MAJOR EXPENDITURE PROPOSALS IN THE 1999-00 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 1999-00 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 1999-00.

Proposal

Governor's Budget-Year Plan. The budget proposes $32.8 billion in total K-12 Proposition 98 funding in 1999-00. This is an increase of $1.5 billion, or 4.8 percent, compared to the 1998-99 revised amount. Student attendance is projected to increase by 1.4 percent, resulting in funding of $5,944 per student, an increase of $192 (3.3 percent) from the revised 1998-99 amount.

The major 1999-00 budget proposals include:

- $571 million to provide a 1.83 percent cost-of-living adjustment (COLA).

- $344 million for enrollment growth.
- $365 million for the Governor's Raising Expectation Achievement and Development in Schools (READ) programs.
- $200 million to reduce the revenue limit "deficit factor."

Figure 9 illustrates how the budget would allocate projected growth in the Proposition 98 funds in 1999-00.

Additional Proposition 98 Funds Available for the Budget Year. For 1999-00, we estimate that the Proposition 98 minimum funding guarantee will be $111 million higher than estimated in the Governor's spending plan. This increase is due to our upward revision of per capita personal income growth (Proposition 98's "Test 2" inflation factor) from 3.4 percent to 3.7 percent. Thus, under our estimate, the Legislature will have an additional $111 million to allocate to K-14 education in 1999-00.

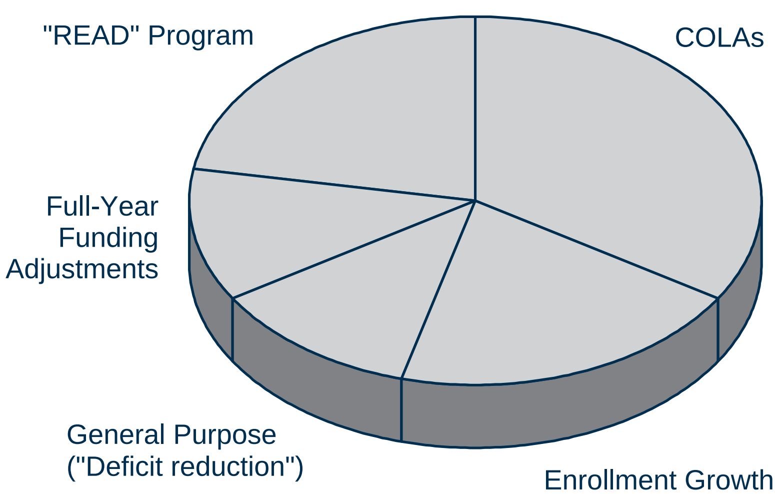
Issues for Legislative Consideration

A Centralized Versus a Decentralized Strategy for Improving Schools. As mentioned above, the *1999-00 Governor's Budget* includes $365 million from Proposition 98 funds for his various proposals to improve reading achievement, teaching, and school accountability, collectively called his

Figure 9

Proposed Use of New K-12 Proposition 98 Funds

1999-00



READ initiative. (Including federal funds and non-Proposition 98 funds, proposed expenditures for READ total $444 million.) In the Governor's various proposals, the general tendency is toward a centralized approach with the state mandating the use of specific improvement strategies in all schools across the state.

The high priority that the Governor has assigned to getting better outcomes from the state's public schools is entirely appropriate. However, the Legislature might consider whether the generally centralized approach taken in the various proposals is the best way of reaching the goal of improved academic outcomes. If there is a theme to the various recommendations we make on K-12 education in our *Analysis of the 1999-00 Budget Bill*, it is one of recognizing the (1) inherent variability in the challenges faced by the state's 8,000 public schools and (2) consequent need to consider decentralized approaches that foster improvements in place of centralized approaches that attempt to impose improvements. Our various recommendations flow from a recognition that:

- There are important variations in local circumstances and needs among the state's schools.
- That there are often several educational strategies that can successfully address a given educational problem.
- Local districts and schools, being closer to the daily task of educating pupils, are often in a better position than the state to determine the mix of strategies and resources that best fit local circumstances.

For example, in addressing teacher quality issues the Governor would have the state effectively mandate that all schools adopt a teacher peer review program under which "exemplary" teachers would assist "veteran" teachers in need of development in subject matter knowledge or teaching strategies. In addition, the Governor's proposal would, after the budget year, end the Mentor Teacher Program, which provides assistance and guidance to new teachers. Under our recommended approach, the proposed peer review program would be optional, not mandated, and would complement, rather than replace, the Mentor Teacher Program. Related recommendations would further increase local flexibility in addressing teacher quality needs.

Providing More Services to English Language Learners With Existing Funds. The stated purpose of Proposition 227, enacted by the voters in June 1998, is to help public school children learn English "as rapidly and effectively as possible." Among other provisions, the proposition appropriates $50 million annually for ten years for English language instruction to parents and other community members who, in turn, pledge to provide English language tutoring to school children with limited English proficiency.

Proposition 227 provides that the Legislature may amend the proposition through a bill passed by a two-thirds vote "to further the act's purposes." We believe that the overall purpose of the proposition, to teach children in our public schools English as rapidly and effectively as possible, would be furthered by allowing school districts to select additional strategies for delivering English tutoring and other specialized assistance in English instruction to English language learner pupils. These additional strategies could include:

- Direct English language tutoring of English language learner pupils by tutors who already know English.
- Additional instructional time (outside regular classroom instruction) for pupils attempting to learn English sufficiently well within one year to transition into "mainstream" English instruction.
- Instructional materials for pupils in structured English immersion classes.

In our *Analysis of the 1999-00 Budget Bill*, we recommend that the Legislature amend Proposition 227 to broaden the permissible uses of the proposition's $50 million annual appropriation.

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 106 campuses. The UC awards bachelor's degrees and a full range of graduate and professional degrees. State policy directs UC to draw 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 $4.7 billion in 1999-00, an increase of $57 million, or 1.2 percent, compared with estimated current-year budgets. After adjusting for one-time spending in 1998-99, the actual increase is $231 million, or 5.1 percent. Budgeted enrollment levels at UC and CSU would increase substantially in 1999-00—by 4,600 full-time equivalent (FTE) students at the UC and 8,381 FTE students at the CSU. The budget proposes 4 percent baseline funding increases totaling $173 million in General Fund appropriations for UC and CSU. The proposed budget also includes a total General Fund increase of $30 million in lieu of student fee increases which are prohibited under Chapter 853, Statutes of 1997 (AB 1318, Ducheny). The budget proposes $15 million in new funding for the two segments for teacher preparation, recruitment, and K-12 staff development aimed at improving California's K-12 educational system.

Community Colleges. The budget proposes $2.3 billion in General Fund local assistance for the community colleges in 1999-00. This entire amount counts towards the state's K-14 minimum funding guarantee under Proposition 98. The 1999-00 General Fund request represents an increase of $119 million, or 5.5 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 $191 million, which represents a 4.8 percent increase in combined funding.

In 1999-00, the budget provides $62.9 million for a 1.83 percent cost-of-living adjustment for general-purpose spending, $83.8 million for enrollment growth, and $20.6 million for new K-12 initiatives including teacher development and high school performance reports.

Student Aid Commission. The budget proposes a General Fund increase of $34.3 million, or 9.7 percent, for the Student Aid Commission in 1999-00. The majority of this increase, $30 million, pays for the cost increase associated with past increases in the number and maximum amount of Cal Grant awards.

Issues for Legislative Consideration

Year-Round Operation on College Campuses. The Department of Finance projects that higher education enrollments will grow at an average rate of 2.4 percent per year over the next decade. Although moderate by historical standards, this growth will cause enrollments on many campuses to exceed reported capacities within the next decade, unless the state acts to increase instructional capacity. The segments could increase capacity most cost-effectively by phasing in year-round operation on campuses. By serving as many students in summer as they do in other terms, the segments could serve up to one-third more students, while saving several billions of dollars in capital construction costs that would otherwise be necessary. The state must create the proper incentives for the segments to operate on a year-round basis. We analyze the issue of year-round operation in Part Five of this document (see page 127). In that analysis, we recommend that the Legislature (1) fund additional instructional facilities based on full use of existing facilities on a year-round basis, (2) provide state support for all enrollment growth, regardless of the season in which it occurs; (3) charge students the same fees in summer that it charges in other terms; and (4) give the segments flexibility to meet campus-specific needs when implementing year-round operation.

Alternatives to Governor's K-12 Initiatives at UC and Community Colleges. The Governor's budget requests $13 million to plan and implement three programs at UC to improve K-12 education. It requests $6 million for UC to develop Reading Professional Development Institutes for K-12 teachers, and another $6 million (Proposition 98) for stipends to K-12 teachers attending the institutes. We recommend that the $12 million be redirected to school districts as staff-development block grants, thereby allowing districts to obtain services that best meet their staff-development needs. The budget requests $1 million for UC to plan and implement a Teachers Scholars program ($500,000) and a Principal Leadership Institute ($500,000). We recommend that the Legislature, instead, shift these funds to the Cal Grant T program to provide grants to 220 additional prospective teachers each year. The students could then choose to attend the accredited public or private teacher-training program that best meets their educational and career objectives.

The budget requests a total of $22.4 million to (1) describe how well students from each high school perform in community college ($10.6 million), (2) encourage community college students to tutor K-12 students in reading ($10 million), and (3) expand a program that offers high-risk high school students the opportunity to take high school courses on community college campuses ($1.8 million). We recommend deleting funds for the first two of these proposals, because the they lack sufficient detail to justify the costs. We recommend deleting funds for the third proposal, because the program, which is ten years old, has not documented its effectiveness in achieving its stated goals.

The CSU Cannot Document Growth in Teacher Preparation Enrollments. In the past two budget acts, the state has invested $13.8 million to expand CSU's teacher preparation enrollments by 2,702 FTE students. Now, CSU reports that it does not know how many students are in its teacher preparation programs. This situation presents the Legislature with two problems. Most importantly, not knowing how many potential teachers are in the training pipeline prevents the Legislature from being able to effectively manage teacher training policy in order to meet the demand for qualified teachers. Secondly, the lack of enrollment numbers prevents the Legislature from determining whether CSU has achieved the enrollment gains CSU agreed to when it asked for the $13.8 million. We therefore recommend that CSU report to the budget subcommittees on how many additional teacher preparation enrollments it produced using the $13.8 million. If CSU cannot document the agreed upon increase, we recommend that the Legislature permanently shift the $13.8 million in CSU's base budget for this purpose to the Cal Grant T program, thereby providing grant aid to about 3,000 additional prospective new teachers.

CALWORKS PROGRAM

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. The CalWORKs program provides cash grants and employment and training services to eligible families.

Proposal

Performance Incentives. For 1998-99 and 1999-00, the Governor's budget proposes over $1 billion in total performance incentive payments to the counties. These incentives are provided to counties as a result of savings from (1) program exits due to employment, (2) increased earnings, and (3) the "diversion" of persons from applying for the program. Current law also requires that the Department of Social Services (DSS), in consultation with the welfare reform steering committee, determine the method of calculating these savings.

Savings from Exits Due to Employment. For 1998-99, the steering committee recommended that county performance incentive payments attributable to savings from exits due to employment be based on the *increase* in exits compared to the average number of exits during 1994-95, 1995-96, and 1996-97. By estimating the savings from exits due to employment in comparison to a baseline, the incentive payments for exits are directly related to improved county performance.

Savings From Increased Earnings. In contrast to its approach with respect to exits, the steering committee did not incorporate a baseline for savings that result from increased earnings. Specifically, the steering committee recommended that *all* savings attributable to earnings—regardless of whether they resulted from CalWORKs interventions or would have occurred absent any change in program implementation—be paid as fiscal incentives. We note that prior to implementation of CalWORKs, 17 percent of the caseload had sufficient earnings to result in reduced grants. For 1999-00, DSS estimates that of the $385 million in savings resulting from increased earnings, $287 million (about 75 percent) would have occurred without CalWORKs. The remaining 25 percent, $99 million, is related to CalWORKs services provided by the counties. Thus, the steering committee approach provides counties with $287 million in "performance incentives" that they would "earn" even if they show no improvement in implementing CalWORKs.

Savings From Diversion. The Governor's budget proposes to provide all net savings that are attributable to diversion as county performance incentives. More specifically, the budget estimates that cases diverted by the counties would have been on aid for an average of six months, and that the average one-time diversion payment would be $1,175. Based on these assumptions, DSS estimates that fiscal incentive payments based on net savings from diversion will be $18.7 million in 1999-00. We note that the diversion payment is a new program component, so any savings should be attributable to CalWORKs.

Issues for Legislative Consideration

Tying Incentives to Improved County Performance. One approach to bringing incentives in line with performance would be to limit incentive payments based on increased earnings to the $99 million in savings from earnings that are actually attributable to CalWORKs. This approach would reduce fiscal incentives by $287 million, down to a total of $192 million in 1999-00. We note that even though DSS has estimated that only $99 million in statewide savings from earnings can be attributed to CalWORKs, it is administratively difficult to separate baseline savings from CalWORKs savings at the individual county level. This technical estimating problem is one reason why the steering committee did not limit the fiscal incentive payments in this way.

To address this problem, we recommend providing counties with 50 percent of *all* savings attributable to earnings. Under this approach, fiscal incentives would be reduced by $193 million, to a total of $286 million. Although this approach leaves counties with more in incentives than can be strictly justified on the basis of improved performance, it does not rely on a county-level estimate of the baseline and still provides counties with a significant fiscal incentive to assist recipients in obtaining employment.

How Could the Legislature Use the Identified Savings? We identify several options for the Legislature to consider with respect to the potential use of these federal savings. Specifically, the savings 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 (Title XX), where the funds could be used to offset General Fund spending in other departments.

Of the three options for using identified savings, we recommend that the Legislature place at least 50 percent of the savings into a reserve for future years. There are two advantages to this approach. First, we note that in the event of a recession, the state will be responsible for 100 percent of any increased costs for CalWORKs grants or services that would result from an increase in the caseload. Establishing a TANF reserve would help mitigate the fiscal impact of a recession. Second, creating a TANF reserve increases 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.

HEALTH CARE REFORMS

Millions of Californians are uninsured—they do not have health coverage, whether job-based, privately purchased, or through a public program such as California Medical Assistance (Medi-Cal). The large number of uninsured persons has raised concerns about the adequacy of health care services for a significant portion of the state's population, and it has imposed a large burden on county indigent care programs, community clinics, and other components of the state's health care "safety net."

Proposal

Expanding Health Care. The budget includes a "set-aside" of $37.3 million from the General Fund that is reserved for expenditure on health care reforms, pursuant to a plan to be submitted by the Secretary of the Health and Human Services Agency. According to the administration, this plan may be submitted either as a budget proposal or as a proposal for separate legislation. Funding for the set-aside is contingent on federal action because it is tied to federal approval of a waiver to provide Medicaid funding for family planning services currently funded by the state. The budget assumes the waiver will result in General Fund savings of $122 million in 1999-00. The set-aside would be derived from these funds.

In his budget summary, the Governor indicates that the plan will give consideration to the following issues, many of which involve the Healthy

Families Program (HFP), a program that currently provides health insurance for children:

- Expanding the family income eligibility limit for the HFP from 200 percent of the poverty level to 250 percent.
- Providing state-only funded HFP coverage to recently arrived legal immigrant children, who are not eligible for federal funding.
- Streamlining HFP application documentation requirements.
- Seeking federal permission to allow Medi-Cal-eligible families to enroll their children in HFP rather than Medi-Cal.
- Providing HFP coverage for parents and older siblings of HFP-eligible children, including exploring the use of the federal Children's Health Insurance Program (CHIP) funds to provide this coverage.
- Recommending outreach and education strategies to increase the enrollment of children in Medi-Cal and HFP.

Issues for Legislative Consideration

Criteria for Evaluating Health Care Expansion Proposals. Health care programs can be very expensive, and their cost can grow rapidly if not carefully controlled. Given limited state resources, it is crucial to target any health coverage expansions where they will be the most effective and make the best use of existing resources and funding streams. With this in mind, we suggest the following criteria for evaluating proposals to expand coverage:

- ***Maximize Federal Funds to the Extent Possible.*** Medicaid and the federal CHIP provide one-half or two-thirds, respectively, of the funding for covered services to eligible persons. Accordingly, it is important to structure coverage expansions so that they qualify for these programs wherever possible. Similarly, coordination with Medicare is important for the elderly or disabled. We recognize that with federal funds often come "federal strings." In some cases, the state may decide that the additional federal funds are not worth the accompanying federal requirements.
- ***Consider Existing Indigent Care Funding.*** Expanded coverage would reduce the burden on indigent care systems. Accordingly, it may be appropriate to redirect a portion of these funds (such as state realignment funds currently provided to counties) to cover some of the expansion cost (for example, to provide a share of the nonfederal match for Medi-Cal or HFP expansions).

- ***Target the Most Needed Services.*** The cost of coverage generally increases with the scope of coverage. Targeting the most essential services allows coverage of more people with limited funds.
- ***Target the People Who Most Need, and Can Best Use, Coverage.*** Many groups with specific health care needs (such as the elderly, disabled, people with AIDS, children, and pregnant women) already are targeted by public health insurance or special benefit programs. Other groups that would be good candidates for expanded coverage include low-income nonelderly adults with chronic health problems, such as diabetes, and low-income working parents, on the basis that their health is important to the well-being of their children.
- ***Insurance Is Not Always the Answer.*** Absent a system of universal or mandatory coverage, some people will remain uninsured, even if coverage is free or heavily subsidized. Many healthy adults without children, the homeless, transients, or persons in the midst of a transition in their lives are likely to remain uncovered. Safety-net programs will continue to be needed to serve this segment of the population.
- ***Include Cost-Sharing on an Ability-to-Pay Basis.*** As coverage is extended to persons at higher income levels, it becomes important to require that those covered contribute to the cost of coverage. Imposing premium contributions on a sliding-scale basis limits incentives to substitute public coverage for private or job-based coverage, provides a partial offset to state costs, and phases out, rather than abruptly eliminating, the coverage subsidy as income rises.
- ***Be Skeptical of Claims of Offsetting Savings from Expanded Coverage.*** Preventive care can produce savings in specific cases, especially through good management of chronic illnesses, but in general it will cost more to provide regular health coverage and broader access to care.

Options for Expanded Coverage. The new federal CHIP program and recent changes in federal Medicaid laws and regulations provide the state with a number of approaches to further expand health care coverage to working families, with federal funds providing one-half to two-thirds of the cost. Expanding coverage will require state (and/or local) funding to cover the nonfederal share of costs. However, we believe that simplifying eligibility could produce some partially offsetting administrative savings to the state and that expanding coverage could reduce county indigent care costs.

We further suggest that the Legislature consider funding for coverage expansion on its own merits within the Legislature's overall fiscal priorities and available resources rather than tying it to a single action, such as federal approval of the family planning waiver.

We have identified a number of approaches for expanding coverage. These approaches include variations of—or more specific means of implementing—the options mentioned in the Governor's budget, as well as other approaches for the Legislature's consideration, as listed below:

- Expand HFP eligibility to children in families with incomes above 200 percent of poverty.
- Expand Medi-Cal coverage for uninsured parents by increasing Medi-Cal income and asset limits for working families using federal Section 1931(b) flexibility provided in the 1996 welfare reform law and recent revisions to Medicaid regulations.
- Adopt a sliding schedule of premium payments to gradually phase out the public subsidy to families with higher incomes.
- Unify and simplify coverage for low-income working families by (1) allowing access to the same plans and providers through both Medi-Cal and HFP and (2) providing Medi-Cal coverage (and redetermining eligibility) in managed care plans on an annual, rather than a quarterly, basis—similar to the current annual eligibility period in the HFP.

Implementing these approaches in a coordinated and cost-effective manner probably would require the state to seek a Section 1115 demonstration project waiver from the federal government. Waiver authority might be needed, for example, to unify eligibility criteria and benefit packages under Medi-Cal and HFP, and possibly to enable the state to use the federal share of any administrative savings to provide additional financing for extended coverage. Waiver authority also may be needed to allow the state to charge premiums on a sliding-scale basis for Medi-Cal beneficiaries at higher income levels.

MEDI-CAL

The Medi-Cal program is a joint federal-state program that provides health services to public assistance recipients and other qualified individuals who cannot afford to pay for these services themselves.

Proposal

The budget assumes that the federal government will approve two state requests that would result in a total of $332 million of General Fund savings in the Medi-Cal Program.

Federal Medical Assistance Percentage (FMAP) Increase—$210 Million. On January 12, 1999, the Secretary of the U.S. Department of Health and Human Services announced the FMAPs, which is the federal share of cost that will be in effect for each state during federal fiscal year (FFY) 2000 (October 1999 through September 2000). California's FFY 2000 FMAP is 51.67 percent. The budget assumes that the federal government will revise California's FFY 2000 FMAP to 53.36 percent. This increase in the federal share of Medi-Cal costs would reduce state General Fund costs by $210 million.

The FMAP is calculated according to a federal statutory formula based on the relationship of percapita personal income in each state to the national average over a moving three-year period. The *lower* a state's percapita personal income relative to the nation, the *higher* its FMAP. Percapita personal income is derived by taking the U.S. Department of Commerce's estimate of total state personal income and dividing it by the U.S. Census Bureau's estimate of state population. Accordingly, a higher population estimate for a state will reduce the calculated percapita personal income and result in a larger FMAP.

The Governor's budget indicates that the Census Bureau's population estimates for California are too low because they continue to show a net movement of people from California to other states, whereas the Department of Finance estimates that California has been gaining population from other states in recent years in response to an improved economy. The bureau uses federal tax return information, which tends to have a significant lag, to track population movement between states. The Department of Finance, however, uses more recent drivers' license information to estimate net migration for California.

Family Planning Waiver—$122.2 Million. Currently, California's family planning program serves both Medi-Cal eligibles and those whose incomes exceed the normal Medi-Cal income limits. The state receives 90 percent federal funding for family planning services for those who are Medi-Cal eligibles, but no federal funds for those who are not Medi-Cal eligible. The budget proposes to shift the state-only portion of the existing family planning program to 90 percent federal funding under a Medicaid demonstration project waiver that will require federal approval.

Issues for Legislative Consideration

The FMAP Increase. We believe that the administration is correct, and an increase in the state's FMAP is justified. However, no mechanism currently exists to make that adjustment for FFY 2000. Under federal law, the determination of FMAPs by the federal Health and Human Services Secretary is "conclusive," and therefore there is no process for appealing it. Furthermore, allocating more population to California requires reducing the population estimates of other states and adjusting their FMAPs accordingly. This probably is not feasible in the short term, since there is no national database of drivers' license information.

Alternatively, Congress could address the state's concern by adding funds to the federal FFY 2000 budget to provide an *ad hoc* adjustment for California. In any case, the budget's assumption of an increase in California's FMAP creates a General Fund risk. In estimating the state's General Fund condition, we have assumed these funds would not be available in the budget year.

Family Planning Waiver. Several states have received family planning waivers or are currently applying for them. Oregon, for example, recently received this type of waiver to substantially expand its family planning program to individuals not previously served by that state. Waiver programs, however, must be "budget neutral" (that is, have no net cost) to the federal government. In the Oregon expansion, the additional federal costs for expanding coverage will be more than offset by the estimated federal Medicaid savings from reduced pregnancies. California's proposal is similar to Oregon's, but does not involve an expansion of coverage beyond that which currently is provided by the state. For this reason, in estimating the state's General Fund condition we have not assumed the receipt of these funds in the budget year.

CAPITAL OUTLAY

The state owns a vast amount of infrastructure including nearly 2.5 million acres of land, 180 million square feet of building space and 15,000 miles of highways. Also, much of the state's infrastructure is aging—55 million square feet of building space in the three public higher education segments was built or renovated more than 30 years ago and most of the 9.5 million square feet of buildings in the state hospitals and developmental centers was built over 40 years ago.

The state departments responsible for this infrastructure have estimated that over the next five years more than $20 billion will need to be spent on improvements and expansion. (Around 50 percent of this amount is for highways and rail programs.) As we have cautioned in the past, some of the planning effort to develop these estimates may be incomplete and some estimates may contain proposals that upon examination may not merit funding. In general, however, the estimates give a reasonable overall magnitude of the capital outlay needs.

Proposal

Budget Bill Proposal. The budget includes $1.1 billion for capital outlay for state infrastructure (excluding highway and rail programs). As shown in Figure 10, over 50 percent of the proposal is for higher education, with the next largest amount for youth and adult corrections and resources.

Budget Relies Heavily on Debt Financing. The amounts included in the budget consist of debt financing (using bonds), direct General Fund appropriations, and special funds. Nearly 80 percent of the proposed funding is from bonds. The bond proposals include (1) $582 million from general obligation bonds, most of which is for higher education; and (2) $262 million from proposed lease-payment bonds for prisons, criminalistic laboratories, and health-care related buildings. Direct appropriations from the General Fund total $195 million for projects in 20 departments for a variety of proposals (such as land acquisition, fire stations, and various infrastructure and building code improvements). The remaining $52 million is from various special funds for resource

Figure 10

State Capital Outlay Programs

1998-99 and 1999-00
(In Millions)

	1998-99	1999-00	Difference
Legislative, Judicial, and Executive	$30.5	$58.8	$28.3
State and Consumer Services	272.2	27.4	-244.8
Transportation (excluding highways and rail)	15.8	28.5	12.7
Resources	401.5	152.7	-248.8
Health and Social Services	167.5	49.1	-118.4
Youth and Adult Corrections	55.0	188.2[a]	133.2
Education (state special schools)	—	1.1	1.1
Higher Education	637.4	572.4	-65.0
General Government	25.1	17.5	-7.6
Totals	**$1,605.1**	**$1,095.6**	**-$509.5**

[a] Includes proposed fund shift of $62.4 million appropriated from the General Fund in 1998-99 to lease-payment bonds in 1999-00.

programs and transportation-related buildings for the California Highway Patrol and Department of Motor Vehicles.

Bond Debt. The state's debt payments on bonds will be $2.7 billion in the budget year—an increase of 10 percent over current-year costs. These payments include $2.1 billion for general obligation bonds and $0.6 billion for lease-payment bonds. We estimate that this debt payment as a percent of General Fund revenue (that is, the state's debt ratio) will be 4.5 percent in the budget year. As more bonds are sold, including those proposed in the budget, we estimate the state's debt ratio would rise to 4.6 percent in 2001-02 and decline thereafter if no other bonds are authorized.

Issues for Legislative Consideration

State's Infrastructure Planning and Financing Process. Addressing these issues of aging infrastructure and population growth will require the expenditure of billions of dollars to renovate existing infrastructure and develop new public infrastructure. To effectively assess the variety and complexity of infrastructure projects, the state needs a well-defined process for planning, budgeting, and financing these projects. Unfortunately, the state lacks such a process. Instead, under the current process, decisions to investment in infrastructure are made more on an ad hoc basis. Proposals are considered without an overall sense as to how any proposal fits within statewide needs and priorities or how it affects the state's ability to finance infrastructure needs over time.

In order to better address these issues, we believe it is time to overhaul the state's approach by taking the following steps:

- Develop an integrated statewide infrastructure plan based on policies established by legislative committees.
- Determine which local government infrastructure programs the state should continue to finance.
- Adopt a policy that devotes 6 percent of annual General Fund revenues for infrastructure investment, with an increased level of pay-as-you-go financing within this level of funding.

Taking these steps will allow the administration and the Legislature to be better informed and proactive in addressing infrastructure needs and will help maximize the benefits of the state's investments in infrastructure in the years to come. (A more detailed discussion of this issue is in Part V of this document.)

Year-Round Operation in Higher Education. Enrollment projections for public higher education indicate that there will be an additional

300,000 FTE students by 2007-08. To construct new educational facilities for these additional students would require the expenditure of several billion dollars. This cost could be avoided if the state's public higher education campuses operated on a year-round basis instead of three quarters of the year. Consequently, we recommend the Legislature direct the segments to implement year-round operation and fund capital outlay projects on this basis. (A more detailed discussion of this issue is in Part V of this document.)

Funding Higher Education Capital Outlay. In recent years, the segments have received equal amounts of available bond funds. This "granting" of equal amounts to each segment fails to recognize the differences among segments or the condition of the facilities on each campus. This can result in lower-priority projects in one segment receiving funds while a higher-priority project in another segment may go unfunded. We believe it is essential to target the highest statewide priority because there is a limited amount of bond funds dedicated to higher education. In November 1998, the voters approved a $2.5 billion general obligation bond program for higher education and half of this amount cannot be sold until after July 1, 2000. The segments, however, have developed five-year capital outlay plans that total over $6 billion. To assure that the bonds approved by the voters are spent on the highest statewide priority, we recommend that the Legislature appropriate funds for higher education on the merits of each project in the context of statewide priorities.

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.

Proposal

Inmate and Parolee Growth. The Governor's budget proposes $4 billion from the General Fund for support of CDC in 1999-00, an increase of $135 million, or 3.5 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 that would result in any significant reduction in the growth in the inmate or parolee populations. In addition, the budget does not propose to construct any new state-operated prisons.

Federal Funds for Undocumented Felons. The budget's total spending figures assume that the state will receive $273 million in federal funds in 1999-00 to offset the costs of incarcerating and supervising on parole, illegal immigrant adults and juveniles who have been convicted of a felony in California. This amount is $100 million, or 58 percent, above the administration's estimate of federal funds for the current year.

Issues for Legislative Consideration

Despite Slower Growth, Overcrowding Remains. Driven by costs to house increasing numbers of state prison inmates, CDC has been one of the state's fastest growing General Fund budgets over the past decade. However, the 1999-00 budget proposal for CDC represents a significant slowdown in the growth of its expenditures. The CDC expenditures have not grown by a smaller amount since 1983-84, except for 1992-93—a year when the state faced an unusually large revenue shortfall and CDC spending actually decreased slightly. The CDC expenditures have not otherwise grown this slowly on a percentage basis since 1967-68, when they went up 3 percent.

The proposed slowdown in correctional spending is associated with a slowing in the growth in the inmate population and related changes in CDC staffing. The CDC projects that the population will increase at an average annual rate of about 3.9 percent over the next five years, reaching almost 208,000 inmates by June 2004. There are a number of reasons for the slowdown in growth, most of which are related to a reduction in the number of parolees returned to prison for parole violations and new prison terms.

Even with this slower growth, however, the state's prison system remains severely overcrowded and the budget proposes to further overcrowd the system's day rooms, gyms, and housing units. In addition, the system is approaching its long-term housing capacity. Given current projections and trends, we estimate that the system will run out of bed space as soon as 2001 and would need additional space for as many as 27,000 inmates by the end of 2003-04. This is the equivalent of five to six state-operated prisons carrying a one-time construction cost of $1.6 billion and annual ongoing operational costs of more than $500 million.

In order to meet the needs of the system, the Legislature will need to consider options for accommodating this growth. The two basic ways are to add new prison capacity or enact policy changes that would reduce the expected inmate population growth. We believe that a balanced approach, weighted almost evenly between adding capacity and enacting changes to further slow the growth, would be in the state's best fiscal and public safety interest. This approach is also consistent with actions taken by the

Legislature in 1998 in which construction of additional prison capacity within existing prisons was authorized, and additional spending for services for parolees was provided.

We have offered other recommendations using this balanced approach to meeting the state's prison capacity, including constructing new state-run prisons, contracting for additional community correctional facility beds with vendors, restructuring the state's parole system, reforming the state's sentencing laws, and expanding existing academic, vocational, and work programs for inmates.

Increased Federal Funds for Undocumented Felons. In estimating the state's General Fund condition, we have assumed these funds would not be available in the budget year. We have assumed this for two reasons. First, in order to achieve the additional $100 million, Congress would have to appropriate significantly more for the program than it has in the past. We note that the President's budget proposal for federal fiscal year 2000, which was released in early February, requests less than the amount appropriated by Congress for the past two federal fiscal years.

Second, even if Congress appropriates more money, it is likely that the state's share will continue to decline as more jurisdictions throughout the nation improve their abilities to apply for and claim reimbursement.

TRANSPORTATION

Transportation Funding. The State Highway Account (SHA), the primary source of state funds for transportation expenditures, derives its revenues primarily from taxes on gasoline and diesel fuel and from truck weight fees. In 1999-00, total resources are projected to be almost $4 billion.

The Public Transportation Account (PTA) is the primary state fund source for transit equipment and rolling stock (buses and rail cars) acquisition and improvement. The PTA derives most of its revenues from the sales tax on diesel fuel and gasoline. In 1999-00, total PTA revenues are projected to be about $178 million. Current law requires that half of the account's revenues be allocated annually for transit operating assistance under the State Transportation Assistance (STA) program. The remaining funds support intercity rail service, transportation planning and research, high speed rail development, passenger rail safety, the California Transportation Commission, and transit capital improvements.

Department of Motor Vehicles. The Department of Motor Vehicles (DMV) is continuing its multiyear effort to redesign and replace its major computer information systems. The existing systems were designed in the 1960s and have become technologically obsolete and expensive to maintain. This is the department's second attempt to revamp its computer system over the last decade. The first effort, which began in 1988, was abandoned as a failure after DMV had invested $50 million in the project.

Proposal

State Highway Account. The SHA has a current-year cash balance of approximately $1.5 billion. Our analysis shows that the balance, which has grown continuously since 1993-94, is likely to grow still further. Although the Governor's budget projects a balance of $1.1 billion for 1999-00, we believe it is likely to be substantially higher since actual SHA balances have consistently exceeded the amounts projected—by significant margins.

Public Transportation Account. Due to recent declines in revenues and increasing expenditures, PTA will not be able to meet all outstanding commitments. The budget proposes a transfer of $28 million from the SHA in order to meet outstanding obligations for transit capital improvement through 1999-00. The revised fund estimate, adopted by the California Transportation Commission in January 1999, projects a $38 million shortfall in PTA through 2003-04. Due to the account's condition, the 1998 State Transportation Improvement Program (STIP) provides no funds for additional transit capital projects through 2003-04.

Department of Motor Vehicles. The department requests $6.7 million to continue its computer system redevelopment effort. Specifically, it proposes to spend:

- $984,000 to continue efforts, started in the current year, to secure a business partner who will subsequently redesign the vehicle registration system.
- $857,000 for the fourth year of a Business Process Re-engineering effort, with a focus on the driver license system.
- $4.9 million to begin a three-year effort to replace its financial system hardware and software. Total project cost is currently estimated at $13.2 million.

The department has provided new completion dates for its database redevelopment effort. The latest projections are up to 18 months later than projections offered last year, and several *years* later than estimates offered when the new effort began in 1995. The department is not able to estimate when the entire redevelopment effort will be fully completed.

Issues for Legislative Consideration

State Highway Account. One factor that contributes to the size of the cash balance is the inability of local agencies to obligate their share of federal funds. When local agencies are unable to use their share of federal funds within the year in which they are allocated, the Department of Transportation (Caltrans) tries to use them for state projects in order to avoid any loss of federal funds. Caltrans then allows local agencies to use state funds for their projects at a later time. This leaves funds in the SHA unexpended until local agencies are ready to deliver their projects, and thereby contributes to the growth of the account's cash balance. With the significant increase in federal funds under the new federal transportation act, TEA-21, local agencies are likely to have even greater difficulty obligating their share of federal funds in a timely manner.

In order to reduce the size of the SHA cash balance, the Legislature should consider the enactment of legislation to limit the time period for which state funds are available to local agencies as a substitute for federal funds. This would help to reduce the size of the SHA cash balance by creating an incentive for local agencies to expend their allocation of funds in a more timely manner.

Public Transportation Account. Article XIX of the State Constitution restricts fuel tax revenues (deposited in SHA) from being used to fund rolling stock (that is railcars or buses). As a result, these types of transit investments must rely on the PTA for funding. Because of the account's condition, it appears that the state will be unable to make such investments until the 2002 STIP, which covers the period 2002-03 through 2005-06.

In order to ensure the stability of funding for transit rolling stock, we recommend that the Legislature enact a constitutional amendment, subject to voter approval, to permit expenditure of gas tax revenues for such purposes. This could provide more flexibility in funding public transportation improvements, and enable funds to be used more efficiently to meet transit needs.

Department of Motor Vehicles. In addition to the large sums of money at stake in funding this computer system redevelopment project, fundamental aspects of the state's transportation infrastructure (such as driver licensing and automobile registration) and the collection of significant amounts of revenues (such as the vehicle license fee) depend on DMV's databases. Given the costly failure of the department's first attempt, every effort should be made to ensure that the current project be well designed, realistically scheduled, and carefully implemented.

Accordingly, we recommend that the Legislature consider:

- Preventing DMV from proceeding with certain major components of its database procurement until earlier scheduled installations have been completed. In this way, the department could build on lessons learned from the earlier procurement. Further, this staggered procurement should help to ensure compatibility among the various systems.
- Requiring DMV to make regular reports to the Legislature, providing its best estimate of when major milestones in the redevelopment effort will be met and what they will cost. The reports also could explain any deviations from past estimates. These reports would help impose a better degree of accountability on the department as it pursues this critical project, and would help the Legislature to make more informed funding and policy decisions with regard to the project.

RESOURCES

Deferred Maintenance in State Parks. The Department of Parks and Recreation (DPR) oversees 265 park units, including state beaches, state parks, museums, day-use and overnight campgrounds. The ongoing maintenance needs of these units are substantial. Over the past 15 years, funding for state parks has declined and this has resulted in a backlog of maintenance. At the time this analysis was prepared, DPR estimated deferred maintenance of about $180 million and annual ongoing maintenance needs of about $15 million.

State Funding of Local Flood Control Projects. Currently, the state shares in the costs of locally sponsored, federally authorized flood control projects. State and local governments are responsible for 70 percent and 30 percent, respectively, of the nonfederal share of a project's costs. Before state funds are committed, the Legislature (or the Department of Water Resources, if the local project is small) must authorize the project.

Due to the state's budget condition in the 1990s, the state has been unable to pay its full share of costs. The unpaid amount owed to local governments will total about $132 million at the end of 1998-99. If no new funding were provided in the budget year, the arrearages would increase to about $189 million by the end of 1999-00.

Coastal Access and Land Acquisition. The State Coastal Commission (SCC) acquires land, undertakes projects, and awards grants for a variety of purposes, including the restoration of wetlands and the development of a system of public accessways.

Beverage Container Recycling Program. The Beverage Container Recycling Program, administered by the Department of Conservation (DOC), is designed to encourage the voluntary recycling of beverage containers. All the costs of the program, including per-container payments to persons who return empty containers, are funded through fees paid by beverage manufacturers and distributors. Some or all of these costs are passed on to consumers. For the past several years beverage container recycling rates have been declining. With higher numbers of containers not being redeemed, the unexpended reserve in the Beverage Container Recycling Fund has been growing. The reserve currently exceeds $120 million.

Proposal

Deferred Maintenance in State Parks. The budget does not provide any funding to reduce the maintenance backlog in state parks.

State Funding of Local Flood Control Projects. The budget proposes no funding for either the arrearages or new claims for the state share of costs of local flood projects in 1999-00. Although Chapter 326, Statutes of 1998 (AB 2784, Strom-Martin) appropriated $44 million to pay down the arrearages in 1999-00, the budget proposes to revert this amount to the General Fund, pending the enactment of legislation to authorize the reversion.

Coastal Access and Land Acquisition. The Governor proposes a new $10 million "Challenge Grant" program, which will offer grants for projects that increase coastal access or restore wetlands along the coast. The program would be administered by SCC, and eligible recipients would include local agencies and nonprofit organizations. Grant proposals would be required to include funding from non-state sources in an amount that matches or exceeds the grant amount. The SCC could also use the grant funds to carry out it own projects directly, so long as the one-to-one matching requirement was met.

Beverage Container Recycling Program. Several statutory provisions of the program will sunset on January 1, 2000. In general, these provisions provide subsidies to beverage manufacturers, certain types of recyclers, and curbside recycling programs.

Issues for Legislative Consideration

Deferred Maintenance in State Parks. If maintenance on buildings and infrastructure components (such as roads and trails) is continuously deferred, facilities will eventually require higher expenditures for emergency repairs, major rehabilitation or replacement, or the initial investment may be lost. Additionally, a large backlog of deferred maintenance projects negatively impacts the level and type of service the department can provide and, thus, reduces the department's ability to carry out its mission.

Given the estimated magnitude of the department's deferred maintenance, we believe it is important that the reduction of deferred maintenance continue, to the extent possible. Accordingly, we recommend that the Legislature, in determining the state's priorities in funding various programs, consider providing some level of funding for DPR's deferred maintenance. The Legislature should also consider how to provide funding (1) for the department's ongoing maintenance and (2) to eliminate the significant backlog over time.

State Funding of Local Flood Control Projects. The lack of state funds for local flood control projects has caused construction to stop or be delayed on a number of projects. The Legislature should consider the following:

- ***Addressing Unpaid Obligations.*** The amounts currently owed to local governments are obligations of the state that should be addressed. To the extent that additional General Fund resources—over the currently projected amount—become available for the budget year, we think that consideration should be given to reducing these arrearages.
- ***What Types of Projects Should Be Funded in the Future?*** Currently, there is no clear, specific criteria for prioritizing local flood control projects for state funding. We think that the Legislature should set criteria that would provide a basis to decide which projects to authorize in the *future* in light of limited available state resources. Funding eligibility criteria, for example, could be based on the extent to which a project provides multiple benefits in addition to flood control (such as water quality/supply improvements or habitat conservation). Eligibility criteria could also be designed to encourage land use decision-makers to give greater consideration to the potential flood control-related costs of their decisions.
- ***How Should the State Share in the Cost of Future Local Projects?*** The Legislature should also reevaluate the proportion of the nonfederal share of local projects' costs to which the state is will-

ing to commit. The Legislature might consider setting different state percentage amounts based on the relative statewide benefits derived from the projects.

Coastal Access and Land Acquisition. In evaluating the proposed Challenge Grant program, the Legislature should consider the following:

- ***Consistency With Statewide Priorities***. While preserving coastal access and coastal wetlands is an important statewide goal, these goals should be considered within the larger context of the state's overall priorities for resources and the environment. It would be helpful for the Legislature to know what criteria will be used by the administration to evaluate grant proposals, and whether any portions of the grant funds will be earmarked for specific regional, habitat, or access priorities.

- ***Long-Term Cost Impacts***. Different types of projects may have quite different long-term cost impacts for the state. For example, new acquisitions of land may impose maintenance costs on the state or increase the state's liability in hazardous areas.

Beverage Container Recycling Program. Any changes to this program should be guided by a commitment to the program's central objective—encouraging the voluntary recycling of beverage containers. Four issues in particular warrant the Legislature's consideration:

- ***What Should Be Done With the Program's Mounting Reserve?*** We recommend this reserve be used in ways that would raise recycling rates. By raising the redemption value payout on returned (recycled) containers, recycling rates should improve.

- ***What Fees Should Manufacturers Pay?*** We recommend that the cost of recycling beverage containers be borne by beverage manufacturers, consistent with the "polluter pay" principal. Offsetting these fees as is currently being done, dilutes the market signal the fee is designed to communicate to manufacturers.

- ***Should Certain Recyclers Receive Special Subsidies?*** We believe that special subsidies currently going to "convenience zone" recyclers do not further the goals of the program. Accordingly, we recommend that these subsidies be discontinued.

- ***Should Curbside Recycling Programs Receive Grant Funds?*** We recommend that modest grants be provided to encourage the expansion or establishment of new curbside programs.

EMPLOYEE COMPENSATION

Most state employees (other than those in higher education) last received a general pay increase (3 percent) on January 1, 1995. Figure 11 shows a history of general salary increases for state civil service employees and the consumer price indices for the United States and California since 1981-82.

In the current year, employees in four of the 21 bargaining units received general salary increases ranging from 3 percent to 10 percent. In addition, employees not represented by a bargaining unit received a 3 percent salary increase.

Figure 11

State General Salary Increases

1981-82 Through 1999-00

Fiscal Year	State General Salary Increase	Consumer Price Index	
		United States	California
1981-82	6.5%	8.8%	10.7%
1982-83	—	4.2	2.3
1983-84	6.0	3.7	3.6
1984-85	8.0	3.9	4.9
1985-86	6.0	2.9	4.0
1986-87	6.0	2.2	3.3
1987-88	3.8	4.1	4.2
1988-89	6.0	4.6	4.8
1989-90	4.0	4.8	5.0
1990-91	5.0	5.5	5.3
1991-92	—	3.2	3.6
1992-93	—	3.1	3.2
1993-94	5.0	2.6	1.8
1994-95	3.0	2.9	1.7
1995-96	—	2.7	1.4
1996-97	—	2.9	2.3
1997-98	—	1.8	2.0
1998-99[a]	—[b]	2.0	2.1
1999-00[a]	—[c]	2.6	2.8

[a] Department of Finance estimate of consumer price indices.

[b] Appropriated funds provided general salary increases of 3 percent to 10 percent for about 32,000 employees in 4 of the 21 bargaining units and a 3 percent salary increase for nonrepresented employees.

[c] Governor's budget proposal is equivalent to about a 2 percent general salary increase for all employees.

Proposal

State Civil Service Employees. The Governor's budget includes a total of $358 million ($164 million General Fund and $97 million each from special funds and nongovernmental cost funds) to provide increased compensation to state employees other than employees in higher education. The $358 million consists of (1) $168 million ($64 million General Fund) for the annual cost of any increases in employee compensation that are approved in the current year for employees currently in collective bargaining negotiations and (2) $190 million ($100 million General Fund) for employee compensation changes that may be agreed to through collective bargaining and become effective in the budget year. Actual salary increases provided to employees by these funds are dependent on the terms of negotiated agreements. As an example, however, the $168 million amount could cover the annual cost of an average pay increase of 3 percent for those currently in collective bargaining. The $190 million that would be available for changes in the budget year could provide an additional salary increase of 2 percent for all employees.

Employees in Higher Education. The University of California (UC) budget request sent to the Governor included a total of $97 million for employee compensation to provide salary and benefit increases to faculty and staff. Similarly, the California State University (CSU) requested $103 million for salary and benefit increases to faculty and staff. The Governor's budget, however, includes less total funding support for UC and CSU than requested and indicates that UC and CSU will develop specific budget plans in the spring to allocate the proposed funds (including monies for employee compensation). Consequently, the amount in the budget for employee compensation is unknown at this time.

Issues for Legislative Consideration

Current Status of Negotiations. The Department of Personnel Administration (DPA) began negotiations in 1995 with the 21 bargaining units representing rank-and-file state employees (other than higher education) for new memoranda of understanding (MOUs) governing compensation and other terms and conditions of employment. These MOUs were to replace those that expired June 30, 1995. (Under current law, the provisions of expired MOUs generally remain in effect pending adoption of replacement MOUs.)

In 1998, DPA reached agreement with four of the 21 units and the Legislature approved these MOUs—California Correctional Peace Officers Association; California Department of Forestry Firefighters; Physicians, Dentists, and Podiatrists; and Health and Social Services/Professional. These MOUs are in effect until June 30, 1999. In addition, DPA has reached a tentative agreement with the California Highway Patrol, but at the time this analysis was written the Legislature had not approved the MOU. This MOU, if approved, would also be in effect until June 30, 1999.

The Governor has indicated his desire to reach an early agreement with the remaining 16 bargaining units in the current year and also to reach agreement with all units for MOUs that would be effective after June 30, 1999. If this occurs, the Legislature will be presented with a large number of MOUs to consider over the next several months.

Strengthen Legislature's Collective Bargaining Oversight. The Ralph C. Dills Act directs the administration and employee representatives to endeavor to reach agreement before adoption of the budget act for the ensuing year. The act further specifies that provisions of MOUs requiring the expenditure of state funds be approved by the Legislature in the annual budget act before the provisions may take effect. Historically, however, agreements often have not been reached in time for legislative consideration as part of the budget process. Instead, the Legislature has received MOUs for approval late in the session. In addition, assessments of the total cost of the MOUs have not always been available or complete for consideration with the proposals.

To ensure that the Legislature has the opportunity to appropriately review any proposed MOUs, we recommend that the Legislature (1) require a minimum 30-day review period between the submittal of proposed MOUs to the Legislature and hearings on the proposals to ensure that their fiscal and policy implications are fully understood and (2) review the administration's MOU proposals at budget hearings and adopt them in the annual budget act (or as amendments to the act if they are not available for review during budget hearings). This is consistent with our recommendation in past *Analyses* and with supplemental report language adopted by the Legislature with the *1996-97 Budget Act*.