CALIFORNIA BUDGET PROJECT

BUDGET WATCH

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STATE FACES $12.5 BILLION BUDGET GAP

Governor Gray Davis released his proposed 2002-03 Budget on January 10. The Budget outlines a plan to close a $12.5 billion budget gap caused by a sharp drop in state revenues. The Budget uses spending reductions; cost shifts from the General Fund to other funds; assumptions of increased federal support for state programs; and loans, revenue accelerations, and transfers to bridge the gap between anticipated revenues and expenditures. The Legislative Analyst's Office (LAO) review of the budget, released as this newsletter goes to press, estimates that the gap could be substantially larger (see below).

The Budget increases General Fund spending by $43 million (0.1 percent) over the 2001-02 spending plan signed into law by the Governor in July 2001. Although significant reductions are proposed in Health and Human Services, K-12 Education, and Higher Education programs, these cuts are roughly proportional to these programs' share of General Fund expenditures. The Budget includes a reserve of $511 million (0.6 percent of proposed expenditures).

The proposed Budget outlines $2.677 billion in 2002-03 reductions in addition to the $2.4 billion in cuts announced last November. In late January, the Legislature approved a slightly modified package that reduces current year spending by $2.2 billion and 2002-03 spending by $589 million. Other gap bridging proposals include:

- ***Assuming The Feds Will Pick Up The Bill.*** The Budget assumes the state will receive an additional $1.066 billion in federal funds, including $400 million in Medi-Cal funds; $181 million in relief for penalties the state is estimated to owe for failure to have a statewide automated child support collection system; $350 million in reimbursements for past and anticipated security costs related to the September 11 terrorist attacks; and $35 million in savings due to a reinstatement of federal food stamp eligibility for legal immigrants.
- ***Loans And Deferrals.*** The largest share of the budget balancing solutions comes from loans, revenue accelerations, and transfers from Special Funds to the General Fund including: $2.4 billion from securitizing a portion of the payments the state receives from the tobacco settlement; a $672 million loan from the Traffic Congestion Relief Fund (TCRF); $879 million in deferred employer contributions to the Public Employees Retirement System (PERS) and State Teachers Retirement System (STRS); $97 million from transferring cash balances in unrestricted Special Funds to the state's General Fund; and $579 million in loans from restricted Special Funds to the state's General Fund.

The Roots Of The Problem

The budget gap results from a shortfall in revenues in the current budget year relative to the amount needed to fund the current level of state services. Most of the revenue shortfall is attributable to an $8.2 billion drop in taxes paid on capital gains and stock options between 2000-01 and 2001-02. In 2000-01, tax paid on stock options and capital gains accounted for nearly a quarter of state General Fund revenues. The downturn in high technology industries and the dot.com bust severely depressed tax revenues generated by these two sources of income.

The downturn in the state's economy and revenue situation began long before the September 11 terrorist attacks. California's downturn is largely linked to the cutbacks in technology-related industries. These reductions, in turn, have caused unemployment rates to rise significantly in the Bay Area. For example, Santa Clara County's unemployment rate rose from 1.3 percent in December 2000 to 6.1 percent in December 2001. However, the California economy continues to outperform that of the nation. Nonfarm employment rose by 1.8 percent in California in 2001, while it increased by just 0.3 percent in the US as a whole.

The budget gap is ***not*** the result of the energy crisis or the state's $6.2 billion loan to finance the purchase of electricity on behalf of customers of investor-owned utilities. The Budget assumes that this loan will be repaid along with $300 million in interest during the current year. The Administration and the Public Utilities Commission recently agreed on a compromise rate agreement that should allow the state to issue bonds to repay the state's General Fund. Electricity ratepayers will repay these bonds.

The Problem Has A Long- And A Short-Term Dimension

The state's budget crisis has both a short-term dimension linked to the recession and a long-term dimension resulting from an imbalance between revenues and expenditures. In November, the LAO released a long-term forecast of state revenues and expenditures that showed expenditures exceeding revenues through 2006-07. In January, the LAO noted that "even though the year-end 2002-03 budget would be balanced under the Governor's assumptions, we estimate that an operating deficit of nearly $4 billion would emerge in 2003-04." In fact, that 2003-04 gap is likely to be much larger due to the risks described below. Factors contributing to the long-term imbalance include:

- The recovery is likely to be modest. While economists expect the recession to end during mid-2002, few expect the state or the country to return to the levels of growth seen in the late 1990s.
- The prospects for recovery in investment-related income are even weaker. The Congressional Budget Office (CBO), for example, recently downwardly revised its estimates of capital gains. Capital gains realizations increased by an average of 27 percent per year between 1995 and 2000. The CBO estimates that capital gains will drop by an average of 4 percent between 2001 and 2006, dropping by 19 percent and 5 percent in 2001 and 2002, respectively, and growing by 2 percent per year between 2003-2006.
- When the economy does recover, revenue growth will occur off a lower base. Even though revenue growth is expected to surpass spending growth in the next several years, the difference will not be enough to bridge the current gap.

Risks To The Budget

There are a number of reasons to believe that the budget gap may be wider when the Governor releases his May Revision containing the final revenue and caseload estimates used as the basis of the budget. Additional risk factors include:

- ***The Budget's Revenue Forecast Appears Overly Optimistic.*** As of the end of January, revenue collections were $743 million below the forecast used as the basis of the Governor's Budget. The LAO's forecast, released as this newsletter goes to press, estimates that combined 2001-02 and 2002-03 General Fund revenues will be $3.9 billion below the Governor's forecast and expenditures over the two year period will be $1.1 billion higher. Most of the difference in expenditures stems from the LAO's projection that the Proposition 98 guarantee will be $825 million above the level assumed by the Governor in 2002-03.
- ***California Is Unlikely To Receive Full Federal Funding.*** California is unlikely to receive the $1.1 billion in additional federal aid assumed in the Governor's Budget. While recent announcements suggest that California will receive some aid for bioterrorism-related expenses and a partial federal restoration of food stamp eligibility for legal immigrants, the President's budget eliminated funding for the State Criminal Alien Assistance Program (SCAAP).

Budget Does Not Include Proposals To Increase State Revenues

The Budget assumes that the state will conform state income tax law to a number of recent changes made in federal tax law. Tax proposals include adopting federal contribution limits for retirement and educational savings accounts and estimated tax payment amounts (which accelerate, but do not increase, revenue collections) and requiring corporations to make the same choices on a number of options ("elections") for state tax purposes as they do for federal purposes. The proposed changes would increase state tax collections by $178 million in 2002-03, but would reduce revenues in future years. The increased revenue results from taxpayers paying amounts due sooner, rather than paying more.

The phase out of the federal estate tax included in last year's federal tax package will reduce 2002-03 state revenues by $367 million. The loss stems from the fact that states receive a portion of federal tax collections. This loss will increase to $1.27 billion in 2005-06, when the state's share of the tax is eliminated.

Where Are The Cuts?

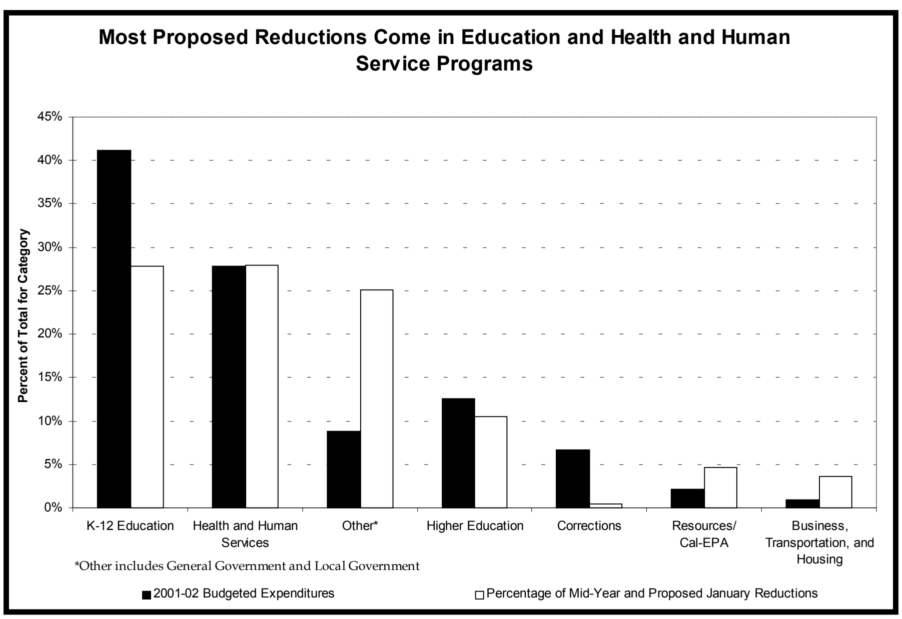
Many of the $5.2 billion in proposed spending reductions roll back or delay expansions made during recent years. The largest dollar reductions come from Health and Human Service programs (28.6 percent of the total proposed reductions) and K-12 Education (27.2 percent of the total), which received 30.4 percent and 39.9 percent increases respectively in spending between 1998-99 and 2000-01.

CalWORKs Faces A Deficit. The Governor proposes to bridge an estimated CalWORKs program deficit of several hundred million dollars with a combination of one-time and ongoing measures. The deficit is the product of the depletion of reserves from prior years' TANF block grants combined with cost increases as counties have fully implemented welfare-to-work programs, and a modest caseload increase due to the downturn in the economy. Funding for CalWORKs and related programs are constrained by the fact that the federal TANF block grant ($3.7 billion) has not increased and the state has continued to provide the minimum level of funding for the federal maintenance of effort requirement ($2.7 billion).

The Governor's Budget:

- Does not include a cost of living adjustment (COLA) for recipients, for a savings of $117 million;
- Proposes reallocating $169 million in performance incentive funds previously paid to the counties to support the core CalWORKs program;
- Eliminates funding for employment services for CalWORKs recipients, other than those funded through counties, including $94 million for the Community Colleges and the Department of Education; and
- Does not provide an inflation adjustment for county CalWORKs administration, for a savings of $44 million. County employment services are currently underfunded by as much as $250 million.

The Budget provides counties with a block grant to fund employment services, eligibility administration, child care, mental health and substance



abuse services, and juvenile probation.

The Budget assumes an increase in the overall CalWORKs caseload in 2002-03. However, families will begin hitting the CalWORKs five-year time limit in January 2003, resulting in a loss of the adult's portion of the grant and loss of eligibility for most employment services. Families that are employed after reaching the time limit will remain eligible for transitional child care and job retention services.

Social Service Programs Face COLA Suspensions. The Budget reduces social services spending by $742 million. In addition to cuts in the CalWORKs program, savings are achieved primarily by suspending state cost of living adjustments for Supplemental Security Income/State Supplemental Payment (SSI/SSP) recipients and foster care providers. However, SSI/SSP recipients will receive a federal COLA of 1.8 percent in January 2003. Cash Assistance Program for Immigrants (CAPI) recipients, immigrants who are not eligible for SSI/SSP, will receive the same 1.8 percent adjustment from state funds. The Budget does not include an inflation adjustment for county administration of many programs.

The Budget eliminates funding for the California Food Assistance Program (CFAP), for a net savings of $35 million. CFAP provides food stamps for individuals who are not eligible for federal food stamps because of their immigration status. The Budget anticipates restoration of federal eligibility for these individuals. This could result in a temporary loss of benefits between June 30, 2002 (the end of the state fiscal year) and October 1, 2002 (assuming federal restoration begins in the 2003 federal fiscal year), as well as an ongoing loss for any CFAP recipients who would not be covered by the federal eligibility restoration. As of September 2001, 83,066 people received food stamps though CFAP.

The 2001-02 Budget included funding for wage increases for certain In-Home Supportive Service (IHSS) workers, who provide supportive services to low-income aged, blind, and disabled individuals so that they may remain in their homes. The Governor's Budget does not provide funding for wages beyond the level supported in last year's budget.

Most Health Reductions Hit Providers. The 2002-03 Budget includes $407 million in spending reductions in health care programs. The Legislature approved $89 million in health program reductions in January. The Budget increases total funding for the Medi-Cal program by 4.6 percent, to $26.9 billion. The Budget reduces total (state and federal) spending for the Healthy Families Program (HFP) and related outreach and coverage efforts from $819.8 million to $795.1 million, reflecting an increase in costs due to enrollment growth and a reduction in spending for outreach. Proposed reductions include:

- Postponing the expansion of the Healthy Families Program to cover parents until July 1, 2003 for a savings of $54.3 million in the current and $160.5 million in the budget year. However, the federal government's January 24 approval of the state's request to extend the HFP to parents approximately a year after the state's original waiver submission may result in a reinstatement of funds for the parent expansion. The approved waiver would cover parents in families with incomes of up to 200 percent of the federal poverty level, lower than the 250 percent of poverty income ceiling contained in the legislation authorizing the state's expansion.
- Imposing copayments of $1 to $5 per adult Medi-Cal visit.
- Partially rescinding recent provider rate increases. The Budget states that reductions will be structured to minimize the impact on children and seniors.
- Increasing the fee the state charges public and University of California hospitals for the Disproportionate Share Hospital (DSH) program by $55.2 million.
- Reducing funding for Medi-Cal and the Healthy Families Program outreach activities by $20.7 million.
- Eliminating the Child Health and Disability Prevention Program (CHDP) and shifting the CHDP caseload to Medi-Cal and the Healthy Families Program (HFP). On balance, the proposal to eliminate CHDP would result in a savings of $55.8 million. The impact of elimination is unclear, due to the lack of reliable data on the children served by the

current program. One concern is that the current network of CHDP providers is broad (approximately 4,500), while the elimination relies heavily on the state's approximately 320 Expanded Access to Primary Care (EAPC) clinics to serve children that would lose CHDP benefits. There are also questions as to whether children currently served by CHDP would meet Medi-Cal or Healthy Families eligibility requirements.

Significant spending augmentations include $42.1 million ($21.1 million General Fund) to implement "express lane" eligibility, which would link eligibility for the Medi-Cal and Healthy Families programs to the Food Stamp Program and the National School Lunch Program, $350 million ($175 million General Fund) for a one-time payment to address prior years' reimbursement rates for hospital outpatient services, and $183 million ($91.5 million General Fund) to continue the higher hospital outpatient services reimbursement rates that were included in the 2001-02 Budget.

Budget Cuts Housing Programs Deeply; Bond Would Provide Replacement Funds. The Budget reduces General Fund housing spending by $107.8 million in the current year and $37.9 million in the budget year. The bulk of the cuts ($134.3 million) come from the Jobs-Housing Balance Improvement Program ($59.7 million in the current year) and the Multifamily Housing Program ($45.1 million in the current year and $29.5 million in the budget year). Other budget year cuts include $3.6 million from the Farmworker Housing Program, $2.0 million from the Emergency Housing and Assistance Program, and $2.1 million from the Self-Help Housing Program. The Budget also reduces funding for the Supportive Housing Program by $17.5 million.

The Governor justifies the proposed reductions by supporting a $2.1 billion general obligation bond to be submitted to voters in November 2002. This bond, contained in SB 1227 (Burton), would finance housing and code enforcement programs, including $910 million for the Multifamily Housing Program, $290 million for the Homebuyer Downpayment Assistance Program, $200 million for the Farmworker Housing Program, $195 million for the Emergency Housing and Assistance Program, $195 million for the Supportive Housing Program, $205 million for the CalHOME Program, $100 million for the Jobs-Housing Improvement Program, and $5 million for code enforcement and compliance programs.

SB 1227 also creates a Housing Finance Committee composed of the Treasurer (Chair), Controller, Directors of the Departments of Finance and Housing and Community Development, and the Executive Director of the California Housing Finance Agency (CHFA). Additional legislation, AB 1008 (Lowenthal), has been amended to provide implementation language for the bond. These measures are on a fast track to the Governor, who expressed support for the bond in the 2002-03 *Budget Highlights.* At press time, SB 1227 was scheduled to be heard in the Assembly Appropriations Committee and AB 1008 was scheduled to be heard in the Senate Appropriations Committee.

Budget Funds Enrollment And COLAs For Education. The Budget proposes a total 2002-03 Proposition 98 funding level of $46.0 billion for K-14 programs, a 1.1 percent increase over the 2001 Budget Act level of $45.5 billion. The state General Fund share of 2002-03 Proposition 98 funding is $31.4 billion, a 1.9 percent decrease from the 2001 Budget Act share of $32.0 billion. The decrease in the state's share of funding is due to an anticipated 7.8 percent growth in local property tax revenues. The Budget's estimate of the spending guarantee is approximately $935 million less than that of the Legislative Analyst. The difference results from forecasts of per capita personal income growth, the inflation factor used to adjust the spending guarantee. The LAO projects a smaller drop in per capital personal income, which would increase the Proposition 98 guaranteed spending level.

The Budget fully funds the Proposition 98 guarantee and statutory growth and COLAs for K-12 programs resulting in $7,058 per pupil, an increase of $136 or 2.0 percent over the amended 2001 Budget Act level. In order to provide the full COLA and growth adjustments, the Governor proposes $487.0 million in K-12 spending reductions and uses a $112.3 million increase in the Federal Special Education Grant to replace, rather than fully augment, state spending for special education. The largest share of the proposed cuts (43.8 percent) is in instructional support programs. The Budget provides $197 million for the High Priority Schools Block Grant program. Implementation of the block grant was delayed from the current year to the budget year as part of spending reductions proposed in the November Revision to the budget.

Governor Proposes A New Workforce Development Agency. The Budget includes a proposal that would reorganize existing departments to form a new Labor Agency. The new agency would include the current Employment Development Department (EDD), Department of Industrial Relations (DIR), Workforce Investment Board (WIB), and Agricultural Labor Relations Board (ALRB). The proposal aims to improve coordination of state workforce development activities. Apprenticeship programs would be consolidated under the DIR. The California Community Colleges (CCC) would administer existing vocational and adult education programs, now administered by the CCC, the California Department of Education (CDE), and the Governor's Secretary of Education.

The proposal would also streamline existing job training funds in various programs into two block grants: a $2.9 billion ($458.7 million General Fund) grant for employment services, economic development, and job training; and a $1.7 billion ($1.6 billion General Fund) grant of existing program funds for a vocational and adult education block grant.

Budget Includes Sweeping Changes To State Child Care Programs. The Budget proposes far reaching changes to the state's child care and development programs that serve at-risk and low-income children. The Budget increases child care spending by $150 million (4.9 percent) over current year levels and assumes $400 million in savings attributable to restructuring proposals, including increased family fees and a reduction in the market rate cap for provider payments. These savings would be used to serve an additional 102,000 children, of whom 79,000 will be served in the After-School program, with the balance served in the Alternative Payment (voucher) child care program. The reforms include:

- Eliminating the CalWORKs Stage 3 child care program. The Governor's Budget eliminates Stage 3 as of April 1, 2003. The proposal transfers families in Stage 3 as of April 1, 2003 and the funds attributable to them ($218.1 million) to the Alternative Payment program that serves other low-income families. Families that exhaust their eligibility for Stage 1 and Stage 2 child care after March 31, 2003 would compete with other low-income working families for subsidized slots based on family income and space availability.
- Instituting fees for all families, a change from the current exemption from fees for families with incomes below 50 percent of the state median. In addition, fee levels would be based not only on family income, as under current law, but also on the length of time a family receives subsidized care.
- Reducing the reimbursement limit for providers to the 75th percentile of the regional market from the current market rate ceiling of approximately the 93rd percentile. Parents who select or retain care from providers with higher rates would be required to make additional copayments to their provider.
- Lowering the income eligibility ceiling for families to qualify for subsidized child care. The current ceiling is 75 percent of state median income (SMI), or $35,100 for a family of three. The Budget reduces the income eligibility limit to 66 percent of the SMI in four Bay Area counties, to 63 percent of SMI in other high cost counties, and to 60 percent of SMI for remaining counties.
- Changing the current priority for services to give top priority to families who work full-time and have children under age five who are in need of care.

The Budget also provides $26.1 million to support a 2.15 percent COLA for "all eligible child care programs" and eliminates funding for the Child Development Policy Advisory Committee, effective January 1, 2003, for a General Fund savings of $492,000.

MAXIMIZING THE STATE'S ECONOMIC DEVELOPMENT INVESTMENTS

Policymakers are facing the challenge of bridging a substantial budget gap and, at the same time, coping with the impact of an economic slowdown. In light of this challenge, a new report by the California Budget Project (CBP) examines how much the state currently spends to promote a healthy economy, what constitutes economic development, and whether these public investments are well spent. *Maximizing Returns: A Proposal for Improving the Accountability of California's Investments in Economic Development* finds that California's current structure of economic development spending is fragmented and lacks a systematic review and evaluation process. As a result, it is difficult, if not impossible, to determine whether the $7.8 billion devoted to economic development in 2000-01, or even the total $39.3 billion since 1995-96, has had a measurable impact on the vitality of the state's economy and the well-being of Californians. The report makes the following findings and recommendations.

Finding 1: The State Lacks A Structural Framework For Economic Development Spending. California's economic development spending is scattered across more than two dozen departments, agencies, boards, commissions, and authorities, as well as more than six dozen tax expenditures.
Recommendation 1: Develop A Unified Economic Development Strategy. As a first step toward increasing accountability and maximizing program effectiveness, the state should establish a comprehensive economic development strategy. The Governor and the Legislature should work together to coordinate and oversee economic development programs and implement this strategy.

Finding 2: Most Economic Development Funds Go To General Support for Business. Of the eight categories identified in this report, by far the largest share of state support for economic development in 2000-01 ($4.0 billion, or 52 percent) went to Planning and Management Support for Business, primarily in the form of untargeted tax relief.
Recommendation 2: Prioritize Economic Development Spending On Areas Of Strategic Importance. Using the planning process outlined in Recommendation 1, policymakers should identify goals and objectives where strategic allocation of resources could have a measurable impact on the state's economy.

Finding 3: Tax Expenditures Account For The Majority Of Economic Development Spending. In 2000-01, economic development tax policies cost the state $5.5 billion, $3.2 billion more than budgeted programs.
Recommendation 3: Institute A Systematic Review Of Tax Expenditure Programs. The state should establish a sunset review process to ensure that state resources support programs with the greatest economic return. The state should also evaluate whether existing tax expenditures support current state policy priorities, taking into account the need for sufficient revenues to support broader policy goals such as improving the state's schools and investing in California's infrastructure.

Finding 4: Most Economic Development Spending Is Not Evaluated. Only 17 percent of 2000-01 economic development spending went to programs with evaluations or outcome-based reviews.
Recommendation 4: Evaluate Economic Development Spending Based On Outcomes. Policymakers should use outcome measures to evaluate the effectiveness of economic development spending. The Governor and the Legislature should adopt, as a matter of policy, a requirement that programs collect and report basic data and provide adequate staff and budget resources for the data collection.

Both the Executive Summary (14 pages) and the full report (124 pages) of *Maximizing Returns* can be ordered or downloaded by visiting the CBP website at www.cbp.org.

TANF REAUTHORIZATION POSITIONS ARE BEING DEFINED

The Bush Administration began to reveal its

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priorities for reauthorization of the Temporary Assistance for Needy Families (TANF) block grant with the January release of the President's proposed budget for FY 2003. The budget continues funding the block grant for the next five years at $16.5 billion, the same level since 1997, rather than adjusting the block grant for inflation as many have proposed. This would leave California's block grant of $3.7 billion unchanged. The budget also includes $2 billion to reinstate the TANF contingency fund, which is intended to provide states with additional resources during recessions. In addition, the proposed budget freezes funding for the Child Care and Development Fund (CCDF) for the next five years at $2.7 billion, ending the policy of increasing funding annually, and freezes funding for the Social Services Block Grant (SSBG) at $1.7 billion.

Representative Ben Cardin (D-MD) has introduced the House Democrats' TANF reauthorization bill (HR 3625), which indexes TANF block grant levels to inflation, includes poverty reduction as an explicit TANF goal, allows more recipients to engage in training and education, permits states to serve legal immigrants with TANF funds, and substantially increases funding for the CCDF and the SSBG.

The President's budget also modifies the Food Stamp Program, extending eligibility to legal immigrants who have been in the US for more than five years and relaxing vehicle ownership restrictions. A House-Senate conference committee will resolve differences between the House and Senate Farm Bills, which include reauthorization of the Food Stamp Program (HR 2646 and S 1731).

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.

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