CALIFORNIA BUDGET PROJECT

BUDGET WATCH

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GOVERNOR DAVIS SIGNS 2001-02 BUDGET

Governor Gray Davis signed the 2001-02 Budget (SB 739, Peace) into law on July 26, nearly four weeks into the new fiscal year. The budget provides the blueprint for $78.8 billion in General Fund ($103.3 billion in total fund) spending for the 2001-02 fiscal year. The 2001-02 Budget spends $1.3 billion (1.7 percent) less than in 2000-01 (unless otherwise noted, all figures refer to the state's General Fund). The drop in spending reflects declining revenues due to the recent economic slowdown and, in particular, reductions in taxes paid on stock options and capital gains. Available resources, consisting of both revenues and reserves, dropped $5.0 billion between 2000-01 and 2001-02, a 5.7 percent reduction. The new budget includes a $2.6 billion reserve, equal to 3.3 percent of expenditures.

Storm Clouds on the Horizon

The 2001-02 Budget reflects a significant deterioration in the state's fiscal condition between January, when the Governor released his proposed spending plan, and May, when the revised revenue projections used in the budget were released. Revenues for 2000-01 increased by $1.1 billion between January and the end of the fiscal year, while 2001-02 revenues fell by $4.3 billion.

The 2001-02 Budget spends $3.7 billion more than it takes in in revenues and transfers, with the balance made up by a $7.1 billion balance carried forward from 2000-01. The sizeable operating deficit in this year's budget, coupled with continued weakness in the economy, is likely to create problems in next year's budget. In early June, the Legislative Analyst estimated that 2002-03 expenditures could exceed available resources by over $4 billion, even if revenues post significant growth. Current trends suggest revenue growth could be weak. June revenue collections from the state's three major taxes – personal income, corporate income, and sales tax – were below the May forecast, and at the end of June, 2000-01 revenues were $389 million below the projection issued just a month earlier. The substantial drop in projected revenue collection reflects:

- An assumption that tax revenues attributable to capital gains and stock options will fall from 23.1 percent of all General Fund revenues in 2000-01 to 16.8 percent in 2001-02;
- Weakness in sales tax collections due to lower consumer spending;
- Lower bank and corporate income tax collections due to weaker profits and increased use of tax incentives; and
- A drop in personal income tax withholding.

The California Economy: A Significant Slowdown

While the California economy continues to outperform the nation with respect to job growth, the rate of increase slowed substantially during the first half of 2001, from an average of 49,000 jobs per month in 2000 to an average of 12,500 jobs per month during the first five months of 2001. Moreover, the unemployment rate rose to 5.1 percent in June, up from 4.9 percent in the prior month. Bay Area unemployment rates, while generally still lower than the state as a whole, have risen significantly in recent months. The Santa Clara rate, for example, rose from 1.7 percent in January to 4.2 percent in June.

Be Careful About What You Ask For…

Each house of the Legislature passed a budget before the beginning of the fiscal year by a substantial majority, but less than the required two-thirds, on a party line vote. The Republican holdouts argued for a tax cut specifically, the elimination of the ¼ cent triggered sales tax rate, (see CBP's *Is the Sales Tax Trigger a Tax Increase* at www.cbp.org); additional spending; and a larger reserve.

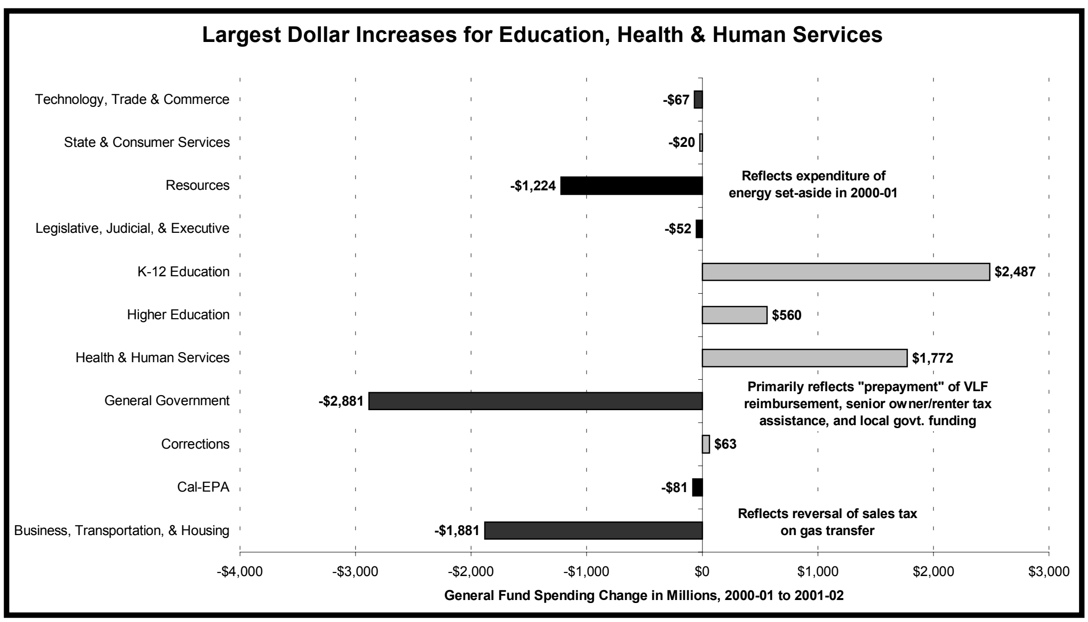
In order to achieve the required two-thirds vote, the Legislature increased spending for education, public safety, and agriculture; enacted new sales tax exemptions for farm and timber harvesting equipment, liquid petroleum gas, diesel fuel used in agriculture and related transportation, and for racehorse breeding stock; and expanded the Senior Citizens Property Tax and Renters' Assistance program. The last minute changes reduced the size of the reserve in the package sent to the Governor, however the Governor used his line item veto authority to reduce spending by $573 million. Spending changes made to the budget after it left the budget conference committee increased spending by approximately $80 million, while the new tax reductions totaled $126 million. The budget package also included modifications to the sales tax trigger and a constitutional amendment (ACA 4) dedicating sales tax collections on gasoline to transportation.

The change in the sales tax trigger reduces the state's sales tax rate if the reserve, exclusive of revenues from the ¼ cent rate, reaches 3 percent of projected revenues and if revenues for the period May 1 through September 30 equal or exceed the May budget forecast. The prior calculation required a 4 percent reserve in two successive years. The new trigger will make it difficult, if not impossible, for the state to build the 3 to 5 percent reserve state finance experts consider prudent.

The 2000-01 budget agreement transferred sales taxes paid on gasoline to a special fund for transportation. The 2001-02 Budget reversed this transfer to help close the gap created by declining revenues. The proposed constitutional amendment (ACA 4) would permanently shift approximately $1.2 billion per year to transportation if approved by the voters in 2002, beginning in 2003-04. ACA 4 would allocate 20 percent of the proceeds to public transit, 40 percent for highways and related projects, and 40 percent for local street and highway maintenance beginning in 2008-09. In the meantime, the funds would be allocated pursuant to the transportation plan adopted by the Legislature as part of the 2000-01 budget agreement.

Winners and Losers

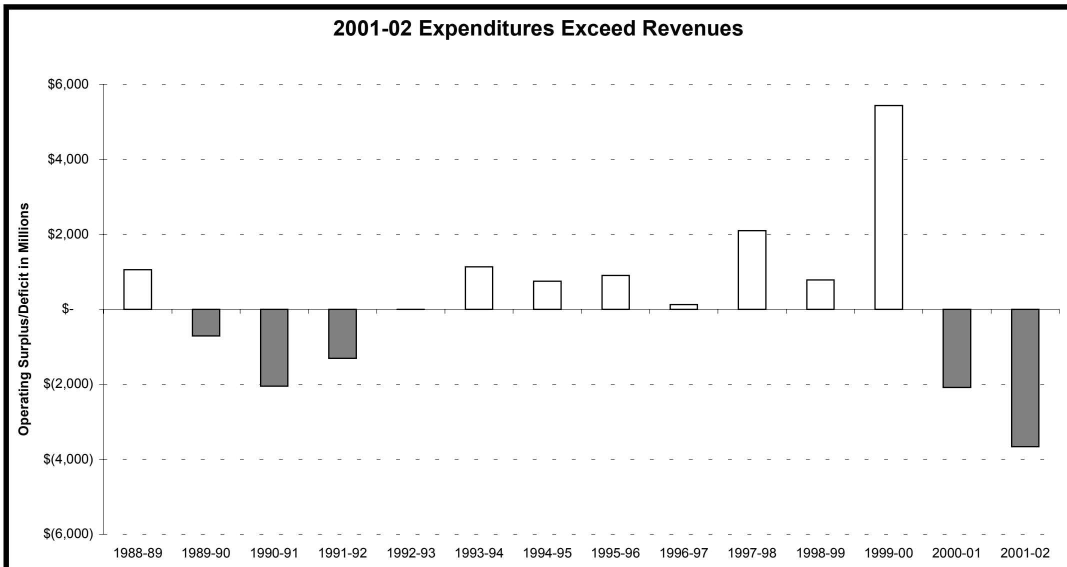
Spending for Health & Human Services (HHS) and K-12 Education received the largest increases between 2000-01 and 2001-02, $1.8 billion (8.8 percent) and $2.5 billion (8.3 percent) respectively. Spending on Higher Education and Corrections rose by $560 million (6.0 percent) and $63 million (1.2 percent) respectively.



The biggest loser in terms of absolute dollar reduction from 2000-01 to 2001-02 was General Government, which dropped by $2.9 billion (44.3 percent). The reduction is primarily due to last year's "prepayment" of a portion of the 2001-02 Vehicle License Fee reimbursement to local governments and cuts in both property tax assistance to seniors and local government assistance. Business, Transportation, and Housing spending fell by $1.9 billion (73 percent), due mainly to the deferred transfer of the sales tax on gasoline for transportation programs for two years and lower housing spending. The biggest "loser" in terms of percentage change was the Resources Agency, which dropped 49 percent ($1.2 billion) below 2000-01 levels, primarily attributable to one-time energy expenditures in 2000-01.

In January, the CBP released a report, *Winners and Losers: Where Has the Money Gone?*, comparing how different areas of the budget have fared under Governor Davis as compared to former Governor Wilson's final budget. The report found that while K-12 Education and HHS enjoyed the biggest dollar increases from 1998-99 to 2000-01, both actually decreased as a share of the General Fund spending. Extending this analysis to the newly signed budget, K-12 Education still represents a smaller percentage of General Fund expenditures in 2001-02 than it did in 1998-99; however, HHS' share of spending increased slightly. The share of spending accounted for by Higher Education and Corrections is down relative to 1998-99, while General Government's share (primarily attributable to tax reductions that are scored as expenditures) is larger.

Significant budget and policy changes in the 2001-02 budget include:



An operating deficit or surplus is the amount by which revenues collected in a budget year are less than or exceed expenditures in the same year excluding any carryover balances.

Social Services

CalWORKs. The budget exhausts nearly all available federal and state CalWORKs funds by the end of 2001-02, leaving a reserve of $30.1 million. In order to finance the core components of CalWORKs, the budget agreement retroactively eliminates county performance incentive funds for 2000-01. Counties may need to dip into their performance incentive fund reserves to fully fund employment services. Counties have amassed approximately $1 billion in unspent performance incentive funds that they were awarded for moving recipients off aid and into work in prior years.

Legislation accompanying the budget, AB 429, requires the Department of Social Services to develop a new budget methodology for the CalWORKs program, as well as a new methodology for allocating CalWORKs mental health and substance abuse funds to counties. AB 429 also implements recent federal regulations that exempt certain low-value vehicles in the determination of eligibility for food stamps and CalWORKs. However, the budget does not sufficiently reform the vehicle asset rule to allow parents who work to own a reliable car. This issue (AB 144, Cedillo) will likely be taken up by the Legislature when it returns from recess in August.

Food Stamps. The Governor deleted a no-cost provision requiring the Department of Social Services to explore possibilities of implementing a federal option to provide a transitional food stamp benefit for families leaving cash assistance. AB 429 also requires an audit of the Statewide Fingerprint Imaging System for food stamps and CalWORKs to determine if the fraud deterrence system is effective or discourages immigrants and other eligible applicants from applying for benefits.

Immigrant Assistance. The budget eliminates the sunset date for the Cash Assistance Program for Immigrants (CAPI) and the California Food Assistance Program (CFAP) for immigrants who arrived in the US after August 22, 1996. The budget extends from five to ten years the period during which an immigrant's sponsor's income and resources are "deemed" or counted as available to CAPI participants.

IHSS Worker Wages. Last year's budget agreement included a five-year plan to increase the wages of and purchase health coverage for In-Home Supportive Service (IHSS) workers in counties with public authorities. The additional state funding was tied to specified increases in General Fund revenues, a condition which was not fulfilled due to the drop in state revenues. This year's budget agreement waived the requirement that General Fund revenues must increase. As a result of this change, the state will pay a share of costs for wages up to $9.10 per hour at a General Fund cost of $31.4 million. The budget agreement also boosts the state's share of costs for wage increases for independent providers of IHSS services that are not employees of public authorities.

Foster Care. The budget includes $6.5 million for a new program, the Supportive Transitional Emancipation Program (STEP), to provide cash support for emancipated foster youth under 21 years of age. The Transitional Housing for Foster Youth Fund ($10 million) will assist with transitional housing costs for emancipated youth.

Bilingual Services. The Governor deleted $1.1 million in funding for four departments to comply with the Dymally-Alatorre Bilingual Services Act, which requires state agencies to provide bilingual services. The Governor directs all "departments to comply with the Act within existing budgeted resources."

Health Care

The 2001-02 spending plan allocates a total of $13.6 billion for health programs, a 9.8 percent increase over 2000-01 spending levels. The budget provides for a "single point of entry" in the Medi-Cal and the Healthy Families Program (HFP) in order to accelerate the enrollment of children.

Healthy Families Program. The budget assumes that HFP enrollment will increase by 250,000 by June 30, 2002, primarily as a result of expanding eligibility to parents of currently eligible children. The budget expands the HFP to include parents with incomes between 200 and 250 percent of the Federal Poverty Level (FPL) contingent upon federal financial participation. The Health Care Financing Authority (HCFA) has yet to approve the state's earlier waiver request, which extended eligibility to parents in families with incomes of up to 200 percent of the FPL. The 2001-02 Budget also:

- Allows licensed dental and vision plans to provide application assistance on behalf of children enrolling in the HFP and Medi-Cal.
- Allows HFP applicants to sign a statement verifying their income if documentation cannot be provided.
- Grants two months of health care coverage through a "bridge" program to give Medi-Cal and HFP recipients who no longer qualify for their respective program time to apply for the other program.

Medi-Cal. The final budget assumes that Medi-Cal enrollment will increase by 800,000 reflecting the combined impact of expanded eligibility and steps taken to simplify the application and enrollment process. The final budget provides for annual eligibility reviews for adults in the Medi-Cal program, thereby standardizing eligibility reviews for adults and children. The budget also implements a program for accelerated Medi-Cal eligibility for children who are entering the foster care system, and requires the state to direct counties to remove any indication of health coverage other than Medi-Cal from a foster child's eligibility information in order to expedite foster children's access to Medi-Cal. The budget assumes that the state Children and Families First Commission (the Prop 10 Commission) will allocate $5 million for Medi-Cal outreach for children. To date, the Commission has rejected the assumed transfer. The budget agreement and related legislation also:

- Include a lump sum payment of approximately $191 million to settle outstanding litigation over reimbursement rates for Medi-Cal outpatient services provided by hospitals in *Orthopaedic Hospital v. Belshe*, and approximately $80 million to boost reimbursement rates for these services by 30 percent in 2001-02.
- Include $9.5 million ($5.3 million in state funds and $4.2 million in federal funds) to support the initial phase of a federal option to provide breast and cervical cancer treatment to women in families with incomes of up to 200 percent of FPL. The new program covers women who were not previously eligible for Medi-Cal. The expansion will cover breast cancer treatment for a maximum of 18 months and cervical cancer treatment for a maximum of 24 months.
- Redirect a portion of the state's share of Tobacco Settlement funds to a new Tobacco Settlement Fund for health care. The budget allocates $401.9 million to the fund, with the remainder ($73.1 million) of the 2001-02 settlement payment going to the General Fund.
- Allocate $25 million to a new Trauma Care Fund to support local Emergency Medical Services (EMS) agencies and their designated trauma centers.
- Provide $7 million in state funds for reimbursement rate increases for long-term care facilities that provide employee wage increases.
- Increase funding for community clinics under the Expanded Access to Primary Care (EAPC) program by $10 million.

Child Care

The budget "fully funds" CalWORKs Stage One and Stage Two child care. Stage One is provided to families upon their enrollment in CalWORKs, while Stage Two child care is available for families once they are deemed "stable" and for two years after they no longer receive cash aid. The budget assumes that the California Children and Families First Commission allocates $25 million to cover a portion of the cost of CalWORKs Stage One child care. However, the Commission voted against transferring the funds in June, leaving a gap in funds allocated for Stage One. The budget includes a $153 million child care reserve for Stage One and Stage Two.

The CalWORKs Stage Three child care program provides services to families who have exhausted their two-year post-CalWORKs child care benefit. As passed by the Legislature, the budget fully funded Stage Three child care; the Governor, however, vetoed a total of $44 million. The Governor stated that $20 million of the total reduction is based on a revised estimate of the need for Stage Three child care, and committed to restoring the balance of the funds ($24 million) once pending legislation is passed. Finally, the budget added $29.7 million to expand the After School Learning and Safe Neighborhoods Partnerships program, including $14.9 million to establish before school programs.

K-12 Education

The 2001-02 Budget provides $28.8 billion for K-12 Proposition 98 education programs, a $1.5 billion increase over 2000-01 levels. The additional spending brings per pupil spending to $7,009, $331 (5 percent) more than 2000-01. Significant features of the K-12 education spending plan include a new program targeting low-performing schools. The budget:

- Allocates $200 million to establish a High Priority Students Block Grant program for schools scoring in the bottom five deciles on the Academic Performance Index (API), with an emphasis on schools in the lowest two deciles. The details of the new program will be spelled out in legislation to be enacted later this year.
- Includes $161 million for the Immediate Intervention/Underperforming Schools program to fund new planning grants and increase the per pupil implementation grant level from $168 to $200.
- Redirects $1.2 billion in combined desegregation and economic impact aid funds to the Targeted Instructional Improvement Grant to fund existing court-ordered desegregation and provide grants to districts to improve instruction for their lowest performing students.
- The final budget agreement did not include the Governor's proposal for a longer middle school year.

A measure allocating $40 million to equalize schools districts' discretionary spending was added to the budget package during the final stages of negotiations. The budget also includes $250 million in one-time funding to offset schools' rising energy costs and $125 million to cover the first of ten payments made as part of the settlement of a lawsuit over special education costs.

Other areas of interest include:

- ***Housing.*** The Governor's line item veto slightly reduced last year's baseline funding for core housing programs. Reductions include Multifamily Housing ($31 million to $23.1 million), Farmworker Housing ($18.5 million to 13.9 million), Supportive Housing ($25 million to $20.1 million), and Emergency Housing ($14 million to $13.3 million). The budget also reduced the Downtown Rebound Program by $1.4 million and the Down Payment Assistance Program under CHFA by $18 million. The School Facilities Fee Assistance Program under CHFA was eliminated, with a $13 million allocation provided for program needs through the end of the calendar year. Funding for the Jobs-Housing Incentive Program was reduced to $50 million in the 2000-01 Budget, and zero in 2001-02.
- ***Local Government.*** The past two budgets included discretionary assistance for local governments. This year's budget did not include similar discretionary aid. The budget did boost assistance for several programs providing assistance to local law enforcement, including $35.4 million for technology grants.
- ***State employee salaries and benefits.*** The budget does not provide funding for state employee salary or benefit increases, despite the fact that most state employees are in the process of negotiating new collective bargaining agreements. The budget does include a $455 million ($195 million General Fund) increase in state contributions toward state employees' retirement due to increased retirement benefits effective January 1, 2000, and an additional $55 million to cover the rising cost of state employee health insurance benefits.

House Agriculture Committee Fast Tracks Food Stamp Reauthorization

On July 27 the US House Agriculture Committee passed the Farm Bill, which would reauthorize the Food Stamp Program for ten years (2002-2011). The bill includes $3.25 billion in food stamp improvements such as benefit increases for certain needy households and provisions that are likely to make the program more accessible for the working poor. This legislation also provides an additional $40 million per year for The Emergency Food Assistance Program (TEFAP). Changes the bill would make in the Food Stamp Program include:

1. Increasing benefits to larger families. By increasing the "standard deduction" for households of four or more persons, this bill would increase benefits for these households. According to the Center on Budget and Policy Priorities, more than half of the increased benefits from this change would go to working families, and almost two-thirds of the benefits would go to families with incomes below 75 percent of the poverty line.

2. Extending transitional food stamp eligibility to six months. US Department of Agriculture (USDA) rules currently allow states to continue food stamps for three months after a family leaves TANF cash assistance without any further paperwork from the family. The bill would also simplify the transitional food stamp rules and make it easier for states to administer transitional benefits. California has not implemented the current transitional benefit option, and the Governor deleted a provision in the 2001-02 Budget that required the California Department of Social Services to report to the Legislature on options for implementing transitional benefits to welfare leavers.

3. Creating incentive payments for states to improve customer service. The bill would require the USDA to measure state performance in administering the Food Stamp Program in two areas: the timely processing of food stamp applications, and the extent to which states improperly deny food stamps or terminate benefits to households that meet the eligibility requirements for the program. Each year, $1 million would go to the five states with the best performance and to the five states with most improved performance.

4. Reforming the food stamp quality control system. The bill would reform the quality control (QC) system so that only states with serious, persistent administrative problems would be sanctioned. The current QC system focuses on minimizing payment error rates and has led states to adopt policies that appear to have significantly reduced food stamp participation, especially among the working poor. Under current QC rules, about half of the states are subject to fiscal penalties each year. California received a penalty of $11.9 million for its error rate in 2000.

5. Simplifying the Food Stamp Program's definition of income. The bill would give states the option to eliminate consideration of obscure forms of income in the Food Stamp Program if they do not count them in their state TANF or Medicaid programs. This should allow states to conform food stamp rules to rules in other programs and help them limit the questions on their application forms to items that significantly affect families' ability to purchase food.

6. Offering grants to develop simplified application forms and eligibility determination systems. The bill would provide $10 million per year to help states develop simplified application forms or eligibility determination procedures (such as centralized change reporting centers).

The House bill does not restore federal eligibility to legal immigrants. California has a state-only food stamp program for immigrants, at an annual state cost of over $60 million. Many other immigrant families, including families with citizen children, no longer receive food stamps due to confusion over eligibility.

It is unclear when the bill will move to the floor of the House. The Senate Agriculture Committee will likely pass its own version of the Farm Bill in the fall.

Legislative Spotlight: SB 910 - Housing Element Compliance

One of the more controversial bills introduced in the State Legislature this year is SB 910 (Dunn), which would penalize cities and counties that lack a state-approved housing element. The battle over SB 910 pits concerns over local governments' autonomy against the state's ability to use financial sanctions to penalize jurisdictions that don't comply with state law and policy goals.

State law requires every city and county in California to adopt a "general plan" for its long-term development. The general plan must include seven elements: land use, transportation, housing, conservation, open space, noise, and safety. The plan's housing element addresses the existing and projected housing needs of people from all income levels in the community. Housing elements must also account for the jurisdiction's share of regional housing needs, including a jurisdiction's "fair share" of affordable housing, as determined by the local council of governments (COG). Local governments must update and submit their housing elements to the state Department of Housing and Community Development (HCD) every five years to ensure that the element complies with state law.

The Legislature eliminated funding for COG regional assessments and waived the deadlines for both assessments and housing elements during the early 1990s. In the 1998-99 Budget, the Legislature finally funded COGs again and re-established the deadlines. Based on the argument that COGs needed time to catch up, however, the Legislature passed bills in 1998, 1999, and 2000 to extend the deadlines for housing element submission.

Despite these extensions, only 49 percent of cities and 78 percent of counties, had housing elements that were in compliance with state law as of May 2001. This poor submission rate may be attributable to the lack of penalties for non-compliance. If the HCD finds that a draft housing element is not in substantial compliance, the city or county

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has the choice of simply explaining why they believe the element is valid. Moreover, despite the fact that many local governments lack valid housing elements due to local resistance to affordable housing, the most common penalty is, ironically, withholding government funds for affordable housing; advocates argue that this is a somewhat empty and counterproductive threat.

In an attempt to increase compliance, SB 910 hits non-compliant jurisdictions where it hurts - in the pocketbook. The bill requires the State Controller to temporarily withhold the monthly gas tax allocations to any jurisdiction whose third or subsequent revision of its housing element is not in compliance with state law. SB 910 also makes it easier to successfully sue local governments over housing elements that were deemed invalid by the HCD.

SB 910 has been the subject of heated debate between local governments and affordable housing advocates. Proponents argue that the state fails to penalize jurisdictions that do not comply with state law. Local governments, however, argue that they are not to blame for the state's shortage of affordable housing and that SB 910 will allow the HCD to "over-zealously" enforce the housing element law.

SB 910 is pending before the Assembly Local Government and Housing Committees. The committees are currently working with the author and major stakeholders to reach a compromise. Negotiations may continue through the fall recess if the group is unable to draft compromise language before the Legislature adjourns in mid-September.

The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low and middle income Californians. General operating support for the California Budget Project is provided by foundation grants and individual donations and subscriptions.

The California Budget Project can be reached at 921 11th Street, Suite 502, Sacramento, CA 95814-2820, by phone at (916) 444-0500, by fax at (916) 444-0172, or by email at cbp@cbp.org. Budget Watch is published quarterly. Subscriptions are $25/year. Visit CBP's web site at www.cbp.org.