IV

Perspectives on State Expenditures

AN OVERVIEW OF STATE EXPENDITURES

PROPOSED CURRENT-YEAR AND BUDGET-YEAR SPENDING

The Governor's Budget proposes spending $72.4 billion from the General Fund and state special funds in 1998-99, as shown in Figure 1 (see next page). Of this total, General Fund spending accounts for about 77 percent. The level of proposed total spending is about $3.2 billion, or 4.7 percent, more than estimated current-year spending. The proposed 1998-99 budgetary amount translates into $2,159 for every man, woman and child in California, or $198 million per day.

General Fund Spending

The state's General Fund is primarily funded through tax revenues and thus is highly dependent on the state's economic condition. As indicated in Parts Two and Three of this volume, the budget projects that the state's economy will continue to grow at a moderate pace in 1998 and 1999. This, in turn, will generate moderate revenue growth. The General Fund accounts for about $2.4 billion, or 75 percent, of the $3.2 billion increase in total 1998-99 state spending proposed by the Governor.

Figure 1

Governor's Budget
Proposed and Adjusted Spending

1997-98 and 1998-99
(Dollars in Millions)

			Change From 1997-98	
	1997-98	1998-99	Amount	Percent
Budgeted spending				
General Fund	$53,022	$55,416	$2,394	4.5%
Special funds	14,383	15,150	767	5.3
Totals shown in budget	**$67,405**	**$70,566**	**$3,161**	**4.7%**
Adjustments				
Add Local Public Safety Fund	$1,776	$1,859	$84	4.7%
Adjusted totals	**$69,180**	**$72,426**	**$3,245**	**4.7%**

Detail may not total due to rounding.

Special Funds Spending

The budget proposes special funds expenditures of $15.2 billion in 1998-99, which is an increase of $767 million, or 5.3 percent, over estimated current-year expenditures. Special funds are used to allocate certain tax revenues (such as gasoline and certain cigarette tax receipts) and various other income sources for dedicated purposes. In this way, they differ from General Fund revenues, which are allocated among competing programmatic needs based on the priorities of the Governor and Legislature.

Adjustment for Local Public Safety Fund Expenditures—$1.9 Billion. The budget does not include in its totals for state special funds any expenditures from the Local Public Safety Fund (LPSF). As in previous years, we include these amounts in our spending totals because LPSF revenues are state tax receipts expended for local public purposes. This treatment is consistent with how the budget treats other dedicated state funds, such as the Motor Vehicle License Fee Account (which, like the LPSF, is constitutionally dedicated to local governments) and the Cigarette and Tobacco Products Surtax Fund (Proposition 99). The budget includes spending from both of these funds in its totals. As Figure 1 indicates, including the LPSF adjustment adds roughly $1.8 billion to the budget spending totals in 1997-98 and $1.9 billion in 1998-99. We use this adjustment to special funds spending in all our subsequent discussions that follow.

Spending from Federal Funds and Bond Proceeds

In addition to the $72.4 billion of proposed spending from the General Fund and state special funds discussed above, the budget also proposes $34.4 billion of spending from federal funds, and another $3.2 billion in bond proceeds used for capital outlay purposes. Including bond funds and federal funds, spending proposed in the budget for 1998-99 totals $110.1 billion—an increase of $4.6 billion from the current year.

Federal Funds

The budget proposes to spend a total of $34.4 billion of federal funds in 1998-99. The largest portion of these budgeted federal funds is for federal contributions to health and welfare programs ($22.7 billion), education ($7.9 billion), and transportation ($2.1 billion). These three program areas combined account for 95 percent of total federal funds. There is one state agency whose federal funding is proposed to drop sharply—the Office of Emergency Services (OES). Its spending declines from $446 million in the current year to $273 million in the budget year (a decrease of 39 percent), reflecting a reduction in state claims processed for prior disasters.

Bond Proceeds

Budgetary Treatment. The state makes debt-service payments for principal and interest on general obligation bonds and lease-payment bonds. These payments *are* included in the budget's spending figures, as are expenditures on capital outlay projects financed through direct appropriations. In contrast, the spending of bond proceeds does not represent a *current* state cost and, therefore, is not reflected in the General Fund and special funds figures until the associated debt-service costs are incurred.

General Obligation Bonds. The budget estimates that the state will expend $3.2 billion in general obligation bond proceeds in 1998-99. The majority of these bond fund expenditures (about $2 billion) are for the School Facilities Aid Program, to build additional classrooms. Other significant anticipated bond fund expenditures involve facilities for higher education ($460 million) and transportation projects ($536 million).

The budget also proposes $7 billion in new bond authorizations, most of which are general obligation bonds, to support infrastructure spending in several program areas. Before these bond sales associated with this proposal can occur, however, such bonds must be approved by both the Legislature and the state's voters. The budget assumes that about $2.5 billion of the proposed $7 billion in bond authorizations will be appropriated in 1998-99. This amount consists of the aforementioned $2 billion for construction of K-12 education facilities, in addition to $450 million to support the construction of higher education facilities.

Lease-Payment Bonds. In addition to general obligation bonds, the state also uses lease-payment bonds to finance the construction and renovation of facilities. Lease-payment bonds do not require voter approval. Their debt service is paid from annual lease payments by state agencies (funded for the most part through General Fund appropriations) for the facilities they use that have been constructed with the bond proceeds.

The budget proposes $174 million in new authorizations of lease-payment bonds, primarily for the construction of new laboratory facilities. This figure is down sharply from the $343 million that was proposed in the *1997-98 Governor's Budget.* Most of that proposed $343 million was for prison construction, which was rejected by the Legislature. In addition, the Governor is also proposing another $1 billion in new authorizations (presumably lease-payment bonds, primarily to build prisons) in separate legislation.

STATE SPENDING SINCE 1987-88

Figure 2 illustrates the trend in state General Fund and special funds expenditures from 1987-88 through 1998-99 (as proposed). The figure presents expenditures in both "current dollars" (amounts as they appear in the budget) and "constant dollars" (that is, "real" dollars—current dollars adjusted to remove the effects of inflation). We have used the Gross Domestic Product (GDP) implicit price deflator for state and local government purchases of goods and services in making these inflation adjustments. This GDP deflator is a good general measure of the price increases faced by state and local governments, and allows comparisons of the "purchasing power" of state resources over time.

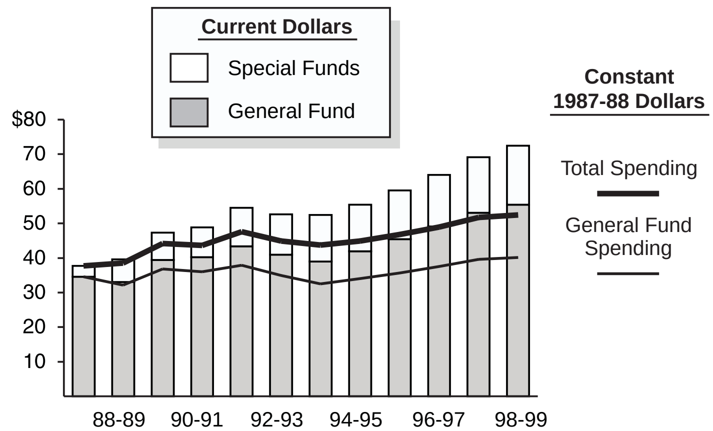
Spending Growth Accompanies Economic Recovery

Recession Caused Sharp Decline in Spending. As indicated in Figure 2, total spending grew fairly rapidly from 1987-88 through 1991-92—averaging 9.7 percent annually in current dollars and 6 percent after removing the effects of inflation. Then, during the subsequent two years, real General Fund spending fell sharply at a 7.3 percent average

Figure 2

State Spending[a]
Current and Constant Dollars

1987-88 Through 1998-99
(In Billions)



[a] Budget basis. Excludes selected bond fund expenditures and federal funds.

rate due to the emergence of severe budgetary problems associated with the recession. Although special funds spending continued to increase during this period, this growth only partially offset the General Fund decline. Indeed, the decline in total spending from 1991-92 through 1993-94 was unprecedented in the post-World War II period, and reflected the severity and longevity of the recession.

It also should be remembered that there were a wide variety of budget-related anomalies occurring during the early 1990s which underlie the spending trends shown in Figure 2 and complicate their interpretation—things such as General Fund Proposition 98 loans, General Fund loans from the state's retirement system, property tax shifts, and temporary tax increases.

Spending Rebounded With Onset of Recovery. Once the economic recovery in California began, General Fund spending growth in both current and constant dollars resumed. Between 1993-94 and 1997-98, total spending grew at an average annual rate of 7.2 percent, or 4.3 percent in real terms. There are two reasons for the increase in real spending between 1993-94 and 1997-98. First, California has experienced an economic expansion, producing healthy revenue growth supportive of expenditure increases. Second, inflation has slowed markedly, increasing the purchasing power of state spending.

Moderate Budget-Year General Fund Spending Growth Proposed. As can be seen from Figure 2, the proposed rates of growth in General Fund and total spending for 1998-99 (4.5 percent and 4.7 percent, respectively) represent a slight moderation from the growth rates experienced during the past five years.

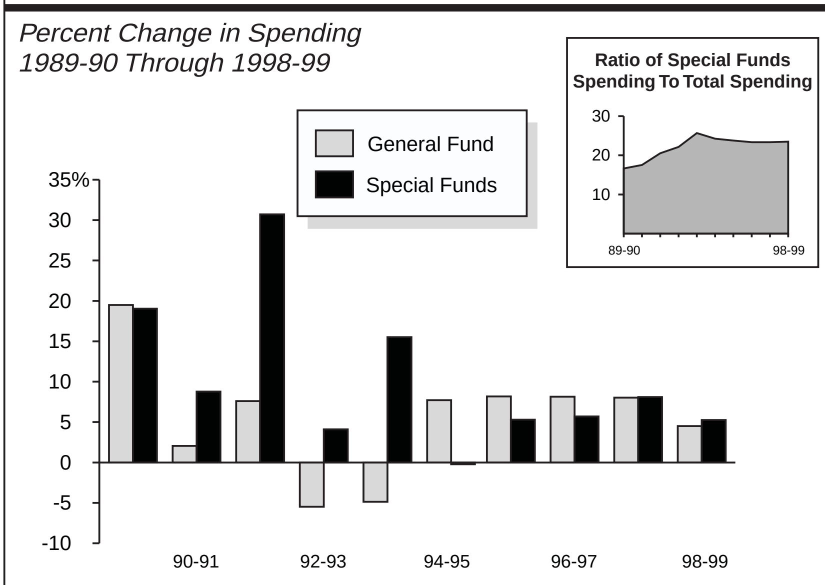
No Growth in Real Per Capita Spending. In addition, when population changes and inflation effects are considered jointly, proposed total state spending for 1998-99 is slightly below the estimate for the current year. Moreover, in spite of the economic recovery and ongoing economic expansion, total real per capita spending proposed in 1998-99 is only slightly above its 1991-92 level. This is also essentially the case for General Fund spending.

Special Funds Share of Spending Levels Off

Over the last ten years, the special funds share of total state spending has increased, as shown in Figure 3. This figure also compares annual growth in special funds expenditures with the growth in General Fund spending since 1989-90. Between 1989-90 and 1993-94, the portion of state spending financed by special funds increased from 17 percent to 26 percent. During this interval, the percentage increase in special funds

Figure 3

Special Funds Spending Share Levels Off



spending exceeded that of General Fund spending (except for the initial year)—and by a significant margin.

Prior to 1991-92, rapid growth in special funds spending reflected increases in revenues earmarked for programs that had not been traditional General Fund responsibilities. Major examples of this include Proposition 99 in 1988 (which imposed additional cigarette and tobacco taxes) and Proposition 111 in 1990 (which increased the gasoline tax and other transportation revenues).

Since 1991-92, however, spikes in the rate of special funds spending growth largely reflect restructuring within the budget, involving shifts of General Fund costs to counties along with shifts of state special funds revenues to counties to offset those costs. Specifically:

- The realignment of state and county health and welfare responsibilities enacted in 1991-92 placed revenue from a half-cent increase in the state sales tax (traditionally a General Fund revenue source) into a special fund to help counties offset a portion of the General Fund costs that were shifted to them. This realignment also provided counties with additional special fund revenues from increased vehicle license fees to offset the remainder of the costs that were shifted to them.
- Moreover, Proposition 172 (approved in November 1993) imposed an additional half-cent sales tax and dedicated the revenue to the Local Public Safety Fund. Monies from this fund are allocated to local governments to partially offset the loss of property tax revenues shifted to schools and community colleges in order to reduce state General Fund spending.

As California's economic recovery and subsequent expansion proceeded, the improved state economy produced increasingly healthy General Fund revenue performance. Consequently, the change in General Fund spending annually exceeded that from special funds over the three-year period 1994-95 through 1996-97. This caused the special funds share of total state spending to decline slightly from 26 percent in 1993-94 to 23 percent in the current year. Based on the budget's revenue projections, the rate of increase in special funds spending during the budget year is expected to exceed that of the General Fund, causing their share to rise slightly to 24 percent.

PROPOSED SPENDING BY PROGRAM AREA

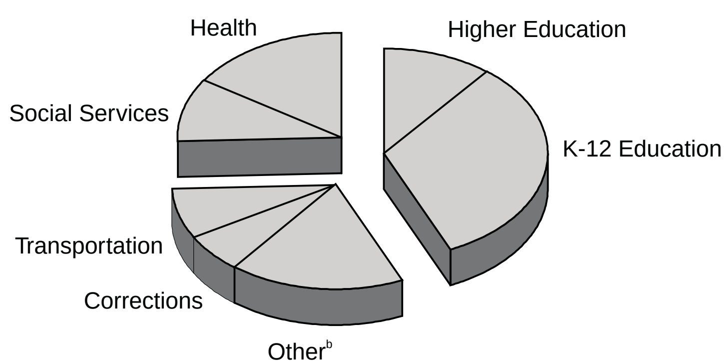
Figure 4 shows the allocation of the proposed $72.4 billion of total state spending in 1998-99 among the state's major program areas. Both General Fund and special funds expenditures are included in order to provide a meaningful comparison among broad program areas, since special funds provide the bulk of the support in some areas (such as transportation). Also, funding shifts between the General Fund and special funds would distort comparisons that did not include all budgeted funds (for example, the aforementioned shift of a portion of health and welfare spending to a special fund for state-local program realignment).

Figure 4

Proposed State Spending by Major Program Area[a]

1998-99
(Dollars in Billions)

Total Spending
$72.4 Billion



[a] Excludes bond funds and federal funds.
[b] Among others, includes general government and Local Public Safety Fund.

Figure 4 shows that K-12 education receives the largest share of proposed total state spending—nearly one-third. (It should be noted that K-12 education also receives funding from local sources.) When higher education is included, education's total rises to 43 percent. (In terms of just General Fund spending, education's share actually exceeds 50 percent.) Health and social services programs account for 26 percent of proposed total spending, while transportation and corrections together account for another 14 percent. In the "all other" category (17 percent), the largest shares are $2.7 billion of general-purpose assistance provided to local governments in the form of vehicle license fees, and $1.9 billion dedicated to localities from the Local Public Safety Fund.

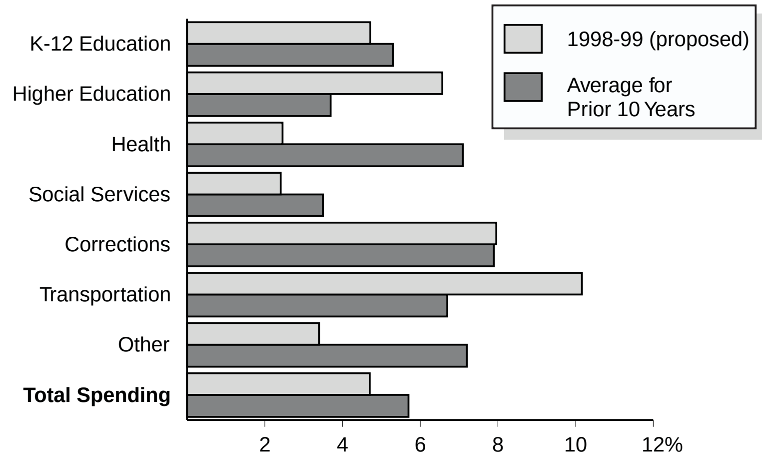
PROGRAM SUPPORT GROWTH AND TRENDS OVER TIME

Although the Governor's budget proposes to increase total spending by 4.7 percent in 1998-99, changes for individual program areas vary widely. Figure 5 shows proposed changes in support for major program areas in 1998-99. It also provides an historical perspective by showing the average annual growth over the previous 10 years for major programs.

Figure 5

Growth in Total State Spending By Major Program Area

Annual Percent Change
1998-99 and Prior 10 Years



Proposed 1998-99 Growth. The greatest percentage growth proposed in the budget year is in the areas of transportation (over 10 percent) and corrections (nearly 8 percent). Moderate growth is proposed for education, including 4.7 percent for K-12 education and 6.6 percent for higher education. Health and social services grow relatively slowly—a bit over 2 percent.

Growth Over the Past Decade. Over the past decade, total spending growth has averaged 5.7 percent annually, compared with the 4.7 percent 1998-99 proposed increase. Thus, the proposed budget-year rate of growth is below the average over the past decade. With regard to individual program areas, Figure 5 indicates that corrections and transportation have experienced the highest average rates of growth over the past ten years.

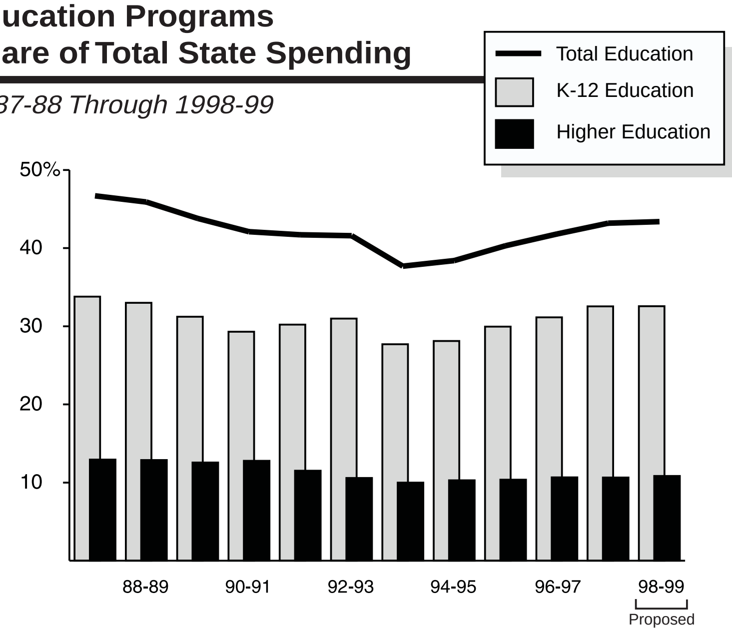
Education's Budget Share Is Proposed to Rise a Tad

Figure 6 shows education programs' share of the budget since 1987-88. In 1987-88, almost half of total state spending was devoted to either K-12 or higher education programs. By 1993-94, however, education's percentage of total state spending had fallen to 38 percent. Since then, though, education's share has trended back up. Under the Governor's proposal, it would reach 43 percent in 1998-99, a slight rise from the current year.

Figure 6

Education Programs Share of Total State Spending

1987-88 Through 1998-99



Factors Involved in the 1993-94 Drop Off. Property tax shifts enacted in 1992-93 and 1993-94 contributed significantly to the decline in education's share of total spending through 1993-94. These shifts replaced a portion of the state's education funding with an equivalent amount of local property tax revenues that were diverted away from local governments to schools and community colleges. Consequently, the abrupt drop in education's share of the state budget from 1992-93 to 1993-94 primarily reflected a restructuring of school funding, instead of a significant reallocation of total resources away from education.

What Was the Recession's Impact? With respect to the early 1990s' recession, its impact on education's share of the budget was mixed. Higher education's share of spending fell from 13 percent in 1987-88 to a low of 10 percent in 1993-94. Much of this decline was offset by increased student fees. However, education's overall share of the budget stayed relatively constant during the recession (excluding the impact of the property tax shifts). This is because the decline in higher education's share was offset by an increase in K-12 spending, which was driven by school enrollments and the funding requirements of Proposition 98.

Proposed K-12 Funding. The budget proposes $23.6 billion in K-12 spending during 1998-99, an increase of about $1.1 billion, or 4.7 percent. This growth rate is less than that of recent years. For example, between 1993-94 and 1997-98, the economic recovery and increases resulting from Proposition 98 contributed to an average annual growth rate of nearly 12 percent. Moreover, the funding formula which produces the Proposition 98 minimum funding guarantee has allowed K-12 education to capture an increasing share of the budget, rising five full percentage points in only five years. This increase allowed the state to undertake new K-12 education initiatives, such as class size reduction. The budget proposes spending new K-12 funds in a variety of ways, such as increasing the school year to 180 days.

Higher Education—The Compact. The 1998-99 budget proposes an increase of $484 million for higher education. It implements the fourth and final year of the funding plan for the University of California (UC) and California State University (CSU). It also provides funding for additional enrollment at UC and CSU, and the "buy-out" of the 5 percent student fee reduction for both systems as required by legislation passed in 1997. The UC budget also includes planning funds for a 10th campus at Merced. With respect to community colleges, the budget includes funding for enrollment growth, as well as investments in technology and infrastructure.

Health Programs Share to Decline Slightly

Support for health programs would grow by 2.5 percent in 1998-99 based on the budget proposal. As shown in Figure 5, this compares with an annual growth of 7.1 percent over the past decade—a period that reflected high rates of caseload growth and significant increases in the cost of medical care. In numerical terms, the budget increase for health programs amounts to $277 million. The budget estimates that spending on the state's largest health program, Medi-Cal, will be close to flat—up

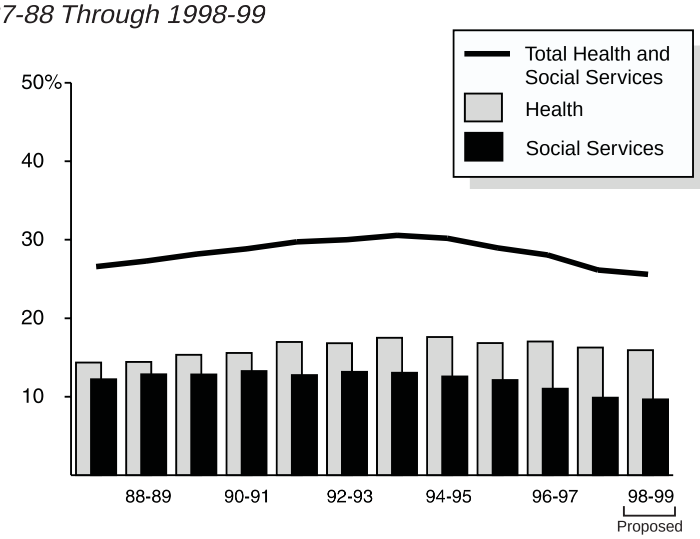
0.6 percent from the current year. Increases in costs and utilization of benefits are partially offset by a projected 2.9 percent reduction in caseloads. The moderating growth in Medi-Cal spending is also due to the planned elimination of prenatal care for undocumented women. This action would lower Medi-Cal spending by about $105 million in the current and budget years combined. In addition, the budget reflects the first full year of funding for the new Healthy Families program ($59 million, including related Medi-Cal charges).

Over the past decade, the health programs share of state spending rose from 14 percent to a peak of almost 18 percent in 1993-94, then stabilized and subsequently has drifted down a bit. The proposed share for 1998-99 is slightly under 16 percent (see Figure 7). Rising welfare-linked caseloads and rapid increases in the cost of providing health care were the main causes of the share's increase prior to 1993-94. The falling off of the share since that time reflects such factors as declining welfare caseloads and a stabilization of other components of the Medi-Cal caseload.

Figure 7

Health and Social Services Programs Share of Total State Spending

1987-88 Through 1998-99



Social Services Share Also Declining

Most state spending in the social services area is for grants to low-income persons in families with children under the CalWORKs program (formerly AFDC / TANF), or who are elderly, blind or disabled under the

Supplemental Security Income / State Supplementary Programs (SSI / SSP). Caseloads in these programs grew sharply during the early 1990s in part due to the recession. Consequently, the social services share of total spending grew to over 13 percent in 1992-93, as shown in Figure 7.

Starting in the early 1990s, however, the state began to adopt a series of grant reductions thereby somewhat slowing the growth of welfare spending. That year, AFDC grants were reduced by 4.4 percent and automatic COLAs were suspended. Additional grant reductions in 1992-93 and 1993-94 that also applied to SSI / SSP grants brought the cumulative reduction in grant levels to more than 10 percent for AFDC and about 7 percent for SSI / SSP. Annual caseload growth, which peaked at 11 percent for AFDC in the early part of the decade, slowed substantially, partly in response to the end of the recession and also due to changing demographic factors. In the current year, CalWORKs caseloads are declining significantly, and SSI / SSP caseloads are experiencing a slight growth.

The Budget Proposal. Under the budget proposal, state spending for social services programs in 1998-99 increases by $165 million, or 2.4 percent, compared with estimated spending in the current year. Since 1991-92, social services share of the budget has declined to less than 10 percent. The budget proposal marks the first time since 1993-94 that social services spending would increase in dollar terms. Specifically, the budget proposes $96 million in increased spending for SSI / SSP, although it does not assume increases in *state* spending on CalWORKs. On the contrary, a large carryover of unexpended federal TANF block grant funds allows state support for CalWORKs to decline by $88 million. The budget proposes to make permanent the temporary statewide CalWORKs grant reductions and COLA suspensions enacted in prior years, for a General Fund cost avoidance of $151 million and $97 million, respectively. Elsewhere, the budget proposes increases for other programs such as In-Home Supportive Services, whose spending totals reflect the loss of $47 million in federal funds. It also should be noted that, despite the Governor's proposed increased spending in the overall social services area, Figure 7 shows that its share of total state spending would decline slightly compared to the current year.

Spending Trends Elsewhere in the Budget

Corrections Spending Continues on Growth Path. Youth and adult corrections will continue to experience robust spending growth under the proposed budget. Over the last decade, corrections support increased at an annual rate of 7.9 percent. The budget proposes an increase of 8.0 percent, almost identical to the historical trend. The high rate of growth of corrections spending is largely driven by the continuing growth in the inmate population—estimated at 6 percent in the budget year.

Transportation Share of Funding Increases. Transportation's share of overall state spending has been relatively stable since the mid 1980s, falling within a range of 7 percent to 8 percent of total spending (this includes state subventions for local streets and roads).

Under the Governor's budget proposal, transportation funding would experience the most rapid growth of any of the major program areas. This would cause transportation's share of total spending to rise by roughly half a percentage point; however, it still would remain below 8 percent. The increased spending primarily reflects capital outlay spending from prior-year appropriations.

BUDGET PROPOSALS THAT REQUIRE LEGISLATIVE OR FEDERAL ACTION

Figure 8 lists the major proposals and assumptions in the *1998-99 Governor's Budget* which require state legislation or federal actions to implement, as well as the timing of the actions assumed by the budget. The fiscal effects identified in Figure 8 represent the amounts estimated in the budget as submitted.

STATE APPROPRIATIONS LIMIT

In his 1998 State of the State Address, the Governor expressed a desire to adjust the state appropriations limit (SAL) so as to make it more of a constraint on state spending. (Apparently, his changes would not affect *local* limits). Thus far, however, the administration has not released a specific proposal. As estimated in the budget, the limit is projected to exceed proposed appropriations by nearly $8 billion in 1998-99. This section explains what the appropriations limit is, how it is calculated, and its past and current budget-related implications.

Article XIIIB

Article XIIIB was added to the State Constitution when the voters approved Proposition 4 on the November 1979 special election ballot. In short, Article XIIIB does three things:

Figure 8

**1998-99 Governor's Budget
Requirements for Legislative or Federal Action**

(Dollars in Millions)

Proposal	State Legislation Required?	Federal Action Required?	Assumed Effective Date	Budget Savings
Make Temporary Savings Permanent				
SSI/SSP				
No statewide COLA	Yes	No	1/1/99	$39
CalWORKs/TANF				
Statewide 4.9 percent grant reduction	Yes	No	11/1/98	151
No COLA	Yes	No	11/1/98	97
Eliminate renters' credit	Yes	No	1998	540
Federal Assumptions				
Reimbursement for illegal immigrant incarceration costs[a]	No	Yes	—	286
Revenue Proposals				
Offset delinquent state taxes against federal refunds[b]	No	Yes	1998	85
Other				
Opportunity scholarships in K-12 education[c]	Yes	No	7/1/98	39

[a] Assumes $71 million from an existing federal appropriation and $215 million from future federal funds.
[b] Assumes enactment in time to provide 1998-99 revenue accrual.
[c] Would allow students to attend private schools and lower the Proposition 98 guarantee.

- It limits the level of *tax-funded* appropriations which can be made by the state and individual local governments in any given year. The limit for each year is equal to the limit for the prior year, adjusted for an inflation factor, population growth, and certain other factors (for example, transfers of financial responsibility between levels of government).
- It precludes the state and local governments from retaining surplus funds. It originally required state and local governments to return to the taxpayers moneys collected or on hand that exceeded the

amount which can be appropriated in any given fiscal year, though this provision was later amended (see below).

- It requires the state to reimburse local governments for the cost of certain state mandates.

Thus, Article XIIIB seeks to constrain the spending of California's governmental entities by establishing a limit on the level of tax-supported appropriations that can be made in each fiscal year. The measure designated the 1978-79 fiscal year as the "base year" for purposes of computing the initial appropriations limit. The initial appropriations limit in 1978-79 was set equal to the amount of "appropriations subject to limitation" for that year. As originally drafted, the figure for appropriations subject to limitation was essentially the amount of appropriations financed by the proceeds of taxes, less:

- The amount of state subventions to local governments (these were factored into the limits for individual local entities);
- The amount of appropriations for debt service (voter approved); and
- The amount of appropriations for court and federal mandates.

Transfers of Financial Responsibility. The appropriations limits for beyond the base year are calculated by adjusting the base-year limit for cost-of-living and population changes, and for "transfers of financial responsibility." These transfers occur when one level of government assumes the burden of financing a service from another level of government, or when the source of program financing is shifted from tax proceeds to fees or other nontax proceeds. The appropriations limit of each entity which is a party to a service transfer must be adjusted by a corresponding amount, so that in the aggregate, the total amount of their appropriations limits is *no larger after the transfer than it was before.* Thus, adjustments must be made to the limit when such a transfer results in an increase or decrease in costs to the state.

Proceeds of Taxes. As noted above, the limit applies only to appropriations financed from "the proceeds of taxes" (such as revenues from property, sales, personal income and corporation taxes). Article XIIIB defines the term "proceeds of taxes" to include:

- All tax revenues to the General Fund and special funds, including those carried over from a prior year.
- Any proceeds from the investment of tax revenues, such as interest earnings.

- Any revenues from a regulatory license fee or user charge that exceed the amount needed to cover the reasonable cost of providing the regulation, product or service.

Appropriations financed by other sources of revenue, such as tidelands oil and gas revenues, federal funds, and bond funds are *not* subject to the appropriations limit. Nor does the appropriations limit for the state apply to certain specific categories of appropriations, even though these appropriations are financed by tax proceeds. These exempt categories include:

- State subventions to local governments and school districts (the appropriation of these funds *is* subject to limitation at the *local* level);
- Payments to beneficiaries from retirement, disability insurance and unemployment insurance funds;
- Payments for interest and redemption charges on state debt existing as of January 1, 1979, or payments on bonded indebtedness approved by the voters after that date;
- Appropriations needed to pay the state's cost of complying with mandates imposed by federal laws and regulations or court orders; and
- Appropriations of revenues derived from gasoline taxes and motor vehicle weight fees above January 1, 1990 levels, and appropriations of certain special taxes imposed by initiative (for example, cigarette and tobacco taxes).

History of the Appropriations Limit

Limit Not a Constraint in Early Years. Figure 9 (see next page) shows the state's appropriations limit, and amount of appropriations subject to limitation, for each year since the limit became effective in 1980-81. It also shows the amount of unused appropriations (that is, "room" under the limit) for the same period. (Figure 10, see page 89, shows this graphically.) As the data indicate, the "room" between the limit and the amount of appropriations subject to limitation increased significantly during the first three years the limit was in effect. These increases, in part, reflected the economic conditions of the time—the recession of the early 1980s restrained the growth of state revenues. Because tax revenues grew slowly, the state lacked the funds to support appropriations that could fully realize the room below the limit. Moreover, these three years were a period of high inflation. Partly because the limit is adjusted for the increase in inflation, it grew by almost 21 percent between 1980-81 and 1982-83.

Figure 9

State Appropriations and the SAL Over Time

1980-81 Through 1998-99
(Dollars in Billions)

	Appropriations Limit (SAL)		Appropriations Subject to Limit		"Room" Under Limit[a]
	Level	Percent Change	Level	Percent Change	
1980-81	$16.2	—	$15.5	—	—
1981-82	18.0	11.0%	16.9	8.6%	$1.2
1982-83	19.6	8.7	16.2	-4.3	3.4
1983-84	20.4	4.0	17.7	9.8	2.6
1984-85	21.7	6.7	20.8	17.4	0.9
1985-86	23.0	5.6	22.5	7.9	0.5
1986-87	24.3	5.9	25.4	13.3	-1.1
1987-88	25.2	3.7	24.0	-5.6	1.2
1988-89	27.1	7.4	26.8	11.5	0.3
1989-90	29.3	8.3	27.7	3.3	1.6
1990-91	32.2	9.7	25.1	-9.5	7.1
1991-92	34.2	6.4	30.4	21.4	3.8
1992-93	35.0	2.3	30.8	1.2	4.2
1993-94	36.6	4.5	30.1	-2.5	6.5
1994-95	37.6	2.6	31.7	5.5	5.9
1995-96	39.3	4.7	32.7	3.1	6.6
1996-97	42.0	6.9	35.0	7.0	7.0
1997-98	44.8	6.6	38.0	8.7	6.8
1998-99	48.1	7.4	40.3	6.1	7.8

[a] Defined as the state appropriations limit (SAL) minus appropriations subject to this limit.

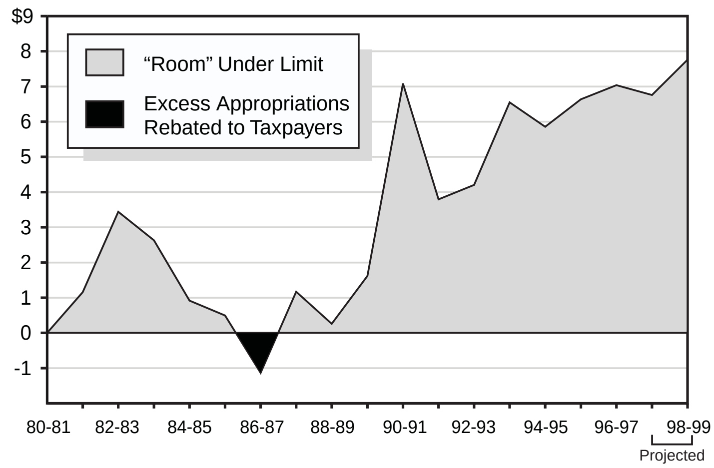
Gap Narrowed as Economy Improved. In 1983-84, the gap between the limit and appropriations subject to the limit began to narrow, as the state's economy recovered from the recession and began to generate additional tax revenues. These tax revenues, in turn, were used to expand programs, particularly in the area of education. This is evidenced by the fact that appropriations subject to limitation grew by almost 10 percent in 1983-84. Simultaneously, the rate of growth of inflation and per capita personal income declined sharply, causing the limit to grow by only 4 percent.

In 1984-85, the amount of unused "room" within the limit fell dramatically, as appropriations subject to the limit climbed by more than $3 billion. This increase reflected the dramatic improvement in the condi-

Figure 10

"Room" Under Limit Has Fluctuated Over Time

State Appropriations Limit Minus Actual Appropriations[a]
1980-81 Through 1998-99 (In Billions)



[a] In 1986-87, appropriations exceeded the limit, and dark-shaded amount shown ($1.1 billion) was rebated to taxpayers.

tion of the General Fund brought about by a healthy economy. Fiscal year 1984-85 also marked the second straight year that the inflation rate remained below 5 percent, causing the state's limit to grow at a rate less than half the rate of growth in appropriations subject to the limit. Thus, although relatively high rates of inflation and population growth when the limit first went into effect meant that the appropriations limit initially had little real impact on the budget process, this situation quickly reversed itself.

Revenues Exceeded the Limit in 1986-87. As the rate of inflation and population growth slowed in the mid 1980s, the SAL began to have a direct and important impact on the budget. In 1986-87, an unexpected surge in revenues occurred, largely the result of changes in federal tax law. As a result, revenues exceeded the SAL, meaning that not all of these revenues could be appropriated. This led to debate over how to deal with the extra dollars—either return them to the taxpayers or appropriate them for SAL-exempt purposes. A consensus was not arrived at in sufficient time and, with the close of the fiscal year on June 30, the funds reverted to the taxpayers. This resulted in a $1.1 billion tax rebate during the Christmas season of 1987 (checks were mailed directly to taxpayers). Thus, in that year, the SAL played a role in determining spending levels.

Efforts to Amend the Limit's Computation Resulted. The SAL's impact on the budgetary process in 1986-87 prompted efforts to change its methodology. This took several forms. One included directly exempting certain appropriations from it. Specifically, Proposition 99 (passed in November 1988) placed an additional tax on cigarettes of 25 cents per pack. Normally, an additional tax such as this would have counted as revenue subject to the limit. This proposition, however, specified that these additional tax proceeds are not subject to the limit. Moreover, Proposition 98 (passed in November 1988) modified the allocation of any excess SAL revenues. Specifically, it required any excess revenues to be distributed to public schools and community colleges, up to an amount equivalent to 4 percent of the Proposition 98 minimum school funding level. In 1988-89, this 4 percent amount was about $500 million. Any amount in excess of this was to be returned to taxpayers.

Proposition 111. A more comprehensive modification, however, occurred with Proposition 111 (June 1990). Proposition 111 changed the appropriations limit in several ways. First, it provides that tax revenues received in excess of the state appropriations limit in one fiscal year may be carried over to the subsequent fiscal year. The portion of the carryover that cannot be appropriated in the subsequent fiscal year would then be considered "excess revenues." Proposition 111 also stipulates that 50 percent of any such excess revenues must be diverted to Proposition 98-funded programs, with the balance being returned to taxpayers.

Proposition 111 also made two significant changes regarding limit calculations. First, it modified the inflation factor which entered into the formula. Previously, the factor used was the lower of the change in the U.S. Consumer Price Index (CPI) and state per capita personal income. For most of the 1980s (especially in the latter half of the decade), the growth rate of state per capita personal income exceeded that of national inflation. Thus, national inflation drove growth in the limit. Proposition 111 amended Article XIIIB by removing the CPI from consideration altogether. Thus, since 1990-91, the inflation measure used to determine the SAL is state per capita personal income. Given that the 1990s has been a period of low inflation nationally, the effect of this change has been to allow the limit to rise faster than it otherwise would have. Moreover, Proposition 111 calculated how much "limit room" was "lost" due to using the U.S. inflation rate between 1986-87 and 1989-90, and adjusted the 1990-91 limit upward by a commensurate amount. This explains the upward "spike" in limit in that year (refer to Figure 10).

Second, Proposition 111 also reworked exactly which appropriations are subject to limitation and which are not. For instance, Proposition 111 excludes from appropriations subject to limitation the costs of natural disasters and qualified capital outlay projects. It also excludes the spending derived from increases in motor vehicle fuel taxes, sales and use taxes on the increased motor vehicle fuel taxes, and weight fees.

Why Is There So Much Room Under the Limit?

Proposition 111's Effect. The most significant factor responsible for there currently being $8 billion in "room" under the SAL involves Proposition 111. As noted above, it both increased the growth rate of the appropriations limit, as well as inhibited the growth rate of appropriations subject to it. We estimate that, had Proposition 111 not occurred, the limit would have grown at a much slower rate, and the amount of "room under the limit" would be considerably less—$2.3 billion in 1998-99 compared to $7.8 billion under current law.

Economic Factors. The recession that California experienced during the 1990s and the delayed recovery which followed significantly reduced state tax revenues, thereby lowering the amount of money available for appropriations. This, too, expanded the "room" under the SAL.

Legislative Actions. In addition, the Legislature has taken certain actions in recent years, some in response to the recession's effects on revenues, that have contributed to increasing the "room" under the limit. These actions have involved reducing both expenditures and revenues. On the expenditure side, for example, the Legislature has adopted certain grant reductions and COLA suspensions in welfare programs, enacted various reductions in Medi-Cal funding, suspended the renters' credit, and made cuts to state operations. On the revenue side, significant actions have included the adoption of the investment tax credit, the 5 percent corporate tax rate cut, and last year's tax relief package.

Conclusion

The voters added the state appropriations limit to the Constitution in 1979 and amended it significantly in 1990. It is one of many factors that the Legislature and the Governor must take into account when fashioning a state budget or realigning responsibilities and funding between the state and local governments.

Perspectives on State Expenditures

MAJOR EXPENDITURE PROPOSALS IN THE 1998-99 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 1998-99 Budget Bill*.

PROPOSITION 98—K-12

Proposition 98 establishes a minimum funding level that the state must provide for public schools and community colleges each year. K-12 education receives about 90 percent of total Proposition 98 funds. Below, we describe the budget's K-12 proposal for prior-year Proposition 98 funds and for new funds required to meet the minimum guarantee in 1998-99.

Prior-Year Funds

The budget includes $472 million to meet the Proposition 98 funding requirements for previous years. This results primarily from reductions in 1996-97 and 1997-98 local property tax revenue ($170 million) and increases in General Fund revenues above previous estimates. In addition, the budget proposes to spend $46 million in Proposition 98 funds that were previously appropriated, but unspent, in prior budgets. The budget proposes to spend these available funds as follows:

- $180 million to provide school site block grants.
- $170 million to offset lower-than-expected local property tax revenues.
- $60 million to expand the Digital High School program.
- $12.5 million for the continuation of California Work Opportunity and Responsibility to Kids adult education programs started in 1997-98.

Budget Year Proposal

The budget proposes $30.8 billion in total K-12 Proposition 98 funding in 1998-99. This is an increase of $1.7 billion, or 5.9 percent, compared to the 1997-98 revised amount. However, student attendance is projected to increase by 1.7 percent, resulting in funding of $5,636 per student, an increase of $222 (4.1 percent) from the revised 1997-98 amount.

The major 1998-99 budget proposals include:

- $657 million to provide a 2.22 percent cost-of-living adjustment (COLA).
- $507.1 million for enrollment growth.
- $350 million for staff development day incentive grants and an extended school year.
- $135 million to expand the deferred maintenance program.
- $123.5 million for expanded child care programs.

Figure 11 illustrates how the budget would allocate projected growth in the Proposition 98 funds in 1998-99.

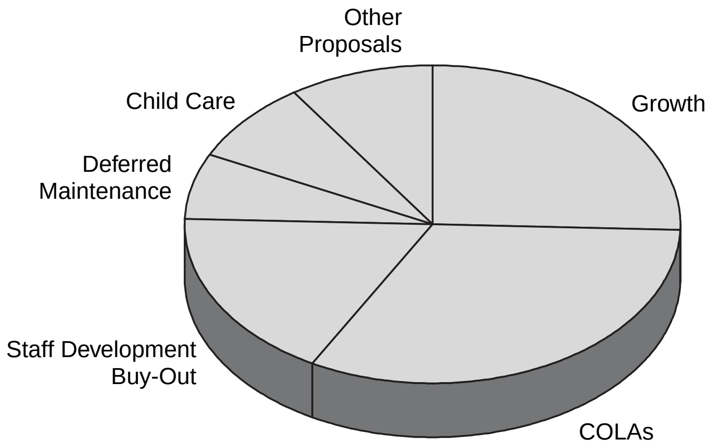
Issues for Legislative Consideration

Competing Uses of Funds Requires Choices. The Governor's budget proposes to spend about $800 million to support new or expanded state programs in 1998-99. Before the Legislature makes any final decision about the Governor's priorities, it must first resolve three "big picture" issues. These issues involve such large amounts of Proposition 98 funds that the rest of the Governor's K-12 spending proposals—and any legislative proposals—hinge on their outcome. These issues are:

Figure 11

Proposed Use of New Proposition 98 Funds

1998-99



- ***The Proposition 98 Minimum Guarantee.*** We estimate General Fund revenues will be about $1 billion *higher* over two years than projected in the Governor's budget. This higher General Fund revenue projection, however, translates into a lower estimate of Proposition 98 funds for 1998-99 ($176 million).
- ***The Appropriate K-12 COLA for 1998-99.*** Although the budget proposes a 2.22 percent COLA for K-12 programs, statute calls for a 4 percent COLA in the budget year. Providing the larger percentage would require an additional $530 million in Proposition 98 funding.
- ***The Governor's Longer School Year Proposal.*** The budget would spend $350 million in new Proposition 98 funds to extend the school year to 180 days. Currently, districts use an average of 4 to 5 days of the 180-day school year for planning and staff training. The budget proposal would provide schools with additional funds for staff development days that occur outside of the 180-day school year.

With the drop in the amount of the 1998-99 Proposition 98 guarantee, the amount available for new or expanded programs falls from $800 million to $625 million. As a result, the amount needed to fund the statutory 4 percent COLA or longer year program would absorb most of the new funds. In fact, if the Legislature chooses to provide the 4 percent COLA, there would be only $100 million in funds left for other K-12 programs. Similarly, approving the longer year program would require the Legislature to reject many of the other budget proposals.

Cost-of-Living Adjustment Revision Is Appropriate. The budget proposes trailer bill language to change the way K-12 COLAs are calculated. Currently, statute requires the Department of Finance (DOF) to measure inflation by calculating the increase in inflation over the past year. When the federal government revises the inflation index, however, statute requires DOF to compare the revised data for the year just past with the *unrevised* data for the previous year.

Because the data were recently revised, the statutory calculation produces a 4 percent COLA. The actual year-to-year inflation, however, is 2.22 percent. Providing the full 4 percent COLA in 1998-99 for most K-12 programs would cost an additional $530 million.

The proposed trailer bill language would use only revised data for calculating COLAs beginning in the budget year. We recommend the Legislature approve the proposed trailer bill language because the proposed 2.22 percent COLA more accurately reflects inflation that has occurred over the past year. In addition, our review indicates that, over the long run, the proposed COLA calculation would fairly adjust school funding levels for the effects of inflation.

Research Does Not Support Longer School Year. The budget proposes to spend $400 million ($350 million in new funds) to extend the school year to 180 days by (1) eliminating current statutory provisions that permit schools to use up to 8 days of the existing 180-day school year for staff development and (2) provide $50 million for each day of staff development provided by schools outside of the 180-day year. The proposal also eliminates the longer-year incentive program, established in the *1997-98 Budget Act*, which creates a similar program to increase the school year by one day. (The $50 million currently supporting this program would be redirected to the program proposed in the budget.)

Our review of the research evidence on the impact of a longer school year shows that buying extra days of the same type of instruction has not been found to improve student achievement. We also found one state—Indiana—that rescinded a longer-year program because student test scores did not improve as a consequence. While a longer school year has intuitive appeal, research evidence suggests that spending $400 million to extend the school year would not be an effective use of Proposition 98 funds. For this reason, we recommend the Legislature reject the Governor's proposal.

State Assessment Is Behind Schedule. State law currently calls for two state assessments of student achievement. The Standardized Testing and Reporting test will be given annually to almost all students in grades 2 through 11 beginning spring 1998. This test is designed to give students, parents, and teachers annual information on student achievement. The comprehensive test of applied academic skills is designed to measure how well students can solve problems and communicate. This applied test, which would be given to students in grades 4, 5, 8, and 10, has yet to be developed.

Current state law requires that before the applied test can be developed, content and performance standards must be adopted by the State Board of Education based on recommendations from a state standards commission. Content standards, which define what students should know in different subject areas, have been approved by the board in language arts and mathematics. Performance standards, which describe what a student needs to do to demonstrate he or she is "proficient" in the areas outlined by the content standards, have not been approved. In fact, the standards commission has not started work on developing performance standards.

As a result, the State Department of Education (SDE) can not begin developing the applied tests. Because test development takes a minimum of 15 to 18 months, it is unlikely that the applied tests in language arts and mathematics will be ready by the spring of 1999. This means that $31 million included in the 1998-99 budget is not needed.

In addition, unless the Legislature changes the statutory requirements prohibiting SDE from developing the tests until performance standards are adopted, a further delay in testing may occur. This appears unnecessary, since some testing experts believe that performance standards are best developed along with test items. Therefore, we recommend the Legislature adopt trailer bill language that permits SDE, in conjunction with the state board and standards commission, to begin developing the test simultaneously with the performance standards.

HIGHER EDUCATION

California's system of public higher education is the largest in the nation, serving approximately 2 million students. This system consists of three distinct segments—the University of California (UC) with nine campuses, the California State University (CSU) with 22 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. The system accepts students from the top one-eighth of high school graduates. The CSU awards bachelor's and master's degrees and accepts students from the upper one-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.

The Student Aid Commission provides financial aid to students through a variety of grant and loan programs. The Cal Grant program is the major state-funded aid program.

Proposal

UC and CSU. The budget proposes General Fund support for UC and CSU of $4.4 billion in 1998-99, an increase of $338 million, or 8.3 percent, compared with estimated current-year budgets. Budgeted enrollment levels at UC and CSU would increase substantially in 1998-99—by 2,800 full-time equivalent (FTE) students at the UC and 10,320 FTE students at the CSU. The proposed General Fund increase includes $42 million approved by the Legislature in Chapter 853, Statutes of 1997 (AB 1318, Ducheny), to compensate the systems for lost fee revenues caused by the 5 percent undergraduate fee reductions mandated by that legislation. The budget proposes to allocate $171 million for employee compensation increases and $72 million for enrollment growth.

Community Colleges. The budget proposes $2.1 billion in General Fund local assistance for the community colleges in 1998-99. This entire amount counts towards the state's K-14 minimum funding guarantee under Proposition 98. The 1998-99 General Fund request represents an increase of $169 million, or 8.7 percent, from the current year. The combined increase proposed from the General Fund, local property tax revenues, lottery funds, and net student fee revenues (after accounting for financial aid) is $251 million, which represents a 6.8 percent increase in combined funding. This figure understates actual budget-year growth, however, because 1997-98 expenditures include $32 million in one-time spending. Thus, actual growth in the CCC base budget is $283 million, or 7.8 percent. Like UC and CSU, the budget restores revenues lost due to the legislatively mandated reduction of student fees from $13 to $12 per credit unit (an estimated $13 million revenue loss).

In 1998-99, the budget provides $72 million for a 2.2 percent cost-of-living adjustment for general-purpose spending, $56 million for statutory enrollment growth, $34 million for "extra" enrollment growth, and $50 million for a proposed "Partnership for Excellence," under which the Chancellor's Office would allocate payments to college districts based on specific performance measures.

As a result of an increase in the Proposition 98 guarantee in the current year, the budget provides a total of $51 million in one-time funding. This consists of (1) a $40 million block grant for instructional equipment, library materials, deferred maintenance, education technology, and hazardous materials abatement; and (2) the "backfill" of an $11 million property tax shortfall.

Student Aid Commission. After adjusting for one-time expenditures in the current year, the budget proposes a General Fund increase of $31.6 million, or 11 percent, for the Student Aid Commission in 1998-99. The majority of this increase, $26.3 million, pays for the second-year and third-year cost increase associated with past increases in the number and maximum amount of Cal Grant awards. The administration has convened a working group of administrative, legislative, and private sector representatives to discuss possible changes to the Cal Grant program.

Issues for Legislative Consideration

Projected Enrollment Increases Are Not of "Tidal Wave" Proportions. Various reports characterize future increases in California's higher education system as "Tidal Wave II." Using college-participation rates from 1996, we project that higher education enrollments will grow by 98,000 by 2005. This represents annual growth of 0.3 percent above the peak enrollments of 1991. Even if the higher participation rates assumed by other studies occur, student enrollments will not grow at tidal wave proportions. Enrollments *will* increase over the next decade. The Legislature, however, has many policy levers that it can use to manage this growth and ensure students receive the best possible service. In Part Five of this document, we explore enrollment growth issues in greater detail.

How New Federal Tax Credits for Higher Education May Affect California. Last August, President Clinton signed into law the Taxpayer Relief Act of 1997. Part of the act creates the "Hope Scholarship" and "Lifetime Learning" tax credits, which will dramatically lower the after-tax price of higher education fees for most middle-income students (or their parents) by lowering their federal taxes. In Part Five of this document, we explore several revenue and spending options for the state that arise as a consequence of the new tax credits. In addition, in the Higher Education section of the *Analysis of the 1998-99 Budget Bill*, we discuss potential interactions between the tax credits and the state's current practices in student financial aid. In that analysis, we recommend that the three public higher education segments and the Student Aid Commission each report to the Legislature, prior to budget hearings, on the financial aid implications of the tax credits. Our primary concern is that current financial aid practices may prevent significant numbers of students (or their parents) from receiving federal tax credits for which they otherwise would be eligible. If uncorrected, this would result in unintentionally supplanting federal funds that otherwise would come to California.

Requested New Enrollments for 1998-99 Not Fully Justified. All three segments request significant new funds for increases in enrollments.

- ***University of California.*** The UC requests $20.6 million from the General Fund to increase enrollments by 2,800, or 1.8 percent. We recommend reducing this proposal by $9.4 million because (1) UC has not justified why it needs to increase enrollments above the 1 percent contained in the Governor's compact and approved by the Legislature the past three years and (2) UC already can and should shift its class offerings to reflect changes in student needs.
- ***California State University.*** The budget requests $40 million for "extra" growth for CSU. This growth, however, already has taken place. During 1996-97 and 1997-98, CSU has successfully accommodated the extra students, drawing from a $50 million-plus pool of (1) productivity savings promised under the "compact," and (2) unreported student fee revenues. Since resources already exist to teach the extra students, CSU does not need the $40 million augmentation for that purpose. As an alternative, we suggest redirecting the augmentation to (1) provide new incentives for CSU faculty to increase their teaching commitments and (2) fund a plan adopted by the Legislature in 1996-97 to address CSU's deferred maintenance.
- ***California Community Colleges.*** The budget includes $90 million for 3 percent enrollment growth. This is significantly above the state's projected level of adult population growth. Providing such high levels of growth funds, however, may create incentives for colleges to offer lower-priority classes (such as recreation classes). For this reason, and to align growth funding with the increase in the underlying population served by CCC (particularly young adults), we recommend the Legislature delete $18 million budgeted for this purpose.

The UC Request for $9.9 Million for the Tenth Campus Lacks Sufficient Detail. The UC received $4.9 million in 1997-98 for activities related to the tenth UC campus in Merced County. The budget requests $9.9 million in 1998-99 to continue these activities. The university indicates that it will need over $80 million in operating funds before it opens the campus in 2005. The UC has provided only broad descriptions of how it plans to spend funds for the tenth campus in the current and budget year. We withhold recommendation on the budget-year funds until UC provides the Legislature with details of how it plans to spend them.

CALWORKS GRANTS

The federal welfare reform legislation of 1996 replaced the Aid to Families with Dependent Children (AFDC) program with the Temporary Assistance for Needy Families (TANF) program. The Legislature subsequently enacted Chapter 270, Statutes of 1997 (AB 1542, Ducheny, Ashburn, Thompson, and Maddy), which created the California Work Opportunity and Responsibility to Kids (CalWORKs) program to replace the AFDC program in the state. This program provides cash grants and employment and training services to eligible families.

Proposal

Under current law, CalWORKs grants are scheduled to increase on November 1, 1998 due to the termination of two previously enacted provisions: a 4.9 percent statewide grant reduction and the suspension of the cost-of-living adjustment (COLA), which would increase grants by an estimated 2.84 percent. The Governor proposes to (1) make permanent the statewide 4.9 percent grant reduction and (2) eliminate the COLA. These proposals, if adopted, would result in an estimated General Fund cost avoidance of $248 million in 1998-99.

Issues for Legislative Consideration

As indicated, the Governor's proposals would result in significant savings. In evaluating the proposal, it is useful to consider how the grant increases would affect CalWORKs families and the incentives to work.

The maximum grant under CalWORKs differs according to whether recipients live in "high-cost" or "low-cost" counties. For purposes of evaluating the Governor's proposal, we will refer to the maximum grant levels for a family of three in the high-cost region. Under the Governor's proposal, the maximum monthly grant would remain at the current level of $565, compared to $611 under the provisions of current law. When combining the maximum grant with the value of food stamps, the Governor's proposal would result in a total of $832, which is 75 percent of the federal poverty level, compared to $864 under current law (78 percent of the poverty level).

We note that an increase in the maximum grant would not affect the "work incentive" in the same way that it did prior to the CalWORKs legislation. Previously, a maximum grant increase would have reduced the financial incentive to work because grants for nonworking recipients would increase but grants for most working recipients would not. The

CalWORKs legislation changed the grant structure so that increases in the maximum grant would result in corresponding increases for working and nonworking recipients. Thus, for persons in the CalWORKs program, a maximum grant increase will no longer affect the work incentive. For persons who are eligible for CalWORKs but not on assistance, however, a grant increase could make the program relatively more attractive and, therefore, could have some effect in inducing more families to apply for aid.

CalWORKs Employment Services And Administration

CalWORKs recipients receive a range of welfare-to-work services which include: job search, assessment, education, training, and community service employment.

Proposal

The budget includes $883 million for CalWORKs "basic" employment services. This budget allocation is designed to fully fund the program, assuming that counties would begin implementing CalWORKs in January 1998, and would phase in all existing recipients by January 1999 at the latest. The budget, however, proposes substantially more for employment services than the amount in the basic allocation. In fact, the total budget for employment services exceeds the estimated need by *$766 million* over the two-year period, 1997-98 and 1998-99. In our *Analysis of the 1998-99 Budget Bill*, we identify the components of this "overbudgeting" and the factors that lead to their inclusion in the budget, summarized as follows:

- $95 million from the state General Fund to match the new federal Welfare-to-Work block grant funds.
- $105 million in federal TANF block grant funds in the current year.
- $272 million from the new federal Welfare-to-Work grant, of which $222 million would be allocated to local Private Industry Councils and $51 million for a local competitive grant program.
- $293 million (about half General Fund and half federal TANF funds) allocated to county welfare departments as "fiscal incentive" payments, pursuant to the provisions of the state CalWORKs legislation.

In a related issue in the *Analysis*, we also conclude that proposed funding for county administration of CalWORKs is overbudgeted by

$43 million because the budget does not reflect savings from projected caseload decline.

Issues for Legislative Consideration

Overbudgeting in CalWORKs. Although the budget for employment services exceeds the estimated need by $766 million, not all of this "excess" funding should necessarily be considered overbudgeting. For example, the budget includes a total of $293 million ($26 million in 1997-98 and $267 million in 1998-99) for county fiscal incentives. We believe it is reasonable to assume that the CalWORKs legislation intended that county fiscal incentives be provided to the counties even if the total budgeted expenditures exceed the amount needed. Accordingly, we view the incentives as a county-run program enhancement rather than overbudgeting. Conversely, the new federal Welfare-to-Work block grant funds must be spent for employment services for CalWORKs recipients, and therefore could be used to replace some of the federal TANF funds in the base budget for employment services. (As a block grant, these federal TANF funds would be retained by the state and can be carried over into future years.)

In the *Analysis*, we review each of the components listed above, and recommend that the $95 million proposed for the state match for the federal Welfare-to-Work grant be deleted because the match can be provided in future years, when it is likely that these state funds could come from within baseline CalWORKs spending at no additional cost to the General Fund. This would not preclude the state from receiving the full federal funds allocation in the current and budget years, as permitted under federal law.

We further recommend that the budget for CalWORKs employment services be reduced by $209 million in federal TANF funds. In conjunction with our recommendations to reduce the budget for county welfare administration by $43 million, this would free up $252 million in federal TANF funds. (These savings are in federal funds because the federal maintenance-of-effort requirement would preclude General Fund reductions.)

How Could the Legislature Use the Identified Savings? We identify several options for the Legislature to consider with respect to the potential disposition of the $252 million in federal funds savings. Specifically, the federal funds could be (1) redirected to other priorities in CalWORKs, (2) placed into a reserve for future years, and/or (3) transferred to the Social Services Block Grant (SSBG) (Title XX), where the funds could be used to offset General Fund spending in other departments. Below, we discuss these options in more detail.

Option 1: Redirect Funds for Other CalWORKs Priorities. The identified savings could be redirected to other legislative priorities in the CalWORKs program, such as grants or job creation programs.

Option 2: Establish a TANF Reserve. The Legislature could set aside the identified savings into a reserve for future years. There are three advantages to this approach. First, establishing a TANF reserve will help mitigate the impact of a future recession. We note that in the event of a recession, the state will be responsible for 100 percent of any increased CalWORKs grant costs associated with an increase in the caseload. Second, the reserve could mitigate the impact of a likely increase in General Fund spending for CalWORKs in 1999-00 because the Governor proposes to spend all available TANF federal funds in 1998-99, including $489 million carried over from prior years. These carry-over funds will not be available in 1999-00, thereby potentially creating a General Fund obligation. The third advantage to creating a TANF reserve is that it would provide legislative flexibility. If counties need more funds for CalWORKs services, they could request them during the budget year and the Legislature could authorize additional funding.

Option 3: Reducing General Fund Expenditures by Transferring TANF Funds to the SSBG. We estimate that about $100 million of the identified savings could be transferred to the SSBG and then used to offset General Fund spending in the "residual" (state-only) In-Home Supportive Services program or in the community-based programs in the Department of Developmental Services. An advantage of this approach is that it maximizes the Legislature's flexibility by freeing up General Fund monies for any legislative priorities.

Legislative Analyst's Office Recommendation. In the *Analysis*, we recommend that the Legislature redirect at least half of the federal TANF funds savings that we identified ($126 million) to establish a reserve, to be expended in 1999-00 or subsequent years. The remaining savings ($126 million) could be (1) redirected to other legislative priorities in the CalWORKs program and / or (2) transferred to the Social Services Block Grant (up to $100 million) in order to offset General Fund expenditures.

HEALTHY FAMILIES

The Healthy Families program is a new state program to expand health insurance coverage for children in families whose incomes are under 200 percent of the federal poverty level but are too high to qualify for Medi-Cal coverage. It implements the federal Children's Health Insurance Program that was enacted in 1997, which makes federal matching funds available to California on a two-to-one basis for this purpose. As a result of the enactment of state legislation, most of the new coverage will be provided by the Managed Risk Medical Insurance Board (MRMIB). The board will contract with health plans to provide a package of benefits similar to state employee coverage for health, dental, and vision care. The program also includes some expansions and simplifications of Medi-Cal coverage for children.

The budget proposes total net spending of $197.2 million ($62.6 million General Fund) for all of the components of the Healthy Families program in 1998-99. Of this amount, MRMIB will spend $97.9 million for the new insurance program, $78.6 million will be spent for increased Medi-Cal costs by the Department of Health Services, and $20.7 million represents spending in existing children's health programs to provide services that will qualify for the new federal matching funds.

Issues for Legislative Consideration

$1.4 Billion of Federal Funds Will Roll Over to 1999-00. The budget proposes to spend $135 million of federal funds for the Healthy Families program in 1998-99. This will result in a rollover of about $1.4 billion of unspent federal allocations. Even after full implementation of the Healthy Families program, the administration estimates that the state would use only about $320 million of federal funds annually, which is about $500 million *less* than the state's current annual allotment. Consequently, under the administration's projections, the Healthy Families program will not be able to spend most of the federal funding allotted to California.

Without Congressional action to expand the use of these funds, leaving a significant portion unspent may be unavoidable. However, the Legislature has some options available to increase the use of these federal funds. We recommend, for example, enacting a requirement that all eligible children in the California Children's Services Program (which serves children with certain serious medical conditions) sign up for the Healthy Families program. This would result in a net savings of $6.2 million each to the state and counties, and would provide broader health coverage for these children. We also recommend that the administration report on the feasibility of including, as a Healthy Families benefit, services provided by the regional centers for developmentally disabled children.

CAPITAL OUTLAY

The five-year plans developed by state agencies indicate the need for a total investment of $10.5 billion in the state's infrastructure over the five-year time period. This estimate does not include highways and rail nor does it include K-12 schools—estimated to be $16 billion and $11 billion, respectively. The plans cover a wide range of state needs—such as state office buildings, prisons, state hospitals, higher education, forestry fire stations, and development of state parks. As we have mentioned in the past, these five-year estimates should be viewed with caution because some plans are incomplete and some may include proposals that, upon examination, do not merit funding. Overall, however, the plans give a reasonable assessment of the magnitude of the state's capital outlay needs.

Proposal

Budget Bill Proposal. The Governor's budget includes $958 million for these capital outlay programs. This amount consists of $710 million from bond proceeds—general obligation ($525 million) and lease-payment ($185 million), (2) $152 million from the General Fund, (3) $81 million in special funds, and (4) $15 million in federal funds. The Budget Bill amount represents a $200 million (27 percent) increase compared to current-year appropriations. The majority of this increase ($147 million) is in the area of Health and Social Services for two projects for the Departments of Health Services and Mental Health, respectively. The future cost to complete all projects in the Budget Bill totals $418 million.

New Bond Proposals. The Governor proposes new bond authorizations in several capital outlay program areas. These proposals total $13.2 billion—$11.7 billion in general obligation bonds and $1.5 billion in lease-payment bonds. Of the general obligation bond total, $6 billion for K-12 schools would be for future statewide ballots, with bond measures of $2 billion each for the 2000, 2002, and 2004 elections.

Bond Debt. We estimate that the state's annual debt payment on bonds will be $2.6 billion in 1998-99—an increase of $123 million (10 percent) over the current year. This amount includes payments on general obligation bonds ($2 billion) and lease-payment bonds ($551 million). Debt payments on lease-payment bonds are becoming a greater portion of the total, increasing from 13 percent in 1990-91 to 21 percent in 1998-99.

The debt ratio (debt payments as a percent of General Fund revenue) is estimated to be 4.3 percent in the current year. We estimate that, as currently authorized bonds are sold, this ratio will increase to 4.7 percent in 1999-00 and decline thereafter if no new bonds are authorized. We estimate that if the Governor's proposal for $13.2 billion in bonds is approved, the debt ratio would peak at 5.1 percent in 2001-02 and decline thereafter.

Issues for Legislative Consideration

California's economic growth and quality of life are, in part, dependent on the adequacy of the state's public infrastructure. In addition to the state's transportation, water, and parks systems, the state has an immense inventory of other physical facilities including universities, prisons, and state hospitals. Given the magnitude of the public infrastructure in California, decisions about building or renovating facilities, acquiring and selling property, or expanding and replacing utility systems should be considered in a longer-term context.

In our view, to get the "biggest-bang-for-its-buck" in addressing infrastructure needs, the state should develop an integrated five-year state capital outlay plan, which sets priorities and identifies financing alternatives. This plan should be presented as part of the annual budget. This approach would provide a statewide context of needs and priorities, and highlight the financing tradeoffs to meet the state's highest priorities.

There are several areas within the state's capital outlay program that merit consideration in the near-term:

Bond Proposals. The level of bond financing proposed by the Governor is affordable in terms of the future General Fund impact of annual debt payments. In evaluating the specific bonds proposed by the Governor, however, the Legislature should consider the following:

- Is the bond program clearly a state responsibility, or if not, when and to what extent should the state assist with funding?
- Are the bonds needed this year to finance projects that are either ready to proceed or are part of a well-defined plan and will be ready to proceed before the next statewide ballot?
- Are there ways to reduce the infrastructure need in a particular program (for example, by making better use of *existing* facilities)?
- Will funds be available to operate and maintain the capital investments?

Financing High Priority Projects. The state will probably always rely to some extent on bond financing to address its large capital outlay needs. The Legislature should consider establishing a better balance between bond funding and direct appropriations ("pay-as-you-go" funding). We recommend dedicating a portion of annual General Fund revenues to a special account dedicated for direct spending on capital outlay. This would allow the state to avoid paying bond interest costs and provide a reliable funding source to annually address the state's highest priority infrastructure needs. For 1998-99, we recommend the Legislature substitute General Fund appropriations for the new lease-payment bonds proposed in the budget.

Addressing Higher Education Needs. The administration is again proposing to allocate higher education bonds in equal shares to the three segments. On the surface, this approach has the appearance of being equitable, but it fails to consider differences among the segments in the overall condition of their existing facilities and their capacity to accommodate current and future enrollment growth. In lieu of this approach, we recommend the Legislature establish specific priority criteria and fund those projects that meet these priorities across higher education, within available funds.

State Prisons. The administration's plan for accommodating inmate population growth relies solely on expanding the prison system by leasing beds from public or private sector entities and building new state prisons. This approach is similar to past proposals that the Legislature has rejected. We continue to recommend a balanced approach to the state's inmate housing problem—one that encompasses (1) development of additional capacity and (2) policy and program changes to reduce the growth rate in the inmate population. Further, if the Legislature wishes to expand the use of leased prison facilities, as proposed by the administration, it should consider both the short- and long-term benefits of this approach to housing the state's inmates. Also, proposals for funding new state prisons should be considered as part of the budget process so that these costs can be considered in the context of other capital outlay and program needs.

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 33 institutions, 12 community correctional facilities, and 38 fire and conservation camps. The Community Correctional Program includes parole supervision, operation of community correctional centers and facilities, outpatient psychiatric services for parolees, and narcotic testing.

Proposal

The Governor's budget proposes $3.9 billion from the General Fund for support of CDC in 1998-99, an increase of $262 million, or 7.2 percent, over the current year. This amount provides full funding for projected growth in the number of prison inmates and parolees under current law, as well as several program changes. The budget does not propose any policy or program changes to reduce the inmate or parole populations.

The budget's total spending figures assume that the state will receive $286 million in federal funds in 1998-99 to offset the costs of incarcerating and supervising on parole, illegal immigrant adults and juveniles who have been convicted of a felony in California.

Issues for Legislative Consideration

Over the past ten years, CDC has been one of the state's fastest growing General Fund budgets, increasing at an average annual rate of about 10 percent. As a share of the General Fund budget, CDC increased from 3.8 percent in 1989-90 to 7 percent in 1998-99. The increase has been largely due to the costs to house increasing numbers of state prison inmates. The Governor's budget projects that the prison inmate population will increase to about 172,000 by the end of 1998-99 (an increase of 6 percent in the budget year), and will increase to about 259,000 by the end of 2006-07. Given the administration's current population projections, we estimate that the costs to operate the department will reach almost $6.6 billion by 2006-07.

Given the long-term implications of CDC's projected growth on the state's budget, the Legislature will need to consider various options for addressing these increases. There are two basic approaches: (1) reduce the costs of operating the state's prison system and (2) slow the growth of the prison population.

We have offered a number of examples of both approaches, both in the *Analysis* and in previous publications. For example, we have recommended that the Legislature consider expanding substance abuse treatment services to inmates at an existing prison, because existing treatment programs have been shown to be successful in reducing the number of inmates who, after release from custody, commit new offenses and return to prison. In addition, we recommended an approach to reforming the state's parole system that could also reduce recidivism, save money, and improve public safety. Finally, in previous publications, we have offered a number of alternatives for legislative consideration to control inmate and parole population growth.

Whatever actions the Legislature decides to take, it will be important to make changes soon to either reduce the population growth or add new prison capacity to the system. This is because, CDC ‘s inmate population projections indicate that the prison system will run out of space to house additional inmates early in the year 2000 if additional prison space is not made available by then. The administration has proposed to lease 15,000 private community correctional facility beds, construct four new prisons, and overcrowd existing prisons. Although we believe that there is merit in adding some space to the prison system, we recommend that the expansion of prison capacity be balanced with policy changes that slow the growth of inmate population.

TRANSPORTATION

The Motor Vehicle Account (MVA) derives most of its revenues from vehicle registration fees and driver license fees. In 1998-99, total MVA revenues are projected to be about $1.2 billion. The account is the primary funding source for the California Highway Patrol (CHP) and the Department of Motor Vehicles (DMV).

The Public Transportation Account (PTA) derives most of its revenues from the sales tax on diesel fuel and gasoline. In 1998-99, total PTA revenues are projected to be about $247 million. The PTA provides transit operating assistance under the State Transit Assistance program. In addition, PTA funds support the state’s intercity rail service, mass transportation and transportation planning programs, and transit capital improvements. The PTA is the primary state fund source for transit equipment and rolling stock (buses and rail cars) acquisition and improvement.

Proposal

Motor Vehicle Account. The Governor’s budget projects a balance of about $75 million by the end of 1998-99. However, this balance is predicated on a number of proposed actions. Absent these actions, the account will face a funding shortfall.

- The account will not repay an existing loan to the State Highway Account (SHA) in 1998-99, as required.
- The budget proposes to shift funding of the Commercial Vehicle Inspection program fully to SHA, despite legislative direction that the program be funded with a mix of MVA and SHA funds.
- The budget continues to defer maintenance and facilities improvements.

The projected balance also does not take into account the impact of any potential increase in employee compensation. Additionally, the budget's revenue estimates remain overly optimistic.

Public Transportation Account. In accordance with current law, the budget proposes about $100 million from PTA for support of the State Transit Assistance program in 1998-99. However, this will not leave sufficient funds in the account to cover proposed support for intercity rail services, pay outstanding commitments for transit capital projects funded in the past and current years and contribute to toll bridge seismic retrofit in 1998-99. Thus, in order to avert a projected deficit, the budget proposes a transfer of $30.5 million from SHA. Even with the proposed transfer, however, there will not be sufficient funds remaining in the account at the end of 1998-99 to pay for all remaining outstanding commitments (estimated at $62 million).

Beyond the problem it faces in 1998-99, PTA is projected to have a funding shortfall over the six-year period from 1998-99 through 2003-04. As a consequence, there will be no PTA funds available for new transit capital improvements projects over the period. In addition, support expenditures, for instance, for intercity rail service, would need to be curtailed or additional transfers from another fund source, such as SHA, would be necessary over the period.

Issues for Legislative Consideration

Motor Vehicle Account. Even if the account is balanced in the budget year, MVA still faces long-term problems. Based on past MVA expenditure and revenue trends, the account will continue to experience deficits unless actions are taken to align MVA revenues and expenditures to provide a long-term stable funding source for CHP and DMV. The Legislature should consider the following options.

- Provide new funding sources whenever new programs are established thereby ensuring that those programs are self-financing. Such self-financing is appropriate so that those who benefit from the program pay for the program's support.
- Fund nonvehicular activities from non-MVA sources. The use of vehicle registration and driver license fee revenues should be limited to transportation-related activities such as the regulation of vehicular use and operations and to the mitigation of environmental effects of vehicular operations, as specified by the State Constitution. Activities that are not solely for the purpose of vehicular regulation and enforcement should not be funded entirely by MVA. The Legislature may want to consider providing a portion

of funding for such activities from non-MVA sources, such as the General Fund.

- Transfer existing driver-related revenues to MVA. For example, the Penalty Assessment Fund is supported by penalties imposed on persons who violate criminal *and* traffic laws. Because penalty assessments come primarily from driving violations, there is a strong connection to MVA-supported programs such as the Highway Patrol.
- Provide alternative one-time funding (from the General Fund, for example) for deferred maintenance.

Public Transportation Account. In 1993-94, due to the state's fiscal condition, $91.5 million was loaned from PTA to the General Fund. In order to provide some funds for transit capital projects in the budget year and beyond, the Legislature may want to consider directing the repayment of the loan in 1998-99 from the General Fund.

RESOURCES

The state conserves and manages its natural resources through a number of programs. Many of these programs have tended to focus relatively narrowly either on (1) reviewing and mitigating the environmental impacts of particular projects or (2) managing and restoring specific species of fish or wildlife. In recent years, there has been a trend away from a project-based review and towards a broader focus on natural resource management. Instead of focusing on individual species or particular habitat, this broader approach focuses on whole ecosystems, bioregions, watersheds, and natural communities.

Proposal

The budget proposes about $59 million for four initiatives that are designed to further implement this broader approach to natural resource conservation and management, as follows:

- ***Natural Community Conservation Planning (NCCP) Program***. The budget proposes $20.6 million primarily for land acquisition and implementation of local plans to promote the management and conservation of multiple species and natural communities. This is an expansion of the NCCP Program, established by Chapter 765, Statutes of 1991 (AB 2172, Kelley).

- ***Lake Tahoe Initiative.*** The budget proposes $11.5 million to preserve and enhance the Lake Tahoe Basin. Proposed activities include the acquisition and restoration of wildlife habitat, the control of soil erosion, and water quality monitoring and improvement. This proposal represents California's initial contribution to the Environmental Improvement Plan (EIP)—a joint agreement among the States of California and Nevada, the federal government, local governments, and the private sector to repair environmental damage done to the Lake Tahoe Basin. The EIP covers a 10-year period with estimated total costs of $906 million, of which $274 million is California's share.

- ***Watershed Initiative.*** The budget proposes $8.9 million primarily for grants to local agencies for watershed restoration and related state technical assistance.

- ***Ocean and Coastal Initiative.*** The budget proposes $17.7 million to improve coastal resources, by enhancing coastal access, restoring coastal wetlands (including establishing wetlands mitigation "banks"), establishing a marine ecosystem database, monitoring coastal water quality, and controlling coastal polluted runoff.

Issues for Legislative Consideration

In evaluating these initiatives, we think that the Legislature should consider the following:

- ***Consistency With Statutory Policy.*** The Legislature should assess the degree to which the initiatives are consistent with existing statutory direction. For example, the Legislature should consider whether the proposed expenditures from the Salmon and Steelhead Restoration Account for the Watershed Initiative are consistent with a statutory allocation of expenditures from this account.

- ***Long-Term Costs and Fund Sources.*** The Legislature should assess the degree to which the initiatives could require significant state investments in future years, and consider appropriate funding sources to meet these needs. For example, the budget proposes $11.5 million from various funds, and the administration has proposed an additional $95 million in new bond funding, to support California's share of funding for the Tahoe Basin EIP. However, this leaves over 60 percent of the state's 10-year funding commitment of $274 million without identified funding sources.

- ***Measurable Objectives to Be Achieved and Work to Be Accomplished.*** The Legislature should consider whether (1) adequate details have been provided to assess the merits of the initiatives and their likely cost-effectiveness and (2) there are measurable objectives which allow it to hold the various departments accountable for results under the initiatives. For example, the budget proposes $5.7 million to improve coastal access, but does not identify where the access will be made available.