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LAO
65 YEARS OF SERVICE

Highlights of the 2008-09 Analysis

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OUTLOOK ON ECONOMY AND REVENUES

- ***Economy.*** We expect both the U.S. and California economies to experience weak performance in the near term. For 2008 as a whole, we forecast economic growth and inflation will be modest, but with the first half of the year especially sluggish. Full-year growth will average well below its 2007 pace, which itself reflected a slowdown from 2006. Although the second half of 2008 should strengthen some, significant improvement will likely not come until 2009. The key factors holding down growth will be the depressed housing market and high energy prices. Our forecast is somewhat weaker than the administration's, principally due to more negative developments since its forecast was prepared. (P&I, "Part II.")

- ***Revenues.*** Based on our own economic forecast but assuming the Governor's revenue-related proposals, we forecast that General Fund revenues will be $1.5 billion below the administration's estimate for the current and budget years combined. Most of this shortfall—$1.4 billion—is due to our lower projected receipts from the state's three major taxes. This reflects our lower forecast for such key revenue-determining variables as taxable personal income, taxable sales, and taxable corporate profits. We also expect lower revenues than the administration from tribal gambling compacts, including the effects of recently approved ballot propositions. (P&I, "Part III.")

ASSESSMENT OF GOVERNOR'S BUDGET

- ***Larger Budget Shortfall.*** Over the current and budget years, the Governor identified a gap of $14.5 billion between revenues and expenditures. Due principally to our lower revenue estimates, we now project the state would face roughly a $16 billion shortfall, absent corrective actions.

- ***Structural Shortfalls Would Return.*** Even if the Legislature adopted the Governor's budget in whole, the state would face multibillion dollar shortfalls in future years. As shown in Figure 1 (next page), we project that the state would face about a $4 billion operating shortfall in 2009-10, shrinking to between $2 billion and $3 billion in the two following years.

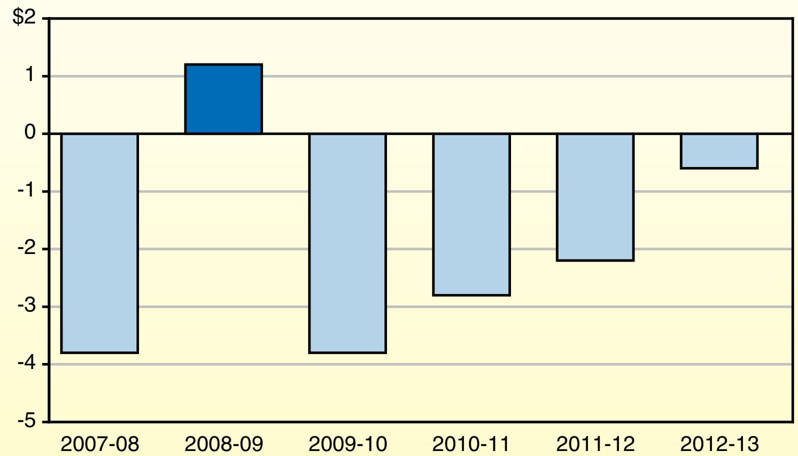
- ***Budget Fails to Set Priorities.*** The administration's across-the-board budget reductions reflect little effort to prioritize and determine which state programs provide essential services or are most critical to California's future.

- ***Revenue Solutions Are Minimal.*** By focusing almost exclusively on the spending side, the administration's plan unnecessarily limits the range of budget solution options.

Figure 1

Operating Shortfalls Return After 2008-09 Under Governor's Budget

General Fund (In Billions)



- ***Missed Opportunity on Proposition 98.*** The Governor's budget would leave the state about $1 billion above the minimum guarantee in 2007-08 and lock the state into a higher minimum guarantee in 2008-09 and beyond. This higher guarantee, in turn, increases pressure in 2008-09 to either suspend the guarantee or find significantly greater budget solutions in other areas.

LAO'S ALTERNATIVE BUDGET APPROACH

➢ More Balanced and Targeted Approach

- Facing a huge 2008-09 budget problem, the Governor's budget fails to put forward a plan that prioritizes state spending. We recommend the Legislature reject the administration's across-the-board approach. In the absence of a meaningful starting point for budget deliberations from the administration, we have developed an alternative budget approach. (See Figure 2 for the key elements of our approach.) In contrast to the Governor's budget, we put forth a strategic alternative that is both more balanced and targeted in addressing the state's budget shortfall. (P&I, "Part V.")

Revenue Solutions

- Using the same approach as we do for evaluating direct spending programs, we have examined the state's tax-related programs—what are referred to as tax expenditure programs (TEPs)—and recommended changes to those that are not achieving their stated purposes or are of a lower priority. These TEPs are special provisions in law—such as exemptions, deductions, and cred-

Figure 2

Key Elements of the LAO Alternative Budget

✓ **A Balanced Budget Through 2012-13**

- Provides reserve of $1.3 billion at the end of 2008-09, about $150 million more than our forecast of the Governor's budget reserve.
- Keeps budget balanced—though precariously—through our five-year forecast period. Small operating shortfalls in some years are covered by carry-in reserves.

✓ **Targeted Program Reductions**

- In contrast to an across-the-board approach, makes targeted program reductions. To the extent possible, maintains core services at their current spending levels.
- Eliminates or modifies ineffective or nonessential programs.
- Considers availability of other fund sources in order to maintain service levels.

✓ **Rethink Which Programs Are Operated or Funded by the State**

- Shifts programs to the local level when it makes programmatic sense.
- Reduces or eliminates program funding for programs that are primarily local government responsibilities.

✓ **A Better Proposition 98 Approach**

- Reduces current-year funding to the minimum guarantee to maximize budget-year flexibility but not impact school operations in 2007-08.
- Suspends the guarantee by $800 million, compared to a $4 billion suspension by the Governor. The suspension is only required because of added revenues as part of our overall solution.

✓ **Add Revenues in a Reasonable Manner**

- Selects tax credits or exemptions for reduction or elimination because they are not achieving their stated purposes or are of lower priority.
- Makes no broad-based tax rate increases.
- Does not include the administration's problematic $2 billion revenue accrual.

✓ **No Additional Borrowing or Debt**

- Does not add any new borrowing or debt to the state's credit card. However, we do restructure some repayments of existing debt.

its—that attempt to encourage certain behavior or that target relief to specific groups of people or taxpayers. We have identified 12 such programs for modification or elimination, which would generate $2.7 billion in 2008-09 revenue solutions. (P&I, "Part V," "LAO Revenue-Raising Proposals.")

Proposition 98

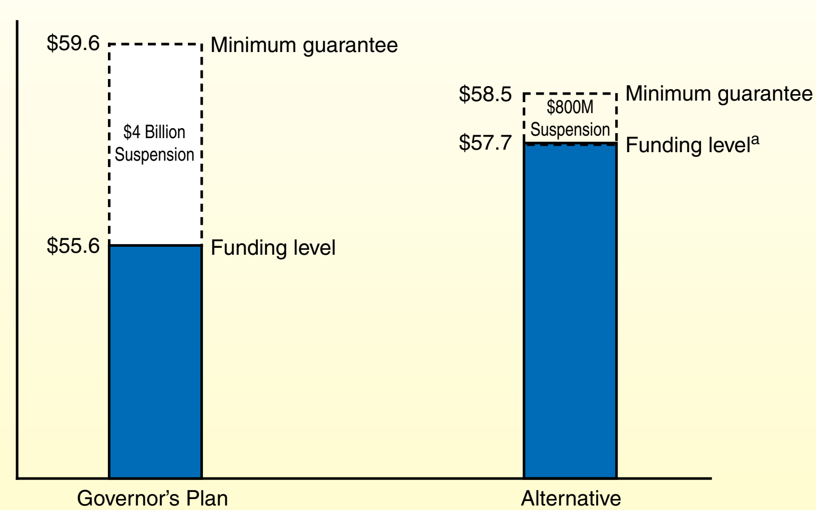
- ***Maintain Current Level of Programmatic Support.*** Our alternative Proposition 98 spending plan would provide K-12 schools and community colleges roughly the same amount of ongoing program support in 2008-09 as in the current year ($57.7 billion). (The Governor's budget, in contrast, provides $2.1 billion less—see Figure 3.) Our alternative covers all K-14 growth-related adjustments as well as the ongoing costs of mandated education activities. It would not provide a cost-of-living adjustment (COLA), and it would make targeted reductions (totaling almost $180 million) to programs that are poorly structured, duplicative, or routinely spending less than budgeted.

- ***Achieve Substantial Additional K-14 Savings.*** The alternative plan relies heavily on adjusting Proposition 98 spending down to the minimum guarantee in 2007-08, but without affecting current school operations. We also recommend suspending the Quality Education Investment Act (QEIA) in 2008-09 (for savings of $450 million). To ramp up QEIA while at the same

Figure 3

Comparing 2008-09 Proposition 98 Budget Plans

(In Billions)



[a]Provides roughly the same amount of ongoing program support as in 2007-08.

time not providing a COLA to base programs supporting QEIA schools would be counterproductive. (Analysis, page E-15.)

Higher Education

- ***Fund Enrollment Growth and Maintain All Cal Grant Programs.*** Our alternative to the Governor's higher education proposal avoids making unallocated reductions and adheres to the state Master Plan for Higher Education. It funds anticipated enrollment growth at all the public segments; modestly increases the share of education cost paid by students in the form of fees, while increasing grant aid to cover these fee increases for financially needy students; maintains all existing Cal Grant programs; and provides no funding for salary increases. (Analysis, page E-151.)

Health

- ***Focus on Maintaining Direct Medical Services.*** Our alternative adopts a number of the budget-balancing reductions proposed by the Governor which we believe are least likely to result in either the elimination or severe reduction of health services. For example, we adopt the cost-containment measures intended to control regional center expenditures, measures to achieve savings in the Healthy Families Program, and proposals to reinstate quarterly status reporting and eliminate continuous eligibility for children in the Medi-Cal Program. However, we did not adopt the Governor's Medi-Cal provider rate reductions with the exception of hospitals which have received rate increases over the last couple of years. (Analysis, page C-34.) Nor did we adopt the Governor's proposal to reduce Proposition 36 funding. (Analysis, page C-19.) Beyond this, we identified additional federal funds which could be shifted from public hospital payments to offset General Fund spending for various medical programs. In addition, we would implement a cap on nursing home rate increases. (Analysis, page C-39.)

Social Services

- ***Grant Levels and Program Changes.*** Most of the savings in the LAO alternative come from deleting the June 2008 and June 2009 state Supplemental Security Income/State Supplementary Program (SSI/SSP) COLAs (same as the Governor); reducing the grants for SSI/SSP couples down to 125 percent of the federal poverty level; delaying California Work Opportunity and Responsibility to Kids (CalWORKs) performance incentives and the restoration of the Temporary Assistance for Needy Families reserve; and canceling the Integrated Statewide Automated Welfare System migration computer project. In general, our proposed reductions do not reduce service, grants, or county administration for social services programs below the levels in place on July 1, 2007, unless there was a specific policy rationale for doing so.

Criminal Justice

- ***Local Assistance Programs Need Restructuring.*** The Governor's budget proposes 10 percent across-the-board reductions for criminal justice local assistance programs to achieve about $60 million in savings. We recommend instead that the Legislature achieve savings of about $270 million by eliminating or reducing General Fund support for programs that have not demonstrated results, do not serve a statewide purpose, could be consolidated, or could be funded from other sources. (Analysis, page D-15.)

- ***Prison and Parole Population Reduction Proposals Not Best Options.*** We recommend alternatives to the administration's early release and summary parole proposals which we believe offer a better trade off between public safety and budget savings by: (1) changing crimes currently classified as "wobblers" to misdemeanors and (2) substituting an "earned discharge" program for the Governor's summary parole proposal. (Analysis, page D-105.)

- ***Cost-Savings Options for the Judicial Branch.*** Rather than an unallocated reduction of $246 million, we recommend the Legislature adopt a savings target that is consistent with its own program and spending priorities. Savings options we identify include suspending the State Appropriations Limit adjustment, phasing in electronic court reporting, adjusting the budget for delays in the appointment of new judges, and increasing court revenues. (Analysis, page D-40.)

Parole Realignment

- ***Improve Public Safety and Address Budget Shortfall.*** We propose a nearly $500 million realignment of responsibility for supervision of lower-level criminal offenders from the state parole system to county probation. Funding for parole realignment would come from a reallocation of waste and water district property taxes, city Proposition 172 sales taxes, and vehicle license fees. Our alternative is designed to give counties a greater stake in the success of these offenders in the community, thereby reducing their likelihood of reoffending. (P&I, "Part V.")

Resources

- ***Alternative Fund Sources to Support Programs.*** The LAO alternative takes advantage of opportunities to shift funding from the General Fund to fees (either by increasing existing fees or creating new ones)—by applying the "beneficiary pays" or "polluter pays" funding principles. Our major General Fund savings proposals related to fees are in the following program areas:

— Wildland firefighting ($239 million in savings). (Analysis, page B-47.)

— Flood management ($40 million in savings). (Analysis, page B-81.)

— Water quality management and water rights regulation ($30 million in savings). (Analysis, page B-100.)

— Timber harvest plan review and enforcement ($23 million in savings). (Analysis, page B-36.)

— State parks ($13 million in savings, the amount of the Governor's reduction achieved largely by closing 48 state parks). (Analysis, page B-73.)

General Government

- ***No Pay Raise for Correctional Officers.*** The LAO alternative rejects the Governor's proposal to provide a 5 percent pay raise to correctional officers retroactive to July 1, 2007 (reducing costs by about $500 million in 2007-08 and 2008-09 combined). An LAO report released earlier this month, Correctional Officer Pay, Benefits, and Labor Relations, found that current compensation levels for correctional officers are sufficient to meet personnel needs at the present time. (Analysis, page F-130.)

- ***Improving Tax Gap Activities.*** Our alternative builds upon the Governor's proposals to increase tax collection and enforcement. We redirect resources away from Board of Equalization activities which have low revenue benefits per dollar spent and towards the Franchise Tax Board. In total, we spend slightly less than the administration—yet with the benefit of tens of millions of additional General Fund dollars. (Analysis, page F-55 and F-60.)

Key Differences Between the Governor's Budget and LAO Alternative

- ***Revenues.*** In addition to the tax expenditure differences noted above, our alternative does not include the $2 billion accrual of tax revenues from 2009-10 to 2008-09 because it is problematic. (P&I, "Part V.")

- ***Spending.*** In addition to the changes and alternatives noted above, our alternative does not adopt the major reforms proposed for CalWORKs (discussed further below), or the policy changes proposed for the California State Teachers' Retirement System. (Analysis, page F-72.)

OTHER FINDINGS AND RECOMMENDATIONS

Education

➢ Reform K-14 Funding System

- We recommend consolidating more than 50 K-14 categorical programs into a few large block grants. Categorical reform of this magnitude would offer districts multiple benefits—including a simplified, streamlined, more transparent funding system; greater ability to focus on student success rather than program compliance; and, perhaps most relevant in tight fiscal years, greater latitude to use available funds to address critical local needs. (Analysis, page E-61.)

Higher Education

➢ Legislative Oversight of Campus Growth and Mitigation Costs

- The California Supreme Court recently ruled that the state's colleges and universities are responsible for mitigating the off-campus impacts of capital projects on surrounding communities. We discuss how the Legislature can play an important role in planning for campus growth by (1) assessing the need for growth, (2) clarifying key provisions of current environmental laws, and (3) selecting the way it pays for mitigation costs. (Analysis, page E-164.)

Health

➢ Pay-for-Performance Improves Patient Outcomes and Reduces Medi-Cal Costs

- We estimate that the implementation of a Medi-Cal pay-for-performance program would improve patient care and eventually save the state tens of millions of dollars. We recommend the Department of Health Care Services take steps toward implementing a statewide pay-for-performance program for all Medi-Cal providers. (Analysis, page C-40.)

➢ Funding for Over 30 Public Health Programs Is Fragmented and Inflexible

- The state's current process for administration and funding of over 30 public health programs at the local level is fragmented, inflexible, and fails to hold local health jurisdictions (LHJs) accountable for achieving results. We make several recommendations to improve the coordination and integration of these programs so that LHJs can focus on meeting the overall goal of improving the public's health. (Analysis, page C-52.)

➢ Failure to Promulgate Regulations Leads to State Laws Not Being Enforced

- The Department of Public Health (DPH) is slow to promulgate regulations and consequently some state laws are not being enforced or applied consistently across the state. For example, regulations to establish sterilization, sanitation, and safety procedures for persons engaged in the business of tattooing, body piercing, or permanent cosmetics have been pending for about ten years. We recommend DPH report to the Legislature at hearings on the status of the development and promulgation of unissued regulations. (Analysis, page C-64.)

Social Services

➢ Alternative Approaches to Reducing Child Welfare Services (CWS) Costs

- The Governor proposes to reduce county allocations for CWS by $84 million. We estimate this will eliminate approximately 500 social workers statewide, substantially increasing their caseloads and affecting their ability to serve children. We provide alternatives with less budgetary savings that should largely avoid the negative impact on social worker caseloads. (Analysis, page C-118.)

➢ Rethinking the Future of Child Welfare Automation

- The budget proposes to continue with the development of a new CWS computer system at a total cost of $247 million. We recommend canceling the proposed new system and instead updating the existing Child Welfare Services Case Management System (CWS/CMS) to provide required functionality, resulting in savings of $184 million over the next seven years. (Analysis, page C-124.)

➢ Alternatives to the 10 Percent Foster Care Rate Reduction

- The Governor proposes to reduce almost all foster care rates by 10 percent, resulting in General Fund savings of $82 million. This could reduce the supply of foster family homes, meaning that more children would be placed in more costly agency homes and group homes. We present two alternatives with less budgetary savings and therefore probably no negative impact on the supply of foster family homes: (1) rescinding the January 2008 5 percent increase and (2) reducing specialized care increments in seven counties where the maximum increments are much higher than the state average. (Analysis, page C-129.)

Alternative Approach to Increasing Work Participation in CalWORKs

- Failure to comply with federal work participation requirements could result in penalties in the hundreds of millions of dollars. The Governor proposes a graduated full-family sanction and a five-year time limit for children whose parents cannot or will not meet federal work participation requirements. These policies would address anticipated work participation shortfalls and result in savings of $471 million. We present alternative approaches to increasing work participation that result in less budgetary savings and fewer children losing aid. (Analysis, pages C-105 and C-113.)

Tying State Participation in In-Home Supportive Services (IHSS) Wages to the Quality of the Workforce

- Current law grants counties broad discretion to set wage levels and the conditions under which potential providers may list themselves as available to be employed by recipients. To improve the IHSS labor force and the quality of services for recipients, we recommend enactment of legislation, prior to 2010-11, which ties state participation in wages to the level of training and tenure of IHSS providers. (Analysis, page C-146.)

Alternatives to the Governor's IHSS Hour Reduction

- We believe the Governor's proposal for an across-the-board 18 percent reduction for domestic service hours will not achieve the estimated savings of $110 million primarily because recipients will be able to appeal their reductions. We provide alternatives for statutory changes which set clearer standards for determining the hours of domestic service. These include weekly hour caps on certain services and making distinctions based on the recipient's living situation. (Analysis, page C-139.)

Criminal Justice

Implementing AB 900's Infill Bed Plan: Progress and Concerns

- Prison officials have made some progress, but encountered some obstacles, in implementing a $7.7 billion package of prison construction projects. We raise concerns about how the estimated construction cost per bed for new infill bed facilities has nearly tripled compared to the cost of a prison built a few years ago. We recommend that the infill bed plan be revised after obtaining an independent estimate of construction costs to avoid the possibility of overspending hundreds of millions of dollars for these projects. (Analysis, page D-138.)

Transportation

➢ Highway Rehabilitation and Maintenance Requires More Funds

- The state faces increasing costs to maintain and rehabilitate its highways as the system ages. However, the revenues which traditionally pay for these costs have grown at a much slower pace than vehicle travel, resulting in an estimated annual shortfall of over $3 billion for highway maintenance and rehabilitation. We recommend legislative actions to address this shortfall, including increasing and indexing the gasoline tax. (Analysis, page A-30.)

➢ Proposition 1B Projects at Risk of Being Delayed

- The timely delivery of projects funded with Proposition 1B bonds depends on several factors, such as the availability of funds anticipated from other sources, adoption of program eligibility and funding allocation guidelines, and the ability of the Department of Transportation to hire the necessary state staff. We recommend measures to ensure that bond-funded projects are not delayed, including determining an ongoing process for allocating transit funds and requiring the department to present a realistic staffing plan that includes the use of contracted resources to minimize project delays. (Analysis, pages A-48 through A-56.)

➢ Restructuring of Transit Funding Will Likely Delay Projects

- The State Transportation Improvement Program (STIP)—the state's primary program for funding transportation capital projects—is underfunded by about $1 billion from 2007-08 through 2009-10 as a result of current-year actions that changed how transit funds are allocated. While funding of STIP projects in the current year is kept on track by advancing the use of Proposition 1B bond funds, projects will likely be delayed beginning in 2008-09. (Analysis, page A-20.)

➢ Public Transportation Account (PTA) Requires Loan to Stay Solvent

- The budget proposes no PTA money for new transit projects in 2008-09. Additionally, it assumes that up to $300 million in funding commitments made to transit projects in past years will not be paid in 2008-09. Even so, PTA will have a shortfall in the budget year. The budget proposes a $60 million loan to PTA in order to keep the account solvent and end the budget year with a slim balance. (Analysis, page A-29.)

➢ Hike in Vehicle Registration Fee to Fix Motor Vehicle Account (MVA)

- In order to address a projected shortfall in the MVA, the Governor proposes to increase the vehicle registration fee by $11 per vehicle—bringing the total registration fee to $52 per vehicle, and to double the penalty for late registration. Absent such corrective actions, the level of MVA spending proposed by the budget would leave the account with a shortfall of over $160 million at the end of 2008-09, growing to $500 million in 2009-10, and nearly $1 billion at the end of 2010-11. If revenues and expenditures grow at historical rates, the fee hike proposal would keep MVA solvent through 2013-14. (Analysis, page A-36.)

Resources

Governor's AB 32 Funding Plan: Not Responsive to Legislative Direction

- The budget proposes $55 million, to continue implementation of the Global Warming Solutions Act of 2006 (commonly known as "AB 32") to reduce the state's greenhouse gas emissions. More than one-half of the funding comes from a loan from the California Beverage Container Recycling Fund—a special fund unrelated to the AB 32 program. This funding proposal is contrary to legislative direction that the administration produce a sustainable, long-term funding plan for AB 32 implementation in the budget year. We recommend that the Legislature not take action on budget items relying on this borrowing, pending the administration's adoption of a plan that provides a stable, dedicated funding source for this program as directed by the Legislature. (Analysis, page B-29.)

State's Hydrogen-Powered Vehicle Program: Little Progress, but Still Plenty of Fuel to Go Forward

- The budget proposes an additional $6 million—on top of over $19 million provided in previous years—for the Governor's Hydrogen Highway initiative to establish and deploy hydrogen-powered vehicles and hydrogen fueling stations. To date, the Air Resources Board has made relatively little progress either in getting hydrogen-powered vehicles on the road or in establishing hydrogen fueling stations, resulting in substantial funds remaining available from prior funding allocations to pay for continued program activity in the budget year. Therefore, the additional requested funding is not warranted at this time, and the funding request should be denied. (Analysis, page B-91.)

CALFED Budget Needs Better Focus, Better Funding Plan, Better Targeted Science

- We recommend denial of a number of budget proposals for the CALFED Bay-Delta Program on the basis that they either lack clear objectives and funding priorities, do not apply the beneficiary pays funding principle, or, as proposed science expenditures, do not meet the information needs of policy makers. (Analysis, page B-17.)

➢ Recommend Hearings on the "State" of the State's Water Supply

- We recommend that the Legislature hold joint budget and policy hearings to evaluate the state of the state's water supply and future challenges in addressing the state's water supply requirements. This is particularly important in light of the Governor's proposed $11.9 billion water bond and recent events that fundamentally affect this issue, including court decisions affecting the Delta, multistate agreements regarding the use of Colorado River water, and the release of various Delta-related planning documents. (Analysis, page B-87.)

➢ Flood Management Activities Should Be Funded by Beneficiaries

- We recommend the enactment of legislation to establish a broad-based fee to cover the Department of Water Resources flood management expenditures that provide a direct benefit to property owners in flood zones statewide and those protected by the Central Valley flood control system. The fee should be structured in a way to provide incentives for local governments who give greater consideration to potential costs and benefits of approving development in flood zones. Implementation of this recommendation would result in General Fund savings of about $40 million. (Analysis, page B-81.)

➢ Water Quality Programs Should Be Funded by Polluters

- While much of the State Water Resources Control Board's funding comes from fees, the budget still proposes substantial funding—about $39 million—from the General Fund. We recommend that much of these costs be funded through fees, on the basis of applying the polluter pays funding principle. (Analysis, page B-100.)

➢ Landowners in Wildland Areas Should Pay for Their Fire Protection, Rather Than Insurance Policyholders Statewide

- The Governor proposes to create a surcharge on commercial and residential insurance policies statewide to partially pay for fire protection in state responsibility areas (SRAs). The Governor's proposal would raise about $100 million in the budget year to partially fund existing services and to pay for program expansions (including increasing the level of staffing on each fire engine).

- Because landowners in SRAs receive a direct benefit from the state's fire protection services, we think that they should share in the state's costs of providing these services. We therefore recommend that the Legislature create a fire protection fee to be assessed largely on residential property owners in SRAs, raising about $265 million per year. We also recommend the Legislature reject most of the Governor's proposal for increased wildland fire expenditures as they have not been shown to be cost-effective. (Analysis, page B-47.)

State Timber Harvest Plan Review and Enforcement Costs Should Be Paid By Timber Operators

- Under state law, various state agencies are required to review and enforce plans under which timber is commercially harvested. Currently, these review programs are mostly supported by the General Fund. We recommend that timber harvesters pay the full cost of this regulatory program, since approval of timber harvest plans allows revenue-generating timber production to begin. (Analysis, page B-36.)

Increased State Park User Fees Can Prevent Park Closures and Address Maintenance Shortfall

- The Governor proposes to save $13 million by closing 48 state parks and reducing lifeguard staffing at many state beaches. In addition, the state park system has an ongoing maintenance shortfall of about $120 million per year and a deferred maintenance project backlog of $1.2 billion.

- We find that park entrance fees are low and have not kept up with inflation over the last decade. We also find that paid attendance at state parks does not seem to vary significantly with changes in park fee levels. We recommend the department raise fees in line with inflation over the last decade, which would generate about $25 million in additional revenues in the budget year. These additional revenues can be used to prevent park closures and begin to address the state park system's unmet maintenance requirements. (Analysis, page B-73.)

General Government

Increase Legislative Oversight and Reduce Debt Financing of FI$Cal

- The Governor proposes to issue $1.2 billion in bonds over the next ten years to fund implementation of a $1.6 billion computer system to modernize the state's accounting and budgeting, known as Financial Information System for California (FI$Cal). We recommend an alternative approach which limits the initial scope of the project, ensures legislative review before proceeding with statewide implementation, results in lower initial expenditures, and reduces the project's reliance on borrowing. (Analysis, page F-91.)