THE 2001-02 BUDGET: PERSPECTIVES AND ISSUES

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

California Legislature

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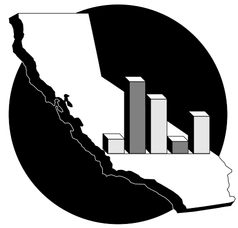


INTRODUCTION

The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the *2001-02 Budget Bill* and in other legislation. It seeks to accomplish this by (1) providing perspectives on the state's fiscal condition and the budget proposed by the Governor for 2001-02 and (2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement the *Analysis of the 2001-02 Budget Bill*, which contains our review of the *2001-02 Governor's Budget*.

The *Analysis* continues to report the results of our detailed examination of state programs and activities. In contrast, this document presents a broader fiscal overview and discusses significant fiscal and policy issues which either cut across program or agency lines, or do not necessarily fall under the jurisdiction of a single fiscal subcommittee of the Legislature.

The 2001-02 Budget: Perspectives and Issues is divided into five parts:

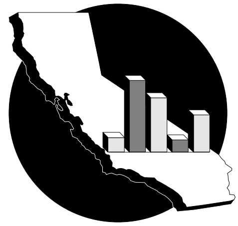
- Part I, "State Fiscal Picture," provides an overall perspective on the fiscal situation currently facing the Legislature.
- Part II, "Perspectives on the Economy and Demographics," describes the current outlook for the economy and the administration's and our forecasts.
- Part III, "Perspectives on State Revenues," provides a review of the revenue projections in the budget and our own assessment of revenues through 2002-03.

- Part IV, "Perspectives on State Expenditures," provides an overview of the state spending plan for 2001-02 and evaluates the major expenditure proposals in the budget.
- Part V, "Major Issues Facing the Legislature," provides analyses of: (1) the 1991 realignment of health and social service programs between the state and local governments, (2) what high schools and colleges are doing to identify and assist college-bound students who are not yet prepared for college-level work, and (3) e-government services provided by the state.

I

State Fiscal Picture

State Fiscal Picture



This year, the Legislature and Governor face the dual challenge of both (1) crafting a budget that addresses the programmatic needs of California citizens and (2) developing strategies for dealing with the state's ongoing electricity crisis. These tasks are especially challenging given that the state's economic and fiscal environment is increasingly uncertain. As discussed in the "Legislative Considerations" section below, decisions made with regard to addressing the state's electricity issues—including the amount of General Fund resources that should be used for this purpose—could have a significant impact on the amount of resources available for other budget priorities and proposals this year. They also could necessitate significant revisions to the Governor's budget proposal between now and its final enactment.

In this part we discuss the Governor's 2001-02 budget proposal and provide our own perspective on the budget outlook. We then discuss key decisions that the Legislature will face as it juggles addressing both the electricity crisis and its other priorities.

OVERVIEW OF THE GOVERNOR'S BUDGET

The *2001-02 Governor's Budget* proposes total state spending of $102 billion (excluding expenditures of federal funds and selected bond funds). This represents an increase of $7.5 billion, or 7.9 percent, over the current year. Slightly over 80 percent of this total spending is from the General Fund, while the remainder is from special funds. As discussed below, the main focus of the Governor's budgetary initiatives involves education and energy.

As shown in Figure 1, the budget projects that General Fund revenues will total $79.4 billion in 2001-02, an increase over the current year of $2.5 billion (3.3 percent). By comparison, budget-year General Fund expenditures are estimated at $82.9 billion, an increase of $3.1 billion (3.9 percent) over 2000-01. After accounting for set-asides for litigation and encumbrances, the Governor's estimated 2001-02 year-end General Fund budgetary reserve is $1.9 billion, or about 2.4 percent of expenditures.

Figure 1

Governor's Budget General Fund Condition

1999-00 Through 2001-02
(Dollars in Millions)

			2001-02	
	1999-00	2000-01	Amount	Percent Change
Prior-year fund balance	$3,930	$9,367	$6,557	
Revenues and transfers	71,931	76,899	79,434	3.3%
Total resources available	$75,861	$86,266	$85,991	
Expenditures	$66,494	$79,708	$82,853	3.9%
Ending fund balance	$9,367	$6,557	$3,139	
Encumbrances	$701	$701	$701	
Set-aside for legal contingencies	—	7	500	
Reserve	**$8,666**	**$5,849**	**$1,937**	

Detail may not total due to rounding.

How the Budget Allocates Uncommitted Resources

The budget allocates approximately $8 billion in resources not committed for current-law requirements in 2001-02. Figure 2 shows that about $5.5 billion of this total is for new spending initiatives, $0.1 billion is for tax relief, $1.9 billion is for the reserve, and $0.5 billion is set aside for litigation. Of these uncommitted resources, about 70 percent ($5.7 billion) of the total is for one-time uses (including funding reserves), while the remaining 30 percent ($2.3 billion) is for ongoing uses.

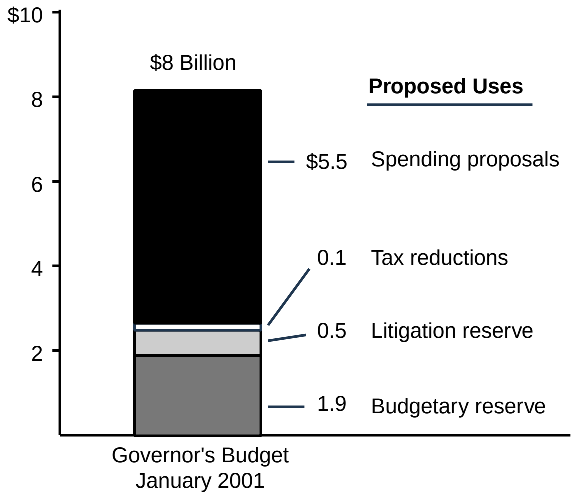
Total Spending by Program Area

Figure 3 shows the proposed distribution of General Fund spending in 2001-02 by major program area. Nearly 52 percent of the total involves education, including about 39 percent for K-12 and 13 percent for higher education. About 26 percent is for programs relating to health and social

Figure 2

The Budget's Proposed Use of Uncommitted Funds[a]

(In Billions)

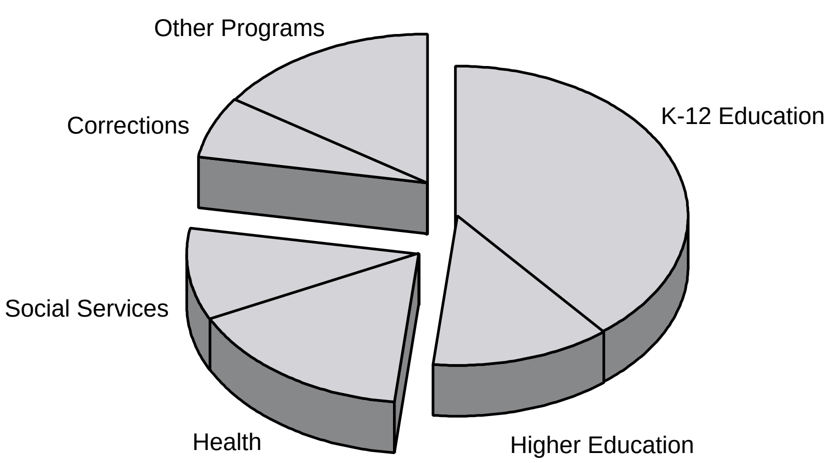


[a] Resources in excess of current-law requirements.

Figure 3

How General Fund Spending Is Distributed

2001-02



services, including Medi-Cal, the Supplemental Security Income/State Supplementary Program (SSI/SSP), and the California Work Opportunity and Responsibility to Kids (CalWORKs) program. Another 7 percent is for corrections, and the remaining 15 percent covers general government, local tax relief, and other programs.

Figure 4 details the budget's proposed General Fund spending levels by major program areas for 1999-00 through 2001-02. It shows that:

- All segments of education receive substantial funding increases.
- Medi-Cal shows a small decline in the budget year, which is due to various funding redirections. Without these shifts, Medi-Cal's General Fund spending would show an increase of 6.7 percent over its 2000-01 amount.
- The budget also proposes roughly 10 percent increases for both the CalWORKs program and SSI/SSP. Most of the budget-year's percentage growth in CalWORKs is due to one-time savings in the

Figure 4

General Fund Spending by Major Program Area

(Dollars in Millions)

			Proposed 2001-02	
	Actual 1999-00	Estimated 2000-01	Amount	Percent Change
Education Programs				
K-12—Proposition 98	$25,270	$27,270	$29,471	8.1%
Community Colleges—Proposition 98	2,390	2,654	2,877	8.4
UC/CSU	4,891	5,826	6,397	9.8
Other	3,058	3,956	4,137	4.6
Health and Social Services Programs[a]				
Medi-Cal	$8,065	$9,458	$9,325	-1.4%
CalWORKs	1,991	1,935	2,128	10.0
SSI/SSP	2,501	2,626	2,870	9.3
Other	5,193	6,849	7,866	14.8
Youth and Adult Corrections	$4,748	$5,181	$5,389	4.0%
All Others[b]	$8,780	$14,659	$13,144	-10.3%
Totals	**$66,494**	**$79,708**	**$82,853**	**3.9%**

[a] The 2001-02 decline in Medi-Cal and increase in the "Other" category is due to a technical shift of $600 million to the Department of Developmental Services and the replacement of $170 million of General Fund spending with tobacco settlement funds.

[b] The 2001-02 decline is primarily due to the magnitude of one-time spending in 2000-01.

current year related to the use of federal funds. The increase in SSI/SSP reflects caseload growth and a cost-of-living-adjustment (COLA).

- Youth and Adult Corrections is growing by a proposed 4 percent in the budget year, while "all other" programs are showing a collective decline of 10.3 percent. The latter decline is primarily due to the fact that one-time spending in the current year (approximately $5.8 billion) is even greater than that proposed for the budget year ($3.3 billion).

MAIN FEATURES OF THE GOVERNOR'S PROPOSAL

The Governor's proposed budget continues major themes of the past two years. It includes significant increases in ongoing funding for K-12 and higher education, a large amount of one-time commitments, and set-asides for a budgetary reserve and litigation contingencies. In other areas, it generally covers caseload and cost-of-living increases, but includes relatively few new ongoing initiatives. Figure 5 summarizes these key features.

Figure 5

Key Features of the 2001-02 Governor's Budgetary Proposal

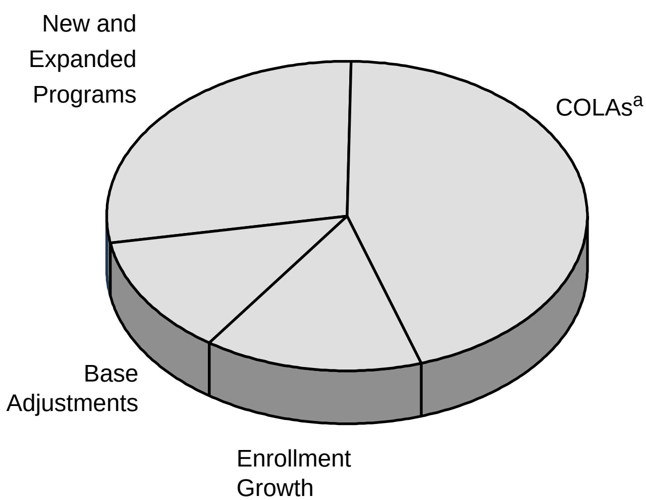
- ☑ ***K-12 Education.*** Substantial funding increases to cover a variety of initiatives, including teacher training and 30 days of additional instruction in middle schools.
- ☑ ***Higher Education.*** Substantial funding increases for the University of California and the California State University to support a 5 percent general increase plus enrollment growth. Community college funding increases to support increased part-time faculty salary increases.
- ☑ ***Energy Set-Aside.*** Includes $1 billion set aside for various energy-related programs, focusing on electricity.
- ☑ ***Health Programs.*** Expansion of health care coverage to parents of children in the Healthy Families Program.
- ☑ ***Tax Relief.*** Includes $108 million in targeted tax relief, including an increase in the manufacturers' investment tax credit and a three-day sales tax holiday.
- ☑ ***One-Time Expenditures.*** In addition to the electricity set-aside, contains one-time funds for capital outlay, housing, local fiscal relief, and resources.

K-12 Education

Proposition 98 allocations (which include local property tax revenues) to K-12 schools total $41.3 billion in 2001-02. This represents an increase of over $3.2 billion, or 8.3 percent, above the current-year estimate. Per-pupil spending under Proposition 98 increases by $479, or 7.1 percent, to $7,174 per pupil. The budget proposes Proposition 98 spending that exceeds the estimated minimum funding guarantee by $1.9 billion. Figure 6 displays the major proposed uses of the additional $3.2 billion of Proposition 98 funds.

Figure 6

Proposed Uses of New K-12 Proposition 98 Funds



[a]Cost-of-living adjustments.

The largest share of the new monies—$1.4 billion (45 percent)—would provide a 3.91 percent COLA for district and county office apportionments (revenue limits) and categorical programs. General purpose and categorical program funding for the projected 1.08 percent growth in the student population accounts for $463 million, or 15 percent, of new Proposition 98 funds. Providing full-year funding for programs that began in the current year and other net adjustments account for almost $400 million, or 13 percent of new funding.

The budget allocates the remaining funds (almost $900 million) for (1) a variety of new and expanded categorical spending programs over which school districts would have minimal discretion in most instances (over $750 million), and (2) a proposed settlement of school district claims for mandated special education costs ($125 million). (In addition, the budget provides $270 million of one-time funds—attributed to 1999-00—for this proposed settlement.) The largest of these programs in the budget year is a $335 million augmentation to provide intensive training to teachers in recently adopted academic content standards for mathematics and English language arts. The largest new program in terms of annual costs beyond the budget year is the Governor's proposal to add 30-instructional days to the academic year at middle schools. The budget provides $100 million for this purpose in 2001-02. The administration intends that the program reach virtually all middle schools in the state by 2003-04, at an estimated cost to the state potentially exceeding $1 billion annually.

Higher Education

Community Colleges. The budget proposes an 8.3 percent increase in California Community Colleges Proposition 98 funding (the General Fund portion of this share increases by 8.4 percent). This increase includes money for a 3.9 percent COLA and 3 percent enrollment growth. The budget also proposes new funds to assist districts in making part-time faculty salaries more comparable to full-time salaries, and for helping students obtain CalGrants.

The University of California (UC) and the California State University (CSU). The budget proposal includes increases in General Fund spending of 11 percent for UC and 7.8 percent for CSU in the budget year. The new funds support a 5 percent general increase in each budget, in addition to 3 percent enrollment growth for CSU and 3.5 percent enrollment growth for UC. The UC budget includes $308 million in General Fund spending for capital outlay projects. Funding is also included for summer sessions, research, and student outreach and retention.

Energy Set-Aside

The budget also includes a $1 billion set-aside for energy-related initiatives, relating to the current electricity crisis facing the state. The funds would be available for programs directed at energy conservation and to increase energy supplies. The administration indicates that specific proposals will be developed in consultation with the Legislature. As discussed in the accompanying shaded box (see next page), energy purchases by the state authorized by (1) the Governor's emergency proclamation; (2) Chapter 4x, Statutes of 2001 (AB 1x, Keeley); and (3) Chapter 3x, Statutes of 2001 (SB 7x, Burton) will be reimbursed from revenue bond proceeds. Thus, they will not affect the General Fund resources available for the energy set-asides.

State Electricity Purchases

Background. On February 1, the Governor signed Chapter 4x, Statutes of 2001 (AB 1x, Keeley), which authorizes the state Department of Water Resources (DWR) to enter into contracts to purchase electricity for resale to utility customers in California. With this measure, the state government is now a key purchaser of electricity for customers of California's private investor-owned utilities. Assembly Bill 1x also authorizes the state to issue revenue bonds to help finance the power purchases, and authorizes the California Public Utilities Commission (CPUC) to set rates which are adequate to cover DWR's power purchasing costs and debt repayments. Although the amount of debt authorized is based on a formula which will be calculated by the CPUC, the administration has indicated that it will likely be in the range of $10 billion.

The measure also appropriates $500 million from the General Fund to cover the initial costs of purchasing electricity, and authorizes the state to incur additional deficiencies for this purpose. As of mid-February, the state had used up the $500 million AB 1x appropriation, and had submitted a $500 million deficiency to finance additional power purchases. When combined with $600 million previously authorized by (1) Chapter 3x, Statutes of 2001 (SB 7x, Burton) and (2) the Governor's January 17 emergency proclamation, the state has thus far committed $1.6 billion for electricity purchases.

Large Electricity Purchases Are Scheduled. Between now (mid-February) and when the first bond sales occur (currently estimated to be in early May), the General Fund will incur large additional electricity purchase costs—potentially exceeding $2 billion. These large outlays will occur for two reasons. First, there is a 75-day electricity billing cycle, meaning that the General Fund will not receive the first reimbursements for DWR's purchases until mid-April. Second, even after the reimbursements begin, the customers' regulated rate for wholesale purchases (about 7¢/kwh) is well below current-wholesale costs (over 25¢/kwh). The state is currently negotiating fixed-price contracts in an attempt to bring DWR's future procurement costs down. Given current market conditions, however, these costs will likely remain well above current-regulated customer rates during 2001.

Current General Fund Appropriations to Be Fully Reimbursed. Under the terms of AB 1x, *all* General Fund outlays for electricity purchases including interest costs made since the Governor's January 17 emergency proclamation order will be reimbursed from the bond proceeds—including both the $1.6 billion in commitments made through mid-February and the additional deficiencies that are incurred between mid-February and May. Thus, while current electricity purchases will have a temporary adverse effect on the General Fund's cash position, *they will not affect the General Fund's budget condition*. Under existing law, all electricity purchases currently authorized will be borne by California's utility customers through their future rate payments.

Future Fiscal Pressures Could Emerge. While in the near term the bond proceeds will be used to cushion ratepayers from the full magnitude of high electricity costs, these funds are not inexhaustible. At some point, customer rates will need to be raised to cover DWR's purchasing requirements or another funding source will need to be found.

One-Time Spending

As shown in Figure 7, the budget is proposing about $3.3 billion in new one-time programmatic spending in 2001-02 (this one-time amount excludes the $2.4 billion noted earlier that is allocated to reserves). This includes the $1 billion set-aside for various energy initiatives and $772 million in direct appropriations for capital outlay. The budget also includes significant one-time funds for local fiscal relief, new housing initiatives, and various environmental and resources-related purposes.

Figure 7

Key One-Time Commitments Proposed in the 2001-02 Budget

(In Millions)

Purpose	Amount
Energy initiatives set-aside	$1,000
Capital outlay	772
Local government fiscal relief	250
New housing initiatives	220
Diesel replacement	100
Clean beaches	100
Law enforcement technology grants	75
Flood control subventions	74
River parkway initiative	70
Prison electromechanical doors	58
Zero-emission vehicle subsidies	50
Touch screen voting pilot project	40
Other	505
Total	**$3,314**

The Budget's Economic and Revenue Outlook

The budget's economic forecast assumes that after a very strong year in 2000, the California economy will slow in line with the national economy during 2001. Accordingly, strong current-year revenue performance will be followed by more-modest gains in 2001-02. Specifically, the budget forecasts that:

- In the *current year*, General Fund revenues will increase by $5 billion (6.9 percent), reflecting strong collections attributable to 2000 economic activity and an assumed 30 percent increase in combined capital gains and stock options reported on personal income tax returns.

- In the *budget year*, revenue growth will subside to $2.5 billion (3.3 percent), reflecting the anticipated slower growth in economic activity and a 10 percent decline in capital gains and stock options-related income in 2001.

THE LAO'S OUTLOOK FOR THE BUDGET

This section provides our own perspective on the General Fund outlook for 2000-01 and 2001-02, based on the LAO's economic and revenue forecasts which are described in "Part II" and "Part III" of this volume. We have also developed a forecast for 2002-03 to provide the Legislature with an indication of the longer-term implications of the Governor's mix of one-time and ongoing budgetary proposals. For purposes of these estimates, we assume that the General Fund's costs associated with the energy crisis are limited to those identified in the budget, which mainly consist of the $1 billion set-aside. The purpose of our projections is to provide the Legislature with our independent estimate of the fiscal implications of the Governor's budgetary plan.

Our General Fund outlook for 2000-01 through 2002-03 is shown in Figure 8, while our key outlook-related findings are summarized in Figure 9.

Figure 8

The LAO's General Fund Condition Assuming Governor's Policy Proposals

2000-01 Through 2002-03 (In Millions)

	2000-01	2001-02	2002-03
Prior-year fund balance	$9,367	$7,373	$3,179
Revenues and transfers	77,609	78,960	85,612
Total resources available	$86,976	$86,333	$88,791
Expenditures[a]	$79,603	$83,153	$85,968
Ending fund balance	$7,373	$3,179	$2,823
Encumbrances	$701	$701	$701
Set-aside for litigation	7	500	—
Reserve	**$6,664**	**$1,978**	**$2,122**

[a] Assumes the LAO's estimates of caseload and costs.

Our "Bottom Line"

In contrast to the past two years, our current General Fund fiscal outlook is generally similar to the administration's. As shown in Figure 8, we forecast that 2001-02 will end with a reserve of $2 billion, or slightly more than the $1.9 billion included in the budget. (If the Governor's set-aside for litigation is included in the reserve, the corresponding figures are $2.5 billion versus $2.4 billion, respectively.) The small difference in our reserve estimates reflects our slightly higher estimate of two-year revenues, partly offset by the two-year additional costs we have identified on the expenditure side of the budget.

Figure 9

Key LAO Budget Outlook Findings

☑ **LAO "Bottom Line"—Budgetary Condition Is Similar to Administration's**

- We forecast slightly higher two-year revenues due to recent positive cash developments.
- We also see higher two-year expenditures, largely due to state employee-related and Medi-Cal costs.

☑ **But Outlook Is Clouded by an Uncertain Economic Environment**

- California's economy was healthy through end of 2000 and current revenue trend is above budget forecast.
- However, the state faces significant challenges in 2001.
- Clearer picture of outlook will emerge by the May Revision.

☑ **Important to Coordinate Energy Issues With Budgetary Decisions**

- Depending on the types of energy activities considered, General Fund fiscal exposure could easily surpass the amount set aside in the budget.
- Thus, important to establish priorities between energy and other budget commitments.

Key Assumptions

Economy to Slow in 2001. Although California's economy escaped the national economic slowdown that occurred in the second half of 2000, we believe that economic growth in the state will taper off in 2001. In particular, the state's high-tech sector, which has been a key engine driving our economic growth, will be negatively affected by slowing U.S.

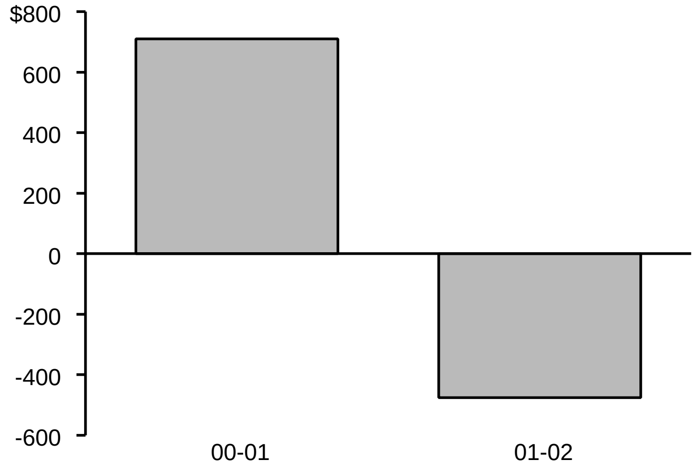
business and personal spending on computers, electronics, and software. Another factor contributing to slower state growth is high costs for gasoline, natural gas, electricity, and rents—all of which are limiting the amount of disposable income available for other purchases. Our forecast assumes that electricity prices will rise significantly this year but that major supply disruptions are kept to a minimum.

Revenue Picture Mixed. The state's revenue picture is being affected by strong opposing forces. The current revenue trend is moderately *above* the budget forecast. However, the projected economic slowdown, coupled with the major decline in stock share prices for California's high-tech firms, is likely to have a pronounced adverse effect on budget-year revenue receipts. Taking into account these opposing factors, our revenue forecast is *up* from the budget projection by $710 million in the current year but *down* from the budget forecast by about $475 million in the budget year—for a net two-year gain of $235 million (see Figure 10).

Figure 10

LAO Revenues Up in Current Year, Down in Budget Year

Difference Between LAO and DOF Revenue Forecasts (In Millions)



Expenditures to Exceed Budget Estimate. We project that General Fund expenditures will exceed the budget by about $195 million in the current and budget years combined. The net increase is due to our inclusion of funds for employee compensation and Medi-Cal rate increases that were not recognized in the Governor's January proposal, partly offset by lower estimates of Department of Corrections inmate population and debt-service costs.

The Outlook Beyond the Budget Year

Assuming that the economic slowdown is confined to 2001, we believe that the Governor's budgetary proposal would remain in balance through 2002-03. As discussed in "Part III," our projections are that the economic rebound in 2002 will boost revenues by over 8 percent in 2002-03. Expenditures will grow by about 3.4 percent during that year. The year would end with a reserve of slightly more than $2 billion.

Budget Faces Large Challenges and Uncertainties

Our budget outlook represents our best assessment of what the net impact will be of the conflicting forces influencing the state's economy and revenues at this time—namely, the *current strength* in revenue-related data, contrasted with the potential *future weakness* related to a softening national economy, lower stock market valuations, higher energy prices, and uncertainties about electricity supplies this summer. Depending on how these factors evolve, the revenue outlook could either improve or worsen between now and the May Revision. At this point, however, we believe that the downside risks are particularly significant.

LEGISLATIVE CONSIDERATIONS

The Legislature will be developing a budget amidst one of the most unusual and challenging set of circumstances in recent history. With the passage of AB 1x, the Governor and Legislature have taken a first step toward stabilizing the state's electricity markets. However, the Legislature now faces a number of major decisions relating to the state's longer-term role in the electricity markets.

One of the basic questions it faces involves the extent to which General Fund resources will be committed for such purposes as utility ratepayer relief, incentives for conservation, and increasing energy supplies. Given the enormous size of California's economy and energy markets, and depending on the types of activities considered, General Fund fiscal exposure could easily surpass the one-time amount set aside in the budget for energy initiatives.

Thus, in addition to the fundamental choices it faces regarding the direction of future energy policy, the Legislature will need to decide—early on—the extent to which it intends to use General Fund resources to achieve its goals in the energy area. If significant General Fund resources are to be committed to the energy crisis, it will be extremely important that this be taken into account as the 2001-02 budget is crafted. In this regard, we recommend that the Legislature withhold consideration of $2.3 billion of the Governor's one-time proposals in the areas outside of energy until May, when the nature and costs of energy-related legislation are better known and the revenue outlook becomes clearer.

II

Perspectives on the Economy and Demographics

Perspectives on the Economy and Demographics

Economic and demographic trends in 2001 and 2002 will have important effects on California's 2001-02 budget outlook. For example, the strength of California's economy is an important determinant of the level of revenues collected from personal income taxes, sales and use taxes, and corporate income taxes. Similarly, both economic and demographic variables affect state government expenditure programs, including those relating to education, health and social services, and youth and adult corrections.

In this part, we review recent economic developments for the nation and state, discuss the Governor's economic forecast, and present our own perspective on California's economic outlook. We also discuss current demographic developments and highlight our population projections through 2003.

THE ECONOMIC OUTLOOK

Our "Bottom Line**."** Although California's long-term economic outlook remains positive, the state faces major near-term challenges associated with the current weakening in U.S. growth, a high-tech cyclical downturn, and rising costs in certain key areas in the economy.

In addition, although the state is making progress toward reaching a near-term resolution to its power crisis, the electricity market will remain under considerable pressure. This summer, for example, the adequacy of electricity supplies is uncertain and will depend on such factors as temperatures in the U.S. western region, the availability of hydroelectric power, and the success of conservation efforts.

Our forecast assumes that California's economy will slow in line with the nation's in 2001, before rebounding in 2002. However, given the challenges facing the state, the risk of a steeper slowdown than we foresee is significant, and thus must be kept in mind by state policymakers as they craft the final 2001-02 budget.

Recent Developments

U.S. Economy Has Slowed Abruptly

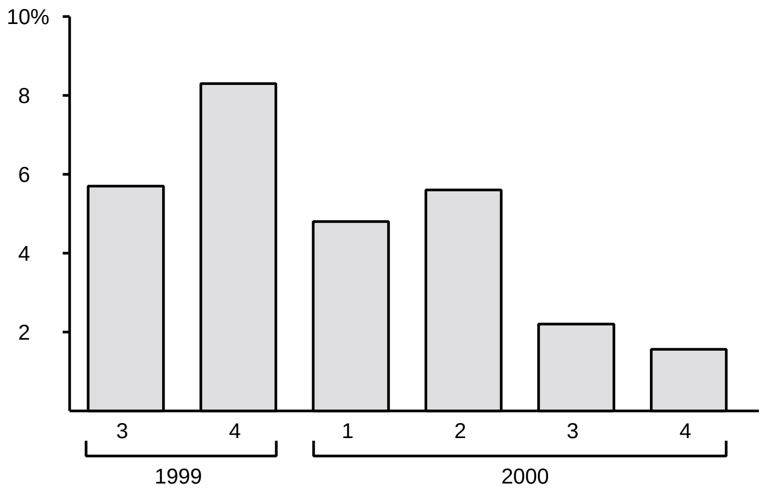
After experiencing nearly ten years of sustained economic growth, the U.S. economy decelerated sharply beginning in mid-2000. As shown in Figure 1, growth in real gross domestic product (GDP) slowed from over 5 percent in the first half of 2000 to 1.4 percent by the fourth quarter of the year.

Recent evidence of softening U.S. economic activity is pervasive and includes weak Christmas sales, falling manufacturing output, extremely sluggish employment growth, and weaker-than-expected company prof-

Figure 1

U.S. Economy Has Slowed Sharply

Percent Change in Real GDP, by Quarter
Seasonally Adjusted Annual Rates



its. One of the key factors in the weak fourth-quarter GDP report was a significant decline in business investment spending on computers and software. The decline was in dramatic contrast to the major increases that had been occurring throughout this expansion. The University of Michigan's survey of consumer confidence was down sharply in both December and January—the largest two-month drop for that survey since the beginning of the last recession in September 1990. The U.S. index of leading economic indicators fell by 0.4 percent in both October and November, and by another 0.6 percent in December, indicating that slow growth lies ahead.

What Happened?

Although most forecasters had anticipated that the U.S. economy would moderate beginning in mid-2000, the abrupt nature of the actual slowdown caught virtually all observers—including the Federal Reserve—by surprise. As recently as November, the "consensus" outlook was for continued healthy, though somewhat tapering, economic growth through 2001, and the main risk to the outlook was that growth was not easing *enough* to curtail inflationary pressures that had been building up in recent years.

The abrupt slowdown appears to be due to the combined effects of several factors. Chief among these are: (1) the constraining effects of prior interest rate increases by the Federal Reserve on auto sales, real estate markets, and other interest-sensitive sectors of the economy; (2) the adverse effects of the sharp drop in stock market values on household wealth and consumer spending; and (3) weakening profits, which have caused many businesses to postpone plans for business expansions. Of considerable importance to California and its high-tech industries is the fact that much of the capital spending slowdown is centered in information technology (IT), where California accounts for over 20 percent of total national output.

In response to the recent economic slowdown, the Federal Reserve took the unusual step in early January of cutting interest rates by a full 0.5 percent, and by a further 0.5 percent at the end of the month. In addition, the new administration has introduced a federal personal income tax reduction proposal, partly in an effort to stimulate U.S. economic growth.

While the interest rate cuts appear to have stabilized the U.S. equity markets, there is normally a 6-month to 12-month time lag between changes in monetary policy and corresponding changes in the economy's "real" spending and output levels. Similarly, any tax reductions are unlikely to significantly stimulate household spending until later this year—at the earliest. Thus, any positive impacts on the nation's economy of stimulative federal monetary and fiscal policies are unlikely to be seen until the second half of 2001 or later.

California Escaped a Slowdown in 2000

The national slowdown that began in mid-2000 did not materially affect California. The state's job growth, personal income tax withholding, and retail sales all remained healthy through December (see Figure 2). As a result, 2000 was the strongest year of California's current economic expansion, with total personal income and taxable sales increasing by about 11 percent, and employment up by more than 3.5 percent. Reflecting strong economy-wide job growth, the state's unemployment rate had fallen to 4.8 percent by year-end, with the rates in several Bay Area counties hovering around 1.5 percent—an all-time low.

Figure 2

California's Current Economic Situation

✓ **Economy Entered 2001 With Considerable Momentum**

- Job growth, income tax withholding receipts, and retail sales all were healthy through December.
- The state's unemployment rate was near all-time lows.

✓ **But Major Challenges Lie Ahead**

- Slowing U.S. spending in areas that affect California, particularly on high-tech products.
- Recent declines in stock market-related wealth.
- Energy crisis involving the cost and reliability of electricity.
- High costs in other areas, including natural gas, rents, and gasoline.

However, 2001 Will Be a Much Tougher Year

While the state largely escaped the national slowdown in 2000, it faces major challenges as the new year unfolds. In addition to its well-publicized electricity crisis, California is confronted with a sharp slowdown in national spending on computers and other IT goods, a major decline in the stock market values of many of its major technology companies, and sharply rising living costs (which are beginning to limit the amount of discretionary income available to its households).

So far, the signs of a slowdown in the state have been limited to mostly anecdotal information—such as reports of softening rental markets and postponed business expansion plans. However, the multitude of negative forces that has emerged in recent months strongly suggests that slower growth lies ahead.

THE BUDGET'S ECONOMIC OUTLOOK IN BRIEF

The administration interprets recent national developments as signaling a U.S. economic slowdown, but not a recession. As shown in Figure 3, the budget forecasts that real GDP growth will slow from 5.1 percent in 2000 to 3 percent in 2001, before rebounding to 4.3 percent in 2002. While some slowing of consumer and business spending is projected in the first half of the year, the administration expects growth to be revived by a combination of lower interest rates, a slow reversal of recent energy price increases, and further productivity gains during the next 12 months. Slowing economic growth is expected to result in a moderation in inflation, with growth in the Consumer Price Index (CPI) slowing from 3.5 percent in 2000 to 2.5 percent in 2001.

Figure 3

Summary of the Budget's Economic Outlook

		Forecast	
	2000	**2001**	**2002**
United States Forecast			
Percent change in:			
Real GDP	5.2%	3.0%	4.3%
Personal income	6.5	5.5	5.6
Wage and salary jobs	2.1	0.4	1.2
Consumer Price Index	3.4	2.4	2.1
Unemployment rate (%)	4.1	4.5	4.7
Housing starts (000)	1,610	1,600	1,710
California Forecast			
Percent change in:			
Personal income	11.7%	5.7%	6.9%
Wage and salary jobs	3.6	2.8	2.7
Taxable sales	11.3	4.9	6.4
Consumer Price Index	3.7	3.1	2.5
Unemployment rate (%)	4.9	4.8	4.7
New housing permits (000)	147	155	167

Regarding California, the administration projects that its economic expansion will continue but slow to a more moderate rate during the next two years. Personal income growth is forecast to slow from 11.7 percent in 2000 to 5.7 percent in 2001, before rebounding to 6.9 percent in 2002. The slowdown in 2001 includes the effects of a projected 10 percent decline in stock option income during the year. The budget anticipates that easing growth-related pressures on energy and real estate prices will result in a moderation of inflation over the next two years. The budget projects the California CPI will increase by 3.1 percent in 2001 and 2.5 percent in 2002, down from 3.7 percent in 2000.

THE LAO'S ECONOMIC OUTLOOK

Reflecting continued negative developments at both the national and state levels, our forecast calls for a sharper near-term slowdown in both U.S. and California economic growth in 2001 than does the administration. Our national and state economic forecasts through 2003 are summarized in Figure 4.

Figure 4

Summary of the LAO's Economic Outlook

		Forecast		
	2000	**2001**	**2002**	**2003**
United States Forecast				
Percent change in:				
Real GDP	5.0%	2.2%	3.9%	4.5%
Personal income	6.3	4.9	5.4	6.2
Wage and salary jobs	2.1	0.6	1.2	1.9
Consumer Price Index	3.4	2.6	2.2	2.4
Unemployment rate (%)	4.0	4.6	4.9	4.8
Housing starts (000)	1,594	1,560	1,611	1,660
California Forecast				
Percent change in:				
Personal income	11.3%	5.2%	6.3%	6.9%
Wage and salary jobs	3.7	2.2	2.4	2.4
Taxable sales	10.9	4.5	5.8	7.0
Consumer Price Index	3.7	3.6	2.6	2.7
Unemployment rate (%)	4.9	5.4	5.2	5.0
New housing permits (000)	145	144	152	160

National Forecast

We forecast that the slowdown in U.S. economic growth will persist through mid-year, before lower interest rates revive consumer and business spending in late 2001 and into 2002. Overall, we forecast that real GDP growth will slow from 5 percent in 2000 to about 2.2 percent in 2001, before rebounding to 3.9 percent next year.

The weaker growth in 2001 reflects across-the-board slowdowns in U.S. consumer and business spending. As shown in Figure 5, substantial slowdowns are projected for consumer spending on durable goods (including computers and autos), business investment, and residential construction. Of particular significance for California is the slowdown in consumer and business spending on computer and IT-related goods and services.

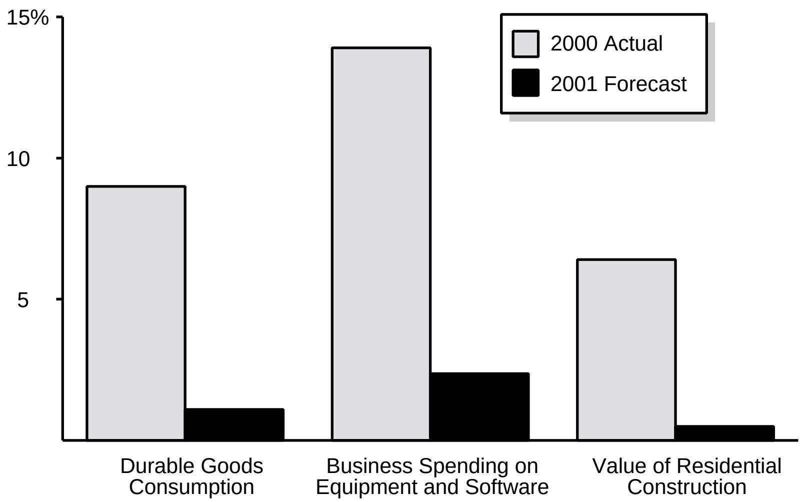
We expect the recent easing in inflation indices to continue in 2001 and 2002, with consumer prices slowing from 3.4 percent in 2000 to about 2.6 percent in 2001 and 2.2 percent in 2002.

Over the longer term, a resumption of strong investment in new technologies and continued high productivity growth will continue to be driving forces behind solid growth in output and incomes in 2002 and beyond.

Figure 5

U.S. Spending to Slow Across Key Sectors

Real Annual Percent Change in Selected GDP Categories



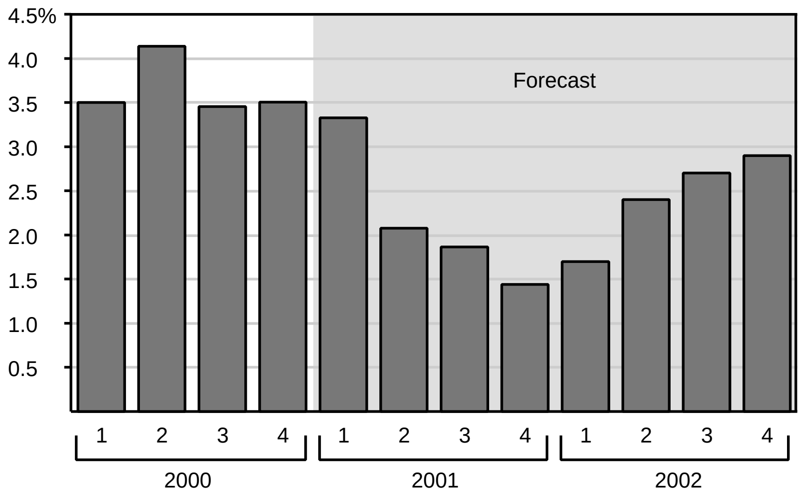
California Forecast

We expect California's economy to slow sharply in the first half of 2001 and remain sluggish in the second half of the year. As indicated in Figure 6, year-over-year wage and salary employment growth—which was near 4 percent in mid-2000—is projected to subside to about 1.5 percent by the fourth quarter of 2001. We also expect corresponding slowdowns in other key measures of economic activity, such as personal income and taxable sales. However, our forecast assumes that an outright recession will be avoided.

Figure 6

Tapering California Job Growth Forecast for 2001

Year-Over-Year Percent Change in Wage and Salary Employment, by Quarter



On an annual average basis, employment growth is expected to slow from 3.7 percent in 2000 to 2.2 percent in 2001, before partially rebounding to 2.4 percent in 2002. Personal income and taxable sales growth rates in 2001 are expected to be less than one-half of 2000's pace, reflecting the impacts of both slowing employment growth and reduced stock option-related income and wealth in the economy.

Power Crisis Is Key "Wild Card" in Outlook

The most pressing challenge currently facing the state relates to its electricity crisis, especially in light of the multiplicity of ways that energy affects the economy and ultimately the state's finances (see shaded box). The combination of sharply rising electricity demands throughout the western region of the nation, lagging investment in new generation capacity, and soaring wholesale market prices has dramatically increased the costs of energy purchased by California's utilities. Under the terms of the state's energy restructuring measure enacted in 1996, two of the state's three privately owned utilities—Pacific Gas and Electric (PG&E) and Southern California Edison—have been prohibited from passing most of their higher wholesale electricity costs forward to their customers. This has required them to absorb huge operating losses and has put them close to financial insolvency.

The Situation as of Early February. On February 1, the Governor signed AB 1x (Keeley), which authorizes the state Department of Water Resources (DWR) to enter into long-term power contracts with electricity suppliers and resell the electricity to consumers in California. In addition, the measure authorizes DWR to issue revenue bonds to cover, in the near term, the difference between its electricity acquisition costs and the amount paid by ratepayers. The measure also permits the California Public Utility Commission (CPUC) to set electricity rates to cover the revenue requirements of DWR's power purchasing program, although current "baseline" rates would be protected.

As this analysis is going to press, the state was negotiating fixed-rate contracts with energy suppliers. The Governor and Legislature were also negotiating an agreement aimed at assisting California's investor-owned utilities in regaining financial stability and the Governor had implemented emergency electricity orders aimed at conserving commercial electricity use.

These are crucial steps toward the resolution of the state's *immediate* electrical crisis. However, given the current supply-demand characteristics of the state's energy market, this summer will be when the greatest challenges will be faced—*even under the best of circumstances*. Such uncertainties as the level of summertime temperatures, the reliability of certain existing generators, the success of conservation efforts, the speed with which new generation capacity is brought on-line, and the availability of hydroelectric power from northern California and the Pacific Northwest, will all have significant impacts on the availability and price of electricity in California during this period.

Outlook Assumes Crisis Will Not Derail Economy. Given recent progress by the administration and Legislature in developing solutions to the crisis, our forecast assumes that the state will make it through this

The Electricity Crisis and the Economy

Few commodities are as basic as electricity to the underlying health and ongoing growth of California's economy. California is a relatively efficient user of energy products, and its per-capita usage of electricity has been relatively low compared to other states. Nonetheless, electricity is required by essentially every element of the state's economy—whether it be its high-tech computer and information technology industries, basic manufacturing activities, banking and financial sector, agricultural industries, or the retail trade sector. Given this, developments affecting the supply and price of electricity are important to the state's economy both in the near term and longer term.

The Situation to Date

Economy Has Been Somewhat Shielded. Thus far, the crisis has primarily affected the state's two largest investor-owned utilities, which have incurred major financial losses from purchasing power at wholesale market prices many times what they are permitted to charge their customers under the terms of the 1996 electricity deregulation law. In contrast, the state's economy at large has been shielded from the majority of the price increases. However, it has been adversely affected by power supply disruptions associated with rotating blackouts and repeated supply curtailments (the latter being for industrial users that had signed interruptible contracts for reduced power rates). Estimates of economic losses to the economy from these price and power disruptions vary, but by some accounts exceed $1 billion. Also, in early January 2001, the California Public Utilities Commission approved temporary rate increases averaging about 10 percent, whose effects have yet to be felt.

Future Problems Are Likely. The Legislature and Governor have already taken important steps to address short-term price and availability issues—including passage of Chapter 4x, Statutes of 2001 (AB 1x, Keeley), which facilitates the purchase of electricity by the state through the use of bonds (see "Part I"). The state is also currently negotiating fixed-price contracts and considering various conservation and energy supply initiatives. Even with these actions, the state faces the likelihood of higher electricity prices in the future and the possibility of further supply disruptions this summer.

Potential Future Impacts

Higher Electricity Prices. As an illustration of potential future price-increase effects of the crisis, consider that the total value of electricity consumed in California during 1999 was about $25 billion, with roughly one-third of that amount attributable to households and roughly two-thirds attributable to businesses, governments, and other entities. On average, spending on electricity accounted for 2 percent to 3 percent of both business production costs and average household budgets.

If the wholesale electricity prices in effect during the past two months were "passed forward" so as to be reflected in utility rates, the total annual California electricity bill would be over $40 billion this year. This increase would represent a $15 billion transfer of wealth from California households, businesses, and government to electricity generators and their suppliers. A transfer of this size would have a significant impact on the amount of discretionary income available for household spending on other goods and services in the economy. It would also depress corporate profits growth, which could in turn lead to higher product prices and potentially fewer business expansions. These effects would vary from industry to industry.

Given the financing mechanism put in place by AB 1x, actual near-term rate increases are likely to be considerably less than what would be necessary to cover current wholesale prices. Long-term contracts should also bring down electricity prices in the near term. Rate increases could reduce statewide economic growth over the next two years—but would likely not, by themselves, derail the economic expansion. Nor would we expect somewhat higher electricity prices to result in a significant exodus of California businesses to other states, partly because of the fact that rising energy prices are currently a problem throughout the western region of the nation.

Electricity Supply Disruptions. In terms of their impacts on the economy, a bigger concern than electricity price increases is the prospect of chronic supply shortfalls. Surveys reveal that the disruptions that have already occurred have had significant impacts on the sales, production, and profits of the businesses affected. Uncertainty about the state's electricity reliability is already a leading concern among businesses and chronic disruptions could materially affect business location decisions and expansion plans over the next year. Thus, a significant risk to the economy from supply problems remains.

summer without substantial electricity-related disruptions to the economy but that consumers and businesses will face higher prices.

Several Other Factors Pressuring State's Economy

In addition to its electricity-related problems, the state's near-term expansion faces challenges in three other key areas:

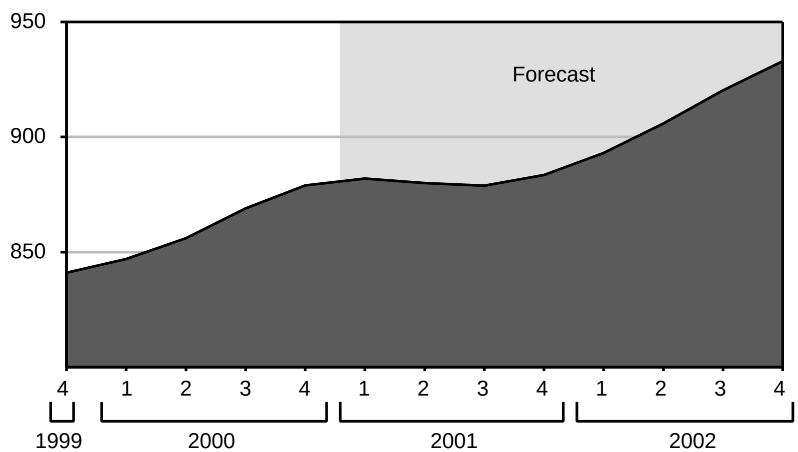
High-Tech Cyclical Slowdown. One of the key engines of the state's expansion has been its high-tech sector. With its high-valued products and its above-average wages, this sector has accounted for a substantial share of the state's overall growth in output and income during recent years. However, as 2001 unfolds, this sector is entering a period of consolidation (see Figure 7). Part of the slowdown it is experiencing is related to slower national investment in IT in 2001, as business spending in these areas pauses following several years of major product upgrades. Similarly, household expenditures on computers has softened in recent months, due in part to the lack of new software innovations that necessitate newer and more powerful computer systems.

Foreign purchases of IT equipment are also expected to slow in 2001, due to weakening economic growth in Japan and some other Asian economies. The large amount of output and income directly and indirectly at-

Figure 7

Nation's High-Tech Slowdown to Adversely Affect California

Jobs in California's High-Tech Industries (In Thousands)



tributed to this sector (over 20 percent of the state's private-sector economic output) means that slower growth in the high-tech sector will have a significant adverse impact on overall growth next year. The slowdown, however, is expected to be short-lived. Business investment in computer systems and software is expected to resume its strong upward trend in 2002, leading to a corresponding rebound in job growth in California's high-tech industries.

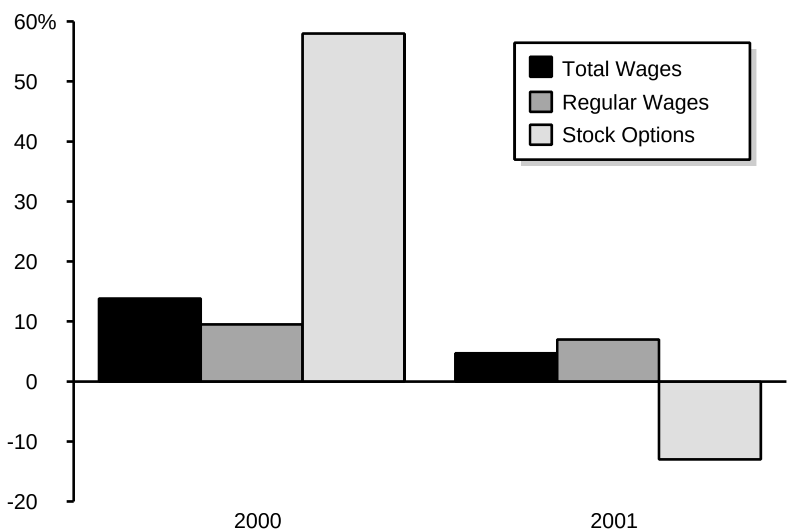
Declines in Wealth. In a related development, the recent decline in stock market values among high-tech firms is partly reversing one of the key factors behind California's economic boom in 2000—the so-called "wealth effect." While some of the declining stock values can be viewed as simply eliminating a "bubble" in share values that occurred between late 1999 and early 2000, there is no question that the stock market slide that began last March and intensified late last year has left many investors and employees with stock options less wealthy than a year ago.

This recent decline in high-tech companies' stock values will also have a material adverse effect on California personal income growth in 2001 through its effect on stock options. As shown in Figure 8, an extraordinary increase in options-related income boosted overall wages by nearly 14 percent in 2000. However, given the recent decline in stock share prices,

Figure 8

Decline in Stock Options to Slow Wage Growth in 2001

Percent Change in Wage Components



we expect option-related income to fall this year—holding overall wage growth to just 4.7 percent in 2001.

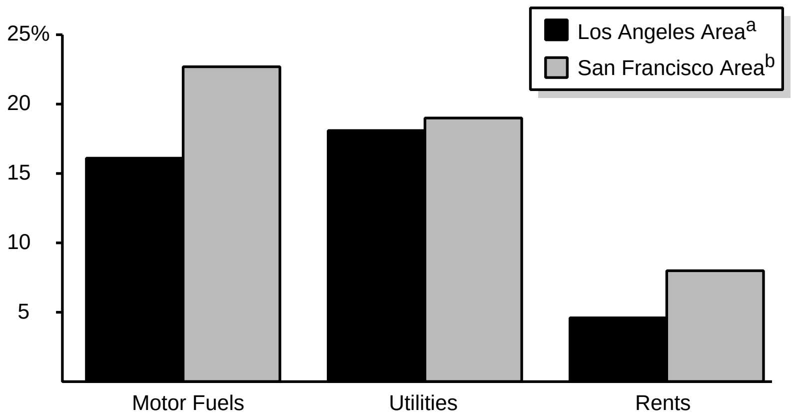
It is important to note that, even with the stock market declines, there is still a large amount of capital gains and stock option income "stored up" that is related to stocks purchased (or options granted) in previous years. Similarly, the huge amount of options-related income realized in 2000 will have residual positive effects on the economy in 2001 and beyond. On balance, however, we expect the reduced 2001 level of stock market-related wealth and income to lead to more restrained personal spending growth this year.

Price Increases. California is facing sharply higher costs in a number of key areas. As shown in Figure 9, consumer prices for motor fuels jumped over the past year by 16 percent in the Los Angeles region and 23 percent in the San Francisco region. Similarly, utility costs are up 18 percent in Los Angeles and 19 percent in San Francisco. (The increases through December are primarily due to higher natural gas prices. Electricity price increases were granted by the PUC in early January for Southern California Edison and PG&E, but these increases are not reflected in the December data.) Likewise, rents in San Francisco jumped by 8 percent, following similar gains in 1998 and 1999.

Figure 9

Californians Facing Substantial Price Increases

Percent Change in Selected CPI Components
December 1999 to December 2000



[a] Los Angeles refers to the Los Angeles/Riverside/Orange County metropolitan area.
[b] San Francisco refers to the San Francisco/Oakland/San Jose metropolitan area.

For high-income households, these various cost increases are relatively minor compared to other factors that can adversely affect their financial positions (such as reduced equity values, changing home values, and adjustments in wages and bonuses). However, the increases are more significant for lower- and moderate-income households, where higher costs are significantly cutting into discretionary incomes, leaving less funds for other spending or for saving.

Construction Activity to Hold Up Reasonably Well

On a positive note, we forecast that residential construction will remain relatively immune from the projected slowdown in overall economic activity in 2001, with total residential building permits holding steady at about 145,000 units this year. Positive factors in the construction outlook are low inventories of unsold homes and low long-term interest rates. In contrast, we expect inflation-adjusted permit valuations for nonresidential construction to fall about 5 percent in 2001, due partly to postponed plans for industrial expansions and slowing demand for retail space. The latter is related to both the projected softening in retail sales in 2001 and the recently announced closures and consolidations of national retail chain stores.

Longer-Term Outlook Remains Positive

Although we have made a significant downward revision to near-term California economic growth since our previous forecast was prepared in November (see below), our longer-term forecast remains positive. As indicated earlier in Figure 4, personal income is projected to increase 6.3 percent in 2002 and 6.9 percent in 2003, reflecting widespread gains in employment and output in each of those years. Our forecast assumes that with added generation capacity in the years to come, the electricity markets will become more stable, and that the state will continue to benefit from the national trends of strong investment in high-tech products and services in subsequent years.

Comparisons of Recent Economic Forecasts

Figure 10 (see next page) compares our forecasts for the nation and California to those we made in November 2000 (see *California's Fiscal Outlook*), as well as those of the University of California, Los Angeles (UCLA) (December 2000); the consensus forecast published in *Blue Chip Economic Indicators* (January 2001); *Western Blue Chip Economic Forecast* (February 2001); and the Governor's budget forecast. With the exception of UCLA, our forecasts for both the nation and California are less optimistic than the other projections shown. Our more restrained outlook stems from further evidence of slowing economic growth and the continued deterioration in consumer and business confidence at both the national and state levels.

Figure 10

Comparisons of Recent Economic Forecasts[a]

(Percent Changes)

		Forecast	
	2000	2001	2002
United States Real GDP:			
LAO November	5.1%	3.2%	4.1%
UCLA December	5.1	1.1	2.2
DOF January	5.2	3.0	4.3
Blue Chip "Consensus"[b] January	5.1	2.7	3.4
LAO February	5.0	2.3	3.9
California Wage and Salary Jobs:			
LAO November	3.7%	3.4%	2.9%
UCLA December	3.6	1.9	1.8
DOF January	3.6	2.8	2.7
Western Blue Chip "Consensus"[c] Febuary	3.5	2.4	2.4
LAO February	3.7	2.2	2.4
California Personal Income:			
LAO November	11.5%	6.6%	6.5%
UCLA December	11.3	6.7	5.4
DOF January	11.7	5.7	6.9
Western Blue Chip "Consensus" Febuary	9.5	6.2	6.3
LAO February	11.3	5.2	6.3
California Taxable Sales:			
LAO November	11.7%	6.7%	6.0%
UCLA December	11.0	5.5	4.3
DOF January	11.3	4.9	6.4
Western Blue Chip "Consensus" Febuary	8.5	5.5	5.6
LAO February	10.9	4.5	5.8

a Acronyms used apply to Legislative Analyst's Office (LAO); University of California, Los Angeles (UCLA); and Department of Finance (DOF).
b Average forecast of about 50 national firms surveyed in January by *Blue Chip Economic Indicators*.
c Average forecast of organizations surveyed in February by *Western Blue Chip Economic Forecasts*.

As discussed in "Part Three," our more restrained near-term economic outlook translates into a somewhat lower revenue forecast for 2001-02 compared to both our November report and the Governor's budget forecast.

CALIFORNIA'S DEMOGRAPHIC OUTLOOK

California's demographic trends both directly and indirectly affect the state's economy, revenue collections, and expenditure levels. For example, they influence the size of the labor force, the demand for autos and homes, the volume of taxable sales, and the amount of income taxes paid. Similarly, the population and its age distribution affect school enrollments and public programs in many other areas, such as health care and social services. Given this, the state's demographic outlook is a key element in assessing and projecting the state's budgetary situation.

State Population Greater Than 35 Million

Figure 11 summarizes the LAO's updated demographic forecast. We estimate that California's total population will rise from an estimated 35.4 million in 2001, to 36 million in 2002 and 36.5 million in 2003. This translates into an annual growth rate of roughly 1.6 percent, which is well above the nation's current growth rate of about 1 percent annually.

Figure 11

Summary of the LAO's California Demographic Forecast

2001 Through 2003
(Populations in Thousands)

	2001	2002	2003
Total population (July 1 basis)	35,396	35,949	36,502
Changes in population			
Natural change (births minus deaths)	275	279	283
Net in-migration (in-flows minus out-flows)	279	275	269
Total changes	**554**	**554**	**552**
Percent changes	1.59%	1.56%	1.54%

Detail may not total due to rounding.

Growth Exceeds Half-a-Million People Annually. California is adding over 550,000 people each year, which is roughly equivalent to the size of the entire state of Vermont. About half of this yearly growth is attributed to net in-migration from other nations and states, while the remainder is due to "natural" increase (that is, births in excess of deaths). Foreign in-migration dominates the net in-migration component, as over 200,000 people enter California from foreign countries annually.

Revised LAO Population Estimates Adjust for 1990 Census Undercount. The population estimates presented in this forecast are somewhat larger than those in our forecast made last November. This reflects revisions we have made to our population estimates for the past decade so as to include the 838,000 person undercount that occurred in the 1990 Census. We expect that our inclusion of this undercount will make our 2000 population estimate more in-line with the adjusted 2000 Census estimates that should be released in March 2001 (see shaded box). Including this undercount has increased our estimate of California's population for each year since 1990. However, it does not result in large changes in the annual percent change in population from year to year.

In making our revised demographic projections, we did not have the opportunity to include data from the 2000 Census; however, we will incorporate this information when we revise our estimates this spring, once the adjusted Census data become available.

California's Population Characteristics

The implications of population trends for the budget depend not only on the total number of Californians, but also on their characteristics. California's population continues to be not only the largest, but also the most diverse, in the nation. For example, the state's population reflects a rich mix of different ethnicities, a large number of people from other na-

2000 Census Results for California

The U.S. Census Bureau conducted its decennial census in April of 2000 and released its first unadjusted estimate of California's population in late December. This estimate—33.9 million as of April 1—is well below our 2000 estimate of the state's population—34.8 million as of July 1. The difference primarily reflects the fact that the Census number has not been adjusted upward to account for any undercount of the population.

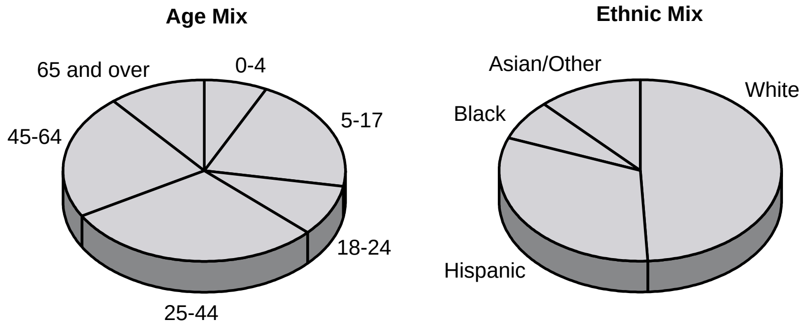
There is widespread agreement that an undercount does exist. In 1990, the Census undercount for the state was an estimated 838,000 persons, and demographers believe that an undercount of similar size occurred in 2000. A better estimate of California's true population and details about it will become available in future months when adjustments to the official Census 2000 data are released. These will be made available on a flow basis during the remainder of 2001 and in 2002. The first adjusted population numbers should be available in March 2001. Although the LAO demographic forecast presented here does not reflect any data from the 2000 Census per se, it does approximate the likely 2000 undercount by specifically incorporating the 1990 undercount and carrying it forward throughout the decade. Our demographic projections will be revised to incorporate the actual 2000 undercount figures if they do become available this spring.

tions and states; a broad age distribution; and considerable geographic dispersion amongst urban, suburban, and rural areas. The state's current age and ethnic mix is shown in Figure 12.

Figure 12

The Age and Ethnic Mix of Californians

July 1, 2001



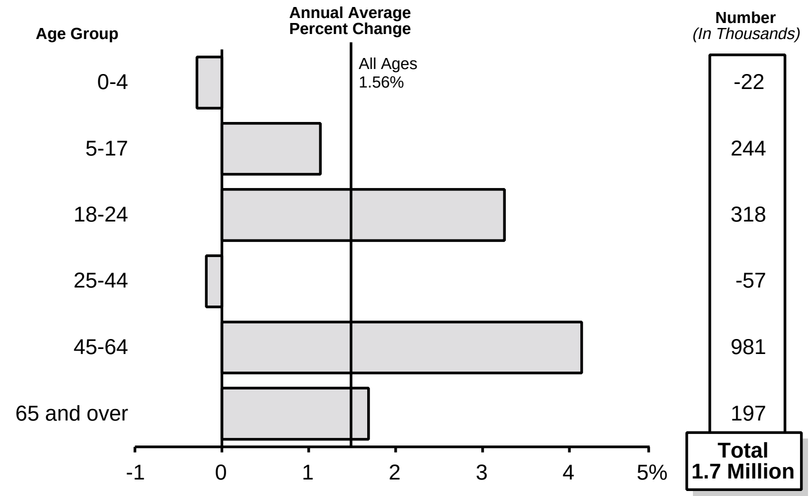
Growth by Age Group. The age-related characteristics of California's population growth are especially important from a budgetary perspective, given their implications for such program areas as education, health care, and social services. Figure 13 (see next page) shows our forecasts for both the percentage and numeric changes in different population age groups. It indicates that by far the greatest growth is expected for the 45-to-64 age group (the "baby boomers"). However, large growth is also expected in the 18-to-24 age group, which will have implications for higher education. Figure 13 also shows that the under-5 age group is expected to decline over the three-year forecast period, indicating a further slowdown in K-12 enrollment growth in coming years.

Growth by Ethnicity. For the first time in history, no single ethnic group currently holds a majority in California. This trend should continue as the white share of population declines further below 50 percent, and the shares of Hispanics and other ethnic groups continue to expand. The total number of Hispanic and Asian persons in California is forecast

Figure 13

California's Population Outlook by Age Group

Population Change 2000 Through 2003



to continue to grow about 3 percent annually over the next three years. This is compared to the near-stagnant growth expected of the white population and the 1.5 percent annual growth of the black population.

Overall Budgetary Implications

California's continued strong population growth—including its age, ethnic, and migratory characteristics—can be expected to have many implications for the state's economy and public services in the budget year and beyond. Some examples of demographic influences are as follows:

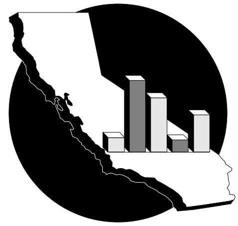
- Economic growth will benefit from an expanded labor force, due to a stronger consumer sector and the increased incomes that accompany job growth.
- However, overall demographic growth will also produce additional strains on the state's physical and environmental infrastructure, including demands on the energy sector, transportation system, parks, and water-delivery system.
- Growth in the young-adult population will place greater demands on higher education, job training programs, and possibly the criminal justice and correctional systems.

- Similarly, the graying of the baby-boomers will place strains on the state's health programs and services, including Medi-Cal and long-term nursing care facilities.
- The increasing ethnic diversity of the state's population will also mean that many public institutions, especially schools, will serve a population that speaks a multitude of languages, and has a wide range of cultural backgrounds.

III

Perspectives on State Revenues

Perspectives on State Revenues



As discussed in "Part I," we are forecasting that General Fund revenues in the current and budget year combined will exceed the administration's forecast by $235 million. This difference reflects both the *positive* effects of recent strong cash receipts on current-year receipts and the *negative* effects of the projected 2001 slowdown in California's economic growth on budget-year receipts.

This part provides background information relating to the revenue side of the budget, summarizes the budget's revenue forecast, and discusses our own revenue forecast and how it compares to the administration's.

TOTAL STATE REVENUES

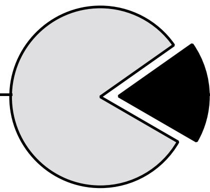
The budget projects that California state government will collect an estimated $97 billion in taxes and other revenues in 2001-02. As indicated in Figure 1 (see next page), over four-fifths of these revenues are deposited into the General Fund, where they are allocated through the budget process each year for such purposes as K-12 and higher education, health, social services, criminal justice, and resources programs. The remaining one-fifth of revenues is deposited into numerous special funds, where they are earmarked for specific purposes. For example, motor vehicle fuel taxes support transportation programs, most tobacco taxes support a variety of targeted health programs, and vehicle license fees (VLFs) are allocated to local governments. Some taxes, such as the sales and tobacco taxes, are distributed amongst both the General Fund and special funds.

Figure 1

State Revenues in 2001-02

(In Billions)

Total State Revenues $96.9 Billion



General Fund Revenues	
Personal Income Tax	$44.8
Sales and Use Tax	23.4
Bank and Corporation Tax	6.9
All Other[b]	4.3
Total	**$79.4**

Special Funds Revenues	
Motor Vehicle-Related Taxes	$8.7
Sales and Use Tax[a]	2.7
Tobacco-Related Taxes	1.0
All Other[b]	5.0
Total	**$17.4**

[a] Includes $2.4 billion to Local Revenue Fund and $0.3 billion for transportation-related purposes. Excludes $2.4 billion allocated to Local Public Safety Fund, which is not included in the Governor's budget totals.

[b] Includes transfers and loans. Special funds amount includes $0.5 billion in settlements from tobacco-related litigation.

General Fund Revenues Dominated By the "Big Three" Taxes. Almost 94 percent of General Fund revenues (and over three-fourths of all state revenues) are attributable to three major taxes—the personal income tax (PIT), sales and use tax (SUT), and bank and corporation tax (BCT). Of these, the PIT is by far the largest, accounting for about 57 percent of the General Fund total. The remaining 6 percent of revenues is attributable to a variety of smaller taxes—including the insurance, estate, tobacco, and alcoholic beverage taxes—as well as investment earnings and such other sources as asset sales and unclaimed property receipts.

Revenue Performance Over Time

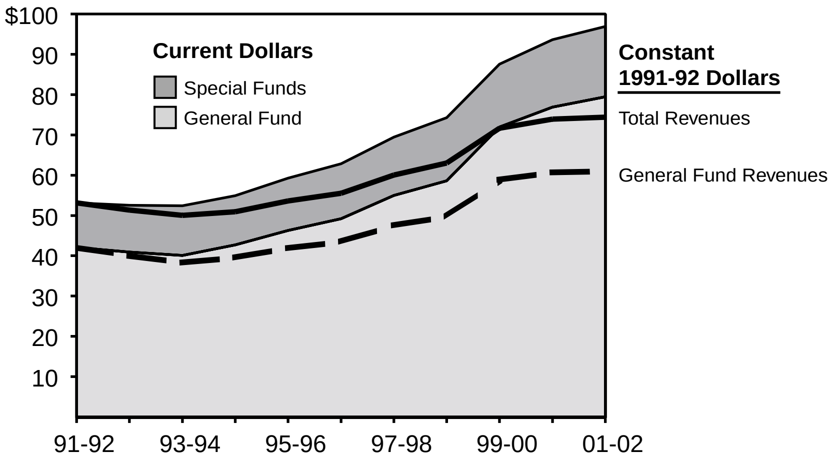
Tax receipts are primarily influenced by changes in the state's economy, although other factors, such as law changes and soaring stock market values, have also played a significant role in recent years. Figure 2 shows total state revenues, General Fund revenues, and special funds revenues over the past decade, in both current-dollar and "real" (that is, inflation-adjusted) terms.

The figure shows that revenue growth lagged in the first half of the 1990s, as the state's recession took a severe toll on California personal income, taxable sales, and corporate profits. Revenues began to pick up in 1995-96, and have soared in recent years due to both the state's healthy

Figure 2

Historical Trends in State Revenues[a]

General and Special Funds, 1991-92 Through 2001-02 (In Billions)



[a] Excludes transfers, bond funds, and federal funds. Also excludes Local Public Safety Fund.

economic expansion and increasing stock market values (which boosted capital gains and stock options on PIT returns).

Based on the budget's estimates, total state revenues between 1995-96 and 2000-01 will have increased 58 percent, or 38 percent after adjusting for inflation. These increases occurred despite substantial reductions to the VLF, large increases in the PIT dependent exemption credits, and a variety of targeted reductions involving the PIT and the BCT. During the same period, the General Fund increase will be about 66 percent (45 percent in inflation-adjusted terms), with one-third of that increase occurring in 1999-00 alone.

The Budget's General Fund Revenue Outlook

Figure 3 (see next page) summarizes the budget's General Fund revenue outlook for 2000-01 and 2001-02.

Current-Year Forecast. After soaring by more than 22 percent in 1999-00, revenues are projected by the administration to rise another 6.9 percent this year, to $76.9 billion. After eliminating the effects of recent and proposed tax relief, diversions, and transfers of receipts between funds, the underlying increase in current-year revenues is a bit stron-

Figure 3

Summary of the Budget's General Fund Revenue Forecast

1999-00 Through 2001-02
(Dollars in Millions)

Revenue Source	Actual 1999-00	2000-01 Amount	2000-01 Percent Change	2001-02 Amount	2001-02 Percent Change
Personal Income Tax	$39,575	$43,305	9.4%	$44,810	3.5%
Sales and Use Tax[a]	21,137	21,980	4.0	23,441	6.6
Bank and Corporation Tax	6,639	6,865	3.4	6,931	1.0
Insurance Tax	1,300	1,330	2.3	1,353	1.7
Other taxes	1,378	1,408	2.2	1,457	3.5
Other revenues[b]	1,523	1,998	31.7	1,358	-32.0
Transfers	379	13	—	84	—
Totals	**$71,931**	**$76,899**	**6.9%**	**$79,434**	**3.3%**

a Includes diversion of $500 million in 2000-01 for transportation purposes and a quarter-cent rate reduction for calendar year 2001.

b Includes tobacco settlement receipts of $515 million in 1999-00 and $393 million in 2000-01, plus $163 million from one-time asset sales in 2000-01.

ger—8.6 percent. The main factors behind this positive current-year revenue performance are California's strong employment and income growth through 2000 and the correspondingly large increases in monthly cash receipts during the first half of this fiscal year. Stock options and capital gains proved to be especially important for revenues. For example, based on cash receipts, the administration estimates that stock options and capital gains combined grew by over 30 percent in 2000.

Budget-Year Forecast. The administration forecasts slowing revenue growth in 2001-02. Total General Fund receipts are projected to total $79.4 billion, a 3.3 percent increase from the current year. After adjusting for the impacts of recent and proposed tax relief, as well as funding redirections, the underlying increase is a slightly stronger 3.6 percent. The modest revenue gain is consistent with the administration's economic forecast of slowing personal income and sales growth in 2001 and early 2002. It also reflects the administration's assumption that capital gains and stock-option income will decline 10 percent between 2000 and 2001.

Recent and Proposed Tax Relief

The budget's revenue forecast reflects tax-related legislation passed in conjunction with last year's budget and proposed in this year's budget, as well as a triggered reduction in the SUT rate. The fiscal effects of the tax-relief legislation are summarized in Figure 4.

2000 Legislation. Last year the state enacted tax relief legislation that will reduce taxes by $2 billion in the budget year and $1.2 billion in 2002-03. As shown in Figure 4, the main provision was an acceleration of VLF rate reductions, which under prior legislation would have been phased in over the next several years. Under this legislation, the VLF rate was reduced by about one-half—from 1.3 percent down to 0.65 percent effective January 1, 2001. Other tax relief measures passed last year included a PIT credit for credentialed teachers and partial conformity to the federal child care credit.

2001 Proposals. The 2001-02 budget includes several targeted tax relief proposals, which would reduce General Fund revenues by a combined total of $108 million in 2001-02. The main provision is an increase in the manufacturers' investment tax credit from 6 percent to 7 percent. The budget also proposes a three-day sales tax holiday in August 2001. Under this proposal, the state portion of the sales tax would be suspended for up to $200 per purchase of clothing and footwear, and up to $1,000 per purchase for computers and related equipment. Local governments would have the option of participating in the program at their own expense.

Figure 4

Recent and Proposed Tax Relief Measures

(In Millions)

Provision	2001-02	2002-03	2003-04
2000 Budget Package[a]			
Vehicle license fee acceleration	$1,440	$630	—
Credentialed teacher tax credit	188	202	$217
Child care tax credit	189	193	197
Other provisions	161	133	136
Totals	**$1,978**	**$1,158**	**$550**
2001 Proposed Package			
Manufacturers' investment tax credit	$70	$90	$95
Sales tax holiday	27	—	—
Other provisions	11	7	6
Totals	**$108**	**$97**	**$101**

[a] 2000 budget package also included $1.2 billion of tax reductions in the current year.

Other proposed relief includes an increase in the capital gains exclusion for small business stock held for more than five years, a credit for employers who subsidize transit passes for their employees, and the addition of software developers to the list of companies eligible for the SUT exemption for purchases of manufacturing equipment.

Triggered SUT Rate Reduction. Under legislation accompanying the imposition of a quarter-cent sales tax increase in 1991, this quarter-cent rate can "trigger off" in any year in which the Director of Finance certifies, by November 1, that the preceding year's budgetary reserve and the estimated current-year budgetary reserve are both more than 4 percent of General Fund revenues. In late October 2000, the Director made this certification, which resulted in a quarter-cent SUT reduction effective for calendar year 2001. This reduction will lower General Fund revenues by a total of $1.2 billion, of which $530 million will occur in the current year and $620 million will occur in the budget year. The 2001-02 budget forecast assumes that the quarter-cent tax rate will be reinstated on January 1, 2002.

THE LAO'S GENERAL FUND REVENUE OUTLOOK

Figure 5 provides the LAO's updated General Fund revenue outlook for 2000-01 through 2002-03. These revenue projections are based on our

Figure 5

Summary of the LAO's General Fund Revenue Forecast

2000-01 Through 2002-03 (Dollars in Millions)

	2000-01		2001-02		2002-03	
Revenue Source	**Amount**	**Percent Change**	**Amount**	**Percent Change**	**Amount**	**Percent Change**
Personal Income Tax	$43,980	11.1%	$44,540	1.3%	$48,300	8.4%
Sales and Use Tax	21,800	3.1	23,240	6.6	25,410	9.3
Bank and Corporation Tax	7,130	7.4	6,920	-2.9	7,610	10.0
Insurance Tax	1,336	2.8	1,397	4.6	1,484	6.2
Other taxes	1,405	2.1	1,462	4.0	1,533	4.8
Other revenues	1,945	27.5	1,317	-32.3	1,175	-10.8
Transfers	13	-96.6	84	546.2	100	19.0
Totals	**$77,609**	**7.9%**	**$78,960**	**1.7%**	**$85,612**	**8.4%**

economic forecast presented in "Part II" of this volume and also take into account recent positive cash developments through the end of January. Our estimate also incorporates the fiscal effects of the administration' proposed tax reductions, as well as its proposal relating to the redirection of tobacco tax settlement monies from the General Fund to special funds.

Current-Year Forecast. We forecast that General Fund revenues will reach $77.6 billion in the current year, a 7.9 percent increase from 1999-00. The fastest growing revenue source is PIT, which is expected to increase by slightly over 11 percent. Our forecast is $710 million above the administration's estimate, but is down by about $320 million from our November 2000 projection made when the economy looked stronger.

Budget-Year Forecast. We project 2001-02 General Fund revenue growth of just 1.7 percent, to $79 billion. This modest growth reflects the negative impacts of the sharp national and state economic slowdowns which are becoming increasingly apparent, and an assumed 15 percent decline in stock options and capital gains for calendar year 2001. Our revised forecast is down by about $474 million from the administration's estimate, and is down by over $2.5 billion from our November 2000 projection (after netting out the effects of proposed accounting and law changes).

2002-03 Forecast. We project that General Fund revenues will reach $85.6 billion in 2002-03, a healthy 8.4 percent increase from 2001-02. While some of the growth is related to the reinstatement of the quarter-cent sales tax rate in 2002, most of the increase is due to an assumed rebound in the California economy during that year.

Key Factors Affecting the LAO's Forecast

Figure 6 (see next page) summarizes some of the key factors behind our General Fund revenue outlook.

Given the normal time lags between changes in economic activity and corresponding changes in tax payments, the majority (about two-thirds) of the revenue picture in the current year is related to economic activity that has already occurred in calendar year 2000, while a similar share of budget-year revenues will be related to economic activity in 2001. As indicated in "Part II," California experienced strong economic growth and cash receipts through the end of 2000, and this has contributed to our outlook for healthy revenue growth in the current year. In fact, year-end withholding and quarterly estimated tax prepayments received in January *exceeded* the budget forecast amount by over $500 million, suggesting that PIT liabilities in 2000 were even stronger than projected by the administration.

Figure 6

Key Factors Affecting the Revenue Outlook

☑ **Strong 2000 Economy Boosting Current-Year Revenues**

- Economic growth in 2000 produced even more revenues than previously expected.
- Major tax receipts in January were up by over $650 million from the budget forecast, due primarily to strong year-end capital gains, stock options, and bonuses.

☑ **But Weak 2001 Economy to Restrain Budget-Year Receipts**

- Slowing employment and income growth will adversely affect taxes attributable to 2001 economic activity.
- Most of these effects will show up in 2001-02, when revenue growth is expected to taper to just 1.7 percent.

☑ **Net Effect—LAO's Two-Year Revenue Forecast Is Slightly Above the Administration's**

However, we anticipate that the economic slowdown projected for 2001, coupled with the expected decline in stock options and capital gains, will restrain growth in revenue receipts during the months ahead. Given the time lags between when tax liabilities are incurred and when payments toward these liabilities are received by the state, only about one-third of current year receipts will be affected by the 2001 economic slowdown. Thus, the predominate effect of the slowdown will be felt in 2001-02, when we expect revenue growth to fall to only 1.7 percent.

THE LAO'S FORECAST FOR MAJOR REVENUE SOURCES

As indicated earlier, 94 percent of General Fund revenues are attributable to the state's three major tax-revenue sources—the PIT, SUT, and BCT. Below we provide a detailed discussion of the forecasts for these taxes and factors affecting their projected growth.

Personal Income Tax

The PIT is levied on taxable income attributable to California, with taxable income equaling total income minus various statutory exclusions, exemptions, and deductions. This taxable income is subject to a progressive marginal tax rate schedule, with the individual marginal rates ranging from 1 percent to 9.3 percent. Once a taxpayer's liabilities on this taxable income have been computed, various credits are applied to arrive at the final tax liability. In general, the state's PIT is patterned after the federal PIT and many of its provisions conform to federal PIT law.

The PIT Share of Total Revenues Has Increased Substantially

As shown in Figure 7, the share of total General Fund revenues attributable to the PIT has increased from about 38 percent in 1980-81 to nearly 57 percent in 2000-01. The share increased considerably throughout the 1980's economic expansion, retreated slightly during the early 1990's recession, and then soared during the second half of the decade. Between 1995-96 and 1999-00, receipts from this source increased at an average annual rate of 17.3 percent, or nearly three times as fast as statewide personal income growth.

Some of the increased PIT share merely reflects the interaction of strong California personal income growth and the state's progressive PIT rate structure. However, the rapid growth has also been due to the stock market, which has contributed to major increases in capital gains and stock option-related income. As shown in Figure 8 (see next page), these

Figure 7

Income Tax's Role Has Dramatically Increased Over Time

Personal Income Taxes as a Percent of Total General Fund Revenues

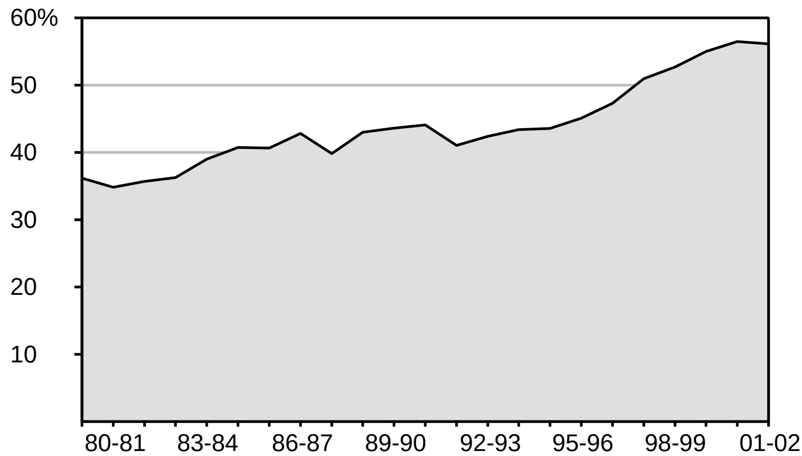
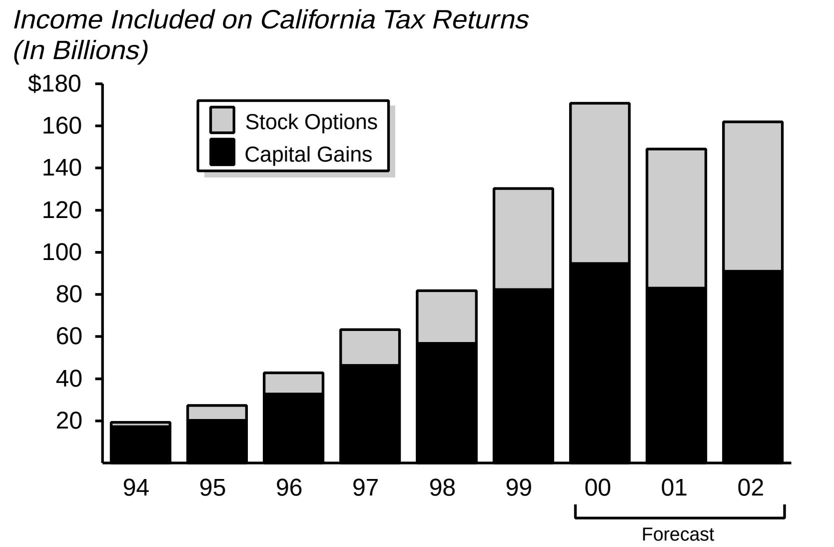


Figure 8

Stock Market Decline to Moderate Stock Options and Capital Gains



two sources grew from a combined total of about $25 billion in 1995 to $130 billion in 1999—a more than five-fold increase. As a result of these increases, we estimate that capital gains and options together now account for more than one-third of total PIT collections. While gains in these sources are responsible for much of the state's strong revenue performance in recent years, their increased importance also adds an additional element of volatility and uncertainty to the state's revenue stream.

Current Outlook for Capital Gains and Stock Options Based on cash receipts through the end of 2000, we estimate that capital gains and stock option-related income grew by over 30 percent during 2000. This growth occurred even as the stock market's major indexes fell during the year—with the NASDAQ down at year-end by more than 40 percent from the beginning of the year and by more than 50 percent from its March 2000 peak. It appears that many stocks were sold as investors and employees attempted to "cash out" gains that had accumulated in previous years. While this increased "profit taking" boosted gains attributable to 2000, the amount of "stored-up" gains that remain to be realized has correspondingly diminished. As a result, we are forecasting that revenues attributable to these sources will fall by 15 percent in 2001, before rebounding by 9 percent in 2002.

Forecast for PIT Receipts. Based on the state's strong income and job performance through the end of 2000, we estimate that PIT revenues in the current year will total $44 billion—an 11 percent increase from 1999-00. We expect revenue growth to subside in the budget year, however, with PIT receipts totaling $44.5 billion—a marginal 1.3 percent growth rate. Thereafter, the subsequent rebound in economic activity is projected to boost PIT receipts in 2002-03 by 8.4 percent, to a total of $48.3 billion.

Sales and Use Tax

The SUT is the General Fund's second largest revenue source, accounting for slightly less than 30 percent of total receipts in 2001-02. The SUT actually is comprised of the following two separate levies:

- The largest is the *sales tax*, which is imposed on retail sales of tangible goods purchased in California. These include spending on such items as clothing, furniture, computers, electronics, appliances, automobiles, and motor vehicle fuel. Also included are business purchases of equipment and building materials. Most services are exempt.
- The *use tax* is imposed on products bought from out-of-state firms by California residents and businesses for use in the state. With the exception of automobile purchases (which must be registered), out-of-state purchases are difficult to monitor, and the state is prohibited under current federal law from requiring out-of-state sellers to collect the use tax for California. As a result, use tax receipts account for only a small portion of total SUT revenues.

Sales and Use Tax Rates

The total SUT rate levied on transactions subject to the tax is a combination of several different individual rates imposed by the state and various local governments.

State Rates. The main component of the overall SUT rate is the 5 percent General Fund rate (which in January was reduced to 4.75 percent for 2001 under the terms of 1991 sales tax trigger legislation discussed earlier). Also included are two 0.5 percent rates, whose proceeds are deposited, respectively, into (1) the Local Revenue Fund, which supports health and social services program costs associated with the 1991 realignment legislation and (2) the Local Public Safety Fund, which was approved by the voters in 1993 for the support of local criminal justice activities.

Uniform Local Rate. There is a uniform local tax rate of 1.25 percent levied by all counties (the so-called Bradley-Burns rate). Of this total, 0.25 percent is deposited into county transportation funds, while the remaining 1 percent is allocated to city and county governments for general purposes.

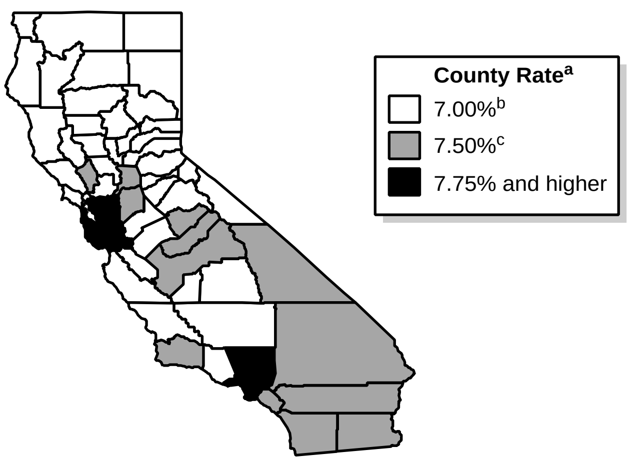
Optional Local Rates. The final component involves optional local tax rates, which local governments are authorized to levy for a variety of purposes. These taxes, which require local voter approval, are normally levied on a countywide basis, primarily for transportation-related purposes. They can be levied in 25 cent or 50 cent increments and cannot exceed 1.5 percent (except in San Francisco and San Mateo Counties).

Combined State and Local Tax Rates. The combined state and local SUT rate varies significantly across California, due to the optional local rates. As depicted in Figure 9, the combined rate currently ranges from 7 percent up to 8.25 percent (the latter for the City and County of San Francisco). No county currently imposes the maximum allowable SUT rate of 8.5 percent.

Figure 9

Sales Tax Rates Vary by County

January 1, 2001



[a] Reflects 0.25 percent reduction in state portion of rate for the 2001 calendar year.

[b] Includes Stanislaus, Nevada, and Solano (7.125%), and Sonoma (7.25%).

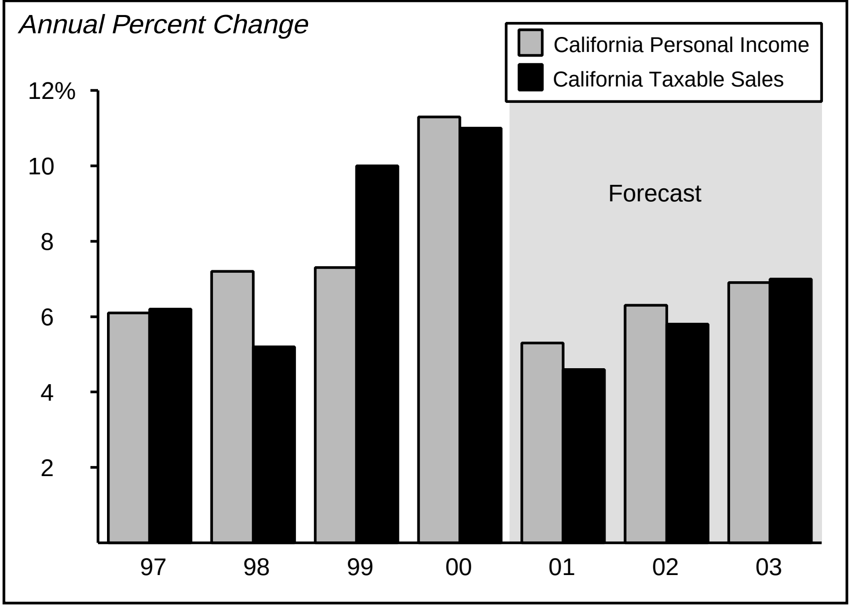
[c] Includes Fresno (7.625%).

Taxable Sales Soared In 1999 and 2000 . . .

After several years of moderate growth, taxable sales jumped by 10 percent in 1999 and by about 11 percent in 2000—the strongest back-to-back years in recent history. As shown in Figure 10, taxable sales increases in recent years have generally tracked growth in personal income, which peaked in 2000. The healthy gains experienced have also been due to high consumer and business confidence levels, as well as the "wealth effect" related to sharply rising stock market values.

Figure 10

Slowing Income Growth to Constrain Taxable Sales



The taxable sales increases experienced in recent years have been spread among many different industry categories, including major growth in auto sales, home furnishings, computers, electronics, and other durable goods. Also contributing to the growth has been strong business spending on investment equipment and in new facilities (important because building materials are subject to the SUT). In most cases, the taxable sales growth has reflected increased real spending as opposed to just price increases. Gasoline sales, however, are an exception, as price increases have been a key factor behind their taxable sales growth.

. . . But Will Slow Sharply In 2001 Before Rebounding

We forecast that taxable sales growth will slow sharply during 2001 before partially rebounding in 2002. Key factors behind the expected slowdown are the downturn in California's personal income growth, the effects of sharply reduced consumer and business confidence levels, and a partial reversal of the wealth effect (caused by declining stock market values). Recent sharp increases in energy costs and rents are also likely to cut into the budgets of lower-income and moderate-income households, thereby putting more downward pressure on their discretionary spending on taxable items. Finally, the sharp cutback in business investment plans will have a dual adverse effect in California. First, it implies less business-to-business sales of information technology products in the state. Second, it will also have impacts on the expansion plans of California's high-tech companies, which will reduce taxable sales of building materials.

We expect that consumer and business spending will rebound in line with overall California economic growth beginning in early 2002, leading to annual increases in taxable sales of 5.8 percent in 2002 and 7 percent in 2003.

Forecast for SUT Receipts. Based on our projections of taxable sales, we forecast that SUT receipts will increase from $21.1 billion in 1999-00 to $21.8 billion 2000-01, a 3.1 percent increase. This current-year estimate reflects the impact of the 2001 quarter-cent SUT rate reduction, as well as a diversion of $500 million in sales taxes on gasoline from the General Fund to a transportation fund.

We estimate that sales tax receipts in 2001-02 will total $23.2 billion, an increase of 6.6 percent. However, part of this healthy increase reflects a change in the accounting treatment of sales taxes used to support transportation programs. Specifically, under the terms of last year's budget agreement, the full $1.2 billion in sales taxes on gasoline will support transportation programs—up from the $500 million noted above for the current year. The budget, however, is reflecting this commitment as an *appropriation* from the General Fund for transportation purposes, rather than as a diversion of sales taxes as is their treatment in the current year. Adjusting for this accounting change, the underlying increase in SUT receipts is a more modest 4 percent.

Bank and Corporation Tax

The BCT is levied at a general tax rate of 8.84 percent on California taxable profits. Banks and other financial corporations also pay an additional 2 percent tax, which is in lieu of most other state and local levies. Corporations that qualify for California Subchapter "S" status are subject to a reduced 1.5 percent corporate rate (but, in exchange, have their income for tax purposes "passed through" to their shareholders where it also is subject to the PIT). Approximately two-thirds of all BCT revenues come from multi-state and multi-national corporations, a share of whose income is apportioned to California based on a formula. California's BCT allows for a variety of exclusions, exemptions, deductions, and credits, many of which fully or partially conform to, or are based on, the federal BCT. Major examples include the research and development tax credit, and the ability of companies to carry forward a portion of any operating losses so that they can deduct them later on when they have positive profits.

Recent Profit Growth Has Been Erratic

During the current economic expansion, California taxable profits have performed erratically, jumping by 13 percent in 1997, falling by 1 percent in 1998, and then rebounding by roughly 8 percent per year in 1999 and 2000. During the past five years, profits have generally benefitted from strong sales and high rates of productivity growth. However, earnings within certain specific industries have been adversely affected by such factors as the Asian economic and financial crisis (which depressed high-tech manufacturing and banking profits in 1998), and industry restructuring involving banking, utilities, and telecommunications.

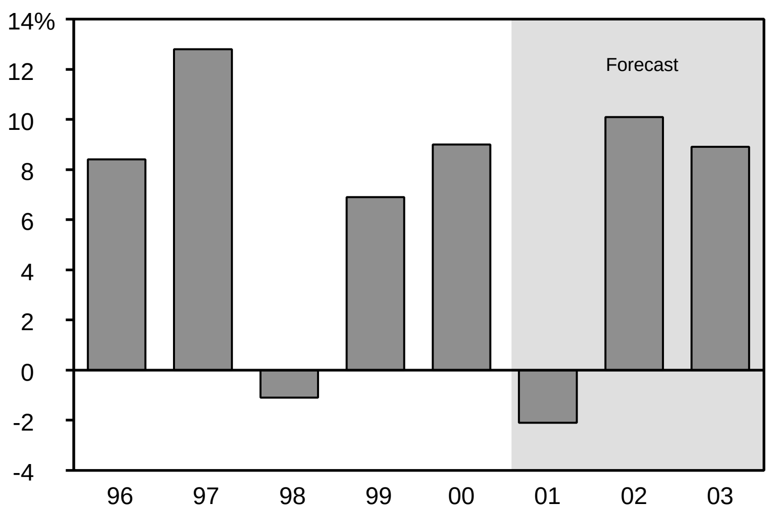
Earnings To Dip In 2001

We expect that the national and state economic slowdowns will cause corporate profits to decline in 2001 (see Figure 11). All industries will feel the impacts of slowing sales, as well as rising costs for compensation (particularly health care benefits) and energy. The slowdown in information

Figure 11

Hi-Tech Slowdown to Reduce 2001 Corporate Profits

Percent Change in California Taxable Corporate Profits



technology-related sales will have a particularly significant negative impact on California's high-tech manufacturers and service providers. We look for profit growth to rebound in 2002, however, as cost pressures subside and sales improve.

Forecast for BCT Receipts. We forecast that BCT revenues will rise by 7.4 percent in the current year to $7.1 billion, largely based on the strength of profit growth through the end of 2000. We forecast that BCT receipts will decline slightly to $6.9 billion in 2001-02, primarily reflecting the profit decline expected for 2001, and then grow by nearly 10 percent—to $7.6 billion—in 2002-03 as profits rebound.

Outlook for Other General Fund Revenue Sources

The remaining 6 percent of General Fund revenues is related to a variety of sources, including the insurance, estate, tobacco, and alcoholic beverage taxes, as well as a variety of lesser sources—including minor taxes, fees, interest earnings, and transfers from special funds.

We forecast that revenues from these other sources will total $4.7 billion in the current year, decline to $4.2 billion in 2001-02, and then partially rebound to $4.3 billion in 2002-03. The year-to-year comparisons of revenues from these other sources are affected not only by their underlying trends, but also by accounting changes affecting tobacco settlement funds and child support reimbursements, one-time asset sales, and certain other anomalies. Our forecast assumes modest growth in insurance and estate taxes receipts, but slight declines in collections from the tobacco taxes during the next three years. Pooled money investment earnings are expected to rise from $470 million in 1999-00 to $680 million in the current year (due to large investable General Fund cash balances), before falling back to about $450 million in 2001-02 and 2002-03.

THE BUDGET FORECAST FOR SPECIAL FUNDS REVENUES

Special funds revenues support a wide variety of state and local government programs. As shown in Figure 12, about one-half of these revenues are related to motor vehicle-related taxes and fees. These include VLF revenues (which are distributed to local governments for general purposes) and fuel taxes and registration fees (which support transportation-related projects). The other one-half of special funds revenues consist of certain SUT receipts; certain cigarette and tobacco tax revenues; and a variety of other taxes, fees, and interest earnings.

Figure 12

Special Funds Revenues and Transfers

1999-00 Through 2001-02
(Dollars in Millions)

Revenue Source	Actual 1999-00	2000-01 Amount	2000-01 Percent Change	2001-02 Amount	2001-02 Percent Change
Motor Vehicle Revenues					
License fees (in lieu)[a]	$3,296	$3,205	-2.8%	$3,483	8.7%
Fuel taxes	3,041	3,137	3.2	3,221	2.7
Registration, weight, and miscellaneous fees	1,917	1,975	3.0	1,951	-1.2
Subtotals	($8,254)	($8,317)	(0.8%)	($8,655)	(4.1%)
Other Sources					
Sales and use tax[b]	$2,320	$3,043	31.2%	$2,717	-10.7%
Cigarette and tobacco taxes	1,084	1,058	-2.4	1,043	-1.4
Interest earnings	269	259	-3.7	271	4.6
Other revenues[c]	4,022	4,123	2.5	4,806	16.6
Transfers and loans	-344	-48	—	-52	—
Totals	**$15,605**	**$16,752**	**7.4%**	**$17,440**	**4.1%**

a Incorporates impacts of Vehicle License Fee rate reduction.
b Excludes Local Public Safety Fund revenues.
c Includes tobacco settlement receipts of $468 million in 2001-02.

Special funds revenues are projected by the administration to total $16.8 billion in 2000-01 (a 7.4 percent increase from 1999-00) and $17.4 billion in 2001-02 (a 4.1 percent increase from the current year). Underlying these moderate increases are the effects of accounting and other changes implemented in prior years, as well as new changes proposed in the 2001-02 budget.

The large current-year increase in special funds SUT revenues is partly related to the one-time diversion of $500 million of General Fund sales taxes on gasoline to a transportation special fund. Finally, the major increase in other special funds revenues in 2001-02 is partly related to the budget's proposal to shift $468 million in tobacco settlement revenues from the General Fund to a newly created Tobacco Settlement Fund.

IV

Perspectives on State Expenditures

Perspectives on
State Expenditures

An Overview of State Expenditures

Proposed Total Spending in 2000-01 and 2001-02

The Governor's budget proposes total spending in 2001-02 of $102 billion, including spending from both the state's General Fund and its special funds (see Figure 1). This total budget-year spending is 7.9 percent more than the $94.6 billion proposed for the current year. Of total budget-year spending, General Fund spending accounts for slightly more than 80 percent.

Figure 1

Governor's Budget Spending Totals

2000-01 and 2001-02
(Dollars in Millions)

			Change	
	2000-01	**2001-02**	**Amount**	**Percent**
Budget Spending				
General Fund	$79,708	$82,853	$3,145	3.9%
Special funds[a]	14,843	19,163	4,320	29.1
Totals	**$94,551**	**$102,016**	**$7,465**	**7.9%**

[a] Does not include Local Public Safety Fund expenditures of $2.3 billion in 2000-01 and $2.4 billion in 2001-02. These amounts are not shown in the Governor's budget.

Detail may not total due to rounding.

General Fund Spending

Background. The General Fund is the predominate source of support for state programs, and thus finances a wide variety of activities. For example, it is the major funding source for K-12 and higher education programs, health and social services programs, youth and adult correctional programs, and tax relief.

The General Fund is primarily funded from tax revenues. As discussed in "Part III" of this volume, three taxes are projected to account for 95 percent of the total General Fund revenues in the budget year. These taxes are the state's personal income tax, sales and use tax (SUT), and bank and corporation tax.

Proposed Spending. In 2001-02, the Governor proposes General Fund spending of $82.9 billion. This is up $3.1 billion from the current-year's proposed amount of $79.7 billion —a relatively modest 3.9 percent growth compared to the exceptionally strong 15 percent to 20 percent increases experienced in the current and prior years. This modest growth partially reflects the fact that one-time spending in the budget year ($3.3 billion) is less than in the current year ($5.8 billion). After adjusting for the reduced amount of one-time spending, as well as funding shifts and accounting changes, General Fund growth would be higher—about 7.5 percent.

Special Funds Spending

Background. Special funds are used to allocate certain tax revenues (such as gasoline and certain cigarette tax receipts) and various other income sources (including many licenses and fees) for particular functions or activities of government designated by law. Around one-half of the special funds revenues come from motor vehicle-related levies. Other major funding sources include the SUT and tobacco-related receipts, including for the budget year tobacco settlement monies.

Proposed Spending. In 2001-02, the Governor proposes special funds spending of $19.2 billion. This is up by nearly 30 percent from the current-year's proposed total of $14.8 billion. This unusually large increase primarily reflects funding shifts and accounting changes involving vehicle license fee (VLF) reductions, transportation spending, and tobacco settlement funds. Without these anomalies, the budget-year increase would be around 9 percent.

It should be noted that the budget's special funds spending totals exclude expenditures from the Local Public Safety Fund. Although we believe that such spending does constitute state spending, we do not include it in our figures so as to facilitate comparisons with the budget figures.

Spending From Federal Funds and Bond Proceeds

In addition to the $102 billion of proposed 2001-02 spending from the General Fund and special funds, the budget also proposes $43.5 billion in spending from federal funds and another $2.7 billion from bond proceeds. If expenditures from bond proceeds and federal funds are included in total state spending, 2001-02 spending exceeds $148 billion.

Federal Funds

Of the $43.5 billion in federal funds the budget proposes to spend in 2001-02, 75 percent flows through the state budget to local governments in the form of local assistance. The majority of federal funds in the budget are federal contributions to health and social services programs ($27.5 billion, or 63 percent of the total) and education ($10.1 billion, or 23 percent). These program areas account for about 85 percent of total federal money that flows through the state budget. It is, however, important to note that the federal money flowing through the state budget only accounts for just over one-quarter of the $160 billion in total federal funds that California receives annually.

Spending of Bond Proceeds

Budgetary Treatment. When the state relies on bond proceeds instead of direct appropriations to fund its capital outlay projects, the use of these proceeds is not itself reported as budgetary spending as it occurs. Rather, the debt-service cost for principle and interest on the bonds is what is recorded as budgetary spending. For 2001-02, the budget's proposed General Fund debt-service costs total $3.3 billion—$2.6 billion for general obligation bonds and $656 million for lease-payment bonds.

Although this way of treating bonds makes sense from a budgetary standpoint, tracking bond fund expenditures themselves still is useful as an indication of the actual volume of "brick and mortar" activities going on in a given year with respect to capital projects.

Spending of General Obligation Bond Proceeds. The budget estimates that the state will spend $2.7 billion in general obligation bond proceeds for capital projects in 2001-02. This compares to $6.1 billion in the current year and $2.6 billion in the prior year. The majority of the budget-year bond fund expenditures (over 60 percent) is for various local assistance projects such as K-12 school construction and resource programs. The bulk of the remaining general obligation bond proceeds is dedicated to state-level capital outlay projects, with over 70 percent of the money ($554 million) dedicated to higher education projects in the budget year.

Spending of Lease-Payment Bond Proceeds. In addition to general obligation bonds, the state also uses lease-payment bonds to finance the construction and renovation of capital facilities. Lease-payment bonds do not require voter approval, and their debt service is paid from annual lease payments made by state agencies (funded primarily through General Fund appropriations). For 2001-02, the budget proposes $350 million in lease-payment bonds to finance a capital outlay project for the Department of Mental Health.

State Appropriations Limit

Background. In 1979, California's voters established a state appropriations limit (SAL) when they approved Proposition 4. The SAL places an "upper bound" on the amount of tax proceeds that the state can spend in any given year and grows annually by a population and cost-of-living factor. Most state appropriations are subject to the SAL; however, certain appropriations are exempt—including subventions for schools and local governments, capital outlay, and tax relief. If actual tax proceeds exceed the SAL over a two-year period, the excess must be divided among taxpayer rebates and Proposition 98 education funding.

Current Situation—No Effect. For most of the 1990s, spending fell well below the limit due to the recession's adverse effect on state revenues. However, in recent years, rapid spending growth eroded the "room" under the limit until the SAL was exceeded by $702 million in 1999-00.

In 2000-01, however, appropriations subject to limitation will fall $3.7 billion *below* the SAL. This is primarily due to the large amount of exempt appropriations that were enacted in the 2000-01 budget including school subventions, VLF rebates, capital outlay, and local fiscal relief. Thus, the state will not have excess revenues for the two-year period ending in 2000-01.

State spending is also projected to be well below the SAL in the budget year—by $5.4 billion. This is due to the slowing in General Fund revenue growth to 3.9 percent, which is well below the 9 percent growth projected for the SAL itself.

State Spending—An Historical Overview

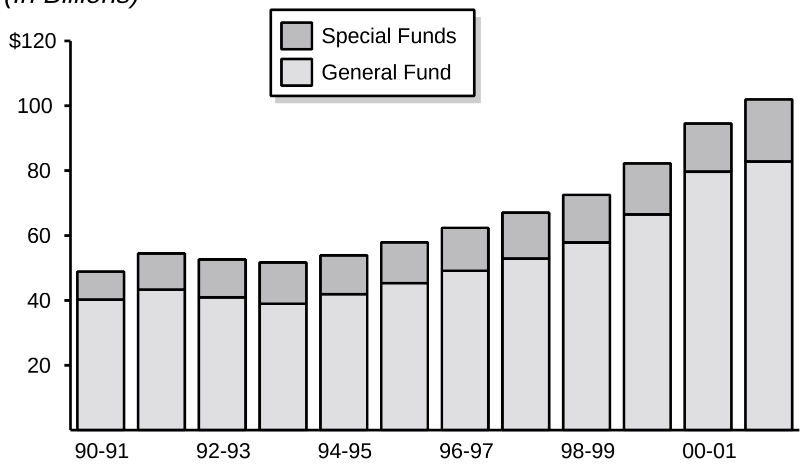
Prior to looking at the programmatic details of the Governor's spending plan for 2001-02, it is first helpful to provide some perspective on state spending by looking at how the new plan's spending amounts compare to historical trends.

Spending Trends and Their Determinants. Figure 2 shows the amounts of state General Fund and special funds expenditures during the 1990s and compares them to the current and budget years. These trends and their year-to-year variations are affected by a variety of factors. Generally, the most important factor tends to be the strength of the economy and the state revenues it generates to fund expenditure programs. Another key factor involves the decisions policy-makers and voters arrive at that affect spending levels. Among some of the more important of these over the past decade have been the realignment of state and county health-related responsibilities in 1991-92, the imposition of additional cigarette and tobacco taxes due to Proposition 10 (1998), and the manner in which available resources have been allocated between spending priorities and tax relief.

Figure 2

Total State Spending Over Time[a]

1990-91 Through 2001-02
(In Billions)



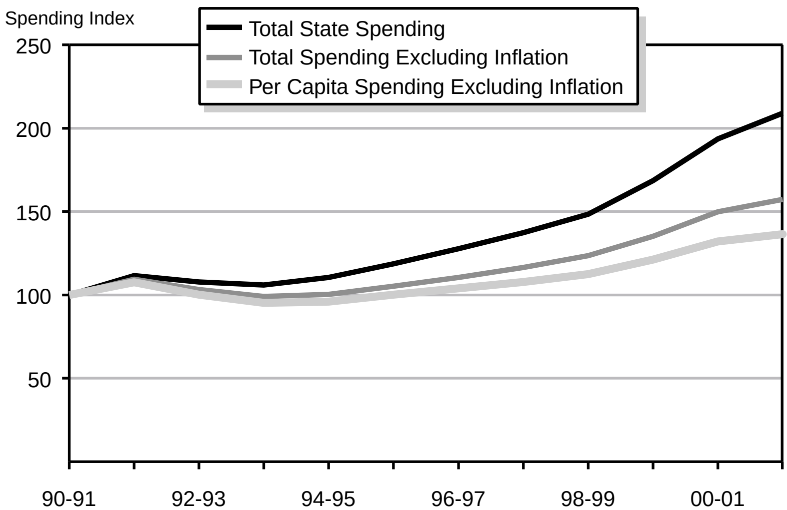
[a] Data are on a budget basis and exclude bond fund expenditures, federal funds, and Local Public Safety Fund expenditures.

Figure 2 shows that total state spending has roughly doubled over the entire period, with declines during the early-1990s' recession followed by growth thereafter. About half of the total growth has occurred since 1997-98. Figure 3 (see next page) breaks out the causes for this growth according to its three principal determinants—population growth, inflation in the costs of providing public services, and "real" growth in state programs. It indicates that:

Figure 3

Spending Adjusted for Inflation and Population

Index Value =100 in 1990-91



- Inflation-adjusted spending has grown by about 50 percent over the period, indicating that about one-half of the doubling in spending has been due to inflation.
- Real per-capita spending—which adjusts for both inflation and population growth—has increased by about 36 percent over the period. This reflects the fact that this spending is projected to be $2,152 per capita in 2001-02, up from $1,577 per capita in 1990-91. This represents an annual average rate of increase in real per-capita spending over the entire 12-year period of about 2.6 percent.

The strong spending growth in recent years has reflected California's extraordinary healthy economy and strong revenue performance, which has provided sufficient resources to undertake a variety of new one-time and ongoing spending commitments.

SPENDING BY PROGRAM AREA

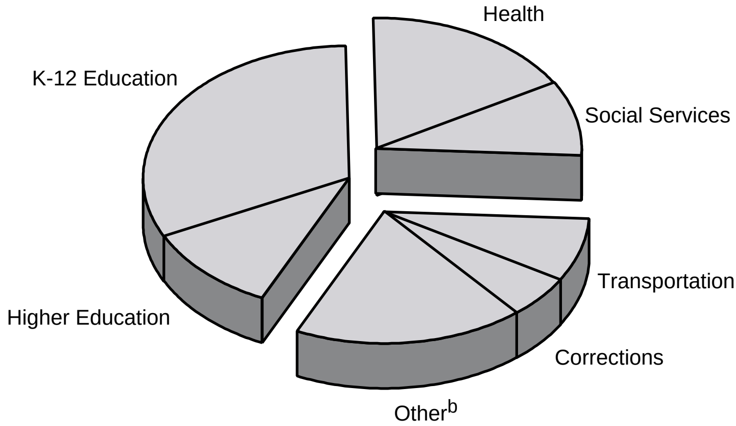
Total State Spending

Figure 4 shows the allocation of the proposed $102 billion of total state spending in 2001-02 among the state's major program areas. Both

Figure 4

Proposed Total State Spending By Major Program Area[a]

2001-02



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

General Fund and special funds expenditures are included in order to provide a meaningful comparison of state support among broad program categories, since special funds provide the bulk of the support in some areas (such as transportation).

The figure shows that K-12 education receives the largest share of total spending—about one-third. (It should also be noted that K-12 education receives additional funding from local sources.) When higher education is included, the education share rises to over 43 percent. Health and social services programs account for about 26 percent of proposed total spending, while transportation and corrections together account for roughly 13 percent. In the "all other" category (18 percent), the largest share is for general-purpose fiscal assistance provided to local governments in the form of shared revenues and General Fund payments that backfill losses from VLF reductions.

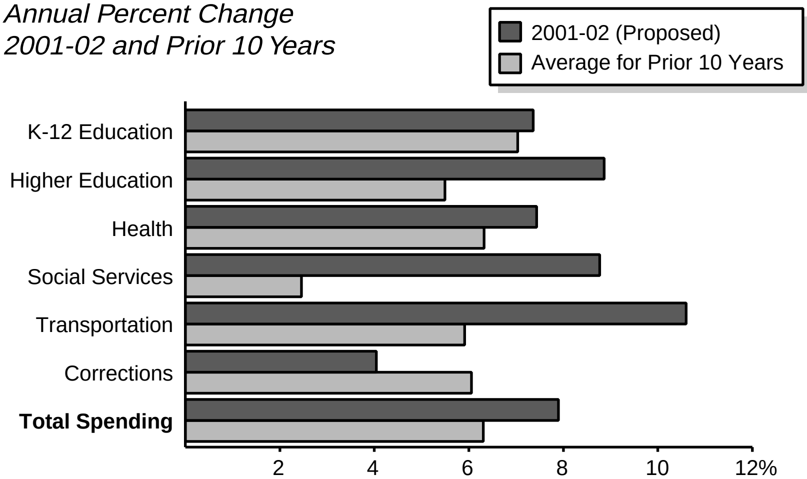
Relative Growth in the Budget Year

In order to get a perspective on how total state spending has changed for each broad programmatic area, Figure 5 (see next page) shows their proposed growth in the budget year compared to the average annual growth in these programs over the past ten years. As noted before, total state spending growth is relatively strong in the budget year (7.9 percent), which is well above the ten-year average growth of 6.3 percent.

Figure 5

Growth in Total State Spending By Major Program Area[a]

Annual Percent Change 2001-02 and Prior 10 Years



[a] Excludes "all other" spending.

Transportation shows the largest increase in programmatic spending in the budget year (10.6 percent), mainly reflecting large increases in special funds spending for capital outlay projects. The increases in health and social services are also above-average, and are largely driven by General Fund spending increases associated with cost-of-living adjustments (COLAs) and expansions in some program elements. The budget also proposes rapid growth in higher education spending—nearly 9 percent—which is due in part to one-time funding for various capital outlay projects. The percentage increase in total spending on K-12 education—nearly 8 percent—is above the ten-year average, reflecting a large overappropriation of the Proposition 98 minimum guarantee. Growth in total expenditures on corrections in the budget year is relatively small when compared to the ten-year historical average, which is primarily due to slowing caseload growth.

Key General Fund Spending Developments

Despite the moderation in total General Fund expenditure growth proposed for the budget year, sufficient resources have been provided to fund existing programs, augment some programs, and propose certain new programs. Figure 6 provides detail by program area for the General

Figure 6

General Fund Spending by Major Program Area

1999-00 Through 2001-02
(Dollars in Millions)

	Actual 1999-00	Estimated 2000-01	Proposed 2001-02 Amount	Proposed 2001-02 Percent Change
Education Programs				
K-12 Education	$27,588	$30,311	$32,540	7.4%
Community Colleges	2,552	2,819	3,048	8.1
UC/CSU	4,891	5,826	6,397	9.8
Other	577	750	897	19.7
Health and Social Services Programs				
Medi-Cal[a]	$8,065	$9,458	$9,325	-1.4%
CalWORKs	1,991	1,935	2,128	10.0
SSI/SSP	2,501	2,626	2,870	9.3
Other[a]	5,193	6,849	7,866	14.8
Youth and Adult Corrections	$4,748	$5,181	$5,389	4.0%
All Others[b]	$8,780	$14,659	$13,144	-10.3%
Totals	**$66,494**	**$79,708**	**$82,853**	**3.9%**

a The 2001-02 decline in Medi-Cal and increase in the "Other" category is due to a technical shift of $600 million to the Department of Developmental Services and the replacement of $170 million of General Fund spending with tobacco settlement funds.

b The 2001-02 decline is primarily due to the magnitude of one-time spending in 2000-01.

Fund spending amounts contained in the budget, while Figure 7 (see next page) summarizes the budget's key elements and proposals. Most of the new proposals and augmentations are discussed in detail in our accompanying *Analysis of the 2001-02 Budget Bill,* and some major ones are highlighted in the following section entitled "Major Expenditure Proposals in the 2001-02 Budget." Certain developments in key areas of the budget are briefly discussed below.

Education Funding Remains a High Priority. The main priority of the current administration has been education. Based on the Governor's proposed budget plan for 2001-02, General Fund spending for K-12 education will increase in inflation-adjusted terms by 75 percent since 1990-91. While most of the K-12 education increase over this period reflects the rapid rise in the Proposition 98 minimum funding guarantee during the second half of the 1990s, it also is due to explicit policy decisions to overappropriate the guarantee beginning in 1997-98. The increased K-12

Figure 7

Major General Fund Expenditure Proposals In the Budget

- ✔ Major funding increases for education.
- ✔ $3.3 billion proposed for one-time purposes, including $1 billion set-aside for energy-related programs.
- ✔ Expansions in Medi-Cal and Healthy Families Programs.
- ✔ About $1 billion direct appropriation for capital outlay.

expenditures have primarily been used to fund enrollment growth, COLAs, and various education-related initiatives. In the budget year, $900 million has been proposed for a variety of new spending programs, including a proposal for expanding the middle-school year and for intensive teacher training in math and English language skills.

Spending on higher education has also increased significantly in recent years, due both to enrollment growth and additional monies provided for student fee reductions, building maintenance, new technology grants, and research. New proposals in the budget year continue the theme of strong funding support for higher education, including over $500 million for new capital outlay projects as well as a 5 percent general increase for both the University of California and California State University.

Increased Costs Are Driving Health and Social Services Programs. General Fund expenditures for the state's major health and social services programs are proposed to experience moderate growth in 2001-02. This compares to receiving relatively modest increases throughout much of the past decade, when declining caseloads were occurring. The recent switch to more rapid growth in health care expenditures reflects increased costs and utilization of prescription drugs and services in the Medi-Cal Program, as well as a proposed expansion of the Healthy Families Program. In the case of social services programs, these have contributed to increased General Fund spending in the budget year largely due to COLAs in Supplementary Security Income/State Supplementary Program and technical changes related to the maintenance-of-effort requirement in the California Work Opportunity and Responsibility to Kids program.

Significant One-Time Expenditures. In recent years, the state's extraordinary strong revenue performance, combined with a conscious effort to not overcommit future budgets, resulted in a significant volume of one-time General Fund expenditures. These one-time expenditures have been for a variety of state and local purposes. The Governor's budget proposal continues this trend with over $3.3 billion earmarked for one-time spending in 2001-02. This includes the $1 billion set-aside for energy initiatives along with over $700 million for capital outlay. Other one-time expenditures are allocated to local government fiscal relief, housing initiatives, and clean beaches. Despite the large amount of proposed budget-year one-time expenditures, however, their volume was even more in the current year—which is the primary reason for the decline in the "All Others" spending category shown in Figure 6.

MAJOR EXPENDITURE PROPOSALS IN THE 2001-02 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 2001-02 Budget Bill*.

EDUCATION

Education programs account for 52 percent of General Fund spending in the *2001-02 Governor's Budget*. Below we provide an overview of the budget for K-12 and higher education, beginning with a focus on Proposition 98.

Proposal—K-12

Background. 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.

Governor's Budget-Year Plan. The budget proposes $41.3 billion in total K-12 Proposition 98 funding in 2001-02 (consisting of state General Fund and local property tax allocations). This is an increase of almost $3.2 billion, or 8.3 percent, compared to the 2000-01 revised amount. Pupil attendance is projected to increase by 1.08 percent, resulting in funding of $7,174 per pupil, an increase of $479 (7.1 percent) from the revised 2000-01 amount.

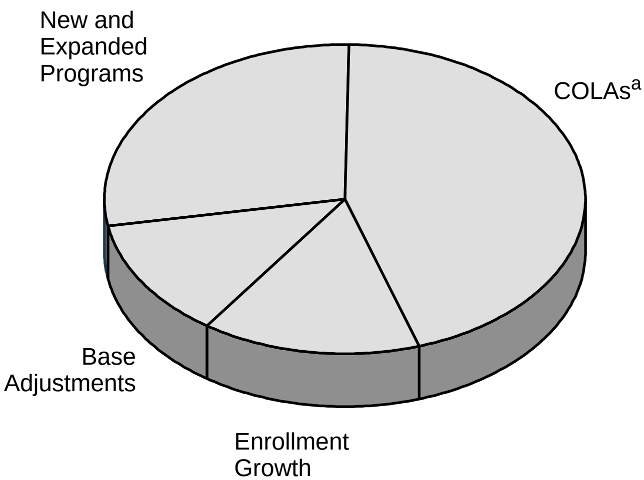
The major 2001-02 budget proposals include:

- $1.4 billion for a 3.91 percent cost-of-living-adjustment (COLA).
- $463 million for projected 1.08 percent growth in average daily attendance (ADA).
- $335 million to train teachers in instruction of mathematics and English based on the state's new academic content standards.
- $125 million for settlement of a long-standing special education mandate claim. The settlement also proposes a one-time payment of $270 million, attributed to 1990-00 for Proposition 98 purposes.
- $123 million to increase awards to schools under the Governor's Performance Awards program to the statutory maximum of $150 per ADA.
- $100 million for initial implementation of an incentive program to extend the school year from 180 days to 210 days in "middle school grades" (grades 6 through 9, depending on school configuration). The annual cost of this program could approach or exceed $1 billion by 2003-04.

Figure 8 illustrates how the budget would allocate projected growth in K-12 Proposition 98 funds in 2001-02.

Figure 8

Proposed Uses of New K-12 Proposition 98 Funds



[a]Cost-of-living adjustments.

Budget "Overappropriates" Proposition 98 Minimum Requirement. The Governor's proposed spending level for Proposition 98 (including the community colleges) exceeds his estimate of the constitutionally required minimum amount for 2001-02 by $1.9 billion. Under the terms of Proposition 98, the state could set its K-14 education spending level at the required minimum amount determined for 2001-02 by the proposition's "test 3" calculation. However, this would cause the state to fall far short of the amount required to meet COLAs, enrollment growth, and adjustments needed to annualize spending for new programs and program expansions authorized in the *2000-01 Budget Act*. The Governor set his proposed appropriation total at Proposition 98's "test 2" amount, which not only meets COLAs, enrollment growth, and annualization needs, but provides resources for further K-14 initiatives. This test 2 spending amount—a combined total of $46.4 billion from the General Fund and local property tax allocations to school and community college districts—also is consistent with the minimum level of annual appropriations that will be required in future years under the terms of Proposition 98. (For all practical purposes, the test 2 calculation determines this long-run appropriations requirement.)

Proposal—Higher Education

The University of California (UC) and the California State University (CSU). The budget proposes General Fund support for UC and CSU of $6.1 billion in 2001-02, an increase of $418 million, or 7.4 percent, compared with estimated current-year budgets. Budgeted enrollment levels at UC and CSU would increase by 5,700 full-time equivalent (FTE) students at UC and 8,760 FTE students at CSU. The budget proposes a 5 percent baseline funding increase totaling $267 million in General Fund appropriations for the two segments. The proposed budget also includes a total General Fund increase of $38 million in lieu of student fee increases.

Community Colleges. The budget proposes $3 billion in General Fund support for the community colleges in 2001-02. All but $83 million of this amount counts as Proposition 98 spending. The 2001-02 General Fund request represents an increase of $225 million, or 8.2 percent, from the current year. The combined increase proposed from all funding sources, including student fee revenues is $444 million, which represents a 7.8 percent increase in combined funding.

In 2001-02, the budget provides $154 million for a 3.91 percent COLA for general-purpose spending, $114 million for enrollment growth of 3 percent, and $62 million to increase part-time faculty salaries.

Student Aid Commission. The budget proposes a General Fund increase of $138 million, or 26 percent, for the Student Aid Commission in

2001-02. The majority of this increase, $128 million, pays for the added costs associated with additional Cal Grant awards authorized by Chapter 403, Statutes of 2000 (SB 1644, Ortiz).

Issues for Legislative Consideration

Need for Greater Local Flexibility—K-12 Education. We take broad issue with the priorities and approach to K-12 education taken by the budget. One of the salient aspects of the *2001-02 Governor's Budget* is the relative lack of discretion given to local school districts. The budget adds to the major area of general purpose funds for K-12—"revenue limits"—only what existing law requires to cover COLAs and enrollment growth. The budget proposes spending the remainder of new funds for K-12 education on a long list of new and expanded categorical programs. As well-intentioned as these programs are, we believe most will be diminished in effectiveness because of constraints on local discretion. A notable exception is the Governor's proposal to expand standards-based training to K-12 teachers over three years, where a significant element of local discretion has been introduced.

To maximize the chances for improving educational results, the state must give local school districts and school sites more flexibility to fit budgetary resources to local circumstances and needs. The approach we take to the state's K-12 education budget in the *2001-02 Analysis of the Budget Bill* builds on this foundation.

Disadvantaged Schools Block Grant. We recommend various changes in Proposition 98 appropriations for the budget year, involving the redirection of almost $800 million of proposed spending. The largest of these changes is a recommendation to establish a $500 million disadvantaged schools block grant focused on middle schools and high schools that are very low-performing and/or have high concentrations of students in poverty. We make this recommendation, in part, as an alternative to the Governor's proposal to extend the length of the school year for middle school grades. Although this proposal by the Governor requires $100 million in 2001-02, it could require annual spending of $1 billion or more by the 2003-04 fiscal year. As we discuss in detail in the *2001-02 Analysis*, the Governor's proposal attempts to address student achievement problems, as measured by standardized test scores, that manifest around grade nine. As we also discuss, however, the proposal's approach is flawed in many respects, including:

- Lack of research strongly supporting the strategy of increasing school year length.
- Lack of flexibility granted to local school districts to use resources for other interventions that could be more effective.

- Absence of means to target "pockets" of educational failure—those schools where low academic performance is most severe.
- High opportunity cost of committing large amounts of money to (1) a single unproven strategy and (2) schools where academic achievement is not a major problem.
- Failure to fully address the fact that the achievement problems persist through high school.

We believe our recommended disadvantaged schools block grant better addresses the above problems. The essence of our block grant is twofold (1) targeting resources to schools and students most in need of additional state help and (2) local discretion to draw from a broad "menu" of specific educational interventions. These interventions could include lengthening the school year at disadvantaged schools—if school officials determine this best meets local needs—but also could include a "mix" of such measures as selective reductions of class size, focused tutoring, improved after school programs, improved quality of curriculum, enriched (or restored) music and arts education, and more and better counseling.

Other Recommendations Provide Expanded Local Flexibility. We make various other recommendations that would give school districts and community colleges more control over their resources. For example, we recommend allocating an additional $175 million to K-12 revenue limits, which districts could use for any purpose. With regard to community colleges, we recommend that $81 million in the budget targeted for various part-time faculty issues and financial aid administration be redirected to Partnership for Excellence. This program gives districts flexibility to direct funding to local priorities in order to meet their education goals.

Make Better Use of Existing Teacher Training Resources. As mentioned above, the Governor proposes a greatly expanded effort over the next three years to train nearly all the state's teachers in providing instruction based on the state's academic content standards. The Governor proposes spending $830 million over the three years, including a $335 million augmentation for 2001-02. We recommend an approach that better accounts for existing programs and provides a more realistic implementation time frame. Our approach provides the same number of teacher training opportunities over the three years, at a General Fund savings of $235 million in 2001-02 and $500 million over the three years.

Better Preparing Students for College. In the *Analysis*, we recommend that the Legislature adopt a multifaceted strategy to improve students' academic preparation for higher education and increase the segments' accountability for appropriately serving unprepared students. Specifically, we recommend the segments assess students' college readiness earlier, report on the preparedness of all entering students, and study the effectiveness of their precollegiate courses across the three segments in a more equitable manner.

ENERGY-RELATED PROPOSALS

The Governor's budget proposes a number of augmentations totaling $1.2 billion ($1.1 billion General Fund) related to the state's energy crisis (see Figure 9). These proposals would add nearly 100 positions across six departments. The largest share of proposed expenditures is for a $1 billion General Fund set-aside for energy initiatives to address the energy crisis. Proposed budget bill language specifies that (1) the funds are for "projects awarded by the Governor's Clean Energy Green Team" and (2) allocation of the amount appropriated will be subject to legislation. No further information is available on this set-aside at this time.

We have withheld recommendation on most of the funding requested, including the $1 billion set-aside, pending receipt and review of information justifying the proposed expenditures. For the Air Resources Board diesel engine grant proposal, we have recommended that, given the policy implications involved, the Legislature delete the $100 million request from the budget bill and adopt the proposal in separate legislation if it wants to fund the program. An overview of all the energy-related proposals can be found in the "Crosscutting Issues" section of the "General Government" chapter of the *Analysis of the 2001-02 Budget Bill*.

Recent Legislative Actions

In addition to these proposals in the Governor's budget, the Legislature convened in a special session on electricity beginning in January. At the time this analysis was written, the special session was continuing and the Legislature had approved several bills related to the state's electricity crisis.

State Purchases of Electricity. On January 17, 2001, the Governor declared a state of emergency in response to the financial condition of Pacific Gas and Electric and Southern California Edison. The Governor ordered the Department of Water Resources (DWR) to buy electricity for these two utilities to meet customer demand. Under this emergency authority, DWR spent $150 million buying electricity.

Subsequently, two special session bills were enacted authorizing the state to purchase and sell electricity. These bills are:

- ***Chapter 3x, Statutes of 2001 (SB 7x, Burton).*** Appropriated $400 million from the General Fund for DWR to purchase elec-

Figure 9

Energy-Related Budget Proposals
2001-02 Governor's Budget

(Dollars in Thousands)

Proposal	Amount: General Fund	Amount: Special Funds	Positions
Energy Initiatives (Item 3365)			
Set-aside for energy projects	$1,000,000	—	—
Air Resources Board (Item 3900)			
Diesel engine grant program to offset new power plant emissions	100,000	—	4
Utilities Costs (Item 9911)			
For increased state department costs for natural gas and electricity	25,000	$25,000	—
Department of Transportation (Item 2660)			
Diesel retrofit and green fleet program to offset emissions from new power plants	—	20,332	—
Energy Commission (Item 3360)			
Long-Term Energy Baseload Reduction Initiative: electricity market analysis, Renewable Energy Program administration, and energy efficiency standards update	3,230	2,626	8
Power plant siting program	3,129	—	19
Alternative energy grant programs	—	1,000	—
Subtotals (Item 3360)	($6,359)	($3,626)	(27)
Department of Justice (Item 0820)			
Investigate electricity generators and natural gas suppliers	$3,975	—	15.5
Public Utilities Commission (Item 8660)			
Green Team activities	2,738	—	34
Track San Diego Gas and Electric costs to purchase electricity	—	$682	4
Subtotals (Item 0820)	($2,738)	($682)	(38)
Electricity Oversight Board (Item 8770)			
Augment and reorganize staff by function to improve market oversight	—	$983	7
Green Team activities	$512	—	4
Contract funds for the University of California Energy Institute for market research	—	500	—
Reauthorize expired positions	—	249	3
Contract funds for legal services	—	75	—
Subtotals (Item 8770)	($512)	($1,807)	(14)
Totals	**$1,138,584**	**$51,447**	**98.5**

tricity for 12 days beginning January 19 (the day the statute became effective), and sell it at cost to the Independent System Operator (ISO), municipal utilities, or directly to utility customers.

- ***Chapter 4x, Statutes of 2001 (AB 1x, Keeley).*** Authorized DWR to enter into long-term contracts to purchase electricity, authorized the sale of revenue bonds (discussed further below), appropriated $500 million from the General Fund for the state to continue purchasing electricity, and authorized a ten-day notification process to the Legislature for deficiency requests from the Department of Finance (DOF) for additional funds.

As the state began negotiating cheaper long-term contracts, pursuant to AB 1x, DOF submitted a deficiency request to the Legislature for an additional $500 million. Thus, the state had committed to $1.6 billion from the General Fund to buy electricity at the time this analysis was written.

Assembly Bill 1x also authorized DWR to issue revenue bonds to help finance the cost of the state's electricity purchases. These bonds would be used in part to reimburse the General Fund for the funds already committed for this purpose, presumably before the end of the current year. In addition, the bonds would prospectively finance the difference between the actual cost DWR pays for electricity and the rate consumers pay. A portion of ratepayers' payments will be designated to pay off these bonds.

Other Legislation. In addition to these two bills, the Legislature has also revised some provisions of the original restructuring legislation. Chapter 1x, Statutes of 2001 (AB 5x, Keeley), replaced the 26-member stakeholder board of ISO with a five-member board of gubernatorial appointees. Board members cannot be affiliated with any participants in the electricity market and do not require Senate confirmation.

Chapter 2x, Statutes of 2001 (AB 6x, Dutra), prohibits the utilities from selling any more power plants until January 1, 2006. Remaining utility-owned power plants are to be dedicated to providing electricity to utility customers.

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. Much of this infrastructure is aging. For example, 55 million square feet in the three public higher education segments was built or renovated over 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.

Proposal

Budget Bill Proposal. The budget includes nearly $2 billion for the state's infrastructure (excluding highways and rail programs). As shown in Figure 10, over 40 percent of the proposal is for higher education with the next largest amounts in health and human services and resources. Nearly all of the amount under health and human services is for one project—a new 1,500 bed sexually violent predator facility in Coalinga (Fresno County) for the Department of Mental Health.

Nearly 50 percent of the amount proposed in the budget is for pay-as-you-go funding. Of this amount about $758 million is from the General Fund, with the balance from special funds and federal funds. These direct appropriations are for 32 agencies for a variety of proposals—such as land acquisition, new courthouses, fire stations, research institutes, and various infrastructure and building improvements. Bond financing totals $1 billion, consisting of general obligation bonds ($667 million) and lease payment bonds ($349 million). The proposed general obligation bonds primarily finance projects for higher education ($554 million) and resources ($113 million). The proposed $349 million in lease payment bonds would finance the sexually violent predator facility mentioned above.

Figure 10

State Capital Outlay Program

2000-01 and 2001-02
(In Millions)

	2000-01 Appropriations	2001-02 Governor's Budget	Difference
Legislative, Judicial, and Executive	$69.2	$19.2	-$50.0
State and Consumer Services	54.7	141.7	87.0
Business, Transportation (excluding highways and rail), and Housing	26.9	170.7	143.8
Environmental Protection	0.3	3.1	2.8
Resources	972.2	287.1	-685.1
Health and Human Services	18.7	360.0	341.4
Youth and Adult Corrections	123.7	115.3	-8.4
Education	8.0	2.6	-5.5
Higher Education	826.1	862.3	36.2
General Government	11.3	32.0	21.6
Totals	**$2,111.0**	**$1,993.9**	**-$116.2**

Bond Debt. The state's debt payments on bonds will be about $3.2 billion in the budget year. This is an increase of 10 percent over current-year payments. The payments include $2.6 billion for general obligation bonds and $574 million for lease-payment bonds. We estimate that the amount of debt payments on General Fund-backed bonds as a percent of General Fund revenue (that is, the state's debt ratio) will be 3.8 percent in the budget year.

Issues for Legislative Consideration

Implementing the California Infrastructure Plan. Addressing the issues of an aging infrastructure and population growth will require expenditures of billions of dollars to renovate existing infrastructure and develop new public infrastructure. A significant step toward developing a process to address this issue was the enactment of Chapter 606, Statutes of 1999 (AB 1473, Hertzberg)—*The California Infrastructure Planning Act*. The act requires—beginning January 10, 2002 and annually thereafter—the Governor to submit to the Legislature a statewide five-year infrastructure plan and a proposal to fund it. The plan is to contain infrastructure needs of all state departments and public schools.

The new California Infrastructure Plan should provide the Legislature with more information on a statewide basis than it has had in the past. The specific information required to be included in the plan, however, may not be sufficient for the Legislature to assess whether or not the plan supports statewide infrastructure needs. We are also concerned that the Legislature will not receive the information in a timely manner. For example, the DOF issued a budget letter dated January 12, 2001, directing departments not to share capital outlay budget proposals and five-year plans with our office. This is contrary to the practice of over 30 years, whereby departments have sent the information to our office at the same time it is sent to DOF. This will severely limit our ability to conduct site visits of proposed projects and provide timely policy analysis and recommendations to the Legislature. This also greatly restricts the information available to the Legislature when it is asked to appropriate capital outlay funding. To address these concerns and to begin the Legislature's participation in the infrastructure planning process, we recommend the Legislature hold hearings this spring on the administration's process for developing the plan and on the way the plan can be used by both the administration and the Legislature to more effectively provide for the state's future infrastructure.

Funding Higher Education Capital Outlay. We continue to recommend that the Legislature fund the capital outlay program for the three segments of higher education based on statewide priorities and criteria, making use of appropriate construction cost guidelines, and on the basis of year-round operation (YRO) of facilities.

- ***Priorities and Criteria.*** We recommend the Legislature apply statewide priorities and criteria when funding higher education capital outlay. Our recommended priorities and criteria are summarized in Figure 11. Also, we recommend the Legislature appropriate funds on the basis of *statewide* priorities and criteria, not on the formula used in recent years that allocates one-third of available bond funds each to UC, CSU, and the community colleges.

Figure 11

LAO Recommended Priorities for Funding Higher Education Capital Outlay Projects

Priority Order	Description of Priority
1	**Critical Fire, Life Safety, and Seismic Deficiencies**
2	**Necessary Equipment**
3	**Critical Deficiencies in Utility Systems**
4	**Improvements for Undergraduate Academic Programs** ✔ New construction or renovations that increase instructional efficiency, and are needed based on year-round operation. ✔ Libraries. ✔ Renovation of existing instructional buildings. • Enrollment shifts in wet laboratories. • Enrollment shifts in other instructional spaces. • Buildings 30 years or older that no longer can accommodate the academic program. • Instructional program changes.
5	**Research and Administrative Facilities** ✔ Research laboratories. ✔ Faculty and administrative offices.
6	**Integrity of Operationally Important Facilities**
7	**Support Facilities**

- ***Construction Cost Guidelines.*** Based on our review of construction costs for over 550 classrooms, teaching laboratories, and research buildings throughout the country, we have concluded that construction cost guidelines used by CSU and the community colleges are in line with construction costs elsewhere. However, for UC, which does not use construction cost guidelines, construction costs are extremely high. Thus, we recommend that the Legislature fund UC facilities—other than research laboratories—based on the CSU guidelines. Our review of 357 research buildings comparable to those at UC shows that the construction cost of those at the 75th percentile (that is, the building that is costlier than 75 percent of the buildings in the group) is $441 per assignable square foot. While UC research buildings can be expected to have a range of costs (depending on the research program to be housed), we recommend they be funded in an amount not exceeding the 75th cost percentile. Our recommendations on research projects in the Governor's budget are based on this guideline.

- ***Year-Round Operations.*** We recommend the Legislature fund capital outlay for higher education on the basis of YRO. With YRO, UC could accommodate up to 50,000 additional FTE students in its existing facilities. The CSU campuses could accommodate up to an additional 90,000. The community colleges say that they currently operate their campuses year round, but the state provides capital outlay funding to them on the basis of operating only three quarters of the year. This results in capital outlay funding in excess of what is needed. We therefore recommend the Legislature also fund capital outlay for community colleges on the basis of YRO. Construction of new facilities may be necessary under YRO, but it will be primarily for reasons other than enrollment growth. For example, new teaching laboratories may be needed because of shifts in academic programs, or new instructional facilities may be justified because they increase instructional efficiency (for example, using distance learning).

HEALTH SERVICES

Proposal

Background. The state system for providing health care services to the medically needy is comprised of a number of separate programs, the most significant of which are Medi-Cal, Healthy Families, Child Health and Disability Prevention (CHDP), and California Children's Services.

The state also supports a number of public health programs targeted at certain diseases and certain populations with special health needs.

The *2001-02 Governor's Budget* provides funding to continue the implementation of several recent efforts to expand the number of persons receiving health benefits through the Medi-Cal and Healthy Families Programs. It also proposes a new initiative to expand eligibility for Healthy Families to certain parents. The budget plan also proposes some new public health programs and the expansion of some existing ones. We summarize the major 2001-02 budget proposals below.

Medi-Cal. The Medi-Cal Program provides health care benefits to welfare recipients and to other qualified low-income persons, primarily families with children and the aged, blind, or disabled. Funding for the program is split about evenly between the state and the federal governments. The 2001-02 budget plan includes funding to continue implementation of major initiatives relating to Medi-Cal. These include (1) the expansion of health coverage to families, including working families with two parents, earning up to 100 percent of the federal poverty level (FPL), and (2) the provision of benefits without a share of cost to all aged, blind, and disabled persons with current income equivalent to 133 percent of the FPL. The budget plan would also implement previously approved changes in Medi-Cal that would provide continuous eligibility for children up to 19 years of age and eliminate quarterly status reporting requirements for families.

Healthy Families. The Healthy Families Program implements the federal State Children's Health Insurance Program, in which each state dollar spent for persons eligible for health coverage is matched by about $2 in federal funding. Families pay a relatively low monthly premium and can choose from a selection of managed care plans for their children.

The *2001-02 Governor's Budget* provides funding to continue an expansion of health coverage to children in families earning up to 250 percent of the FPL and to provide state-only benefits for children who are legal immigrants who do not qualify for federal funding because they entered the U.S. after August 22, 1996.

The Governor's budget plan includes a proposal to expand coverage under Healthy Families to parents of Health Families' eligible children with family income between 100 percent and 200 percent of the FPL. Funding would also be provided to expand coverage to parents of Medi-Cal eligible children who are ineligible or enrolled in Medi-Cal with a share of cost with incomes between 100 percent and 200 percent of the FPL, as well as parents with income below 100 percent of the FPL who do not qualify for Medi-Cal because of asset tests.

Public Health Programs. The budget plan provides funds to create or expand various public health programs. The funds would come from the General Fund and a proposed new trust fund comprised of monies from the settlement of tobacco litigation. Proposals include medical screening and treatment programs for prostate cancer and breast cancer, as well as programs to prevent youth from using tobacco and better tracking of infectious diseases.

Issues for Legislative Consideration

Ensure Programs Work More Effectively. An estimated 5 million low-income people in California do not have health coverage. Of this total, about 1.6 million are uninsured low-income children and the remainder are parents and single adults who do not qualify for government health assistance and lack private coverage through their employers.

In recent years, the Legislature and the Governor have focused on efforts to reduce the number of uninsured children and adults and to improve access to health care for those who do have coverage. While the changes will expand health care coverage, the Legislature may wish to consider further steps to ensure that the state's complicated mosaic of health programs is working effectively—both separately and in combination with each other—to improve access to health care. Our analysis indicates that California's health care system remains fragmented and overly complex, with significant negative consequences for the health of California's medically needy and for state taxpayers. New health programs have been added or expanded over the years without full consideration of how the changes fit with the ones that were made before. This has led to a number of significant problems.

For example, while eligibility for coverage is being expanded, many persons who were already eligible for these programs are not being enrolled in them. A number of barriers continue to deter enrollment in health coverage, including requirements that parents and children enroll in different programs and be served by different health providers; asset tests to determine eligibility; and complicated application approval procedures. In a number of respects, California's public health care system is not operating much like a system at all. State-funded public health programs such as CHDP often fail to refer and help enroll their clients in more comprehensive coverage; incompatible computerized data systems and overlapping eligibility criteria lead to inefficiencies such as double-billing and added paperwork; and persons enrolled in coverage may encounter difficulty finding a doctor willing to accept them as patients.

Given this situation, the Legislature may wish to consider further steps to create a more comprehensive and effective health care system by improving the way existing state health programs work separately, and together, to provide medically necessary coverage. Opportunities for improving the state's health care system are summarized below and discussed in more detail in the *Analysis.*

Make CHDP a True "Gateway" Program. The CHDP program provides health screens and immunizations for California's low-income uninsured children. The program was also intended to serve as a gateway for children to enter a more comprehensive health care system provided by the Medi-Cal and Healthy Families Programs. However, the state has missed opportunities to establish CHDP as a gateway to better health coverage for these children and to use available federal funds to help support the cost of providing the care.

We recommend in the *Analysis* a number of steps to address this problem, including establishing new requirements for providers to encourage enrollment in Medi-Cal and Healthy Families, conforming CHDP income eligibility rules with those of the Health Families Program, improving data tracking systems, providing greater assistance to families in applying for coverage, and further simplifying the benefits application process.

Healthy Families Expansion. Our analysis indicates that the Governor's proposal to expand Healthy Families coverage to certain parents appears to meet the criteria needed to obtain the approval of the federal government, but misses some opportunities to further reduce the ranks of the uninsured and to conform and simplify the Healthy Families and Medi-Cal Programs.

In the *Analysis*, we outline an option for the Legislature to further expand coverage to parents in families earning up to 250 percent of the FPL in a way that would maximize the use of available federal funding. We also discuss an option of eliminating the asset test for determining eligibility for Medi-Cal, a step that would bring the Medi-Cal and Healthy Families Programs into closer conformity.

A More Rational Approach to Setting Medi-Cal Physician Rates. There is some evidence to suggest that the level of rates paid to physicians affects access to medical care. Our analysis indicates that the rates paid to physicians for Medi-Cal services are relatively low compared to those paid by other providers. Despite state and federal requirements, the state has not conducted annual rate reviews or made periodic adjustments to Medi-Cal rates to ensure reasonable access to health care services. Rate adjustments have generally been adopted on an ad hoc basis.

In the *Analysis*, we recommend that the Legislature establish a more rational process for setting Medi-Cal rates and for periodically reviewing and adjusting those rates. Medicare rates would be used as a benchmark in the interim. Later, a comprehensive analysis of access to physician services and the quality of care provided to Medi-Cal beneficiaries would become the basis for future rate adjustments.

Breast and Cervical Cancer Coverage. Federal legislation enacted last year gives California the opportunity to build on the limited services now available for low-income women who are diagnosed with breast or cervical cancer. Our analysis indicates that the state could coordinate its existing cancer screening programs with new Medi-Cal coverage options in a way that would simplify eligibility determinations, meet the health care needs of low-income individuals with cancer, and improve access to cancer screens for women with a high risk of cancer.

In the *Analysis*, we outline several options for the Legislature that would allow the state to address the current gaps in coverage of cancer treatment, drawdown available federal funding, better align eligibility among related programs, and expand the network of providers who could provide needed treatment services.

CRIMINAL JUSTICE AND JUDICIARY

State and local governments spend more than $18 billion annually to fight crime. Local governments are largely responsible for crime fighting and thus, spend the bulk of total criminal justice monies for law enforcement activities. State expenditures have grown significantly in recent years, however, particularly for support of the state's largest criminal justice department, the California Department of Corrections (CDC). The CDC is responsible for the incarceration, training, education, and supervision in the community of adult criminals. Other state entities spend large sums of money on criminal justice activities as well, including the Departments of the Youth Authority and Justice; the courts; and the Office of Criminal Justice Planning (OCJP).

Proposal

The budget proposes about $8.2 billion from the General Fund and other funds for support of criminal justice programs in the budget year, an increase of 3.8 percent over the current year.

The CDC accounts for the largest share of this funding, $4.8 billion, or about 5 percent more than the current-year amount. The CDC budget provides full funding for projected growth in the number of prison inmates and parolees under current law, as well as several program augmentations.

Other significant criminal justice General Fund increases include $40 million for a new War on Methamphetamine program in OCJP to provide noncompetitive grants to local law enforcement agencies within the Central Valley. The Governor also proposes $30 million for OCJP grants to local governments to improve local forensic laboratories for all but the City and County of Los Angeles which received a $96 million grant last year. Finally, the budget proposes $11.1 million to OCJP for two programs to fight high-technology crime.

Issues for Legislative Consideration

Target Crime Fighting Based on Need. Between 1991 and 2000, California experienced a steep drop in crime. In fact, the 1998 rate was the lowest the state had experienced in over 30 years. In the last year, however, this trend reversed itself very slightly as the California crime index inched up by 1.3 percent. This increase was not distributed evenly across types of crimes, nor was it distributed evenly across jurisdictions. Instead, crime increases were registered primarily in Los Angeles metropolitan communities and other selected locales around the state.

These variations—both in the rates of increase or decrease as well as the locations—point to the need to target crime fighting efforts at specific locales based on need. This would be a more cost-effective approach for state funding than spreading resources across jurisdictions on a per-capita basis.

Correctional Spending Trends. Past declines in statewide crime rates have contributed to a slowdown in the growth of the state's correctional populations. The CDC continues to project a slowing rate of growth, but has not yet taken into account the effect of Proposition 36, the Substance Abuse and Crime Prevention Act, enacted by the voters in 2000. Our review indicates that inmate growth rates will be slower than projected and, when coupled with the effects or Proposition 36, will actually decline slightly between the current and budget year. Youth Authority wards and parolees also are expected to decline slightly.

With regard to spending for correctional programs, the Governor's budget contains no significant initiatives or major expenditure changes. Instead, it provides modest program enhancements and reforms for medical care, substance abuse, and mental health in both the CDC and Youth Authority budgets.

The CDC has taken steps to screen and provide specialized services to inmates with developmental disabilities, in response to a recent court case. We point out, however, that CDC's plan fails to address the community service needs of *parolees* with similar disabilities. To ensure that these parolees receive such services, it will be necessary for the department to examine their service needs and develop a follow-up plan.

Focus State's Crime-Fighting Role. Because law enforcement is primarily a local responsibility, it is important for the state to carefully delimit an appropriate role for itself. In our view, some of the Governor's proposals would unnecessarily overlap the responsibilities of different state agencies for targeted crimes. For example, the new War on Methamphetamine program proposed for OCJP would overlap the Department of Justice's existing statewide effort to combat methamphetamine production, trafficking, and use. In addition, some proposals such as those directed at high-technology crime and identity theft, would significantly expand the state's involvement in local law enforcement activities. Alternatively, we recommend targeting funds on those functions that would benefit from centralized statewide development, such as database and research support or training. Finally, some proposals fail to consider alternative funding sources or give inadequate attention to the desired state funding approach, described above, of awarding competitive grants based on demonstrated local need.

Question of State Support for Trial Courts Needs Resolution. The state General Fund now contributes over $1.2 billion toward the cost of trial court operations. This is a result of recent legislation that transferred responsibility for court operations and personnel systems from counties to the state. One issue which the Governor's budget does not address is whether and under what circumstances responsibility for court facilities also should be transferred to the state. In our view, state responsibility for those facilities would be consistent with prior legislative actions in the area of court operations and personnel.

This issue of facility responsibility is one which deserves immediate legislative attention for several reasons. First, until this issue is resolved, some counties are likely to continue to backlog deferred maintenance, thereby resulting in continued facility deterioration. Second, facility transfer poses a potentially huge funding liability to the state's General Fund. The current annual cost of supporting court facilities is estimated at $119 million (which would be offset by $80 million to $90 million in county maintenance-of-effort agreements). The larger cost, however, is the estimated *future* capital funding needs which are estimated in the multibillion dollar range over the next 20 years.

Because of the fiscal implications and complexity of the task, we recommend enactment of legislation that would carefully detail and streamline the process of transferring the court facilities from the counties to the state. The legislation should also carefully define state and county responsibilities so as to appropriately limit the state's future funding liability. In addition, we recommend a number of ways to develop a strategy for the state to use in dealing with the escalating costs of state support for court operations and personnel.

TRANSPORTATION

Intercity Rail Program. The state supports and funds intercity passenger rail services on three corridors—the Pacific Surfliner (formerly the San Diegan) in Southern California, the San Joaquin in the Central Valley, and the Capitol in Northern California. Intercity rail services primarily serve business and recreational travelers going between cities in California and to other parts of the country.

The state contracts with Amtrak for the operation and maintenance of the intercity rail service. In 2000-01, state operating costs for intercity rail services are about $64 million.

Proposal

Caltrans Issues Ten-Year Rail Plan. In October 2000, the California Department of Transportation (Caltrans) issued its statutorily required ten-year passenger rail plan, covering the period from 1999-00 through 2008-09. The plan calls for a substantial expansion of state-supported intercity rail service over ten years in order to improve customer service. Specifically, the plan envisions $3.2 billion in capital improvements over ten years, including track and signal improvements, as well as maintenance facilities. In general, these improvements are expected to increase on-time performance, reduce travel times between stations, and expand track capacity for additional round trips between cities. The plan also forecasts annual state operating costs to increase to $118 million by 2008-09, mainly due to additional round-trip services on existing corridors and the start of service on new corridors.

Budget Request Begins to Implement Ten-Year Plan. For 2001-02, Caltrans requests substantial funds from the Public Transportation Account to make capital improvements and to expand rail service on two corridors in order to carry out the rail plan. For capital improvements, the budget requests $98 million for the following:

- $48 million for track improvements on the Pacific Surfliner in Orange County.
- $29.4 million for double tracking and signal improvements on the San Joaquin in Contra Costa County.
- $20.6 million for double tracking on the Capitol in Yolo County.

For service expansion, the budget requests $9.5 million for the following:

- $4.2 million for an additional round trip between Bakersfield and Sacramento, bringing the total number of round trips on the San Joaquin corridor to six.
- $5.3 million for the Capitol corridor to continue operating two new round trips, funded by the 2000 Transportation Congestion Relief Program and anticipated to begin service in April 2001.

Issues for Legislative Consideration

The Legislature should consider the following two factors when assessing the budget proposal in the near term, and Caltrans' ten-year rail plan in the long term: (1) what it wants the state's role to be in funding intercity rail vis-a-vis commuter rail and (2) the extent to which proposed capital improvements and service expansions are justified by ridership performance.

Current State and Local Passenger Rail Roles Blurred. Chapter 622, Statutes of 1997 (SB 45, Kopp) defined the state's role in mass transportation as primarily providing for interregional transportation while local agencies are responsible for regional services. As a result, Caltrans concentrates on providing intercity rail service, while leaving regional services to commuter and urban rail systems run by regional and local agencies. Commuter rail generally offers frequent service during the commute hours throughout a metropolitan region and may cover a number of cities. Urban rail generally provides regular service throughout the day.

The distinction, however, between state and local responsibilities has started to blur. For example, on portions of the Pacific Surfliner corridor, state-supported rail transportation is in direct competition with regional commuter rail systems. Specifically, between Oceanside and San Diego, the Surfliner travels the same corridor with the Coaster, a regional commuter rail system. North from Oceanside to downtown Los Angeles, the Surfliner shares tracks with Metrolink, another commuter rail service.

The blurring of responsibilities is also found in northern California. For example, the San Joaquin corridor provides daily service between Stockton and Oakland, while the Altamont Commuter Express—another regional commuter rail service—provides daily round trips between Stockton and San Jose.

The increased investments proposed for intercity rail further blur the distinction between the state-supported intercity rail program and regional commuter rail systems. This is because Caltrans' plan to expand the intercity rail service, through adding more round trips particularly at commute hours, moves the state closer to providing regional commuter rail service. Essentially, this moves the state further away from the policy established under Chapter 622 which envisions the state providing interregional rail service while local agencies provide regional service. If the Legislature determines that the state's responsibility should continue to be interregional transportation, then as intercity rail investment decisions are made, the Legislature should consider whether capital and service enhancements primarily benefit interregional or regional mobility.

Justification for Intercity Rail Enhancements Depend on Ridership Performance. A key reason to make rail capital improvements is to increase the number of passengers who ride the system. According to Caltrans, the proposed track and signal projects in the Governor's budget would increase track capacity, thereby enabling an increase in round-trip service that would generate more riders. Therefore, the decision whether to invest in additional capital improvements should be based on evidence that the increased expenditures will increase ridership.

Of the $3.2 billion in capital improvements proposed in the rail plan, $2.6 billion are for improvements on the three existing intercity rail corridors. With these investments, the plan projects ridership to increase by 84 percent (from 2.9 million in 1999-00 to 5.4 million in 2008-09).

The projected ridership increase is likely to be overstated, however. The increase—at an average annual growth rate of 7 percent—is significantly higher than the average growth rate (2.9 percent) experienced between 1990-91 and 1999-00. Furthermore, in the past, Caltrans has been too optimistic in its intercity rail ridership projections. For instance, from 1997-98 through 1999-00, actual ridership was between 7 percent and 18 percent *below* the department's ridership projections.

Our review also shows that an increase in round-trip service on two of the three corridors has not resulted in a corresponding ridership increase in recent years. For instance, between 1990-91 and 1999-00, additional capital improvements were made to the Pacific Surfliner corridor and round-trip services expanded from 8 to 11 per day. Yet, over this period, ridership on the Surfliner either fell or remained relatively flat, largely because of alternative commuter rail service being available within the same corridor. As for the San Joaquin corridor, a large increase in total ridership occurred in 1996-97 and 1997-98, after four years of no expansion in round-trip service. However, when a new round trip was added in 1998-99, ridership remained flat for two consecutive years.

Analyst's Recommendation. Capital improvements to the intercity rail services are warranted to the extent the improvements lead consistently to more use by riders. However, as discussed above, increased service on both the Pacific Surfliner and the San Joaquin in recent years, facilitated by various capital improvements, have not generated a commensurate increase in riders. Accordingly, we recommend that the capital projects proposed for the two services in 2001-02 not be funded.

For primarily the same reason, we recommend that the request for $4.2 million to add a sixth round-trip on the San Joaquin corridor not be funded. Our review shows that while ridership dropped by 4.4 percent between 1997-98 and 1999-00, state costs to support the San Joaquin service increased by 50 percent from about $24 to over $36 per passenger. As a result, expending additional funds to expand round-trip service does not seem warranted at this time.

RESOURCES

State Faces Major Water-Related Problems. The state faces a number of water-related problems, including (1) various issues related to the San Francisco Bay/Sacramento-San Joaquin Delta Estuary (the Bay-Delta) and (2) the existence of a large number of seriously polluted water bodies statewide.

Bay-Delta Problems. The CALFED Bay-Delta Program (CALFED) was formed in 1995 to address the interrelated water problems in the Bay-Delta, including inadequate water quality, declining fish and wildlife populations, deteriorating levees, and uncertain water supplies. This program is a consortium of 18 state and federal agencies that have regulatory authority over water and resource management responsibilities in the Bay-Delta. Since 1995, the program has been developing a planning framework to address these water-relater problems. The planning process culminated in August 2000 with the signing of the "Record of Decision" (ROD) by the lead CALFED agencies. The ROD guides the first seven years of the program's implementation at an estimated cost of $8.5 billion. The ROD allocates costs among federal, state, and user/local sources.

The existing organizational structure of CALFED, currently housed in the Department of Water Resources (DWR), is loosely configured. This reflects the fact that the program has evolved administratively and has not been spelled out in state statute.

Seriously Polluted Water Bodies. Under federal law, states are required to develop plans to address pollution in the state's most seriously impaired water bodies. These plans—called Total Maximum Daily Loads (TMDLs)—are developed for each pollutant contributing to the pollution problem. The TMDLs allocate responsibility for reducing pollution among the various sources of pollution. Currently, there are 509 water bodies on the state's most recent list of impaired water bodies, requiring the development of 1,471 TMDLs.

Proposal

The CALFED Bay-Delta Program. The budget proposes $414 million of state funds—spread throughout seven state departments—for CALFED-related programs in 2001-02. Of this amount, $94 million is from the General Fund and the balance is mainly from bond funds. The program is divided into 11 program elements. As in the current year, the largest state expenditures are proposed for ecosystem restoration ($161 million) and water storage ($56 million, of which $19 million is for studies to be conducted by DWR). In addition, the budget proposes about $30 million for the Environmental Water Account (EWA). The EWA is a new concept that would involve the state buying water to hold in reserve to release when needed for fish protection.

The TMDL Program. The budget proposes about $12 million (mainly General Fund) for the State Water Resources Control Board (SWRCB) to develop TMDLs. In addition, the budget proposes about $1.6 million for the Department of Pesticide Regulation to assist SWRCB in developing TMDLs. These proposed expenditures represent no change from estimated expenditures in the current year.

Issues for Legislative Consideration

The CALFED Bay-Delta Program. As part of its review of CALFED-related proposals, the Legislature should consider the following:

- ***Enhancing Legislative Review of CALFED Budget Proposals.*** A department-by-department review of CALFED budget proposals would not give the Legislature a comprehensive picture of the proposed funding and program activities of CALFED and how the various program elements work together. We therefore recommend that each house's water and natural resources policy committees and budget subcommittees hold joint hearings on CALFED budget proposals. This will give the Legislature an opportunity to evaluate the policy choices inherent in CALFED's plan and provide policy direction where needed.
- ***Improving Accountability to the Legislature.*** As a result of the current loose structure of CALFED, there is not a clear point of accountability to the Legislature for CALFED-related decisions and expenditures. We recommend the enactment of legislation to establish an organizational structure that provides this accountability.
- ***Lack of Federal Funds.*** The budget assumes receipt of about $365 million in federal funds for CALFED in 2001-02 (in addition to the proposed state funds of $414 million). Each of the program's 11 elements depends to some degree on federal funds. However,

the availability of these funds is highly uncertain. The Legislature should be advised of the programmatic implications as well as the administration's plans if federal funds do not materialize. The Legislature should also provide clear direction on its expenditure priorities to guide any midyear budget adjustments in the event that the federal funds are not forthcoming at anticipated levels.

- ***The EWA.*** The EWA raises a number of policy and implementation issues that should be considered by the Legislature before this activity proceeds. Specifically, the Legislature should evaluate the costs and benefits of EWA and the impacts of EWA on the water transfer marketplace and groundwater resources. The Legislature should also evaluate the appropriate state role in EWA, particularly in terms of funding. If the Legislature approves of the EWA concept, we recommend the enactment of legislation to create the program and to specify how the program will be governed, funded, operated, and held accountable.

- ***Water Storage Studies.*** The budget allocates funds for various water storage studies, including offstream storage north of the Delta and surface/groundwater conjunctive use. The Legislature should consider whether the budget's proposed allocation of expenditures among these elements meets its own priorities.

The TMDL Program. Our review finds that the state lags in developing TMDLs, has no long-term work plan, and is spending ten times the national average to develop each plan. The slow pace of developing TMDLs has potentially serious consequences, including delays in improving water quality, a loss of federal funds, and federal takeover of aspects of the state's water quality program.

We find that there are a number of efficiencies and improvements that would make the TMDL program more effective and timely while reducing the costs of the program. In this regard, we recommend enactment of legislation to (1) require greater policy direction from SWRCB to the regional water quality control boards (the entities mainly responsible for developing TMDLs) and (2) streamline the TMDL approval process. Greater policy direction from SWRCB is needed to address a general perception in the regulated community that regional board decisions related to TMDLs are made arbitrarily. If this perception is not addressed, further delays and costs in TMDL development are likely because TMDL decisions are more likely to be challenged in court. Finally, to enable legislative evaluation of the program's funding requirements, the Legislature should require SWRCB to develop a ten-year work plan and budget for the program.

EMPLOYEE COMPENSATION

State employees (other than those in higher education) last received a general pay increase of 4 percent on September 1, 2000. Figure 12 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.

Proposal

State Civil Service Employees. The Governor's budget does not include any budget-year funding for employee compensation. However, the Department of Personnel Administration (DPA) will begin collective

Figure 12

State General Salary Increases

1981-82 Through 2001-02

Fiscal Year	State General Salary Increases	Consumer Price Indices	
		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	5.5	1.7	2.5
1999-00	4.0	2.9	3.1
2000-01[a]	4.0	3.0	4.0
2001-02[b]	—[b]	2.3	2.8

[a] Legislative Analyst's Office estimate of consumer price indices.
[b] To be determined through collective bargaining.

bargaining negotiations to replace the expiring memoranda of understanding (MOUs) this spring. As a result, we anticipate the state will face increased compensation costs in 2001-02. Based on current salary levels, we estimate that a 1 percent salary increase for state employees increases General Fund costs approximately $55 million.

Employees in Higher Education. In higher education, the Governor's budget proposes $131 million for UC and $96 million for CSU for employee compensation to provide salary and benefit increases to faculty and staff. Figure 13 shows how these amounts would be allocated.

Figure 13

Higher Education Proposed Compensation Increases

General Fund (In Millions)

University of California	
Merit salary increases	$43.0
Average 2 percent cost-of-living increase	38.4
Full-year cost of 2000-01 salary increases	19.5
Health benefit cost increases	13.1
Parity adjustments for staff and nonfaculty academic employees	10.0
Parity adjustments for faculty	7.1
Subtotal	($131.1)
California State University	
4 percent compensation pool (effective July 1, 2001)	$81.5
Health and dental benefit cost increases	13.2
Full-year cost of 2000-01 salary increases	1.5
Subtotal	($96.2)
Higher Education Total	**$227.3**

Issues for Legislative Consideration

Current Status of Negotiations. In September 1999, the Legislature approved MOUs for all of the state's 21 collective bargaining units. (This does not include employees in higher education.) These agreements are effective until June 30, 2001. The new MOUs provided 4 percent general salary increases effective July 1, 1999 and September 1, 2000. For employees not covered by collective bargaining (such as managers and supervisors), DPA approved a compensation package similar to that approved in the MOUs. As noted above, DPA will begin negotiations for new MOUs with the unions representing the 21 bargaining units this spring.

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 during 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).

V

Major Issues Facing the Legislature

REALIGNMENT REVISITED:

An Evaluation of the 1991 Experiment In State-County Relations

How Has Realignment Affected Mental Health, Social Services, and Health Programs? How Can Realignment Be Improved?

Summary

In 1991, the state enacted a major change in the state and local government relationship, known as realignment. In the areas of mental health, social services, and health, realignment transferred programs to county control, altered program cost-sharing ratios, and provided counties with dedicated tax revenues from the sales tax and vehicle license fee to pay for these changes. This report summarizes the major components of realignment, evaluates its effectiveness, and provides recommendations to improve its administration.

Realignment has been a largely successful experiment in the state-county relationship. Its dedicated revenue stream has helped to create an environment of fiscal stability which improves program performance. The flexibility provided within realignment has allowed some counties to effectively prioritize their needs among many competing demands.

Realignment could be improved by creating greater fiscal incentives to promote more efficient delivery of public services. Specifically, we propose a simplified system for allocating all new realignment dollars that would improve county incentives to control costs and increase local control. By emphasizing efficient fiscal incentives and performance accountability, realignment could serve as a useful model for future program changes in the state-county relationship.

INTRODUCTION

In 1991, the state enacted a major change in the state and local relationship—known as realignment. In the areas of mental health, social services, and health—realignment shifted program responsibilities from the state to counties, adjusted cost-sharing ratios, and provided counties a dedicated revenue stream to pay for these changes. While there have been other significant changes in the broader state-county relationship since the enactment of realignment, the effects of realignment over the past decade have not been reviewed in a comprehensive manner.

In this piece, we (1) summarize the major components of realignment, (2) evaluate whether realignment has attained its original goals and its ability to meet current and future needs of the state, and (3) provide recommendations to improve the workings of the state-local relationship in this area.

BACKGROUND

In 1991, the state faced a multibillion dollar budget problem. Initially responding to Governor Wilson's proposal to transfer authority over some mental health and health programs to counties, the Legislature considered a number of options to simultaneously reduce the state's budget shortfall and improve the workings of state-county programs. Ultimately, the Legislature developed a package of realignment legislation that:

- Transferred several programs from the state to the counties, most significantly certain health and mental health programs.
- Changed the way state and county costs are shared for social services and health programs.
- Increased the sales tax and vehicle license fee (VLF) and dedicated these increased revenues for the increased financial obligations of counties.

The specific programs that were transferred and the changes in cost-sharing ratios are summarized in Figure 1 and discussed below.

Realignment Principles

While closing the budget gap was a top priority at the time, the Legislature also relied on a series of policy principles in implementing the realignment changes, including:

Figure 1

Components of Realignment

Transferred Programs—State to County

Mental Health
- Community-based mental health programs
- State hospital services for county patients
- Institutions for Mental Diseases (IMDs)

Public Health
- AB 8 County Health Services
- Local Health Services (LHS)

Indigent Health
- Medically Indigent Services Program (MISP)
- County Medical Services Program (CMSP)

Local Block Grants
- County Revenue Stabilization Program
- County Justice Subvention Program

County Cost-Sharing Ratio Changes

	State/County Shares Of Nonfederal Program Costs (%)	
	Prior Law	**Realignment**
Health		
• California Children's Services	75/25	50/50
Social Services		
• AFDC—Foster Care (AFDC-FC)	95/5	40/60
• Child Welfare Services (CWS)	76/24	70/30
• In-Home Supportive Services (IHSS)	97/3	65/35
• County Services Block Grant (CSBG)	84/16	70/30
• Adoption Assistance Program	100/0	75/25
• Greater Avenues for Independence (GAIN) program	100/0	70/30
• AFDC—Family Group and Unemployed Parent (AFDC-FG&U)[a]	89/11	95/5
• County Administration (AFDC-FC, AFDC-FG&U, Food Stamps)[a]	50/50	70/30

Local Revenue Fund

- Sales tax—half-cent
- Vehicle License Fee (VLF)—24.33 percent

[a] The AFDC-FG&U program was subsequently replaced by CalWORKs.

- ***Dedicated Revenue Stream.*** Whereas a number of the realigned programs previously had relied on annual appropriations of the Legislature, realignment hinged on the dedication of a portion of the sales tax and VLF—outside of the annual budget appropriation process—to selected programs. The intent of realignment was to provide greater funding stability for selected health, mental health, and social services programs. At the same time, the Legislature maintained control of the *allocation* of these revenues to reflect legislative priorities. The series of allocation formulas developed by the Legislature are discussed in detail below.
- ***Increased County Flexibility.*** The Legislature hoped to free counties from unnecessary state regulation of programs, provide counties the freedom to expand program eligibility or service levels at their discretion, and foster innovation at the local level.
- ***Productive Fiscal Incentives.*** In the years before realignment, it was clear in some cases that counties operated under fiscal incentives that did not encourage the most cost-effective approaches to providing services. By changing these incentives, the Legislature aimed to both control costs and encourage counties to provide appropriate levels of service.
- ***Shift Responsibility to Counties.*** In many areas, realignment aimed to shift responsibility over program decisions from the state to counties.
- ***Maintain State Oversight Through Performance Measurement.*** While shifting program responsibility to counties, the state wished to maintain a level of oversight over the administration of these programs. The Legislature expressed its desire to move towards oversight that relied more on outcome and performance-based measures and less on fiscal and procedural regulations.
- ***Ability to Alter Historical Allocations.*** While the initial allocations to each jurisdiction were based on their level of funding just prior to realignment, the Legislature indicated its desire to equalize some future funding based on such factors as poverty incidence and changes in program caseloads.

Program Transfers

In 1991, realignment transferred more than $1.7 billion in state program costs to counties, accompanied by an equivalent amount of realignment revenues. While eliminating state General Fund spending, the state maintained varying degrees of policy control in these areas. These programs, as detailed below, are now funded through realignment dollars and other county sources of funds.

- ***Community-Based Mental Health Services.*** These services, which are administered by county departments of mental health, include short- and long-term treatment, case management, and other services to seriously mentally ill children and adults.
- ***State Hospital Services for County Patients.*** The state hospitals, administered by the state Department of Mental Health (DMH), provide inpatient care to seriously mentally ill persons placed by counties, the courts, and other state departments.
- ***Institutions for Mental Diseases (IMDs).*** The IMDs, administered by independent contractors, generally provide short-term nursing level care to the seriously mentally ill.
- ***Assembly Bill 8 County Health Services.*** This group of services reflects 1979 legislation (AB 8, Greene), in which counties received state funds for county health services and matched state funds with their own general purpose revenues for the same purpose. The state funding could be used for public health, and inpatient or outpatient medical care at the discretion of each county. Public health activities were broadly defined to include personal health programs, such as immunizations and public health nursing, as well as environmental health programs and administration. Inpatient and outpatient services included but were not limited to indigent medical care.
- ***Medically Indigent Services Program (MISP).*** The MISP was a state fund source for larger counties to support the cost of medical services for persons not eligible for Medi-Cal and who had no source of payment for their care.
- ***County Medical Services Program (CMSP).*** The CMSP provides medical and dental care to low-income, medically indigent adults in smaller counties. These counties contract with the state to administer the program.
- ***Local Health Services (LHS) Program.*** The LHS Program provided state public health staff to small rural counties.

In addition, realignment eliminated two block grants that had previously provided funding to counties. The County Justice Subvention Program had provided funding for local juvenile justice programs, and the County Revenue Stabilization Program had provided funding to improve the fiscal condition of smaller counties. At the time of realignment, the value of these block grants totaled $52 million. Counties received in their place an equal amount of realignment funding that could be used for juvenile justice, health, mental health, or social services programs.

Cost-Sharing Ratio Changes

As shown in Figure 1, realignment increased the county share of nonfederal costs for a number of health and social services programs. In two cases, the county share of costs was reduced. These programs are detailed below.

Increased County Shares

- ***California Children's Services (CCS) Program.*** The CCS program provides medical diagnosis, treatment, and therapy to financially eligible children with specific chronic medical conditions.
- ***Aid to Families with Dependent Children (AFDC)-Foster Care.*** Children are eligible for foster-care grants if they are living with a foster-care provider under a court order or a voluntary agreement between the child's parent and a county welfare department.
- ***Child Welfare Services (CWS) Program.*** The CWS program provides ongoing services to abused and neglected children and children in foster care and their families.
- ***In-Home Supportive Services (IHSS).*** The IHSS program provides various services to eligible aged, blind, and disabled persons who are unable to remain safely in their own homes without such services.
- ***County Services Block Grant (CSBG).*** The CSBG funds can be used for various social services, including adult protective services and programs to provide information and referrals.
- ***Adoption Assistance Program.*** The Adoption Assistance Program provides grants to parents who adopt children with special needs. The grant levels, which vary by age, conform to foster family home rates until the adopted child is 18 or 21 years of age.
- ***Greater Avenues for Independence (GAIN) Program.*** Under the GAIN program—subsequently replaced by the California Work Opportunity and Responsibility to Kids (CalWORKs) program—cash assistance recipients received education and job training services in order to help them find jobs and become financially independent.

Reduced County Share

- ***The AFDC-Family Group and Unemployed Parent Program.*** The AFDC programs, succeeded by CalWORKs, provided cash grants to families with children whose incomes were not adequate to meet their basic needs.

- ***County Administration.*** The federal, state, and county governments share the costs of administering the AFDC (now CalWORKs) and Food Stamps programs.

Realignment Revenues

Revenue Sources

In order to fund the more than $2 billion in program transfers and shifts in cost-sharing ratios, the Legislature enacted two tax increases in 1991, with the increased revenues deposited into a state Local Revenue Fund and dedicated to funding the realigned programs. Each county created three program accounts, one each for mental health, social services, and health. Through a complicated series of accounts and subaccounts at the state level (described below), counties receive deposits into their three accounts for spending on programs in the respective policy areas.

Sales Tax. In 1991, the statewide sales tax rate was increased by a half-cent. The half-cent sales tax generated $1.3 billion in 1991-92 and is expected to generate $2.4 billion in 2001-02.

Vehicle License Fee. The VLF, an annual fee on the ownership of registered vehicles in California, is based on the estimated current value of the vehicle. In 1991, the depreciation schedule upon which the value of vehicles is calculated was changed so that vehicles were assumed to hold more of their value over time. At the time of the tax increase, realignment was dedicated 24.33 percent of total VLF revenues—the expected revenue increase from the change in the depreciation schedule.

In recent years, the Legislature has reduced the VLF tax rate. As of this year, the effective rate is 67.5 percent lower than it was in 1998. The state's General Fund, through a continuous appropriation to local governments outside of the annual budget process, replaces the dollars that were previously paid by vehicle owners. In other words, realignment continues to receive the same amount of dollars from VLF sources as under prior law. The VLF allocations to realignment have grown from $680 million in 1991-92 to an expected $1.2 billion in 2001-02.

The VLF Collections. In 1993, the authority to collect delinquent VLF revenues was transferred from the Department of Motor Vehicles to the

Franchise Tax Board (FTB) in order to increase the effectiveness of delinquent collections. The first $14 million collected annually by the FTB is allocated to counties' mental health accounts as part of realignment. The distribution schedule is developed by the State Department of Mental Health in consultation with the California Mental Health Directors Association.

Jurisdictions Affected

All counties are affected by realignment and receive funding from the two revenue sources. In addition, a few cities also receive realignment funding due to their historical responsibility for some of the realigned programs. Berkeley receives funding for both mental health and health programs. Long Beach and Pasadena receive funding for health programs. The Tri-City area (Claremont, LaVerne, and Pomona) receives funding for mental health programs.

Allocation of Revenues

The original allocations to each jurisdiction were based on their level of funding in these program areas just prior to realignment. These allocations, as of 1991, were in many cases rooted in historical formulas and spending patterns. For instance, funding for the AB 8 county health programs was based on county spending in the 1970s for such programs. As such, realignment did not represent an overhaul of the historical allocation formulas in these program areas. Instead, the realignment formulas emphasized maintaining the county funding levels in existence at the time of its enactment.

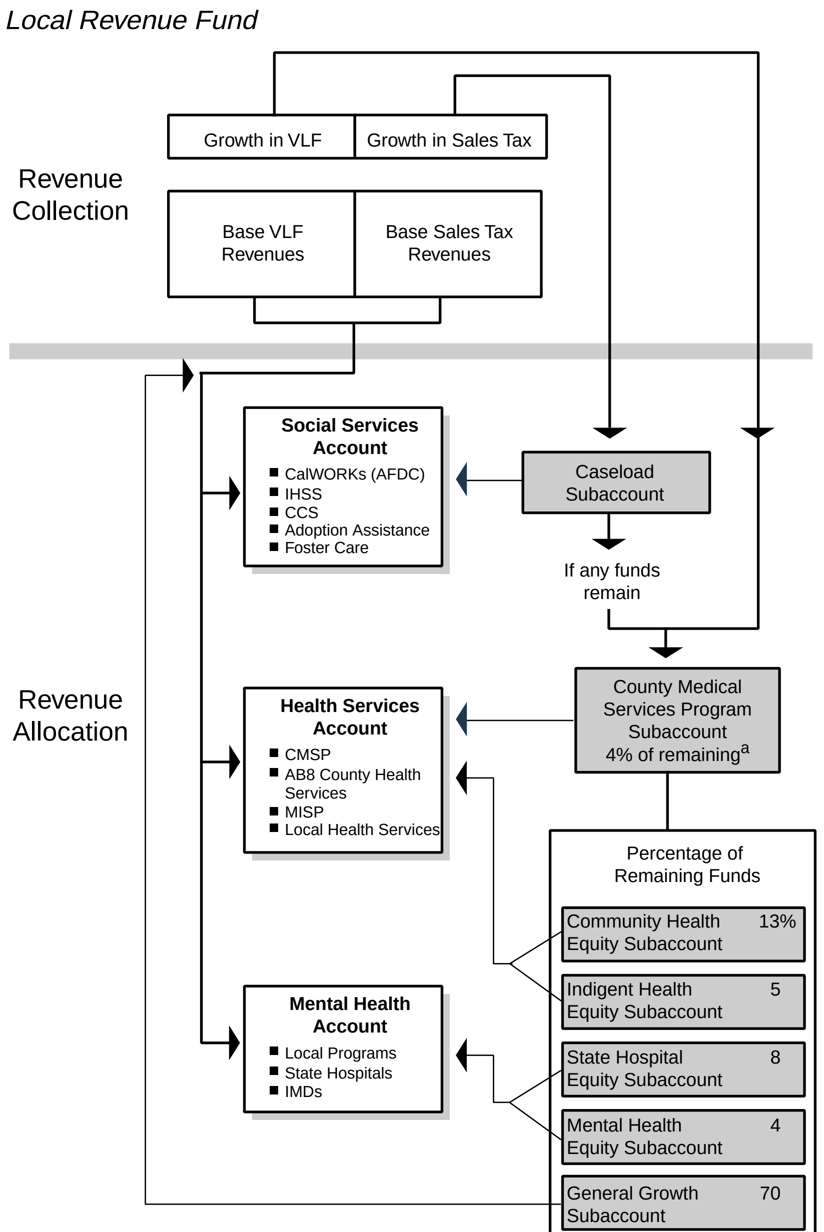
The realignment legislation established a revenue allocation system in which the total amount of revenues received in one year becomes the base level of funding for the following year for each jurisdiction (excluding the VLF delinquent collections allocation). For instance, a county's total realignment allocation in 1997-98 became its base level of revenues for 1998-99. Growth in revenues between the two years was then allocated based on a series of statutory formulas. Thus, a county's base revenues in 1998-99 plus any growth revenues received in that year becomes the base for 1999-00.

Figure 2 illustrates how these revenues are allocated. The allocation of growth revenues is described in more detail below.

Growth Revenues. Any amount by which the sales tax and VLF realignment revenues have grown is deposited into a series of state subaccounts, each associated with one of the mental health, social services, or health accounts of each county. Sales tax growth funds are first committed to the:

Figure 2

Allocation of Realignment Revenues



[a] The CMSP subaccount receives 8 percent of the remaining funds in any year in which the caseload subaccount receives more than $20 million.

- ***Caseload Subaccount.*** The caseload subaccount (part of the social services account) provides funds to repay counties for the changes in cost-sharing ratios for specified social services programs (and CCS, a health program) implemented as part of realignment. The payments from the caseload subaccount are calculated based on annual changes in caseload costs and made a year in arrears. The payments to each county are the *net* of all changes in caseload costs when compared to their costs under pre-realignment cost-sharing ratios. In other words, the county payments are adjusted to reflect both cost increases and savings due to caseload changes.

Any remaining sales tax growth funds and *all* VLF growth funds are allocated to the following subaccounts (which then flow back into one of the three main accounts, as noted in parentheses).

- ***County Medical Services Program Subaccount.*** The CMSP subaccount (health account) provides funding for health programs to those counties which participate in CMSP.

- ***General Growth Subaccount.*** The general growth subaccount (all three accounts) makes its allocations to counties in proportion to their share of state funding for the non-social services caseload realigned programs.

- ***Equity Subaccounts.*** There are four active subaccounts designed to provide payments to those counties below the statewide average in various components of health and mental health funding. The statewide average for equity is defined in statute by a formula based on population and poverty. These equity subaccounts will cease operating within several years when their total lifetime allocations reach $207.9 million. The four subaccounts are the *Community Health Equity Subaccount* (health account), *Indigent Health Equity Subaccount* (health account), *State Hospital Equity Subaccount* (mental health account), and *Mental Health Equity Subaccount* (mental health account).

Figure 3 summarizes the specific distributions of revenues in 1998-99, when realignment revenues totaled $2.9 billion. In that year, the total amount owed the caseload subaccount exceeded the total growth in sales-tax revenues. Consequently, no other subaccount received funding from the sales tax growth in 1998-99, and the remaining 1998-99 caseload obligation is allocated from the 1999-00 sales tax growth. In those years where caseload allocations account for the entire amount of sales tax growth, VLF growth funds are allocated to the subaccounts in the same proportion as the 1996-97 allocations.

Figure 3

Distribution of Realignment Revenues

1998-99
(In Millions)

	Account			
	Mental Health	**Social Services**	**Health**	**Total**
Base Revenues (from 1997-98)	$888	$691	$1,144	**$2,723**
Growth Subaccounts				
Caseload		$96		**$96**
CMSP	—	—	$9	**9**
Community Health Equity	—	—	11	**11**
Indigent Health Equity	—	—	5	**5**
State Hospital Equity	$6	—	—	**6**
Mental Health Equity	4	—	—	**4**
General Growth	25	5	29	**59**
Totals	**$923**	**$792**	**$1,197**	**$2,912**
VLF Collections	$14	—	—	**$14**
Total Revenues	**$937**	**$792**	**$1,197**	**$2,926**

Note: Totals may not add due to rounding.

Transfer Provisions

Although funds are deposited into the three separate accounts in each county, the realignment statute allows for transfers of dollars among these accounts in certain circumstances. These transfers allow counties to adjust program allocations to best meet their service obligations.

Each county is allowed to transfer up to 10 percent of any account's annual allocation to the other two accounts. In order to take advantage of this provision, the county must document at a public meeting that the decision is being made to ensure the most cost-effective provision of services. Each county may transfer an additional 10 percent *from* the health account *to* the social services account under specified conditions. Each county may also transfer an additional 10 percent *from* the social services account *to* the mental health or health accounts under specified conditions. All transfers apply for only the year in which they are made, with future allocations based on the pre-transfer amounts.

"Poison Pill" Provisions

At the time of the enactment of the realignment statutes, it was unclear whether the legality or constitutionality of any of the components would be challenged. Therefore, a series of "poison pill" provisions were put into place that would make components of realignment inoperative under specified circumstances. These provisions are still active and fall into three types.

Reimbursable Mandate Claims. If, as a result of the realignment provisions, (1) the Commission on State Mandates adopts a statewide cost estimate of more than $1 million or (2) an appellate court makes a final determination that upholds a reimbursable mandate, the general provisions regarding realignment would become inoperative.

Constitutional Issues. Although local entities receive their realignment VLF allocations as general purpose revenues, the realignment statute requires that each entity must then deposit an equal amount of revenues into their health and mental health accounts. Section 15 of Article XI of the State Constitution requires VLF revenues to be subvened to cities and counties. If a final appellate court decision finds that the realignment provisions related to VLF deposits violate the Constitution, the VLF tax increase from 1991 would be repealed.

Similarly, if a final appellate court decision finds that revenues from the half-cent realignment sales tax are subject to Proposition 98's education funding guarantee, this portion of the sales tax would be repealed.

Court Cases Related to Medically Indigent Adults. If a final appellate court decision finds that the 1982 legislation that transferred responsibility from the state to counties for providing services to medically indigent adults constitutes a reimbursable state mandate, the VLF increase would be repealed.

If any of these poison pill provisions were to take effect, the affected statute would become inoperative within three months, with the precise timing dependent on the particular provision.

EVALUATING REALIGNMENT

Below we analyze the impacts of realignment in detail for each of the three areas affected—mental health, social services, and health programs. We have focused upon the major programs and therefore, do not discuss every program funded by realignment. We also discuss several realignment issues which cut across the program areas.

Mental Health Programs

The realignment of mental health programs has accomplished most of its original intended purposes. The relative fiscal stability and flexibility that has resulted from the shift of funding and program responsibilities from the state to the counties has encouraged efficiency and innovation while resulting in modest revenue growth. However, significant concerns remain regarding efforts to have the state measure and track the performance of the counties in using the funds.

As was noted above, the Legislature had a number of programmatic and fiscal goals in enacting the realignment of mental health care programs. Our review of expenditure and caseload data over the last decade and discussions with state and county officials strongly suggests that most of the original intended purposes of realignment have been accomplished.

Pre-Realignment Concerns

Mental Health Funding Once Vulnerable. Before the enactment of realignment, state funding for local mental health services was subject to annual legislative appropriation, which could vary significantly from year to year depending upon the state's financial condition. Because 90 percent of so-called Short-Doyle grant funding for mental health programs generally came from the state (with the remaining 10 percent funded by the counties), local mental health services were particularly vulnerable to reductions when the state was faced with financial shortfalls. In 1990-91, for example, state expenditures for community mental health programs declined by about $54 million or 8.6 percent below the prior-year's spending level.

At the time that realignment legislation was considered, mental health program experts had voiced concern that the uncertainty created by the annual state appropriations process was harmful to the development of sound community programs. The significant year-to-year swings in funding levels and uncertainty in the state budget process were also said to have discouraged county government officials from making the multiyear commitments needed to develop innovative programs. Before a pioneering new program could be staffed, made operational, and fully developed over several years, a county mental health department was at risk of having to scale back the commitment of funding and personnel for such efforts. The intent of realignment was to provide mental health programs stable and reliable funding through a dedicated revenue source in order to foster better planning and innovation.

Program Flexibility Was Constrained. The lack of flexibility provided to counties to use the resources available to them in the most cost-effective and medically effective manner was also a concern at the time realignment was considered. For example, prior to realignment each county was given a set allocation of beds for seriously mentally ill patients receiving a civil commitment to the state mental hospital system under the Lanterman-Petris-Short (LPS) Act. Counties were also allocated state-funded nursing care beds known as Institutions for Mental Diseases (IMDs). A county mental health department did not have the option of using fewer LPS or IMD beds and instead using the money for much less-costly (and in some cases potentially more medically effective) community-based treatment programs. In effect, counties were required to "use or lose" their allocation of LPS or IMD beds even if more cost-effective options were available.

Counties were also concerned that much of the state funding for their mental health systems was in the form of categorical programs, by which specific state grants were restricted for use for programs assisting specific target groups of mentally ill individuals. This categorical funding approach limited the ability of county mental health systems to meet the specific mental health needs of their communities and to combine funding from various programs to coordinate services.

The realignment plan was intended to provide additional flexibility to the counties in their use of state funding. For example, the realignment plan directly allocated to county mental health systems the funding for LPS beds within the state hospitals and for IMDs. Counties were free to continue to use the funds for the same number of LPS or IMD beds as before. With advance notice to the state, however, they could use fewer beds than previously allocated and use the savings for other components of their community-based programs. The realignment plan also eliminated some categorical community-based mental health programs, including the Community Support System for Homeless Mentally Disabled Persons and the Self-Help for Homeless programs. The counties were free either to continue the programs using realignment funds or to reallocate the funds to other purposes.

System Accountability Deemed Lacking. Finally, the enactment of realignment was intended to provide more effective state supervision and oversight of local mental health programs. While the state had long collected fiscal and program activity data about community-based mental health programs, state policymakers had voiced concern that the state had little information about the effectiveness of the county programs it had been funding. For these reasons, the realignment legislation expressed the intent that the state implement an effective data system that would measure such performance outcomes.

Results of Mental Health Realignment

Funding Stability Did Improve. The realignment plan adopted by the Legislature and Governor (as shown in Figure 4) addressed concerns over the lack of funding stability for community-based mental health programs by shifting a share of sales tax and VLF revenues to counties along with the primary fiscal responsibility for operating those programs. Since an initial shortfall caused by the state's recession, the total amount of state revenues redirected to county-run mental health programs under realignment has grown fairly steadily. Mental health realignment funding is anticipated to exceed $1 billion in the current fiscal year, an increase of more than $350 million since 1991-92 and an average annual growth rate of 6 percent.

Improved Program Efficiency and Flexibility. The implementation of realignment has generally succeeded in establishing better coordinated, more flexible, and less costly mental health programs in the community. The evidence suggests that counties have been successful in shifting their treatment strategy so that fewer clients receive treatment in costly mental health hospitals and other long-term care facilities and more clients are served with a potentially more effective treatment approach in less costly community-based outpatient and day-treatment programs.

As shown in Figure 5 (see next page), county LPS placements in state mental hospital beds dropped dramatically after the enactment of realign-

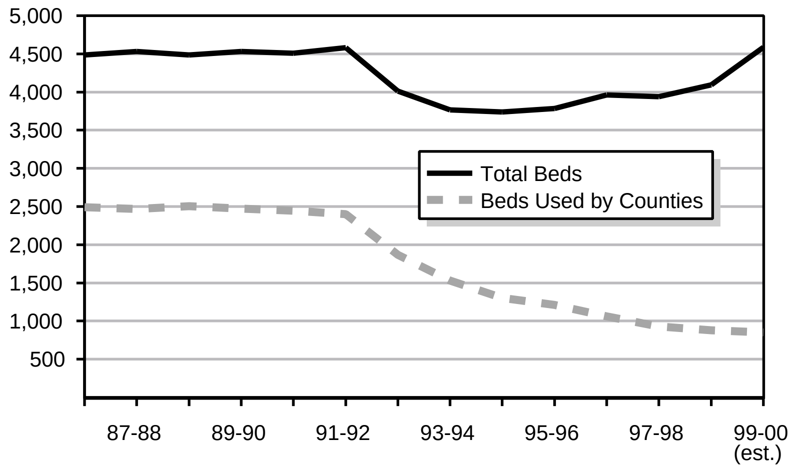
Figure 4

The Results of Mental Health Realignment

- ✓ Funding stability of county mental health systems generally improved amid steady growth of their realignment funding over the last decade.
- ✓ Realignment has generally worked to allow counties to run better coordinated, more flexible, and less costly community programs.
- ✓ Some of the improvements in mental health systems are due to other subsequent program changes, rather than realignment. Although in some cases, realignment enabled county officials to take advantage of these other changes.
- ✓ State oversight of community-based programs, including the adoption and enforcement of performance outcome standards, has not improved as intended under realignment.

Figure 5

Counties Are Using Fewer State Mental Hospital Beds



Source: Governor's Budget, Department of Mental Health. Last Wednesday of fiscal year.

ment—from about 1,900 in 1992-93 to about 850 today. The number of patients placed in IMDs has also dropped. Before realignment was enacted, almost 3,900 mentally ill persons were in IMD beds at any given time. The DMH recently estimated the IMD population to be about 3,500.

County expenditure reports document that the funds saved by scaling back inpatient care have shifted to outpatient treatment. In 1991-92, when realignment was enacted, county mental health program expenditures for outpatient care were about $300 million, about 32 percent of their total spending. By 1997-98 (the most recent year for which statewide data is available), $666 million was being spent on outpatient care, and these expenditures represented 42 percent of their total spending. Realignment funding played a critical role in this expansion of outpatient care. About $72 million in realignment funding was used to support outpatient care programs in 1991-92. By 1997-98, this amount had almost quadrupled to $265 million.

County officials have indicated that the new flexibility they gained under realignment has allowed them to launch experimental community-based programs to better coordinate services for their clients and to establish new types of services that were previously unavailable. Los Angeles County, for example, initiated an effort to coordinate the services its mental health programs provide to adults and children with other social services agencies within targeted neighborhoods. San Diego County established "clubs" for mentally ill clients in the community where they receive peer counseling and other nontraditional support services. Riverside County created special teams of county staff members to respond to the crises of individual patients in the community and divert them from commitment to expensive inpatient beds. Some of these experimental programs might not have been possible without realignment's elimination of some categorical programs.

Non-Realignment Policy Changes Have Also Influenced Program Changes. These major changes in mental health programs over the past decade should not be attributed to realignment alone. A number of other significant changes to the structure and finances of county mental health systems have occurred since the enactment of realignment. These include the establishment of a statewide program of managed care for mental health services under the Medi-Cal Program and the resulting consolidation of fee-for-service Medi-Cal services with the county mental health system in each county. In addition, the statewide Medi-Cal plan was amended to allow a broader array of mental health services, including case management, to be reimbursed under the Medi-Cal Program. Other key changes have been the dramatic expansion of mental health services for children under the Early and Periodic Screening, Diagnosis, and Treatment (EPSDT) program and the commitment of additional state funds to expand services for homeless mentally ill persons.

County officials indicate that, in a number of cases, the availability of realignment funding has enabled them to take full advantage of these other changes in the mental health system to expand their services and caseloads. For example, county officials have indicated that they have used realignment funding to expand rehabilitative services for mentally ill persons who are eligible for Medi-Cal. Because the federal government is obligated to pay for half the cost of Medi-Cal services, counties are in a position to "buy" more mental health services for less money by effectively leveraging the realignment funds available to them.

What Mental Health Realignment Has Not Changed

Accountability System Still Needs Improvement. Implementation of realignment has yet to result in a significant improvement of the state's oversight of the provision of community-based mental health services. Several efforts are progressing to establish new, standardized measures by which to judge the performance and quality of county mental health programs. A committee of state and county officials and mental health program providers appears to be nearing completion of an initial list of agreed-upon performance measures providing data on the cost of services, client and family satisfaction, client retention rates, and other factors. Another committee continues to examine the process by which counties would be held accountable for their performance. Also, a new statewide computerized Client and Service Information System (CSIS) is coming on-line, providing more up-to-date information on a statewide basis regarding the demographics, diagnoses, and treatment outcomes of mental health clients. As of September 2000, about 49 counties were in compliance with state CSIS data-reporting rules.

However, completion of these efforts is long overdue. The establishment of statewide performance outcome measures was initially to have been completed by 1992-93. More recent legislation requires that measurements of access and quality for mental health care provided in community-based programs be developed by an undetermined date, with a status report to the Legislature by March 2001. Despite the progress made to date, it remains unclear when and if these efforts will lead to an effective statewide system providing rewards for counties with exemplary programs and appropriate consequences for counties that do not meet minimum performance standards.

Not All Mentally Ill Are Served. Realignment was intended to help stabilize mental health funding, and also enable some marginal growth in county systems. Realignment, however, was not meant to close the gap in meeting the state's full mental health service needs, and it has not done so. Given recent estimates that 600,000 seriously mentally ill persons annually lack needed mental health services, substantial additional funding might be needed to accomplish such an expansion.

Social Services Programs

Realignment increased the county share of nonfederal costs for certain health and social services programs, and reduced the county share for others. These increased shares of costs in a number of programs, paired with limited funds for new cases, were initially intended to create incentives for counties to control costs. However, early legislative changes to the realignment program largely negated realignment's cost control incentives. Although realignment altered the costs shared between the state and counties for cash assistance programs, the changes implemented by welfare reform have overshadowed the impact of realignment in this area.

Major Programs Affected

Our analysis focuses on the major social services programs affected by realignment—specifically, foster care, IHSS, and AFDC/CalWORKs. These three programs accounted for 85 percent of realignment's net shift in social services costs in 1991.

Foster Care. Foster care is an entitlement program funded by the federal, state, and local governments. Children are eligible for foster care grants if they are living with a foster care provider under a court order or a voluntary agreement between the child's parent and a county welfare department. The California Department of Social Services (DSS) provides oversight for the county-administered foster care system. County welfare departments make decisions regarding the health and safety of children and have the discretion to place a child in foster care. Following the decision to remove a child from his or her home, county welfare departments have the discretion to place a child in: (1) a foster family home (basic grant of $405 to $569 monthly), (2) a foster family agency home ($1,467 to $1,730 monthly), or (3) a group home ($1,352 to $5,732 monthly).

In-Home Supportive Services. The IHSS program is currently an entitlement providing various services to eligible aged, blind, and disabled persons. The costs of this program are shared by the federal, state, and county governments. An individual is eligible for IHSS if he or she lives in his or her own home and meets specific criteria related to eligibility for the Supplemental Security Income/State Supplementary Program. Services are intended to serve as an alternative to out-of-home care, but eligibility for the program is not based on an individual's risk of institutionalization. Authorized services include domestic services, nonmedical personal care services, and protective supervision.

The DSS provides oversight for the IHSS program, and county welfare departments make assessments regarding client eligibility, monthly hours of service per case, and duration of services. In addition, counties provide various administrative services related to worker wages, taxes, training, and referrals.

Cash Assistance. At the time of realignment, California's cash assistance program for families with children was known as AFDC. This program, like its successor program—the CalWORKs program—provided cash assistance to families with incomes inadequate to meet their basic needs. Some families also received welfare-to-work services (such as job search, on-the-job training, and education) through the GAIN program.

Changes in Cost-Sharing Ratios Intended to Control Costs

Prior to realignment in both foster care and IHSS, costs were generally shared by the federal, state, and local governments, with the federal government paying approximately half of total costs. The state paid virtually all of the nonfederal costs for both programs. Although foster care placement decisions and IHSS assessments of client needs were made at the county level, counties at that time assumed little of the fiscal responsibility for these decisions. Under these sharing ratios, counties therefore had little incentive to seek the most cost-effective alternatives within these care systems.

Under realignment, the Legislature significantly increased the county share of nonfederal costs for these programs (from 5 percent to 60 percent for foster care and from 3 percent to 35 percent for IHSS). To pay for any net caseload cost increases as a result of these cost-sharing changes, the original realignment statute provided counties with a fixed amount of dollars from growth revenues.

The apparent purpose of these changes was to establish county incentives to control costs. Both the change in sharing ratios and the fixed amount of growth funds available for new cases were expected to create fiscal pressure on counties to seek out less expensive alternatives within the programs. If counties exceeded the fixed amount of funds allocated for caseload growth, they were to cover these additional costs from their own revenues.

Examples of less expensive service alternatives within the foster care system could be a shift away from group homes and toward foster family and foster family agency homes, as well as emphasizing both family reunification and adoptions as alternatives to foster care. In addition, the designers of realignment had hoped that increased collaboration and innovation with probation, mental health, and community-based service organizations would reduce foster care placements.

Early Statutory Changes Negated Realignment's Cost Control Incentives

Legislation enacted within two years of the original realignment plan changed a key piece of the realignment funding strategy. While the original realignment statute provided a fixed pool of funds for caseload growth, Chapter 100, Statutes of 1993 (SB 463, Bergeson) provided that *all* net costs incurred by counties due to caseload growth would be backfilled by realignment revenues in a subsequent year. Because this statutory change effectively returned county caseload costs to their pre-realignment cost-sharing ratios, realignment's cost control incentives were negated. This statutory change relieved some fears that the original formula could have exposed the state to mandate claims for the unfunded portion of the entitlements.

We note that after the enactment of Chapter 100, counties still have a very modest incentive to control costs because of cash flow concerns. Specifically, counties must wait at least one year for realignment funds to backfill county costs for caseload cost increases. Thus, to the extent that counties face cash flow difficulties in funding their caseload costs, they would face a modest incentive to control costs.

Cost Controls Largely Not Achieved. Given the minimal incentives for counties to control costs, it is not surprising that costs per case since realignment have increased in both foster care and especially IHSS. In foster care, potential savings have not been realized since realignment's enactment and the cost per case has increased slightly after adjusting for inflation. We note that in IHSS a series of non-realignment policy changes that started in the 1990s, and that are expected to impact counties through 2005-06, have added to the total cost of IHSS services.

AFDC: Welfare Reform Changes Overshadow Realignment

Prior to realignment, costs for AFDC grant payments, program administration, and welfare-to-work services (GAIN) were shared among the federal, state, and local governments. As summarized in Figure 1, realignment changed the nonfederal cost-sharing ratios for the state and county governments, with a net *decrease* in county costs of about $210 million in 1991-92.

In response to the 1996 federal welfare reform legislation, the Legislature replaced the AFDC program with California's own version of welfare reform—the CalWORKs program. This legislation made two changes in the state/county fiscal relationship that benefitted the counties. First, the CalWORKs legislation fixed the county share of costs for administration, employment services, and support services (such as child care) at their 1996-97 dollar levels. Thus, the state now absorbs all of the increased costs (more than $1 billion in 2000-01) for welfare-to-work services. Second, the state welfare reform legislation created a performance incentive program for the counties. Specifically, all savings attributable to program exits from employment or recipient earnings are paid to the counties as performance incentives. As of 2000-01, the Legislature has appropriated approximately $1.3 billion for payment of these incentives that must be expended on needy families. Compared to the modest changes in this area made by realignment, welfare reform has provided counties with significant financial benefits.

Health Programs

The realignment of health programs was largely a shift in funding sources—from the state's General Fund to realignment's revenue sources—without significant changes in fiscal incentives or program administration. A lack of data makes evaluating realignment's impact on health programs difficult to gauge, but there do appear to be opportunities for improving counties' flexibility.

Unlike some programs within the social services and mental health areas, the realignment of health programs was largely not intended to alter fiscal incentives, establish performance measures, or shift program administration to the counties. According to state and local government officials, the main purpose was to relieve the state General Fund of fiscal pressure. At the time of realignment, MISP and AB 8 services were already being administered by the counties, and realignment did not change the state's role in the administration of CMSP and LHS. Essentially then, realignment substituted fund sources—replacing state General Fund appropriations with realignment's tax increases. At the same time, realignment did make several changes in the areas of data reporting and fiscal flexibility, which we discuss below. The realigned health programs received $833 million of the original realignment allocations, which had grown to $1.3 billion in 1999-00.

Lack of Data Makes Evaluation Difficult

Realignment Reduced Reporting Requirements. Realignment was intended to reduce the reporting requirements for the AB 8 program. Prior to realignment, counties were required to submit to the state an AB 8 Plan and Budget and an Actual Financial Data Report. The Actual Financial Data Reports showed how AB 8 funds were being allocated among public health, inpatient care, and outpatient care within an individual county and contained details of AB 8 budget appropriations, revenues, and the county's share of costs for its programs.

A county's AB 8 Plan and Budget presented detailed descriptions of the affected programs. For example, a county would report its total public health expenditures, its specific allocation to chronic disease, and which specific diseases were being tracked (such as cancer, diabetes, arthritis, and heart disease). In addition, counties would report their public health staffing levels by type of personnel (such as administrative staff, physicians, nurses, or sanitarians). Pursuant to realignment legislation, counties are no longer required to submit their AB 8 Plans and Budgets to the state. Today's level of reporting does not include the tracking of specific diseases or detailed staffing information.

Much of the previously collected data was helpful at the state level for understanding a particular county's approach to providing health services. Aggregating this data for statewide analysis, however, could only be done manually. As a result, it was difficult for DHS to use the reported data for policy purposes.

Lack of Data Restricts Statewide Evaluation. Our analysis of realignment's impact on health programs indicates that there are data gaps in the realigned health programs. Specifically, there is no state system to collect data regarding each county's (1) total expenditures for indigent care by fund source, or (2) total expenditures by fund source for each major spending category—public health, indigent inpatient care, and indigent outpatient care. The lack of this data leaves the state unable to answer fundamental questions regarding the provision of health services in each county and hampers the state's ability to devise effective health financing policies and budgets.

Flexibility Could Be Enhanced

Realignment appears to have improved county fiscal flexibility in some areas. For example, realignment has provided additional authority to shift resources between AB 8 services and MISP services to the area of greatest need. Specifically, any growth in realignment funding that counties receive can be spent in either the AB 8 service area (public health, inpatient care, or outpatient care) or MISP (indigent care) area.

Assembly Bill 8 Historical Restrictions Remain. Realignment, however, has continued some funding restrictions *within* the allocations for AB 8 services. Prior to realignment, a county had the authority to use state AB 8 General Fund monies within the public health area for (1) those programs that it had selected to fund just prior to the passage of AB 8 in 1979 and (2) any new public health programs that were established subsequent to the passage of AB 8. A county could not, however, use AB 8 funds for any existing public health programs that the county had not funded in the year prior to AB 8. Realignment's preservation of this restriction limits the discretion of counties to shift realignment funds among public health programs, leverage federal funds, implement local cost-saving measures, or reflect current local preferences.

These restrictions have created difficulties for at least one county. Humboldt County officials wanted to use realignment funding for administrative costs associated with public health programs. After the county sought clarification from the state, DHS denied the county the use of realignment funds for this purpose because the county had not used certain funding prior to AB 8 for this purpose. Other counties which did spend their funding on this purpose years ago *would* be eligible to spend their realignment dollars in this manner.

Crosscutting Realignment Issues

Realignment has generally provided counties with a stable and flexible revenue source. Realignment's growth allocation formulas have not, however, created incentives for counties to control their costs. Over time, the social services account has gained a greater share of total realignment dollars, with a corresponding reduction in the shares of funding for

health and mental health programs. While these formulas have somewhat reduced allocation inequities, 22 counties remain "under-equity" as defined by realignment law. Realignment's transfer provisions were used by many counties over a five- year period and provided those communities an opportunity to adjust funding allocations in order to reflect local priorities.

Fiscal Incentives Could Be Improved

As discussed earlier, one of the original goals of realignment was to design a system that, through changes in fiscal incentives, would encourage counties to make more cost-effective and efficient program decisions. In the social services discussion above, however, we highlighted how the passage of Chapter 100 in 1993 effectively restored the pre-realignment cost-sharing ratios for the realigned programs. These pre-realignment ratios generally required only minimal county contributions for new caseload expenditures and, therefore, counties have little incentive to control their caseload costs, as was the case prior to realignment.

Growth Allocation Formulas Limit Incentives to Control Costs. Furthermore, the system of revenue growth allocations provides little benefit to those counties which do reduce their caseload costs. This is because counties are not permitted to retain any realignment caseload savings. Rather, each dollar that a county saves in realignment caseload costs will be distributed among all 58 counties through the remaining growth subaccounts. Therefore, counties have little incentive to seek savings in their caseload costs. This dynamic will likely intensify in the coming years as counties decide whether to increase IHSS program expenditures (due to non-realignment policy changes)—potentially driving up caseload subaccount payments without facing significant fiscal incentives to control their costs.

Revenue Stream Has Been Stable, But Lacks a Reserve

The combination of the half-cent sales tax and a portion of the VLF has generally provided counties a stable, reliable, and expanding funding source for the realignment portion of the various programs. Overall annual growth rates have exceeded 5 percent during the past five years. In an economic downturn, realignment program demands would likely rise at the same time that revenue growth would slow. Currently, no mechanism exists within realignment for a funding reserve to assist counties in such a situation. Furthermore, due largely to the property tax shifts of the early 1990s, counties' general purpose revenues have generally eroded over the past decade—leaving most counties with limited access to alternative revenues in such a situation.

Funding Allocations Have Favored Social Services

Under the initial realignment allocations, the social services account received 24 percent of total funds, mental health 34 percent, and health 42 percent. In the mid 1990s, as shown in Figure 6 , growth rates for both the mental health and health accounts exceeded the rate for the social services account. However, in more recent years, the social services account has outpaced the other accounts in growth rates—receiving about half of new revenues in 1998-99. The social services account has averaged 10 percent growth since the beginning of realignment, while the health and mental health accounts have averaged 6 percent growth. Consequently, the social services account has, over time, gained a larger share of the total realignment allocations. As shown in Figure 7 (see next page), by the end of 1998-99, the social services account was receiving 27 percent of total funds, mental health 32 percent, and health 41 percent.

This trend reflects realignment's emphasis on fully funding entitlement programs (all but one are social services programs) as a first priority. The caseload subaccount receives the first allocation from the sales tax growth account. The allocations are based on the difference in caseload costs under realignment and the previous cost-sharing ratios. As this difference has grown in recent years, fewer dollars have been available to

Figure 6

Realignment Account Revenues

Growth Rates

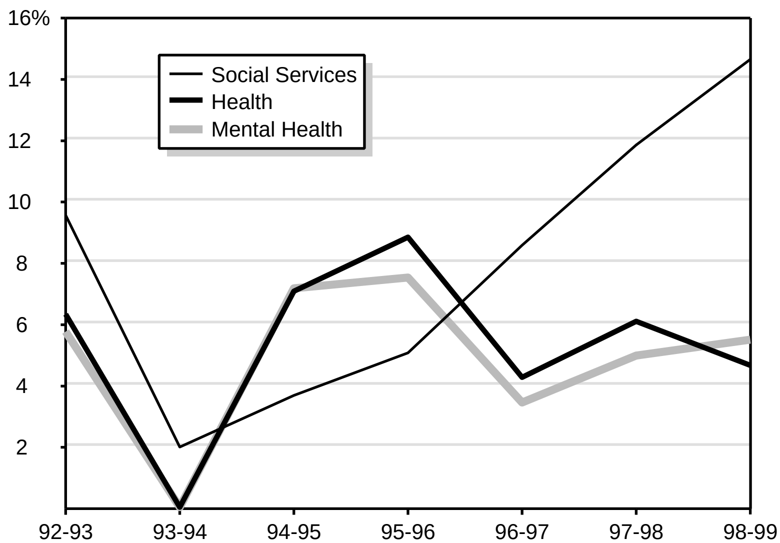


Figure 7

Changes in Account Shares of Realignment Funds

	Mental Health	Social Services	Health
1991-92	34.0%	23.7%	42.3%
1998-99	32.0	27.1	40.9

allocate to the mental health and health accounts from the sales tax growth funds. Although the social services account's share of revenues has increased, counties do maintain the flexibility to transfer these new dollars in the social services account to either of the other accounts. Furthermore, VLF growth dollars are allocated almost exclusively to mental health and health programs.

Inequities in Allocations Remain

One of the original goals of realignment was to provide the capacity to address the historical differences in funding allocations among counties and link funding to estimates of a county's program needs. Since the original allocations were based on each county's funding levels just prior to realignment's enactment, counties' allocations generally reflected a combination of their historical spending, caseloads, and populations of 1991 or even earlier.

Beginning in 1994-95, a portion of realignment growth funds have been dedicated to the four equity subaccounts—community health, indigent health, state hospital, and mental health. A fifth equity subaccount—the special equity subaccount—has completed its payments to its designated recipients and ceased operations. Each of the four remaining equity subaccounts use the same definition of equity (varying only by which jurisdictions provide the respective services). This definition—half based on population and half based on estimated poverty population—sets a statewide average of revenue allocation for each policy area. Jurisdictions below this statewide average receive a proportionate share of the dollars allocated from the respective equity subaccount. Because all realignment allocations received in one year become part of the next year's base, "under-equity" counties continue to receive these allocations in future years as part of their base realignment funding.

In 1994-95, the first year of these equity allocations, there were 22 under-equity counties. At that time, it would have taken about $250 million (about 11 percent of total realignment allocations in that year) to bring these counties to the statewide average. In 1998-99 (the most recent equity allocations available), this "equity shortfall" had been reduced to $219 million, but 22 counties remained under-equity. Due to overall realignment revenue growth over that time, the equity shortfall now represents less than 8 percent of total realignment allocations.

Under-Equity Counties Regionally Concentrated. Thirteen of the 22 counties' equity shortfalls represent more than 10 percent of their total realignment allocations. As shown in Figure 8, these 13 counties are concentrated in the Central Valley.

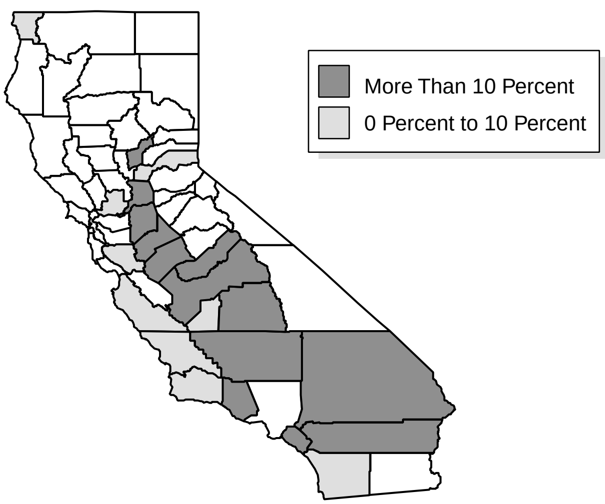
Thus, over the five-year period, variations among counties have been reduced, but this reduction is not occurring rapidly. Of the $190 million in realignment growth dollars available in 1998-99, for instance, only $26 million (14 percent) was allocated towards equity payments. In comparison, $59 million (31 percent) was allocated to the general growth subaccount in that year—which reinforces the existing funding disparities by allocating revenues in the same proportion as counties' existing shares of revenues. Additionally, the existing formulas will not achieve equity,

Figure 8

Under-Equity Counties

1998-99

Equity Shortfall as a Percent of Total Realignment Allocation



as defined by state law, by the time the equity subaccounts reach their statutory limit on allocations. To the extent that counties remain under-equity, they may be at a disadvantage in relation to other counties in their ability to provide services on a per-client basis.

Transfer Provisions Provide Opportunity for Local Preferences

The realignment transfer provisions allow each county the option of shifting up to 10 percent of any of their three account's annual revenues to another account (and up to 20 percent in some circumstances). These provisions were used by 22 counties during the five-year period from 1993-94 to 1997-98 (the only years for which statewide data is currently available). These counties collectively transferred a total of $193 million, or 1.6 percent of total realignment allocations during that period.

Social Services Accounts Gain From Transfers. The majority of revenue transfers have shifted dollars to social services accounts from health or mental health accounts. Over the five-year period as shown in Figure 9 (see next page), counties' social services accounts had a net gain of $133 million, with nearly two-thirds of this amount coming from counties' health accounts.

At the time realignment was being considered, some concern was voiced by advocates of mental health programs that funding for such programs might be significantly eroded by the transfer provisions. As shown in Figure 9, these fears have largely proven unfounded. Since 1993-94, mental health programs had a cumulative net reduction of about $49 million. In other words, about 1 percent of the funding allocated to county mental health programs during that period has been shifted to health and social services programs. Moreover, of that $49 million, about

Figure 9

Realignment Account Transfers

(Dollars in Millions)

	Mental Health	Social Services	Health	Number of Counties
1993-94	$3.9	$5.9	-$9.8	10
1994-95	-25.9	80.3	-54.4	13
1995-96	2.2	7.9	-10.0	14
1996-97	-18.7	26.7	-8.0	21
1997-98	-10.4	12.6	-2.2	18
Totals	**-$48.9**	**$133.3**	**-$84.4**	**22**

Note: Amounts may not total due to rounding.

$32 million of the shift can be attributed to the actions of just one county—Los Angeles. In some years, it should be noted, mental health programs received a net gain of several millions of dollars under the transfer provisions.

Because shifts in non-realignment revenues are not reported to the state, the reports of these transfers do not necessarily reflect the entire county story regarding county program priorities. A number of counties, including Los Angeles, have taken advantage of the transfer provisions and later restored at least some of the transferred dollars using non-realignment revenues. Other counties may shift non-realignment dollars to accomplish changes in funding priorities and therefore do not report any use of realignment's transfer provisions.

At the same time, a number of counties have expressly not used the transfer provisions—citing the desire to avoid contested debates at the local level over which programs deserve additional funding. By maintaining realignment allocations as they were received from the state, counties have avoided the controversy that could result from shifting funds away from a particular program.

Transfers Allow Local Control. Nonetheless, the transfer provisions represent an important component of local control within realignment's framework. While the realignment formulas reflect statewide decisions on program funding priorities, the transfer provisions allow each county to adjust funding levels to reflect their local priorities. Furthermore, the majority of realignment dollars are allocated on historical formulas even though communities' needs and demands for services may have significantly evolved over time. The transfer provisions allow counties to appropriately modify allocations to reflect these changing needs and demands. Finally, the transfers allow counties to accommodate short-term funding shortfalls in one policy area more easily than might otherwise be possible.

Concerns Regarding Administration of Allocations

In our conversations with counties, a couple of administrative issues regarding the allocations of funding from the state to counties were raised.

Unpredictable Level of Revenues. Given the complicated nature of the allocation formulas, some counties have found it difficult to develop reliable estimates of the funding they should expect from realignment on a monthly and annual basis. As a result, counties have found program planning difficult.

Delay in Caseload Payments. Since the payments from the caseload subaccount are calculated as an actual change from the prior year and made a year in arrears, payments for caseload cost increases may not be paid to a county for as many as two or more years after the time the costs were incurred. With rising caseload costs in a number of programs, some counties expressed concerns that they will face cash flow difficulties in covering the current expenses of caseload cost increases.

RECOMMENDATIONS FOR IMPROVING REALIGNMENT

Our analysis indicates that, after a decade of implementation, realignment can be considered largely successful. Yet, our evaluation highlights a number of areas where improvements could be made. While maintaining its underlying structure, we recommend that the Legislature take the following actions as summarized in Figure 10, so that realignment will be better able to address the challenges and demands of the coming decade.

Figure 10

Summary of LAO Realignment Recommendations

☑ **Improve Fiscal Incentive Structure of Growth Allocations**

- Change growth allocations to single formula to determine each county's new revenues.

☑ **Improve Administration of Fund Allocations**

- Provide monthly estimates of allocations.
- Create loan fund to assist with cash flow problems.

☑ **Improve Data in Health Area**

- Explore feasibility of collecting statewide data.

☑ **Increase County Flexibility**

- Eliminate unnecessary restriction on use of health funds.

☑ **Create a Reserve Subaccount**

- Create a fund to mitigate reductions during revenue shortfalls.

☑ **Consider Using Realignment as a Model for Future State-County Program Decisions**

- Emphasize original realignment goals of productive fiscal incentives and accountability through the measurement of program performance.

Improve Fiscal Incentive Structure Of Growth Allocations

At several points in this analysis, we have noted that realignment preserved the system of programs and revenue allocations as existed in 1991. With each passing year, the 1991 system of funding allocations and fiscal incentives becomes more disconnected from contemporary needs and preferences. In particular, the retention of pre-realignment cost-sharing ratios in social services programs provides little incentive for counties to control costs in these programs. This, in turn, can affect the funding available for mental health and health programs. In order to promote cost-effective decision making, we believe a county's fiscal decisions in one program area should have a clear impact on its available funds in other areas. This can perhaps best be achieved by a system which provides each county its new realignment revenues in a separate distribution from other counties. As discussed above, the current system's pool of funds from which all counties compete against each other fails to provide counties an incentive to control caseload costs.

For instance, an improved growth allocation system could allocate all growth funds by a single formula. The ideal formula would provide funds to each county based on the level of demand for realigned programs in that county. For instance, the current statutory "equity" formula half based on population and half based on poverty population would be one reasonable estimate of county program demands. While maintaining their base level of funds in each of the three program accounts, counties could receive all new growth funds based half on their proportionate share of the state's population and half on their share of the state's poverty population. These funds could be distributed to each county without designating their allocation to the mental health, social services, or health accounts. County officials could then decide which realignment programs had the most pressing needs. This approach would have several advantages over the current funding allocation formulas, including:

- ***Increased Local Control.*** Each county would be able to determine its own funding priorities and needs. While a single stream of growth funds would result in local debates over funding for one program versus another (especially across program areas), the existing system already includes this tension both at the local level with transfer decisions and at the state level with the interaction of the caseload subaccount with the other subaccounts.

- ***Cost Control Incentives.*** Counties would have an increased incentive to reduce expenditures. Each dollar saved in a program would be available for another program *in that county*, increasing local pressure for innovation and cost savings. Counties would no longer operate under a system in which a competition among counties for funds creates a disincentive for caseload cost controls.

- ***Simple Allocations.*** Realignment's complicated growth formulas would be replaced by a single formula which would adjust accordingly to changing demographics.

Improve Administration of Fund Allocations

Earlier, we noted that counties were concerned with two revenue allocation issues: (1) the lack of predictable revenue payments and (2) delays in caseload subaccount payments. The simplified growth allocation system proposed above would address both of these concerns. Since a county's share of population and poverty population does not change dramatically from year to year, a county could expect a consistent share of the total projected growth dollars. There would no longer be delayed payments based on caseload changes.

Even within the existing growth allocation system, we believe these administrative concerns could be relatively easy to address. To make the flow of allocations more predictable, the State Controller, in conjunction with the Department of Finance, could provide estimates of monthly allocations at the beginning of the year (similar to the Controller's existing annual shared revenue estimate for gas tax and base VLF revenues). Caseload payment delays and cash flow concerns could be addressed by creating a short-term loan fund. Counties could apply for loan funds based upon a reasonable estimate of future caseload payments. These loan amounts could simply be deducted from future caseload payments. Loan funds could be administered by counties in the same manner as other realignment funds and could be transferred by counties among their three accounts.

Other Recommendations

Improve Data in the Health Area. We were unable to undertake a comprehensive study of realignment's impacts in the health area as a result of limited data. In order to assist in future decision making for these programs, we recommend exploring the feasibility of collecting meaningful health data at the state level. Specifically, the state should collect annual data regarding county expenditures for public health and indigent care by fund source.

Increase County Flexibility. In our review of health programs, we noted the unnecessary restrictions placed upon counties regarding their use of former AB 8 program funds. In our view, while preserving the intent of the original AB 8 program is a reasonable approach, the spending decisions of a county more than two decades ago is an unnecessarily restrictive standard for determining appropriate spending decisions today. We recommend that the Legislature eliminate these restrictions on county flexibility and explore other ways to increase program flexibility without a loss of accountability.

Create a Reserve Subaccount. We recommend that the Legislature create a realignment reserve subaccount. The establishment of such a reserve would help mitigate the need for program reductions during periods of economic difficulty. In this regard, the Legislature could create a reserve subaccount either from (1) existing realignment revenue growth (thereby lowering new revenues available for program spending), or (2) a new revenue source, presumably a state General Fund appropriation. When the funds accumulated in the reserve subaccount reached an adequate level, further contributions could cease. If realignment revenues were to stagnate during a recession, the reserve would automatically be allocated to counties to stabilize their program funding.

CONSIDERING REALIGNMENT AS A MODEL FOR FUTURE PROGRAM DECISIONS

Given a decade of relative success with realignment, we believe its approach to state-county relations can be a useful model for future legislative action in at least three situations, described below.

Expanding Existing Realignment Services. If the Legislature wished to increase the levels of service provided by existing realigned programs, it has several approaches available. For example, it could enact new statutes or specific state General Fund budget appropriations for particular programs. However, the Legislature may wish to instead consider adding additional resources to the existing realignment revenue streams—with counties choosing which specific programs to fund. Providing counties with additional resources within realignment would provide them with the flexibility to meet their different needs (within the general set of realignment programs). To promote accountability, a county's receipt of any additional realignment funding could be contingent upon its providing data on specific performance outcome measurements. The state could establish an Internet Web site to publish a "report card" allowing the public to compare the performance of each county with these standards.

Adding Related Services to Realignment. In order to improve flexibility for programs which provide similar services as the realignment programs, the Legislature could consider the transfer of these additional programs to the county level—along with an equivalent amount of a dedicated revenue source—and integrate them into realignment. For example, the local assistance programs of the Department of Alcohol and Drug Programs now supported through annual state General Fund appropriations could be transferred to the counties with revenues equal to their present level of state General Fund dollars (about $128 million). Likewise, in order to further realignment's original goal of creating productive fiscal incentives, counties could also receive additional fiscal responsibility for the mental health services provided under the $563 million EPSDT program. The EPSDT costs have been growing at an average annual rate of 28 percent. County costs for EPSDT are fixed at about $120 million, with the additional costs of the program borne by the state and federal governments. Thus, counties currently have no fiscal incentive to attempt to control the rapid growth in EPSDT spending—such as by implementing a rigorous utilization review process.

Applying the Concept to Non-Realignment Programs. Finally, realignment could be used as a model to "realign" state-county programs in another policy area *separate* from the existing realignment structure by using a dedicated revenue stream, local flexibility and authority, and accountability for new or expanded programs. In the past, we have suggested that juvenile justice, adult parole, and substance abuse might be appropriate programs for further realignment. Providing counties additional resources within a specified policy area, if implemented appropriately, could strengthen local control of program decision making, improve program coordination, reduce growth in state administrative costs, and establish clearer lines of accountability for the success of these programs.

CONCLUSION

The 1991 realignment of mental health, social services, and health programs has been largely a successful experiment in the state-county relationship. In particular, a dedicated revenue stream for the realigned programs has helped to create an environment of fiscal stability which improves program performance. Moreover, the flexibility granted within realignment has allowed some counties to effectively prioritize their communities' needs among many competing demands. With some changes, realignment can continue to provide the state an effective way to fund the various mental health, social services, and health programs.

Academic Preparation for Higher Education

How Can the State Better Prepare Students for College?

Summary

According to university officials, approximately one-third of freshmen at the University of California (UC) and more than two-thirds of freshmen at the California State University (CSU) arrive "unprepared" for college-level reading, writing, or mathematics.

Assessing Better. *Many students who fail college placement exams typically spend a portion of their first year of college completing precollegiate courses. We recommend UC, CSU, and Calfornia Community Colleges (CCC):*

- *Work with high schools to develop methods to diagnose earlier whether students are ready for college-level studies.*
- *Consider aligning skills assessments with existing exams.*

Ensuring Progress. *The UC, CSU, and CCC do not assess whether students who must take precollegiate courses actually obtain the necessary skills to succeed in college. They also do not measure the effectiveness of services employed to help students overcome their skill deficiencies. We recommend UC, CSU, and CCC assess and report on the level of preparedness of all entering students and the effectiveness of programs to help them prepare for college-level studies.*

Funding Precollegiate Education. *Currently, the state provides UC, CSU, and CCC with very different levels of support for their precollegiate courses. We recommend the state fund precollegiate courses consistently across the segments.*

INTRODUCTION

The Master Plan for Higher Education envisioned a California university system that would be renowned for providing high-quality education to the most academically distinguished high school graduates in the state. *The Master Plan* entrusted the community colleges with providing courses for students who were not yet prepared for college-level courses as well as lower-division college courses. *The Master Plan* states:

"The quality of an institution and that of a system of higher education are determined to a considerable extent by the abilities of those it admits and retains as students. This applies to all levels—lower division, upper division, and graduate. It is also true for all segments, but the emphases are different. The junior colleges are required by law to accept all high school graduates; therefore the junior colleges must protect their quality by applying retention standards rigid enough to guarantee that taxpayers' money is not wasted on individuals who lack capacity or the will to succeed in their studies. If the state colleges and the University have real differentiation of functions between them, they should have substantially different admission requirements. Both should be exacting (in contrast to public higher educational institutions in most other states) because the junior colleges relieve them of the burden of doing remedial work. Both have a heavy obligation to the state to restrict the privilege of entering and remaining to those who are well above average in the college-age group."

Many Students Arrive Unprepared for College-Level Courses. Today, both the University of California (UC) and the California State University (CSU) admit students who are not yet ready to enroll in college-level reading, writing, and mathematics courses. The CSU estimates that more than two-thirds of its first-time freshmen require remedial courses in writing or mathematics. The UC estimates that approximately one-third of its freshmen require remedial courses in writing. (The UC does not require students to demonstrate preparedness for college-level mathematics.)

Legislative Interest in "Remedial" Education at CSU and UC. The Legislature has expressed much interest in the issue of remedial education. Specifically, the Legislature has requested information regarding the proportion of unprepared students in college, the services colleges offer to help better prepare students for college-level work, and the cost the state incurs to provide remedial education to unprepared students on university campuses. To address these issues, this report:

- Places current unpreparedness rates in historical context.

- Evaluates how the community colleges, CSU, and UC assess the preparedness of entering students for college-level studies.
- Evaluates the services the segments provide to initially unprepared students.
- Identifies options for improving precollegiate education.

Defining "Prepared" and "Unprepared" Students

In this report we frequently use the terms "prepared" and "unprepared" to describe the skill level of college applicants and students. In doing so, we are borrowing from the terminology often used by administrators and faculty within CSU and UC.

Students can demonstrate they are prepared in one of three ways (see Figure 1). First, students can demonstrate preparedness by scoring above a minimum level on the SAT, American College Testing Assessment (ACT), or Advanced Placement (AP) exams. All UC applicants take the SAT I and SAT II exams, and most CSU applicants take the SAT I exam. Approximately one-third of UC and CSU regularly admitted

Figure 1

Standards for Demonstrating College Preparedness

Reading and Writing	Math
CCC	
None	None
CSU	
• Score 550 on SAT I verbal test; 680 on SAT II writing test; 25 on ACT verbal test; or 3 on AP writing test; or • Pass CSU's English Placement Test (EPT); or • Pass precollegiate course(s).	• Score 560 on SAT math test; 560 on SAT II math test; 24 on ACT math test; or 3 on AP math test; or • Pass CSU's Entry-Level Mathematics Test (ELM); or • Pass precollegiate course(s).
UC	
• Score 680 on SAT II writing test, or score 3 on AP English test; or • Pass UC's "Subject A" writing examination; or • Complete prescribed "Subject A" writing class.	None

freshmen demonstrate proficiency in this manner. (Most of these national tests are taken in students' junior and senior years in high school.) Approximately 10 percent of specially admitted UC freshmen do so. (Specially admitted students have not completed all college preparatory courses, obtained minimum grade point average (GPA) standards, and/or taken all necessary entrance exams.) The CSU could not provide data on how specially admitted students perform on these tests.

Second, students who do not score sufficiently high on the standardized exams can demonstrate they are prepared by performing satisfactorily on placement tests developed and administered by the universities. The UC administers its placement exam—the Universitywide Subject A Examination—the first Saturday in May each year, whereas CSU offers its placement exams—the English Placement Test (EPT) and the Entry-Level Mathematics (ELM) test—several times throughout the year.

Finally, students who do not score sufficiently high on college admissions or placement exams must enroll in a precollegiate course. Typically, students take these courses on campus in their first year of college. These students demonstrate proficiency by passing the precollegiate course with either a credit (CR) grade or a D- or better.

The segments do not use the same standard for defining unpreparedness. As a result, students UC defines as unprepared in reading and writing (because they fail the Subject A exam) might be considered prepared by CSU standards (because they pass the EPT). Similarly, students CSU defines as unprepared in reading, writing, or mathematics might be considered prepared by a community college.

UNPREPAREDNESS IS PERSISTENT AND PERVASIVE

Based on the segments' standards, available data suggest many students entering California's public colleges and universities do not have the requisite skills to engage in college-level work. Below, we track unpreparedness rates at CSU and UC over the last decade. We do not track unpreparedness rates at the community colleges because they do not require students to take admissions tests (such as the SAT) or placement tests (such as the EPT). Consequently, the community colleges could not provide data on their students' level of preparedness for college-level studies.

Unpreparedness Rate Has Increased Significantly at CSU

As described earlier, CSU requires all first-time freshmen to demonstrate readiness for college-level reading, writing, and mathematics.

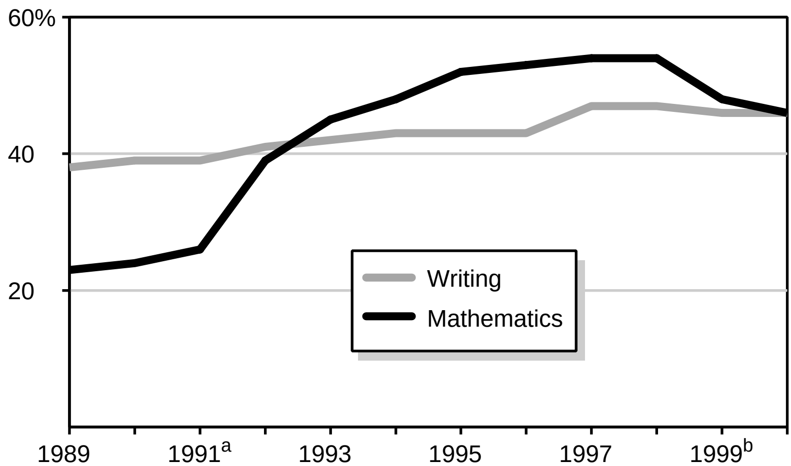
Almost Half of Regularly Admitted CSU Students Arrive Unprepared in Reading and Writing. Figure 2 shows the unpreparedness rate in reading and writing for regularly admitted freshmen over the last decade. In fall 1989, 38 percent of regularly admitted freshmen were unprepared for college-level reading and writing. By fall 2000, the unpreparedness rate had increased by more than a fifth—to 46 percent of regularly admitted freshmen. In recent years, many students have not passed the EPT because they have been unable to complete the reading portion of the exam successfully. Of regularly admitted freshmen taking the EPT in June 1997, 78 percent failed the reading component of the exam. (The combined reading and writing failure rate is lower because students can score sufficiently high in the writing section to pass the exam even if they fail the reading section.)

Almost Half of Regularly Admitted CSU Students Arrive Unprepared in Mathematics. Figure 2 also shows the unpreparedness rate in mathematics for regularly admitted freshmen. In fall 1989, 23 percent of regularly admitted freshmen were unprepared for college-level work. In 1992, CSU increased its admission standards to require three years of college preparatory mathematics. To reflect this change, CSU made the ELM more difficult by including questions on data interpretation, counting, probability, and statistics. Likely as a result of these changes, the number of

Figure 2

CSU Unpreparedness Rates Have Risen

Percent of Regularly Admitted Freshment Needing Remediation



[a] CSU made the mathematics exam more difficult in 1992.
[b] Effective 1999, students could use calculators during the mathematics exam.

regularly admitted students needing remedial classes in mathematics jumped from 26 percent in fall 1991 to almost 40 percent in fall 1992. From 1992 to 1998, the unpreparedness rate continued to climb, reaching 54 percent in fall 1998. The rate of unpreparedness fell in 1999 to 48 percent of entering freshmen (when the CSU allowed students for the first time to use calculators while taking the test). In fall 2000, the rate dropped further to 45 percent.

In total, more than two-thirds of regularly admitted first-time freshmen failed at least one of CSU's entry-level placement tests. Approximately one-third of regularly admitted first-time freshmen failed both placement tests.

Unpreparedness Rates Vary Considerably Across CSU Campuses. Figure 3 shows for each CSU campus the percentage of regularly admitted first-time freshmen that failed to demonstrate proficiency in writing and/or mathematics. At CSU Dominguez Hills and CSU Los Angeles—the campuses with the highest proportions of unprepared students—more than 90 percent of regularly admitted first-time freshmen were unprepared for college-level work. By comparison, approximately 25 percent of regularly admitted first-time freshmen at CSU San Luis Obispo were unprepared for college-level work.

Almost All Specially Admitted Students Arrive Unprepared for College-Level Courses. A significant percentage of new freshmen at CSU do not meet the university's minimum admission standards. In 1999-00, for example, CSU admitted a total of 9.2 percent of first-time freshmen "by exception." The CSU does not record the proportion of these specially admitted students who are unprepared for college-level studies, but it indicates almost all specially admitted students are unprepared. Data provided by CSU Sacramento support this assertion. In fall 1998, 17 percent of first-time freshmen entering CSU Sacramento did not meet the regular admission criteria. Of these students, 91 percent were unprepared for college-level writing or mathematics.

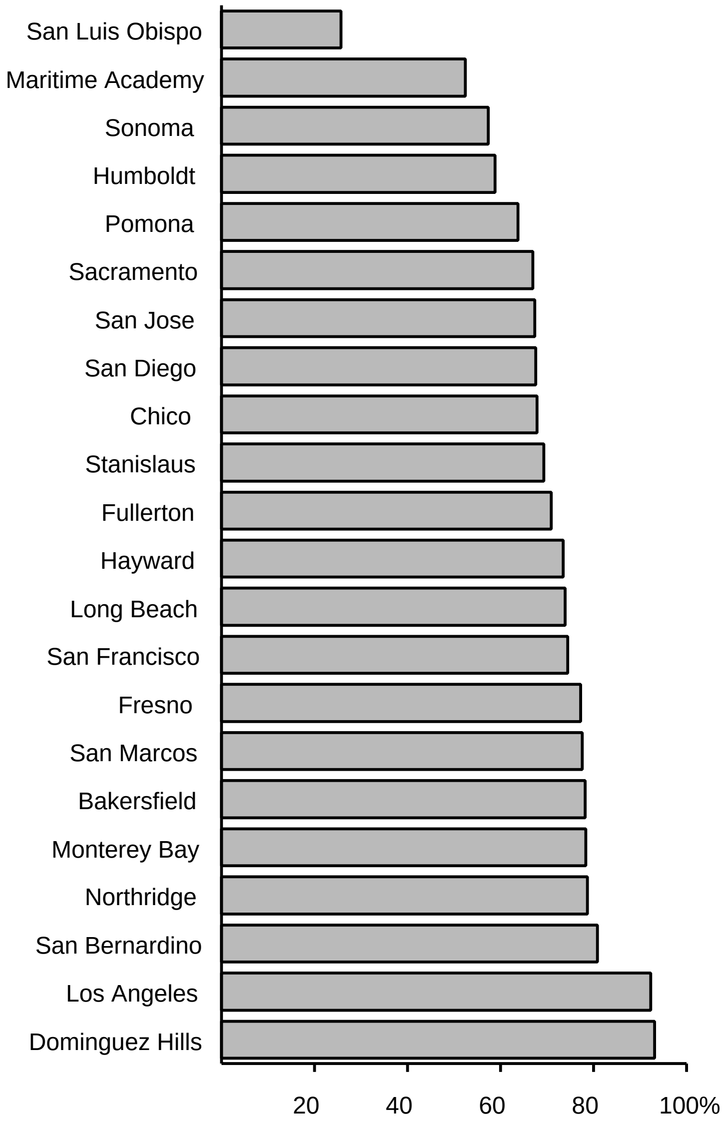
Unpreparedness Has Remained Relatively Constant at UC

Whereas CSU tests for proficiency in mathematics and writing, UC tests for proficiency only in writing. The UC calls its writing proficiency standard the "Subject A" requirement. Students can satisfy the Subject A requirement either by exceeding a minimum score on the SAT I, SAT II, ACT, or AP tests or by passing the university's Subject A writing test. Students who do not demonstrate proficiency must enroll in a remedial writing class.

Figure 3

Some CSU Campuses Have Very High Remediation Rates

Percentage of Regularly Admitted Freshman Needing Remediation
Fall 1998

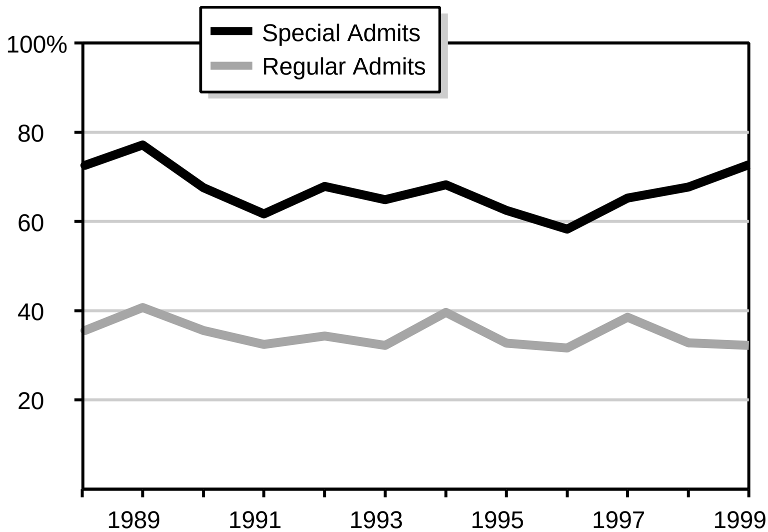


More Than One-Third of UC Students Arrive Unprepared for College-Level Writing. Figure 4 shows the percentage of UC students that did not satisfy the Subject A requirement from fall 1988 to fall 1999. In fall 1988, 35 percent of regular admits and 74 percent of special admits were unprepared for college-level writing. By 1999, these percentages had changed only slightly—to 32 percent and 73 percent, respectively. (During these years, the university specially admitted approximately 5.5 percent of freshmen.)

Figure 4

UC Unpreparedness Rates Steady Over Time

Percentage of Freshmen Requiring Remediation

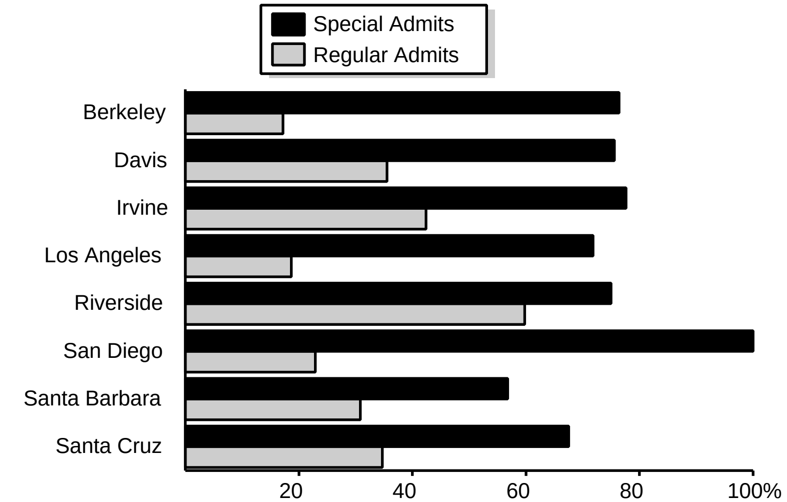


Considerable Variation Exists Among UC Campuses. Figure 5 shows the percent of entering students that did not meet the Subject A requirement at each UC campus in fall 1999. (The San Francisco campus is not included because it serves only postbaccalaureate students in health sciences.) At UC Berkeley, only 17 percent of regularly admitted freshmen did not satisfy the Subject A requirement. By comparison, 60 percent of regularly admitted freshmen did not satisfy the Subject A requirement at UC Riverside. At all campuses, the unpreparedness rates for special admits are substantially higher than the rates for regular admits. In fall 1999, the unpreparedness rates for special admits ranged from a low of 57 percent at UC Santa Barbara to a high of 100 percent at UC San Diego (though it specially admitted only four students).

Figure 5

Wide Variations in Unpreparedness Among UC Campuses

Percentage of Freshmen Needing Remediation–Fall 1999



ASSESSING STUDENT PREPAREDNESS

The college administrators and faculty we interviewed all agreed that students' preparation for college-level studies is a key determinant of their prospects for success in college. They said students benefit significantly from comprehensive assessments of their skills. They also emphasized the importance of assessing all prospective students and assessing them as early and regularly as possible. In this section, we identify options for improving the segments' assessment process. We then examine the services the segments provide to unprepared students and identify options for improving the segments' level of accountability to students and the state.

Assess Preparation For College-Level Studies Earlier

We recommend the community colleges, CSU, and UC work with high schools to develop methods to diagnose readiness for college-level work while students are in high school.

Students who do not score sufficiently high on college entrance exams do not know whether they will be able to enroll directly in college-level courses until *after* they have been admitted to UC or CSU. Only after these students have been admitted and have taken the requisite entry-level tests do they know whether they must take remedial writing or math classes. Similarly, students entering community colleges often do not know they are unprepared for college-level studies unless they take placement exams or until they actually enroll in a college-level course. Consequently, the current process poorly serves students both because it informs them of their skill deficiencies only after they have been admitted to college and because students then must pay relatively high fees to enroll in remedial classes. Given these serious disadvantages, we recommend the segments work closely with high schools to ensure students are advised as early and as frequently as possible about their preparedness for college-level studies.

Early Diagnoses Could Save Students Time and Money. Currently, almost all students who fail UC's and CSU's placement exams enroll in precollegiate writing and/or mathematics courses during the first (and sometimes second) year of college. Students taking precollegiate courses do not receive credits toward their college degree. Consequently, students taking precollegiate courses in college tend to require more time and more resources to obtain their college degrees.

In addition to prolonging students' time to degree, both CSU and UC charge the same fees for precollegiate courses—such as reading and vocabulary development, basic writing, and basic algebra—that they charge for all other undergraduate courses. Full-time students pay approximately $60 and $130 per semester unit at CSU and UC, respectively. If students knew they needed to improve their basic skills to be prepared for college-level work, students might prefer to take or retake courses at no charge while they are still in high school. They could also take the necessary precollegiate courses at community colleges, which charge only $11 per unit (or $33 for a typical 3-unit course).

The UC's and CSU's Recent Efforts to Assess Students Earlier. In an effort to provide aspiring college students, parents, and high school teachers with earlier warnings of skill deficiencies, UC and CSU recently instituted two noteworthy programs—both of which demonstrate how UC, CSU, and the community colleges might alter their current assessment to better serve students. First, UC and CSU began piloting the Diagnostic Writing Service (DWS) in 1999. The DWS is a web-based tool that 11th grade students may access to obtain feedback on their writing skills. Students respond to questions from previously administered EPT and Subject A exams, and university faculty assess their essays.

The UC and CSU also are expanding their Mathematics Diagnostic Testing Project (MDTP) to allow high school students to take math diagnostic tests. (Previously, UC and CSU administered the diagnostic tests only to college students.) Now, high school students can take diagnostic exams before and after each college preparatory math course. Although scores on these exams satisfy college proficiency requirements only when taken in college, the exams do provide students with an opportunity to identify and remedy their skill deficiencies prior to enrolling in college.

Segments Should Consider Aligning Skills Assessments With Existing High School Exams or University-Approved Exams. Although UC and CSU have made efforts to inform students of their skill deficiencies while still in high school, they might also seek to base their assessments on existing high school exams. High school students are tested from among several standardized tests, including the:

- Augmented Standardized Testing and Reporting (STAR) exam.
- Subject-matter Golden State Exams.
- AP exams.
- SAT I and SAT II tests.
- State high school exit exam (will be mandatory beginning in *2003-04*).

Given the breadth of high school testing, students could use high school test results to diagnose their level of preparedness for college. If the universities, however, prefer different tests, then the segments could work with high schools to develop university-approved writing and mathematics tests that schools could administer following college preparatory writing and math courses.

Precollegiate Education in California's Colleges and Universities

Once students have been assessed and deemed unprepared, the community colleges, CSU, and UC employ a variety of strategies to help them overcome their skill deficiencies and succeed in college-level courses. In this section, we identify the precollegiate services each segment offers. In the remaining sections, we highlight options for improving precollegiate education.

Community Colleges Offer Noncredit and Credit Precollegiate Courses

The community colleges offer collegiate, vocational, and recreational courses. In addition to these courses, they offer both noncredit and credit precollegiate courses. Noncredit precollegiate courses primarily serve students who have not yet graduated from high school and adults who have special educational needs. Noncredit courses also include some English as a Second Language (ESL) courses, high school equivalency exam (GED) courses, and elementary and secondary education courses.

In contrast, precollegiate courses taken for credit primarily serve students aspiring to progress into transferable college courses. These precollegiate classes are designed for students who are somewhat better prepared than students enrolled in noncredit precollegiate courses. Thus, the primary differences between noncredit and credit precollegiate courses are the students' entering levels of proficiency and the students' basic educational objectives.

The CSU Offers Several Types of Precollegiate Services

Precollegiate courses at CSU do not provide credits toward a baccalaureate degree. Most of CSU's precollegiate courses are traditional, term-length classes, taught by CSU instructors. These types of courses account for a large percentage of all lower division writing and mathematics courses. In spring 1999, for example, CSU Sacramento offered 156 course sections in precollegiate writing and mathematics. By comparison, the campus offered 169 sections in all its college-level lower division writing, English, and mathematics courses combined.

Although many precollegiate courses are taught by CSU faculty, several CSU campuses arrange for community colleges to teach precollegiate courses to their students. In fall 1999, for example, community colleges taught 55 of the 142 precollegiate course sections offered at CSU San Diego.

In addition to term-length precollegiate courses, several CSU campuses have begun experimenting with alternative course formats. For example, CSU San Diego and CSU Los Angeles have begun offering special courses that allow students who score only a couple points below the passing score on the EPT to enroll in a college-level writing course on the condition they also enroll in a noncredit tutoring session. Several campuses now also offer computer-assisted and self-paced instruction. The CSU San Luis Obispo campus, for example, has replaced all traditional remedial math classes with self-paced (but instructor-assisted) computer tutorials. In addition, several campuses have begun offering short workshops. For example, CSU Los Angeles currently offers a 40-hour mathematics workshop for students who fail the ELM and have not completed their precollegiate course work by the beginning of their second year.

The CSU's Disenrollment Policy. In fall 1998, the Chancellor's Office issued Executive Order 665, which requires campuses to disenroll students who do not complete precollegiate courses in a timely fashion. Specific campus policies vary, but most campuses now require students to complete their precollegiate courses in 12 months or 15 months after initially enrolling on campus. (Variations exist because some campuses allow students to enroll in precollegiate courses during the summer before or after their first academic year without having these terms apply to the time limitations.)

As Figure 6 (see next page) shows, the percentage of students needing remedial education that did not complete it within the required time varied from a low of 7 percent at the Maritime Academy to a high of 58 percent at CSU Stanislaus. Of all CSU regularly admitted first-time freshmen in fall 1998 who needed remediation, more than 20 percent had not completed their precollegiate courses within one calendar year.

Of the students not completing precollegiate course work within the allotted time, approximately one-third were administratively disenrolled, one-third left voluntarily, and one-third were permitted to extend their precollegiate course work into their second year of college. Figure 7 (see page 153) shows, for each CSU campus, the percent of regularly admitted first-time freshmen entering CSU in fall 1998 who needed remediation but were allowed to enroll in fall 1999 even though they had not yet passed all requisite precollegiate courses. Despite CSU's policy—which requires campuses to disenroll students who do not meet the time requirement unless the student faced extenuating circumstances—actual campus practices vary greatly. Reenrollment rates range from zero at the Maritime Academy to 60 percent at CSU Stanislaus. No information was available regarding the remaining students who did not continue to their second year. The CSU indicated, however, that many campuses encouraged these students to enroll in community colleges.

The UC Also Offers A Variety of Precollegiate Services

Most UC students needing remediation satisfy their Subject A writing requirement in full-term courses that do not provide credit toward a baccalaureate degree. Like CSU, UC encourages native and nonnative English speakers to enroll in different precollegiate course tracks. Whereas native speakers typically enroll in a one-term writing intensive course, nonnative speakers typically enroll in a one- to three-term language-focused and writing-focused course sequence.

Figure 6

Wide Variation in Remediation Completion Rates At CSU

Percentage of Unprepared Students Not Completing Remediation Within Allotted Time

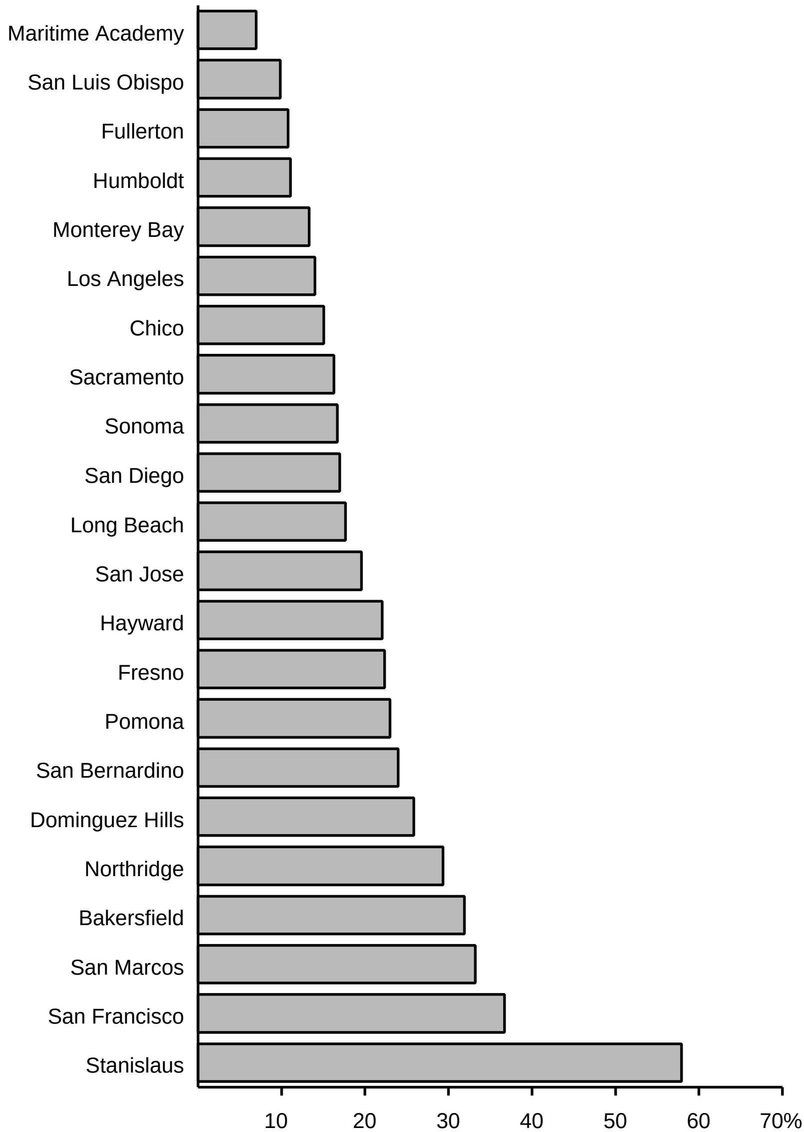
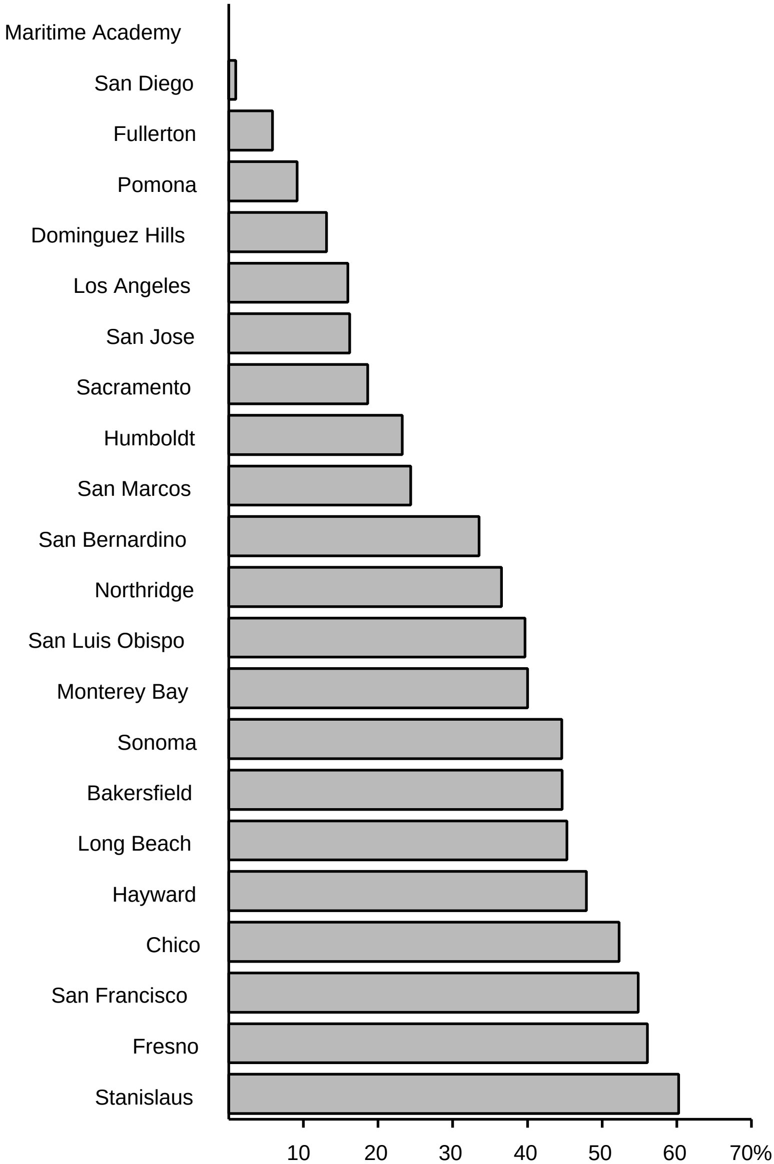


Figure 7

Considerable Differences in Reenrollment Practices

Percent of Students Not Completing Remediation Allowed to Continue–Fall 1999



Remedial Classes for Credit. Several campuses have reformatted their precollegiate courses for credit. For example, UC Berkeley now offers a six unit degree-credit course to students needing to satisfy the Subject A requirement. Faculty say they offer degree credit because the course now combines precollegiate material with more advanced, college-level material.

The UC Also Uses Community College Faculty. Both UC San Diego and UC Davis collaborate with local community colleges to provide UC students with precollegiate courses. The San Diego campus has used local community colleges to teach its precollegiate courses for more than 15 years, and UC Davis began its collaboration with Sacramento City College in 1993. Faculty we interviewed at both of these campuses praised the collaborations.

IMPROVING ACCOUNTABILITY IN PRECOLLEGIATE EDUCATION

Although all public higher education segments offer precollegiate services, it is difficult to hold them accountable for providing high-quality services. Currently, neither the Legislature nor the public can easily or meaningfully evaluate how public higher education helps unprepared students obtain the skills they need to succeed academically during the remainder of their college experience. To encourage segments to serve students with high-quality, cost-effective, and prompt services, we recommend the Legislature consider the following two options. First, the Legislature should require all three segments to assess and report on the preparedness of all entering students. Second, the Legislature should require all three segments to assess and report on the effectiveness of their precollegiate services.

Segments Should Assess and Report on The Preparedness of All Entering Students

We recommend the Legislature require the community colleges, CSU, and UC to assess and annually report on the reading, writing, and mathematics proficiency of all entering students—including transfer students.

If the Legislature and the public are to begin holding the three segments accountable for the precollegiate services they provide, they must first obtain basic information on the nature and magnitude of entering students' unpreparedness. Once they have access to this information, they can then begin measuring the segments' ability to help these students overcome their deficiencies. Although information on the proficiency of entering students is critical to the Legislature's ability to hold all segments of public education accountable, UC is the only higher education segment that has historically assessed and reported on the preparedness of all entering students.

Community Colleges Should Assess and Annually Report on the Proficiency of All Entering Students. As noted earlier, the community colleges do not routinely or uniformly assess students for proficiency in basic reading, writing, and mathematics. Many community college faculty we interviewed, however, were discouraged by the large number of their students who lacked basic academic skills and were thus, unable to succeed in college-level courses. Campuses could better assist students in identifying which courses best meet their needs by more systematically assessing their level of academic preparedness. Equally important, campuses should report on the proportion of all entering students who are unprepared for college-level reading, writing, and mathematics, and the community college Chancellor's Office should report systemwide figures on unpreparedness.

The CSU Should Also Assess and Annually Report on the Proficiency of All Students—Including Specially Admitted Students. Unlike UC, which has reported the Subject A pass rates of all entering students—both regular and special admits—since 1978, CSU did not provide the Legislature with any systemwide information on its unprepared students until fall 1999. The CSU is now making efforts to report the EPT and ELM pass rates of regularly admitted students at each of its campuses. In its new annual accountability reports, CSU also plans to report the proportion of unprepared regularly admitted students who complete remedial coursework and reenroll one year later. Although these recent efforts are laudable, CSU still is not reporting any comparable information for its specially admitted students. Given these students are likely to be in greatest need of precollegiate services, the Legislature should require CSU to report on their entering level of proficiency.

The CSU and UC Should Assess and Annually Report on Proficiency of All Transfer Students. Whereas CSU and UC require first-time freshmen to demonstrate through testing that they are proficient in basic skills, they do not require transfer students to take comparable proficiency exams. Transfer students only need to have passed the appropriate community college courses to be able to enroll in upper division CSU and UC courses. The reason CSU and UC treat first-time freshmen and transfer students so differently is unclear. The universities say they require first-time freshmen to demonstrate proficiency by passing placement exams because the content of college preparatory courses varies considerably among high schools and high school grades mask real discrepancies in skill levels. Based upon interviews with CSU and UC faculty, the content of college transferable courses and the standards used in determining community college grades are also likely to vary substantially across campuses, making it difficult for faculty to place transfer students appropriately without more objective assessment tools. Our interviews with transfer students reinforced the faculty's claims. Transfer students also stated that their community college coursework did not always prepare them for rigorous upper division CSU and UC courses, and some students believed they were poorly served by being inappropriately placed into CSU and UC courses. Consequently, we recommend that CSU and UC work with community colleges to develop methods for assessing transfer students before they transfer and annually report on the proficiency of all transfer students.

The CSU San Diego Already Requires Transfer Students to Demonstrate Proficiency. Of all CSU and UC campuses, CSU San Diego is the only one that currently requires transfer students to demonstrate proficiency in basic skills. The San Diego campus requires transfer students to pass its Transfer Writing Proficiency exam and Transfer Mathematics Proficiency exam—both of which were developed by the campus. Transfer students who do not pass the tests receive remedial training and then must retake and pass the tests before they can enroll in upper division writing and mathematics courses. (Transfer students who have not passed the proficiency exams can nonetheless enroll in upper division courses in other subjects, just as first-time freshmen deemed unprepared can still enroll in lower division courses in other subjects.) The campus says it began this practice precisely because (1) it had difficulty in appropriately placing incoming transfer students, (2) transfer students were struggling, and (3) faculty were having difficulty maintaining the rigor of their upper division courses.

Segments Should Assess and Report on The Effectiveness of Their Precollegiate Services

We recommend the Legislature require the community colleges, CSU, and UC to assess and routinely report on the effectiveness of their precollegiate services.

None of the three segments currently requires students to pass a standardized proficiency exam upon completion of a precollegiate course. When we asked the universities why they do not use standard exit tests to ensure students have obtained the requisite basic skills, they said students demonstrate proficiency for college-level writing and mathematics after passing one or more precollegiate classes. Not only do the segments not assess students upon the completion of remedial courses, they also do not track the future academic success of initially unprepared students.

This means they cannot evaluate the merits of any of the various precollegiate services they provide.

Post-Assessment Key to Accountability. Just as the universities test high school graduates for competency in basic skills—even though the students may have received high grades in their high school writing and mathematics classes—it would make sense for universities to evaluate whether completion of precollegiate classes adequately prepares students for college-level studies. If the standardized tests CSU and UC rely on to measure a student's preparedness for college-level studies are valid, then they should also be valid indicators of whether a student has become adequately prepared after taking a precollegiate class. Such post-course assessments would signal to students, faculty, and administrators whether students do become adequately prepared for more rigorous college-level work by completing CSU or UC precollegiate courses. College administrators could also use standardized assessments to measure the relative effectiveness of different instructional strategies, thereby allowing them to enhance the quality of their services.

Tracking Future Academic Success Also Key to Accountability. Currently, the segments have very little information on the future academic performance of initially unprepared students. The segments should track and periodically report on the future academic performance of randomly selected students. The segments should identify the type of precollegiate service(s) students receive as well as students' future academic performance and retention. Periodically assessing the progress of students—both those who are initially prepared and unprepared—would provide greater assurances that the segments are meeting students' academic needs. It would also provide data that policymakers could use to evaluate campus performance and to identify the types of programs that best serve students.

FUNDING PRECOLLEGIATE COURSES

State funding practices affect the segments' decisions regarding whether to admit unprepared students. These funding practices also affect how the segments provide precollegiate instruction. In this section, we examine how the state funds precollegiate courses at each of the segments and analyze how these budget practices affect CSU's and UC's incentives to serve unprepared students.

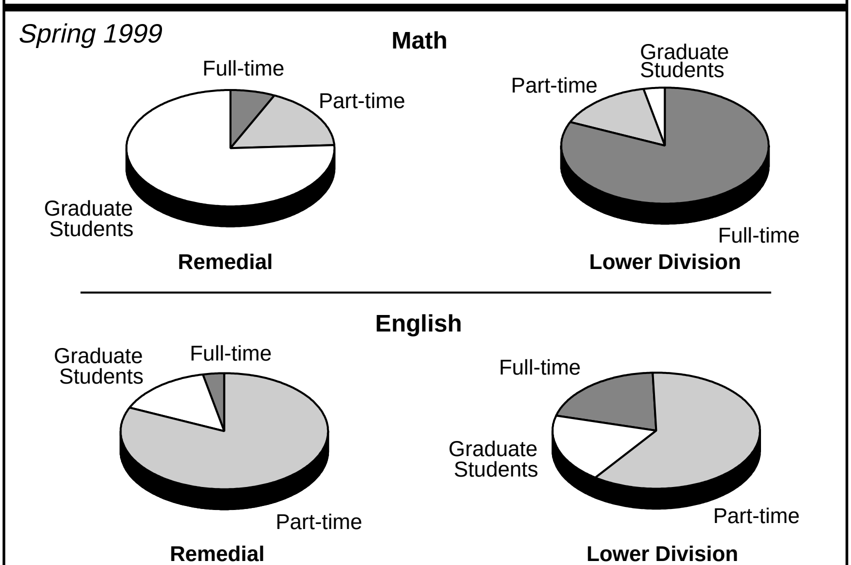
State Funds All Precollegiate Courses at the Community Colleges. The 1999-00 budget provided $1,915 in state and local funds per full-time-equivalent (FTE) student enrolled in *noncredit* precollegiate courses. By comparison, the 1999-00 budget provided $3,492 per FTE student enrolled in *credit* precollegiate courses. Additionally, as noted earlier, UC and CSU contract with some community colleges to provide precollegiate instruction. In such cases, community college faculty teach UC and CSU students on the universities' campuses. The community colleges receive state funding for enrollment in these courses (as noted above—$3,492 per FTE student in 1999-00).

State Funds Precollegiate Courses at CSU But Not at UC. Currently, the state provides CSU with the same level of funding for students enrolled in precollegiate and college-level courses. It does so even though students enrolled in precollegiate courses at CSU do not receive credit toward their baccalaureate degree. For 2000-01, the state provided CSU with $5,813 per additional FTE student.

Precollegiate courses at CSU, however, appear to be much less costly than college-level courses. Figure 8 shows, for example, that CSU Sacramento uses disproportionately more graduate students and part-time instructors for precollegiate courses than for regular lower-division courses. Given that the vast majority of precollegiate courses are taught by graduate students or part-time faculty, these courses are also likely to be comparable in cost (or might even be less costly) than community college courses.

Figure 8

Remedial Courses Typically Taught by Less Senior Staff–CSU Sacramento



In contrast to CSU, the state does not fund precollegiate courses at UC. While the state currently provides $8,554 for each additional FTE student UC enrolls in college-level courses, it does not provide any funding for students enrolled in precollegiate courses. The UC campuses bear the costs of these courses.

Current Funding Practices Generate Perverse Incentives for Both CSU and UC. By providing CSU with the same level of funding for unprepared and prepared students (even though precollegiate courses are typically less costly than college-level courses), state policy encourages CSU to admit unprepared students—regardless of whether those students could be as well or better served at a community college. If the state funded courses for unprepared students at a rate more consistent with costs, it would reduce this incentive.

In contrast, by not providing state support for unprepared students enrolled in precollegiate courses at UC, many UC campuses allow only the most challenged students to enroll in precollegiate courses. For example, UC Riverside allows only nonnative English speakers to enroll in precollegiate writing courses. Several UC campuses also routinely mainstream students that have not yet satisfied the system's Subject A requirement, which allows The UC to obtain more state funding for remedial students. The UC Riverside, for example, encourages native English speakers who fail the Subject A exam to enroll directly in lower division courses. Because it does not characterize these courses as precollegiate, it receives full state funding for them.

State Should Offer Only One Precollegiate Funding Rate

We recommend the state fund CSU's and UC's precollegiate writing and mathematics courses at the same rate it funds credit courses at the community colleges.

As described in the previous section, the state currently funds precollegiate services at the three segments in widely disparate ways. The current funding system also appears to reflect poorly the actual costs the segments are incurring in providing these courses. To address these concerns, we recommend the state fund all precollegiate courses at the community college rate.

This proposed funding change would improve the incentives CSU and UC have to tailor precollegiate services to the special needs of unprepared students. Whereas CSU currently has an incentive to admit unprepared students without considering the full array of options available for serving them, this funding change would encourage CSU to reconsider the most efficient and effective way to deliver precollegiate services. Perhaps most importantly, it would provide CSU with additional incentives to expand its collaborations with community colleges.

In contrast to CSU, UC would actually obtain more funding for its precollegiate courses because the state currently does not support them. Obtaining state support would obviously make it easier for UC to offer these courses. Moreover, the proposed funding change would encourage UC to provide all unprepared students—both native and nonnative English speakers—with appropriate academic assistance.

CONCLUSION

Today, many students are arriving at public colleges in California unprepared for college-level reading, writing, and mathematics courses. In this report we recommend a multifaceted strategy to address this problem by assessing student preparedness earlier, improving accountability in precollegiate education, and funding precollegiate courses in a more equitable and effective manner.

"E-GOVERNMENT" IN CALIFORNIA

What Services Should the State Provide Through the Internet?

Summary

California state government has begun to implement "e-government"—the provision of government services directly available to citizens via the Internet. It appears that there are a number of potential *benefits from e-government implementation, including reducing the costs of government, streamlining governmental operations, and making government services more accessible and convenient to the public.*

These benefits, however, may not materialize given the state's current approach which lacks (1) public input in determining the services to be provided, (2) clearly defined priorities for e-government proposals, and (3) executive-level sponsorship from the state's program areas whose services are to be provided through e-government.

We recommend that the Legislature, in reviewing e-government proposals, approve those that (1) reduce the cost of government or increase efficiency and/or program effectiveness, (2) demonstrate the public's interest in and the public's ability to access the proposed service, (3) protect private confidential information, (4) implement reengineered processes, (5) are piloted first and operational in a short period of time, and (6) have strong sponsorship from the state's program areas.

We also recommend that the Legislature direct the administration to (1) develop policies related to user and credit card fees and authentication for services and (2) identify the need and the costs associated with modifying the existing state information technology systems to operate efficiently with the newer e-government systems.

What Is "E-Government" and How Does it Work?

A Definition. Electronic government, or "e-government," is the process of transacting business between the public and government through the use of automated systems and the Internet network, more commonly referred to as the World Wide Web.

Most federal, state, and local government agencies have had some sort of presence on the web for some time, such as providing information about the role of the agency, published reports, printable forms, and data files. In addition, some agencies, such as California's Franchise Tax Board (FTB), have the capability to allow the public to enter information and then receive back information concerning the status of a particular activity. We do not consider these types of activities to be e-government services as we have defined them. This is because the public is not transacting business but simply receiving a service also accessed through other means, such as interactive voice systems or speaking directly to staff.

How Does an E-Government Service Work?

An e-government service allows the public to initiate a request for a particular government service and then receive that government service through the web site. The government service is delivered without the public going into a government office or having a direct in-person or telephone contact with a government employee.

To conduct an e-government interaction, a citizen generally needs to:

- Use a personal computer (PC) connected to the Internet through a telephone line.
- Understand how to use a keyboard and a mouse to both type and "point and click."
- Understand how to access and use web sites.
- In some cases, use a unique identifier such as a social security number or personal identifier number (PIN) to either access or provide private confidential information.

For the public to request and receive e-government services means that they must have access to PCs with Internet connections. Studies show that roughly 60 percent of Californians have access to the Internet through PCs either in their homes, at work, or in public libraries, schools, or community-based organizations. The public can gain the basic understanding of how to use a keyboard, a mouse, and also how to use web sites by reading books, attending classes, or through "trial and error."

Theoretically, once the public has connected to the Internet and located the appropriate web site, e-government services become available. Figure 1 displays some of the services most frequently available through e-government in various states throughout the nation.

Figure 1

State E-Government Services Referred to Most Frequently

- Filing personal income tax return.
- Reserving a campsite in a state park.
- Applying for a state fishing or hunting license.
- Renewing a professional license.
- Submitting employment information.
- Registering a complaint against a business or professional licensee.
- Renewing a driver's license.
- Requesting a government loan.

In order to receive these kinds of e-government services, the public generally needs to provide:

- A unique identifier to ensure that government is providing the service to the correct person or business.
- Personal information concerning the person or business to ensure eligibility to receive the service.
- Financial information, generally a credit card number, in those cases when a payment is necessary.

Once the public has provided the necessary information, government must be able to:

- Process the information to ensure that the information being provided is accurate, that the service is being provided to the correct person, the person receiving the service is entitled to the service, and that payment can be made.
- Respond to the public concerning any problems encountered during the processing of the provided information.

- Provide the appropriate service and then issue a verification that a service was rendered, such as providing a printable fishing license or e-mailing a confirmation that a tax return was received.

E-government consists of both the ability for the public to interact sufficiently with government to receive a service, and then government to sufficiently interact with the public to provide a service.

What Are the Potential Benefits of E-Government?

There is limited data available with which to conduct a definitive cost-benefit analysis of providing services through e-government. This is primarily because no state is providing a full range of e-government services as we have defined it. However, it is likely that there are benefits to e-government systems based on government's overall experience with improvements achieved through the implementation of automation systems.

Since government at all levels started using information technology (IT) to solve operational problems, overall benefits have been (1) reduced or avoided operational costs, (2) reduced time frames to deliver services, and (3) improved services. We believe these same type of benefits could be achieved with properly implemented e-government systems. Ultimately, whether these benefits are realized depends on whether e-government systems incorporate qualities we describe later in this report.

Potential benefits of full-scale implementation of e-government are summarized in Figure 2 and described in more detail below.

Reduced Costs and Increased Interest. E-government has the potential to reduce the size and cost of government. These savings can take many different forms. For example, government agencies should be able to provide e-government services to the public with less staff than would be required to provide the services through in-person contacts, thereby reducing personnel costs. Similarly, fewer or smaller offices would be

Figure 2

Potential Benefits of E-Government

- Reduced government costs; increased interest earnings.
- Streamlined government operations.
- Providing government services to citizens 24-hours-a-day, 7-days-a-week.
- Reduction in the number of in-person government contacts.
- Delivering government services from any place.

needed in which in-person services will be provided, thereby reducing capital outlay costs. Also by allowing the public to enter information online as opposed to filling out a paper form, government organizations can reduce certain operating costs.

Another potential benefit of e-government solutions is to conduct monetary transactions more efficiently, resulting in increased interest earnings on state revenues. Most Californians make payments to the state through the mail. Currently, when state agencies receive these payments, they must process those payments through a series of activities—opening the mail, gathering the payments into batches, entering data into departmental IT systems, and then providing the batch to the bank which is responsible for further processing. This entire process of mailing in payments and handling checks can take anywhere from a few days to a few weeks.

However, if e-government solutions were implemented which allowed direct payment without the mail-in and check batching processes, funds could be immediately transferred and posted to the state treasury. The sooner the funds are deposited, the more interest the state earns and more revenue is generated.

Streamlining Government Operations. E-government solutions can potentially help streamline the operations of government. Most government processes have been operating for a substantial amount of time, having evolved over many years. These processes usually involve many steps, tasks, and activities. Many of the processes that support government programs generally undergo few in-depth reviews or changes. In some cases, this means that state government may not be operating as efficiently and effectively as it could, and therefore could benefit from a reexamination. This reexamination process and the resulting improvements are commonly referred to as "business process reengineering."

Ideally, state government should review its operations on a regular basis. Generally, this does not occur unless a significant change in the underlying program occurs. The emergence of e-government, with its emphasis on the use of IT and the delivery of services using the Internet, presents the state with the opportunity to fundamentally rethink how it delivers services to its citizens. Specifically, e-government offers the state the opportunity to:

- Examine its current operations.
- Identify business processes and practices that could be streamlined.
- Implement those streamlined business processes.
- Implement new technologies that enhance those improvements.

Reengineering the Teacher Credentialing Process

The Commission on Teacher Credentialing (CTC) is responsible for issuing permits and credentials to all classroom teachers, student services specialists, school administrators, and child care instructors and administrators. The commission's workload has increased significantly since the implementation of class size reduction. It must process more credentials, respond to more questions from applicants, and review more discipline cases. It takes between 4 to 12 weeks for CTC to perform its primary task—processing a request for a teaching credential or permit.

In the *1999-00 Budget Act,* the Legislature appropriated funds for a comprehensive review of the credentialing process. The major recommendations from this review placed particular emphasis on modifying CTC organizational structure and using IT to improve its operations. The review recommended that the commission:

- Eliminate the CTC credentialing renewal process and allow local administrators to verify professional development course work.
- Create a formalized staff training program that allows CTC staff to specialize in particular types of credentials.
- Create an Institute of Higher Education training program to improve the accuracy of forwarded applications.
- Consolidate the fingerprinting process and use fingerprinting live-scan technology to decrease credential processing times.
- Provide counties with electronic access to check application status to reduce mailing costs.
- Allow electronic submission of applications to streamline processing.

We believe this review provides a good example of what a reengineering study should demonstrate—suggested improvements to the current process and recommendations on how IT can be used to assist in those improvements.

In the process of streamlining its business operations, a properly implemented e-government solution provides the state the opportunity to focus its resources on those service delivery efforts that are most efficiently provided through direct contact versus other means. For example, for the past few years, Employment Development Department (EDD) has posted all job openings available through their field offices on the CalJobs web site. This statewide posting has enabled job seekers to view EDD job openings without going into an EDD office. It has also allowed EDD to focus its staff on those activities that are best delivered through more direct contacts with both employers and job seekers.

We believe that this use of e-government offers benefits to both Californians and government. Citizens receive services that offer the most value at the time they need it, and government has the opportunity to focus its staff resources on those services that are best provided through direct in-person contact.

"Open for Business—All Day Every Day." The Internet phenomenon has changed the way people and businesses interact. Transactions, such as purchasing merchandise, conducting banking activities, and receiving news, no longer occur during specific hours of the day as they once did. Web transactions are basically available any time of the day, as long as the IT system is up and running. E-government systems can also offer this same type of availability. However, being continually available does have important policy implications which we discuss later in this report.

"On-Line, Not In-Line." A successful e-government system could provide citizens the convenience of not having to go into a government office to receive a service. This provides such tangible benefits as reducing the amount of time that citizens have to take away from their jobs or reducing traffic to and from government offices.

"No Wrong Door." Finally, e-government can potentially enable citizens to receive government services from a single point of entry or from "one stop." Currently, to locate an on-line service, the public must know *which* department at *what* level of government is responsible for providing the needed service. Then the public must locate the department either in the telephone directory or on the department's web site. Most citizens and businesses know *what* they need but not necessarily *who* provides it. A "no wrong door" strategy means that a citizen's ability to receive a service is no longer dependent on knowing "who" provides the service. Rather, once a citizen knows what service is desired, he/she will be able to locate it from a general government website.

What Is the State Doing With Respect to E-Government?

The Administration's Approach

E-Government Planning Efforts. Since spring 2000 the administration has been developing a plan for how e-government will be implemented and operated in the state. The plan is being developed under the direction of the staff in the Office of Planning and Research (OPR) with input from Chief Information Officers in state departments and the state's two major data centers.

Based on our discussions with the administration, we understand that the planning effort will result in the following documents:

- ***Vision.*** This document will be released first and it will describe the administration's overall vision for e-government.
- ***Implementation Planning Guidelines.*** This document which is expected to be released 60 days after the vision document, will consist of guidelines which departments will use when developing plans to implement e-government systems.
- ***Technical Approach and Standards.*** This document will describe the state's technical approach and standards for e-government systems. The document is expected to cover such topics as information privacy, security, maintenance, and interface standards, and is expected to be released 60 days after the implementation planning guidelines.

The administration has not provided estimated release dates for these documents. It is unclear how these three planning documents will fit together and provide direction to individual state agencies and departments. At a minimum, these documents should describe how the state will approach e-government, how departments will be expected to implement this new policy, and how all of the planning documents and budget proposals will fit together.

Governor's E-Government Executive Order. In September 2000, the Governor issued Executive Order D-17-00 announcing the state's direction for e-government. The Executive Order:

- Established a Director of E-Government, within the Governor's office, responsible for policy direction and coordination between the Department of Information Technology (DOIT) and OPR.
- Described the oversight roles of DOIT, the Department of Finance (DOF), and the Department of General Services (DGS).
- Required that departments submit e-government implementation plans to DOIT as the agency responsible for reviewing those implementation plans.
- Mandated the creation of a statewide portal (that is, a "one-stop" web site).

In a subsequent announcement, the Governor established a Governor's E-Government Business Advisory Council composed of representatives from the state's IT firms. The purpose of the council is to advise the state on e-government architecture and policy.

Roles and Responsibilities. Based on our discussions with the administration, Figure 3 summarizes the roles and responsibilities for the oversight and implementation of the state's e-government systems.

State's Current E-Government Systems

Although the administration's overall e-government planning efforts are still underway and the organizational structure for e-government was only recently developed, the state has already undertaken a number of e-government efforts.

Figure 3

E-Government Oversight Roles and Responsibilities

Department	Role and Responsibility
Director of E-Government, Governor's Office	• Sets the state's policy direction. • Coordinates the activities of DOIT and OPR.
Office of Planning and Research	• Ensures project focus is on customer service. • Monitors customer service. • Acts as executive sponsor for specific Governor initiatives.
Information Technology	• Reviews e-government implementation plans. • Provides project reviews and oversight.
Finance	• Provides project fiscal analysis reviews.
General Services	• Administers procurement activities.
Teale Data Center and Health and Human Services Agency Data Center	• Provides operational support to e-government systems. • Develops e-government systems for smaller departments. • Supports and operates core e-government components for common state business functions.
Individual departments	• Prepares e-government implementation plan. • Manages e-government projects. • Develops and implements e-government systems.

Department Web Sites. California state government, like all other states, has its own web site, and each state agency and department has its own web site. Each of these various web sites has a distinctive appearance, including different colors, screen layouts, and web technology features.

For the most part, the majority of the information provided through department web sites covers informational items such as descriptions of what the department does, how to contact the department, and regulations and data of general interest. Some departments, such as FTB, provide additional features described earlier in this report.

The EDD's CalJobs. In 1996 the U.S. Department of Labor required all state employment security agencies (SESA)—EDD in California—to establish web sites to post SESA job openings. In response to this requirement, EDD began piloting an interactive on-line system in 1996 to allow job seekers to review EDD job listings and employers to directly enter information about job openings. In 1997, EDD began the full scale implementation of these interactive services with a project titled CalJobs. The total project cost for CalJobs was $10 million over five years.

The DMV's On-Line Vehicle Registration. In 1999, the Department of Motor Vehicles (DMV) began a project to permit the on-line registration of vehicles. To participate in the on-line vehicle registration (VR) system, vehicle owners must (1) have a valid credit card with which to pay registration fees, and (2) possess automobile insurance issued by one of the three companies set up to electronically transfer insurance data to DMV. By accessing the DMV web site, California vehicle owners who meet this criteria can then register their vehicle on-line. The current cost for this project is estimated to be $5.5 million over three years.

***E-Government Projects Funded in* 2000-01 Budget Act.** In addition to CalJobs and DMV's VR, the Legislature provided funds for three new e-government projects in the *2000-01 Budget Act*, as shown in Figure 4. Both the E-Business Center and the Government to Citizens projects are required to submit reports to the Legislature by April 2001, describing the results of the various studies.

How Do California's E-Government Efforts Compare?

Overall Government Efforts. Much has been written concerning government's overall progress towards implementing e-government systems. Most government entities at the federal, state, and local levels have all done relatively well in establishing web sites containing static or unchanging information. However, our review found that relatively little has actually been implemented that meets our e-government definition—the process of transacting business between citizens and government agencies.

Figure 4

New E-Government Projects
Funded by the *2000-01 Budget Act*

(Dollars in Millions)

Project Name	Responsible Department	Budget Amount	Project Purpose
E-Business Center	General Services	$4.6	• Conduct studies to determine opportunities to develop a "one stop" web site for California businesses.
Government to Citizens Studies	Finance	1.2	• Conduct studies to determine opportunities to develop e-government systems for employer tax filing, expanding Department of Motor Vehicles on-line services, and state permits.
California Enterprise Project	General Services	5.1	• Redesign the California Home Page. • Enhance e-mail system with citizens. • Upgrade the supporting network.

State Government. We found that 25 states have not implemented any e-government systems, while 25 states (including California) have implemented at least one e-government system. California is on par with most other states with respect to implementation of e-government, as shown in Figure 5 (see next page). In addition, we found that most states:

- Are in various stages of developing and implementing an e-government vision and plan.
- Are making attempts at providing e-government services, with DMV-type services being the most commonplace (14 states have an operational VR system).

In addition, some government jurisdictions have established mandates in which e-government must be implemented. For example, federal government organizations have been mandated to provide some form of e-government services by 2003. The Utah Legislature has mandated that every state agency have some form of e-government service available by 2002 and the Maryland Legislature has mandated that 80 percent of its state services be on-line by 2004.

Figure 5

States With E-Government Services

State	Renewing Vehicle Registration	Renewing Driver's License	Applying for Hunting/ Fishing Licenses	Filing Personal Income Tax Returns	Other On-Line Services Available
Alaska	✓		✓		
Arizona	✓				✓
Arkansas	✓				
California	✓			✓	
Colorado				✓	✓
Delaware				✓	
Georgia			✓		✓
Idaho			✓		
Illinois			✓		
Indiana	✓				
Kansas			✓		
Kentucky			✓		
Louisiana	✓				
Maine			✓		
Maryland	✓				
Massachusetts	✓				✓
New Jersey	✓			✓	
New Mexico	✓				
New York	✓				
North Carolina	✓				
South Dakota					✓
Virginia	✓	✓			✓
Washington					✓
Wisconsin	✓				
Totals	**14**	**1**	**7**	**4**	**7**

Note: Review conducted in September 2000. States not listed above do not have these on-line services available as of September 2000.

The State of Washington was the first state to establish statewide IT policies and standards for e-government systems. South Dakota embarked on an e-government education technology initiative as a means to deal with problems being encountered in such areas as education reform and rural service delivery. Pennsylvania, North Carolina, and Utah are in the beginning phases of implementing "one-stop" web sites where the public can receive most services through entering from a single site.

Local Governments. A small number of California's cities and counties have made some government services available on the Internet. For example, Orange and Los Angeles Counties have established web sites through which the public can request birth, marriage, or death certificates, although there is an additional fee to receive these services on-line. The City of Sunnyvale has established a web site through which building permits can be filed on-line. But, overall, widespread use of interactive e-government systems are not yet available at the local level.

Concerns With the Administration's Current Approach

Our review identified three concerns with the administration's current approach to e-government.

State Needs to Identify the E-Government Services that the Public Wants. In order for e-government to be effective, the state needs to provide e-government services that the public wants and finds valuable. So far the state's current approach has failed to obtain public input to determine the types of services which will be provided through e-government. Ascertaining the level of public interest in receiving e-government services—and which specific services are the highest priority—is important to ensure the system will actually be used once it becomes operational.

The Legislature has recognized the importance of citizen input and has directed the administration to seek such input. We understand that the administration intends to meet this requirement and report to the Legislature by April 1, 2001.

Administration Has Not Set Statewide Priorities. It appears that the administration has not yet established statewide priorities for its various e-government projects. For instance, it is unclear if issuing fishing licenses or renewing driver's licenses have the same or different priorities for the administration. It is important that the administration clearly identify its statewide priorities so that the Legislature, when making budgetary decisions, can determine if those priorities are consistent with its policy choices.

Programs, Rather Than Technology, Should Drive E-Government Initiative. One of the primary reasons that state IT efforts have failed in the past is due to the lack of "ownership" and involvement by the staff of the program that is being automated. Because the chief benefits derived from the e-government initiatives will fall in program areas, it is imperative that the program staff, not IT staff, lead the initiative. It is important that the Legislature ensure that e-government initiatives are not "IT initiatives," but rather program initiatives that will result in improved government operations resulting in improved services to the public.

It appears that the majority of the administration's involvement in the e-government initiatives has been from the state's IT organizations.

In particular, input has been primarily provided by IT professionals, not program and policy specialists at the department level.

What Qualities Should the Legislature Look for In a Good E-Government Proposal?

It is likely that the Legislature will continue to receive e-government proposals from the administration over the next few years. Figure 6 summarizes the qualities that we believe the Legislature should look for in a good e-government proposal.

Proposal Reduces Government Cost or Increases Government Efficiency and/or Effectiveness. E-government projects, like other state automation projects, should result in some clear benefit. Projects should either reduce the cost of government, increase government efficiency, and/or improve the effectiveness of government programs.

Public Demonstrates an Interest in Receiving On-Line Services. It is important that the e-government services provided are those that the public has expressed an interest to use. Without interest from the public to use the on-line service, the project could result in limited usage at a potentially high cost. For this reason, proposals provided to the Legislature should demonstrate, based on surveys by independent objective parties, that the public wants to receive the proposed service on-line. For example, Texas conducted a statewide study assessing the public's interest in using

Figure 6

Qualities of a Good E-Government Proposal

- Reduces government costs or increases efficiency and/or effectiveness.
- Demonstrates that the public wants it and has access to it.
- Protects private confidential information.
- Identifies "customer support" during business and nonbusiness hours.
- Identifies fees to be paid by public.
- Implements a reengineered process.
- Tests a new service delivery model.
- Was piloted first.
- Operational in a short time frame.
- Uses IT best practices.
- Has executive sponsorship.

e-government services. The results of this study are being used to set the priority and direction of the state's e-government initiative.

Public Being Served Has Access to the Internet. Studies have demonstrated that there are some sectors of California's population that do not have access to the Internet from either their homes or places of work. For these Californians, it is necessary to provide access through other means, such as in libraries or community centers. Since access is a vital component for going "on-line," we believe that it is important for the Legislature to know *who* actually will be served by the e-government proposal and then *how* the administration proposes to ensure that the target populations have access to the proposed on-line service.

Proposal Protects Private Confidential Information. Several recent independent studies have found that the public is concerned about the collection and protection of private confidential information gathered by commercial web sites. Studies have shown that a large majority of Internet users, in some cases up to 85 percent, have concerns about *how* information is being collected, *why* information is being collected, *what* happens to the information once its been collected, and *how* information can be changed after it is collected.

One of the major issues for the Legislature to address over the next few years will be to ensure that the private confidential data collected by e-government systems is properly administered and protected. We note that the Legislature included budget control language in the *2000-01 Budget Act* specifically related to information privacy and confidentiality. The language requires that each department post a privacy policy that describes why data is being collected, how the data will be used, how the data will be protected and who within the department is responsible for the privacy policy. The Legislature should only approve those e-government services proposals that address these privacy concerns.

Proposal Needs to Describe Customer Support Services. Although typical state business hours are Monday through Friday, 8:00 A.M. to 5:00 P.M., the public uses the Internet 24 hours a day, 7 days a week. This means that as the state moves towards using the Internet to deliver services, methods must be implemented to provide customer service to the public when its needed. For this reason, we recommend that the Legislature determine for each e-government proposal how customer support will be provided for the on-line service—during both business and nonbusiness hours—and how much that customer support will cost.

Proposal Identifies Fees to Be Paid by the Public. For many government services, users of services are charged a fee to offset the cost of those services. Under this principle, the costs associated with delivering services through e-government would be passed along to the users of those services.

However, under certain circumstances, it may be desirable to actually reduce charges as an incentive for individuals to use e-government services if that results in governmental or societal benefits (for example, reduced traffic congestion). We recommend that the Legislature determine if some e-government proposals would benefit from such a strategy of reduced fees.

Proposal Includes Reengineering. Some state government processes are viewed as cumbersome and difficult "to navigate" by the public. For these types of government processes, "reengineering" the way government works could be beneficial. Simply automating the current state business process will in some cases only perpetuate current inefficiencies and ineffectiveness. Therefore, we recommend that the Legislature only fund those e-government proposals that are the result of a re-engineering study that includes not only the automation solution, but also changes in the way the state conducts business.

Proposal Tests New Service Delivery Models. E-government proposals, if constructed properly, could test new models of how government provides services in a more efficient and effective manner. E-government proposals could test service delivery models that:

- Cut across organizational lines—the public would receive the service without having to know which department actually provided the service. For example, a nurse could renew a professional license without having to go through the Department of Consumer Affairs.
- Build upon private sector investments—the proposal incorporates the use of systems already used in the private sector and does not require government to "reinvent" the wheel. For example, if software companies have developed a "generic" on-line loan application, the state could use those software solutions in lieu of developing one specifically for the state.
- Complement federal or local level efforts—the proposal builds upon e-government services being offered through other governmental entities and leverages that investment with the state's investment. For example, if both the Internal Revenue Service and FTB allowed on-line tax filing, the public could file both taxes at the same time.

Proposal Should Be Piloted First. Piloting e-government systems, in particular, could prove beneficial to ensure that the proposed e-government service actually meets the needs of the public. We believe that piloting first will:

- Provide data on potential cost savings.
- Help identify issues that may result with statewide implementation.
- Ensure that the proposed e-government service will truly meet the needs of those it was intended to serve.

As the Legislature evaluates e-government project proposals, we recommend that (1) proposals that have been piloted with documented positive results be considered for funding, or (2) for those proposals that have *not* been piloted, that the Legislature direct the administration to do so prior to receiving funding.

Proposal Is Operational in a Short Time Frame. One of the problems encountered in state automation projects is the amount of time it takes to develop and implement an automation system. The longer it takes to develop and implement a system, the higher the cost to the state. In our view, properly implemented e-government systems should result in reducing the cost of government and/or making government more efficient. E-government proposals should therefore have relatively short time frames to both design and implement the on-line system.

We recommend that the Legislature consider funding those proposals that will be piloted and operational for the public within one year of start-up. However, we do recognize that some e-government projects due to complexity may take longer to implement. For these projects, we recommend that the administration utilize a multi-phased approach with some operations being offered in a short time frame with full implementation coming later. We believe that this overall approach will allow cost savings and efficiencies to be realized earlier as opposed to later in the implementation process.

Proposal Includes IT Best Practices. E-government projects, like other state automation projects, will experience significant problems and be at risk of failure unless they incorporate IT best practices into their design. Generally, these best practices include use of project and contract management and measurable project objectives. We recommend that the Legislature evaluate e-government projects as it would any other state automation effort and make sure that they incorporate IT best practices. (For a discussion of IT best practices, see our December 1998 report entitled *State Should Employ "Best Practices" on Information Technology Projects*.)

Proposals Demonstrate Program Leadership. Successful automation projects have strong executive sponsorship and leadership from the program staff. E-government projects share this key to success. Since the majority of the process changes resulting from an e-government proposal will be in the program area, it is vital that the program staff lead and sponsor the e-government proposal.

For these reasons, we recommend that the Legislature determine program commitment and leadership by asking:

- Who is pursuing the proposal?
- What program changes will occur as a result of the proposal?
- What commitment has the program area staff made to implement the changes and support the automation effort?

Hopefully, the answers to these questions would reveal a strong commitment by program staff to the e-government proposal. Without such a commitment, the likelihood of success is reduced.

WHAT ARE THE FUTURE ISSUES?

Several of the qualities of a good e-government proposal have embedded in them issues for which the Legislature will need to provide direction relatively soon. Figure 7 summarizes these issues which are discussed below.

Ensuring Access. Much has been written in recent years about how some segments of the population lack access to home computers and the Internet. This phenomenon is usually referred to as the "Digital Divide."

In our view, this is a problem largely related to income, educational attainment, and age. Statistics indicate that Californians without a college education and incomes under $20,000 are least likely to have home computers and access to the Internet, while Californians with higher in-

Figure 7

E-Government Issues That Will Need to Be Addressed

- Ensuring access.
- Protecting information privacy.
- User and credit card fees.
- Customer support.
- Authentication.
- Modifications to existing systems.

comes and higher educational attainment are more likely to have home computers and access to the Internet. In addition, studies have found that Americans over the age of 50 are less likely to use the Internet than younger Americans.

As the state expands e-government services, the issue of access and the ability to fully use the available systems will become more important. We believe that expanding existing programs that provide the public access to PCs and the Internet through schools, libraries, and community-based organizations, provide the most near-term promise to meeting public needs in this area.

Protecting Information Privacy. As we noted earlier, protecting personal confidential information is a key concern. The advent of Internet technology with its capability to provide improved services offers both opportunities and challenges for government. The Legislature will need to ensure that the:

- Collection of private confidential information is appropriate.
- Sharing of information both within and outside of government is consistent with how that information was originally collected.
- Information collected can be changed by those who provided it.

User and Credit Card Fees. The most common method to pay for financial transactions through Internet systems is with credit cards. However, credit cards are *not* the most common method used to pay for government services. Cash, money orders, and personal checks are currently the most common methods used by the public to make payments to government.

Processing credit card payments is more costly because of a transaction fee imposed by the credit card companies on the businesses that accept payment by credit cards. (These transaction costs may be absorbed by the business or passed along to the consumer.) These transaction fees are a percentage of the total payment. The average percentage is 1.5 percent.

If the state moves more payment activities to the Internet, then there will be a shift from the traditional modes of payment to credit card payments. This means that the state will have to determine how to pay these transaction fees. The options are to either pass the fees back to the public or for the state to pay the fees, which ultimately increases government costs.

Credit card fees like user fees, generally, are appropriately charged to the users of services. However, as discussed earlier, there may be circumstances under which it would be appropriate for government to absorb these costs if in so doing it achieves other governmental or societal objectives. Therefore, we recommend that the Legislature direct the administration to develop an "e-government fee" policy that describes *when* user and credit card fees are appropriate, how much these fees will cost the public, and the circumstances under which fees should *not* be imposed.

Authentication. When the state provides services to an individual, it must authenticate that the person receiving the service is eligible to receive the service. When a service is provided in-person, this is easily achieved through identification cards, birth certificates, et cetera. When the service is provided through other means, authentication becomes a challenge. As e-government systems expand, new means such as digital signatures or use of a PIN for authenticating service recipients will have to be explored. The Legislature will need to ensure that these new methods protect both the rights of Californians while ensuring that government services are provided to those who are eligible. Therefore, we recommend that the Legislature direct the administration to develop an e-government authentication policy that describes the methods which will be used to authenticate services and how these methods will protect Californians' rights and eligibility to services.

Modifications to Existing Systems. E-government systems are based on a relatively new technology—PCs and the Internet. Most state IT systems, however, are based on an older technology which relies mainly on large mainframe technology. It is unclear what impact the newer technology will have on the older technology. It is likely, however, that the older systems will require modifications, but the costs of such changes is unclear. Therefore, we recommend that the Legislature direct the administration to examine the need to modify the existing mainframe systems to operate efficiently with the e-government systems and identify the additional costs to implement any necessary modifications.

CONCLUSION

E-government services are in their infancy. Data does not yet exist as to what the true costs and benefits will be of this new service delivery mechanism; however, it appears that e-government systems have some potential benefits which are worth exploring. For this reason, we recommend that the Legislature evaluate future e-government proposals by determining how these systems will assist in making government operate more efficiently and effectively in delivering services to the public.

We believe that the Legislature will be faced with a number of issues over the next several years concerning e-government systems. These issues will touch upon both the rights of citizens and the long-term cost of government operations.