic beverage consumption), and falling interest rates.

Shifts Reduce Sales Tax Receipts. Although Figure 3 indicates that sales and use tax receipts are expected to decline significantly in both 1993-94 and 1994-95, this reduction is not attributable to the state's weak economy. Rather, these reductions are entirely attributable to shifts of sales tax revenues to special fund accounts. These include:

- ***Local Public Safety Fund.*** In 1993-94 revenue attributable to a 1/2 cent rate of the state's sales tax was shifted to the Local Public Safety Fund (LPSF) for the first six months of the fiscal year by the Legislature and the Governor. The state's voters in November 1993 approved a constitutional amendment making this tax permanent and dedicating this revenue to the LPSF.

- ***Client Services Fund.*** For 1994-95, the budget proposes another shift of General Fund sales tax revenues to a new special fund account as part of a proposal to restructure the state-county fiscal relationship. The revenue attributable to a 1/2 cent rate of the state's sales tax would be deposited into this fund and used to pay county costs for health and welfare programs previously paid for by the state's General Fund. (Please see Part Five of this volume for a complete description and analysis of this proposal.)

Tax Proposals in the Budget

Aside from the sales tax shift discussed above, the budget contains two major tax proposals that the administration is requesting legislative authority to implement. Specifically, the administration proposes to establish the following tax credits for moderate-income individuals and new businesses:

Tax Credit to Offset Federal Gasoline Tax Increase. The first proposal would reduce state income taxes for moderate-income individuals. The administration proposes to provide an income tax credit of $25 to most single taxpayers earning less than $25,000, and a $50 credit for most married taxpayers earning less than $40,000 annually. The stated purpose of this credit is to offset the increase in the federal gasoline excise tax implemented in October 1993.

According to staff at the Department of Finance, this credit would not be refundable. This means that if the amount of the credit exceeds the taxpayer's state income tax liability, the taxpayer's liability is reduced to zero. Taxpayers with no tax liability would not benefit from the credit.

As proposed, this credit would not be available for most low-income taxpayers who have children. Department staff indicate that these taxpayers would be excluded from the credit because they have been granted additional federal income tax relief with the recent increase in the federal earned income tax credit. Consequently, single parents earning less than $10,000 annually and married parents earning less than $25,000 would not be eligible for the credit.

The Franchise Tax Board estimates that this credit would reduce General Fund receipts by approximately $95 million annually, beginning in 1994-95. The General Fund revenue totals used in this document have been adjusted to reflect this loss. (Following the release of the Governor's Budget, the administration released an announcement adjusting the figures for this loss and for $300 million in anticipated federal funds that were not included in the budget due to an oversight.)

Tax Credit for New Businesses. The administration also proposes to provide tax credits to businesses that begin their operations in the next two years. These businesses would receive a $1,000 tax credit for each of the first 100 new full-time jobs they create. These credits could only be taken after an employee had been on the job for one year, and the credit could only be taken on behalf of any particular employee for a maximum of two years.

Unlike the proposed personal income tax credit, however, this credit would be refundable. This means that if the amount of the credit exceeds a new business's state income tax liability, the taxpayer receives the excess. Further, if a new business has no tax liability, the business would receive the full amount of the credit the year the credit is earned. In effect, this credit would amount to a state subsidy of $1,000 to new businesses for each full-time job they create. The Franchise Tax Board estimates that this credit would result in revenue losses to the General Fund of approximately $50 million annually for four years beginning in 1995-96.

Individual General Fund Revenues

Below we examine the forecasts for the state's individual taxes. After providing some background on each tax, we review the Department of Finance's revenue projection and then compare it to our forecast.

The Forecast for Personal Income Taxes

Background

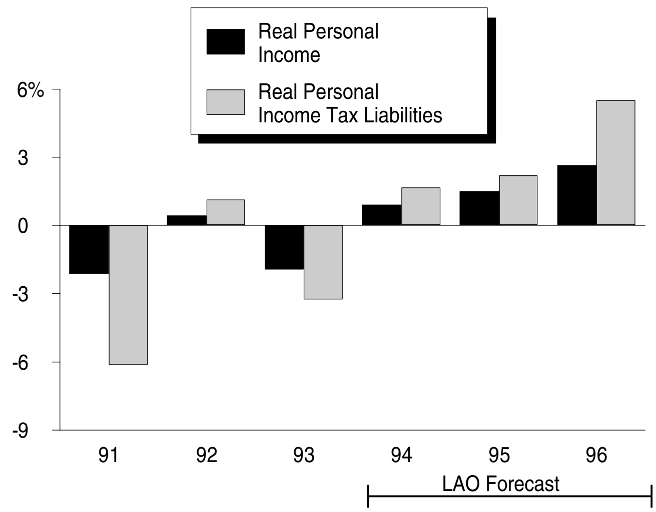
The California personal income tax provides the largest percentage share of General Fund revenues. The PIT's structure is progressive, in that higher-income households generally pay a higher proportion of their income in taxes than low-income households. This is illustrated by the fact that, in 1991, the top 4 percent of taxpayers in the state paid nearly 50 percent of the total tax collected, although they accounted for only 25 percent of the total income subject to the tax. The marginal rates range from 1 percent to 11 percent of taxable income. The PIT tax base essentially conforms to the federal tax base and includes various income exclusions, deductions, and credits. Income brackets and other key elements are indexed for inflation so that a taxpayer's real income must rise before his or her real income tax liability increases.

The PIT is also the most sensitive of the state's taxes to changes in the rate of economic growth. The progressive structure of the PIT makes it highly "elastic" relative to personal income. In general, this means that as real (inflation-adjusted) incomes rise, real tax collections rise more than proportionately. The converse is also true, in that declines in "real" personal income in the state, as have occurred in two of the past three years, result in a more than proportionate decline in real income tax revenues. Figure 4 illustrates the elasticity of the personal income tax and shows that PIT revenues are forecast to increase much faster than personal income as the economy recovers.

Weak PIT Growth in Recent Years. Personal income tax collections have grown by an average of less than one percent per year over the past four years. This very weak growth largely reflects the generally depressed economic conditions in California. After adjusting for inflation, total personal income in the state declined by over 2 percent in 1991, grew by less than one percent in 1992, and is estimated to have declined almost another 2 percent last year. More significantly, key sources of taxable income—for example, wages and salaries, business income, capital gains, and interest income—declined by even greater percentages over this period, reflecting high unemployment levels, low wage increases, reduced business profits, depressed stock and asset values, and a dramatic drop in interest rates.

Figure 4

Growth Rates of Real Personal Income and Real Personal Income Tax Liabilities 1991 Through 1996



Erratic Capital Gains Income. Projecting PIT collections is made particularly difficult by the volatility of realized capital gains income from year to year. Capital gains tend to be highly unpredictable because they are influenced by a combination of largely unrelated factors. These factors include stock market fluctuations, changes in real estate values, investment timing decisions, and tax policy changes. As reported for tax purposes, capital gains dropped sharply in 1990 and 1991—falling by 11 percent and 25 percent, respectively—reflecting a weak stock market and the plunge in California real estate values. On the positive side, the DOF expects capital gains income to contribute significantly to PIT collections in the current and budget years, primarily due to the strong performance of the equity and bond markets.

The DOF PIT Forecast

The Department of Finance projects PIT collections of $18.5 billion in the budget year, an increase of 5.4 percent over the $17.5 billion estimate for the current year. This forecast takes into account several expiring tax expenditure programs (TEPs) and the effects of recently enacted TEPs, including: (1) the December 1993 sunset for the jobs tax credit, recycling equipment credit, and commercial solar system credit; (2) the December 1994 sunset for the employer child care credit; (3) the resumption of the suspended net operating loss carryover provisions (NOLs) beginning in 1993; and (4) the PIT provisions of Chapter 881/93 (SB 671, Alquist) which is discussed later in this part.

The LAO PIT Forecast

The Department of Finance's estimates of PIT collections for the current and budget years are generally consistent with their underlying economic assumptions. As we discussed earlier in our review of the economic outlook, however, we believe that there is a potential for the state's economy to be significantly weaker than the department has projected over the next two years. Key differences in our economic assumptions as they relate to those variables that primarily determine PIT collections are shown in Figure 5.

Figure 5

Comparison of PIT-Related Forecast Variables

(Percent Change)

	1994		1995	
	DOF	**LAO**	**DOF**	**LAO**
Total personal income	4.0%	3.6%	5.0%	4.3%
Wages and salaries	3.9	3.1	4.8	3.7
Proprietors' income	4.2	3.1	5.6	3.6
Interest income	0.9	1.1	3.2	3.3
Dividend income	5.4	3.7	6.9	5.3
Capital gains income	11.7	7.9	11.2	7.7
Real personal income	1.3	1.0	1.2	1.5
Consumer prices	2.7	2.7	3.8	2.8
PIT liabilities	6.0	4.4	6.3	5.1

With the exception of interest income, our forecasts of the annual growth in the principal sources of taxable personal income fall significantly below those of the Department of Finance for both the 1994 and 1995 calendar years. This primarily reflects our expectations for declining employment levels, weaker growth in business profits, declining real estate values, and lower inflation over the two-year forecast period. Largely because of our differences in the economic forecast, we estimate that total personal income tax collections during both the current and budget years could be cumulatively $770 million *less* than estimated by the Department of Finance.

The Forecast for Sales and Use Taxes

Background

The sales and use tax is imposed primarily on retail sales of goods, but not services, to consumers in the state. It also generally applies to goods purchased by business to the extent that they are not intended for resale. The "use" tax is imposed on products bought from out-of-state firms by California individuals and businesses for use in the state. Such purchases are generally difficult to monitor, and an increasing portion of purchases by individuals are escaping taxation due to the state's inability to require out-of-state "mail-order" businesses to collect this tax.

Figure 6 shows that the sales and use tax actually consists of many different rates of tax, representing the different purposes for which the sales and use tax is levied. As the table shows, both the state and local governments levy multiple rates of tax. Under current law, the basic state sales tax rate is 6 percent, of which the state General Fund portion

Figure 6

Sales and Use Tax Rates in California

	Current Law	Proposed
State:		
General Fund	5.0%	4.5%
1991 program realignment	0.5	—
Local Public Safety Fund	0.5	0.5
1993 restructuring	—	1.0
Totals, state	**6.0%**	**6.0%**
Local:		
Uniform local taxes[a]	1.25%	1.25%
Optional local taxes[b]	1.50	1.50
Totals, local	**2.75%**	**2.75%**
Statewide maximum rate	**8.75%**	**8.75%**

[a] Levied in all counties.

[b] Maximum allowable combined rate, except maximum combined rate is 1.75 percent in San Francisco and 2 percent in San Mateo.

is 5 percent. In addition, the state levies two 0.5 percent sales taxes: one to fund health and welfare program costs associated with the 1991 program realignment legislation, and one dedicated to local public safety programs. The Governor's Budget would reduce the General Fund's rate by 0.5 percent, and transfer these funds, along with the 1991 program realignment rate, to a new "Client Services Fund" to pay for increased county health and welfare program costs.

At the local level, a 1.25 percent rate is levied in all counties, under the Bradley Burns Uniform Sales and Use Tax Law. Of this amount, revenue from the 0.25 percent portion of the rate is deposited in county transportation funds, while the 1.0 percent portion of the rate is allocated to city and county governments for general purposes. City governments receive the proceeds generated within their boundaries and counties receive the remainder.

In addition to statewide sales taxes, many local governments—mostly on a county-wide basis—levy sales taxes for a variety of other purposes. These taxes can be imposed at rates of either 0.25 percent or 0.5 percent, and cannot exceed an aggregate of 1.5 percent. In total, the sales tax rate ranges from 7.25 percent in counties with no optional taxes, to 8.5 percent in the City and County of San Francisco. At this time, no county levies the maximum rate of 8.75 percent.

The DOF Sales Tax Forecast

The Department of Finance forecasts General Fund sales tax collections of $12.8 billion in the budget year, nearly $1 billion lower than the $13.7 billion estimated for the current year. The budget-year forecast includes the impact of a proposed shift of approximately $1.4 billion in sales tax revenues from the General Fund to counties (as discussed earlier). Without this shift, the department's sales tax forecast for the budget year would be 3.1 percent *higher* than the current year, reflecting a projected 1.8 percent increase in taxable sales in 1994 and a 3.5 percent increase in 1995. Much of the expected taxable sales growth results from stronger sales of new motor vehicles and building materials during the next two years.

Taxable Sales Forecast Too Low? The Department of Finance's forecast of taxable sales is somewhat *weaker* than we would expect given their underlying personal income assumptions. The department is projecting total personal income growth of 4 percent in 1994 and 5 percent in 1995, while its growth rates for taxable sales are only 1.8 percent and 3.5 percent in these years. Much of the discrepancy between these growth rates can be explained by the department's very low estimate of inflation as it applies to taxable sales. These estimates of inflation are significantly lower than the corresponding percentage growth in the Consumer Price Index (CPI). Inflation in the prices of durable goods in particular has been held down in recent years due to the global recession, increasing labor productivity and stiff foreign price competition. The department's forecast appears to assume that this trend will continue.

The LAO Sales Tax Forecast

In general, we believe that the Department of Finance's forecasts of real taxable sales are consistent with their real economic growth assumptions (that is, ignoring the effects of inflation.) For the reasons discussed above, however, we believe that the department's low taxable sales inflation assumptions may tend to understate General Fund sales tax receipts relative to their economic forecast. Although our forecast for real economic growth in the state is weaker than the department's, our baseline sales tax projections are $120 million higher in the current and budget years because of our higher taxable sales inflation assumptions. For purposes of projecting taxable sales inflation over the next few years, our forecast assumes that prices of durable and nondurable goods will trend upward in 1994 and 1995, as a fairly robust economic recovery at the national level and some recovery in international markets puts more pressure on factory operating capacities, labor costs, and other manufacturing costs. At the same time, inflation in the services sector is expected to moderate somewhat, reflecting lower home prices and the impact of increased competition on the cost of medical services. The net effect of these trends should be to increase the average prices of taxable goods somewhat and bring them more in line with consumer price inflation.

Figure 7 compares our forecast of the taxable sales and related forecast variables with the department's forecast. After adjustment for inflation, our forecast assumes a nominal 0.1 percent growth in real taxable sales this year, improving moderately to 1.1 percent in 1995. We do not expect real taxable sales growth to gain significant momentum until 1996, when construction activity and vehicle sales should be showing substantial improvement. The Department of Finance real taxable sales forecast, on the other hand, assumes somewhat more improvement this year (0.9 percent growth), and a fairly significant recovery (2.1 percent) in 1995.

Figure 7

Comparison of Taxable Sales and Related Forecast Variables

(Percent Change)

	1994		1995	
	DOF	LAO	DOF	LAO
Nonagricultural employment	-0.6%	-1.1%	0.7%	0.0%
Taxable sales	1.8	2.6	3.5	3.8
Real taxable sales	0.9	0.1	2.1	1.1
Consumer price index	2.7	2.7	3.8	2.8
Taxable sale inflation	1.0	2.4	1.4	2.7

The Forecast for Bank and Corporation Taxes

Background

Banks and corporations doing business in California are subject to a tax rate of 9.3 percent measured against the portion of their taxable profits that are earned in California. Banks and other financial corporations pay an additional tax, currently set at 2.17 percent, which is in lieu of all state and local taxes except those on real property and motor vehicles and the local business license tax.

The DOF B&C Forecast

The Department of Finance projects that Bank and Corporation (B&C) taxes will raise $5.1 billion in the budget year, 7.3 percent higher than the $4.8 billion projected for 1993-94. This would be the first significant gain since 1988-89. This gain, however, is attributable to the inclusion of $600 million in receipts the department expects to receive from winning the Barclays and Colgate "unitary tax" cases now before the United States Supreme Court (please see below for a further discussion of this issue). Without these additional funds, projected bank and corporation tax revenues would be $4.5 billion in 1994-95, 5.2 percent *less* than the current year estimate.

B&C Profits Expected to Gain Momentum This Year. After adjusting for law changes, the Department of Finance estimates bank and corporation profit growth of 7.7 percent last year, followed by a stronger gain of 10.2 percent in 1994. The department's profit forecast for 1994 is consistent with their expectation for some marginal improvement in state employment and income levels this year. Corporate downsizing and restructuring, improved labor productivity, and increased equipment investment also are expected to contribute to higher earnings growth as domestic companies adapt to an increasingly competitive global marketplace.

The LAO B&C Forecast

As shown in Figure 8, our standard forecast is for significantly *weaker* corporate profits this year and next year (4.8 percent and 4.9 percent, respectively) than projected by the DOF.

Figure 8

Comparison of Taxable Corporate Profits and Related Forecast Variables

(Percent Change)

	1994		1995	
	DOF	LAO	DOF	LAO
Taxable corporate profits[a]	10.2%	4.8%	7.5%	4.9%
Total personal income	4.0	3.6	5.0	4.3
Proprietors' income	4.2	3.1	5.6	3.6
Total nonfarm employment	-0.6	-1.1	0.7	0.0

[a] Adjusted for law changes.

There are several reasons why we believe corporate profits growth in California could be generally constrained over the next few years. First, as discussed in our review of the economic outlook, we do not expect a significant economic recovery to occur in California until the second half of 1995. Accordingly, continued weakness in employment, real income and taxable sales in the state could continue to dampen the revenues and profits of corporations that produce primarily for the in-state market. Second, downsizing and restructuring should eventually increase the profitability of many corporations doing business in California. However, these cost-saving measures often require substantial one-time write-offs that can reduce taxable profits in the short run. Third, increased investment in equipment and other labor-saving technology can also involve start-up and training expenses that lower short-run profits. Most importantly, however, continuing defense cutbacks over the next several years are likely to have a substantial ongoing impact on the profitability of major defense contractors and other affected corporations, as well as many of their suppliers.

Based on the more conservative corporate profit levels assumed in our standard economic forecast, we estimate that bank and corporation tax collections in the current and budget years could be more than $500 million *below* the Department of Finance's projections. It is important to note that this potential for lower B&C tax revenues relates only to lower profit forecasts, and does not take into account the potential loss that would occur if the state is unsuccessful in the Barclays and Colgate court cases.

In addition, our analysis indicates that the budget overstates the amount of revenues attributable to one-time audit activities undertaken in the current year. In the 1993

Budget Act, the Legislature provided the Franchise Tax Board (FTB) $900,000, on a one-time basis, to work down its inventory of backlogged corporate audit cases during 1993-94. This one-time activity was expected to generate increased revenues of $36 million in 1993-94 only. Recent information from FTB indicates that only $10 million in revenue will be generated. The budget, however, includes revenues of $36 million in both 1993-94 and 1994-95, thereby overstating expected revenues by a total of $62 million over the two years combined.

The Forecast for Other General Fund Revenues

The other 12 percent of General Fund revenues consist of a variety of minor taxes, regulatory fees, service charges, interest income and other sources, including funds transferred from special accounts. In addition, the Governor's Budget includes as revenues $2 billion in reimbursements from the federal government. With the exception of this reimbursement, nearly all of these other revenue sources are forecast to decline in the budget year. Our review of these revenue sources indicates that the department's forecasts are generally reasonable, and we have identified no significant discrepancies.

SUMMARY OF LAO GENERAL FUND REVENUE FORECAST DIFFERENCES

The accuracy of the state revenue forecasts reflected in the Governor's Budget depends primarily on the accuracy of the underlying economic forecasts. In each of the past several years, forecasters have predicted the state would soon begin recovering from the economic recession that began in the Spring of 1990. For a variety of reasons, the California economy has yet to exhibit any clear signs of a significant and sustainable recovery despite substantial gains at the national level. As a result, revenue forecasts over the past three years have been continually adjusted downward, as illustrated in Figure 9.

Figure 9

Recent History of Governor's Budget General Fund Revenue Forecasts 1990-91 Through 1993-94

(In Billions)

Estimate Date	1990-91	1991-92	1992-93	1993-94
January 1990	$43.1	—	—	—
January 1991	40.4	$45.8	—	—
January 1992	38.2	43.6	$45.7	—
January 1993	—	42.0	40.9	$39.9
January 1994	—	—	40.9	39.7

DOF Forecast Is Reasonable

The current Department of Finance budget forecasts assume that continuing defense cuts and base closures will postpone even a nominal employment turnaround in the state until later this year. This forecast also assumes that a modest pickup in home-building, along with other areas of strength, will offset weakness in the manufacturing sector and permit a more significant recovery in 1995. Given the difficulties inherent in predicting the turning point in an economic recession, particularly a long lasting one, we believe that the Department of Finance's economic forecasts for the next two years are reasonable. We also believe that the department's General Fund revenue projections for the current and budget years are generally consistent with their underlying economic forecasts, and that these revenue projections provide a reasonable basis for making budget decisions.

Delayed Recovery Equally Reasonable

The Department of Finance's current forecast of a turnaround in the economy beginning later this year rests largely on the assumption that home building will show a significant pick up over the next several months. Given low mortgage rates, more affordable home prices, and pent-up demands for housing, we believe that there is a reasonable possibility this could occur. We also believe, however, that there is at least an *equal possibility* that declining home prices and continued weakness in the manufacturing and nonresidential construction sectors could delay a significant economic recovery in the state until late 1995. Thus, our state revenue estimates for the current and budget years reflect a somewhat weaker economic outlook.

Figure 10 summarizes the differences between our forecasts of General Fund revenues from the state's three major taxes and those assumed in the Governor's Budget. Over both the current and budget years, our forecast of major tax revenues is approximately $1.2 billion *lower* than the budget forecast.

Figure 10

Comparison of Major General Fund Tax Forecasts

(In Millions)

	Governor's Budget	LAO Forecast
1993-94		
Personal income taxes	$17,535	-$350
Sales taxes	13,748	35
B&C taxes	4,765	-171
Totals, major taxes	**$36,048**	**-$486**
1994-95		
Personal income taxes	$18,585	-$420
Sales taxes	12,762	85
B&C taxes	5,115	-416
Totals, major taxes	**$36,462**	**-$751**
Two-year forecast differences		
Personal income taxes	—	-$770
Sales taxes	—	120
B&C taxes	—	-587
Totals, major taxes	**—**	**-$1,237**

HOW 1993 TAX LEGISLATION AFFECTS THE FORECAST

In 1993, the Legislature enacted several significant changes to California's tax laws, which will affect General Fund revenue collections in 1994-95. The following discussion summarizes three of the most important changes.

Tax Relief for Multinational Corporations and Manufacturers

The most significant tax legislation passed in 1993 was Ch 881/93 (SB 671, Alquist). One of its provisions provides tax relief to many multinational corporations by allowing these companies to account for income on either a domestic or international basis without paying special fees or conforming to special rules. This change was in response to challenges to California's procedure for taxing multinationals (see side bar). The provisions of Chapter 881 affecting multinational businesses will result in revenue losses of approximately $20 million annually to the General Fund and $40 million annually to special funds.

Chapter 881 also provides in-state manufacturers with tax relief from state income and sales taxes. Existing manufacturing companies are now eligible for corporate income tax credits equal to 6 percent of the value of all purchases for depreciable equipment used in a manufacturing process. If the credit exceeds a company's income tax liability, the company can use the excess to offset tax liabilities for up to seven years. Chapter 881 exempts new manufacturing companies—established after January 1, 1994—from paying the state sales tax when purchasing manufacturing equipment. The credit and exemption would be automatically reauthorized in 2001 if the level of nonaerospace manufacturing jobs is at least 100,000 jobs higher than existed in 1994.

Chapter 881 also provides tax relief to small businesses by reducing the "sub-chapter S" income tax rate by 1 percent to 1.5 percent. In addition, this measure provides relief to stockholders of small businesses and businesses which have research and development expenses.

As reflected in the DOF revenue forecast, the provisions of Chapter 881 provide over $300 million in tax relief in 1994-95, and over $600 million in 1995-96. Offsetting these revenue losses is a provision which reduces the tax relief to businesses for entertainment expenses. This provision will increase revenues by $140 million in 1994-95 and $150 million in 1995-96. Thus, on balance Chapter 881 resulted in a net revenue loss of $161 million in 1993-94 and $462 million in 1994-95.

Net Operating Loss Sunset Repealed

Chapter 880, Statutes of 1993 (AB 34, Klehs and Alpert) repeals the 1996 sunset on the authority of businesses to deduct net operating losses (NOLs) in determining their taxable income. When a business's expenses exceed its income, the business typically does not pay income taxes, other than a minimum fee of $800. Prior to the enactment of Chapter 880, businesses could deduct 50 percent of these "excess" expenses from future-year profits for a period of up to 15 years.

Chapter 880 allows businesses to *earn* NOLs after 1996, but limits the time in which businesses can *use* NOLs to five years after they are earned for existing companies, and up to eight years for new companies. In addition, new companies and small companies would be able to use 100 percent of their NOLs. By limiting the number of years NOLs can be "carried over," this measure reduces the revenue losses attributable to the existing deduction by approximately $20 million annually through 1998. After 1998, however, DOF projects that revenue losses from NOLs will *increase* by up to $120 million, as a result of allowing businesses to earn NOLs after 1996.

Income Apportionment Formula Geared to "Exporters"

Chapter 94, Statutes of 1993 (SB 1176, Kopp), changes the formula that multi-state or multinational businesses use to allocate income among states for tax reporting purposes. The formula allocates income based upon the proportion of businesses' property, payroll, and sales that are in California. Prior to enactment of Chapter 94, the formula used in California weighed each of these three factors evenly. Chapter 94 adjusted the formula so that the sales factor is *twice* as important (double-weighted) than the property and payroll factors. As a result, income tax liabilities will decline for multi-state or multinational companies that conduct a relatively large portion of their activities *in* California, but "export" a relatively large portion of their products or services *out of* California. On balance, this measure will increase state revenue by approximately $15 million annually, beginning in 1994-95.

U.S. Supreme Court To Rule

This past fall, the United States Supreme Court agreed to rule on two legal challenges to California's procedure for taxing multinational businesses. Two firms, Barclays Bank, PLC, and the Colgate-Palmolive Company, challenged California's taxation of worldwide income. In essence, these companies argue that California's tax violates the federal government's constitutional authority to regulate international commerce. The state's position is that its tax practice in this area has never been directly repudiated by the federal government, either by Congressional action or international treaty. The Court is expected to rule on these challenges by this June.

Taxation of Worldwide Income Now Optional. Until 1988, the state taxed multinational businesses and their affiliates on the basis of their worldwide income, using a formula to estimate the portion of the companies' worldwide income attributable to their business activity in California. Since 1988, the state has given these companies the option of apportioning only their United States income to California. Companies could choose this method of taxation, known as "water's-edge," only if they paid special "election" fees and conformed to special accounting rules. In response to continuing dissatisfaction with this arrangement and the threat of retaliation by foreign governments, the state in 1993 eliminated the election fees and relaxed the accounting rules. Thus, the issue before the court relates entirely to whether the state's *past* practices violate the federal constitution.

$600 Million Gain Is Optimistic. The *1994-95 Governor's Budget* assumes that the U.S. Supreme Court will rule in California's favor. As a

The Relationship Between Tax Relief and Economic Stimulus

The stated purpose for these tax changes was to help stimulate economic activity in California. Generally, these changes created new tax expenditure programs to favor California-based businesses. (Tax expenditure programs include tax credits, reduced tax rates, or prefer ential tax procedures that reduce the amount of revenue collected from the state's tax system.) In effect, these changes provide benefits to certain individuals and businesses much like direct governmental expenditures, except that they will be paid for by reduced tax collections rather than by the normal legislative appropriation process.

on State "Unitary Tax" Disputes

result, DOF's forecast for bank and corporation tax revenue includes $600 million in 1994-95 to reflect the collection of outstanding assessments from multinational businesses that have essentially been placed on "hold" pending resolution of this issue. If the Court rules against California, however, the state would not only "lose" the $600 million but it could potentially be required in 1994-95 to refund up to $2.1 billion in prior-year tax collections associated with this issue. Such an outcome would increase the state's budget gap by $2.7 billion.

The administration's assumption that the state will gain $600 million in 1994-95 from a ruling on these cases essentially represents the "best case" scenario in terms of the range of possible outcomes in these cases. We have two major concerns about this assumption:

First, the Court is not limited to a simple "all or nothing" type of decision. It may rule completely for, partially for, or completely against the state. These challenges involve many complex legal issues, some of which the Court has not reviewed in the past. The Court may determine, for example, that only certain aspects of California's tax are appropriate or that its use was valid only for a limited period of time. As a result, the budget's "complete victory" assumption is only one of several possible outcomes.

Second, the loss and gain estimates are based on preliminary information from the Franchise Tax Board (FTB). The FTB staff are currently updating their estimates to take into account additional information. Based upon our review of their preliminary estimates, we believe that the estimates of both potential gains and losses may be lowered considerably.

Together, the three measures discussed above will reduce General Fund revenue by approximately $125 million in 1994-95, or 2.5 percent of the revenue generated by bank and corporation taxes. In 1995-96, these changes will result in revenue losses of approximately $410 million, which would be approximately 8 percent of the revenue expected from bank and corporation taxes.

A significant amount of the debate on these measures focused on the question of the extent to which the measures would stimulate additional economic activity to offset their direct revenue losses. Specifically, these new tax expenditure programs are intended to cause taxpayers (both individuals and businesses) to change their behavior in ways that will cause the economy to grow faster (or decline more slowly) than it would without these changes.

Long-Term Growth Stimulus Difficult to Measure. Of course, the stimulus from these changes may not be completely realized until several years in the future. In this context, it is extremely difficult to estimate the amount of long-term economic growth that will result from marginal changes to the tax system. This is because future economic decisions by taxpayers are a function of many factors, including world-wide consumer demand, wage rates, and regulations, as well as the tax environment. Growth forecasts are complicated even further by the great uncertainty inherent in estimating the long-term economic outlook. Because the revenue losses from these changes will increase substantially over the next few years, however, whatever stimulus is produced clearly must be substantial if the direct revenue losses are to be recovered.

Substantial Increase in Growth Needed. In order to illustrate the magnitude of the growth needed, we examined this question in the one-year context of revenue losses and economic growth for 1995-96. We estimate that taxable personal income will grow by $19 billion, or 5 percent, and that taxable business income will grow by $1.8 billion, or 4 percent, in 1995-96. To fully offset the revenue losses associated with these tax changes, taxable business income would need to grow almost 4 times as fast, by $6.4 billion (rather than $1.8 billion). Taxable personal income would need to be $6 billion higher than forecast in order to offset the projected PIT losses.

What these figures demonstrate is that, *if the revenue losses were to be fully offset*, the state's investment in these tax relief benefits would have had a substantial "leveraging" effect on the economy. Specifically, each dollar of B&C tax relief would be producing about $11 of net profit growth, whereas each dollar of PIT relief would be producing about $13 of net income. While this illustration oversimplifies the relationship between tax relief and economic growth, we believe it provides some helpful perspective on the issue.

THE GOVERNOR'S BUDGET FORECAST FOR SPECIAL FUND REVENUES

Special fund revenues support a variety of specific state and local government programs. These range from transportation systems to health programs. Figure 11 indicates that motor-vehicle-related fees account for the single most important share (48 percent) of special fund revenues. While motor vehicle revenues are forecast to rise only 2.0 percent, the remaining special fund revenues are forecast to rise nearly 32 percent. The latter increase reflects the administration's

Figure 11

Special Fund Revenues 1992-93 Through 1994-95

(In Millions)

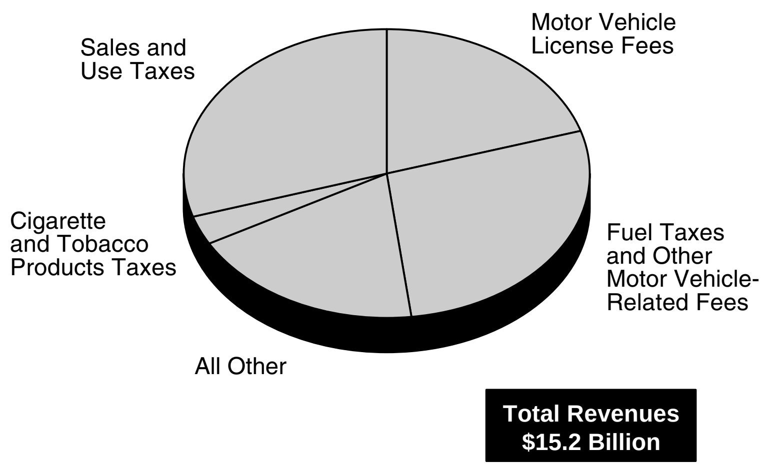
Source of Revenue	Actual 1992-93	Estimated 1993-94	Proposed 1994-95	Change From 1993-94 Amount	Change From 1993-94 Percent
Motor Vehicle Revenues					
License fees (in lieu)	$2,942	$3,037	$3,063	$26	0.9%
Fuel taxes	2,468	2,596	2,675	79	3.0
Registration, weight, and miscellaneous fees	1,495	1,530	1,565	35	2.3
Subtotals	($6,905)	($7,163)	($7,303)	($140)	(2.0%)
Other Sources					
Sales and use taxes[a]	$1,570	$2,997	$4,517	$1,520	50.7%
Cigarette and tobacco products taxes	518	486	480	-6	-1.2
Interest on investments	83	56	47	-9	-16.1
Other	2,504	2,440	2,823	383	15.7
Subtotals	($4,675)	($5,979)	($7,867)	($1,888)	(31.6%)
Totals	**$11,580**	**$13,142**	**$15,170**	**$2,028**	**15.4%**

[a] Includes state sales tax revenues allocated to Local Public Safety Fund, which are not included in Governor's Budget totals.

proposal to re-allocate General Fund sales tax revenue to counties (as discussed earlier). Figure 12 illustrates the relative importance of the different sources of special fund revenue sources.

Figure 12

1994-95 Special Fund Revenues by Source



How Are Special Fund Revenues Used?

As noted above, motor-vehicle related revenues are the largest single category of special fund revenues, and these funds are used primarily for transportation-related purposes. Other sources of special fund revenues are earmarked for a variety of specific programs. Examples of special fund programs include the following:

Transportation Programs. State programs that are funded by motor-vehicle revenues include the Department of Transportation (Caltrans), the Department of Motor Vehicles (DMV), and the California Highway Patrol (CHP). A large share of these funds are distributed to local governments for specific programs, including streets and highways and mass transit programs.

Proposition 99 Programs. Cigarette and tobacco tax revenues imposed by Proposition 99 are devoted primarily to public health and natural resources programs. Starting January 1, 1994, a new 2 cents per pack tax on cigarettes (and related taxes on other tobacco products) is allocated to breast cancer research.

State-County Realignment Programs. Legislation in 1991 imposed a new 0.5 percent state sales and use tax rate to pay for increased county health and welfare program costs. Counties share of existing program costs in such programs as mental health, public health, and foster care were increased by the legislation and funded by the increased tax revenues. State costs were reduced correspondingly.

The Budget's Forecast for Individual Special Fund Revenues

Motor Vehicle Fee Revenues

Motor vehicle fee revenue estimates are shown in Figure 11 under two headings: license fees (in lieu) and registration, weight, and miscellaneous fees. Both categories are expected to increase very slowly. License fees have been negatively affected both by the sluggish economy's effect on new vehicle purchases and by changes in the fee structure that took place in 1991. The Vehicle License Fee is a tax based upon the depreciation-adjusted sales price of a vehicle. The 1991 fee structure reduced the allowed level of depreciation, especially in the early years of ownership. The structure now also assesses newly sold used vehicles at their recent sales price, rather than the prior depreciation-adjusted sales prices. These changes had the effect of dramatically increasing revenues initially, but have made the structure of the tax more sensitive to economic downturns. This change and lower levels of new car sales have dramatically reduced the rate of growth in this revenue source.

Motor Vehicle Fuel Taxes

These taxes consist primarily of per gallon excise taxes on fuels used for private motor vehicles. Most of the revenues come from gasoline and diesel fuels sold for use in autos and trucks on the public roads of the state, although there are other related fuel taxes on alternative fuels such as natural gas and alcohol. At present the tax rate on gasoline and diesel fuel is 18 cents per gallon. January 1, 1994 was the date of the last scheduled increase (1 cent per gallon) in the California fuels tax under Proposition 111, which was passed by the voters in June 1990. This final tax rate increase contributes to the budget's forecast of a 3.0 percent increase in these revenues for 1994-95, although the percentage increase in the tax rate is effectively much higher (approximately 6 percent).

The main element in low fuel tax revenue growth in the state during the past two years, despite falling gasoline prices and tax rate increases, is the general economic decline since late 1990. Forecasting revenues has also been made more difficult by unprecedented volatility in diesel fuel tax revenues, even though the diesel fuel tax accounts for only 12 percent of total revenues in the budget year. There has been a major controversy over new diesel fuel formulations required for air quality improvement purposes.

Realignment Revenues Still Sluggish

As shown in Figure 13, the budget's revenue forecasts indicate that $1,449 million of sales taxes and $741 million of vehicle license fees (VLF) would be available for deposit into the Local Revenue Fund in 1994-95. This represents an increase of $43 million, or 2 percent, over the amount deposited in this fund in 1993-94. This level of revenues continues to be less than the amount originally forecast for 1991-92, when the realignment program was first enacted.

The Governor's Budget proposes that the Local Revenue Fund be abolished and that these revenues be allocated to a new Client Services Fund, in the case of the sales tax, and a new Community Services Fund, in the case of the VLF revenues. In addition, revenue from a 0.5 percent rate of the sales tax now allocated to the General Fund would be allocated to the new Client Services Fund. (Please see Part V of this volume for a complete description of this proposal.)

Figure 13

Local Revenue Fund Tax Receipts Under Current Law 1992-93 Through 1994-95

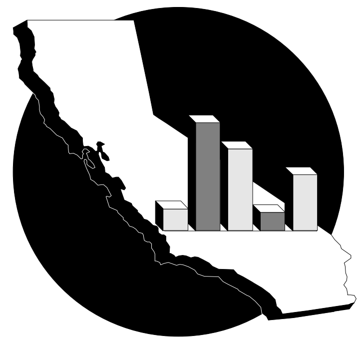
(In Millions)

	1992-93	1993-94	1994-95
Sales and Use Taxes	$1,391	$1,412	$1,449
Vehicle License Fees	716	735	741
Totals	**$2,107**	**$2,147**	**$2,190**

Proposition 99 Revenues Falling

The Cigarette and Tobacco Products Surtax is projected to decline by 4.7 percent, to $445.4 million, in the budget year. This reflects a continuing decline in total cigarette consumption of about 4.8 percent, and a decline in per capita consumption of 6 percent.

President Clinton's health care reform proposal includes an additional excise tax on cigarettes of 75 cents per pack. Revenues from this tax would help offset costs of the proposal. A large portion of this tax, however, is likely to be fully passed on to cigarette consumers as an increase in cigarette prices. Previous studies have demonstrated that cigarette consumers reduce their consumption in response to price increases of this magnitude. We estimate that a 75 cent per pack tax increase by the federal government would dramatically reduce cigarette consumption in California. This would result in losses of approximately $150 million annually in Proposition 99 revenues.



An Overview of State Expenditures

Proposed Current- and Budget-Year Spending

The Governor's Budget proposes spending $52.5 billion from the General Fund and state special funds in 1994-95, as shown in Figure 1. This expenditure level is only slightly more than estimated current-year spending of $52.3 billion—an increase of $228 million, or 0.4 percent. General Fund spending shown in the budget declines by 1.4 percent, while spending from special funds increases by 6.1 percent. However, as we discuss in greater detail later in this part, this reflects a shift in how programs are financed rather than a change in program spending priorities or in underlying revenue trends. This shift in financing results from the Governor's state-county restructuring proposal.

Figure 1 also includes two adjustments that we have made to the spending totals shown in the budget in order to better reflect actual state spending levels, and to make spending amounts more comparable from year to year. The first adjustment recognizes a net $596 million of off-budget education spending in the current year (a current-year off-budget loan of $786 million to K-12 schools and community colleges against their future Proposition 98 state funding entitlements less $190 million to repay a prior loan).

The second adjustment adds spending from the Local Public Safety Fund (LPSF) established by Proposition 172, which was approved at the

November 1993 election. Proposition 172 made permanent, as of January 1, 1994, a temporary half-cent increase in the state sales tax that had been enacted in 1991-92 to provide General Fund revenue. The proposition, however, dedicated this revenue to the LPSF for allocation to counties and cities. These LPSF allocations, in effect, offset some of the local revenue loss from property taxes that were shifted to schools in order to reduce state education funding obligations as part of the 1993-94 budget agreement. The budget treats the LPSF as a trust fund and excludes it from spending totals. We disagree with the budget's treatment of LPSF funds because the LPSF consists of state tax revenues which are expended for public purposes. Furthermore, the LPSF is not fundamentally different from other dedicated state funds, such as the Motor Vehicle License Fee Account (also constitutionally dedicated to local governments) and the Cigarette and Tobacco Products Surtax Fund (Proposition 99) which *are* included in budget spending totals.

Figure 1

Governor's Budget
Proposed and Adjusted Spending Changes
1993-94 and 1994-95

(Dollars in Millions)

			Change From 1993-94	
	1993-94	**1994-95**	**Amount**	**Percent**
Budgeted Spending:				
General Fund	$39,347	$38,788	-$559	-1.4%
Special funds	12,972	13,760	787	6.1
Totals shown in budget	$52,320	$52,548	$228	0.4%
Adjustments				
Add net Proposition 98 loan	596	—		
Add Local Public Safety Fund	686	1,450		
Adjusted totals	$53,602	$53,997	$396	0.7%

Including these adjustments adds approximately $1.3 billion to the budget spending totals in 1993-94 and $1.5 billion in 1994-95, raising them to $53.6 billion and $54.0 billion, respectively. We use these adjusted figures in our discussions below.

Spending from Federal Funds and Bond Proceeds

Federal Funds. The budget proposes to spend a total of $30.7 billion of federal funds in 1994-95. Most of these federal funds are for federal contributions to health and welfare programs ($20.9 billion), education ($6.5 billion), and transportation ($2.4 billion). Although the budget relies on $3.1 billion of additional federal funds to resolve most of the 1994-95 budget gap, expenditures of federal funds actually decline by $1 billion in 1994-95 compared with estimated spending in 1993-94. The main reason for this apparent discrepancy is that the budget treats $2 billion of the additional 1994-95 federal funds as General Fund *revenues* rather than expenditures. Projected reductions of $2.1 billion in federal funds for ongoing programs such as unemployment benefits, transportation projects, and sewage projects more than offset the remaining $1.1 billion of new federal funds for health and welfare costs that the budget assumes.

Bond Proceeds. Debt service on general obligation bonds and lease-payment bonds is included in spending from the General Fund and special funds within the appropriate program areas, as are direct expenditures on capital outlay projects. Spending from bond proceeds has *not* been included in these figures, however. Instead, the cost of bond programs is reflected when the debt-service payments are made.

The budget estimates that the state will spend $2.8 billion of general obligation bond proceeds in 1994-95. Half of these bond fund expenditures ($1.4 billion) are to finance local K-12 school facilities, with funding provided by a proposed 1994 school facilities bond act. The budget also proposes to spend $488 million of general obligation bond proceeds for higher education facilities, which would be financed primarily from a new 1994 bond act. Other major uses of general obligation bonds would be for transportation projects ($367 million); flood control, drinking water and water conservation projects ($220 million), and prisons and correctional facilities ($193 million).

Spending for earthquake safety projects could increase bond fund expenditures above the amount shown in the budget. Approximately $195 million of authorized general obligation bonds for earthquake safety projects remain available and were not proposed for expenditure in the budget, which was released prior to the Northridge earthquake.

In addition to general obligation bonds, the state also uses lease-payment bonds (supported almost entirely from the General Fund) to finance some facilities. In 1994-95, the budget indicates that the state will spend about $500 million of lease-payment bond proceeds, primarily to build prisons.

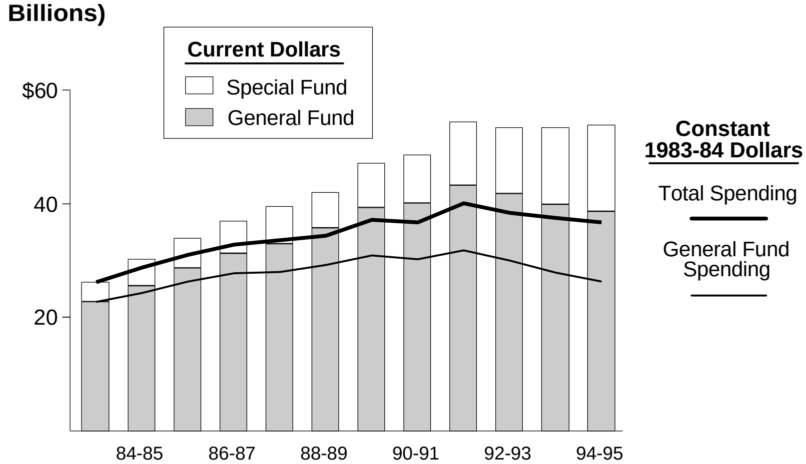
STATE SPENDING SINCE 1983-84

Figure 2 illustrates the trend in state General Fund and special fund expenditures from 1983-84 through 1994-95. The figure shows expenditures in both "current dollars" (amounts as they appear in the budget) and "constant dollars" (current dollars adjusted for the effects of inflation). Using constant dollars allows comparisons of the "purchasing power" of state spending over time.

Figure 2

State Spending[a]
Current and Constant Dollars
1983-84 Through 1994-95

(In Billions)



[a] Excludes bond funds and federal funds.

Recession Puts Brakes on State Spending Growth

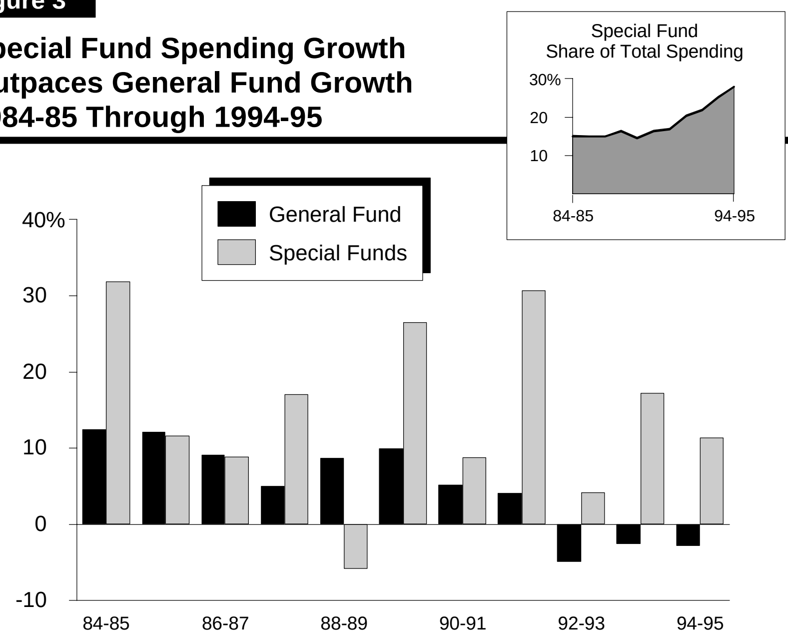
Spending grew at an annual rate of more than 9 percent between 1983-84 and 1991-92, when spending peaked at $54.5 billion (a one-time accounting change in Medi-Cal exaggerates this spending peak by $1 billion). After adjusting for inflation, spending still grew at annual rate of 5.4 percent during this period, which was more than twice the rate of population growth. After 1991-92, however, state spending declined and has remained essentially flat since then. This spending decline and stagnation is unprecedented in the post-World War II period, and reflects the depth and stubbornness of the current recession in California. The budget would carry this flat spending trend into 1994-95. As Figure 2 shows, flat spending means declining purchasing power after adjusting for inflation. In constant dollars, proposed spending in 1994-95 is 8.3 percent less than spending in 1991-92. On a per-capita basis, the decline in constant-dollar spending will be even greater—13 percent.

State-County Realignment Shifts Spending From General Fund to Special Funds

Spending from special funds accounts for a growing share of state spending, as shown in Figure 2. Figure 3 illustrates this rapid growth in special fund spending. In 1983-84, spending from special funds was about 13 percent of total spending, but will reach 28 percent in 1994-95.

Figure 3

Special Fund Spending Growth Outpaces General Fund Growth 1984-85 Through 1994-95



Prior to 1991-92, most special fund spending consisted of transportation funds and fees used to support a wide variety of programs. Growth in special fund spending during that time largely reflected enactment of new fee-based environmental and recycling programs and approval of Propositions 99 and 111 in 1988 and 1990. Proposition 99 enacted a cigarette and tobacco products surtax and placed the revenue in a special fund dedicated primarily to augmenting health-care programs, while Proposition 111 activated a schedule of gasoline tax increases and increased truck weight fees to enhance transportation funding. Thus, special fund spending growth during this period was based on special sources of dedicated revenues that were used for programs that had not been General Fund responsibilities.

The 1991-92 Realignment and Subsequent Actions. Beginning in 1991-92, however, growth in special fund spending primarily reflects a shift of General Fund costs and state sales tax revenues to new special funds that are allocated to local governments (mainly counties). The realignment of state and county health and welfare responsibilities enacted in 1991-92 included a half-cent increase in the state sales tax that was placed in a special fund for distribution to county governments to offset a portion of the General Fund costs that were shifted to them. The state budget agreement for the current year (and Proposition 172) dedicated an additional half-cent of the state sales tax to the new Local Public Safety Fund to partially offset the loss of property tax revenue shifted to public schools and community colleges in order to reduce state General Fund spending. For 1994-95, the budget proposes to shift an additional half-cent of the state sales tax to counties as part of a second realignment of state and county responsibilities for health and welfare programs. As a result, $4.3 billion (28 percent) of proposed special fund spending in 1994-95 consists of state sales tax revenue that will be allocated to county governments to directly or indirectly offset former state General Fund costs that have been shifted to them.

Vehicle license fee (VLF) revenues have been another growing source of special fund financing for state costs shifted to local governments. The VLF is a tax levied on the value of motor vehicles, similar to a property tax. The state collects the tax as a special fund revenue and allocates it to cities and counties, as required by the California Constitution. As part of the 1991-92 state-county program realignment, the Legislature increased vehicle license fees, so that in combination with realignment sales tax revenues, local governments received additional revenues approximately equal to the costs that the state shifted to them. For 1994-95, the Governor's Budget estimates that the state will distribute $2.1 billion of regular VLF revenues and $741 million of additional VLF realignment funding to cities and counties.

Two categories of spending account for more than two-thirds of the total $15.2 billion in projected spending from special funds in 1994-95. Local government allocations from sales tax and VLF total $7.2 billion, and transportation spending (including local transportation subventions) totals $3.8 billion. A wide variety of special funds financed by special fees and taxes make up the remainder of special fund spending . Among the largest of these are California State University student fees and income ($517 million), the Beverage Container Recycling Fund ($356 million) and Proposition 99 cigarette and tobacco surtax funds ($445 million).

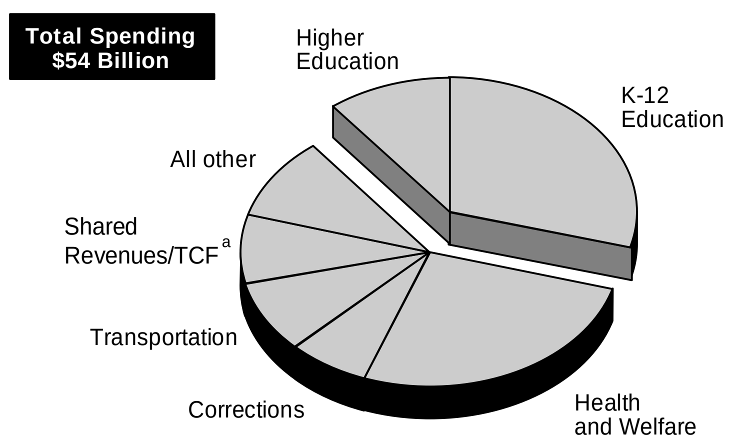
PROPOSED SPENDING BY PROGRAM AREA

Figure 4 shows the distribution of the proposed $54 billion of state spending in 1994-95 among the state's major program areas. The figure includes both General Fund and special fund expenditures in order to provide a meaningful comparison of program areas that have different mixes of General Fund and special fund support.

As Figure 4 shows, education receives the largest share of proposed state spending from all funds—a total of 40 percent (29 percent for K-12 education and 11 percent for higher education). Health and welfare programs (including state-county realignment funds) receive the next largest share of state spending—26 percent.

Figure 4

Total State Spending by Major Program 1994-95



[a] Includes VLF, Local Public Safety Fund and Trial Court Funding Block Grants.

PROGRAM SUPPORT TRENDS OVER TIME

Year-to-year changes in budget spending by program (that is, amounts shown in the budget) have become less meaningful over time and now are misleading in some cases. This is because spending adjustments and shifts—adopted in the last few years, as well as new funding shifts and program restructuring changes proposed in the budget—mean that changes in state spending from one year to another do not necessarily translate into similar changes in *program support levels*. By program support level, we mean the *total funding* provided for a program through state actions, not just the amount of state funding shown in the budget. It should be noted that most of the state budget is used, in one way or another, to support locally administered programs. In addition, program support levels take into account amounts provided through funding shifts to local governments, the federal government or to the future (using loans) and treat the total as a package.

Education funding provides an example of how program support levels are a more meaningful measure of funding than budget spending. State spending for K-12 education increases by 11 percent from 1993-94 to 1994-95 based on the figures that appear in the Governor's Budget, yet schools will realize only a 1.7 percent increase in their support level funding. This is because the increased state funding merely offsets two funding reductions that are not reflected in the budget's education spending totals. First, $1.1 billion of state spending replaces local property tax revenue that the Governor's state-county restructuring plan shifts from K-12 schools back to counties (where they offset state health and welfare costs shifted to the counties). Second, a net increase of $419 million is needed to replace the K-12 portion of the off-budget Proposition 98 loan provided in the current year.

In order to compare program support trends, we have calculated program support levels using the methodology shown in Figure 5 for major program areas in 1993-94 and 1994-95.

The support levels that we have derived only reflect funding provided by the state or (as in the case of property tax shifts) resulting from state budget actions. They do not include any effects of changes in local spending (outside of realignment and restructuring) or in federal funding (other than amounts used to offset state costs).

Figure 6 shows the proposed percentage changes in funding support level by program for 1994-95 and compares them with the average annual growth rate in support for each program during the past decade. Total program support has grown at an annual rate of 7.4 percent over the last decade, but the overall growth rate proposed for 1994-95 is much smaller—2.6 percent. Furthermore, the growth rate in 1994-95 is lower than in the past decade for every major program, although there are sharp differences among program areas in the magnitude of the change. Only a small portion of the slowdown in support growth can

Figure 5

Program Support Levels
State Funding Plus Cost Shifts
Adjustments by Program Area
1993-94 and 1994-95

K-12 Education and Community Colleges

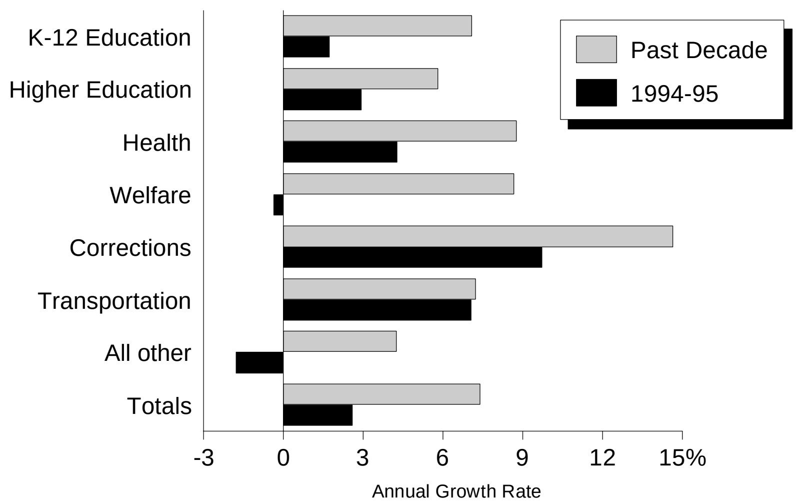
- Include funding provided by property tax shifts enacted as part of the 1992-93 and 1993-94 budget agreements and as proposed in the budget for 1994-95.
- Include spending financed by off-budget Proposition 98 loans in 1993-94 and exclude on-budget spending for repayment of prior loan.

Health and Welfare

- Allocate state/county realignment and restructuring funds among health and welfare programs.
- Include the indirect state funding that is proposed as part of the state-county restructuring plan in 1994-95. These funds consist of property tax revenue shifted back to counties from schools and increased trial court funding that would be provided to free up county resources for health and welfare costs.
- Include federal immigration funding and increased federal aid that the budget assumes for 1994-95.

Figure 6

Growth in Program Support Levels 1983-84 Through 1993-94/Proposed for 1994-95



be attributed to lower rates of inflation and population growth compared with the last decade. From 1983-84 to 1993-94, an annual growth rate of 6 percent was needed to keep pace with inflation and population growth, while for 1994-95, the anticipated increase is 4.6 percent. Thus, overall support levels for state programs will not keep pace with inflation and population growth based on the budget proposal.

Corrections

Youth and Adult Corrections will continue to experience the most rapid growth of any of the major program areas. Over the last decade, corrections support increased at an annual rate of 14.7 percent, and the budget proposes an increase of 9.7 percent in 1994-95. The budget estimates a 6.9 percent growth in the inmate population in 1994-95. Additional funding is proposed to open and staff several new prisons and make payments on bonds used to finance prison and jail construction.

Health and Welfare

Over the last decade, state support for health and welfare programs has grown by 8.7 percent annually. They have been the most rapidly growing programs after corrections. Support for health and welfare programs during this period includes state-county realignment funding, federal State Legalization Impact Assistance Grant (SLIAG) funds and Proposition 99 funding from the cigarette surtax. For 1994-95, however, the budget proposes to reduce the growth rate of health program support to 4.7 percent and support for welfare programs would decline slightly (1.1 percent).

The slowdown in health support growth reflects the elimination of some optional benefits and other proposed Medi-Cal savings that partially offset continued growth in caseload and medical costs. It also reflects a steady decline in Proposition 99 funding. Welfare support would fall slightly in 1994-95, despite increasing caseloads, as a result of substantial AFDC grant reductions proposed in the budget. Health and welfare support levels in 1994-95 include proposed funding from state-county restructuring and $1.1 billion of assumed additional federal funds, primarily for costs related to immigrants, but also due to a proposed increase in the federal match percentage for Medi-Cal and AFDC.

Education

Support for K-12 schools will grow by 1.7 percent in 1994-95, based on the budget proposal, compared with an annual growth rate of 7.1 percent over the past decade. These figures include the effects of property tax shifts and Proposition 98 loans. (Program support growth differs from the growth in Proposition 98 cash support because the latter includes local revenue changes in base property taxes and excludes non-Proposition 98 K-12 spending, such as debt service on state school bonds.) The level of support provided in 1994-95 primarily reflects anticipated enrollment growth with a flat level of per-pupil support.

Support for higher education increases by 2.9 percent in 1994-95 (including the effects of property tax shifts and Proposition 98 loans on community college resources). The proposed growth is about half of the annual growth rate during the last decade. The 1994-95 increase primarily reflects funding to cover a portion of cost and salary increases, additional student financial aid , and funding to make up for a shortfall in property tax revenues at the community colleges.

Transportation

Support for transportation, including subventions to cities and counties for streets and highways, has grown at essentially the same rate as overall state support for all programs during the last decade, and the budget proposes to continue growth in transportation support at a similar pace (7.1 percent) in 1994-95. Because transportation spending is financed by its own revenue sources, such as the gasoline tax, it has been less subject to the funding pressures that have affected other programs due to the ongoing General Fund budget problem.

Other Programs

Support for all other programs declines slightly (by 1.8 percent) in 1994-95, compared with an annual growth rate of 4.3 percent over the last decade. The decrease is somewhat misleading, however, because it reflects the budgeting practice of including in this category various statewide savings proposals (such as the reduction in middle managers) that are not allocated among the individual program areas.

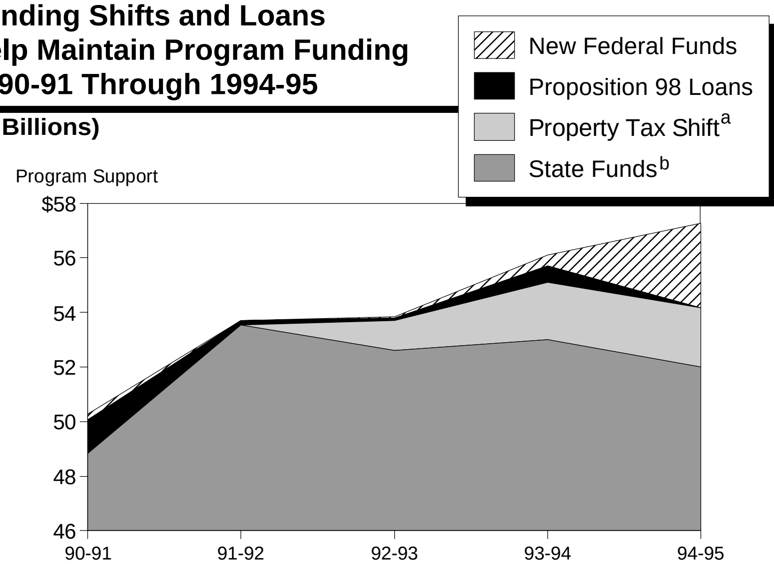
Funding Shifts Have Maintained Program Support

As the discussion above points out, growth in program support levels has slowed considerably compared with the last decade, but the budget still continues to provide some growth for most programs. In fact, since 1990-91, when the current fiscal crisis began in earnest, total state program support levels have increased by 17 percent, despite a series of massive revenue shortfalls. Figure 7 examines how the state has managed to finance growth in program support during a time when its revenue base has been shrinking.

Figure 7

Funding Shifts and Loans Help Maintain Program Funding 1990-91 Through 1994-95

(In Billions)



[a] Net of revenue from Local Public Safety Fund.

[b] Includes Local Public Safety Fund; excludes $1 billion Medi-Cal accounting change in 1991-92.

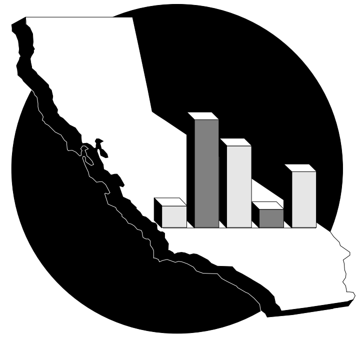
The lower area in the figure represents spending shown in the budget for each year from the General Fund and special funds for all state programs, including those administered at the local level. We have also included allocations to local governments from the Local Public Safety Fund (LPSF) in 1993-94 and 1994-95 (since these are state sales tax revenues).

The top three components in the figure represent the major funding shifts that the state has used. Property tax shifts from local governments to schools have maintained school funding while reducing state costs. Off-budget Proposition 98 loans to schools and community colleges during this period shift funding between years and also provide current funding while shifting recognition of that spending to future years. Federal funds used to offset state costs include SLIAG grants and the additional $3.1 billion of federal funds assumed in the budget for 1994-95 ($2 billion as General Fund revenues and $1.1 billion as federal funds expenditures which have the effect of reducing General Fund expenditures.

As Figure 7 shows, spending from the state's own revenues increased sharply in 1991-92 and financed a substantial increase in program support. This resulted from tax increases totaling about $7 billion that were enacted that year. Since then, however, funding shifts and off-budget loans have played an increasing role in maintaining state program support levels. These shifts and loans contribute $3.1 billion in the current year and they will contribute $5.3 billion in 1994-95 under the Governor's budget proposal.

The large net increase in 1994-95 shown in Figure 7 results from the budget's assumption that the federal government will take over $3.1 billion of existing state costs. Based on the Governor's Budget, these funding shifts will allow program support levels to grow by 5.3 percent from 1991-92 to 1994-95 even though spending from current state resources declines by 4.6 percent during the same period.

What does Figure 7 say about service level trends? First, a caveat: Our analysis addresses only *state* program levels—that is, programs funded by the state but operated by different levels of government. It does not, for example, take into account the declines in local government program levels that resulted from the 1992-93 and 1993-94 property tax shifts. With respect to state programs, however, an approximation of the ability to provide services can be derived by adjusting for the effects of inflation and population growth. When this is done, per-capita support levels decline—by 4.8 percent—since 1990-91. The decline is somewhat greater—7.9 percent—using 1991-92 as the base year. Thus, the funding shifts have not enabled the state to completely maintain the per-capita purchasing power of its programs, but they have avoided the reductions in state-financed programs that would otherwise have been required.



MAJOR EXPENDITURE PROPOSALS IN THE 1994-95 BUDGET

In this section, we discuss several of the most significant spending proposals in the budget. For more information on these spending proposals and our findings and recommendations concerning them, please see our analysis of the appropriate department or program in the *Analysis of the 1994-95 Budget Bill*.

Few Major Changes Proposed by Budget

As discussed in Part One, the Governor's Budget proposal relies on federal budget actions and a favorable decision by the U.S. Supreme Court to provide $3.7 billion of additional resources to balance the budget. Because of its assumption of additional funding, the budget makes few proposals for program reductions, except in welfare (AFDC) and health (Medi-Cal) programs. Generally, the budget continues programs at approximately current funding levels adjusted for caseload changes. Thus, outside the health and welfare area, the budget itself does not present the Legislature with many major proposals to change spending priorities or existing levels of program support. The budget's plan for restructuring state and county health and welfare responsibilities (which we discuss in detail in Part Five) would make significant revisions in the division of responsibilities between the state and the counties, but it is proposed to be fiscally neutral and does not change existing program priorities.

Figure 8

Summary of Major Budget Balancing Proposals In the 1994-95 Governor's Budget

(In Millions)

Proposal	Legislation Required?	Federal Action Required?	Assumed Effective Date	Savings 1993-94	Savings 1994-95
Increased Federal Funding					
Reimbursement for K-12 undocumented students	No	Yes	10/1/94	—	$1,700
Reimbursements for undocumented felons	No	Yes	10/1/94	—	300
Pay full Medi-Cal costs for undocumented immigrants	No	Yes	10/1/94	—	300
Pay three years health and welfare costs of refugees	No	Yes	10/1/94	—	114
Increase federal health and welfare match (FMAP)	No	Yes	10/1/94	—	599
Expand coverage of IHSS Personal Care	No	Yes	10/1/94	—	46
Eliminate SSI/SSP administrative charge	No	Yes	10/1/94	—	43
Welfare Reductions					
AFDC grant reductions and reforms	Yes	Yes	7/1/94	—	460
Medi-Cal					
Eliminate some optional benefits	Yes	No	7/1/94	—	154
Eliminate prenatal services for undocumented immigrant women	Yes	No	2/1/94	$14	92
Implement pharmacy contracting	Yes	No	1/1/95	—	34
Property Tax Shift (Proposition 98)					
Correct calculation methodology to realize full shift	Yes	No	6/30/94	200	210
Other Proposition 98					
Increase community college fees	Yes	No	7/1/94	—	35
State Administration					
Reduce managers by 10 percent	No	No	7/1/94	—	75
Natural Resources					
Shift flood control costs to bonds	Yes	No	7/1/94	—	135

Proposals that Require Legislation or Federal Action

Figure 8 lists the major budget-balancing proposals in the budget and indicates whether legislation or federal action is needed to implement them, as well as the timing assumed by the budget.

INCREASED FEDERAL FUNDING

Federal Immigration Funding

Immigration policy and enforcement is the responsibility of the federal government. The federal government also determines the eligibility of immigrants for health and welfare benefits under programs such as Medicaid (Medi-Cal in California), AFDC, and SSI/SSP, which are supported jointly by state and federal funds. In addition, the U.S. Supreme Court has determined that the federal Constitution entitles immigrant children to public education, regardless of their legal status.

Proposal

The Administration is seeking a total of $2.4 billion of additional federal funds for services related to undocumented immigrants ($2.3 billion) and refugees ($114 million). Of this amount, $2.0 billion is budgeted as revenue to the General Fund from federal reimbursements and the remaining $0.4 billion offsets state costs directly.

Education of Undocumented Immigrant Children. The budget assumes receipt of $1.7 billion in federal funds as reimbursement for the costs of providing K-12 education to undocumented immigrant children, based on the administration's estimate of the number of undocumented immigrant children in the state's public schools. In a decision on a Texas case (*Plyler v. Doe*), the U.S. Supreme Court determined that the equal protection clause of the federal Constitution prohibits states and localities from excluding undocumented children from public schools. The budget counts the $1.7 billion as an addition to General Fund revenues, rather than as a spending offset because Proposition 98 does not permit the use of federal funds in lieu of state funds in meeting the state's funding requirements. In other words, the federal funds were budgeted as revenue in order to improve the state's General Fund condition.

Incarceration Costs. The budget assumes that the state will receive $300 million in federal funds (also budgeted as General Fund revenues) for the cost of incarcerating and supervising the parole of undocumented immigrants who have been convicted of a felony in California. The federal Immigration

Reform and Control Act of 1986 (IRCA) authorizes federal reimbursements—subject to annual appropriation—for these state costs. However, Congress has never appropriated any funds for this purpose.

Medi-Cal Costs of Emergency Care. The budget includes $300 million of federal funds for the state costs of providing emergency medical care (including labor and delivery services for pregnant women) to undocumented immigrants in 1994-95. The federal Omnibus Budget Reconciliation Act (OBRA) of 1986 requires states to provide emergency medical services to undocumented immigrants who, aside from their legal status, would otherwise qualify for the Medicaid (Medi-Cal) program. The additional federal funds would replace the state's share of these costs (and the county share under the Governor's restructuring plan), so that the federal government would cover 100 percent of these Medi-Cal expenses.

Services to Refugees. The federal Refugee Act of 1980 entitles refugees to a full range of health and welfare services. The budget includes $114 million in federal funds to provide 100 percent federal funding for these AFDC, SSI/SSP and Medi-Cal services during the first 36 months of residence by refugees, as required by the act. Federal funding for this purpose has been declining since 1986 and the state received no funds for this purpose in 1993-94.

Increase in the Federal Medical Assistance Percentage (FMAP)

The FMAP is the percentage that the federal government pays of the cost of most services provided through the Medicaid (Medi-Cal) program and welfare grants and services provided in the AFDC program. The percentage varies by state according to a formula based on a state's per-capita personal income—with the federal share increasing as the per-capita personal income declines relative to the national average. California, which has a relatively large number of high-income individuals, receives an FMAP of 50 percent—the lowest possible share under the current formula.

Proposal

The budget includes a General Fund savings of almost $600 million due to an increase in the FMAP effective October 1, 1994. Most of the savings would be in the Medi-Cal program ($408 million) and the AFDC program ($170 million), with some savings also occurring in the IHSS Personal Care program. The savings assume that Congress adopts one of the options that the U.S. General Accounting Office (GAO) recommended for revising the FMAP formula. The GAO found that the existing formula does not adequately measure each state's relative need for federal funds or its ability to pay for services. Instead, the GAO recommended that Congress enact one of several alternatives that rely on the relative number of persons in each state living in poverty (to reflect need) and each state's relative tax base (to reflect ability to pay). California's FMAP would increase under any of the GAO alternatives, with the minimum increase raising the FMAP from the current 50 percent to 54.4 percent.

Issues for Legislative Consideration

Backup Plan Needed. California has joined with a number of other states that have experienced substantial immigration, such as Florida, to seek federal assistance. Consequently, the potential cost to the federal government of increased immigration funding could be significantly greater than the $3.1 billion California is requesting. Federal budget constraints will make finding these funds difficult for Congress.

Changing the FMAP formula also presents a difficult problem to Congress and the Clinton Administration. A fiscally neutral change in the formula will result in a reduction of the FMAP for a significant number of states in order to offset an increase in the FMAP for California and other states. Avoiding any losers would require a substantial increase in federal spending.

While we agree that the state has a good case for additional federal funding, we also believe that it is very likely that federal funding will fall short of the amount assumed by the budget, and that the Legislature will face a large budget hole when federal budget actions take shape this spring and summer. In fact, the new federal budget presented to the Congress by President Clinton includes none of the $3.1 billion in funding requested by the administration. (The state also faces substantial other budget risks, as we point out in Part One.) Almost $500 million of the current budget gap results from the failure of Congress to provide funding for immigrant health care costs that President Clinton had requested and which was assumed to be received in the 1993-94 state budget.

Because the federal budget is not enacted until several months after the state's budget deadline, the Legislature should consider a backup budget plan that can be implemented to achieve necessary savings if federal funding (or other budget assumptions) falls short. Because achieving significant savings becomes more difficult as the fiscal year progresses, the Legislature also should consider program reductions that could be implemented in the budget, but restored later if the state receives adequate federal funding.

Restructuring Plan Depends on Federal Funds. The fiscal balance of the Governor's plan for restructuring state and county health and welfare responsibilities depends on: (1) the assumed increase in the FMAP and (2) the assumption of full federal funding of the Medi-Cal costs of undocumented persons and of refugee health and welfare costs. Without these federal actions, the costs shifted to counties by the plan would exceed the revenues provided to them. We discuss this risk to the restructuring plan more fully in Part Five.

PROPOSITION 98

Proposition 98 establishes a minimum funding level that the state must provide for public schools and community colleges (K-14 education) in each year. Generally, this is determined based on one of three so-called "tests." Specifically, the minimum funding level is equal to the greater of:

- ***Test 1—Percentage of General Fund Revenues.*** This is defined as the 1986-87 percentage of General Fund tax revenues provided to K-14 education.
- ***Test 2—Maintenance of Prior-Year Funding Levels.*** This is defined as the prior-year level of total funding for K-14 education from state and local tax sources, adjusted for enrollment growth and for growth in per capita personal income.

In low revenue growth years, defined as years in which General Fund revenue growth, measured on a per capita basis, is more than one-half percentage point below the 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* one-half percent of the prior-year level. However, the increase in per-pupil funding must be at least equal to the increase in per capita expenditures for all other General Fund supported programs. This per-pupil funding floor (the so-called "equal pain, equal gain" or "Test 3b" provision) 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.

Other provisions of Proposition 98 allow the minimum funding level to be suspended by the Legislature and establish a "maintenance factor," which provides for restoration of funding levels in years following suspension or low revenue growth. These provisions ensure that any reductions in K-14 funding levels below those called for by the Test 1 or Test 2 formulas are only temporary in nature.

"Cash" Spending. In evaluating the effect of budget proposals, it is important to determine the amount actually available for K-14 programs ("cash" spending from state, local, and student fee sources), as well as the Proposition 98 funding provided in a given fiscal year. Cash spending differs from Proposition 98 funding due to a variety of adjustments involving funding sources that are not recorded on the state's books at all or are not recorded in the fiscal year that the schools receive the funds. For example, community college fees are not shown in the state budget at all. In the case of loans, funds are received by districts in a different year than the expenditures are recorded on the state's books.

For a more complete discussion of Proposition 98 provisions and additional background on Proposition 98 funding levels, please see the "Overview of K-12 Education" in the *Analysis of the 1994-95 Budget Bill.*

Proposal

The thrust of the Proposition 98 budget proposal is to maintain K-12 funding at the level of $4,217 per pupil in both the current year and 1994-95.

Current Year. The budget proposes $24.4 billion in Proposition 98 cash spending, $68 million less than assumed in the 1993 Budget Act. This reduction consists of a $17 million reduction in funding for K-12 schools (due to minor changes in enrollment and spending) and a $51 million reduction at the community colleges ($41 million due to property tax shortfalls plus a loss of $10 million due to changes in community college fee revenues).

The result of these proposals is to reduce the total amount of state and local spending that counts toward 1993-94 Proposition 98 funding by $58 million. The budget estimate of the minimum Proposition 98 requirement, however, is $385 million less than the June estimate, primarily due to lower estimates of General Fund tax revenues. As a result, proposed Proposition 98 General Fund spending exceeds the budget estimate of the revised Proposition 98 minimum guarantee by $327 million. Our estimate of the Proposition 98 minimum guarantee is lower (due primarily to our lower estimate of General Fund revenues) than the administration's estimate, however. The proposed level of Proposition 98 General Fund spending exceeds our estimate of the minimum guarantee by $566 million.

Budget Year. The budget proposes to provide a total of $25.2 billion in Proposition 98 funding on a cash basis from all sources in 1994-95, $714 million more than proposed current-year funding. This includes (1) $586 million to maintain funding for K-12 schools at $4,217 per pupil; (2)

$122 million for community colleges to fund enrollment growth, backfill the current-year property tax shortfall, and reflect a $7 per unit increase in student fees; and (3) $6 million for growth in other Proposition 98 programs.

The budget proposes $24.9 billion from funding sources that count toward meeting the 1994-95 Proposition 98 minimum funding requirement, $1.3 billion more than provided from these sources in the current year (almost half of this increase is necessary to backfill a current-year off-budget loan). This consists of a General Fund increase of $1.9 billion, offset by a reduction of $640 million in local property tax revenues. The property tax revenue reduction is the net effect of a proposal to shift $1.1 billion in property tax revenues from schools to other local governments partially offset by baseline growth of $460 million in local property tax revenues.

The budget proposes to overappropriate the budget estimate of the Proposition 98 guarantee by $336 million. Our estimate of the Proposition 98 guarantee, under the assumption that the Legislature adopts the administration's proposed 1993-94 budget actions and the 1994-95 property tax shift, is higher than the budget estimate. The level of General Fund spending proposed in the budget exceeds our estimate of the guarantee by about $280 million.

Issues for Legislative Consideration

Revenue Shortfalls Will Result in Painful Choices. The budget overappropriates the Proposition 98 minimum guarantee in 1993-94 and 1994-95 by about $1.4 billion. In other words, the Legislature could use that amount, without suspending the Proposition 98 guarantee, to fund other General Fund programs. To do so, however, would require per pupil funding to drop below the $4,217 level.

Categorical Program Funding. The budget proposes to continue funding most categorical programs through a single mega-item ($4.6 billion). Local education agencies would have substantially more flexibility over the allocation of these funds than the current budget affords. In addition, the budget proposes about $100 million in targeted program increases. Our review indicates that the budget proposal (1) provides too much local flexibility in allocating mega-item funding and (2) unnecessarily diverts funds from instructional programs to new policy initiatives. We recommend an alternative that maintains the Legislature's priorities for mega-item program funding and provides additional local flexibility over new categorical expenditures.

Child Development Carryover Funds Are Available. The budget fails to provide a plan for $7.5 million in state child development carryover funds and $80 million to $93 million in federal child care block grant carryover funds. The funds may be used to increase child development services provided in 1994-95 or substitute for budget-year child development services that would otherwise be provided with Proposition 98 funds. We recommend that $26.5 million ($6.5 million in state carryover and $20 million in federal carryover) free up a like amount of Proposition 98 support included in the proposed 1994-95 budget. We also recommend using $20 million of the federal carryover to increase child development services in the budget year.

California Learning Assessment System (CLAS) Plan Needed. The budget proposes to reduce the amount of performance testing included in state CLAS tests. While this would permit expansion of the program at a minimum of state costs, the proposal leaves unanswered questions about the long-term direction of the program that could have a significant impact on the 1994-95 program and expenditure plan. To ensure the Legislature has all the information needed to understand its CLAS options, we recommend the Departments of Finance and Education provide specified information on their long-term plans for CLAS.

HIGHER EDUCATION

California's system of public higher education is the largest in the nation, serving approximately 2 million students. This system is separated into three distinct segments—the University of California (UC) with 9 campuses, the California State University (CSU) with 20 campuses, and the California Community Colleges (CCC) with 107 campuses. The UC awards bachelor's degrees and a full range of graduate and professional degrees. It accepts students in the top eighth of high school graduates. The CSU primarily awards bachelor's degrees and accepts students from the upper third of high school graduates. The CCC offers a variety of academic and occupational programs, as well as basic skills and citizenship instruction. It is basically open to all persons 18 years or older.

Proposal

The UC and the CSU. The budget proposes General Fund support for the UC and the CSU of $3.4 billion in 1994-95, an increase of 3.5 percent compared with the current year. The increase is primarily for salary-related increases and debt costs on lease-revenue bonds.

For the second year in a row, the budget does not include information on projected enrollment or proposed student fees. It does indicate, however, that the administration “stands ready to discuss fee increase proposals.”

Community Colleges. The budget proposes $1.2 billion in General Fund local assistance for the community colleges in 1994-95. This entire amount counts towards the state's K-14 minimum funding guarantee under Proposition 98. The 1994-95 General Fund request represents an increase of $298 million, or 32 percent, from the amount of estimated General Fund expenditures in the current year. Considering funding from property tax revenues and loan funds (available in the current year), the net increase is $33 million (1.2 percent).

A total of $265 million of the proposed General Fund increase at the community colleges relates to funding source shifts. The budget proposes a General Fund increase of $178 million to support services that were funded by a one-time $178 million loan in the current year. The budget also reflects a General Fund increase of $87 million to offset a net decrease in revenue from the local property tax. This figure represents the net effect of (1) an increase of $151 million related to a proposed property tax shift from the colleges to local governments that is part of the Governor's state-county restructuring proposal and (2) a decrease of $64 million to reflect estimated growth in property tax revenues.

The budget also includes a proposal to raise fees from $13 per credit unit to $20 per credit unit. After accounting for financial aid, this fee increase would raise $53 million.

Issues for Legislative Consideration

As we noted above, the Administration has not offered its view on major issues affecting the higher education segments. In addition to the failure to specify enrollment and fee levels, the administration's proposed higher education budgets do not fund many of the costs of continuing existing programs or address critical long-term needs, such as deferred maintenance.

As in past years, the Legislature faces the difficult task of determining—within severe budget constraints—how to achieve the twin goals of providing open access to higher education and maintaining high-quality programs.

In its deliberations on the higher education budget, we believe the Legislature should consider the following specific actions:

- Specify each segment's enrollment levels, considering expected growth under the Master Plan for Higher Education, and hold the segments accountable for achieving them.
- Specify fee levels, including reasonable fee increases, and provide for adequate financial aid.
- Address, to the extent possible, long-term critical needs such as deferred maintenance, instructional equipment replacement, and library books and materials purchases.

- Provide for productivity increases and the use of non-General Fund resources where feasible.

In our *Analysis of the 1994-95 Budget Bill*, we offer alternative budget proposals for the UC, the CSU, the CCC, and the SAC that address these issues. As a starting point, our alternative budget proposals would provide about the same level of funding as allotted to higher education in the Governor's proposal. As has been true in previous years, additional enrollment and other information will become available in the spring.

AFDC Grant Reductions and Reforms

The state's two primary welfare programs are known as Aid to Families with Dependent Children (AFDC) and Supplemental Security Income/State Supplementary Program (SSI/SSP). Both the state and federal governments fund these programs. In the current year, the budget estimates that the General Fund cost of these programs will be $2.8 billion for AFDC and $2.1 billion for SSI/SSP.

The AFDC program provides cash grants to qualifying families with children whose incomes are not sufficient to provide for their basic needs. The largest component of the AFDC caseload is the AFDC-Family Group (AFDC-FG), in which a family's financial need is related to the death, incapacity, or continued absence of one or both parents. Other program components provide for unemployed families with children and for children in foster care. The federal government shares the cost of AFDC grants primarily with the state. Counties also provide a small contribution that the Governor's state-county restructuring proposal would increase.

The SSI/SSP program provides cash assistance to low-income persons who are elderly, blind or disabled, with the disabled being the largest group of recipients. The federal Social Security Administration administers the program and pays the cost of the SSI grant. California has chosen to supplement the federal payment by providing a state-funded SSP grant.

Proposal

The Governor's package of AFDC grant reductions and reforms is similar to proposals made by the administration in the previous two years. The budget estimates that the package would result in General Fund savings of $460 million (net of administrative costs) in 1994-95. The major proposals are summarized below:

- ***Across-the-Board Grant Reductions.*** The budget proposes a 10 percent reduction in the AFDC maximum grant levels effective July 1, 1994, and an additional 15 percent reduction for families that have an able-bodied adult and are on aid more than six months, beginning January 1, 1995. The impact of the reductions would be primarily on nonworking recipients—those who currently get the maximum grants. The grant reductions would be partially offset by increases in federally funded food stamps. The estimated state savings from these grant reductions in 1994-95 is $432 million.

- ***Maximum Family Grant.*** Under this proposal, the maximum amount of the grant, which increases with family size, would not increase for a child born after the parent has been on aid for nine months. (In effect, the grant would not increase for children conceived while the family is on aid.)

- ***Reduction in Pregnancy Benefits.*** AFDC pregnancy-related payments would be eliminated except for the federally assisted program, which provides payments during the last trimester of pregnancy. Specifically, the budget proposes to eliminate (1) grants provided to pregnant women without other children during the first six months of pregnancy and (2) a $70 monthly supplement that is provided to all pregnant women who are receiving AFDC.

- ***Teen Parent Provisions.*** The budget proposes to require parents under age 18, with some exceptions, to reside with their parents, legal guardian, or adult relative in order to receive AFDC.
- ***Time-Limited Aid.*** The budget proposes legislation to provide that AFDC grants for families with an able-bodied adult will be reduced by the amount of the grant associated with the adult, once the family has been on aid for more than two years cumulative time. The two-year "clock" would not start running until July 1, 1994, so that these grant reductions would not affect any grants until July 1, 1996.

Issues for Legislative Consideration

The Governor's AFDC proposals would result in significant savings to the state in 1994-95, with the amount increasing substantially in future years due primarily to the impact of the maximum family grant proposal and the two-year time-limited aid proposal. Because the grant reductions could be fully offset (without penalty) by increases in earnings from employment, the proposals would have the effect of increasing the financial incentive for recipients to work. The proposals, however, raise a number of significant issues.

Impact on Families. To the extent that recipients do not offset the grant reductions with additional income from other sources, the total income available to families would be reduced substantially. Under current law, the combined maximum grant and food stamps benefit is equal to about 80 percent of the federal poverty guideline. Those subject to both the 10 percent and additional 15 percent reductions in grants would have their resources reduced to about 70 percent of the guideline in the absence of other income.

Availability of Training. Many AFDC recipients have relatively low levels of education and work experience. To address this problem, California's GAIN Program provides training and basic education specifically for AFDC recipients. The program, however, currently is not funded at a level sufficient to accommodate all recipients who are required or wish to participate. Persons facing the expiration of their two-year time limit would have a priority for GAIN services.

Availability of Jobs. The downturn in the state's economy adds to the difficulty of finding employment, even for those adequately prepared. We estimate that nonagricultural employment will *decrease* by 1 percent in 1994 and remain virtually unchanged in 1995. We note that the Governor's two-year time-limited proposal does not include provision for alternatives—such as placement in community service jobs—for those unable to find employment through normal channels; although the federal administration has indicated that such a feature might be incorporated into the President's proposal for a two-year time limit on AFDC eligibility.

Potential for Cost-Shifting. The reduction in families' incomes will, to some extent, increase the use of other public services such as health and foster care. Thus, some of the savings in the AFDC Program will be offset by costs, in an undetermined amount, to the federal, state, and county governments in other programs.

MEDI-CAL

The California Medical Assistance Program is a joint federal-state program that provides necessary health services to public assistance recipients and to other individuals who cannot afford to pay for these services themselves. Federal laws establish a set of minimum eligibility criteria and the basic scope of the benefits to be provided. The states may provide for additional optional categories of eligibility and benefits. Funding for most services provided under California's program is split equally between the state and the federal governments. The budget estimates that the General Fund cost of the Medi-Cal program will be $5.8 billion in the current year.

Proposal

The budget makes two major proposals for program reductions in Medi-Cal.

Elimination of Medi-Cal Optional Benefits. The budget assumes enactment of legislation to eliminate 9 of the 28 optional service categories in the Medi-Cal Program, for a General Fund savings of $168 million in 1994-95. These savings would be partially offset by additional costs of $14 million in the Department of Developmental Services in order to maintain these services for regional center clients.

The services that would be eliminated are adult dental, nonemergency transportation, medical supplies (excluding incontinence supplies), speech and audiology, psychology, acupuncture, podiatry, chiropractic, and independent rehabilitation centers. The budget proposes to continue these services for children under age 21, persons in long-term care facilities, and developmentally disabled clients.

Eliminate Prenatal Care for Undocumented Women. The budget proposes to eliminate the existing “state-only” program that provides prenatal care for undocumented immigrant women. Federal law does not require or fund this program, which is financed entirely from the General Fund. Undocumented immigrants would remain eligible for delivery services and emergency treatment, which are required by federal law and partially funded by the federal government. The budget estimates savings of $14 million in the current year and $92 million in 1994-95 from eliminating this program effective February 1, 1994. No action had been taken as of the time of this writing.

Issues for Legislative Consideration

Potential for Cost-Shifting. In some cases, eliminating one type of service could result in increased costs for other services provided by the Medi-Cal program or other health programs. Although the budget has attempted to account for this, its savings assumptions may still be optimistic. For example, elimination of van transportation as an optional benefit does not relieve the state of its responsibility under federal law to provide "necessary transportation" for Medi-Cal beneficiaries who cannot otherwise access medical care. Thus, it is likely that most, if not all, of the savings from eliminating this service will be offset by other transportation costs, such as the increased use of ambulances. Similarly, eliminating prenatal care for undocumented immigrant women could result in poorer birth outcomes, which would increase Medi-Cal costs. The Legislature will need to examine the cost-shifting potential of these proposals, in particular, to evaluate their savings potential if it wishes to achieve General Fund savings in the Medi-Cal Program.

DEPARTMENT OF CORRECTIONS

The California Department of Corrections (CDC) is responsible for the incarceration, training, education, and care of adult felons and nonfelon narcotic addicts. It also supervises and treats parolees released to the community, as part of their prescribed terms.

Currently, the department operates 28 institutions, including a treatment center for narcotic addicts under civil law commitment. The department also operates 38 fire and conservation camps. The department will open two new prisons before the end of the current year and another two new prisons during the budget year. The Community Correctional Program includes parole supervision, operation of community correctional centers and facilities, outpatient psychiatric services for parolees and their families, and narcotic testing.

Proposal

The Governor's Budget requests $3 billion from the General Fund for support of the CDC in 1994-95, an increase of $251 million, or 9.2 percent, over the current year. This amount funds projected growth in the numbers of prison inmates and parolees. The projected growth is based on provisions of *current law* and does not assume passage of any legislation or ballot measures that may increase the numbers of inmates and parolees.

The budget does not propose any *significant* policy or program changes to reduce the inmate and parolee populations. However, the budget proposes two small programs to provide additional services to parolees who have a history of sex offenses and domestic violence, that are designed to reduce their chances of recidivism and return to prison.

The budget's total spending figures assume that the state will receive $300 million in federal funds for the state's costs of incarcerating, and supervising on parole, undocumented immigrants who have been convicted of a felony in California. However, the CDC's budget has not been reduced by that amount; rather, the funds are counted as General Fund revenues. Thus, the department's budget is held harmless should the federal funds not materialize.

Issues for Legislative Consideration

As part of its efforts to balance the state's budget, the Legislature will need to consider budget-cutting options in *all* areas of the budget, including the CDC. As we have indicated previously, because the CDC is a *caseload-driven* budget, significant expenditure reductions require controlling inmate and parole population growth or major reductions in the cost per inmate or parolee. However, achieving savings in the corrections program will be difficult. A number of pieces of legislation are currently moving through the Legislature that could result in a *major increase* in the state's future prison and parole populations and, thus, the General Fund costs to support the CDC.

Notwithstanding the current concern to ensure that repeat felons remain in prison, we believe that the Legislature should examine reducing the inmate and parole populations. In considering such reductions, the Legislature should follow these principles:

- Target reductions to nonviolent offenders.
- Target reductions to offenders who typically are incarcerated for very short periods.

- Make greater use of enhanced community supervision (such as intensive parole or electronic monitoring) for offenders who would be redirected from the prison system.
- Consider greater use of other community-based sanctions in lieu of incarceration.
- Take into account the impacts of any changes on local governments, particularly local law enforcement, and be aware of behavioral changes on the part of local prosecutors that could mitigate efforts to reduce the prison population.

TRIAL COURT FUNDING

The Supreme Court, the courts of appeal, and the superior, municipal, and justice courts make up the components of the California judicial system. The Supreme Court and the courts of appeal are entirely state-supported. The state and the counties share the costs of supporting the trial (superior, municipal, and justice) courts. Currently, state expenditures for trial court operations are partially offset by a portion of the fines, fees, and forfeitures collected by the courts. The fines, fees, and forfeitures transferred to the state pursuant to Ch 90/91 (AB 1297, Isenberg) are deposited into the General Fund, while the fees collected pursuant to Ch 696/92 (AB 1344, Isenberg) are deposited into the Trial Court Trust Fund. These latter fines, fees, and forfeitures, once collected by the trial courts and remitted to the state, are then redistributed back to the participating counties.

Proposal

The Governor's Budget proposes total expenditures of $1 billion for support of trial courts in 1994-95. This amount is $400 million, or 65 percent, above estimated expenditures in the current year. This major increase is proposed as part of the financing mechanism for the Governor's state-county restructuring plan, which proposes a shift of program responsibilities and funding from the state to counties. Another element of the restructuring plan proposes that counties and cities retain fine, fee, and forfeiture revenues that they currently transmit to the General Fund (estimated to be $348 million in 1994-95). The entire restructuring proposal is designed to be fiscally neutral. The additional trial court funding is intended to free up an equal amount of county funding in order to assume health and welfare costs from the state.

Issues for Legislative Consideration

There are a number of policy issues for the Legislature to consider regarding the Trial Court Funding Program.

Governor's Restructuring Proposal. We find much programmatic merit to the Governor's plan to move toward state financial assumption of the majority of trial court functions because of the compelling statewide interest in promoting the uniform application of justice, and because trial court operations are governed exclusively by state statutes and regulations. It will be important, however, for the Legislature to consider all of the various aspects of the restructuring plan and determine whether each piece is in the best interest of the state (for a full discussion of the restructuring proposal, please see Part V later in this document).

Expenditure Level. The Governor's Budget indicates that the proposed expenditure level will support 65 percent of trial court costs. The level of support is consistent with legislative intent as expressed in Chapter 90. More recent data on the total costs of trial courts suggests, however, that the level of support proposed may represent only about 58 percent of trial court costs. If the Legislature wishes to fund the program at the 65 percent level, the budget would have to be augmented by up to $108 million.

Revenue Sources. Although revenues from fines, fees, and forfeiture collections continue to be below projected levels, permitting local governments to retain these revenues is likely to increase collections significantly. Significant changes in levels of revenue collections could affect the restructuring proposal's fiscal neutrality.

In addition, Trial Court Trust Fund revenues continue to fall significantly below projections. To the extent that these revenues fall below projected levels in 1994-95, the state will fund less than 58 percent of total statewide trial court costs.

Implementation of Efficiencies and Cost Reductions Measures. Although many courts have implemented various efficiencies and cost savings measures, a wide disparity among courts still exists. In order to reduce the state's costs of the Trial Court Funding Program, the Legislature should consider enacting legislation to provide for additional court efficiencies. In addition, the Legislature should direct the Judicial Council to allocate funds to courts based on a system of incentives to encourage implementation of efficiencies and cost savings measures.

THE STATE'S MANAGEMENT STRUCTURE

The Governor's Budget estimates that the state will spend roughly $10 billion in the current year for the support of state agencies and institutions, other than higher education. This includes approximately $9.6 billion for the costs of salaries and benefits of 183,500 authorized positions.

Proposal

Middle Management Reduction. The Governor's budget assumes savings of $150 million ($75 million General Fund) in 1994-95 by reducing the number of managers and supervisors in state government by 10 percent. According to the Department of Personnel Administration (DPA), there are currently about 28,500 supervisors and managers overseeing the work of 150,000 full-time and part-time civil service workers. To accomplish this "downsizing" task, the DPA has imposed a freeze on appointments to management and supervisor positions in civil service, and has asked all state departments to submit plans to reduce management/supervisor positions by 5, 10, and 15 percent. The plans are to be submitted to the DPA and the Department of Finance by March 1, 1994.

Manager "Pay-for-Performance." The budget assumes savings of $21 million ($11 million General Fund) from the institution of a "pay-for-performance" plan for most manager classifications in lieu of across-the-board salary COLAs. Under this plan, approved by the Governor last December, managers did not receive the five percent pay COLA received by rank-and-file employees on January 1, 1994, nor will they receive the COLA due on January 1, 1995 (an expected three percent). Instead, managers in specified classifications may receive pay increases of *up to* five percent each January based on a performance review. Any pay increase that a department approves for a manager, however, must be funded out of existing resources. Under previous pay and budgeting policies, department budgets were augmented for salary COLAs. Data provided by the State Controller as of February 1, 1994 indicate that 86 percent of eligible managers received the full 5 percent.

Issues for Legislative Consideration

Savings Are Likely to Be Less Than Budgeted. The savings estimate used in the budget for the middle manager reduction is very optimistic. The sheer number of managers and supervisors involved in this proposal, combined with the elaborate nature of the civil service process, means that the 10 percent reduction may not be completed before September (as assumed). Moreover, many of those "demoted" to nonsupervisory positions may be entitled under civil service laws to be paid at or very near their current salary levels for some period of time, in which case assumed salary savings would be overstated.

REORGANIZING STATE DEPARTMENTS

Governors and Legislatures are continually looking at ways that governmental agencies can be organized differently. The recent attention given to "reinventing government," however, has given added impetus to reorganization efforts. Indeed, governmental reorganization can be viewed as one means of achieving a reinvented government. But, whereas the primary objectives of reinvention are to make government more responsive to the essential needs of its citizens, and to do so in a more effective manner, a common objective of reorganization, especially during difficult economic times, is to save money. The belief that savings can be made through reorganization is based on the premise that the current organizational structure of state departments includes, for a number of reasons, duplication and otherwise unnecessary work which increase the cost of government, and that these conditions can be avoided through appropriate restructuring.

Proposal

The Governor's Budget proposes a number of changes in the organizational structure of the executive branch to (1) consolidate functions, (2) reduce costs, and (3) improve service. Some of the changes reflect the elimination of various commissions, revenue bond authorities, and programs or consolidation of activities into existing or new organizational units, and these changes are reflected in the proposed budget. The most significant of the proposed changes are *not* reflected in the budget.

Changes Which are Reflected in the Budget. The bulk of the proposed changes reflected in the budget involves the elimination and consolidation of several revenue bond authorities, programs, and commissions. Many would be eliminated outright, while others would have their functions transferred to a new organization—the California Revenue Bond Financing Authority. The Commission for Economic Development would be eliminated, while the duties of the California Tax Credit Allocation Committee and the California Debt Advisory Committee would be transferred to other existing agencies.

According to the *Governor's Budget Summary*, the proposed organizational changes which are reflected in the Governor's Budget will produce an annual savings of approximately $2.7 million. Actual savings in 1994-95 would be less because some of the organizations targeted for elimination are provided funding until January 1, 1995.

Changes Which Are Not Reflected in the Budget. As noted above, the most significant of the proposed changes—changes which would have the greatest fiscal and policy impacts—are not reflected in the budget. Specifically, the Governor proposes:

- Work toward the creation of a single Revenue Department combining current functions of the Franchise Tax Board and the State Board of Equalization in order to consolidate administration of state tax laws.
- Create a new Department of Energy and Conservation, which would assume some of the functions now performed by the California Energy Commission, the State Lands Commission and the Department of Conservation, all of which would be eliminated.
- Create a new Department of Waste Management and transfer to it the functions of the California Integrated Waste Management Board, which would be eliminated, as well as the Beverage Container Recycling Program currently administered by the Department of Conservation.
- Transfer ownership of the Museum of Science and Industry to the County of Los Angeles.
- In conjunction with the state-county restructuring plan, refocus the efforts of state departments on ensuring program accountability and performance at the local level, rather than overseeing counties' day-to-day operations.

Issues for Legislative Consideration

The administration has not provided a specific plan for the most significant of the changes which have been proposed, nor has it provided information which would indicate whether the proposed reduced level of funding will be sufficient to perform remaining workloads. Therefore, in considering the proposed reorganization, the Legislature should:

- Consider whether the reorganizations are appropriate.

- Consider whether the reduced level of funding will ensure that all necessary work performed under the current organizational structure will continue to be performed *in an improved manner* following reorganization.

The Legislature will be in the best position to make these considerations when it has been provided sufficient detail regarding the administration's specific plans for accomplishing the proposed changes. This detail is not currently available.

RESTRUCTURING THE STATE-LOCAL RELATIONSHIP: MAKING PROGRESS IN 1994-95

How Should the Legislature Begin the Process of Restructuring California's System of State and Local Government?

Summary

The 1994-95 Governor's Budget proposes a major restructuring of the fiscal relationship between the state and California's 58 county governments. This proposal would increase county governments' responsibilities for funding a variety of health and welfare programs, and transfer a corresponding amount of state resources to the counties. Its primary objective appears to be increasing the fiscal incentives for counties to take actions that will improve overall program performance.

The Governor's proposal is similar in many respects to a restructuring proposal offered by this office last year. Both would result in a greater decentralization of responsibility and funding than currently exists. Both recognize the importance of fiscal incentives and program linkages, and attempt to promote collaborative efforts in order to improve the way government delivers services. Most importantly, both proposals stress the importance of outcomes over inputs and process management. The Governor's proposal is a reasonable starting point for the Legislature to use in 1994 as it pursues its state and local government restructuring agenda.

To assist the Legislature in pursuing its restructuring agenda, we outline the elements of the Governor's proposal, and evaluate its fiscal implications. We offer modifications to the proposal to correct the weaknesses we identify. Finally, we suggest that the Legislature needs to consider the state's restructuring needs within a long-term context.

INTRODUCTION

The relationship between the state and its units of local government has come under increasing stress in the last several years. This stress is, in part, a product of the state's continuing recession, which has limited the level of resources available to all levels of government. More fundamentally, however, the stress is a product of tensions inherent to the state's system of government; it reflects a growing dissatisfaction with traditional approaches to government that emphasize top-down control of program operations at the expense of flexibility and results.

In last year's *The 1993-94 Budget: Perspectives and Issues*, we reviewed the problems that characterize California's dysfunctional system of state and local government. We also offered a set of principles to guide the state's efforts to address this problem, and a model for restructuring the state and local government relationship. While we believe that the *Making Government Make Sense* model provides a sound framework for addressing the long-term restructuring needs of the state, there are different ways that progress can be made toward this objective in 1994-95.

The *1994-95 Governor's Budget* contains a major proposal for restructuring the relationship between county governments and the state. Largely structured along the lines of the 1991 state-county program realignment legislation, this proposal increases county shares of cost in existing health and welfare programs, and balances these increased costs with increased revenues transferred to counties from the state. In our view, the Governor's proposal generally moves toward a greater decentralization of programs and funding relative to what exists today, and in this respect is similar to our *Making Government Make Sense* model. Although it contains some fundamental weaknesses, it provides a reasonable starting point for the Legislature's deliberations.

The two key questions facing the Legislature in acting on any restructuring proposal are:

- Exactly what changes should be made in 1994?
- How should the Legislature's efforts to plan for other necessary long-term changes in the state-local relationship influence its choice of short-term actions?

In this report, we review the Governor's proposal and its fiscal implications. In addition, we discuss our concerns with certain portions of the proposal, and recommend some major changes to deal with these concerns. Finally, we provide some discussion of long-term policy choices that should be considered in the context of short-term decision-making.

WHAT IS THE GOVERNOR'S PROPOSAL?

Overview

Figure 1 illustrates the shifts in financial responsibility and funding associated with the Governor's proposal. As the figure shows, the administration's estimates indicate that counties would face increased costs of approximately $3.25 billion in a variety of health and welfare programs, and these costs would be offset by increased county resources of a corresponding amount.

As the figure indicates, the proposal would impose a new county cost share for the Medi-Cal program, increase the county share of cost in most AFDC program areas, and transfer full program and financial responsibility to the counties for certain other programs. In return, the county share of the state sales tax would be doubled, property taxes worth about $1.1 billion would be returned to counties from K-14 school districts, and the state would provide increased trial court-related funding. These elements of the proposal are described in the section that follows.

Elements of the Restructuring Proposal

The approach used by the administration in fashioning it restructuring proposal has three major elements: increased county fiscal responsibilities, increased revenues to offset the costs of these increased responsibilities, and increased flexibility to permit greater local control over programs operated at the local level.

Increased County Responsibilities

New County Medi-Cal Cost Share. County governments would be required to pay an 11.51 percent share of the total cost for Medi-Cal program services provided to county residents. The county share of cost would be based on total Medi-Cal program expenditures for all services with three exceptions. These include expenditures for services provided to state hospital and developmental center clients, for targeted case management services, and for costs associated with matching disproportionate share hospital (DSH) payments. Although the proposal states that each county would pay this share of costs based on services provided to residents of that county, no data systems currently exist to allocate Medi-Cal costs on a county-by-county basis. The administration has not submitted a specific proposal as to how this share of cost is to be allocated to the individual counties.

The administration believes this cost transfer will provide counties a strong fiscal incentive to more effectively control the costs of services provided to Medi-Cal program clients.

Figure 1

Governor's Restructuring Proposal 1994-95 County Fiscal Impact

(In Thousands)

Expenditure Changes	
Impose new county share of cost:[a]	
11.51 percent share of Medi-Cal	$1,352,903
Change county shares to 50 percent:[b]	
AFDC Grants	$1,126,586
Child Support	-84,812
AFDC County Administration	69,933
Food Stamps Administration	30,252
Staff Development	1,576
Cal-Learn	208
Child Care	2,711
Child Care Administration	663
Transfer financial and program responsibility:	
Alcohol and Drugs	62,258
IHSS/Personal Care	364,460
County Services Block Grant	16,204
Foster Care	323,821
Total, expenditure changes	**$3,266,763**
Revenue Changes	
Transfer state resources:	
Sales Tax	$1,409,000
Property Tax	1,140,000
Mental Health Revenues	15,000
Trial Court Fines and Forfeitures	296,000
Increase state share of cost:	
Trial Court Block Grants	388,359
Total, revenue changes	**$3,248,359**
Net Fiscal Impact	**-$18,404**

[a] Share of total program costs.

[b] Share of non-federal program costs.

Higher County Share of Cost for AFDC. As shown in Figure 1, there are a variety of different AFDC program elements that would be affected by the administration's proposal. In each of these cases, the county share of non-federal program costs would be increased to 50 percent.

The administration believes that giving counties a higher share of program costs will give them a strong fiscal incentive to make program investments in job training, employment services and other services that will contribute to a reduction in welfare dependency.

Counties to Take Over Social Services Programs. Under the administration's proposal, complete financial and program responsibility for the Foster Care and In-Home Supportive Services (IHSS) programs would be transferred to the counties. In addition, funding and operating responsibility for substance abuse programs would be transferred, with the exception that the state would continue to fund perinatal substance abuse projects. The administration indicates that counties would have discretion to determine service levels, approaches to service delivery and control operations, and the involvement of state agencies in these program areas would be limited.

These program transfers reflect a recognition of the linkages that exist between these and other community-based services. By allowing counties greater flexibility in the operation of these programs, the administration expects that more innovative, outcome-based approaches to collaborative service delivery will result.

Increased County Resources

Increased State Funding for Trial Courts. Under the proposal, the state would significantly increase its funding for trial courts under the existing Trial Court Funding Program. The administration proposes that the state funding level be increased to 65 percent of total statewide trial court operations expenses, generally corresponding to the level intended by current statutes.

This portion of the proposal reflects the view that a greater state share of costs is consistent with the statewide interest in promoting the "uniform application of justice throughout the 58 counties" and recognizes that trial court operations are controlled by state laws and regulations.

Court-Related Fine and Penalty Revenues Returned to Counties. The proposal would return the state's share of local trial court-related fine and penalty assessment revenues (about $348 million) to counties and cities. The return of these trial-court related revenues is intended to improve local incentives to collect these funds, which has been a problem over the entire period that counties have been required to remit these funds to the state.

Increased County Property and Sales Tax Allocations. The proposal would increase allocations of property and state sales taxes to the counties. In contrast to the budget actions of the last two years, the proposal would return to counties $1.14 billion of the property taxes now allocated to schools and used to offset state funding obligations under Proposition 98. In addition, the proposal would earmark an additional one-half cent of the state's sales tax to pay for the increased county costs.

The increased revenue allocations are primarily intended to offset the increased county costs resulting from the proposal. In addition, the transfer of property tax revenues is intended, by increasing the overall county share of the property tax, to improve county incentives to adequately support the administration of the property tax. The budget also proposes a one-time $25 million allocation to counties from the General Fund in 1993-94 to provide some temporary assistance in this area.

Return of Mental Health Patient Revenues. Counties also would receive approximately $15 million of state revenues associated with state hospital patients in civil cases. These revenues represent funds paid by Medi-Cal, Medicare and other private sources towards the cost of care provided to these patients. In these cases, counties also pay the state for 100 percent of the costs of the services provided.

The administration intends that the funds be used to help offset the counties' costs for these patients, but no mechanism has been developed to accomplish this.

Increased County Program Flexibility

Goodbye to 1991 Realignment Fund Structure. The proposal would incorporate both the 1991 realignment program and the above changes within a new overall funding structure. Specifically, the multiple accounts of the 1991 program would be eliminated in favor of a new two-account funding structure, as illustrated in Figure 2.

- The *Client Services Fund* would receive the proceeds of the 0.5 percent sales tax rate now dedicated to the Local Revenue Fund for the 1991 realignment program, as well as the proceeds of an existing 0.5 percent sales tax rate that would be shifted from the state's General Fund. The counties would use this fund to pay their increased costs for Medi-Cal and AFDC grants, and the budget indicates that counties would be allowed to transfer surplus funds to their county general funds.

- The *Community Services Fund* would receive the proceeds of the 1991 Vehicle License Fee increase that funded a portion of the increased county costs resulting from the 1991 realignment program. In addition, this fund would receive the $1.14 billion of property taxes that are proposed to be shifted to the counties. From this fund, counties would pay their increased costs for foster care and the other newly transferred programs. In addition, this fund would help to support the increased county costs associated with the 1991 realignment program.

Figure 2

Proposed Realignment Funding Structure

Client Services Fund	Community Services Fund	County General Funds
Revenues:		
Existing realignment 1/2 cent sales tax	Existing realignment Vehicle License Fee proceeds	Increased state trial court funding block grants
Additional 1/2 cent of state sales tax	Transfer of $1.14 billion from state property tax allocations	Transfer of trial-court-related fine and penalty revenues
		Transfer of mental health patient-related revenues
Expenditures:		
New responsibilities:	*New responsibilities:*	*New responsibilities:*
11.5% share of total Medi-Cal	Foster Care	None
50% share of nonfederal AFDC, including administration, etc.	In-Home Supportive Services	
	Alcohol and Drug Programs	
	County Services Block Grant	
	1991 realignment costs:	*Historical county costs:*
	Foster Care	Foster Care
	In-Home Supportive Services	In-Home Supportive Services
	County Services Block Grant	County Services Block Grant
	Child Welfare Services	Child Welfare Services
	Public Health	Public Health
	Indigent Health	Indigent Health
	Mental Health	Mental Health
	Adoption Assistance	AFDC-FG&U
	GAIN	

County General Fund Contributions Required. Figure 2 also indicates that the restructuring proposal would have a direct impact on county general funds. Specifically, the increased support for the Trial Court Funding Program and the return of fine and forfeiture revenues would increase county General Fund revenues by almost $700 million. The increased trial court support must be used to pay for trial court operating costs, but it is intended to "free up" a like amount of county general funds now used for that purpose.

Under the proposal, the Community Services Fund is intended to pay for the costs of the transferred programs (primarily foster care and IHSS) as well as the costs associated with the 1991 realignment program previously paid for from the Local Revenue Fund. However, because these costs exceed the amount of new revenue to be transferred to the new fund, counties would have to use Client Services Fund surplus revenues and their county general funds to make up the difference. In essence, the additional trial court-related county general fund revenues would be needed to defray the excess costs. Figure 3 illustrates this relationship.

Figure 3

Governor's Restructuring Proposal
Allocation of Revenues and Costs By Fund
1994-95

Client Services Fund	Community Services Fund	County General Funds
+ $2.858 billion sales taxes	+ $741 million Vehicle License Fees	+ $388 million increased trial court support
- $2.5 billion Medi-Cal and AFDC costs	+ $1.14 billion local property taxes	+ $297 million return of trial court revenues
	- $767 million transferred program costs	+ $15 million return of mental health patient revenues
	- $2.1 billion existing realignment costs	
Net +$358 million	**Net -$985 million**	**Net +700 million**

As Figure 3 shows, the Community Services Fund would have excess costs of $985 million, while the Client Services Fund and county general funds would have a combined surplus of $1,058 million, or $73 million more than necessary to offset the Community Services Fund deficit. This $73 million, which would accrue to the benefit of the counties, represents the combined impact of the Governor's Budget proposals on the existing realignment program (+$91 million) and the impact of the restructuring proposal discussed earlier (-$18 million). In other words, the Governor's proposals to reduce welfare grants and obtain higher federal cost sharing would reduce the counties' costs under the 1991 realignment program independently of the new restructuring proposal.

WHAT ARE THE FISCAL IMPLICATIONS OF THE GOVERNOR'S PROPOSAL?

Our review of the proposal's fiscal implications is primarily intended to address the question of the proposal's fiscal neutrality, both in the immediate 1994-95 time frame and through the remainder of this decade. Although fiscal neutrality is a stated objective of the administration, our analysis indicates that it is by no means guaranteed. We provide a projection of the costs and revenues transferred under two scenarios. We also discuss certain other fiscal issues that may affect the fiscal neutrality of the proposal.

The 1994-95 Outlook

County Impact Depends On Unrelated State and Federal Actions. As shown in Figure 1, the level of costs transferred to the counties in 1994-95 is substantially in balance with the level of increased county resources, given the economic, policy and other assumptions that underlie the *1994-95 Governor's Budget.* As the figure indicates, counties would face increased costs of about $3.25 billion, offset by increased resources of almost the same amount.

From the *county* perspective, this conclusion of initial fiscal neutrality is, however, dependent upon the budget's assumptions that there will be multibillion dollar savings from increased federal funds and the adoption of health and welfare program reductions (please see Part 1 of this volume for a detailed description of these proposals). Specifically, the estimates of increased county shares of cost under the proposal are based upon the budget's estimates of total program costs, which reflect these savings. To the extent that the increased federal funds are not forthcoming, and the health and welfare expenditure reductions are not adopted, we estimate that the level of costs transferred to the counties would be $435 million *higher* than shown above.

Figure 4 summarizes the fiscal impact of the budget's assumptions on county costs in 1994-95. Because it is unlikely that all of these assumptions will be borne out, the proposal's assertion of initial fiscal neutrality is a tenuous one.

Figure 4

County Fiscal Risks in 1994-95 Under Governor's Budget Assumptions[a]

Policy Changes—$267 million

- $208 million to reflect AFDC grant reductions
- $57 million to account for reductions in Medi-Cal optional benefits
- $2 million to reflect capping AFDC maximum family grants

Federal Funds Assumptions—$168 million

- $103 million to reflect FMAP changes
- $46 million to reflect expanded eligibility of relative-providers to receive funding under IHSS
- $19 million to reflect expected additional federal support for refugees on AFDC

[a] Dollar amounts reflect assumed reductions in county expenditures associated with restructuring proposal.

State Impact Must Consider Other Factors. As noted above, the net impact on counties is a loss of $18 million. The net impact on the state, however, is not a net gain of $18 million, for two reasons.

- ***Transfer of Revenues to Cities (-$52 Million).*** Under the proposal, a portion of the fine and forfeiture revenues ($52 million) that would be foregone by the state would be returned to city governments. While this portion of the proposal reduces state revenues, it has no effect on the counties.

- ***Transfer of School Property Taxes (+$31 Million).*** As discussed earlier, the budget proposes that $1.14 billion of existing K-14 school district property taxes be transferred to counties to offset their increased costs under the restructuring proposal. As reflected in the budget, however, state costs for K-14 school apportionments increase by about $31 million *less* than the amount transferred. This is because the budget assumes that a portion of the property taxes transferred are taken from so-called "Basic Aid" school districts that are not entitled to state apportionment funds.

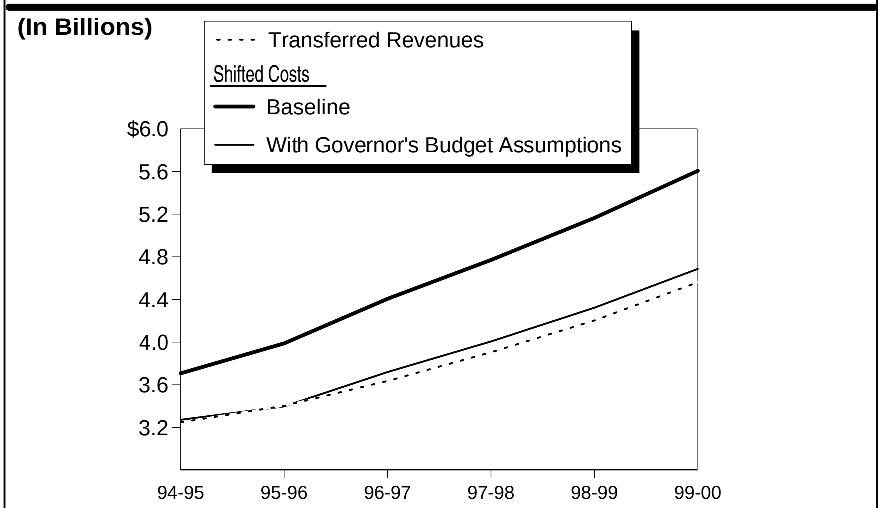
As a result of these factors, the net impact of the restructuring proposal at the state level is a loss of less than $3 million, as opposed to a net county loss of approximately $18 million.

Counties Can Expect Longer-Term Shortfalls

Figure 5 presents our estimates of the proposal's cost/revenue transfers for the period 1994-95 through 1999-2000. The increased county

Figure 5

Governor's Budget Assumptions Affect County Fiscal Impact of Restructuring Proposal 1994-95 Through 1999-00



costs are shown both assuming the increased federal funds and program reductions are realized and assuming that they are not realized ("baseline"). In the first case, the figure shows that the increased county resources are in balance with increased costs for 1994-95 and 1995-96, and thereafter a small deficit develops. This deficit reflects an increased cost in the AFDC program stemming from provisions of existing law that require a restoration of prior AFDC grant levels and the provision of annual cost-of-living adjustments.

In the latter (baseline) case, however, we project that counties would face substantial annual deficits over the entire forecast period, beginning in 1994-95. The magnitude of the annual deficit would more than double over the forecast period. From the state perspective, this annual deficit translates into annual savings of a corresponding magnitude.

Clearly, the budget's assumed federal funds and health and welfare program reductions both reduce the initial costs of the transaction, and limit the rate of growth in transferred programs over time.

Achieving Fiscal Neutrality Will Be Difficult

As a result of the factors discussed above, it will be extremely difficult for the Legislature to ensure that a restructuring proposal of this type actually achieves the goal of fiscal neutrality. Certainly, the Legislature can make adjustments in the level of resources it provides to the counties to account for the policy decisions it makes in acting on the state's budget. However, in the case of the anticipated federal funds, it is unlikely to have any firm basis on which to proceed because federal budget actions will not be finalized until September or October of this year.

Certain other considerations also are important in evaluating the fiscal impacts and overall neutrality of the Governor's restructuring proposal. These are discussed below.

Potential Mandate Liabilities

Because in the aggregate, the administration's proposal provides additional resources sufficient to offset the mandated county costs, the administration contends that it has avoided any potential mandate reimbursement implications. To the extent that the budget's assumptions regarding federal funds and program reductions are not borne out, however, or if revenue growth in future years is not sufficient to offset program cost growth, the state could be liable for reimbursement of the excess costs faced by the counties.

Another issue in this regard concerns the ability of the state to use local property tax revenues as a way of reimbursing counties for mandated costs. The state Constitution allows the state to disclaim responsibility for reimbursement of state-mandated costs under certain circumstances. In some cases, the Legislature has disclaimed this responsibility on the basis that it has provided “self-financing” authority—that is, the legislation provides sufficient revenue or revenue authority to offset the increased costs. Certainly, the Governor's proposal provides roughly sufficient authority to offset its increased costs, but according to Legislative Counsel, *a self-financing disclaimer is not valid where the revenue authority is local proceeds of taxes*. This is a highly technical legal issue, but it would appear to argue that the state could be liable for mandate reimbursement. Some sort of a county "election", such as was used for purposes of the Trial Court Funding Program, may be required to eliminate this vulnerability.

Allocation Formula Issues

The administration intends that its proposal be fiscally neutral, both on a statewide basis *and* on a county-by-county basis. Because the administration has provided no details as to how the Medi-Cal cost shares, increased Trial Court Funding support and property tax transfers would be allocated among counties, we are not currently able to evaluate the proposal on this basis. However, the design of these allocation formulas will have to take into account a number of factors if the proposal is to meet this county-by-county neutrality goal. These include the treatment of "equity" based allocations under the existing realignment program, and potential imbalances between the levels of Community Services Fund expenditures and the level of Trial Court-related revenues and property taxes that are available to offset these costs in some counties.

Trial Court Spending Levels

The budget proposes to increase the level of state support for the Trial Court Funding Program, but as noted above, it anticipates that the county funds "freed up" by this transaction will be available to defray other county costs associated with the proposal. However, because of the existing "judicial sign-off" provisions of the Trial Court Funding Program, it is possible that some portion of these funds will be retained by the trial courts in each county.

Another issue concerns the recent estimates of trial court expenditures released by the Trial Court Budgeting Commission, which are substantially higher than those used by the DOF in preparing the budget proposal. Our review of these figures indicates that they are a more reasonable estimate of expenditures than that used in the budget, so that reaching the 65 percent funding goal would require additional funding of up to $108 million in 1994-95 and higher amounts thereafter. (For purposes of the projections discussed above, we have not incorporated these new estimates of expenditures because they have not been accepted by the administration.)

Administrative Cost Changes Not Reflected

The budget acknowledges that both the state's and the counties' expenditures for program administration will be affected by the proposal. In fact, the budget anticipates that net cost *savings* will be achieved at both levels of government. With regard to the impact on governmental administrative expenditures, we think that it is important for the state to take an aggressive role in the development of program outcome measures and in the development of statewide data processing systems. This role implies the expansion of state agency duties in some cases that will at least partially offset the savings from elimination of existing control functions. The administration has provided no details as to how this elimination of functions will be accomplished, nor are any savings reflected in the budget.

At the county level, we agree that counties may experience some cost savings, to the extent that the state reduces its monitoring, data reporting and other requirements. However, counties are likely to experience increased costs to carry out new responsibilities, for example to establish and regulate foster care rates. Depending upon the specifics of the state's actions to reduce requirements, county administrative costs may increase or decrease.

HOW CAN THE PROPOSAL BE IMPROVED?

The Governor's restructuring proposal reflects a clear statement of the problems that plague the existing state-county relationship, and its statement of principles for restructuring has some commonality with the principles that we offered in last year's *Making Government Make Sense* model. The primary thrust of the proposal toward solving those problems also is positive, in that it seeks to refocus important parts of the state-county relationship towards achievement of better outcomes. It attempts to improve those outcomes through reliance on fiscal incentives to motivate greater program performance. It also recognizes the need for more flexible approaches to service delivery, and promotes collaborative efforts among programs in delivering services to clients.

As a short-term or initial step towards making the longer term changes that are needed in the relationship between the state and all units of local government, the general approach is a workable one. The underlying logic of this approach seeks to increase the role of counties in setting policy goals for a wider range of locally provided programs and in making resource allocation decisions. The proposal takes the existing assignment of responsibilities as a given, and seeks to better align program operations with operating realities and the state's fiscal interests. The shifting of state funding responsibilities and the increased county revenues are the methods by which this is accomplished.

Under this approach, county fiscal incentives—given effect through changes in cost-sharing ratios and program transfers—are used to bring about increased achievement of desirable program outcomes by the counties. We agree that counties *are* likely to respond to changes in fiscal incentives by changing county decisions as to how available local resources are allocated among programs. For example, the Governor's proposal to transfer funding responsibility for foster care is likely to result in counties focusing additional resources on efforts to serve abused or neglected children and their families. Counties would invest more in *preventive* services, such as mental health or substance abuse service, in order to avoid the higher share of cost they would pay under the proposal for *reactive* services, such as foster care.

Modifications Are Needed

Although there are generally positive aspects to the proposal, we do not recommend that the Legislature adopt it as proposed. Specifically, we believe that even within the approach outlined by the Governor, better policy choices are available that more appropriately match fiscal incentives with the ability of counties to control program costs. In addition, the Legislature should consider some policy choices that are consistent with the overall approach but are not addressed by the Governor's proposal.

More specifically, our review indicates that the Governor's proposal has two major flaws. These relate to the broad cost-sharing proposed for Medi-Cal and AFDC, and the inconsistent treatment of fiscal incentive problems. In addition, the Legislature will need to fill in several policy "gaps" in the proposal, such as how the state's interest in maintaining minimally adequate levels of public health programs will be ensured if counties are given broad discretion over program levels as proposed.

Broad Cost-Sharing Undermines Goals of Restructuring

The administration's proposal takes too broad an approach to the application of fiscal incentives, in that it assigns a share of cost that in many cases is not commensurate with county control of program activities. In the AFDC and Medi-Cal programs, for example, we are concerned that the administration's proposal is premised on an unrealistic view of county control over these programs. The bulk of expenditures for both of these programs is driven by economic and demographic factors which counties have limited ability to influence. This is not to say that counties have no ability to influence program costs, but that their influence is of a far more marginal nature than that assumed by the Governor's proposal. The high sharing ratios proposed by the Governor for Medi-Cal and AFDC could pose a significant threat to counties' financial stability, particularly during economic downturns. Under such circumstances, the counties' ability to allocate resources to "preventive" programs could be seriously undermined.

Inconsistent Fiscal Incentives Reduce Efficiency Potential

The proposal does not adequately deal with counter-productive fiscal incentives - situations where a fiscal incentive operates to encourage an inappropriate local decision from an overall program perspective. For example, the proposal may exacerbate the existing problem of some counties using Youth Authority placements as a less-expensive alternative to foster care placements. There are a number of situations where the proposal fails to correct existing problems of this type, or introduces new ones.

What Types of Modifications Are Appropriate?

We believe that these and certain other, less serious, flaws pose a significant threat to the workability of the Governor's proposal. If the Legislature decides to proceed with the Governor's proposal as an initial step toward restructuring the state-county relationship, we suggest that it consider a number of modifications to the *specifics* that will correct for these problems. This section discusses the general types of modifications that we believe are appropriate within the essentially short-term approach of the Governor's proposal. It then provides specific recommendations for improvements within the different program areas affected by the proposal.

Our recommendations for modifications generally fall into four categories, as illustrated in Figure 6. The first two categories directly correspond to the major flaws identified above. In the first category, we recommend that targeted fiscal incentives be used in place of the broad cost-sharing proposed by the Governor. In the second category, we recommend specific changes to ensure that the fiscal incentives that are present in the relationship work in a uniformly positive manner. The third category has to do with limiting the potential for actions taken by one county to adversely affect the citizens of other counties. In the last category, we recommend that the Legislature adopt changes or additions to the proposal that will further the goal of achieving greater efficiency and control of costs in these program areas.

Figure 6

Types of Modifications Needed in Governor's Restructuring Proposal

- Substitute targeted fiscal incentives for broad cost sharing
- Correct and control for counter-productive fiscal incentives
- Address potential migration and spillover problems
- Recognize opportunities for greater effectiveness

Figure 7 summarizes the specific changes that we recommend to improve the overall effectiveness of the Governor's proposal for restructuring the state-county fiscal relationship. In the remainder of this section, we describe these specific recommendations for changes in the Governor's proposal, focusing on each individual program area in turn.

Medi-Cal

In general, we believe that the administration's goal of encouraging greater efficiency is more appropriately and effectively addressed through direct state action as opposed to increased county shares of cost. We provide specific recommendations for such actions in our *Analysis of the 1994-95 Budget Bill*. These include the modification of "disproportionate share payments" to reduce county incentives to extend the hospitalization of Medi-Cal patients, and the expansion of the capitated rate reimbursement system (managed care) to cover additional Medi-Cal recipients (please see our review of the proposed Medi-Cal budget in the *Analysis*—Item 4260). However, there are certain situations where, because of the linkage to other county-operated programs, we believe that a share of cost is appropriate. Our recommendations for changes in this area are discussed below.

Figure 7

Summary of Changes to Governor's Restructuring Proposal Recommended by Legislative Analyst's Office

Medi-Cal

Use targeted incentives rather than total program cost-sharing

- 50 percent county cost share for Medi-Cal long-term care and IHSS
- 100 percent county cost share for Medi-Cal mental health and substance abuse services
- Impose "outcome-based" sanctions, such as cost-sharing for substance-abused infants

Improve Efficiency by Direct State Actions

- Modify Disproportionate Share Payments to "per-discharge" formula
- Expand Capitated Reimbursements to non-AFDC clients

AFDC

Use targeted incentives rather than total program cost-sharing

- Rewards for transitioning recipients to employment
- County shares of cost based on time on aid

Youth Authority and Parole

- Improve fiscal incentives by imposing county share of cost for CYA admissions
- Reinforce incentives for preventive programs by assigning parole responsibilities to counties

Child Welfare Services

- Develop outcome-based fiscal incentives to reduce recidivism rates

Realignment Funding Structure

- Limit county flexibility to reduce funding for public health programs

Medi-Cal Long-Term Care and IHSS. The budget proposes to give counties an 11.51 percent share of the total cost of Medi-Cal (including federally funded costs) and increase the county share of IHSS to 100 percent of nonfederal costs. Because nursing home care (on a *total* cost per case basis) is significantly more expensive than IHSS, it is fiscally appropriate to encourage greater use of IHSS in those cases where it is an effective substitute from a treatment perspective. Under the Governor's proposal, the county share of cost in this area is intended to give them a "financial reward" for using IHSS in lieu of long-term care where appropriate.

Even though we agree that a fiscal incentive is appropriate in this area, we find that the intent of the Governor's proposal does not square with the relative costs that it would impose on the counties. We estimate that, under the proposed sharing ratios, counties would find it advantageous *from a fiscal perspective* to place in nursing homes all IHSS recipients who require more than 100 hours of service per month—nearly one in five current IHSS recipients. Furthermore, these generally are the cases for which nursing home placement is a relevant consideration, due to the relatively high levels of care needed.

In lieu of the administration's proposal, we recommend that the Legislature provide for the same county share of both IHSS and Medi-Cal long-term care costs. If the counties were given responsibility for a relatively large share (say, 50 percent) of both Medi-Cal long-term care and IHSS costs, the cost differential between the two programs would provide the fiscal incentive to use the lower-cost "preventive" program. In order to further strengthen the incentive to minimize inappropriate institutionalization, we also recommend that counties be given a share of costs for non-medical residential facility care provided to SSI/SSP recipients.

Mental Health and Substance Abuse Services in Medi-Cal. The Governor proposes that counties assume responsibility for funding alcohol and drug programs, and continue their responsibility under the 1991-92 realignment legislation for mental health programs. We believe this proposal, in general, has merit. However, it does relatively little to reduce the existing incentive for counties to shift the costs of county mental health and substance abuse services to the Medi-Cal program, where possible. In order to correct this, we recommend that counties be assigned 100 percent of the nonfederal costs for these services in the Medi-Cal Program, thereby eliminating the county incentive to shift these individuals to the Medi-Cal program. This proposal would further have the benefit of effectively consolidating funding and programmatic control for the full range of mental health and substance abuse services—both within and outside the Medi-Cal Program—at the county level. In addition, because counties have more experience with monitoring psychiatric inpatient services in particular, they may prove more effective in controlling utilization of these services than the Medi-Cal field offices.

Outcome-Based Sanctions. Finally, we believe the Legislature should explore the use of "outcome-based sanctions" that would assign county financial responsibility for certain Medi-Cal expenses on a per-case basis. For example, counties could be assessed a significant share of cost for low-birthweight and substance-exposed infants. This would create a fiscal incentive for counties to avert such poor programmatic outcomes, and encourage them to target resources to activities such as alcohol and substance abuse programs that might prevent them.

Aid to Families With Dependent Children

In order to give counties a greater incentive to pursue strategies that keep people off of AFDC, the budget proposes to increase the counties' share of the nonfederal costs of the program from 5 percent to 50 percent. Rather than increasing the overall share of costs, we recommend that the Legislature adopt a more targeted approach that focuses the fiscal incentives to better achieve this objective.

Rely on Incentives and Sanctions. As we indicated in *Making Government Make Sense,* we recommend that a system of incentives and sanctions be established to encourage counties to get AFDC recipients off of aid. For example, the budget is proposing—and we think it is a good idea—to provide fiscal incentives to counties based on their ability to increase terminations from AFDC by Greater Avenues for Independence (GAIN) recipients. Similarly, a county's share of costs could increase to the extent that recipients remain on aid more than a specified period of time.

Promote Linkages. There are various programs that can have an effect on reducing the need for individuals and families to rely on income maintenance programs such as AFDC. Included among these "preventive" programs are job training and education efforts, such as the GAIN Program, and substance abuse programs. The budget proposes to retain the existing cost sharing ratio of the GAIN Program (counties have 30 percent of nonfederal costs) and to transfer all state funded alcohol and drug programs (except perinatal substance abuse) to the counties. We believe that this is appropriate in the case of GAIN, as keeping the cost share low encourages counties to make the needed program investments.

Youth Authority and Parole

As noted above, recognizing the linkages between related programs helps to ensure that fiscal incentives are consistently structured in a positive fashion. We believe that two changes are needed to improve the consistency of the fiscal incentive package with regard to criminal offenders.

Add Parole Supervision Cost Share. Although the Governor's proposal recognizes in several cases the linkages that exist among different programs, the proposal ignores the significant linkage that exists between alcohol and drug abuse and the occurrence of criminal offenses. In order to strengthen the fiscal incentive to allocate resources for substance abuse and other preventive programs, we recommend that counties be given a significant share of the funding responsibility for the supervision of persons paroled from state prisons. Success in such efforts could also help in controlling the costs of incarceration.

Increase Youth Authority Placement Fees. The Governor's proposal also ignores fiscal incentive problems associated with two of the major treatment choices for juveniles offenders - foster care and the Youth Authority. In fact, the Governor's proposal may significantly worsen an existing counter-productive fiscal incentive. This is because it would increase the counties' cost for foster care placements while maintaining an extremely low county share of cost for Youth Authority placements. There are currently 5,500 juveniles on probation who have been placed in foster care, most of whom are placed in group homes costing an average of $3,100 per month. Counties can now place these probationers instead into the Youth Authority, for which the counties are charged *$25 per month* per ward. The Governor's proposal contains no provisions requiring the maintenance of these juvenile probationers in their existing placements, nor does it otherwise constrain a county's ability to transfer these persons to the CYA. By making such transfers, counties could avoid foster care placement costs ,while shifting costs to the state.

In order to correct for this problem, we recommend that the cost faced by the counties for CYA placements be increased. From our perspective, charging the counties a fee similar to the cost of a group home placement for additional CYA placements would ensure that these decisions continue to be based primarily on treatment requirements.

Foster Care and Child Welfare Services

Although the counties would assume full financial responsibility for foster care, no change is proposed to Child Welfare Services (CWS), in which nonfederal costs are shared 70 percent state, 30 percent counties. The proposed shift of foster care funding responsibility would give the counties a strong fiscal incentive to focus on activities designed to reduce the need to place children in foster care arrangements. Similarly, giving counties a relatively small share of CWS would encourage them to allocate resources to the “preventive” components of that program, such as family preservation and family reunification.

We would note that there are circumstances under which the Legislature might decide to increase the county share of CWS costs. The reason that child welfare services are needed in the first place relates largely to adult behavior problems. Giving counties a larger fiscal stake in CWS, for example, would give counties an incentive to pursue activities, such as mental health and substance abuse programs, that are designed to address problems leading to the need for child welfare programs.

While we do not suggest changing the cost-sharing ratios for CWS at this time, we do recommend that outcome-based fiscal incentives be developed for the program. Successful efforts in this area could permit transferring all funding responsibility for CWS to the counties while still maintaining a strong incentive for counties to focus on activities that reduce the need for foster care placements. For example, counties could be given a fiscal sanction tied to the percentage of "recidivism cases" in CWS—cases where the program clearly resulted in an unsuccessful outcome.

County Flexibility in Allocating Funds

As explained above, the budget proposes to replace the existing Local Revenue Fund—the depository for realignment revenues—with two new funds. Because the Local Revenue Fund has numerous accounts, and counties have only limited ability to redirect funds among the accounts, the budget proposal should provide counties with added flexibility in allocating resources among programs. In addition, the budget proposes to give counties unrestricted control over unexpended monies remaining in the funds at the end of a fiscal year.

Counties would not have complete control over program costs because several of the programs involved in the restructuring proposal are entitlement programs under federal law. These include AFDC grants, Medi-Cal, Foster Care, and IHSS (to the extent that persons are receiving personal care services supported by federal Medicaid funds). Because the entitlement programs essentially have first call on realignment revenues, their generally faster rates of growth will constrain the amount of funds available for other programs, many of which are preventive in nature. The Governor's proposal suggests that counties would be given significantly more latitude than they now have to control costs in nonentitlement programs.

County flexibility has the advantage of facilitating innovative efforts at the local level and adaptation to local conditions. Experience with the 1991 realignment and certain other pilot projects indicates that counties will exercise a substantial amount of initiative when given the opportunity, and that they can implement successful innovations. Conversely, increased county flexibility may result in a lack of uniformity in the provision of services, leading to adverse incentives for inter-county migration. It also may result in potential "spillover" effects to the extent that counties "underspend" for needed programs. Underspending for local public health programs in one county, for example, can lead to increased transmission of diseases such as tuberculosis to residents of other counties. As we discussed in *Making Government Make Sense*, these conditions indicate that in a number of program areas there is a statewide interest in ensuring adequate minimum levels of service in each county. This interest can be served by state operation of these programs, as we proposed, or by state laws to set minimum standards for counties.

The Legislature faces a significant dilemma in determining how much control over levels of service the counties should be allowed in each of these program areas. The budget proposes that counties be given "broad authority to determine service and funding levels" for programs funded from the proposed Community Services Fund, including public health and indigent health programs. In these areas especially, we believe there is a compelling state interest in ensuring at least some minimum levels of service statewide, due to the potential for migration and "spillover" problems discussed above. Although Proposition 99 established a "maintenance of effort" requirement for certain health-related county services, it does not specifically require maintenance of effort for public health services in particular. We recommend that the Legislature consider establishing some constraints on county flexibility in this areas, for example, by maintaining the existing separate account for public health program funding.

THE INFLUENCE OF LONG-TERM CONSIDERATIONS

The Governor's proposal focuses on specific changes to be made in the 1994-95 fiscal year, and is silent on further changes that may be necessary in subsequent years. The proposal does, however, raise some questions about how some of the long-term policy choices facing the Legislature should be reconciled with the short-term actions that need to be taken in 1994.

In reviewing the Governor's proposal, we believe the Legislature should consider its own preferences for long-term policy directions. At a minimum, this would allow the Legislature to avoid taking short-term actions that will be difficult to reverse when it later seeks to implement those longer-term preferences. Consideration of longer-term choices also allows the development of strategies for implementation of restructuring choices over time, and the consideration of short-term actions in that longer-term context. From our perspective, there are several specific issues that the Legislature will ultimately need to address, and these are summarized in Figure 8.

Figure 8

Longer-Term Issues May Influence Short-Term Restructuring Choices

Issue	Implications
Trial Court Funding:	
What is state's ultimate objective for funding and operation of the courts?	Greater state control of court spending is consistent with higher state funding State operation of trial courts is consistent with full state funding
General Assistance/Indigent Health Care:	
How can control and funding responsibilities in this area be linked?	Greater flexibility over service levels is consistent with continued county funding responsibility Integration into state system is consistent with continued state control
Growth and Development:	
How can the state ensure that local development incentives are consistent with state policy goals?	Increased city and county allocations of property taxes will improve incentives for appropriate types of development Reduced influence of retail sales taxes can mitigate incentives for inappropriate development choices
County Fiscal Capacity:	
How can the Legislature ensure that counties are able to make preventive investments and be effective program partners?	Actions which result in lower levels of fiscal capacity are incompatible with effective partnerships Greater access to discretionary revenues facilitates local efforts to make preventive investments
Accountability:	
How can the public be reconnected with its government institutions?	Further jumbling of responsibilities is inconsistent with improved accountability

Trial Court Funding

As discussed earlier, the Governor's proposal would significantly increase the state's share of funding for the trial courts, consistent with Ch 90/91, the Trial Court Realignment and Efficiency Act of 1991 (AB 1297, Isenberg). That act expressed legislative intent to increase state support of the trial courts each year, to 65 percent in 1994-95 and to a maximum of 70 percent by the 1995-96 fiscal year.

We agree with the administration that the courts represent a truly statewide function, and the state has a strong interest in promoting uniform access to justice. In addition, greater state funding is justified on the basis that the state exercises primary control over trial court procedures and appoints the judges.

However, the proposal leaves open the question of what the state's ultimate objective is for funding and operation of the trial courts. This question has important implications for the Legislature. Specifically, we are concerned that increased state funding for the trial courts, *without greater state involvement and control over trial court expenditures,* will create a new source of uncontrollable costs in the state budget. Thus, to the extent that the Legislature wishes to avoid becoming involved in exercising control over the costs of trial court operations, it makes little sense to purchase an increased share of trial court costs.

On the other hand, there are a variety of ways that the Legislature could begin to exert its influence to control trial court expenses and bring about operational efficiencies. For example, the Legislature could provide for the allocation of trial court funds based on performance criteria, such as their ability to meet administrative cost-reduction goals and the implementation of efficiency measures. These include allowing superior, municipal and justice court judges to hear matters irrespective of jurisdiction. The achievement of these efficiencies was, in fact, one of the original goals of the Trial Court Funding Program.

General Assistance and Indigent Health Care

County governments are now required by state law to provide services to indigent persons not covered by other state programs, such as Medi-Cal and AFDC. In last year's budget debate, a great deal of attention was focused on how counties might be provided some relief from the burdens of these programs, and an agreement was reached to allow the most financially "distressed" counties to seek state approval for reductions in General Assistance payments. In addition, the state has reduced the procedural requirements that apply when counties attempt to close local health facilities. Although the Governor's Budget asserts that counties would be provided "broad authority to determine service and funding levels" for indigent health programs, the Department of Finance has informed us that no specific changes in general assistance or indigent health care are proposed or contemplated.

The Legislature will continue to face considerable pressure to achieve consistency in the state's current policies as regards services for the indigent population. Specifically, there is a significant lack of correspondence between program control and funding responsibilities in this area. State law generally controls service levels, while counties provide the bulk of the funds. In the long run, the state probably will come under increasing pressure to take a primary role in funding for these programs, or to allow counties greater flexibility in determining service levels. We believe it makes greater sense in the long run to begin to integrate these programs into the state's other programs for the needy, and for the state to assume a primary funding role.

The implications of such a decision for the Legislature in considering its short-term realignment options are several. First, this would argue against allowing counties greater flexibility in determining funding levels for indigent health, as may or may not be intended by the Governor's proposal, because funding reductions could impair integration efforts. Second, such a decision may argue for state participation in the costs of the general assistance and indigent health programs as a transition mechanism pending integration.

Growth and Development

The state has a broad interest in local economic development decisions, as these decisions have a substantial influence on the overall health of the state's economy, the availability of jobs for citizens, and the quality of life in this state. In recent years, the Legislature has increasingly directed its attention to these issues of economic development, and in 1993 enacted several measures designed to improve the state's business climate. The shift of property taxes away from cities and counties to schools that has taken place in the last two years, however, has reduced city and county incentives to approve new developments. In combination with the long-standing incentives that encourage these entities to favor retail over other forms of development, it is clear that the existing incentives do not favor the types of development needed to further the state's economic growth.

In this context, the Governor's proposal to return a portion of the property taxes previously shifted away from counties makes sense. However, we do not believe that this action by itself is sufficient to correct the problem. In the longer run, the Legislature will need to consider the changes in the mix of revenues that support all local governments, as well as alternative methods of allocating these revenues.

Most importantly, the Legislature will need to evaluate whether a relatively high dependence upon the retail sales tax by local agencies is conducive to the balanced pursuit of economic development in this state. To the extent that this high dependence is viewed as problematic, the Legislature should consider substituting higher allocations of property taxes for the transfer of sales taxes proposed by the Governor. It also will need to address the question of how the development incentives faced by cities can be brought into line with the state's goals, because most development occurs within city boundaries.

County Fiscal Capacity

Current constraints on county fiscal capacity—that is, the ability of counties to meet the public service needs of their communities with available resources—place limits on the extent to which counties can enter an effective program partnership with the state under the Governor's restructuring proposal. While fiscal capacity varies significantly across counties, it has declined statewide over the last several years as the state has transferred increasing shares of property tax revenues from counties for support of local schools. In this context, it should be noted that most counties have not yet implemented the full amount of spending reductions required by the 1993-94 property tax transfers. This is because they were allowed to take a credit against the required transfer in 1993-94 for the additional property taxes accruing to schools if they elected to participate in the so-called "Teeter Plan" for allocation of property taxes.

In the long run, the Legislature needs to consider changes to improve the fiscal capacity of county governments. Because of their weak fiscal condition, counties will face pressure to make program investment decisions based more on short-term fiscal considerations as opposed to the potential for improved long-term outcomes. Even as the economy improves, counties as a whole are unlikely to have adequate fiscal capacity to be effective partners with the state in the administration of shared program responsibilities.

As we discussed earlier, the administration's assumptions concerning program reductions and federal funds are *not* likely to be fully realized, so that county fiscal capacity will likely suffer another setback in 1994-95 if the Governor's proposal is adopted. Notwithstanding such a conclusion, we believe that the Legislature should recognize the importance of adequate local fiscal capacity, both for the achievement of the state's programmatic goals in partnership programs and for the effective functioning of the state's system of government generally. Aside from avoiding actions which worsen existing levels of local fiscal capacity, the Legislature should consider acting to minimize the erosion of county resources associated with existing state-controlled programs and providing counties with greater access to discretionary revenue sources.

Accountability

In our view, any broad attempt at restructuring the state and county relationship, or more broadly, government in general, needs to strengthen the connection between governmental institutions and the public they serve. Our current system of overlapping and duplicative responsibilities is not working, partly because people do not know who to hold accountable for failures, or who to credit for successes. Consequently, separating state and local government duties to the *maximum extent possible* is an important component of restoring program accountability and, ultimately, public confidence in government. We agree with the administration that *complete* separation is difficult to achieve, but from our perspective, the state should not ignore the accountability problems created by disproportionately structured program control and funding arrangements. Even where areas of shared interest and responsibility exist, it still is important to assign primary responsibility to one level of government, and to ensure that the levels of assigned program funding responsibility are commensurate with the levels of actual program control.

CONCLUSION

The need to begin serious efforts to restructure California's dysfunctional system of government is a critical one, and it is important that steps be taken during 1994 towards achieving this objective. The Governor's Budget proposal lays the foundation for progress in this area. Further steps will be required, and a certain amount of experimentation will probably be needed to determine which options are the most effective. For these reasons, it is less critical that this first step be perfectly balanced and comprehensive, and more critical that it be a step in the right direction. But, only by examining its long-term policy preferences can the Legislature ensure that its first step is taken on the right track.

RESTRUCTURING PUBLIC SCHOOL FINANCE

How Can the Legislature Increase Local Control Over and Accountability for K-12 General Education Spending?

Summary

California provides K-12 general education programs to its children through a partnership between the state and about 1,000 local school districts. About three-fourths of the proposed $22 billion in K-12 education funding from the state General Fund and local property tax sources supports general-purpose spending by school districts. Although the state determines the level of general-purpose funding that districts receive, districts have significant discretion in how funds are used.

This separation of state control over the level of general-purpose funding and district control over local spending has had positive and negative consequences. On the positive side, state control over the level of revenues has achieved substantial interdistrict equalization of general-purpose funding per pupil. On the negative side, restricted local ability to control revenue levels has hampered the ability of districts to meet local preferences for educational services, and to work with other local agencies to craft innovative responses to local needs. In addition, the separation between revenue control and spending control allows local decision-makers to disclaim accountability for outcomes. This becomes a particular concern in those situations where school district spending commitments exceed available resources.

We suggest an approach to K-12 education funding that would increase local control over the level of general-purpose education revenues and local accountability for outcomes, without compromising the state's fundamental interest in ensuring an adequate education for all. Specifically, while we believe that the state should continue to provide the substantial majority of school funding, we recommend a local option property tax that (1) raises a meaningful incremental amount of general education revenues and (2) is implemented in such a way as to give districts equal ability to generate revenues regardless of property tax wealth. Together with reforms of K-12 categorical programs that we have proposed elsewhere, this approach would give school districts added flexibility in developing creative responses to local educational needs at a time when such responsiveness appears to be much in demand.

INTRODUCTION

Over the past three years, we have conducted a major review of California's system of state and local government that provides services to the state's citizens. We have concluded that this system is dysfunctional—characterized by state and local agencies working at cross-purposes, counterproductive fiscal incentives, lack of accountability for program outcomes, and erosion of local control over the levels and mix of services, among other problems. Accordingly, in our analysis of last year's budget, we recommended ways the Legislature could reorganize state and local government program responsibilities. We offered a general model of a more rational system of government for the state—a plan for "making government make sense"—and recommended that the Legislature proceed to implement this plan.

This section applies the principles of the model to the education of California's children. Specifically, it examines the history and problems of the state/school district partnership in financing K-12 general purpose education programs, and suggests a plan for improving the relationship. In other recent reports, we have discussed reform of special purpose—"categorical"—K-12 programs, vocational education programs, and California's educational outcomes in comparison to other states.

FUNDING K-12 GENERAL EDUCATION: DYNAMICS AND PROBLEMS OF THE STATE/LOCAL PARTNERSHIP

In the current system of financing K-12 general education programs, funding responsibility and spending control reside at different levels of government. The state determines the level of funding and the broad framework of educational policy, while local school districts, governed by boards of education, make the policy and spending decisions that determine the specific shape of local education programs. County Offices of Education occupy an intermediate place between the state and school districts. They provide business and curriculum services to school districts, provide some specialized instructional programs, and oversee school district financial performance on behalf of the state. County offices and school districts together are called local education agencies (LEAs).

A positive result of state control over LEA revenues has been substantial interdistrict equalization of general-purpose spending per pupil. The separation of control over funding levels and control over spending, however, has also resulted in erosion of local fiscal accountability, a diffusion of accountability for program outcomes, and erosion of local control over the level and type of education services offered.

State Determines the Level of General-Purpose Funding

General-purpose funding for school districts supports the core educational programs provided at the local level. This funding totals about $16.4 billion from state and local sources in 1993-94. State aid, generally called "apportionments," supports about 56 percent of the total, and local property tax revenues support the rest (the mix of state and local revenues varies widely from district to district). The state, however, funds virtually all of any increase in spending. This is because of requirements for interdistrict equalization of general-purpose funding, Proposition 13 constraints on *ad valorem* property tax revenues, and the absence of significant local revenue alternatives to the *ad valorem* property tax.

Equalization Requirements

The maximum amount of general-purpose revenue that a school district may receive in any year is determined by a revenue limit. A district's revenue limit generally is the amount of funding per pupil that the district received in the prior year from unrestricted state aid (apportionments) and local property tax revenues, adjusted for inflation. Revenue limits originated in response to the California Supreme Court's ruling in *Serrano v. Priest*, which found that interdistrict differences in general-purpose spending were so dependent upon local property tax wealth as to infringe upon the constitutional rights of pupils in low property wealth districts. The court determined that the state's school finance system should be structured so as to reduce wealth-related spending disparities between districts to amounts less than $100 per pupil. This $100 band has subsequently been adjusted for inflation.

Through several legislative measures that limited the annual inflation increases permitted for districts with above-average revenue limits, and about $1.4 billion in equalization aid to "level up" school districts with below-average revenue limits, the state has made substantial progress in equalizing general-purpose spending. In 1974-75, when *Serrano* was originally decided, 51 percent of pupils were within the specified $100 per pupil band. In 1991-92, 96 percent of pupils fell within the specified band (about $300 per pupil after adjustment for inflation). Virtually all of the pupils outside the range are in districts with revenue limits that are *above* the band. In its most recent review of *Serrano* (1986), the California Supreme Court let stand an appellate court ruling that the state had fully complied with the requirement to reduce wealth-related disparities in per-pupil spending to insignificant differences.

Proposition 13

Proposition 13, adopted by state voters in 1978, capped local *ad valorem* property tax rates at 1 percent of assessed value and capped growth in assessed value at 2 percent per year. This reduced by about 54 percent the amount of property taxes available to fund services provided by cities, counties, school districts, and other governmental agencies. An *ad valorem* property tax is levied on the assessed value of real property, as distinguished from a property tax that levies a fixed dollar charge per parcel or square foot, regardless of property value (commonly referred to as "parcel taxes"). Reliance on parcel taxes, although growing, is limited.

Following adoption of Proposition 13, the Legislature took a number of actions to specify how the remaining local property tax revenues should be allocated and to provide state funding for services that had previously been supported by local property tax revenues.

These actions had two significant effects on general-purpose funding for school districts. First, by reducing local property tax revenues for the schools, they significantly increased the role of the state in supporting school district general-purpose funding. The state share increased from one-fourth of general-purpose funding prior to enactment of Proposition 13 to about two-thirds in the year after enactment.

Second, these actions eliminated local discretion over general-purpose funding levels. Prior to Proposition 13, a district's revenue limit effectively capped property tax revenues for support of K-12 schools. Because revenues for most districts were below the cap, any change in funding from year to year was a subject of local discretion.

Since Proposition 13, each school district has received its share of the 1 percent local property tax based on allocation formulas fixed in state statutory law. A district's entitlement to state aid has become the difference between its revenue limit and its allocation of local property tax revenues. This means that changes in general-purpose funding—such as cost-of-living adjustments—are at the discretion of the state, and are determined as part of the state's budget process. (There are a very few districts—"basic aid" districts— in which the allocated level of local property taxes exceed the revenue limit. In these districts, the spending level is not determined by the state—they receive only the constitutionally required minimum state funds of $120 per pupil—but is instead determined by growth in the assessed value of property.)

Limited Local Revenue Alternatives

While school districts now have no control over the amount of revenues they receive from *ad valorem* property taxes, they do have some limited local options for raising general-purpose revenues. These options, however, have not generated significant additional local revenues for most school districts. This is because they generally require approval by a two-thirds majority of voters, or because they have very limited revenue-raising potential. Existing local revenue options primarily include parcel or square footage taxes and a county-wide sales tax.

- ***Parcel Taxes.*** Upon approval by a two-thirds majority of voters, a school district may impose a flat tax per parcel or square foot of real property (the tax is not based on the assessed value of property). Since 1984, 41 districts have had successful parcel tax elections. About 37 percent of all parcel tax elections by school districts have been successful. In 1991-92, parcel taxes generated about $46 million for school districts statewide. Legislation (SB 1, Hart) that would permit imposition of parcel taxes on approval by a simple majority of voters was approved by the Legislature in 1993 but vetoed by the Governor.

- ***Local Option Sales Tax.*** Chapter 14X, Statutes of 1991 (AB 17X, Willie Brown), permits formation of a local finance authority that, upon agreement of 50 percent of the school districts in a county, can call for an election to authorize a county-wide one-half cent sales tax to benefit public education and various county programs. Imposition of the tax requires approval by a simple majority of county voters. This tax has the potential to raise significant revenues for schools—as much as $1.4 billion statewide, if approved in all counties. Recent court decisions, however, call into question the constitutionality of levying this tax without approval by a two-thirds majority of voters. The City and County of San Francisco is thus far the only county to impose such a tax—it did so with a greater than two-thirds margin.

Existing System Does Not Encourage Local Control or Local Accountability

From a state fiscal perspective, the separation of funding responsibility and spending control causes two problems. First, it allows local boards to disclaim responsibility for outcomes, by blaming problems on the level of funding provided by the state. The state is held accountable for local spending decisions and, in effect, accountability for local spending decisions is diffused among voters statewide. Moreover, since the level of local taxes is not at stake in determining the level of school funding, schools are not fiscally accountable in any direct sense to local voters, and local voters are insulated from the full fiscal consequences of failures by elected school board officials or their appointees.

Second, this gap becomes a concern in those situations where school district spending commitments exceed available resources. Although the vast majority of school districts have budgeted responsibly, even in the recent period of declining "real" (inflation-adjusted) revenues per pupil, the state has paid out over $75 million in emergency loans over the past ten years to ensure that classrooms stay open and staffed in some districts. This is because the California Supreme Court has held that the state bears the ultimate responsibility for basic equality of educational opportunity in California. As affirmed recently in regard to the Richmond Unified School District in *Thomas K. Butt v. State of California*, the state is required to step in when a school district's financial problems threaten to close its schools and thereby deny its students educational opportunity on par with their peers in other districts.

From a local perspective, restricted ability to control revenue levels may hamper school districts' ability to meet local preferences for educational services, and to work with other local agencies to craft innovative responses to local needs. For example, local control of spending levels would give school districts more flexibility to get involved in identifying and working with children in need of community-based services. Local discretion in determining school revenue levels is certainly not the only issue to be addressed in efforts to improve school-community linkages. The lack of it, however, deprives local school officials, their counterparts in other local governments, and voters of an important incentive to exchange views over and build consensus about educational programs, community priorities, and desired outcomes.

RESTRUCTURING PROPOSAL

Principles for Reform

The approach we offer to address the issues of accountability and local control discussed above maintains the state's predominant role in public school finance, but allows for some significant local flexibility to raise revenues at the margin and thus locally determine revenue levels for general education programs. It is consistent with the general model of state/local government relationships we discussed last year in *Making Government Make Sense.*

In Figure 9, we summarize the principles that form the basis for our recommendations about education finance. The first two principles—align funding responsibility with spending control and provide local control over local revenue levels—come directly from *Making Government Make Sense.* The third principle—local option revenues should be wealth-neutral—is unique to education. We then identify (1) our major conclusions from *Making Government Make Sense* about the structure of state/local relationships and (2) implications for school finance reform.

Proposed Funding Model

The thrust of the model we propose is to provide the existing level of general-purpose spending primarily through state aid, with local authority to raise limited additional local revenues. Essentially, base funding levels would be the same as under current law, but districts would have significantly more ability to raise local revenues and thereby control local funding levels. The model is summarized in Figure 10.

"Foundation" Spending Supported by State. In the proposed funding model, the state would continue to guarantee a district's current level of general-purpose spending per pupil with inflation adjustments, as it does under existing law. Funding for this "foundation" level of spending would come primarily from state aid, offset to a limited extent by whatever local property tax revenues remain with the district after most are reallocated to cities and counties.

Local Option Taxes. School districts would be permitted to increase their general-purpose spending beyond their revenue limit up to a specified target level per pupil through a voter-approved increase in the *ad valorem* property tax rate. Specification of an expenditure cap serves

Figure 9

Framework for Reform of School Finance

Principle: State and local government duties must be clearly defined through appropriate alignment of control and funding responsibilities

Conclusions in *Making Government Make Sense*

- To ensure maximum responsiveness to local needs and preferences, local agencies should be responsible for both control and funding of most local services.
- However, due to the state's interest in ensuring an adequate education for all, the state should have primary responsibility for K-12 funding.

Implications for school finance reform

- School districts should continue to have primary responsibility for operating education programs.
- County offices should be continued and strengthened as the fiscal oversight arm of the state.

Principle: Local communities should control local revenues necessary to fund local service preferences

Conclusions in *Making Government Make Sense*

- State Constitution should be modified to allow simple majority of voters to alter existing 1 percent limit on local property tax rates.
- State and local appropriation limits in the State Constitution should be repealed.
- After reallocation of property tax revenues, revenue growth should be allocated to school districts and local governments where growth occurs.

Implications for school finance reform

- School districts should have enhanced local revenue-raising capability to promote local program control and accountability.
- Local revenue option could be based on local property tax.
- Local property tax revenues should be spent where they are raised.

Principle: Local option revenues for education must be wealth-neutral

Implication for school finance reform

- State must ensure that interdistrict variations in level of locally generated revenues do not depend on local tax base wealth.

Figure 10

Elements of Proposed Model

State Funds "Foundation" Level of Spending

- Existing revenue limit funding formulas, with cost-of-living adjustments.
- Primarily from state aid, with some local property tax revenue.

School Districts Provide Added Funding Through Local Option Taxes

- Additional funding limited by state-specified expenditure cap.
- Voter approval required—simple majority vote.
- State guarantees equal revenue for equal tax effort through matching grants.

to limit (1) the potential local tax burden, (2) state equalization expenditures as explained below, and (3) the disequalizing potential of the local revenue option.

Equalize Revenues Based on Tax Effort. In order to satisfy the requirements of *Serrano*, the state would have to take steps to ensure that the amount of revenue raised for any given level of tax effort was similar among districts. This is because a low property tax wealth district (relatively low assessed value per pupil) requires a higher tax rate to generate a given level of spending per pupil than does a high property tax wealth district. In *Serrano*, the court ruled that such differences are unacceptable to the extent that they result in significant disparities in per-pupil spending between districts.

The state could approach this equalization objective in a number of different ways. All involve some level of state-funded match, or "reward" for school district tax effort in order to guarantee that a district receives a given level of revenue if it levies a specified local property tax rate. In the next section, we discuss options for designing such a system, generally referred to as a "guaranteed yield program."

Guaranteed yield programs of the type illustrated below appear to offer the best hope of ensuring that a local revenue option for school funding does not generate wealth-related disparities in per-pupil spending levels among districts. They do not guarantee a wealth-neutral outcome, however. For example, even though all districts are guaranteed equal revenue for equal tax effort, it may turn out that high property tax wealth districts are consistently more likely to make the effort or make a higher level of effort than other districts. To the extent that such differences significantly exceed the level tolerated by the *Serrano* decisions—currently about $300 per pupil—a guaranteed yield approach to school funding could be vulnerable to legal challenge.

The state could mitigate this risk by capping the total amount of revenue that may be generated.

Equalization Program Examples

Below we discuss three examples of guaranteed yield programs. These examples are intended to be illustrative, not exhaustive. Actual selection of an approach would involve extensive district by district modeling of several different approaches, an effort that is beyond the scope of this report. Selection of an approach would most importantly strike a balance between two concerns: (1) level of state equalization costs and (2) extent to which the likely distribution of per-pupil spending among districts is acceptable under *Serrano.*

In each example below, the state subsidizes districts with lower assessed value per pupil in order to reduce the level of local property tax effort required to obtain a given amount of revenue—$300 per pupil. Also in all examples, the state imposes a limit on the maximum amount a district can raise through a guaranteed yield program—no district may end up spending more than 110 percent of the statewide average revenue limit for districts of its size and type.

We use $300 per pupil as the target level of additional revenue because it is about 10 percent of average revenue-limit spending per pupil for districts in California. Thus, under a 110 percent spending cap, the average district participating in a guaranteed yield program could raise up to $300 per pupil. Finally, all three examples include four districts with assessed value (AV) per pupil ranging from $200,000 to $1 million, with an AV per pupil of $315,000 in the average district. This AV profile corresponds roughly to the AV profile of unified school districts in California.

Example 1: Full Equalization

In this example, a district that wants to generate a target level of funding per pupil would be required to levy a set tax rate. This tax rate would be the rate required to generate the target level of funding per pupil in the district with the *greatest* assessed value (AV) per pupil.

Part A of Figure 11 illustrates the results of this approach for four hypothetical school districts, each of which elects to raise $300 per pupil. The district with the greatest AV per pupil ($1 million per pupil) would be required to raise property taxes by 3 cents per $100 of AV to obtain $300 per pupil. To raise the same $300 per pupil, other districts would also be required to levy the same 3-cent property tax rate. In these districts, however, this level of tax effort would generate less than $300 per pupil in property tax revenues. The state would fund the difference. For example, a tax of 3 cents per $100 of AV in the average property tax wealth district would yield $95 per pupil in property tax revenues. The state would therefore provide a matching grant of $205 per pupil. The lower a district's AV per pupil, the greater the amount of state aid supplied as a match for local effort. From the state's standpoint, this would be the most expensive possible matching grant approach to equalization.

Figure 11

Guaranteed Yield Illustrations
State Match Necessary to Deliver $300 per Pupil

School District	Assessed Value (AV) Pupil	Required Tax Rate (Per $100 AV)	Local Revenue Raised per Pupil	State Match per Pupil	Total Revenue to District
A. Example 1: Full Equalization					
High wealth	$1,000,000	0.03	$300	—	$300
Average wealth	315,000	0.03	95	$205	300
Low wealth	275,000	0.03	83	217	300
Low wealth	200,000	0.03	60	240	300
B. Example 2: Low-Wealth Equalization					
High wealth	$1,000,000	0.03	$300	—	$300
Average wealth	315,000	0.10	300	—	300
Low wealth	275,000	0.10	262	$38	300
Low wealth	200,000	0.10	190	110	300
C. Example 3: Power Equalization					
High wealth	$1,000,000	0.10	$1,000	-$700	$300
Average wealth	315,000	0.10	300	—	300
Low wealth	275,000	0.10	262	38	300
Low wealth	200,000	0.10	190	110	300

Example 2: Low-Wealth Equalization

In this example, the tax rate required to raise a given level of revenue would be the rate necessary in an *average-wealth* district. Part B of Figure 11 illustrates the result of this approach for the same four hypothetical school districts. The district with the average AV per pupil ($315,000 per pupil) would be required to raise property taxes by about 10 cents per $100 of AV to obtain $300 per pupil. To raise the same $300 per pupil, below-average wealth districts would be required to levy the same 10-cent tax rate, and the state would fund the difference between the resulting property tax revenues and the target revenue level. For example, a 10-cent tax rate in the district with below-average AV of $275,000 per pupil would generate $262 per pupil in local property tax revenues. The state would therefore provide a matching grant of $38 per pupil. Above-average wealth districts would get no state match.

We developed cost and revenue estimates based on this example because it is in the middle of the three examples with respect to state cost. If implemented in California, we estimate that this approach could, at a maximum, yield up to $1.3 billion in additional local property tax revenues for schools and require up to $300 million annually in state matching grants. This estimate assumes that all districts with revenue limits below the cap levy a tax rate sufficient to reach the cap.

While this approach to equalization would cost the state less than the approach outlined in Example 1, it would not fully equalize the amount of additional revenue received for any given level of tax effort. Districts with above-average AV per pupil would find it easier than others to raise a given amount of revenue. Consequently, this approach could be more vulnerable to a *Serrano*-based legal challenge.

Example 3: Power Equalization

An alternative approach that would also limit the state's cost but more fully equalize the return of revenue to tax effort is commonly referred to as district power equalizing (DPE). Under this approach, the state would proceed as in Example 2, but also require districts with *above-average* AV per pupil to levy the tax rate required in the average AV per pupil district to achieve the target expenditure level. This rate would actually raise more revenue than necessary to achieve the target level of expenditure in those districts. The state would recover the excess funds and redistribute them to participating districts with below average AV per pupil, thus offsetting some of its costs for matching grants.

Part C of Figure 11 illustrates this approach for the four hypothetical school districts. A DPE approach would fully equalize the level of tax effort needed to achieve a given level of revenue. If high-wealth districts participated, this would be the least costly equalization approach for the state.

Prior to enactment of Proposition 13, the Legislature approved a DPE-based reform of school finance (Ch 894/77, AB 65, Leroy Greene). The reform package was never implemented because the Proposition 13 statewide cap on property tax rates made this reform moot.

IMPLEMENTATION ISSUES

Alternatives to the *Ad Valorem* Property Tax

The proposed reform uses the *ad valorem* property tax as a local option revenue vehicle for several reasons:

- It is relatively easy to administer compared to other taxes (the administrative infrastructure is already in place to implement it at the school district level).
- It is historically the primary local funding vehicle for education in California.
- It is easy to levy in such a way as to minimize wealth-related differences.

We recognize, however, that implementation of our suggested *ad valorem* property tax option would require significant changes in the State Constitution.

Alternatives to the *ad valorem* property tax have advantages and disadvantages of their own, but generally appear to be less desirable options. They include local sales taxes, parcel taxes, and local income taxes.

Local Sales Tax. Sales taxes generally fall more heavily on lower income groups, and therefore raise tax burden issues. Moreover, a sales tax that could be levied on a district-by-district basis at a rate that could vary from district to district would significantly increase the cost of business transactions in California. This would go contrary to various initiatives undertaken by the Legislature in the past year to make it easier to do business in the state. The existing option for a county-wide sales tax to benefit schools avoids this issue, but does not meet the objective of giving individual school districts more control over revenue levels. Moreover, it is not clear that a tax levied under the existing option may be considered a general-purpose tax for purposes of Proposition 13. If determined to be a special tax, it could not be implemented upon approval by a simple majority of voters without a constitutional amendment to modify provisions of Proposition 13.

Parcel Tax. The parcel tax is much like the *ad valorem* property tax in ease of implementation and administration. In the long run, a local revenue option based primarily on the parcel tax could be vulnerable to a *Serrano*-related challenge if higher-wealth districts consistently use the tax to achieve higher levels of spending per pupil than lower-wealth districts.

Local Income Tax. A few states permit school districts and other local government entities to levy a local income tax. California does not have a local income tax. Consequently, implementation of such a tax on a district-by-district basis would involve significant administrative costs to the state. This tax would also impose significant administrative burdens on businesses, because they would be required to withhold income taxes at different rates, depending on employees' school district of residence. Implementation of a local income tax on a county-wide basis would mitigate some of these administrative problems, but would not meet the objective of giving school districts more control over their revenue levels.

Proposition 98

In *Making Government Make Sense,* we recommended elimination of the Proposition 98 minimum funding guarantee. This is primarily because the earmarking of specific portions of state-level resources is fundamentally inconsistent with our proposed model for state-local relations. In recommending its elimination, we did not anticipate lowering funding levels for schools.

The specific model of general-purpose funding suggested here would work equally well with or without Proposition 98. If implemented under Proposition 98, we would propose that property tax revenues raised through the local option tax and any state matching grants not count as revenues under Proposition 98. This is because they would be used to increase a district's level of general-purpose spending beyond its revenue limit.

School District Financial Accountability

Our proposed local revenue option for school districts can be expected to improve the accountability of schools to local voters. It would do so by linking voter expectations of school programs with school district planning through voter control over the level of school spending. It cannot, however, be expected to relieve the state, which will still supply the vast majority of funds for schools, from being the financial backstop for irresponsibly managed districts. Consequently, it will be important for the state to find ways to strengthen and more clearly define the fiscal oversight role of the County Superintendents of Education, continuing the process begun by the Legislature in Ch 1213/91 (AB 1200, Eastin).

CONCLUSION

The reform of K-12 general education funding we have outlined above would provide a measure of local control over levels of education spending. As a result, it would increase the accountability of public schools to local voters for financial and program outcomes. Together with reforms of K-12 categorical programs that we have proposed elsewhere, it would give school districts added flexibility in developing creative responses to local educational needs at a time when such responsiveness appears to be much in demand. Accordingly, we recommend that the Legislature take steps to include a local option tax capable of raising significant general education revenues in its ongoing efforts to help schools better respond to local priorities.