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February 8, 2011

Honorable Clayton Hee, Chair
and Members of the Committee on Judiciary and Labor
State Senate
The Twenty-Sixth Legislature
Regular Session of 2011
State of Hawaii
State Capitol
Honolulu, Hawaii 96813

Dear Senator Hee and Members of the Committee on Judiciary and Labor:

SUBJECT: S.B. No. 693 – PROPOSING AMENDMENTS TO ARTICLE VII, SECTIONS 12 AND 13, OF THE CONSTITUTION OF THE STATE OF HAWAII RELATING TO TAX INCREMENT BONDS

The City has serious concerns regarding S.B. No. 693 and opposes its adoption.

Tax increment financing (TIF) jeopardizes the City's control of real property taxes, its largest and primary source of revenue. TIF is not an additional tax. It is a part of the normal real property tax collection that would otherwise flow to the City's general fund. TIF diverts a portion of the City's real property taxes from the City's general fund to a particular tax increment district.

TIF has the potential to weaken and damage the City's real property tax revenue program. It may also result in unfair and unequal burdens and benefits among real property taxpayers for general City services, as real property tax money that would have been used for general government services is redirected to special purposes. Instead of spreading the burden of public improvements over the entire City, as has traditionally been the case, areas that can generate tax increment revenue could divert that portion of their real property taxes to the exclusive benefit of that area. Over time, TIF could have unintended consequences, including a material adverse effect on the City's general fund and a kind of Balkanization of the City's real property tax structure and capital improvement program.

Moreover, the TIF bonds present risks such as insufficient increases in assessed values and tax increments to satisfy bond payment requirements. Negative impacts may lead to lower bond ratings, higher borrowing costs, and overall higher tax rates.

For more than 50 years, the State of California has authorized its cities and counties to create redevelopment agencies, which have used TIF extensively. Recently, Governor Jerry Brown included in his budget, a proposal to eliminate economic redevelopment programs which divert property taxes to special redevelopment districts. The California Legislative Analyst's Office released the attached "The 2011-12 Budget: Overview of the Governor's Budget," supporting that initiative, stating;

"Ending state-assisted local economic development programs like redevelopment makes sense. Redevelopment projects divert property taxes from K-14 districts, increasing state education costs by billions of dollars annually. The state's costs associated with redevelopment has grown markedly over the last couple of decades, yet we find no reliable evidence that this program improves overall economic development in California."

In other words, after more than 50 years of TIF, California is unable to conclude that the cost of TIF was justified. For that reason, Hawaii should be cautious about adopting legislation that another state is repealing because it failed to produce the expected results.

As you can see, we have serious reservations regarding TIF financing and we oppose S.B. 693.

If you have any questions, please call me at 768-3900.

Very truly yours,

Michael R. Hansen
Acting Director of Budget and Fiscal Services

enclosure

LAO

Mac Taylor
Legislative Analyst

January 12, 2011

The 2011-12 Budget:

Overview of the Governor's Budget

CONTENTS

EXECUTIVE SUMMARY

$25.4 Billion Budget Problem Identified by Administration

Administration's Estimate Seems Reasonable. The administration's budget proposal identifies a $25.4 billion budget problem that the Legislature and the Governor must address between now and the time they agree on a 2011-12 budget package. Our initial assessment is that this estimate is reasonable. The $25.4 billion problem consists of an $8.2 billion deficit that would remain at the end of 2010-11 absent additional budgetary action, as well as an estimated $17.2 billion gap between current-law revenues and expenditures in 2011-12.

Reasons for the Budget Shortfall. As we discussed in our November 2010 report, *California's Fiscal Outlook*, the major reasons for this budget problem are the inability of the state to achieve previous budget solutions in several program areas, the expiration of various one-time and temporary budget solutions approved in recent years, and the failure of California to obtain significant additional federal funding for key programs. A weak economic recovery continues, meaning that elected leaders cannot rely on the economy to solve this huge budget problem.

Governor's Plan: Realignment, June Election, and Expenditure Cuts

Realignment and Voter-Approved Tax Increases Are Key Elements. Two significant and interrelated themes run through the Governor's budget proposal: (1) his plan to submit a proposed extension of the four temporary tax increases adopted in February 2009 to voters in a June 2011 special election and (2) his plan to restructure the state-local relationship in the delivery of services (by shifting funding and responsibility to local governments for those services).

Expenditure Reductions Touch Nearly Every Area of State Funding. The Governor's budget includes many significant ongoing program reductions, posing very difficult decisions for the Legislature. His proposals touch nearly every area of the state budget—often (as in Medi-Cal) with proposed reductions similar to ones suggested by the prior Governor and rejected by the Legislature. While the Governor's revenue proposals result in a $2 billion increase in the Proposition 98 minimum funding guarantee for schools above its current-law level, his budget would result in a small programmatic funding decline for K-12 and more significant reductions for community colleges and child care programs.

Plan Would Improve Budget Situation Considerably

Administration Estimates $1 Billion Reserve at End of 2011-12. The administration estimates that the Governor's plan would cut the 2010-11 deficit in half and leave the state with a $1 billion reserve at the end of 2011-12. The plan relies on legislative approval of statutory changes necessary to achieve budget solutions by March 1.

Administration Says Plan Would Eliminate Deficit for at Least a Few Years. The administration projects that the Governor's proposed budget package would eliminate California's budget deficit for at least the next three years and leave the state with a surplus during that period, albeit a very small one in some years. The Governor proposes that voters approve only five-year extensions of temporary taxes, some of which would be used to fund realigned local services. At this time, it is unclear how the Governor plans to replace the proposed temporary taxes when they expire at the end of this five-year period.

LAO Comments

Governor's Proposal Is a Good Starting Point. The state faces another huge budget deficit. In light of this dire circumstance, the Governor's proposal includes reductions in nearly every area of the state budget and a package of revenue proposals that merit serious legislative consideration. We think the Governor's package is a good starting point for legislative deliberations.

Focuses on Multiyear and Ongoing Solutions. We credit the Governor's efforts to craft a budget plan that is heavily focused on multiyear and ongoing solutions. As such, his proposal shows great promise to make substantial improvements in the state's budgetary health—both in the short run and over the long term. The administration, in fact, estimates that its plan would eliminate the state's deficit—at least for the next three fiscal years. Our early assessment of the outyear effects of the Governor's budget is somewhat less favorable than the administration's. Nevertheless, its adoption would go a long way toward eliminating the state's persistent budget gap.

Governor Puts Some Bold Ideas on the Table. The Governor's proposals to "realign" state and local program responsibilities and change local economic development efforts have much merit. His realignment proposal would shift $5.9 billion in state program costs to counties and provide a comparable amount of funds to support these new county commitments. We believe that this type of decentralization of program delivery and authority could promote innovation, efficiency, and responsiveness to local conditions. The Governor also puts forward dramatic changes in the area of local economic development by proposing the elimination of redevelopment agencies. We think this makes sense, as the state's costs associated with redevelopment have grown markedly over the years even though there is no reliable evidence that the program improves overall economic performance in the state.

Still...Some Significant Risks in the Governor's Plan. The Legislature should favor budget solutions that have a strong likelihood of actually achieving budgeted savings or revenue increases. As such, there is significant work ahead to fill in the details of some of the Governor's ambitious, complex budget proposals—especially the realignment and redevelopment proposals, which involve many legal, financial, and policy issues. Acting to pass key budget legislation by March 1, as the Governor proposes, would be helpful even if a special election were not called. Early budget actions give departments more time to implement spending reductions. If it adopts the Governor's timeline and special election approach, the Legislature would have the opportunity in the months after March 1 to review routine budget proposals for departments, adopt clean-up legislation to clarify elements of this complex budget package, and consider alternative budget-balancing solutions in case voters reject the June ballot measures. In total, around $12 billion of the Governor's proposed budget solutions (tax extensions and changes to Proposition 10) are dependent upon voter approval in June.

Conclusion

California's elected leaders need to take big steps toward restoring the state government to fiscal solvency and rebuilding the trust of California's residents in state government. The Legislature's most important function is its control of the state budget. In drafting a 2011-12 budget plan, the Legislature will have to make difficult decisions on both its spending and tax commitments, but it also has the opportunity to reorder state and local government functions to improve the delivery of public services. In the coming weeks, we will work to provide additional guidance on the Governor's proposals and, where appropriate, offer alternatives to them.

OVERVIEW

The Governor released his proposed 2011-12 budget package on January 10, 2011, one week after his inauguration. This report is our office's initial reaction to this package. In the coming weeks, as more information becomes available from the administration, we will provide further analysis to assist the Legislature in its budget deliberations.

Administration Estimates a $25.4 Billion Shortfall

Failed Budget Solutions and Expiring Measures Contribute to the Shortfall. Based on a review of current-law General Fund revenues and program spending, the *2011-12 Governor's Budget* estimates that, without corrective action by the Legislature and the Governor, the state would end 2011-12 with a $25.4 billion deficit. Under the administration's estimates, the Legislature and the Governor would need to identify at least $25.4 billion of General Fund budget solutions between now and the time that they adopt the *2011-12 Budget Act.* Specifically, the administration estimates that the General Fund will end 2010-11 with a deficit of $8.2 billion (as opposed to the $1.5 billion reserve balance assumed when the October 2010 budget package was adopted). For 2011-12, the Governor estimates that the gap between expenditures and revenues will be $17.2 billion.

Our office also pegged the size of the 2011-12 budget problem at $25.4 billion in our November 2010 report, *California's Fiscal Outlook.* As we discussed in that report, the reasons for this year's state budget shortfall include the inability of the state to achieve previous budget solutions in several program areas, the expiration of various one-time and temporary budget solutions approved in recent years, and the inability of the state to obtain significant additional federal funding for key programs.

Governor Proposes $26.4 Billion of General Fund Solutions. In total, the Governor proposes a total of $26.4 billion in budget solutions. If adopted and achieved in full, the Governor's budget plan would leave the state with a reserve of around $1 billion at the end of 2011-12.

How the Budget Addresses the Shortfall

A Mix of Expenditure Reductions and Tax Increases. Figure 1 (see next page) shows our office's categorization of the $26.4 billion in proposed budget solutions. The Governor proposes to reduce current-law General Fund state expenditures by $12.5 billion, as summarized in Figure 1. (These expenditure-related solutions include both reductions in services and benefits and use of other funding sources in lieu of the General Fund.) The Governor proposes a total of $14 billion in new revenues, of which $3 billion is attributed to 2010-11. The additional revenues to be deposited in the General Fund would result in a $2 billion increase in the Proposition 98 minimum funding guarantee for schools and community colleges. (The administration scores its revenue package at $12 billion over two years: the $14 billion described above, less the $2 billion increase in the Proposition 98 guarantee. Figure 1 categorizes the Proposition 98 change separately from the revenue package.) The remaining $1.9 billion in solutions comes from borrowing from special funds and other sources. We discuss the significant proposals in the Governor's budget in more detail later in this report.

Realignment and Voter-Approved Revenues Are Key Elements. Two significant and interrelated themes run through the Governor's budget package: (1) his plan to submit a proposed extension of the four temporary tax increases adopted in February 2009 to voters in a June 2011 special election and (2) his plan to restructure the state-local

relationship in the delivery of services (by shifting funding and responsibility to local governments for those services). Two of the temporary tax increases proposed for the June special election ballot (the 1 percentage point sales tax increase and the 0.5 percentage point increase in the vehicle

Figure 1

Budget Solutions Proposed by the Governor

(General Fund Benefit, in Billions)

	2010-11	2011-12	Totals
Expenditure-Related Solutions			
Shift redevelopment funds to Medi-Cal and trial courts	—	$1.7	$1.7
Reduce benefits and provider payments and charge copayments in Medi-Cal	—	1.7	1.7
Impose time limits, grant reductions, and service cuts for CalWORKs	—	1.5	1.5
Reduce UC and CSU budgets	—	1.0	1.0
Use Proposition 10 reserves and some ongoing revenues for children's programs	—	1.0	1.0
Fund transportation debt costs primarily using weight fees	$0.3	0.8	1.0
Use Proposition 63 funds to support community mental health services	—	0.9	0.9
Reduce developmental center and regional center spending	—	0.8	0.8
Shift some adult and all juvenile offenders to local jurisdictions	—	0.6	0.6
Reduce IHSS hours of service, limit domestic services, and tighten eligibility	—	0.5	0.5
Reduce state employee salary and medical costs	—	0.4	0.4
Suspend, defer, or repeal state mandates	—	0.3	0.3
Reduce SSI/SSP grants for individuals to the federal minimum	—	0.2	0.2
Adopt unallocated funding reduction for the courts	—	0.2	0.2
Reduce Receiver's inmate medical care budget	0.1	0.2	0.2
Achieve efficiencies in state operations	—	0.2	0.2
Reduce other spending	—	0.3	0.3
Subtotals[a]	($0.4)	($12.1)	($12.5)
Revenue Solutions			
General Fund Revenue Solutions			
Extend the 0.25 percentage point personal income tax surcharge for five years	$1.2	$2.1	$3.3
Extend reduction in dependent exemption credit for five years	0.7	1.2	2.0
Make single sales factor mandatory for multistate firms	0.5	0.9	1.4
Repeal enterprise zone tax credits	0.3	0.6	0.9
Adopt other revenue measures	0.4	0.1	0.5
Subtotals	($3.2)	($4.9)	($8.1)
Local Realignment Revenue Solutions			
Extend 0.5 percentage point vehicle license fee increase for five years		$1.4	$1.4
Extend 1 percentage point state sales tax increase for five years	—	4.5	4.5
Subtotals	(—)	($5.9)	($5.9)
Total Revenue Solutions	($3.2)	($10.9)	($14.0)
Borrowing and Transfers			
Loans, transfers, and loan extensions from special funds	$0.5	$0.9	$1.4
Borrow from Disability Insurance Fund for UI interest payments	—	0.4	0.4
Other loans and transfers	—	0.1	0.1
Subtotals	($0.5)	($1.4)	($1.9)
Increase Proposition 98 Guarantee Due to Revenue Proposals	—	-$2.0	-$2.0
Totals, All Solutions	**$4.1**	**$22.3**	**$26.4**

[a] Subtotal may not add due to rounding.
IHSS = In-Home Supportive Services; UI = Unemployment Insurance.

license fee [VLF]) would be dedicated to funding the realignment of programs from the state to local entities. The Governor also proposes a significant change to the way that local redevelopment activities are funded.

Most Solutions Extend Beyond the Budget Year. Apart from the temporary borrowing of $1.9 billion, the vast majority of the proposed budget solutions are intended to last beyond the budget year. In the case of the temporary tax increases, they would be in effect for five years.

General Fund Condition

Solutions Estimated to Leave State With $1 Billion Reserve at End of 2011-12. Figure 2 shows the administration's estimates of the General Fund condition under the Governor's proposals. The estimated deficit at the end of 2010-11 would be cut in half to about $4.1 billion. In 2011-12, revenues would decline 4.8 percent to $89.7 billion, while expenditures would decline 8.2 percent to $84.6 billion. The state would have an operating surplus of $5.1 billion, offsetting the carry-in deficit and leaving a $1 billion reserve at the end of 2011-12.

Administration Says Its Solutions Would Eliminate the Deficit for at Least a Few Years. The administration projects that the proposed budget solutions would eliminate the state's budget deficits for the next three years and leave the state with a surplus, albeit a very small one in some years, through this period. (Specifically, the administration estimates that the General Fund would have an operating surplus of $15 million in 2012-13, $2.4 billion in 2013-14, and $7 million for 2014-15.) At this time, it is unclear how the Governor plans to replace the proposed temporary taxes—which are to be used to fund ongoing realigned local services—when they expire at the end of five years. Absent a plan to replace these taxes, there could be a substantial fiscal "cliff" for the General Fund after the five-year period.

Proposed Accelerated Budget Timeline

Administration Proposes Trailer Bills—Not Budget Act—by March 1. The administration has proposed an accelerated budget process with a target date of March 1 to have all of the enabling legislation necessary to implement the budget solutions in place. It is our understanding that the administration does not propose to have a budget act passed by March 1, but rather only "trailer bills" (the legislation that makes the statutory changes required to implement budgetary solutions or to place items on the special election ballot). This approach would allow the Legislature and the administration to put in place the budget solutions required to address the budget deficit in March and then finalize action on the budget

Figure 2

Governor's Budget
General Fund Condition

(Dollars in Millions)

	Actual 2009-10	Proposed 2010-11	Proposed for 2011-12 Amount	Proposed for 2011-12 Percent Change
Prior-year fund balance	-$5,147	-$5,343	-$3,357	
Revenues and transfers	87,041	94,194	89,696	-4.8%
Total resources available	$81,894	$88,851	$86,339	
Expenditures	$87,237	$92,208	$84,614	-8.2%
Ending fund balance	-$5,343	-$3,357	$1,725	
Encumbrances	$770	$770	$770	
Reserve[a]	-$6,113	-$4,127	$955	

[a] Special fund for economic uncertainties.

bill—presumably in June—prior to the Legislature's June 15 constitutional deadline for adopting a balanced budget. In the view of the administration, this would allow for the incorporation of any updated May Revision forecasts, as well as the results of the special election.

Most or all of the trailer bills passed by March under the administration's approach seemingly would require a two-thirds vote of each house of the Legislature. This is because Proposition 25 (approved by voters in November 2010) appears to require passage of a budget act to designate trailer bills needing only a majority vote.

June Special Election. It is our understanding that the Governor proposes to put two ballot measures before the voters in a June special election: (1) a constitutional measure to extend the temporary tax increases by another five years and to dedicate two of these revenues to realignment and (2) a measure to change Proposition 10 to allow the funds to be used in the Medi-Cal Program. (In addition, two measures have already qualified for the next statewide ballot through the initiative process: a measure to change the term limits currently in place for legislators and a measure to increase cigarette taxes to fund additional cancer research.) We understand the Governor will ask that a separate measure be placed on a future election ballot to allow new mechanisms for funding redevelopment at the local level.

LAO Comments

The Governor's Package Is a Good Starting Point

Reasonable Estimate of the Size of the Budget Problem. Our initial assessment is that the Governor's budget provides a reasonable estimate of the size of the budget problem the Legislature and the Governor must address between now and the time they agree to a 2011-12 budget package. Most, but not all, budget solutions also appear to be scored reasonably, assuming that they are enacted on the Governor's accelerated budget legislation deadline. (We discuss our reactions to specific budget proposals throughout this report.)

Expenditure Reductions Touch Nearly Every Area of State Funding. The Governor's budget includes many significant ongoing program reductions, posing very difficult decisions for the Legislature. His proposals touch nearly every area of the state budget—often (as in Medi-Cal) with proposed reductions similar to ones suggested by the prior Governor and rejected by the Legislature. While the Governor's revenue proposals result in a $2 billion increase in the Proposition 98 minimum funding guarantee for schools above its current-law level, his budget would result in a small programmatic funding decline for K-12 and more significant reductions for community colleges and child care programs.

Tax Package Includes Some Sound, Policy-Based Proposals. The Governor's plan includes several tax proposals that we have previously recommended, including adoption of mandatory single sales factor apportionment for multistate and multinational firms and elimination of enterprise zone tax credits. As we describe later in this report, the proposed extension of the temporary increases in income and sales tax rates poses more difficult issues, but we think the Governor's proposed tax extensions merit serious consideration.

Focuses on Multiyear and Ongoing Solutions. We credit the Governor's efforts to craft a budget plan that is heavily focused on multiyear and ongoing solutions. As such, his proposal shows great promise to make substantial improvements in the state's budgetary health—both in the short run and over the long term. The administration, in fact, estimates that its plan would eliminate the state's deficit—at least for the next three fiscal years.

Our early assessment of the out-year effects of the Governor's budget is somewhat less favorable than the administration's. Nevertheless, its adoption would go a long way toward eliminating the state's persistent budget gap.

Governor Puts Some Bold Ideas on the Table

Restructuring the State-Local Relationship. The Governor's budget includes a major "realignment" of state and local program responsibilities. It would shift $5.9 billion in state program costs to counties and provide a comparable amount of funds to support these new county commitments. We believe there is much merit in the proposal as decentralizing program delivery and authority could promote program innovation, efficiency, and responsiveness to local conditions.

Overhauling Redevelopment. The budget also puts forward dramatic changes in the area of local economic development, by proposing the elimination of redevelopment agencies. We think this makes sense, as the state's costs associated with redevelopment have grown markedly over the years even though there is no reliable evidence that this program improves overall economic performance in the state.

Still...Some Significant Risks in the Governor's Plan

Realignment and Redevelopment Proposals Pose Challenges. While the proposals on realignment and redevelopment have great promise, both will require considerable work by the Legislature to sort through many legal, financial, and policy issues. Implementing these complex proposals in a way that ensures the programmatic benefits and budgetary solutions will be challenging—especially given the short time frame laid out in the budget plan.

Many Details Still Need to Be Worked Out. As some of the solutions proposed by the Governor are complex and cut across many aspects of government, it is unsurprising that just one week into the new administration's term, there are areas where specific implementation and practical details are missing. For example, the budget does not indicate specifically how much of the proposed savings in the Department of Developmental Services (DDS) would be achieved. This lack of detail should not preclude a prompt beginning to legislative consideration of any proposal. Nevertheless, the implementation details—the administration's approach to navigating the legal and practical complexities of many proposals—will determine the level of risk and the corresponding likelihood of successful implementation. As we have stated previously, we suggest that the Legislature favor budget solutions that have a strong likelihood of actually achieving budgeted savings or revenue increases.

Some Savings Estimates Are Optimistic. As we discuss in detail later in this report, our initial review of the Governor's budget suggests that in some key program areas, the administration's estimated savings are optimistic. These areas include some proposals in corrections, state employee health plans, and In-Home Supportive Services (IHSS). In addition, the budget plan includes $200 million of unallocated reductions to state operations for efficiency purposes. In some cases, the administration has not provided significant detail yet on how the savings from these proposals would be achieved. Historically, such lack of detail often has been associated with budget actions that fail to produce the desired level of savings. Proposed budget solutions of over $1 billion could be affected, based on our very early review.

Much Would Depend on the Outcome of the June Special Election. Under the Governor's proposals, around $12 billion of the proposed budget solutions (tax extensions and changes to Proposition 10) will depend on voter approval in the June special election. If the voters reject some

or all of these solutions, the Legislature would need to promptly enact additional cuts or alternative revenue solutions prior to the start of the new fiscal year in July.

Legislature Needs to Act Quickly

Accelerated Timeline. If the Legislature accepts the administration's proposed approach for a June special election, the proposed timeline—to adopt key budget-balancing statutory measures by March 1—has significant advantages. Aside from the timing requirements for the special election and the desire to provide voters a clear idea of the Legislature's path to balancing the budget, many of the Governor's proposals will require lead time to plan and implement. Given the proposed accelerated budget process, the Legislature will need to work quickly with the administration to develop details on each of the proposals and to develop well-crafted legislation on how the solutions are to be implemented. If the Legislature chooses different solutions than those presented by the Governor, a similarly accelerated timeline may still be needed to maximize the opportunity to realize the full amount of budgeted solutions. In the months following March 1, the Legislature would have the opportunity to review routine budget change proposals for departments, adopt clean-up legislation needed to clarify elements of this complex budget package, and consider alternative budget-balancing solutions in case voters reject the June ballot measures.

The Legislature Faces Many Critical Decisions in the Coming Weeks. If the Legislature chooses the Governor's proposal as a starting point, there are still a number of critical questions to be addressed, such as the Legislature's preferred mix of spending cuts and revenue increases, the amount of authority to be devolved to the administration in the form of unallocated or unspecified reductions in some departmental budgets, and what actions (if any) to put before the voters in a June special election. Also, although the Governor's proposal contains many new ideas, there are a significant number (such as those proposed in Medi-Cal) that the Legislature has previously considered and rejected. The Legislature will need to consider if a change of approach to these proposals is appropriate at this time or whether there are alternative actions that it prefers. In the coming weeks, we will work to provide additional guidance on the Governor's proposals and, where appropriate, offer alternatives to them.

ECONOMICS, REVENUE PROJECTIONS, AND TAX PROPOSALS

The Governor's budget package includes the administration's forecast of national and state economic activity and state revenues—including its tax increase and other revenue proposals. (We refer to the forecast of state revenues without the Governor's revenue proposals as the "current-law" revenue forecast.) This section first discusses the economic and current-law revenue forecast of the administration. Next, it describes the Governor's major revenue proposals.

Economic and Revenue Forecast

Economic Forecast

Current Modest Recovery Forecasted to Continue. The administration's new economic forecast assumes continuation of the currently modest economic recovery, including ongoing actions of the Federal Reserve—through its support of low interest rates and a policy known as "quantitative easing"—to support the recovery. As shown in

Figure 3, the administration's January 2011 economic forecast is more pessimistic than our office's May 2010 forecast, upon which the revenue estimates in the October 2010 state budget were based. The budget's 2011 forecast reflects the economy's generally disappointing performance in 2010 and is quite consistent with the economic forecast our office released in our November 2010 publication, *California's Fiscal Outlook.*

Economic Forecast for 2011 May Be Too Pessimistic. In December 2010, Congress enacted a major tax and unemployment benefits measure. Among other actions, this federal measure extended federal income tax cuts adopted during the prior presidential administration, as well as long-term unemployment insurance benefits. These actions appear to be reflected in the administration's new economic forecast. The administration notes, however, that its forecast does *not* consider the new payroll tax relief, one component of the recent federal legislation. This omission occurred because much of the administration's work on the forecast had to be completed prior to passage of the federal legislation. As shown in Figure 3, the most recent U.S. economic forecast of IHS Global Insight, a national forecasting firm, projects significantly more robust growth in 2011 due in part to the federal tax measure. Currently, our office's national economic outlook aligns more with that of IHS Global Insight. Accordingly, there appears to be some upside for the national economy in 2011. Since California's economy generally rises or fall with the U.S. economy, this upside has the potential to affect state revenues positively in 2010-11 and 2011-12.

2012: Modest Recovery and Continued High Unemployment. For 2012, as Figure 3 shows, the administration's new national economic forecast tracks closely with that of IHS Global Insight. The feared "double-dip" recession now seems quite unlikely. Like our office's recent outyear forecasts, however, the administration's forecast assumes that the economic recovery will continue to be modest and the state unemployment rate will remain above 10 percent for a prolonged period. Weak housing markets and the depressed level of home building also should remain major drags on the California

Figure 3

Comparing Governor's Economic Projections With Recent Forecasts

	2011			2012		
	LAO Forecast—May 2010[a]	Governor's Budget Forecast—January 2011	IHS Global Insight—January 2011	LAO Forecast—May 2010	Governor's Budget Forecast—January 2011	IHS Global Insight—January 2011
United States						
Percent change in:						
Real Gross Domestic Product	3.0%	2.2%	3.2%	3.1%	2.9%	2.9%
Employment	2.0	1.0	1.4	2.7	1.8	2.0
California						
Percent change in:						
Personal income	4.4	3.8	NA	4.4	4.0	NA
Employment	0.9	1.5	NA	1.5	2.5	NA
Housing permits (thousands)	70	74	NA	93	122	NA
Unemployment rate (percent)	11.9	12.1	NA	10.9	11.3	NA

[a] The assumptions for state revenue adopted in October 2010 in the *2010-11 Budget Act* were derived from our office's May 2010 economic and revenue forecast.

NA = Not applicable. IHS Global Insight does not produce state-level forecast information of this type.

economy. All of these factors are likely to depress consumer confidence and, therefore, the willingness and ability of individuals and firms to spend and invest for some time. California's elected leaders cannot count on the near-term budgetary problems of state and local governments to be solved by a rebounding economy.

Current-Law Revenue Forecast

Current-law revenue forecasts project receipts of taxes and other revenues, without incorporating proposed tax changes. The administration develops a current-law revenue forecast as part of its budget development process.

2010-11. The administration now forecasts current-law General Fund revenues and transfers of $90.7 billion in 2010-11. This is up by $3.7 billion (4.2 percent) from 2009-10 revenues, but down by $3.5 billion (3.7 percent) from the revenue forecast adopted with passage of the state budget in October 2010. This $3.5 billion decrease from the 2010-11 budget act assumptions—including a $1.7 billion decreased assumption for personal income tax (PIT) revenues—includes:

- A $782 million decrease due to recent federal tax changes resulting in the loss of all planned estate tax revenues in 2011 and 2012.
- About $400 million of decreased state revenue in 2010-11 due to expected changes in taxpayer behavior as a result of the recent federal tax legislation. The Governor's budget proposal assumes that taxpayers delayed realizing some capital gains, dividend, and other income from 2010 to later due to the extension of lower tax rates for these items.
- Around a $400 million decrease resulting from Proposition 22's prohibition of the state borrowing of funds from certain transportation accounts.
- Various technical adjustments, including updated assumptions concerning accruals of revenues to particular fiscal years.

The bulk of the remainder of the decrease in 2010-11 current-law revenues probably results largely from the new economic forecast. It appears that these forecast-related differences represent a relatively small portion of the $3.5 billion decrease.

2011-12. In the current-law revenue forecast for 2011-12, General Fund revenues and transfers drop from forecasted 2010-11 levels by $7.2 billion (7.9 percent) to a total of $83.5 billion. This decline reflects the scheduled expiration in current law of temporary increases in sales and use taxes (SUT), PIT, and VLF that were adopted by the Legislature in February 2009.

The administration's SUT estimate for 2011-12 is $1.3 billion lower than our November 2010 state budget forecast, but $1.1 billion of this difference results from the administration's treatment of the 2010 "fuel tax swap" in its forecast. The swap eliminated General Fund sales taxes on gasoline, but our November forecast assumed the swap would end in November 2011 due to the passage of Proposition 26. By contrast, the administration makes no such assumption in its current-law forecast. Furthermore, the Governor's budget package proposes that the Legislature "re-enact" the swap with a two-thirds vote. Accordingly, if one excludes the fuel tax swap, the administration's current-law forecast is very similar to our November forecast for SUT.

LAO Comments

Administration's Economic Forecast May Be Too Pessimistic for 2011. As described above, the effects of the recent federal tax legislation, among other factors, cause us to be somewhat more optimistic than the administration about the course of the national economy in 2011. The various

federal tax cuts, including the payroll tax, and the extended unemployment benefits seem likely to have a stronger near-term stimulative effect on economic activity than reflected in the Governor's budget forecast. This, in turn, should promote stronger economic activity in California in 2011. As shown in Figure 3, the administration's forecast for U.S. gross domestic product growth in 2011 is about 1 percentage point below that of some other forecasters. As a rule of thumb, a 1 percentage point increase in national economic growth translates roughly to similar growth in the state economy and revenues.

Initial Impression: Revenue Forecast Is Reasonable. For 2009-10, 2010-11, and 2011-12 combined, our initial assessment is that the administration's revenue forecast is reasonable. Our early impression is that there is somewhat more potential for an "up side" to the revenue forecast than a "down side."

In 2010-11, monthly "agency cash" revenues from the General Fund's "Big Three" taxes (PIT, SUT, and corporation tax [CT]) are about $1 billion above the administration's monthly forecast through December 2010. Recently, PIT withholding—largely derived from wages and salaries—has been running more than 10 percent above the same months from 2009. Sales taxes also have been performing reasonably well. We are optimistic that these trends will continue for the rest of the fiscal year. Balancing this optimism, however, is the weak performance to date of CT revenues—$355 million (8.9 percent) below the 2010-11 forecast through December—and our uncertainty that estimated PIT payments will meet monthly targets over the next six months.

For 2011-12, our initial impression is that the current-law revenue forecast appears reasonable. While the administration's overall economic forecast is cautious, the budget package also assumes the resumption of significant growth in net capital gains by taxpayers—an increase of 29 percent in 2011 and 24 percent in 2012. The huge amount of accumulated capital losses by investors resulting from the implosion of financial, housing, and other asset markets in recent years makes it particularly difficult to rely on such positive capital gains assumptions for purposes of budgetary planning. Moreover, an enormous stock of corporate net operating losses—carried forward from prior years, but unable to be used by firms through tax year 2011 due to provisions included in recent budgets—makes us somewhat cautious about the 2011-12 baseline CT forecast as well.

Governor's Revenue Proposals

The key feature of the Governor's revenue proposals is his request that the Legislature place before voters in June 2011 measures that would extend for five years the four temporary tax increases approved in February 2009:

- A 0.25 percentage point increase in each of the state's basic marginal rates for the PIT, which would be extended to apply to tax years 2011, 2012, 2013, 2014, and 2015.
- An extension (as above, for tax years 2011 through 2015) of the temporary reduction of the PIT dependent exemption credit to the same level as the personal exemption credit. (For the 2010 tax year, the personal exemption credit was $99. Prior to the temporary tax increases, the dependent exemption credit was $309.)
- An extension of the 1 percent SUT rate increase for fiscal years 2011-12 through 2015-16. This would maintain the state General Fund's share of the total tax rate at 6 percent.
- An extension of the 0.5 percent VLF increase for fiscal years 2011-12 through

2015-16, maintaining the rate at 1.15 percent.

Increased Revenues for General Fund and Proposed Local Realignment Funds

$9.6 Billion More Revenues and Transfers for General Fund Over Two Years. As shown in Figure 4, the Governor's budget package would increase General Fund revenues and transfers by $9.6 billion over 2010-11 and 2011-12 combined. Of this $9.6 billion, about $5.2 billion ($1.9 billion in 2010-11 and $3.3 billion in 2011-12) consists of revenue from the proposed extension of the two temporary PIT increases described above. The Governor also proposes that the Legislature enact two measures that would primarily increase CT revenues, but also would increase payments by certain PIT filers. These two measures would: (1) replace the optional single sales factor method for apportioning a multistate or multinational firm's taxable income to California with an apportionment method that would require companies to use the single sales factor method and (2) eliminate tax credits for certain investments made in enterprise zones. Combined, these two proposals would increase General Fund revenues by $811 million in 2010-11 and $1.5 billion in 2011-12. The administration's General Fund estimates also assume $1.4 billion of new loans, transfers, or loan extensions from state special funds over the two fiscal years, a $362 million loan to the General Fund from the Unemployment Compensation Disability Fund to pay the state's unemployment insurance loan interest obligations to the federal government, and several other smaller revenue measures.

$5.9 Billion for Proposed Local Realignment Funds in 2011-12. Under the Governor's proposal, voter approval to extend the temporary tax increases also would provide $5.9 billion of SUT and VLF funds for the proposed local government realignment funds—outside of the General Fund—in 2011-12. Over the five-year extension,

Figure 4

Governor's Proposals Increase General Fund Revenues and Transfers by $9.6 Billion Over Two Years

(In Billions)

	2010-11			2011-12		
	Administration's Current-Law Forecast	Governor's Proposals	Total Forecasted Revenues	Administration's Current-Law Forecast	Governor's Proposals[a]	Total Forecasted Revenues
Personal Income Tax	$45.5	$2.3	$47.8	$46.2	$3.6	$49.7
Sales and Use Tax	26.7	—	26.7	24.1	—	24.1
Corporation Tax	10.8	0.7	11.5	9.7	1.2	11.0
Subtotals, "Big Three"	($83.0)	($3.0)	($86.0)	($79.9)	($4.8)	($84.8)
Insurance Tax	$1.8	—	$1.8	$2.0	—	$2.0
Vehicle license fee[b]	1.5	—	1.5	0.2	—	0.2
Sales of fixed assets	1.2	—	1.2	—	—	—
Other revenues	2.3	—	2.3	2.2	$0.1	2.3
Net transfers and loans	1.0	$0.5	1.4	-0.8	1.2	0.5
Total Revenues and Transfers	**$90.7**	**$3.5**	**$94.2**	**$83.5**	**$6.1**	**$89.7**

[a] Does not include proposed $4.5 billion of increased sales and use tax and $1.4 billion of vehicle license fee revenue, which would be deposited to local realignment funds—not the General Fund.

[b] Revenues for 2011-12 consist of late receipts of prior years' fees payable to the General Fund.

these amounts would be expected to grow. The administration's forecast assumes that the SUT and VLF amounts grow to $7.3 billion in 2014-15.

Estimates on Budget Proposals Incorporate New Accrual Method. Generally, the state operates under an "accrual" accounting system that requires recognition of revenues and expenditures to the fiscal year in which they are realized. The administration's budget package estimates 2010-11 and 2011-12 revenues from its PIT and CT proposals with a new budgetary accrual technique that accrues a portion of final payments to the prior fiscal year. Such final payments previously have been accrued to the same fiscal year in which they are received. The new accrual method increases estimated General Fund revenues in 2010-11 and 2011-12 (combined) by $860 million. By changing year-over-year revenue growth, this method may affect calculation of the Proposition 98 minimum funding guarantee. There may be legitimate accounting reasons to adopt the new approach, but additional justification from the administration is needed.

LAO Comments

Basing Budget Plan on June 2010 Election Obviously Carries Some Risk. With a two-thirds vote of each house, the Legislature would have the option of approving extensions of the temporary tax increases without resorting to a vote of the people. The Governor, however, proposes submitting the temporary tax increase measures to voters. These proposed temporary tax increases provide over $11 billion of the Governor's proposed $26 billion in budget solutions. The proximity of the proposed early June 2010 special election date with the Legislature's June 15 deadline for enacting a balanced budget highlights the risks inherent in this approach. Should voters reject the measure, the Legislature would have to ensure that alternate budget-balancing measures were promptly put into place.

Large Elements of Governor's Tax Proposals Are Sound, Policy-Based Proposals. In prior publications and legislative testimony, we have voiced support for enactment of several of the Governor's key revenue proposals:

- Adoption of a mandatory single sales factor apportionment method for the income of multistate and multinational firms.
- Elimination of enterprise zone tax credits.
- Reduction of the PIT dependent exemption credit to the same level as the personal exemption credit.
- Adoption of a VLF rate of around 1 percent—similar to the base tax rate for other property.

We recommend that the Legislature either approve these proposals and enact them into law or, as the Governor suggests for the temporary tax measures, submit a request to voters to approve the increases.

Temporary PIT and SUT Rate Increases Merit Consideration. The proposed extension of the temporary increases in the PIT and SUT rates poses more difficult issues. The current rates are some of the highest in the nation, and the continuation of the rates would affect the work and investment decisions of many individuals and firms. On the other hand, as temporary increases, they would have less negative impacts on economic planning and decision making than permanent ones. More importantly, adoption of the proposed temporary tax extensions would "buy time" for the Legislature to develop additional ongoing solutions in future years while delaying additional cuts on top of the billions of dollars in permanent spending reductions already proposed by the Governor. Accordingly, we think that the Governor's proposed tax extensions (or something similar) merit serious consideration.

STATE-LOCAL REALIGNMENT

Major Proposals

Major Realignment of State-Local Programs. A centerpiece of the Governor's budget proposal is a major realignment of program duties, similar to the plan enacted by the state in 1991. In short, the Governor's plan raises $5.9 billion in taxes, and shifts $5.9 billion to counties to implement increased program obligations. To enable counties to manage their increased fiscal responsibilities, the administration proposes giving them increased authority over the realigned programs.

Although much of the Governor's proposal makes sense, certain key elements—including the extent of county program authority and the methodology for allocating funds—still are under development. As such, the Legislature will have much work to do in reviewing the proposal, shaping it to meet its policy objectives, and potentially placing a funding measure before the state's voters in June.

Proposed Revenues. Under the plan, the state's voters would decide whether to extend by five years two tax increases due to expire on June 30, 2011: a one cent sales tax and the 0.5 percent VLF General Fund rate. If the voters approve these tax extensions, the revenues would be dedicated to implementing the realignment plan. After the taxes expire in 2016, the state would be responsible for providing local governments with replacement revenues, but these revenues are not specified in the plan. If voters do not approve the proposed tax extensions, the realignment plan would not be implemented. The administration indicates, however, that it would continue with its plans to shift to counties the responsibility for certain lower-level adult and juvenile offenders. The administration indicates that it did not include the $5.9 billion realignment revenues in its calculation of Proposition 98's minimum funding guarantee because the new realignment revenues would be allocated to counties, not the state.

Multiyear Approach. Parts of the administration's proposed realignment are phased in over time. For example, the community supervision responsibilities sent to counties would expand over time as more state inmates were released from prison. The administration estimates that counties would be responsible for about 18,500 parolees in the budget year, growing to 66,900 upon full implementation in 2014-15. In addition, the Department of Forestry and Fire Protection (CalFire) would continue to provide fire protection and medical emergency response until local governments assumed these responsibilities. During the first years of this realignment plan, therefore, some of the realignment revenues would be allocated to the state to pay for its costs to continue operating the realigned programs.

The administration also indicates that it plans to propose in the future a second realignment ("Phase 2") mainly involving health care and social services.

Key Issues

Concept of Re-Sorting Program Responsibilities Makes Sense. Several times over the last 20 years, the Legislature has achieved notable policy improvements by reviewing state-local program responsibilities and taking action to realign program and funding responsibility to the level of government likely to achieve the best outcomes. In 1991, for example, the Legislature shifted state mental health responsibilities to counties, giving counties a more reliable funding stream and the authority to develop innovative and less costly approaches to providing services. While implementation of realignment proposals has been complex, the net result of these changes is that California

state and local governments have better ability to implement their programs successfully.

Could the state improve other program outcomes by further realigning state-local responsibilities? If so, which programs should the state control and which should local government control? While there is no single "right" answer to these questions, we find that programs tend to be more effectively controlled by local government if (1) the program is closely related to other local government programs, (2) program innovation and experimentation are desired, and (3) responsiveness to local needs and priorities is important. In addition, assigning full control over program governance and financing to a single level of government has the benefit of reducing fragmentation of government programs and focusing accountability for program outcomes. The Legislature will need to carefully assess these issues in crafting realignment proposals, as once implemented, they can be very difficult to modify. (The nearby box lists LAO reports that provide a more extensive discussion of program realignment.)

Most of the Programs in the Administration's Plan Make Sense. Figure 5 (see next page) summarizes our initial review of the programs proposed for inclusion in the administration's realignment plan. Most of the programs we list in the first group ("Programs Suited for Realignment") are ones that this office previously has proposed for realignment to local government. In our view, decentralized program delivery and authority could promote program innovation, efficiency, and responsiveness to local conditions, and these potential program benefits outweigh whatever benefits are realized from the programs being uniformly administered at the state level.

Very few programs in this first group, however, could be realigned without addressing some significant legal or policy issues. Most notably, in the case of the administration's plan to realign Child Welfare Services, the Legislature would need to address how a decentralized system could work with a federal government that sets regulations, oversees program performance, and assesses state penalties when performance is inadequate.

LAO Realignment Reports

Over the years, our office has published numerous reports (see list) on the subject of state and local program realignments. With one exception, all of the reports were published in "Part V" of the *Perspectives and Issues* in February of the year shown. *Making Government Make Sense: Applying the Concept in 1993-94* was published separately in May 1993. These reports are available on our website: www.lao.ca.gov.

Report	Years
Parole Realignment and the 2008-09 Budget	2008
Realignment and the 2003-04 Budget	2003
Realignment Revisited: An Evaluation of the 1991 Experiment In State-County Relations	2001
The Governor's 1995-96 State-County Realignment Proposal	1995
Making Government Make Sense: Applying the Concept In 1993-94	1993
Making Government Make Sense: A More Rational Structure For State and Local Government	1993

In addition, one program in this first group—AB 3632 Services—merits realignment, but not in the manner proposed by the administration. Instead, schools should have programmatic and financial responsibility for this program providing mental health services to special education pupils. While schools may wish to contract with county mental health departments to provide these programs, the primary fiscal and program responsibility should reside with schools.

Realigning Some Programs Merits Careful Review. The second group of programs in Figure 5—the Early and Periodic Screening, Diagnosis and Treatment Program (EPSDT), Mental Health Managed Care, Substance Abuse Treatment, and Existing Community Mental Health Services—merit careful legislative consideration for several reasons. First, the administration proposes to use Proposition 63 funds to pay the first year costs of the three of these programs (EPSDT, Mental Health Managed Care, and AB 3632), a use of this measure's funds that may not be permissible.

Second, realigning EPSDT, Mental Health Managed Care, and Substance Abuse Treatment raises questions regarding program flexibility and the implementation of federal health care reform. Realigning these programs appears appropriate because it would consolidate related pots of money for behavioral (substance abuse and mental health) services. These changes could allow counties to spend these funds more flexibly and better coordinate mental health services with other county-run programs, such as a realigned drug and alcohol treatment system and rehabilitation programs for criminal offenders. At the same time, however, we note that federal health care reform expands the number of persons eligible to receive Medi-Cal mental health services beginning in 2014. Consolidating behavioral health programs with counties could limit the state's options for better coordinating mental health services with other

Figure 5

Which Programs Are Suited for Realignment?
LAO Initial Review of Governor's 2011-12 Realignment Plan

(In Millions)

	2011-12	2014-15
Programs Suited for Realignment		
Fire and Emergency Response Activities	$250	$250
Local Public Safety Programs	506	506
Local Jurisdiction for Lower-Level Offenders and Parole Violators[a]	1,802	908
Adult Parole to the Counties[a]	741	410
Juvenile Justice Programs	258	242
Adult Protective Services	55	55
AB 3632 Services[b]	—	104
Foster Care and Child Welfare Services	1,605	1,605
Program Meriting Consideration		
Substance Abuse Treatment	184	184
Early and Periodic Screening, Diagnosis and Treatment Program[b]	—	579
Mental Health Managed Care[b]	—	184
Existing Community Mental Health Services	—	1,077
Program Not Suited for Realignment		
Court Security	530	530
Unallocated Revenue Growth	—	621
Totals (Administration Estimates)	**$5,931**	**$7,255**
1% Sales Tax	$4,549	$5,567
0.5% Vehicle License Fee	1,382	1,688
Total Revenues (Administration Estimates)	**$5,931**	**$7,255**

[a] Costs decline by 2014-15 as state reimbursements end. Funding in 2014-15 assumes this program is fully county operated and at lower costs.
[b] First-year costs for this program are paid from Proposition 63 resources.

Medi-Cal services across the state. Thus, although this office previously has recommended realigning most behavioral health programs to counties, we recommend the Legislature consider these factors before including these programs in the realignment plan.

Finally, the last program in this category includes all mental health services funded under the 1991 realignment plan. The administration proposes to include these programs within its 2011 realignment plan—and allow use of the mental health funds from the 1991 realignment plan for other purposes. Because very few details regarding this change are available, we cannot assess the merits of this component of the plan.

Court Security Shift Is Problematic. While the state is now responsible for the operations of the trial courts, current law requires that security for the trial courts generally be provided by county sheriffs at a cost to the state. Under the administration's realignment plan, state funding to pay for security for trial courts would be shifted to counties and state General Fund support in the judicial budget for court security would be reduced by a commensurate amount. In our view, this approach does not make sense. While control of funding for court security would be shifted to counties, the state judicial system would continue to be responsible for the overall operation of the courts. Absent financial control, the courts would have difficulty ensuring that the sheriffs provided sufficient security measures. We believe a better and more cost-effective approach would be to (1) clarify that the state is responsible for trial court security and (2) adopt a separate state law change authorizing the state to use competitive bidding by various private or public entities, including sheriffs, for the provision of these security services.

Need to Address Local Concerns. Given the requirements of the California Constitution and voter-approved measures, enacting realignment would require achieving a broad consensus among many parties. Achieving this broad consensus within the timeframe to prepare a measure for the June ballot will be difficult. Counties are likely to have many questions about the source of revenues to replace the sales tax and VLF in five years, the extent of program authority that will be transferred to counties, the initial program funding levels, the potential for future state increases in county program requirements, and whether the rate of realignment revenue growth will match the rate of program growth.

Fiscal Estimates Require Further Review. Although most of the administration's estimates regarding the fiscal impact of the proposed realignment programs appear reasonable, some of the estimates require further examination. For example, our preliminary review indicates that the administration may be double counting certain savings associated with shifting adult and juvenile offenders to counties. That is, the administration scores the same savings twice—in the realignment plan and as part of the department's budget. Our preliminary review also indicates that the realignment plan understates the cost of the AB 3632 program by up to about $200 million.

Alternatives

Could the Legislature Change the Mix of Programs? There is no perfect list of programs to realign. The Legislature could modify the Governor's proposed list of programs to meet its policy objectives. In considering alternative programs for inclusion in realignment, we recommend the Legislature:

- Focus on programs where innovation, responsiveness to community interests, and efficiency are paramount.
- Avoid programs where statewide uniformity is important, where statewide benefits

are the overriding concern, or where the primary purpose of the program is income redistribution.

Our initial review suggests that there are other programs to consider for realignment. For example, the Legislature could consider realigning pharmaceutical costs for Medi-Cal patients receiving specialty mental health services to the counties, thereby ensuring that all costs for providing services to patients are consolidated. It could also consider going back to the voters to allow the permanent realignment of all Proposition 63 funding to counties, along with increased flexibility in the use of these funds. Finally, the Legislature could consider realigning funding and responsibility to the counties to provide treatment to persons determined by the courts to be incompetent to stand trial for criminal offenses. We will continue to explore these and other options.

Could the Legislature Change the Scale of Realignment? Realignment, implemented correctly, can improve the management and delivery of programs. For this reason, we believe the Legislature's decision to realign a program should focus on program policy objectives—not simply on raising a specific amount of revenues. To that end, we recommend that the Legislature begin its work by identifying programs that would benefit from realignment. Should the Legislature determine that it wishes to raise *more* revenues than it wishes to realign programs, we recommend the Legislature avoid adding programs to the realignment package that are inconsistent with the concept of realignment—or programs over which the Legislature is unwilling to grant counties greater control.

Conversely, should the Legislature determine that it wishes to raise *fewer* revenues than it wishes to realign programs, we recommend the Legislature avoid deleting programs from the realignment package. Instead the Legislature could finance the realignment plan, in part, by redirecting existing state or local revenues.

Is it Possible to Implement Realignment Without Raising Taxes? While realignment often is associated with tax increases, it need not be implemented that way. Although it would be difficult in light of the state's fiscal difficulties, the Legislature could enact realignment by earmarking a portion of *existing* state revenues as the dedicated revenues for realignment.

Addressing Legal Complexities in State Ballot Measure. The administration's plan will require considerable work by the Legislature to sort through many legal, financial, and policy issues. Certain voter-approved measures also will constrain the Legislature's authority to shift program responsibilities to counties and redirect the use of mental health funds. For example, Proposition 63 may not permit the proposed shifts in mental health funds. In addition to requesting voter approval for any proposed tax increase, the Legislature also may wish to request voter approval of these elements of the realignment plan.

REDEVELOPMENT

Major Proposals

Shift Responsibility for Local Economic Development. The administration proposes a substantive shift in responsibility for local economic development programs. The budget phases out state authorization for two economic development programs: redevelopment (discussed below) and enterprise zones (discussed previously). To give communities greater capacity to promote economic development, the administration indicates that it will support a constitutional amendment to allow local voters to approve tax increases and general obligation bonds for these purposes by a 55 percent majority.

Phase Out Redevelopment. For more than 50 years, state law has authorized cities and counties to create redevelopment agencies. The administration proposes to revise these laws to (1) dissolve the state's 425 redevelopment agencies and (2) transfer their revenues (primarily, over $5 billion of annual property tax revenues) to local successor agencies. The successor agencies would use these funds to retire redevelopment debts and contractual obligations and make other payments described below. The successor agencies also would shift any unspent redevelopment housing funds to local housing authorities to use for low- and moderate-income housing.

Use of Funds in First Year. In 2011-12, the successor agencies would use the redevelopment revenues to:

- Pay redevelopment debts and obligations, estimated by the administration to cost $2.2 billion.
- Offset $1.7 billion of state Medi-Cal ($840 million) and trial court ($860 million) costs.
- Allocate $1.1 billion to schools and other local agencies pursuant to current laws that require redevelopment agencies to "pass through" some of their funds to affected local agencies.
- Distribute $210 million to cities, counties, and special districts in proportion to these agencies' current shares of the property tax.

Use of Funds in Future Years. Beginning in 2012-13, any property tax revenues remaining after the successor agencies pay redevelopment debt would be distributed to other local governments in the county. Distributions of these revenues generally would follow provisions in existing law, except that:

- The additional K-14 district property taxes would augment their existing state funding (not offset state education spending) and would be distributed to districts throughout the county based on enrollment.
- The property taxes that otherwise would be distributed to enterprise special districts would be allocated instead to counties. (These districts primarily are fee-financed water and waste disposal districts.)

Key Issues

Proposal Has Merit . . . Shifting responsibility for local economic development to local governments makes sense. Local communities are in the best position to determine the types of programs and assistance needed to promote development in their communities. Ending state-assisted local economic development programs like redevelopment also makes sense. Redevelopment projects divert property taxes from K-14 districts, increasing state education costs by billions of dollars annually. The state's costs associated with redevelopment has grown markedly over the last couple decades, yet we find no reliable evidence that this program improves overall economic development in California. Finally, recent passage of Proposition 22 limits the Legislature's authority to modify the scope of redevelopment to reduce its costs on the state or local agencies.

. . . But Faces Considerable Implementation Issues. The administration's plan will require considerable work by the Legislature to sort through many legal, financial, and policy issues. Several voter-approved constitutional measures, for example, constrain the state's authority to redirect redevelopment funds, use property tax revenues to pay for state programs, or impose increased costs

on local agencies. In addition, the administration's plan does not address many related issues, such as clarifying the future financial responsibility for low- and moderate-income housing (currently, a redevelopment program).

Redevelopment Debt Costs May Be Understated. Although the administration's approach to estimating the annual cost of redevelopment debt is reasonable, their assumptions regarding debt terms, interest rates, and other factors err on the side of *understating* debt costs. Our initial review indicates that the annual cost to pay these debts could be $1 billion or more higher than the administration assumes. If our initial review is correct, this would reduce the funds available for other purposes. For example, the Legislature may not be able to use $1.7 billion of these revenues for state programs *and* make $1.1 billion in pass-through payments to local governments.

Rationale for Increased School Funding Not Clear. The rationale for providing school districts with property tax revenues *in addition to* their existing property taxes is not clear. The administration's proposal does not devolve more responsibilities to school districts. The distribution of these additional school property tax revenues would be uneven throughout the state, with schools in 15 counties (where there is little or no redevelopment) not getting additional property taxes and schools in counties (where there is extensive redevelopment activity) receiving significant sums. The distribution of these new property tax revenues further complicates an already complicated school finance system.

Need to Pause New Redevelopment Activities. Developing the statutory measures to implement this important, but complex, proposal will take considerable work by the Legislature. During this time—potentially several weeks or months—it is possible that redevelopment agencies could take actions that increase their bonded indebtedness and contractual obligations. If so, these new financial obligations could constrain the state's ability to redirect redevelopment revenues and to realize the state savings and local benefits anticipated in the administration's proposal. Accordingly, we recommend that the Legislature pass urgency legislation as soon as possible prohibiting redevelopment agencies—during this period of legislative review—from taking actions that increase their debt. Specifically, the urgency legislation would prohibit redevelopment agencies from (1) taking on any new debt that would be included on their Statement of Indebtedness—the statement that identifies redevelopment agency debt and makes the agency eligible for property tax revenues, or (2) creating, amending, or extending any redevelopment project areas. This approach would preserve the Legislature's options as it reviews the administration's proposal, but would not have a lasting effect on redevelopment agencies if the Legislature elects not to adopt it.

EXPENDITURE PROPOSALS

Proposition 98

Major Proposals

Proposition 98 funds K-12 education, child care, the California Community Colleges (CCC), and various other state agencies (including the state special schools and juvenile justice). The Governor's budget reduces total Proposition 98 spending by less than 1 percent from the current year to the budget year. As shown in Figure 6, K-12 funding would change negligibly from 2010-11 to 2011-12. By comparison, CCC funding would be reduced $361 million or 6.3 percent. The Governor's Proposition 98 plan includes no cost-of-living-adjustments but funds enrollment growth for

K-12 education (0.22 percent) and CCC (1.9 percent). Below, we discuss Proposition 98 K-14 and child care issues in more detail. In the higher education section, we discuss various other community college issues (such as student fees) in more detail.

Assumes Tax Package Adopted, Funds Minimum Guarantee. The Governor's proposal funds Proposition 98 at the minimum guarantee in 2011-12. The proposed spending level assumes adoption of the Governor's tax plan to raise $4.8 billion in additional state General Fund revenues, primarily from the extension of higher personal income tax rates. These additional revenues increase the Proposition 98 minimum guarantee by $2 billion in 2011-12. Absent these additional revenues, the minimum guarantee would have fallen year over year whereas, with the additional revenues, the guarantee stays virtually flat. (The Governor's proposals to maintain higher rates for the sales tax and the vehicle license fee would not increase the Proposition 98 minimum guarantee since those revenues would flow directly to local governments for realignment.)

K-12 Programmatic Funding Declines Slightly Year Over Year. Under the Governor's plan, K-12 programmatic funding per student decreases by about $100 or 1.4 percent from 2010-11 to 2011-12. Most of the decline in K-12 per student funding is attributable to the loss of federal stimulus funding (though many districts reserved a significant portion of their federal education jobs funding for 2011-12, thereby mitigating the cliff effect). As shown in Figure 7 (see next page), K-12 per student programmatic funding in 2011-12 would be 6.4 percent lower than the 2007-08 level.

Figure 8 (see page 25) lists the budget's major Proposition 98 spending proposals for 2011-12, the most significant of which are discussed in more detail below.

Proposes Large New Deferrals. The most substantial component of the Governor's Proposition 98 plan consists of $2.2 billion in new inter-year deferrals from 2011-12 to 2012-13—$2.1 billion from K-12 revenue limit payments and $129 million from CCC apportionment payments. Although the administration has not yet determined from which months K-12 revenue limit payments would be deferred, it has indicated that deferrals likely would not be repaid until September or October of 2012. For community colleges, the

Figure 6

Proposition 98 Funding

(Dollars in Millions)

	2009-10 Final	2010-11 Revised	2011-12 Proposed	Change From 2010-11 Amount	Change From 2010-11 Percent
K-12 Education					
General Fund	$31,732	$32,239	$32,401	$162	0.5%
Local property tax revenue	12,328	11,557	11,406	-152	-1.3
Subtotals	($44,060)	($43,796)	($43,807)	($11)	(—)
California Community Colleges					
General Fund	$3,721	$3,885	$3,542	-$343	-8.8%
Local property tax revenue	2,000	1,892	1,873	-19	-1.0
Subtotals	($5,721)	($5,777)	($5,415)	(-$361)	(-$6.3%)
Other Agencies	$93	$85	$78	-$7	-8.7%
Totals, Proposition 98	**$49,874**	**$49,658**	**$49,300**	**-$358**	**-0.7%**
General Fund	$35,546	$36,209	$36,021	-$188	-0.5%
Local property tax revenue	14,327	13,449	13,279	-170	-1.3

deferral would be made from apportionment payments otherwise made in January through May of 2012 and also would likely not be repaid until September or October of 2012. (In addition to the *inter*-year deferrals, the Governor proposes to continue *intra*-year deferrals to help with the state's cash flow problems. The Governor's intra-year deferral plan would delay $2.5 billion in K-12 payments and $200 million in CCC apportionments beginning in July 2011, reflecting the same magnitude as the 2010-11 intra-year deferrals.)

Significantly Reduces Child Care Funding. The Governor proposes to achieve $750 million in Proposition 98 child care savings by making four major policy changes: (1) reducing child care subsidies by about 35 percent; (2) reducing income eligibility for subsidized child care from 75 percent to 60 percent of state median income (SMI), (3) eliminating subsidized child care for 11- and 12-year olds, and (4) reducing California Work Opportunity and Responsibility to Kids (CalWORKs) Stage 2 caseload based on CalWORKs reform proposals (discussed later in the report). With regard to the 35 percent rate reduction, the administration proposes providing local agencies discretion over how to translate lower subsidies into reduced payments to child care providers, with the expectation that child care slots and days of service remain the same. The savings resulting from these proposals would be offset by a $256 million increase to the CalWORKs Stage 3 program—reflecting a proposed restoration of an earlier budget act veto. After accounting for various other federal and state adjustments, the Governor's 2011-12 proposal would reduce total funding for Proposition 98-supported child care programs by about $652 million (29 percent) and child care slots by about 9,900 (3 percent) compared to 2010-11.

Proposes Various Other Changes. The Governor proposes a $400 million reduction to community college apportionments. In addition, the Governor reduces Proposition 98 funding for the Division of Juvenile Facilities by $8.7 million to reflect a three-year phase-out linked with his

Figure 7

K-12 Programmatic Funding[a]

(Dollars in Millions Unless Otherwise Specified)

	2007-08 Final	2008-09 Final	2009-10 Final	2010-11 Revised	2011-12 Proposed
Programmatic Funding					
K-12 ongoing funding[b]	$48,883	$43,215	$40,717	$42,945	$43,131
New payment deferrals	—	2,904	1,679	1,719	2,063
Settle-up payments	—	1,101	—	267	—
Public Transportation Account	99	619	—	—	—
Freed-up restricted reserves[c]	—	1,100	1,100	—	—
ARRA funding[c]	—	1,192	3,575	1,192	—
Federal education jobs funding[c]	—	—	—	421	781
Totals	**$48,982**	**$50,130**	**$47,070**	**$46,544**	**$45,975**
Per-Pupil Programmatic Funding					
K-12 attendance	5,947,758	5,957,111	5,933,761	5,951,826	5,964,800
K-12 per-pupil funding (in dollars)	**$8,235**	**$8,415**	**$7,933**	**$7,820**	**$7,708**
Percent Change From 2007-08	**—**	**2.2%**	**-3.7%**	**-5.0%**	**-6.4%**

[a] Excludes federal funds not associated with stimulus package, lottery, and various other local funding sources.
[b] Includes ongoing Proposition 98 funding, Proposition 98 accounting adjustments, and funding for the Quality Education Investment Act.
[c] Reflects LAO estimates of funds spent in each year.

realignment proposal and provides no funding authority for the state's student and teacher data systems pending a comprehensive review of the two projects. In contrast to the proposed reductions, the Governor proposes two notable K-12 augmentations. First, the Governor provides $90 million to cover the ongoing cost of about 35 K-14 mandates. Though this is the same level of support as provided in the current year, the state used one-time funds in 2010-11. Second, the Governor provides $43 million in ongoing funding (and $11 million in one-time funding) for the Emergency Repair Program. This program provides grants to low-performing schools to pay for school facility repairs that are needed for public health or safety reasons. (In response to a lawsuit, the state adopted statute specifying that it would provide a total of $800 million for the program. To date, the state has provided $338 million.)

Extends Flexibility Provisions Two Years. The Governor's plan also includes a two-year extension of existing K-14 fiscal relief options. For both school districts and community colleges, the Governor proposes to extend "categorical flexibility" from 2012-13 through 2014-15. (With this flexibility, school districts can use the funding associated with about 40 categorical programs for any educational purpose and community colleges can use the funding associated with about a dozen programs for any categorical-program purpose.) For school districts, the plan also would extend the existing K-3 Class Size Reduction (CSR) rules from 2011-12 through 2013-14. (These rules apply more modest funding reductions to K-3 classes that exceed 20 students.) Additionally, for school districts, the Governor proposes extending for two years the existing statutory provisions that reduce routine maintenance requirements, suspend deferred maintenance requirements, postpone instructional materials purchases, and lower unrestricted budget reserve requirements.

Eliminates the Office of the Secretary of Education (OSE). To help streamline the state's K-12 governance structure, the Governor's budget eliminates OSE. Eliminating OSE would result in non-Proposition 98 General Fund net savings of roughly $400,000 in the current year and $1.6 million in the budget year.

Figure 8

Major Proposition 98 Spending Changes

2011-12 (In Millions)

Proposed Changes	Amount
Backfill prior-year one-time K-14 actions	$2,167
Fund K-12 revenue limit cost increases	470
Make various other K-14 adjustments	96
Fund ongoing K-14 mandates	90
Fund Emergency Repair Program	43
Defer K-12 revenue limit payments	-2,064
Eliminate Special Disabilities Adjustment	-74
Make technical reduction to Economic Impact Aid	-54
Phase out Department of Juvenile Facilities funding	-9
Restore CalWORKs Stage 3 child care veto	256
Reduce child care subsidies by 35 percent	-577
Reduce child care income eligibility ceiling to 60 percent of SMI	-79
Eliminate child care eligibility for 11- and 12-year olds	-59
Reflect Stage 2 child care savings from CalWORKs reforms	-34
Reduce CCC apportionments	-400
Defer CCC apportionment payments	-129
Total Changes	**-$358**

SMI = state median income.

Key Issues

Magnitude of Cuts in Each Area Could Be Reexamined. In building his plan, the Governor reflected his priorities—largely to insulate

school districts from further cuts while notably reducing the state's child care programs and requiring a significant cut to the community colleges. In building its Proposition 98 package, the Legislature has many factors to consider, such as the different populations, needs, programmatic quality, and public benefits of K-12 education, community colleges, and child care. After weighing the associated trade-offs, the Legislature may want to consider distributing Proposition 98 reductions differently among the three areas.

Further Reliance on Deferral Raises Important Questions. The state's reliance on deferrals over the past several years has placed a large cash flow burden on school districts and community colleges. At existing levels, 16 percent of 2010-11 Proposition 98 program will be paid in 2011-12. Under the Governor's proposal, 20 percent of 2011-12 Proposition 98 program would be paid in 2012-13. Nonetheless, adopting deferrals would help mitigate the reductions that districts and community colleges otherwise would need to make in 2011-12. We are concerned, however, that additional deferrals would continue the deterioration of school district and community college fiscal health and could result in the need for state emergency loans to avoid insolvency. These deferrals would be especially problematic if, as indicated by the administration, they are not paid until the fall of 2012 (all existing deferrals are paid by August). The intra-year deferrals further exacerbate the situation—in essence deferring already-deferred payments until even later in the next fiscal year. Combined, the inter-year and intra-year deferrals could result in school districts and community colleges facing significant cash flow difficulties in the summer and fall of 2012.

Approach to Child Care Reductions Has Some Merit, Some Serious Flaws. We believe two of the Governor's child care proposals merit consideration whereas we have serious concerns with one of the proposals. Specifically, we think the Governor's proposal to lower the income eligibility ceiling to 60 percent of SMI is reasonable in that it targets services for the neediest families. Similarly, the proposal to lower the age limit merits consideration. While we know of no other state that limits subsidized child care to children 10 or younger (most states set maximum age at 12 or 13), California funds an extensive before and after school program in which slots could be prioritized for displaced 11- and 12-year olds. We have serious implementation concerns, however, with the proposed 35 percent across-the-board rate reduction. This proposal would result in a substantial reduction to provider rates that are already below federal guidelines, and it raises questions as to what quality of care such low payments would be able to purchase. Furthermore, ceding authority to local organizations (which are in most cases not public agencies) to implement the reduction by adjusting provider rates and family copayments in different ways likely would lead to further inconsistencies in the availability and quality of care.

Some Savings Potentially Unachievable. We believe that up to $128 million of the Governor's anticipated Proposition 98 savings cannot be realized. Specifically, the Governor assumes a $54 million technical reduction to the Economic Impact Aid (EIA) program given the program has not spent all budgeted funds in recent years. However, the state already has made substantial downward adjustments to EIA base funding amounts in recent years, and newly released data indicate very little of the 2010-11 appropriation will go unused. Combined with the projected growth in K-12 enrollment, this information suggests the Governor's estimates are overly optimistic. Additionally, the Governor assumes $74 million in savings due to the sunset of one component of the state's special education program known as the Special Disabilities Adjustment. We believe making

this reduction could violate federal maintenance-of-effort (MOE) requirements, in which case the state would need to continue providing the same amount of funding for some other special education purpose.

Alternatives for Legislative Consideration

Other Child Care Options Could Be Better Than Across-the-Board Reduction. After contemplating the desired mix of Proposition 98 reductions, the Legislature could consider a different combination of policy changes to realize child care savings. In making these changes, we recommend using the guiding principle of prioritizing services for the most needy families and children. The Governor's proposals to reduce income and age eligibility ceilings meet this criterion. To generate additional savings, the Legislature could further reduce eligibility below the proposed 60 percent of SMI and age ten. Other options the Legislature could consider in lieu of reducing subsidies by 35 percent include: more moderate, statewide reductions to provider rate ceilings for licensed and/or license exempt providers; increasing parental fees; and reducing the amount agencies receive for program administration and parental support.

Could Go Further in Providing More Flexibility, Improving School Finance System. While extending the flexibility provisions by two years provides additional fiscal relief to districts, the Governor's plan misses some opportunities to further expand flexibility. For example, as recommended last year, we continue to recommend the state extend flexibility to three of the state's largest stand-alone K-12 categorical programs—K-3 CSR, Home-to-School Transportation, and After School Safety and Education. We also continue to recommend consolidating career technical education programs and removing certain restrictions related to contracting out for noninstructional services as well as priority and pay for substitute teaching positions. Additionally, we continue to recommend linking categorical "flex" funding to average daily attendance, thereby assuring that the associated funding remains connected to students. We also think the Governor and Legislature could make more significant strides toward improving the K-12 school finance system by not merely extending the sunset for the existing flexibility provisions but by thinking about how to strategically redesign the state's K-12 school finance system such that it better serves districts and the public in both the short and long term.

Higher Education

Major Proposals

Sizable General Fund Reductions for All Segments. The Governor's budget includes unallocated $500 million General Fund reductions for the University of California (UC) and the California State University (CSU). The Governor intends that these reductions be achieved primarily by reducing instructional cost. The budget also includes a $400 million reduction in general purpose "apportionment" funding for the community colleges, and proposes unspecified changes in funding formulas.

Tuition Increases for All Segments. The UC and CSU have already approved tuition increases of 8 percent and 10 percent, respectively, for the 2011-12 academic year. Total tuition revenue for the universities is estimated to increase by about $400 million, supporting core programs and campus-based financial aid. The Governor proposes to increase community college fees from $26 per unit to $36 per unit, generating about $110 million in additional revenue that would in effect fund enrollment growth of almost 23,000 full-time equivalent (FTE) students.

Full Funding for Financial Aid Programs. Unlike his predecessor, the Governor proposes no reductions in existing financial aid programs. The budget proposal includes augmentations to fully cover

fee increases in the Cal Grant programs, and assumes full fee waivers at the community colleges covering more than one-half of all credit FTE students.

Major Financial Aid Fund Shift. The Governor's proposal would shift $947 million in Cal Grant costs from the General Fund to federal Temporary Assistance for Needy Families (TANF) funds. This fund swap would have no net effect on total funding for Cal Grants. As discussed later in the report, the TANF funds would be provided through an interagency agreement with the Department of Social Services, whose TANF funding would be freed up by the Governor's proposed cuts in CalWORKs.

Key Issues

University Cuts Needed, but Volatility an Issue. Volatility in public funding is one of the persistent challenges universities confront in managing their operations. The universities received a double-digit General Fund *augmentation* in the current year, followed by the Governor's even larger proposed *reduction* for 2011-12. Efforts should be made to smooth out these peaks and valleys, while still achieving needed General Fund savings.

Unclear How Segments Would Accommodate General Fund Cuts. Although the administration intends that the segments' General Fund reductions be achieved primarily through cost reductions and increased efficiency, the proposed budget package includes no language that would ensure such an outcome. In the past, the segments have responded to unallocated cuts in a variety of ways, including midyear tuition increases, enrollment reductions, and furloughs, as well as some efforts at increased efficiency.

Alternatives for Legislative Consideration

Shift Part of Universities' Cuts to Current Year. Rather than impose a $500 million cut for each university in the budget year, the Legislature may wish to achieve part of that savings by reducing the universities' current-year augmentations. Such an approach would smooth out the volatility of augmentations and cuts that would otherwise result. Evidence suggests that the universities were already preparing for smaller current-year augmentations prior to enactment of the budget in October. This alternative would bring the universities' current-year funding more into line with those contingency plans, and would preserve more funding for the segments to provide education services in the budget year. This would allow additional time for the state to seek alternative savings for the future, or for the segments to align their out-year costs with projected funding levels.

Ensure Reductions Meet Legislature's Expectations. The Legislature could amend the budget package to specify how the segments accommodate General Fund reductions. For example, it could specify the number of FTE students it expects the universities to enroll and the maximum tuition levels the universities should charge. To ensure compliance, General Fund appropriations could be tied to the meeting of these expectations. Similarly, the Legislature could specify whether it will permit CCC to reduce overall funded enrollment, and how it expects campuses to prioritize course enrollment. For example, the Legislature could limit the total number of taxpayer-subsidized credit units that students may earn at a community college.

Develop Longer-Term Fee Strategy for Community Colleges. The Governor's proposal to increase community college fees makes sense, because California's fees are by far the lowest in the country, and existing financial aid programs shield low- and moderate-income students from paying fees. Moreover, federal tax credit programs ensure that most fee-paying students will be reimbursed for the fees they pay, up to about $60 per unit. For this reason, the Legislature could increase fees

beyond the $36 per unit proposed by the Governor as a way of leveraging more federal funds to support CCC programs.

Cash Assistance

Major Proposals

SSI/SSP Grant Reduction. Effective June 1, 2010, the budget for the Supplemental Security Income/State Supplementary Program (SSI/SSP) proposes to reduce the maximum grant for individuals to the minimum required by federal law (from $845 per month to $830 per month). The revised grant would be approximately 92 percent of the 2010 federal poverty guideline. This proposal would result in General Fund savings of $15 million in 2010-11 and $177 million in 2011-12.

CalWORKs Grant Reduction. The Governor proposes to reduce CalWORKs grants by 13 percent effective June 1, 2011, resulting in General Fund savings of $14 million in 2010-11 and $405 million in 2011-12. For a family of three, this proposal would reduce maximum monthly grants from $694 to $604 in high-cost counties and from $661 to $575 in low-cost counties.

Repeal of July 2011 Changes. In 2009 the Legislature enacted a series of changes to sanction policies, time limits, and eligibility rules for CalWORKs. The Governor's budget proposes to delete these changes, resulting in a cost of about $135 million.

Establishment of a 48-Month Time Limit. In lieu of the 2009 CalWORKs changes, the budget proposes, effective July 1, 2011, to establish a 48-month time limit, applied retroactively, on the receipt of CalWORKs cash assistance for all recipients. This would apply to both adults and children, with narrow exceptions. Previous months of cash aid would count toward the 48-month limit, including months in which a recipient had been exempted from participation requirements or was temporarily disabled. However, children in families in which the adult was meeting federal participation requirements would be allowed to receive aid beyond 48 months. This proposal would result in savings of $833 million.

Continuation of Block Grant Reductions While Repealing Participation Exemptions. For 2009-10 and 2010-11, the Legislature reduced the county block grants for welfare-to-work services and child care by approximately $375 million each year. To help counties prioritize resources given this reduction in funding for CalWORKs services, budget legislation exempted families with a child under age two, or with two or more children under the age of six, from work participation requirements. Prior budget legislation also provided that, for any month for which a recipient has been excused from work participation requirements due to lack of support services, the case does not count toward the state's time limit for their receipt of cash aid. The Governor's budget proposes to continue a reduction of $377 million in county block grants while repealing the exemptions.

Figure 9 lists the proposed solutions for SSI/SSP and CalWORKs, totaling $1.7 billion.

Figure 9

Cash Assistance Programs Major Solutions

(General Fund Benefit, in Millions)

Program/Solution	2010-11	2011-12
SSI/SSP		
Reduce grants to the federal minimum	$15	$177
CalWORKs		
Establish 48 month-time limit	—	833
Reduce grants by 13 percent	14	405
Reduce county block grants	—	377
Repeal July 2011 sanctions and time limits	—	-135
Reduce age eligibility for child care	—	34
Subtotals (CalWORKs)	($14)	($1,514)
Totals	**$29**	**$1,691**

Key Issues

Minimal Budget Risk and No Loss of Federal Funds. The Governor's proposals warrant serious consideration by the Legislature, given that they provide $1.7 billion in budgetary savings that the state is likely to achieve with no loss of federal funds. This is because the CalWORKs federal block grant is fixed at $3.7 billion, and the federal portion of the SSI/SSP grant is not affected by the level of state supplementation. Due to the CalWORKs MOE requirement, about $530 million of the General Fund savings is achieved within the CalWORKs budget and about $950 million is achieved by transferring freed-up TANF funds (from the proposed programmatic reductions) to the Student Aid Commission to offset General Fund costs there.

Balancing the Need for CalWORKs Savings With Program Goals. The Legislature can control costs in CalWORKs through changes in eligibility rules, grant levels, and the availability of welfare-to-work services to assist recipients in becoming self-sufficient. The Governor's proposals impact all three areas. In considering these proposals, the Legislature faces a difficult balancing act. On the one hand, the Legislature must achieve savings because of the state's budget deficit. On the other hand, the policy goal of the Legislature in creating the CalWORKs program has been to (1) maintain a safety net for low-income families with children who cannot support themselves financially (especially during a deep recession); (2) encourage CalWORKs recipients to transition to self-sufficiency through work, education, and training; and (3) preserve a county delivery system committed to these goals. As it evaluates the Governor's budget reduction proposals, the Legislature should consider the trade-offs involved among these factors.

Grant Reduction: Pros and Cons. The grant reduction proposal has some merit in that it achieves significant budgetary savings while retaining some level of income maintenance for low-income families. Moreover, an increase in CalFresh benefits (formerly known as Food Stamps) partially offsets (about 22 percent) the grant reduction. For a family of three in a high-cost county, the combined grant and CalFresh benefits would drop from $1,155 to about $1,090 per month, or about 71 percent of the federal poverty level (FPL). However, we also note that the state has never reduced grants by more than 6 percent before. The proposed grant package would be the lowest level in decades relative to the FPL.

Block Grant Reduction Problematic Without County Flexibility. As noted earlier, the previously enacted two-year reduction in county welfare-to-work block grant funds was accompanied by additional exemptions from work participation requirements, which allowed counties to manage the reduction in funding. The Legislature should consider adopting similar work participation exemptions, or some other mechanism to allow counties more flexibility, if it adopts the proposed reduction in funding for these CalWORKs services.

The Impacts of the Proposed 48-Month Time Limit. The proposed 48-month time limit presents very difficult issues for the Legislature. Historically, the CalWORKs program has provided a safety net for children even when the parents have exhausted their allowable five years of assistance. Moreover, in the past, the Legislature explicitly provided that months when a family did not receive welfare-to-work services would not count toward their time limit. Under this proposal, about 115,000 families and 234,000 children would lose all benefits. They would be eligible for General Assistance, potentially resulting in a cost shift to counties in the hundreds of millions annually.

Research by the Public Policy Institute of California (PPIC) (focusing on a period when the economy was healthier) suggests that time limits with complete family benefit terminations do not significantly increase overall poverty rates among

children of single mothers. The PPIC study also suggested, however, that while enforcement of tighter time limits for aid would motivate some families to obtain work and move out of poverty, some families would likely end up poorer due to such a change. This study did not address retroactive application of time limits as the Governor proposes.

Alternatives for Legislative Consideration

Modifying the Earned Income Disregard. Under current law, California "disregards" (does not count) the first $225 of income and 50 percent of each dollar earned beyond $225 when calculating a family's monthly grant. This policy provides a work incentive for families. Savings in the range of $200 million annually could be achieved by simplifying the disregard to a flat 50 percent of all income earned.

Prospective and or Phased Implementation. If the Legislature wants to pursue a family benefit termination time limit, it could elect to adopt it prospectively, allowing current recipients some time to work their way off cash aid before hitting the time limit. Similarly, because the state has never reduced grants by more than 6 percent, the Legislature could phase in the 13 percent over two years. While these approaches would reduce the benefit to the General Fund from the Governor's proposal, they would still achieve a measure of savings that would grow over time.

Further Reductions to Welfare-to-Work Services. Another potential budget solution would be to increase the Governor's proposed reduction to county block grants in accordance with increased county flexibility or exemptions.

In-Home Supportive Services

Major Proposals

Additional Reduction in Hours for Services. The Governor's budget proposes to reduce authorized hours for all IHSS recipients by 8.4 percent to achieve state savings of $128 million in 2011-12. This across-the-board reduction would be in addition to a 3.6 percent reduction enacted as part of the 2010-11 budget. The budget assumes that an appeals process would allow 21,000 recipients to receive a full restoration of hours and 62,000 recipients to receive a partial restoration of hours.

Elimination of Domestic Services for Recipients in Shared Living Environments. Under current law, domestic services are reduced somewhat based on the number of persons in the household. The Governor's budget proposes to eliminate, with certain exceptions, domestic and related care services for recipients who live with others to save $237 million in 2011-12. Domestic and related care services include housework, meal preparation, meal clean-up, laundry, shopping, and errands.

Eliminate All Services for Recipients Without a Physician's Certificate. Lastly, the Governor proposes to eliminate from IHSS recipients who do not have certification by a physician that they need these services to prevent their placement in an institution, such as a nursing home. The budget assumes that 43,000 recipients (10 percent) will lose IHSS eligibility and that the state would save $121 million in the budget year.

Figure 10 (see next page) lists the proposed solutions for IHSS totaling almost $0.5 billion.

Key Issues

Legal Risks Exist. Any time services are reduced or eliminated, there is some risk of litigation asserting that the change puts recipients at risk of institutional placement, which could violate the U.S. Americans with Disabilities Act. The Governor has proposed several measures, such as the appeals process to restore domestic hours, to limit legal risks associated with these proposals. On the other hand, recent litigation in Washington State suggests that there is some legal risk for the proposals to eliminate domestic and related care services for

Figure 10

In-Home Supportive Services Major Solutions for 2011-12

(General Fund Benefit, in Millions)

Solution	Amount
Additional reduction in hours for services	$128
Eliminate domestic services in shared living environments	237
Eliminate all services for recipients without a physician's certificate	121
Total	**$486**

recipients who live with other persons.

Savings Estimates May Be Overstated. Some savings estimates, such as the one related to the adoption of physician certification requirements, appear to be overstated.

High-Hour Recipients Lose Most. When making reductions to the IHSS program, we have generally recommended an approach in the past of targeting reduction to those least likely to enter a skilled nursing facility. However, the proposed across-the-board reduction in service hours results in the greatest loss of hours for recipients who are assessed to need the most hours. We have proposed that the Legislature begin to move toward a system that would better target services to those most at risk of institutionalization.

Alternatives for Legislative Consideration

Reduce State Participation in Provider Wages Pursuant to a Study. The state, together with counties, provides funding to support the wages paid to IHSS workers. The federal courts enjoined California from implementing a 2009-10 reduction in state participation in wages from $12.10 to $10.10. The court ruled that the state should have conducted a study of the impacts of a wage reduction on the supply of available providers. In the meantime, this case has been appealed to the U.S. Supreme Court, and the Legislature adopted a statute that postpones the wage reduction.

Despite these prior actions, the Legislature may wish to reconsider reducing state participation in IHSS provider wages as part of the 2011-12 budget plan. A reduction from $12.10 to $10.10, for example, could save about $100 million annually. To address some of the concerns of the federal court, the wage reduction could be reenacted in a way that allows a reduction down to $10.10 contingent on the results of a state study now under way to determine the potential impact on the supply of available providers.

Proposition 10 Early Childhood Development Programs

Major Proposal

Ballot Measure. Proposition 10, enacted by the California voters in the November 1998 election, imposed a 50-cent increase in excise taxes on cigarettes and other tobacco products to fund early childhood development programs. The Governor's budget proposes to place a measure before voters in a June 2011 special election to allow the use of Proposition 10 funds for Medi-Cal coverage for children in a way that would reduce state General Fund costs. Specifically, the proposed ballot measure would (1) sweep $1 billion on a one-time basis from state and local commissions' fund reserves to pay for Medi-Cal services for children up to age five and (2) redirect on an ongoing basis 50 percent of state and local commissions' future revenues to fund various state children's programs. This proposal would result in General Fund savings of $1 billion in 2011-12 and approximately $215 million in 2012-13. This amount would decline gradually in the out-years in accordance with an ongoing trend of declining tobacco product consumption.

Key Issues

Amount Available for Sweep Uncertain. The administration has cited 2009 data as the basis for its conclusion that $1 billion in Proposition 10 state and local commission fund reserves are available to be swept. Under this proposal, the actual amount available for the one-time sweep would depend on the commissions' fund balances as of June 30, 2011.

Governance of Proposition 10 Funds. Although the state and local commissions provide some important services to young children, they are in accordance with their priorities, which may differ significantly from the Legislature's priorities, especially in times of fiscal distress. Moreover, the commissions have separate staff and governing boards. Eliminating the commissions would remove this layer of bureaucracy.

Alternatives for Legislative Consideration

Governor's Proposal Could Be Modified. The Legislature could go further than the Governor's proposal by seeking elimination of the state and local commissions and use those funds to pay for General Fund-supported children's programs. Alternatively, the Legislature could use these revenues as part of any realignment of health and social services programs. These options would also require voter approval.

Medi-Cal

Major Proposals

Governor Proposes Alternative Funding Sources and Reductions. The Governor's spending plan shifts $1 billion in funding from Proposition 10 and $840 million in local redevelopment agency funds to offset state Medi-Cal costs. (We discuss these proposals in more detail in earlier sections of this report.) The Governor also proposes a two-quarter extension of the existing hospital fee for additional General Fund relief of $160 million in the current year. In addition, the budget plan proposes to achieve almost $1.7 billion in General Fund savings in the Medi-Cal Program. This would be achieved through a combination of copayments, caps on benefit utilization, elimination of benefits, and payment reductions to certain providers, as shown in Figure 11 (see next page).

Governor Pursues Provider Rate Reductions. The spending plan assumes that the courts will rule in favor of the state regarding prior rate reductions and let it go forward with a 10 percent rate reduction to certain types of Medi-Cal providers, for savings of $537 million to the General Fund. The administration anticipates that the U.S. Supreme Court will decide to hear the state's appeals of lower-court rulings that enjoined these prior budget reductions by mid-January 2011 and will rule by July 1, 2011. In addition to the favorable court outcome, the spending plan also assumes that net savings of $172 million General Fund can be achieved by reducing certain long-term care payments by 10 percent.

Governor Proposes Copayments, Hard Caps, and Benefit Eliminations. The governor proposes to achieve almost $1 billion in General Fund savings in Medi-Cal through the imposition of copayments, caps on the utilization of certain benefits, and the elimination of certain benefits, such as Adult Day Health Care (ADHC).

Key Issues

Merit in the Governor's Approach. Given the state's difficult fiscal condition and the significant growth that would otherwise occur in the General Fund budget of the Medi-Cal Program, we believe the Legislature should carefully consider the Governor's proposals for budget reductions in Medi-Cal as well as other alternatives to achieve savings. We note that the administration's options

to control costs in Medi-Cal through reductions in eligibility are limited by requirements imposed by the federal Affordable Care Act (also known as health care reform). While some savings could be achieved by scaling back eligibility for state-only benefits, other major eligibility reductions that could save hundreds of millions of dollars are not permissible because of the federal legislation.

Some Medi-Cal Budgetary Savings Risky or Overstated. In recent years, the Legislature has adopted a number of different measures to contain costs in the Medi-Cal Program that have been blocked as a result of legal challenges. Given prior court injunctions in recent years, for example, there is a significant risk that the courts will rule against the state in regard to the previously enacted provider payment reductions. If so, the state would lose significant savings assumed in the 2011-12 budget plan. The newly proposed payment reduction for long-term care facilities also could be subject to legal challenge. Furthermore, federal approval may be required in order to implement several of the Governor's proposals, including rate reductions. Recent actions by federal Medicaid authorities suggest that the reductions proposed in the Governor's budget could receive close scrutiny.

We caution that some of the Governor's savings estimates may be somewhat overstated because

Figure 11

Medi-Cal Program Selected Budget Solutions

(General Fund Benefit, in Millions)

	2010-11	2011-12
Impose Caps		
Physician and clinic visits at ten per year (adults)	—	$196.5
Drugs at six prescriptions (adults)	—	11.0
Durable medical equipment at 90th percentile (adults)	—	7.4
Medical supplies at 90th percentile (adults)	—	2.0
Hearing aids at 90th percentile (adults)	—	0.5
Subtotals	(—)	($217.4)
Impose Copayments		
$5 copayment for visits to physicians and certain clinics	—	$152.8
$100 copayment per hospital inpatient day	—	151.2
$3 and $5 pharmacy copayments	—	140.3
$50 copayment for nonemergency emergency room (ER) visits	—	73.2
$50 copayment for emergency ER visits	—	38.4
$5 copayment for dental office visits (adults)	$0.2	1.3
Subtotals	($0.2)	($557.2)
Reduce Benefits		
Eliminate Adult Day Health Care services	$1.5	$176.6
Limit nutritional supplements	0.5	14.4
Eliminate selected over-the-counter drugs	0.1	2.2
Subtotals	($2.1)	($193.2)
Implement Provider Payment Reductions		
Assume courts will allow certain provider payment reductions	$9.5	$537.0
Impose a 10 percent payment reduction on long-term care facilities	—	172.3
Subtotals	($9.5)	($709.3)
Totals	**$11.8**	**$1,677.1**

they do not capture the net effect of the proposal. For example, savings from the elimination of the ADHC benefit would be offset by additional costs in Medi-Cal and other state programs, such as the DDS.

Alternatives for Legislative Consideration

Copayments and Caps on Services Could Be Modified. In the event that the Legislature does not wish to adopt in full some of the specific budget reductions contemplated in the Governor's budget plans, options are available to the Legislature that would still achieve some measure of state savings. For example, the Legislature could implement copayments for certain Medi-Cal services in smaller dollar amounts than the copayments proposed by the governor. Similarly, the Legislature could adopt the proposed caps on the utilization of certain benefits, but with allowance for exceptions, thereby allowing Medi-Cal beneficiaries to access critical care.

Department of Developmental Services

Major Proposals

Major Reductions in Regional Center (RC) Programs. The governor's budget plan proposes to achieve $750 million in General Fund savings in DDS. About $125 million of the savings will come from alternative funding sources, such as the continuation of $50 million in funding from Proposition 10 and three separate proposals to draw down a combined total of $75 million in federal funds. Another $92 million in savings would come from the continuation of a 4.25 percent reduction to RC operations and provider payments. The remaining $533 million in savings would be achieved by a proposal described as increasing the accountability and transparency for the use of state funds for the administrative expenditures of RCs and service providers and through the implementation of statewide service standards. The statewide standards would set guidelines to promote consistency in the array of services provided by RCs and would be developed with input from stakeholders.

Key Issues

More Information Needed to Assess Whether Savings Are Achievable. The administration's proposals to achieve savings in the DDS program have merit in concept, given the significant historical increases in spending and caseload for community programs. However, we believe the Legislature requires additional detail to evaluate the proposal for $533 million in savings in RC operations and programs.

Healthy Families Program

Major Proposals

Plan Would Implement Premium Increases, Benefit Eliminations, and Copayments. The Governor's budget plan would achieve $39 million in General Fund savings in the Healthy Families Program (HFP) through benefit eliminations, premium increases, and the implementation of copayments for certain services. Specifically, the plan proposes to eliminate the vision benefit and increase premiums by between 75 percent and 88 percent based upon family income levels. The plan also would increase copayments for emergency room visits from $15 to $50 and inpatient hospital stays from $0 to $100 per day with a maximum of $200 per stay.

Managed Care Tax Would Be Extended. The tax assessed on managed care plans provides revenues that are used to fund rate increases in Medi-Cal and provide health coverage in HFP. This tax expires on June 30, 2011. The budget plan proposes to make the tax permanent and use the revenues to fund Medi-Cal and HFP for savings of $97 million.

Key Issues

Federal Approval of Tax Measure Uncertain. We caution that the managed care tax is subject to federal approval and, based upon our review, there is some risk that it may not be approved.

Alternatives for Legislative Consideration

Some of the Governor's Proposals for HFP Could Also Be Modified. Similar to the options presented under Medi-Cal, the Legislature could adopt more moderate reductions than the ones proposed by the Governor, albeit at a reduced savings level. For example, the Legislature could adopt lesser premium increases or copayments than proposed by the administration.

Judicial and Criminal Justice

Major Proposals

Public Safety Realignment. As we discussed earlier in this report, the administration proposes to realign several public safety programs to counties. These programs include adult parole, jurisdiction of lower-level adult offenders and all juvenile offenders, court security, and various local public safety grant programs (such as the Citizens' Option for Public Safety program and local detention facility subventions or booking fees).

Redevelopment Fund Shift to Trial Courts. The Governor's budget proposes to offset $860 million in trial court costs in 2011-12 with redevelopment funding. (Please see the "Redevelopment" section of this report for a more detailed discussion of the Governor's proposal.)

Revised Corrections Savings. The enacted 2010-11 budget includes an $820 million unallocated reduction to the Receiver's inmate medical services program. The Governor's budget includes additional funding based on the assumption that only about $177 million in these savings will be achieved in 2010-11 and $257 million in 2011-12. Similarly, the proposed budget assumes that the full $200 million from an unallocated inmate population-related reduction will not be achieved in either 2010-11 or 2011-12.

Increased Funding for CDCR Salary and Other Costs. The budget provides an additional $395 million in General Fund support for the California Department of Corrections and Rehabilitation (CDCR) for expenses that the department indicates have exceeded its budgeted authority in previous years. These expenses include correctional officer salaries and wages, overtime for correctional officers, and costs associated with transporting and guarding inmates at health care facilities outside prison walls.

CDCR Workforce Cap Adjustment. As a result of an unallocated 5 percent reduction to the personnel budgets of most state departments (referred to as the workforce cap), the 2010-11 budget assumed a total of about $292 million in personnel savings for CDCR. The Governor's budget assumes that the department will only be able to achieve $20 million of these savings in the current year. However, the proposed budget assumes that the full $292 million in savings will be achieved in 2011-12.

Unallocated Reduction to Trial Courts. The proposed budget includes an unallocated reduction of $200 million to the General Fund support budget of trial courts.

Key Issues

Significant Risk in Fully Achieving Assumed CDCR Savings. At this time, the administration has not presented specific plans as to how the savings related to inmate medical care services and the workforce cap proposal will be achieved. Given the absence of such plans, we believe that assuming the level of savings contained in the Governor's budget poses significant risks. For example, in order to achieve the magnitude of savings proposed in the inmate medical care budget, the Receiver

would need to identify and begin to implement major operational changes now. Moreover, CDCR's ability to achieve the workforce cap savings appears to be limited since the department's personnel costs are largely tied to the operations of the state prisons—which must be staffed on a 24-hour basis.

Funding for CDCR Salary and Other Costs Raises Some Concerns. Although CDCR has exceeded its budget authority in recent years, the administration's approach to address the problem may not be fully justified. For example, the department requests an augmentation of $36 million to its base level of funding for correctional officer overtime of $104 million, in order to account for higher costs that have resulted from increases in correctional officer salaries over the past decade. However, CDCR reports that it spent a total of about $416 million on overtime for correctional officers in 2009-10—over $300 million above the level for which the department is budgeted. This suggests that much of the requested funding is related to excessive overtime costs. The department has not presented a plan to reduce these high costs on an ongoing basis.

Consider Specific Cost-Savings Options for the Courts. Although the state's court system—and in particular the trial courts—have had reductions in General Fund support in recent years, much of these reductions have been offset by fund shifts and revenue from court-related fee increases. As a result, these reductions have not resulted in substantial decreases in the total level of funding for the courts. Thus, the Governor's proposal to achieve $200 million in court savings merits legislative consideration. While the administration has not identified how these savings would be achieved, we believe that the Legislature should work with the courts to determine what specific actions are needed to achieve these, and potentially even greater, savings, in a way that minimizes impacts on access to the courts. For example, the Legislature could direct the trial courts to implement electronic court reporting and to utilize competitive bidding to reduce costs for court security.

TRANSPORTATION

Major Proposals

Transportation Funds Would Provide General Fund Relief. The *2010-11 Budget Act* assumed that the state would achieve roughly $1.6 billion in General Fund relief under a fuel tax swap that permitted significant changes in the use of transportation funds. However, the enactment of Propositions 22 and 26 on the November 2010 ballot could prevent the state from fully achieving this budget solution. Proposition 22 restricts the use of certain transportation funds and Proposition 26 could be interpreted to repeal the fuel tax swap legislation as of November 2011.

The Governor's budget proposes to address these problems in several ways. First, it would reenact the prior fuel tax swap. The Governor's package would allow $262 million in vehicle weight fees to be used to pay transportation debt in the current year, and permit roughly $800 million in State Highway Account (SHA) monies (primarily from weight fees) to pay transportation debt in 2011-12. Also, some transportation funds would be loaned to the General Fund. Altogether, these actions would achieve $1.6 billion in General Fund relief in the current year and $944 million in 2011-12 under this proposal.

Key Issues

Maximize General Fund Benefit. Our analysis indicates that these proposals, similar to ones proposed by the former Governor in the December 2010 special session but not yet adopted, are reasonable and could achieve the level of savings proposed. However, as we noted in December, the proposal does not maximize the use of weight fee revenues for potential benefit to the General Fund.

We believe the amount of General Fund benefit in the current year could be increased by at least $50 million and potentially by a similar amount in the budget year, while still maintaining an adequate reserve in the SHA.

Alternatives for Legislative Consideration

Develop Comprehensive Fix for the Future. The Governor's proposal would help to ensure that transportation funds could be used for General Fund relief in the future. We believe this is appropriate. In addition, we think this is a good time for the Legislature to consider a more comprehensive approach that would provide additional General Fund relief and address other problems in the current transportation funding system. For example, we believe the Legislature should examine the current fragmentation of funding into various special funds that each allows only limited uses. We are exploring what steps the Legislature and the voters could take to allow for more flexible and effective use of these funds.

State Operations

Major Proposals

Savings From Collective Bargaining and Administrative Actions. Currently, 6 of the state's 21 employee bargaining units (about 25 percent of its workforce) are working under expired contracts. The budget assumes that new memoranda of understanding (MOUs) and/or administrative actions related to these employees will generate $308 million in General Fund savings in 2011-12. This amount is equivalent to a 10 percent salary reduction for these employees. The current three-day a month furlough, in contrast, is equivalent to a 14 percent salary cut.

Health Plan Savings. The state's contribution to employee health coverage is based on the average cost of the four health plans with the most enrolled state employees. Beginning in the 2012 calendar year, the administration proposes adding a new health plan that provides somewhat less comprehensive coverage at a somewhat reduced cost to employees electing the plan. The budget assumes that this plan will attract enough employees so that the state would realize $72 million in General Fund savings in the budget year.

Unallocated Cut. The budget includes a $200 million General Fund unallocated cut to state operations to be achieved through various efficiencies.

Key Issues

Erosions of Current-Year Savings. While the *2010-11 Budget Act* assumed $1.5 billion of General Fund savings in employee compensation costs, the budget indicates that the state will not realize more than a third of this amount. The shortfalls include: $281 million from state departments not reducing employment costs fully pursuant to the ongoing state workforce cap, $166 million from lower-than-anticipated savings associated with the ratified MOUs and administrative actions, and $100 million from unrealized operating expenses and equipment savings. The budget assumes, however, that the state will realize virtually all of the workforce cap savings in 2011-12.

Assumed Budget-Year Savings Unrealistic. The proposed savings associated with health plans and the unallocated cuts are not realistic. The new health plan is not likely to attract enough employees to substantially reduce state costs, and the state's experience with across-the-board cuts suggests that they are not likely to generate the anticipated savings.

Alternatives for Legislative Consideration

Greater Savings From Employees With Expired Contracts. Given that the state is not likely to achieve all of the savings associated with the health plan and unallocated cut proposals, the

Legislature and administration could consider increasing the level of proposed savings associated with employees with expired contracts. For example, approving MOUs or authorizing administrative actions that continue the current level of savings associated with these employees (14 percent of salary costs) could reduce General Fund costs by over $100 million in 2011-12.

Extend Personal Leave Program. The Legislature could authorize administrative actions that extend the one day a month "personal leave program," beginning November 2011, for employees represented by Service Employees International Union Local 1000 and for employees not represented by a union. (Extending this program to the six other bargaining units with active MOUs, in contrast, is not permitted under the terms of their MOUs.)

Other Proposals

Debt Service

Proposal: Delaying Spring General Obligation Bond Sale. The state typically sells general obligation bonds in the spring and fall, but the administration plans to eliminate the spring sale in the current year. This one-time pause in the issuance of new bonds, combined with the Governor's proposal to use weight fees and other revenues to cover a portion of transportation debt-service costs, would slow the growth of General Fund debt-service obligations. General Fund debt service would increase in the budget year by approximately $60 million or 1 percent under the proposal. This is a modest increase compared with earlier projections. (The previous administration's assumptions included issuing $7 billion in bonds this spring, which would have increased debt costs by about $475 million in 2011-12.)

Most Departments Have Sufficient Funds to Operate Bond Programs Through the Fall. According to the administration, most departments have sufficient funds to continue existing projects and bond programs through the bond sale in the fall. New projects or local assistance grants, however, could be delayed depending upon departments' remaining balances. The Governor's proposal did not include details on projects or programs that could be affected by the delay. We recommend the Legislature request details on the potential effects of the pause in bond sales in order to ensure that available funds are directed toward its highest priorities.

Savings Represent Temporary Solution. Given the state's fiscal condition, it is reasonable to consider the delay of the spring bond sale. The avoided debt-service costs would reduce pressure on the General Fund in 2011-12. Such relief, however, is temporary. The state still has roughly $50 billion in authorized but unsold bonds, most of which would be sold and spent over the next few years under current practices. The delayed spring sale simply defers the debt-service costs associated with these bonds to future years.

Alternative: Permanently Eliminate or Reduce Some Bond Programs. The planned sale of the remaining authorized bonds would add more than $3 billion annually to the state's debt-service obligations. The Legislature and voters approved many of these programs when the state was on more sound fiscal footing. In light of the state's current fiscal condition, the Legislature may wish to evaluate whether these programs remain state priorities. For example, some bond programs support functions that are not traditionally state responsibilities and the Legislature may wish to focus the state's resources on its core infrastructure responsibilities.

CalFire

Eliminate the Fourth Firefighter on CalFire Engines. In addition to the proposal to shift some wildland firefighting responsibility to the local level, as described in the "State-Local Realignment" section of this report, the administration proposes

$30.7 million in 2011-12 General Fund savings in CalFire from eliminating the fourth firefighter on CalFire fire engines, returning to the pre-2003 level of per-engine staffing. We have previously recommended this approach on the basis that the department has not demonstrated that this level of increased staffing is cost-effective.

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