Overview of the 2014-15 Budget Bill

Senate Bill 851

As Introduced January 9, 2014

Senate Committee on Budget and Fiscal Review

Senator Mark Leno, Chair

February 2014

California State Senate

COMMITTEE
ON
BUDGET AND FISCAL REVIEW

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February 3, 2014

Dear Colleague:

I am pleased to forward a copy of the *Overview of the 2014-15 Budget Bill*, which has been prepared by the staff of the Senate Budget and Fiscal Review Committee. The document is intended to highlight the Governor's major proposals and provide additional information and framework to support the review of these proposals. This document, as well as further analysis by the Legislative Analyst's Office, will provide the basis for budget hearings throughout the spring.

In the first section, we provide an overview of the state's fiscal condition and the Governor's fiscal proposals. The next section, entitled "Major Issues," is organized by budget subcommittee. For each major issue, this report provides background, an explanation of the Governor's proposals, and important issues to consider.

In the Appendix, we include supplementary fiscal documents from the Department of Finance. Also included are a working timeline for completing the 2014-15 budget and a list of budget committee consultants and their respective areas of responsibility.

If you have questions, please do not hesitate to contact me or the committee staff.

Sincerely,

MARK LENO
Chair

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Budget Overview

OVERALL BUDGET PROPOSAL:

The Governor has proposed a budget for 2014-15 which includes resources of $108.7 billion and expenditures of $106.8 billion. Based on the budget proposal, the General Fund would end the 2014-15 budget year with a reserve of almost $1.0 billion and include the deposit of $1.6 billion to the Budget Stabilization Account (BSA). The budget also includes the continuation of established efforts to pay down budgetary debt from past years, but proposes a more aggressive payment schedule. The 2014-15 budget benefits from past years of spending reductions and restraints, temporary taxes approved by the voters in 2012, and a steadily improving state economy.

As a result of the combined efforts of the Administration and the Legislature, the General Fund is in its most solid position in years. In the current year, the fiscal position of the state is expected to be substantially better than when the budget was adopted in June, with additional revenues resulting in a substantial increase in the year-end reserve to $3.3 billion. The proposed 2014-15 budget builds from this base, incorporating a general reserve and BSA of approximately $2.6 billion. Overall, General Fund spending in 2014-15 is expected to grow by approximately 8.5 percent from the current year, driven largely by increases in education funding—both K-12 and higher education—and debt repayment. To provide some context, state budget expenditures previously peaked in 2007-08, with General Fund spending of about $103 billion. Thus, the budget year is the first year in which expenditures are expected to be at or above the level of seven years ago.

OVERVIEW OF GOVERNOR'S BUDGET PROPOSAL:

The Governor's budget includes $108.7 billion in General Fund revenues and other resources and $106.8 billion in total General Fund expenditures, providing for a $967 million reserve, as well as setting aside an additional $1.6 billion for the BSA. Expenditures in 2014-15 are proposed to be about $8.3 billion higher than revised 2013-14 expenditures. Significant additional funding is proposed for K-12 education, higher education, and early debt repayment, with some increases for health and human services, and corrections and rehabilitation. Additional resources that have allowed for measured expansions and program growth are the result of very positive revenue growth based on the general economic upturn. The General Fund budget details are summarized below.

2013-14 and 2014-15
General Fund Summary
(Dollars in Millions)

	Revised 2013-14	Proposed 2014-15
PRIOR YEAR BALANCE	$2,528	$4,212
Revenues and transfers	$100,147	$104,503
TOTAL RESOURCES AVAILABLE	**$102,675**	**$108,715**
Non-Proposition 98 Expenditures	$57,515	$61,731
Proposition 98 Expenditures	$40,948	$45,062
TOTAL EXPENDITURES	**$98,463**	**$106,793**
FUND BALANCE		
Encumbrances	$955	$955
Special Fund for Economic Uncertainties	$3,257	$967
BUDGET STABILIZATION ACCOUNT	**--**	**$1,591**

PERSPECTIVE ON PRIOR BUDGETS:

The Governor's Budget represents the second consecutive budget that does not incorporate significant program reductions. As a result of the Legislature's efforts and the voters' approval of temporary taxes, the state continues to be on the firmest fiscal footing it has been on in years. Measures taken in past years to close the budget gap have been significant and the effect on General Fund spending has reflected the severe economic and fiscal constraints. Prior to the proposed budget, General Fund spending last peaked in 2007-08 at $103.0 billion, dropping to $90.4 billion in 2008-09 and to $86.4 billion in 2011-12. The current year represents only the second time General Fund spending has increased since the recession began. While the trough of the national business cycle actually occurred in June 2009, clearly the fiscal impacts on the state of the steep economic decline have continued to linger.

The budget crisis, from which the state continues to recover, began in full-force in 2008 with the rapid drop in economic activity and the subsequent onset of the recession. This led to sharp declines in revenue—especially from economically sensitive components—and escalating expenditure demands for particular programs and services. Prior budget decisions, including permanent tax reductions, left the state facing budgetary obstacles with reduced fiscal flexibility, coupled with pressures to adopt one-time solutions to address ongoing structural imbalances.

Before 2008, there was some evidence of possible budget stress; in the fall of 2006, the Legislative Analyst's Office (LAO) raised concerns regarding the state's structural balance in the out-years. Even so, the state's General Fund was expected to end the 2006-07 budget year with a reserve of $3.1 billion. Based on continuing revenue improvements at the time—especially stronger than expected investment income—this actually represented an increase of about $1.0 billion from the estimated reserve in the 2006 Budget Act. The LAO did raise concerns regarding the outlook for the 2007-08 budget year, indicating that operating expenditures would outstrip operating revenues by roughly $5.5 billion.

By the fall of 2007, there was additional deterioration in the state's budget situation. The economy was beginning to soften somewhat, leading to modest revenue declines. A leveling off in the rapid run-up of property taxes led to increasing General Fund expenditures on K-14 education. When the 2007 Budget Act was adopted in August, the focus was on closing a modest budget gap and retaining a $4.1 billion reserve which was then forecasted. However, by the fall of 2007, the budget situation had deteriorated by about $6.0 billion and a current year deficit of $1.9 billion was expected. The outlook for the 2008-09 budget was even worse; the LAO indicated an operating shortfall of $8.0 billion and multi-billion dollar shortfalls thereafter.

When the 2008 Budget Act was adopted in September, the prior year shortfall and the budget had been addressed largely through a series of one-time measures. The 2008 Budget Act incorporated a reserve of $1.7 billion for 2008-09. Within weeks of the budget passing, however, national financial and credit markets virtually collapsed, leading to substantial declines in state revenues. By the fall of 2008, LAO forecasted a current year shortfall of $8.4 billion, representing a precipitous reversal of $10.0 billion from the time the budget was adopted in September, and reflective of the free-fall in the state and national economies. Furthermore, the

LAO indicated a $19.4 billion deficit for 2009-10, for a massive combined two-year deficit of $27.8 billion. Absent corrective action, huge shortfalls in the out-years were also forecasted.

The Budget Act of 2009 was comprised of multiple legislative actions throughout the year. Revisions were made to the 2008-09 budget year as well, with major temporary tax increases and significant cuts affecting most state-funded programs. At the time of the July 2009 revisions to the Budget Act, the plan incorporated a $500 million reserve at the conclusion of the 2009-10 budget year and deficit in 2010-11 of $7.4 billion. However, by the Fall of 2009, the situation had continued to deteriorate, and LAO forecasted a current year deficit of $6.3 billion, coupled with a $14.4 billion shortfall in 2010-11, for a two-year budget gap of $20.7 billion.

The Legislature adopted the 2010 Budget Act in October 2010 with an estimated reserve for the 2010-11 budget year of $1.3 billion, and predicated on the receipt of $3.5 billion in federal funds. In its Fall 2010 analysis, LAO assumed these additional federal dollars would not be received and also incorporated other erosions in savings and or revenues in projecting a shortfall in 2010-11 of $6.1 billion. In addition, the slow economic recovery and the temporary nature of some of the budget-balancing measures meant that the state would show an additional shortfall in 2011-12 of approximately $19.2 billion. Despite the still substantial budget deficits, this was actually the first time since the downturn began that the estimates for the out-year deficit had declined from the prior year's estimated shortfall.

By the following year, adopted on-going budget solutions were taking hold in a substantial manner. Still, in the Fall of 2011, the LAO indicated a shortfall of $3.0 billion 2011-12, as opposed to a surplus of $500 million incorporated in the 2011 Budget Act. This prognosis was the result of additional declines in prior year revenues, continuing economic softness in the current year, and the inability to realize certain savings as a result of court decisions. The 2011 Budget Act incorporated a series of trigger cuts that would occur if revenues did not reach a certain level. Even with the assumed trigger cuts, it was expected that the state would still face a 2011-12 shortfall of $3.0 billion, coupled with a 2012-13 operating shortfall of $9.8 billion. The state ended the 2011-12 budget year with a deficit of $3.6 billion.

The 2012-13 Budget, adopted in June 2012, included significant expenditure reductions and a reliance on proposed temporary taxes. In the Governor's Budget for 2012-13, the shortfall addressed through budget-balancing solutions was $10.3 billion—including a $1.1 billion reserve. By May, the budget situation had deteriorated and the deficit had increased to $16.7 billion for the period ending June 30, 2013. This was due to a reduced revenue outlook, higher costs to fund schools, and decisions made by the federal government and courts to block previously-approved budget cuts. In early June, the Legislature adopted a budget that included most of the Governor's May Revision framework, relying primarily on additional expenditure reductions, as well as passage of a tax initiative on the November 2012 ballot. The budget plan contained $16.6 billion in total solutions for the period ending June 30, 2013, including $8.1 billion in expenditure reductions, $6.0 billion in additional revenues, and $2.5 billion in other solutions. The 2012-13 budget assumed that 2012-13 would end with a $254 million reserve. Additional revenues (and a more-than-off-setting increase in K-12 funding) reduced this surplus slightly. This represented the first state reserve since 2007-08.

CURRENT-YEAR BUDGET UPDATE:

The 2013-14 budget, adopted in June 2013, contained measured increases in expenditures from the prior year, with relatively isolated—but important—restorations in selected areas. The Governor's proposed 2013-14 budget, included $98.5 billion in General Fund (and Education Protection Account) revenues, with expenditures of $97.7 billion. The Administration estimated that a $2.4 billion surplus would be sufficient to erase the 2011-12 deficit of $2.2 billion. In January 2013, the Administration also projected that the $167 million ending balance (the first in years) and an $851 million operating surplus in 2013-14, would produce a reserve in 2013-14 of approximately $1.0 billion.

By May of 2013, the budget situation had improved modestly, according to Department of Finance (DOF) projections, largely as a result of somewhat improved revenue estimates. The Administration's revenue estimates at May Revision grew by $749 million for 2011-12, 2012-13, and 2013-14, combined (including a $500 million loan to the General Fund from cap and trade revenues). The May Revision also called for certain realignment changes resulting in budget savings. Initially, the Legislature adopted the LAO's more optimistic revenue projections; however, after negotiations with the Administration, lower revenue estimates were adopted that resulted in a smaller projected surplus. The adopted budget resulted in a 2012-13 reserve of $254 million and a 2013-14 reserve of approximately $1.1 billion. Additional spending on corrections, approved by the Legislature in August, reduced the expected reserve to approximately $700 million.

Instead of having to address major shortfalls, the state 2013-14 budget augmented several programs:

- **School Funding.** Major components included $2.1 billion under Prop 98 for the new Local Control Funding Formula (LCFF), $1.25 billion for Common Core State Standards, and $4.3 billion (2012-13 and 2013-14) to pay down K-14 deferrals.

- **Medi-Cal Expansion.** Adopted in special session, the expansion adopts a state-based plan to exercise the option, under federal health care reform, to cover more than one million additional low-income individuals.

- **Program Restorations and Augmentations.** Various program restorations were implemented, including: $63 million for the judicial branch, $17 million for adult dental care, $143 million for mental health services infrastructure, $67 million for enhanced mental health and substance abuse services, increased resources for CalWORKs, and a new financial aid program for higher education.

Since the budget was adopted, there have been several spending adjustments—particularly in the education and corrections areas—as well as significant improvements from the revenues adopted in the budget. The revenue improvements are generally in line with LAO's May 2013 forecast that was initially adopted by the Legislature. The difference between the adopted and revised current year budget are presented below.

General Fund Expenditures
Current Year Adopted and Revised
(Dollars in Millions)

Program Area	Adopted 2013-14	Revised 2013-14	Change	Percent Change
K-12 Education	$39,661	$41,333	$1,672	4.2%
Higher Education	$10,923	$11,173	$250	2.3%
Health and Human Services	$28,084	$28,330	$246	0.9%
Corrections and Rehabilitation	$8,911	$9,361	$450	5.1%
Business, Consumer Services, Housing	$646	$646	$0	0.0%
Transportation	$206	$151	-$55	-26.7%
Natural Resources	$2,124	$2,127	$3	0.1%
Environmental Protection	$46	$47	$1	2.2%
Labor and Workforce Development	$299	$298	-$1	-0.3%
Government Operations	$742	$753	$11	1.5%
General Government				
Non-Agency Departments	$523	$519	-$4	0.8%
Tax Relief / Local Government	$421	$420	-$1	0.2%
Statewide Expenditures	$917	$611	-$306	-33.4%
Legislative, Judicial and Executive	$2,778	$2,694	-$84	-3.0%
Total	**$96,281**	**$98,463**	**$2,182**	**8.5%**

BUDGET YEAR PROPOSED EXPENDITURES:

Like the current year, the proposed budget incorporates additional but restrained new programmatic increases. The table below summarizes the Governor's proposed expenditures by program area. The most noteworthy changes are in education. The largest change in expenditure by program area is in K-12 education, where the Governor proposes $3.9 billion in additional expenditures to fully fund the Proposition 98 guarantee. On-going funding levels per student are expected to be $8,469 in 2013-14 and $9,194 in 2014-15. In higher education, the budget provides additional stable funding over multiple years. Finally, the Governor makes a significant commitment of resources to paying down debt and establishing a reserve balance.

General Fund Expenditures
Current and Budget Year
(Dollars in Millions)

Program Area	Revised 2013-14	Proposed 2014-15	Change	Percent Change
K-12 Education	$41,333	$45,251	$3,918	9.5%
Higher Education	$11,173	$12,377	$1,204	10.8%
Health and Human Services	$28,330	$28,793	$463	1.6%
Corrections and Rehabilitation	$9,361	$9,560	$199	2.1%
Business, Consumer Services, Housing	$646	$745	$99	15.3%
Transportation	$151	$212	$61	40.4%
Natural Resources	$2,127	$2,175	$48	2.3%
Environmental Protection	$47	$54	$7	14.9%
Labor and Workforce Development	$298	$268	-$30	-10.1%
Government Operations	$753	$685	-$68	-9.0%
General Government				
Non-Agency Departments	$519	$610	$91	17.5%
Tax Relief / Local Government	$420	$437	$17	4.0%
Statewide Expenditures	$611	$1,191	$580	94.9%
Legislative, Judicial and Executive	$2,694	$2,844	$150	5.6%
Economic Recovery Bonds Payment	-	$1,591	$1,591	-
Total	**$98,463**	**$106,793**	**$8,330**	**8.5%**

STATE ECONOMY AND REVENUES:

Economic Outlook

Economic forecasts play an integral role in the state's revenue forecast and fiscal outlook. The state's revenue structure is very 'elastic', meaning it is highly sensitive to economic changes. This is particularly true for personal income tax receipts, which tend to grow (or decline) proportionally more than increases (or decreases) in the underlying income base. The sales and use tax, the second largest state revenue source, is sensitive to consumer confidence and consumption patterns. The property tax—which benefits the General Fund through additional resources for K-12 education—reacts to changes in the underlying property asset values and home prices.

The Governor and the LAO both forecast some improvement in the overall modest—but generally steady—growth in the economy, leading to a gradual recovery in state revenues. The state's recovery has begun to gather modest momentum as a result of better real estate conditions, faster job growth, and improved consumer attitudes. The Administration's economic forecast assumes that the current moderate economic recovery will accelerate in 2014, leading to broad-based improvements in both the U.S. and California economies over the next two years. The assumed growth rates for the U.S. and California are equivalent to rates of improvement in a mature economic expansion, reflecting the consensus outlook that U.S. economic growth is returning to more normal levels.

The Administration expects job growth to improve, with employment projected to grow 2.1 percent in 2013 and 2.3 percent in 2014. Based on its November 2013 *Fiscal Outlook*, the LAO is somewhat less sanguine, with projected growth rates in employment of 1.7 percent and 2.2 percent for these two years. The budget assumes a continued significant improvement in personal income with increases of 2.6 percent in 2013 and 4.6 percent in 2014. The LAO sees somewhat greater growth in personal income in 2014, with an increase of 5.4 percent. Unemployment is expected to decline by about a percentage point from the 2013 rate of 8.9 percent, with housing permits expected to increase in excess of 30 percent from 2013 to 2014. Overall, the Administration's and LAO's economic forecasts are generally congruent.

Revenue Forecast

The state relies on three principal taxes for revenue sources to support the General Fund. Over the recent past, personal income taxes have typically contributed about 50 percent, sales and use taxes about 30 percent, and corporation taxes about 10 percent of total revenues. This revenue profile changed somewhat, as a result of the two tax measures approved by the voters in November 2012, and the realignment of a portion of the state sales and use tax to local governments to fund the 2011 Public Safety Realignment. Revenues are projected to be higher than assumed in the 2013 Budget Act, due primarily to additional capital gains realizations. For the budget year, the personal income tax is expected to generate $69.8 billion (65.8 percent), the sales and use tax $24.1 billion (22.7 percent) and the corporation tax $8.7 billion (8.1 percent). For the current year, the personal income tax shows a significant improvement from the 2013 Budget Act with an increase of 5.6 percent, with the sales and use tax showing essentially no change. In contrast, the corporation tax shows an erosion of about 7 percent, continuing a long-term—and troubling—trend.

Based on increasing economic growth in the state, the major revenue sources are expected to display year-to-year growth of 8.5 percent for the personal income tax, 5.0 percent for the sales and use tax, and 8.9 percent for the corporation tax. The budget includes increased personal income tax and sales and use tax revenues due to the passage of Proposition 30. Personal income tax revenues are expected to increase by $5.5 billion from 2013-14 to 2014-15, based on the most recent forecast. Similarly, sales and use tax revenues are expected to grow by $1.2 billion and corporation taxes by over $700 million. Overall revenues (together with minor transfers) are forecasted to be $101.1 billion in 2013-14 and $106.1 billion in 2014-15, for an increase of almost $6.0 billion.

Tax Administration

Tax payments and refunds are examined monthly to assess the accuracy of the revenue forecast. The Governor's Budget revenue forecast is the annual starting point; LAO releases an updated revenue forecast in February; the Governor releases an additional revenue forecast with the May Revision and LAO typically provides its own update. Finally, the LAO releases a thorough forecast in November each year. Subsequent revenue forecasts benefit from additional months of actual tax collection and refunds. The State Controller's Office (SCO) and DOF release updates on tax collection in the first half of each month. General Fund projections displaying point-in-time estimates are provided in the Appendix of this *Overview*.

Taxes are remitted through different means. Employment wages and bonuses are part of employer personal income tax withholding, which the employer remits to the state, while estimated quarterly payments are required for taxpayers that have capital gains or other significant income outside of wage earnings. The sales and use tax is remitted in monthly payments by retailers. Businesses paying the corporation tax make quarterly tax payments. Tax refunds are also tracked in monthly data for taxpayers who overpaid their tax. The following are some of the key tax dates that occur and inform the budget deliberations:

- **January 15**—Final quarterly estimated payments for personal income taxes are due for the 2013 tax year.

- **January 31**—Final SUT payments are due from retailers for the fourth quarter of 2013.

- **March 15—**Tax filing deadline for those subject to the corporation tax.

- **April 15—**Tax filing deadline for the personal income for the 2013 tax year, and due date for the first quarterly estimated payment for the 2014 tax year. For corporations that use calendar years for reporting, the first quarterly corporation payment is due.

- **April 30—**Final sales and use tax payments are due from retailers for the first quarter of 2014.

Tax Expenditure Programs

The state's major income taxes incorporate numerous policies that result in special income treatment for individuals or businesses based either on situational factors or for engaging in certain activities. The policies that provide this special treatment are known as 'tax expenditure programs' in that they result in the 'expenditure' on a designated program of revenues that would otherwise be received by the state. The tax expenditure construct draws a parallel between direct expenditures of the state on an activity and the provision of special tax treatment to the private sector for engaging in such activity.

Tax expenditures largely come in the form of tax credits (a direct reduction in taxes owed) and income deductions (a reduction in income subject to the tax). These programs result in a substantial reduction in the amount of revenue that would be received by the state, amounting to tens of billions of dollars annually. With the elimination of enterprise zone programs last year, the Legislature took a significant step forward in addressing the continued growth of certain tax expenditures as well as subjecting tax programs to the same level of scrutiny applied to direct budgetary expenditures. The elimination of enterprise zone programs is estimated to result in an additional $375 million in revenues in 2014-15, and growing thereafter.

Revenue Volatility

The state's revenue system has become increasingly volatile, as it has relied more heavily on the personal income tax over time. The reasons for volatility in the personal income tax are several, but generally they relate to the fact that the top income earners that contribute a significant share of personal income tax revenues are taxed at the highest marginal rate and receive a large proportion of their income through capital gains, dividends and bonuses. The sharp increase in these types of income during good times and the sharp drop in bad times, leads to a volatile revenue stream.

Volatility creates problems at the state level because it adds substantial complexity and stress to the budgeting process. The sharp drop in revenues beginning in 2008 required the Legislature and the Administration to address frequent revenue shortfalls and adopt multiple mid-year budget adjustments in order to maintain a balanced approach. The volatile nature of the revenue stream complicated this process. In addition, for services provided by the government—whether at the state or local level—abrupt changes in the level of the resource commitment leads to uncertainty and confusion. The Administration has proposed a new reserve policy which would essentially attempt to 'slice off' a designated part of the volatile portion of the state's revenue stream and place this revenue in a so-called 'rainy day fund.' This proposal is discussed later in this report.

SUBCOMMITTEE NO. 1

EDUCATION

K-12

Higher Education

K-12 Finance & Accountability: Local Control Funding Formula

BACKGROUND:

K-12 School Finance Reform
As of the 2013 Budget Act, the state appropriates more than $48 billion in Proposition 98 funding (General Fund and local property taxes) annually for K-12 public schools. As part of the 2013-14 budget, the state significantly reformed the system for allocating most of these resources to school districts, charter schools, and county offices of education, beginning in 2013-14. Specifically, the new Local Control Funding Formula (LCFF) replaced the state's prior system of distributing funds to local education agencies (LEAs) through revenue limit apportionments (per student average daily attendance) and approximately 50 state categorical education programs.

Under the old system, revenue limits provided LEAs with discretionary (unrestricted) funding for general education purposes, and categorical program (restricted) funding was provided for specialized purposes, with each program having unique allocation and spending requirements. Revenue limits made up about two-thirds of state funding for schools, while categorical program funding made up the remaining one-third portion. For some time, that system was criticized as being too state-driven, bureaucratic, complex, inequitable, and based on outdated allocation methods that did not reflect current student needs.

In his budgets for 2012-13 and 2013-14, Governor Brown proposed a new school finance formula. His proposal in 2012-13 for a Weighted Pupil Formula was not adopted by the Legislature. In 2013-14, the Governor proposed the LCFF with the goals to:

- Increase local control and reduce state bureaucracy.
- Ensure that student needs drive the allocation of resources.
- Increase transparency in school funding, empowering parents and local communities to access information in a more user-friendly manner and enhance their ability to engage in local school matters.
- Ensure sufficient flexibility and accountability at the local level so those closest to the students can make the decisions.

The specifics of the Governor's proposal evolved over those two years while the Legislature considered important aspects of such a major finance reform, including a new accountability structure for the funding. In adopting the LCFF, the Legislature embraced the principal tenets and elements of the Governor's proposal but also refined the funding formula and the accountability framework.

Local Control Funding Formula

The LCFF combines the prior funding from revenue limits and more than 30 categorical programs that were eliminated, and uses new methods to allocate these resources and future allocations to school districts, charter schools, and county offices of education, allowing LEAs much greater flexibility to spend the funds than under the prior system. (There is a single funding formula for school districts and charter schools, and a separate funding formula for county offices of education that has some similarities to the district formula, but also some key differences.)

The LCFF includes new requirements for local planning and accountability that focus on improving student outcomes in state educational priorities and ensuring engagement of parents, students, teachers, school employees, and the public in the local process. In addition, the LCFF features a new system of support and intervention for underperforming school districts that do not meet their goals for improving student outcomes.

Fiscal Impact. The LCFF establishes new "target" LCFF funding amounts for each LEA and these amounts will be adjusted annually for COLAs and pupil counts. Funding all school districts and charter schools at their target levels is currently expected to take seven more years, with completion by 2020-21. County offices of education are projected to reach their target funding levels in the budget year. Funding all LEAs at their target levels is estimated to result in an additional $25 billion (over 2012-13 levels) in new Proposition 98 funding for K-12 schools by 2020-21 (inclusive of future annual COLAs).

The 2013-14 budget provided an increase of $2.1 billion in Proposition 98 funding for schools to begin LCFF implementation in 2013-14. This amount includes $2.1 billion for school districts and charter schools and $32 million for county offices of education. This funding level closed "the gap" to full funding of the LCFF target levels as of 2013-14 by 11.8 percent. (This gap calculation changes annually not only due to funding provided but also due to annual adjustments to the LCFF funding targets.)

School Districts and Charter Schools Formula. This formula is designed to provide districts and charter schools with the bulk of their resources in unrestricted funding to support the basic educational program for all students, plus supplemental funding, based on the enrollment of educationally disadvantaged students (low-income students, English learners, and foster youth), provided for increasing or improving services to these high-needs students. Major components of the formula are briefly described below. (The committee's Final Action Report on the 2013-14 budget contains detailed descriptions of the formula for districts and charter schools and the formula for county offices of education.)

- **Base Grants** are calculated on a per-pupil basis (measured by student average daily attendance) according to grade span (K-3, 4-6, 7-8, and 9-12) with adjustments that increase the base rates for grades K-3 (10.4 percent of base rate) and grades 9-12 (2.6 percent of base rate). The adjustment for grades K-3 is associated with a requirement to reduce class sizes in those grades to no more than 24 students by 2020-21, unless other agreements are collectively bargained at the local level. The adjustment for grades 9-12 recognizes the additional cost of providing career technical education in high schools.

- **Supplemental Grants** provide an additional 20 percent in base grant funding for low-income students, English learners, and foster youth (unduplicated pupil count).

- **Concentration Grants** provide an additional 50 percent above base grant funding for low-income students, English learners, and foster youth that exceed 55 percent of total enrollment.

- **Categorical program** add-ons for Targeted Instructional Improvement Block Grant and Home-to-School Transportation provide districts the same amount of funding they received for these two programs in 2012-13. The transportation funds must be used for transportation purposes. Charter schools are not eligible for these add-ons.

- **LCFF Economic Recovery Target** add-on ensures that districts receive, in 2020-21, at least the amount of funding they would have received under the old finance system to restore funding to their 2007-08 level adjusted for inflation. Districts are not eligible for this add-on if their LCFF funding exceeds the 90th percentile of per-pupil funding rates estimated under the old system.

- **Hold Harmless Provision** ensures that no school district or charter school will receive less funding under the LCFF than its 2012-13 funding level.

Restrictions on Supplemental Funding

Statute requires LEAs to increase or improve services for educationally-disadvantaged students (low-income students, English learners, and foster youth) in proportion to the supplemental funding LEAs receive for the enrollment of these students. The law also allows this funding to be used for school-wide and district-wide purposes. The law requires the State Board of Education (SBE) to adopt regulations governing LEAs' expenditure of this supplemental funding. On January 16, 2014, the SBE adopted LCFF emergency regulations, including these spending regulations, and initiated the permanent regulations rule-making process.

Local Control and Accountability Plan

To ensure accountability for LCFF funds, the state mandated that school districts, charter schools, and county offices of education adopt and update a local control and accountability plan (LCAP). The LCAP must include locally determined goals, actions, services, and expenditures of LCFF funds for each school year in support of the state educational priorities that are specified in statute, as well as any additional local priorities. In adopting the LCAP, LEAs must consult with parents, students, teachers, and other school employees.

The eight state priorities that must be addressed in the LCAP, for all students and significant student subgroups in a school district and at each school, are:

- *Williams* settlement issues (adequacy of credentialed teachers, instructional materials, and school facilities)

- Implementation of academic content standards

- Parental involvement

- Pupil achievement (in part measured by statewide assessments, Academic Performance Index, and progress of English-language learners toward English proficiency)
- Pupil engagement (as measured by attendance, graduation, and dropout data)
- School climate (in part measured by suspension and expulsion rates)
- The extent to which students have access to a broad course of study
- Pupil outcomes for non-state-assessed courses of study

LEAs must use a LCAP template that is adopted by the SBE. The board adopted an initial LCAP template as part of its recent adoption of LCFF emergency regulations. School district LCAPs are subject to review and approval by county offices of education. Statute established a process for districts to receive technical assistance related to their LCAPs. The Superintendent of Public Instruction (SPI) is authorized to intervene in a struggling district, under certain conditions. The SBE is required to adopt evaluation rubrics for the state educational priorities that will assist LEAs and the SPI to assess district and school performance under the LCAPs and to identify where assistance and intervention are warranted.

GOVERNOR'S PROPOSAL:

The Governor's budget provides an increase of $4.5 billion in Proposition 98 funding for schools for the second year of LCFF implementation. This amount includes $4.5 billion for school districts and charter schools and $25.9 million for county offices of education. This is the largest programmatic increase for K-12 schools included in the Governor's budget. According to the LAO, this represents an 11 percent year-over-year increase for the LCFF. The DOF indicates this funding level represents closing approximately 28 percent of the gap between the school districts' 2013-14 funding levels and the LCFF full implementation target rates as of the budget year.

When combined with the funding appropriated in 2013-14, the proposed funding for 2014-15 closes about one-third of the gap to LCFF full implementation during these first two years, according to the DOF. The DOF still anticipates an eight-year phase-in for funding of school district and charter school LCFF target rates, but the budget proposal reflects an acceleration of LCFF funding for districts and charter schools over the next few years that would later taper down. The DOF estimates that county offices of education would be brought very close to their target rates in the budget year.

There are two major proposals to change the LCFF from current law:

- **Create a New Continuous Appropriation of LCFF Funding.** The budget proposes statutory language to require, in any given year, that a specified percentage of Proposition 98 funding be automatically committed to the LCFF. A specific percentage was not proposed. However, the DOF indicates that the LCFF currently makes up about

75 percent of annual Proposition 98 funding and that percentage is expected to increase to about 80 percent. A continuous appropriation is a way in which funds are automatically appropriated every year without the approval of the Legislature. That is, a continuous appropriation occurs outside of the regular budget process and can only be suspended or altered if the Legislature changes the law authorizing that continuous appropriation. Current law allows for the continuous appropriation of prior-year LCFF appropriations, for example, a base level of funding will be provided to LEAs without an enacted state budget. However, increases in LCFF funding above the base appropriation are subject to appropriation by the Legislature in the annual budget. According to the DOF, a new continuous appropriation for the LCFF as a specific share of Proposition 98 funding would give LEAs certainty of LCFF funding increases and would improve their ability to plan educational programs. The DOF also points out that the prior funding system, which the LCFF replaced, featured a continuous appropriation of revenue limit apportionments for LEAs. However, under that system, the Legislature had discretion to approve or deny a cost-of-living adjustment (COLA) for revenue limits, and the Legislature appropriated funding for categorical programs through the annual budget process.

- **Additional Categorical Programs Eliminated and Funding Included in LCFF.** The budget proposes to eliminate two categorical programs—Specialized Secondary Programs ($4.9 million) and Agricultural Vocational Education ($4.1 million)—and transfer the funding for these programs into the LCFF for the districts that received these categorical program funds. This funding would count towards those districts' LCFF targets beginning in 2014-15, without adjustment to the target rates. Those districts could spend this funding to continue the services previously provided through the categorical programs or redirect the funding to other educational purposes.

ISSUES TO CONSIDER:

LCFF Funding Acceleration. The budget proposes to pay down approximately 28 percent of the gap between 2013-14 funding levels and target funding at full LCFF implementation. When the LCFF was enacted, it was anticipated that full implementation would take eight years. The budget still assumes an eight-year timeline, but it accelerates LCFF funding over the next few years and funding winds down in later years. Is this the appropriate funding level and timing for full implementation?

Continuous Appropriation for LCFF. The budget proposes statutory language to continuously appropriate an unspecified percentage of Proposition 98 funding for future LCFF implementation. That would leave the Legislature no role in making this key appropriation every year. Is it prudent for the Legislature to relinquish such authority and oversight, particularly when the LCFF accountability framework (centered on the new Local Control and Accountability Plan) is at an early stage of implementation? It will be important for the Legislature to monitor LCFF implementation to assess how well this funding and accountability reform leads to improved student outcomes, including closing achievement gaps for educationally-disadvantaged students. How does the Administration plan to monitor LCFF implementation?

Career Technical Education Programs. The Governor's plan would eliminate two more career technical education (CTE) programs—Specialized Secondary Programs and Agricultural Vocational Education—and roll funding for those programs ($9 million combined) into the LCFF. When this proposal was made as part of the Governor's 2013-14 budget, the Legislature rejected it. In particular, the Senate raised concerns about the elimination of dedicated funding streams for several CTE programs (also regional occupational centers and programs, California partnership academies, and adult education). What would be the impact of eliminating these two programs?

California Collaborative for Educational Excellence. The California Collaborative for Educational Excellence (CCEE) was created as part of the new LCFF accountability framework with the role to advise and assist school districts, charter schools, and county offices of education to achieve goals in their local plans and petitions under the LCFF. The 2013-14 budget provided $10 million in Proposition 98 funding for the CCEE. According to the DOF, this funding is currently unspent but expenditures will kick in during the spring. The Legislature may want to examine the status and current plan for CCEE.

Clean-up Legislation for LCFF Implementation. The DOF indicates there will be a forthcoming proposal for technical fixes to the LCFF, based on issues identified by the California Department of Education and the State Board of Education. While some technical fixes will likely be needed, the Legislature should be prudent about making changes to the LCFF so early in its implementation.

K-14 Education: Proposed Expenditures of Increased Proposition 98 Resources

BACKGROUND:

California provides academic instruction and support services to approximately six million public school students in kindergarten through twelfth grade (K-12) and 2.3 million students in community colleges. There are 58 county offices of education, approximately 1,000 local K-12 school districts, more than 10,000 K-12 schools, and roughly 1,100 charter schools throughout the state, as well as 72 community college districts, 112 community college campuses, and 70 educational centers. Proposition 98, which was passed by voters as an amendment to the state Constitution in 1988, and revised in 1990 by Proposition 111, was designed to guarantee a minimum level of funding for public schools and community colleges.

The budget includes a revision to the Proposition 98 minimum guarantee for 2013-14, increasing it to $56.8 billion. This represents an increase of $1.5 billion since the estimate at the time of enactment of the 2013-14 budget. The prior year (2012-13) guarantee will also rise, from $56.5 billion to $58.3 billion, for an increase of $1.9 billion. Consistent with this trend, the 2014-15 Proposition 98 guarantee is projected to be $61.6 billion—representing an increase of $4.7 billion over the revised current year guarantee and $6.3 billion higher than projected at the time of the 2013 Budget Act. Thus, compared with the funding levels in the 2013 Budget Act, additional Proposition 98 funding over the three years will total $9.7 billion.

The Governor proposes to allocate anticipated year-over-year increases in Proposition 98 expenditures through a combination of initiatives more fully described below. Most of the additional funding will be used to eliminate past funding deferrals and to increase school funding allocated through the new Local Control Funding Formula (LCFF). The Governor also proposes a Proposition 98 Reserve, which would be established in order to mitigate sharp swings in school funding caused by volatile revenues, and a new continuous appropriation for the LCFF tied to annual Proposition 98 funding.

Proposition 98 Funding

State funding for K-14 education—primarily K-12 local educational agencies and community colleges—is governed largely by Proposition 98, passed by voters in 1988. The measure, modified by Proposition 111 in 1990, establishes minimum funding requirements (referred to as the “minimum guarantee”) for K-14 education. General Fund resources, consisting largely of personal income, sales and use, and corporation taxes, are combined with the schools’ share of local property tax revenues to fund the Proposition 98 minimum guarantee. These funds typically represent about 80 percent of statewide funds that K-12 schools receive. The largest contributors to non-Proposition 98 education funds consist of revenues from local parcel taxes, other local taxes and fees, federal funds and proceeds from the state lottery.

The table below summarizes overall Proposition 98 funding for K-12 schools and community colleges since 2007-08, or just prior to the beginning of the steep recent recession. As shown in the table, the state continues to emerge from the period when sharp cuts were necessitated by the severe economic downturn. The economic recession most dramatically affected the General Fund, but also property taxes. The impact of the decline in property taxes was somewhat lessened in the last two years by the shift to schools of property taxes that were formerly diverted to redevelopment agencies (RDAs), as well as the recapture of certain financial assets of the former RDAs.

Proposition 98 Funding
Sources and Distributions
(Dollars in Millions)

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Sources								
General Fund	$42,015	$34,212	$35,533	$35,499	$33,047	$42,207	$40,948	$45,062
Property Taxes	14,563	15,001	14,624	14,157	14,102	16,135	15,865	16,497
Total	**$56,577**	**$49,213**	**$50,157**	**$49,656**	**$47,149**	**$58,342**	**$56,813**	**$61,559**
Distributions								
K-12	$50,344	$43,162	$44,350	$43,719	$41810	$52,115	$50,502	$54,759
CCC	6,112	5,947	5,714	5,850	5,256	6,149	6,233	6,723
Other	121	105	93	87	83	78	78	77

Source: Legislative Analysts' Office

Calculating the Minimum Guarantee

The Proposition 98 minimum guarantee is determined by comparing the results of three "tests" or formulas that are based on specific economic and fiscal data. The factors considered in these tests include growth in personal income of state residents, growth in General Fund revenues, changes in student enrollment, and a calculated share of the General Fund. The formula for each test, the circumstances in which the test is operative, and how often each test has been applied since the passage of Proposition 98, is displayed in the following table.

Proposition 98 Tests
Calculating the Level of Education Funding

Test	Calculated Level	Operative Year	Times Used
Test 1	Based on a calculated percent of General Fund revenues (currently around 39%).	If it would provide more funding than either Test 2 or 3.	3
Test 2	Based on prior year funding, adjusted for changes in per capita personal income and attendance.	If growth in personal income is ≤ growth in General Fund revenues plus 0.5%.	13
Test 3	Based on prior year funding, adjusted for changes in General Fund revenues plus 0.5% and attendance.	If statewide personal income growth > growth in General Fund revenues plus 0.5%.	7

Generally, Test 2 is typically operative during years when General Fund revenue growth is normal or higher than normal. Test 3 is generally operative when General Fund revenues fall or grow slowly. The Test 1 percentage is linked to property allocations when Proposition 98 was approved, and is recalibrated or "rebenched" based on subsequent policy changes such as the allocation of property taxes among local governments and school districts, or the dissolution of RDAs. In the near future, there will be a rebenching as a result of the retirement of the Economic Recovery Bonds (ERBs) and the reversion of the "Triple Flip." The operable test for a particular year can theoretically change over time, based on additional information; however, for the last few years, additional information for prior years has not resulted in a change in the operable test. At a certain point, prior year adjustments are no longer adjusted and the operable test and the Proposition 98 minimum guarantee is "locked down."

The budget assumes that 2012-13 is a Test 1 year and that the current year is a Test 3 year. In addition, the current assumption is that 2014-15 will be a Test 1 year. Thus, in the budget year it is expected that the calculated share of the General Fund will result in greater revenues under Proposition 98 than either of the growth calculations under Test 2 or Test 3. Generally, the Proposition 98 minimum guarantee calculation was designed in order to provide growth in education funding equivalent to growth in the overall economy, as reflected in changes in personal income (incorporated in Test 2). As noted in the table above, in most years the Proposition 98 minimum guarantee has been determined by the application of Test 2.

Suspension of Minimum Guarantee

Proposition 98 includes a provision that allows the Legislature and Governor to suspend the minimum funding requirements and instead provide an alternative level of funding. Such a suspension requires a two-thirds vote of the Legislature and the concurrence of the Governor. To date, the Legislature and Governor have suspended the Proposition 98 minimum guarantee twice—in 2004-05 and 2010-11. While the suspension of Proposition 98 can create General Fund savings during the year in which it is invoked, it also creates obligations in the out-years, as explained below.

Maintenance Factor

In years following suspension of the Proposition 98 minimum guarantee or the operation of Test 3 (that is, when the Proposition 98 guarantee grows more slowly due to declining or low General Fund growth), the state creates an out-year obligation referred to as the "maintenance factor." When growth in state General Fund revenues is stronger (as determined by a specific formula also set forth in the Constitution), the state is required to make maintenance factor payments, which accelerate growth in K-14 funding, until the determined maintenance factor obligation is fully restored.

The maintenance factor is added on to the minimum guarantee calculation using either Test 1 or Test 2.

- In a Test 2 year, the rule of thumb is that roughly 55 percent of additional revenues would be devoted to Proposition 98 to pay off the maintenance factor.

- In a Test 1 year, the amount of additional revenues going to Proposition 98 could approach 100 percent or more. This can occur because the required payment would be a combination of the 55 percent of new revenues plus the established percentage of the General fund—roughly 39 percent—that is used to determine the minimum guarantee.

Settle-Up

Every year, the Legislature and Governor estimate the Proposition 98 guarantee before the final economic, fiscal, and attendance factors for the budget year are known. If the estimate included in the budget for a given year is ultimately lower than the final calculation of the minimum guarantee once those factors are known, Proposition 98 requires the state to make a "settle-up" payment, or series of payments, in order to meet the final guarantee for that year. The Governor's budget assumes General Fund settle-up payments of $2.0 billion for 2012-13 (due to an increase in the minimum guarantee) and $1.7 billion for 2013-14 (also due to an increase in the minimum guarantee).

Outstanding Obligations

There exist a number of obligations owed to school districts by the state, most of which are included in the Wall of Debt. The state currently has over $11.0 billion in such outstanding school and community college obligations—$6.24 billion in deferrals (late payments), $4.5 billion in unpaid mandate claims, $462 million for the Emergency Repair Program (ERP), and $410 million for the Quality Education Investment Act (QEIA). The state also has a $1.5 billion outstanding Proposition 98 settle-up obligation, which can be used to pay off these aforementioned obligations.

GOVERNOR'S PROPOSAL:

K-14 Proposition 98 Education Overall

The budget estimates that the total K-14 Proposition 98 guarantee for 2012-13 increased by $1.8 billion, compared to the level estimated in the 2013 Budget Act. Similarly, for 2013-14, the Governor estimates an increase in the total guarantee of $1.5 billion. Both of these adjustments lead to Proposition 98 "settle-up" obligations, which result in additional one-time resources for schools. The Governor proposes to use these additional one-time resources to pay off deferrals, as described below. The Governor's budget estimates a total Proposition 98 funding level of $61.6 billion (K-14). This is a $6.3 billion increase over the 2013-14 Proposition 98 level provided in the 2013 Budget Act.

One of the largest components of the Governor's budget plan is his proposal to retire all Wall of Debt obligations, including school and community college obligations, by the end of 2017-18, with many obligations to be paid off in the budget year. The Governor's budget proposes to repay all K-14 deferrals in 2014-15, as cited in the Governor's budget summary, at a total cost of $6.24 billion. This proposal would reverse the practice used in prior budgets, in which school districts and community colleges received a significant portion of their funds a year after they had spent them. This policy resulted in hardships for school districts and community colleges, which would, in some cases, have to either borrow money to accommodate the deferral or cut programs and services. In addition, the budget includes $316 million to pay the estimated costs of the QEIA program in 2014-15, with the expectation that such payment would settle the funding obligation for that program. The budget directs the remaining $94 million in unobligated QEIA funds to cover a portion of the $188.1 million payment for ERP in 2014-15 (the other $94 million for ERP is from unspent prior year Proposition 98 funding). The Governor proposes to retire all remaining Wall of Debt obligations in the following three years (including the remaining obligation for ERP), clearing all debts by 2017-18.

K-12 Proposition 98 Major Spending Proposals

The Governor's budget includes a proposed Proposition 98 funding level of $54.3 billion for K-12 programs. This includes a year-over-year increase of nearly $4.3 billion in Proposition 98 funding for K-12 education, as compared to the revised Proposition 98 K-12 funding level for 2013-14. Under the Governor's proposal, ongoing K-12 Proposition 98 per pupil expenditures would increase from $8,469 in 2013-14 to $9,194 in 2014-15. This 2014-15 proposed funding level in Proposition 98 funds for K-12 reflects a per-pupil increase of 8.6 percent, as compared to the per-pupil funding level provided in the 2013 Budget Act. The Governor's major K-12 spending proposals are identified below.

- **Paying Off Deferrals.** As noted above, the Governor's budget proposes to pay off outstanding payment deferrals—a practice used in previous budgets whereby the state would delay the issuance of money to school districts for months after school districts had planned to spend it. The Governor's budget proposes to end this practice by paying off all payment deferrals, estimated at a cost of $6.24 billion for K-12 programs ($5.6 billion) and community colleges ($600 million). This payment is essentially one-time money for school districts that they can use for any allowable educational expenditure.

- **Local Control Funding Formula.** The 2013 Budget Act adopted a new way for the state to provide funding to school districts, charter schools, and county offices of education: the Local Control Funding Formula (LCFF). The Governor's budget proposes an increase of $4.5 billion to implement the LCFF. This is the largest programmatic increase for K-12 schools included in the Governor's budget. This investment would eliminate about 28 percent of the funding gap between the formula's 2013-14 funding level and its target at full implementation. The budget proposes to fund the formula's base grants at a rate of $7,829 per pupil, as measured by pupil average daily attendance (ADA), inclusive of cost-of-living and grade span adjustments. The 2013-14 budget funded the base grants at $7,643 per pupil ADA. Proposals to change LCFF from current law include transferring funding into the formula for two additional categorical programs (specialized secondary programs and agricultural vocational education), and creating a new continuous appropriation of LCFF funding that would bypass the annual budget process. These issues are discussed more fully in a separate accompanying section.

- **Enrollment and Cost-of-Living Adjustments.** The Governor's budget reflects an estimated decrease in student enrollment in the K-12 system. Specifically, it reflects a decrease of $214.5 million in 2013-14, as a result of a decrease in the projected ADA, as compared to the 2013 Budget Act. For 2014-15, the Governor's proposed budget reflects a decrease of $42.9 million to incorporate a projected decline in ADA for the budget year. For charter schools, the Governor's proposed budget funds an estimated increase in charter school ADA, discussed below. The proposed budget also provides $33.3 million to support a 0.86 percent cost-of-living adjustment for categorical programs that are not included in the new LCFF. These programs include special education and child nutrition, among others. The proposed funding level for the LCFF includes cost-of-living adjustments for school districts, charter schools, and county offices of education.

- **Proposition 98 Reserve Constitutional Amendment.** The Governor's budget proposes a constitutional amendment intended to increase year-to-year stability in education funding. The amendment is designed to create a mechanism to smooth out year-to-year changes in education funding, in order to prevent the damage caused by significant cuts to education. The budget summary states, "The amendment will not change the overall guaranteed level of funding for education." This proposal is further discussed in the section that addresses the Governor's proposal for the overall budget reserve.

- **Non-classroom-based Independent Study.** The Administration plans a legislative proposal regarding the use of non-classroom-based independent study, also commonly known as on-line independent study for grades 9-12. The summary describes the legislative proposal as having the objective "to both streamline and expand the instructional opportunities available through this process." The proposal would require that independent study courses meet the following requirements: 1) be equivalent in rigor and quality to classroom-based courses; 2) contain the same number of educational minutes as classroom-based courses; 3) provide at least one meeting per week between the teacher and students; 4) maintain student-teacher ratios equivalent to that in classroom-based courses (unless a new ratio is collectively bargained); and, 5) may not result in the school district or county office claiming more than one unit of ADA for each student enrolled in independent study.

Other K-12 Education Budget Proposals
Additional proposals contained within the Governor's budget related to K-12 education include the following:

- **K-12 School Facilities.** The budget proposes $188.1 million in one-time Proposition 98 funds for the Emergency Repair Program, which settled the *Williams* lawsuit. In addition, the Administration proposes to continue a dialogue with the Legislature and stakeholders about the best way to fund school facilities, "including consideration of what role, if any, the state should play in the future of school facilities funding." The Administration proposes to transfer $211 million in remaining School Facility Program bond authority from specialized programs to new construction ($105.5 million) and modernization ($105.5 million) programs. The budget summary notes that approximately $163 million remains in the Seismic Mitigation program.

- **Proposition 39 Energy Efficiency Investments.** The Governor's budget proposes to allocate $363 million in Proposition 39 energy funds available in 2014-15, as follows:

    - $316 million to K-12 school districts, for energy efficiency project grants.

- $39 million to community college districts, for energy efficiency project grants.
- $5 million to the California Conservation Corps, to provide technical assistance to school districts.
- $3 million to the Workforce Investment Board, for continued implementation of job-training programs.

- **Assessments for New Common Core Standards.** The Governor proposes an increase of $46.5 million in Proposition 98 funds to implement AB 484 (Bonilla), Chapter 489, Statues of 2013. This bill authorized a new assessment system aligned to the new Common Core Standards (academic content standards), which have been embraced by California and most other states.

- **Adult Education**. While the Governor's budget does not include any new proposals for adult education, the budget summary cites the reforms initiated in the 2013 Budget Act, and notes that adult education consortia plans will be completed in early 2015. The summary also cites the Administration's intent to invest in adult education in 2015-16, via a single adult education categorical program. The summary also signals the Administration's intent to continue working with the Legislature, the California Department of Education and the California Community Colleges Chancellor's Office on the work initiated in the 2013 Budget Act.

- **Child Care and Development.** The Governor's budget includes funding for a demonstration pilot project to try to improve the outcomes for 2,000 CalWORKs families, to involve six counties over three years, providing licensed subsidized childcare and other services. The budget does not include any other major changes or proposals to preschool or childcare funding.

ISSUES TO CONSIDER:

Legislative Education Priorities. According to the Legislative Analyst's Office (LAO), it is possible the state will experience additional revenue growth, beyond the level in the Governor's budget, at the time of the May Revision. It is always prudent for the Legislature to examine expenditure alternatives for meaningful one-time and on-going Proposition 98 funding. For example, both houses of the Legislature have expressed strong interest in the accelerated implementation of transitional kindergarten; however, such an endeavor will require additional fiscal resources, while still providing critical debt payments, providing school districts positive cash flow by reducing deferred funding, and investing in the LCFF. Even absent additional revenues above current projection, the Legislature could choose to make a partial pay-down of the deferral, freeing up resources for additional investment.

Proposed Proposition 98 Reserve. The budget proposes changes to Assembly Constitutional Amendment 4 (ACA 4), specifically the creation of a Proposition 98 reserve (in tandem with a general reserve, discussed elsewhere in this document), presumably from revenues that can be identified as capital gains above 6.5 percent of General Fund revenues. At present, the Administration is drafting this language; however, as the LAO has pointed out, changes to the State Constitution as it relates to "re-doing" any funding formulas "probably would produce unforeseen or unintended consequences for the state in the future." Is it prudent to withhold Proposition 98 funds for purposes of creating a reserve? If so, what magic is there in the identified threshold of any capital gains revenue above 6.5 percent being put in the reserve? How would such a reserve diminish legislative prerogative over appropriations in future years?

Common Core State Standards Implementation and Professional Development. In 2013, the Legislature appropriated $1.25 billion in one-time Proposition 98 funding to school districts for: (a) professional development for teachers and administrators to assist in the implementation of common core math and English-language arts academic content standards; (b) instructional materials aligned to the academic content standards; and (c) instructional technology. However, prior to this recent one-time investment, the state did not provide any supporting appropriations for these items for well over five years. Additional one-time or on-going funding beyond the LCFF will still be warranted. Providing ongoing funding for varied approaches to professional development to support the continued implementation of the Common Core State Standards will build on the one-time investment of $1.25 billion and help teachers better prepare for the dramatic changes in mathematics and English-language arts for which student achievement will be evaluated.

Child Care and Early Childhood Education

The state delivers a variety of child care and early education programs. This section discusses child care and development (CCD) programs and early childhood education programs, including Transitional Kindergarten and Head Start.

BACKGROUND:

Child Care and Development Programs

The state provides many subsidized child care and development (CCD) programs, including the California State Preschool Program (CSPP), for low-income working families. To qualify for subsidized child care, families must demonstrate "need" for care and earn less than 70 percent of the state median income. As long as families meet these requirements, and depending on the program, their children can receive services until age 13.

Table 1 provides a brief description of each CCD program and a corresponding number of proposed slots for this year.

Table 1: Summary of California's Child Care and Development Program

Program	Description	Proposed Slots
CalWORKs		
Stage 1	Provides cash aid and services to eligible families. Begins when a participant enters the CalWORKs program.	42,719
Stage 2[1]	When the county deems a family "stable." Participation in Stage 1 and/or Stage 2 is limited to two years after an adult transitions off cash aid.	55,943
Stage 3	When a family expends time limit in Stage 2, and as long as family remains otherwise eligible.	30,830
Non-CalWORKs		
General Child Care	State and federally funded care for low-income working families not affiliated with CalWORKs program. Serves children from birth to 12 years old.	48,431
Alternative Payment	State and federally funded care for low-income working families not affiliated with CalWORKs program. Helps families arrange and make payment for services directly to child care provider, as selected by family.	29,803
Migrant Child Care	Serves children of agricultural workers while parents work.	2,595
Severely Handicapped Program	Provides supervision, therapy, and parental counseling for eligible children and young adults until 21 years old.[2]	145
State Preschool	Part-day and full-day care for 3 and 4-year old children from low-income families.	136,755

[1] Average cost per case for CalWORKs Stage 2 is $542; average cost per case for Stage 3 is $502.
[2] Recipients must have an individualized education plan (IEP) or individualized family service plan (IFSP) issued through special education programs.

Voucher-Based Delivery System. According to the LAO, California essentially has two child care systems. One system consists of CalWORKs Stages 1, 2, and 3, and non-CalWORKs Alternative Payment (AP) programs, where parents are offered vouchers to purchase care from licensed or license-exempt caregivers, such as friends or relatives who provide in-home care. Families can use these vouchers at any licensed child care provider in the state, and the value of child care vouchers is capped. The state will only pay up to the Regional Market Rate (RMR), which is a different amount in each county. The RMR is based on regional surveys of the cost of child care, which is currently set to the 85th percentile of the RMR survey conducted in 2004. If a family chooses a child care provider, who charges more than the maximum amount of the voucher, then a family must pay the difference, called a co-payment. Typically, a "Title 22" program serves families who receive vouchers. Title 22 regulations require that a licensed provider meet basic health and safety standards according to the Department of Social Services' (DSS) Community Care Licensing Division. DSS funds CalWORKs Stage 1, and county welfare departments locally administer the program. The California Department of Education (CDE) funds the remaining voucher programs, which are administered locally by 76 Alternative Payment (AP) agencies statewide.

Direct Contractor System. The second system is comprised of General Child Care, the State Preschool Program, the Migrant Child Care Program, and the Severely Handicapped Program. Providers of these programs contract with, and receive payments directly from CDE. These programs, known as "Title 5 Centers" for their compliance with Title 5 of the California Code of Regulations, must meet additional requirements, such as development assessments for children, rating scales, and staff development. There are key differences between Title 22 and Title 5 providers, pertaining to teacher-child ratios, provider education and training requirements, and oversight requirements (Table 2).

Table 2: Provider Safety and Educational Requirements

Provider Safety and Educational Requirements

Preschool-Aged Children

	Voucher Providers			CDE Contractors
	License-Exempt Providers	Title 22 FCCHs	Title 22 Centers	Title 5 Providers Including Preschool
Provider/teacher education and training	None.	None.	Child Development Associate Credential or 12 units in ECE/CD.	Child Development Teacher Permit (24 units of ECE/CD plus 16 general education units).
Provider health and safety training	Criminal back-ground check required (except relatives). Self-certification of health and safety standards.	15 hours of health and safety training. Staff and volunteers are fingerprinted.	Staff and volunteers fingerprinted and subject to health and safety standards.	Staff and volunteers fingerprinted and subject to health and safety standards.
Required ratios	None.	1:6 adult-child ratio.	1:12 teacher-child ratio or 1 teacher and 1 aide for 15 children.	1:24 teacher child and 1:8 adult-child ratio.
Accountability, monitoring, and oversight	None.	Unannounced visits every five years or more frequently under special circum-stances.	Unannounced visits every five years or more frequently under special circumstances.	Onsite reviews every three years. Annual outcome reports, audits, and program information.

FCCHs = family child care homes; CDE = California Department of Education; and ECE/CD = Early Childhood Education/Child Development.

Table 2: Issues and Options: Developing Safety and Quality Ratings for Child Care. Legislative Analyst's Office: January 2007. pg. 4. <http://www.lao.ca.gov/2007/childcare/childcare.pdf>

Demand Can Exceed Available Slots. Since 2012, the number of subsidized child care and preschool slots has diminished, except for the Migrant Child Care and Severely Handicapped programs, which increased by 61 slots and one slot, respectively, in 2013-14. Specifically, since 2012, the Legislative Analyst's Office (LAO) estimates that CalWORKs Stage 1, 2, and 3 programs have lost a total of 5,417 slots; General Child Care, 537 slots; and, Alternative Payment programs, 329 slots. For specific figures on how child care and preschool subsidized slots have fared since 2012-13, please see Table 3 below.

When funding exceeds demand, families must contact contractors directly to request information about being placed on waiting lists. The 2011-12 budget eliminated funding for each county's Centralized Eligibility List (CEL), but some counties have opted to administer a locally funded CEL.

Families can also contact a Resource and Referral Agency (R&R) for assistance. R&Rs, which are funded by CDE and located in every county throughout the state, assist families in finding child care, recruiting and training child care providers, and collecting data from parents and child care providers. Some counties, such as Alameda and Los Angeles, have multiple R&Rs that cover regions by zip code.

Table 3: Child Care and Preschool Subsidized Slots

Summary of Child Care and Preschool Subsidized Slots[a]

	2012-13 Actual	2013-14 Revised	2014-15 Proposed	Change From 2013-14	
				Amount	Percent
CalWORKs Stage 1	34,849	45,532	42,719	-2,813	-6%
CalWORKs Stage 2	63,379	56,593	55,943	-650	-1
CalWORKs Stage 3	25,448	32,784	30,830	-1,954	-6
General Child Care	46,036	48,968	48,431	-537	-1
Alternative Payment	24,854	30,132	29,803	-329	-1
Migrant	2,491	2,534	2,595	61	2
Handicapped	143	144	145	1	1
Total Child Care	**197,200**	**216,687**	**210,466**	**-6,221**	**-3%**
State Preschool	**129,511**	**136,182**	**136,755**	**573**	**—**[b]

[a] Reflects average monthly slots. For 2012-13, reflects actual caseloads. For 2013-14 and 2014-15, reflects administration's caseload estimates for all programs other than Migrant and Handicapped. Caseloads for these two programs reflect LAO estimates, as administration's estimates historically have been higher than actuals.

[b] Less than 1 percent.

Posted January 2014.

Table 3: Child Care and Preschool Subsidized Slots. Legislative Analyst's Office: EdBudget Tables, 2014 http://www.lao.ca.gov/sections/education/ed-budget/Summary-of-Child-Care-and-Preschool-Subsidized-Slots.pdf

Funding for CCD Programs. In 2013-14, around $947 million was allocated for CalWORKs Child Care, $678 million for non-CalWORKs Child Care, and $507 million for State Preschool. These programs were funded with non-Proposition 98 General Fund ($776 million), Proposition 98 ($507 million), and federal funds ($924 million).

According to the LAO, since 2008, the state's overall CCD funding has decreased by $985 million, or 31 percent. Until the 2011-12 fiscal year, the majority of these programs were funded from within the Proposition 98 Guarantee for K-14 education. Additionally, California also receives funding from the federal Child Care and Development Fund (CCDF), which is used to help families with incomes below 85 percent of the state median income level. Four percent of the federal block grant must be spent on improving the quality of childcare.[3]

Reimbursement Rates for CCD Programs. All Title 5 programs (General Child Care, Migrant Child Care and State Preschool) receive the same reimbursement rate (depending on the age of the child), no matter where in the state the program is located. Since 2007, the standard reimbursement rate (SRR) has $34.38 per child per day of enrollment. Over the past few years, small and medium-sized providers have increasingly gone out of business and have been absorbed by larger providers that have greater economies of scale. This is one indication that the SRR may not be sufficient for them to operate.

Alternative Payment Agencies (APs), which issue vouchers to eligible families, are paid through the "administrative rate", which provides them with 17.5 percent of total contract amounts. As the state cut the number of child care slots, APs issued fewer vouchers, which generated less funding for programs.

California State Preschool Program (CSPP)

The following sections describe California State Preschool, Transitional Kindergarten (TK), and Head Start programs, which Table 4 summarizes.

AB 2759 (Jones), Chapter 308, Statutes of 2008, consolidated funding for State Preschool, Prekindergarten and Family Literacy, and General Child Care center-based programs to create the California State Preschool Program (CSPP). This program provides both child care and early education.

CSPP serves eligible three- and four-year old children, with priority given to four-year olds who meet one of the following criteria:

- The family is on aid,
- The family is income eligible (family income may not exceed 70 percent of the state median income as adjusted for family size),
- The family is homeless, or
- The child is a recipient of protective services or has been identified as being abused, neglected, or exploited, or at risk of being abused, neglected or exploited.

CSPP, which is administered by Local Educational Agencies (LEAs), colleges, community-action agencies, and private nonprofits, provides both part-day and full-day services with developmentally appropriate curriculum.

According to CDE, state preschool programs with no child care costs are around $21.22 per child per day, approximately $3,820 per pupil for a 180-day program. For full-day state preschool programs with child care, the average cost is $34.48 per child per day, or $8,595 per pupil for 250 days. Family fees, or the cost a family must pay for child care if their income is above a certain level, are based on a sliding scale. In general, a family pays a family fee if their income is

[3] Some examples of quality improvement programs include support for R&Rs, support for the Local Child Care and Development Planning Councils, and training and professional development for child care providers.

above 50 percent of the state median income. Additionally, AB 2759 (Jones), Chapter 308, Statutes of 2008, authorizes contractors to blend State part-day Preschool funds and General Child Care programs to provide three-and four-year-olds with State Preschool and wrap-around child care that is needed to help support working parents.

Contractors must develop and implement an annual evaluation process, which includes a parent survey assessment, an agency self-evaluation, and an analysis of categorical program monitoring/contract monitoring review (CPM/CMR) findings.

Table 4: State Preschool Program, Transitional Kindergarten, and Head Start

	State Preschool	Transitional Kindergarten[a]	Head Start[b]
Eligibility	Three and four year olds whose family's income is below 70 percent of state median income ($42,216 a year for a family of three).	Four year olds whose fifth birthday falls between September 1 and December 1.	Three to five year olds whose family's income is below the federal poverty line ($19,530 a year for a family of three).
Availability	Number of available slots based on state budget appropriation. Waiting lists are common across the state.	Available for all eligible children.	Number of available slots based on federal budget appropriation.
Children Served[c]	Approximately 136,000 children.	Approximately 51,000 children.	Approximately 89,000 children.
Provider	Public and private providers that contract with the state.	Public school districts and charter schools.	Public and private providers that contract with the federal government.
Teacher Qualification Requirements	Child Development Teacher Permit (24 units of early childhood education/child development plus 16 general education units).	Bachelor's degree and multi-subject teaching credential.	"Demonstrated competency to perform basic functions that. . . advance the intellectual and physical development of children. . ."[d]
Maximum Student-Teacher Ratios	24:1 teacher-to-child and 8:1 adult-to-child ratios.	31:1 teacher-to-child ratio.	20:1 teacher-to-child and 10:1 adult-to-child ratios.
Programmatic Standards	California's Preschool Learning Foundations.	Locally developed, modified kindergarten curriculum.	The Head Start Child Development and Early Learning Framework.
Duration	Part day, 175 days a year. (Extended care is available for one-third of children enrolled in the program.)	Part day, 175 days a year. (Some school districts opt to offer longer-day programs.)	Part and full-day programs offered.
Per-Child Funding	Approximately $3,700 per child per year. (Approximately $6,000 per year including extended care.)	$5,516 per non-EL/LI child per year and $6,620 per EL/LI child.[e]	Average of approximately $7,600 per child per year.
Total Funding[c,f]	$507 million (Proposition 98 funds) and approximately $100 million (non-Proposition 98 General Fund).[e]	Approximately $345 million (Proposition 98 funds).	Approximately $750 million (federal funds).

[a] Reflects Transitional Kindergarten under current law.
[b] Details are for Head Start's center-based programs.
[c] Counts/amounts for State Preschool and Transitional Kindergarten from 2013-14. Counts/amounts for Head Start from 2012-13.
[d] *Improving Head Start for School Readiness Act of 2007.*
[e] Reflects 2013-14 rates under Local Control Funding Formula not including concentration funding.
[f] Some First 5 programs provide additional funding to support additional preschool slots in those counties.
EL/LI = English learner/low-income.

Table 4: What are California's Major School Readiness Programs? Legislative Analyst's Office: EdBasics Tables, 2014. http://www.lao.ca.gov/sections/education/ed-basics/What-Are-CA-Major-School-Readiness-Programs.pdf

Transitional Kindergarten (TK)

SB 1381 (Simitian), Chapter 705, Statutes of 2010, enacted the "Kindergarten Readiness Act," which changed the required birthday for admission to kindergarten and first grade, and established a TK program beginning in 2012-13 for children who turn five between September 1 and December 1. The program uses a modified kindergarten curriculum that is age and developmentally appropriate. While state law requires school for six-year-olds, TK, like kindergarten, is not compulsory for a child.

WHO IS ELIGIBLE FOR TK?

A child is eligible if he or she has her fifth birthday between:

- For the 2013-14 school year, October 2 and December 2.
- For the 2014-15 school year and each school year thereafter, September 2 and December 2.

Each elementary or unified school district must offer TK and kindergarten for all eligible children. TK programs must also have 36,000 minutes per year, or 180 minutes per school day, of instructional teaching. According to CDE, there is no state mandated curriculum for TK, so LEAs must modify current kindergarten curriculum to make it appropriate. Also, LEAs may determine the standards, or learning foundations, for TK. Similar to kindergarten, the teacher to student ratio is 1:24, and teachers must be credentialed.

This year, CDE estimates that there are about 51,000 students enrolled in TK. Given that this reflects two months of eligibility, we could reasonably assume that TK, under current law, could grow to about 75,000 students.

Funding for TK. TK is entirely funded through Average Daily Attendance (ADA), so a local district receives the same ADA funding rate as kindergarten students. During the Local Control Funding Formula[4] phase-in, it is not yet possible to determine the statewide rate for TK; however, based on the current level of funding, CDE estimates average cost per child in TK to range from $5,118 per pupil to $7,676, depending on whether a pupil receives a supplemental grant amount.

***Reporting Information*.** All districts report TK information via the California Longitudinal Pupil Achievement Data System (CALPADS), which is a data system that includes information on student demographics, staff assignments, and course data for state and federal reporting. CALPADS was created to meet federal requirements in the No Child Left Behind Act of 2001, and provides LEAs with data and reports on student achievement over time.

Head Start

Head Start is a national program, administered by the Administration on Children, Youth, and Families, which aims to serve preschool-age children and their families in Head Start programs around the state. Head Start programs offer a variety of service models, depending on the needs of the local community. Many Head Start programs also provide Early Head Start, which serves infants, toddlers, pregnant women, and their families who have incomes below the federal poverty level. Programs may be based in:

[4] For more information on LCFF, please see the Education Section of this report. Nothing about LCFF requires specified funding for specified programs. Districts can identify money as supplemental/concentration funds, or for another use.

- Centers or schools that children attend for part-day or full-day services;
- Family child care homes; and/or
- Children's own homes, where a staff person visits once a week to provide services to the child and family. Children and families who receive home-based services gather periodically with other enrolled families for a group learning experience facilitated by Head Start staff.

According to CDE, in 2012, over 111,000 children were served by Head Start with a program budget of over $965 million. California's Head Start programs are administered through a system of 74 grantees and 88 delegate agencies. A majority of these agencies also have contracts with the CDE to administer general child care and/or State Preschool programs. CDE indicates it has over 1,316 contracts through approximately 718 public and private agencies, providing services to approximately 400,000 children.

Other Funding Sources that Support CCD and Early Education Programs
Race to the Top -- Early Learning Challenge (RTT-ELC).[5] In 2012, California was one of nine states awarded a Race to the Top -- Early Learning Challenge grant, which aims to improve the quality of early learning programs and to close the achievement gap for children from birth to age five. California's grant totals $52.6 million over four years (January 2012 to December 2015). State agencies, including the State Board of Education, DSS, Department of Public Health, Department of Developmental Services, and First 5 California, work with a voluntary network of 17 Regional Leadership Consortia (Consortia)[6] to operate or develop a local Quality Rating and Improvement System (QRIS). The grant is also making one-time investments in state capacity, such as teacher/provider training and professional development, kindergarten readiness, home visitation, and developmental screenings

Around 74 percent of California's grant is spent in 16 counties[7] to support a voluntary network of early learning programs. CDE estimates that nearly 1.9 million children, or 70 percent of children under five, can benefit from this grant.

California First 5 and County First 5 Commissions. In 1998, voters approved Proposition 10, the California Children and Families First Act, which created the California Children and Families Program, known as First 5. There are 58 county First 5 commissions, as well as the State California and Families Commission (State Commission), which provide and direct early development programs for children through age five. A cigarette tax (50 cent per pack) is the primary funding mechanism, of which about 80 percent is allocated to the county commissions and 20 percent is allocated to the State Commission. According to the Legislative Analyst's Office, the tax generates approximately $400 million annually.

[5] For more information on California' Race to the Top -- Early Learning Challenge Grant, please see the May 2013 Report to the Governor, the Legislature, and the Legislative Analyst's Office at http://www.cde.ca.gov/sp/cd/rt/documents/rttelc2012legrpt.pdf
[6] The Consortia includes the counties of Alameda, Contra Costa, El Dorado, Fresno, Los Angeles, Merced, Orange, Sacramento, San Diego, San Francisco, San Joaquin, Santa Barbara, Santa Clara, Santa Cruz, Ventura, and Yolo.
[7] The Consortia includes 17 members in the counties of Alameda, Contra Costa, El Dorado, Fresno, Los Angeles, Merced, Orange, Sacramento, San Diego, San Francisco, San Joaquin, Santa Barbara, Santa Clara, Santa Cruz, Ventura, and Yolo.

According to the 2011 First 5 California Annual Report[8], the State Commission has invested in the following:

- Power of Preschool - $15.2 million to fund Power of Preschool demonstration projects in certain counties. Power of Preschool provides free, voluntary, high-quality, part-day preschool to assist three- and four-year old children in becoming effective learners with a focus on developing preschool in underserved and high-priority communities.
- School Readiness - $51.7 million to counties for the School Readiness Program that strives to improve the ability of families, schools, and communities to prepare children to enter school ready to learn. Services are provided to focus on family functioning, child development, child health, and systems of care with a specific target to children and their families in schools with an Academic Performance Index score in the lowest three deciles.
- Low Income Investment Fund Constructing Connections - $600,000 to support Constructing Connections that coordinates and delivers technical assistance, training, knowledge, and facility financing information to support child care facilities development through local lead agencies. The Commission indicates that it leveraged more than $86 million in resources to create and renovate child care facilities and spaces.

***Local School Districts*.** Local school districts have also made considerable investments in early childhood education. Many elementary schools have preschool programs and child care programs on site, such as Head Start, First 5 funded programs, or State Preschool. However, some programs are funded directly by school districts using other funds, including local property tax and parent fees. School districts have flexibility to use their funding streams on early childhood education. There are various funding mechanisms that can also be used to support early childhood education, such as:

- Title I federal funding, which is dedicated to improving the academic achievement of the disadvantaged,
- Federal special education funding,
- California School Age Families Education (CalSAFE) that provided money specifically for child care and other supports for parenting students. This program was added to categorical flexibility in 2008-09 and the funds allocated to districts are no longer restricted to the CalSAFE program.
- The state also provides local school districts with After School Educational and Safety (Proposition 49) funding of about $680 million annually.

***Community College Districts*.** There is also a small amount of funding allocated to the Community College Districts to support subsidized child care for students. The budget includes funding for the following programs:

- CalWORKs: $9.2 million for subsidized child care for children of CalWORKs recipients.
- Cooperative Agencies Resources for Education (CARE): Administered by the State Chancellor's Office, CARE uses Proposition 98 funds to operate 113 CARE

[8] http://www.ccfc.ca.gov/pdf/annual_report_pdfs/Annual_Report_11-12.pdf

programs. For fiscal year 2013-14, the program was allocated $9.3 million to provide eligible students with supplemental support services designed to assist low-income single parents to succeed in college.[9]

- Child Care Tax Bailout: This program was first established in 1978 to mitigate the effect of Proposition 13 on 25 community colleges that had previously dedicated local taxes to child care and development centers. This program was included in the categorical flex item with funding of $3.4 million in the 2009-10 budget, but there has been no change to this program since that time.

GOVERNOR'S PROPOSAL:

The Governor proposes few substantive changes for child care and preschool funding. Overall funding across all programs decreases by $3 million (less than one percent change since last year). The budget includes the following proposals:

- **Parent/Child Engagement Demonstration Pilot.** The budget proposes a three year, six county pilot program to support 2,000 vulnerable low-income families, who have multiple barriers to entry into the workforce and may not have access to licensed child care, or who fall into CalWORKs sanction status. Some of the goals of the pilot project are to:
  - Connect vulnerable children with stable licensed care,
  - Engage parents with children in a child care setting, and
  - Provide parents with work readiness activities that move the family towards self-sufficiency.

  The pilot project is expected to cost $9.9 million General Fund and $115.4 million General Fund over three years. The budget expects the first families to enroll in March 2015, and the second cohort in January 2016.

- **Increases CalWORKs Stage 2 and Stage 3 funding to reflect increased cost-of-care.** The budget proposes an increase in $6.3 million and $2.8 million non-Proposition 98 General Fund for CalWORKs Stage 2 and Stage 3 recipients, respectively.

- **Reflects decreases in federal funds.** The budget reflects a net decrease of $9.1 million federal funds to reflect a reduction of $3.2 million carryover funds, and a decrease of $5.9 million to the base grant.

[9] The Chancellor's Office temporarily suspended the Board of Governors-approved CARE allocations' funding formula, so each CARE program is awarded the same allocation received in the past four years. For more information about CARE's final allocations, please see http://extranet.cccco.edu/Divisions/StudentServices/CARE/Allocations.aspx

Table 5 provides information on proposed funding for CCD programs, including State Preschool.

Table 5: Legislative Analyst's Office, Budget Summary

(Dollars in Millions)

	2012-13 Actual	2013-14 Revised	2014-15 Proposed	Change From 2013-14 Amount	Change From 2013-14 Percent
Expenditures					
CalWORKs Child Care					
Stage 1	$289	$406	$385	-$22	-5%
Stage 2	419	358	364	6	2
Stage 3	162	183	186	3	2
Subtotals	**($870)**	**($947)**	**($935)**	**(-$12)**	**(-1%)**
Non-CalWORKs Child Care					
General Child Care	$465	$473[a]	$479[b]	$6	1%
Alternative Payment	174	177[a]	179[b]	2	1
Other child care[c]	28	28[a]	28[b]	—	1
Subtotals	**($666)**	**($678)**	**($687)**	**($9)**	**(1%)**
Support Programs	$76	$74	$73	-$2	-2%
Totals	**$1,612**	**$1,699**	**$1,694**	**-$5**	**—**
Funding					
State Non-Proposition 98 General Fund	$779	$776	$783	$8	1%
Other state funds	14	—	—	—	—
Federal CCDF	549	541[a]	556[b]	15	3
Federal TANF	372	383	355	-28	-7
State Preschool (Proposition 98)	**$481**	**$507**	**$509**	**$2**	**—**

[a] Differs from administration's estimate due to reflecting the federal sequestration cut and the associated General Fund backfill.
[b] Does not include potential federal sequestration reduction, as estimates are still pending.
[c] Includes Migrant Child Care program and Handicapped Child Care program.
CCDF = Child Care and Development Fund and TANF = Temporary Assistance for Needy Families.
Posted January 2014.

Table 5: Child Care Budget Summary. Legislative Analyst's Office: EdBudget Tables, 2014 <http://www.lao.ca.gov/sections/education/ed-budget/Child-Care-Budget-Summary.pdf >

ISSUES TO CONSIDER:

Regional Market Rate. For child care, CDE conducts its RMR survey every two years, but state law does not require that the state adopt the rate. Over the past few years, providers increasingly have been charging the maximum of what the state will pay for vouchers. In some counties this is more pronounced than in others. If child care providers charge too high a price, families may be unwilling or unable to pay. In communities with large numbers of low-income families who do not receive subsidies, the families' ability to pay may be more limited than what the providers could otherwise charge if all families had subsidies. However, if most families were subsidized the provider could charge closer to the RMR cap without affecting the families' ability to pay. The Legislature may wish to discuss whether updating the RMR based on a more recent survey is appropriate and helpful for families determining where to access care.

Reviewing Current TK system. The current TK framework may deserve additional review and discussion. First, the current TK program provides an additional year of public school, regardless of need, to children born between September and December. However, it is unclear why this subset of children, simply based on birth date, should receive the benefit. Second, current law allows parents of children, who are born after the cutoff, to request a waiver to have their children begin kindergarten early. In addition, districts have much flexibility in providing waivers, creating classrooms, and modifying kindergarten curriculum for TK. The Legislature may be interested in issuing a statewide standard or learning foundation to ensure that quality education is provided to all children, regardless of geographic location. Lastly, a number of legislative proposals reconsider the TK's program structure and service delivery. The Legislature may revisit the TK program and focus its resources to reduce the achievement gap.

Statewide "Stability" Standard for CalWORKs. Before a family moves from CalWORKs Child Care Stage 1 to Stage 2, a county must determine the family to be in "stable" condition. However, there is no statewide definition of what constitutes "stable." Because funding for these programs rely heavily on caseload projections and estimates, unpredictable shifts from Stage 1 to Stage 2 could undermine the ability for resources to be allocated accordingly. The Legislature may choose to define "stable" for purposes of determining eligibility to be transferred from Stage 1 to Stage 2 of CalWORKs Child Care.

Potential CalWORKs Shortfall. In the LAO's November 2013 forecast,[10] the LAO projected a $22 million funding shortfall across CalWORKs Stage 2 and Stage 3 due to increases in the average cost of care. The Governor's budget does not augment current year Stage 2 or Stage 3 to address any shortfall. The Legislature should consider how the current year's child care services may be affected, and whether the proposed budget can be adjusted to address the shortfall.

Updating Quality Measures.[11] Four percent of the Child Care and Development Block Grant must be spent on improving the quality of child care. Examples of uses for quality funds include technical assistance and training, R&R services, and grants and loans to providers for start-up costs. In 2012-13, the state budgeted $72 million for 27 distinct projects including professional development, stipends for providers, and activities related to health and safety. The Legislature may wish to examine more closely how those quality measure funds are being used and identify if there are better ways to allocate the quality funding measures.

Coordination in a Patchwork System. The Legislature may want to examine how current child care services and early education programs are administered and delivered, so that these efforts and programs can best maximize the use of available funding, deliver quality services, and meet the needs of California's families.

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[10] The LAO's full report can be accessed at http://www.lao.ca.gov/reports/2013/bud/fiscal-outlook/fiscal-outlook-112013.pdf

[11] Every two years, California must prepare and submit to the federal government a plan detailing how its CCDF funds are allocated and expended. http://www.cde.ca.gov/sp/cd/re/stateplan.asp

Higher Education – Accountability

BACKGROUND:

The Legislature has been developing and supporting proposals to create greater accountability for higher education for over a decade. Many of the Legislature's efforts have been consistent with the Legislative Analyst's Office's (LAO) recommendations on the need for a public agenda and improved oversight of the higher education segments, and reflect the findings of the most recent review of the state's Master Plan for Higher Education. The Legislature has limited control in regards to the operations and governance of the University of California (UC) and California State University (CSU). They are both governed by independent boards and the UC has constitutional autonomy, thus the budget is a critical legislative tool in ensuring that statewide goals and outcomes are being appropriately addressed by the state's universities.

Given that significant budget authority has been delegated to UC and CSU, the Legislature has historically relied on two primary budgetary control levers or "tools," earmarks and enrollment targets, to ensure that state funds are spent in a manner consistent with the Legislature's intent and that access is maintained. The use of these tools has also ensured a clear public record and transparency of key budget priorities.

With regard to earmarks, typically the annual budget act included a number of conditions on UC's and CSU's General Fund appropriations. These earmarks have varied over the years in keeping with the Legislature's and Governor's particular concerns at the time. Due to the Governor's vetoes, earmarks for the UC and CSU were essentially eliminated from the Budget Acts of 2012 and 2013.

With regard to enrollment targets, historically UC's and CSU's budgets have been tied to a specified enrollment target. To the extent that the segments failed to meet those targets, the state funding associated with the missing enrollment reverted to the General Fund. The Legislature adopted budget bill language setting enrollment targets for the UC and CSU for the current budget year that would maintain 2012-13 enrollment levels. The Governor vetoed the budget bill language, thus eliminating enrollment targets for the current year, noting that the Administration would rather give the UC and CSU greater flexibility to manage its resources to meet obligations, operate its instructional programs more effectively, and avoid tuition and fee increases.

University of California. The 1960 Master Plan for Higher Education designates the UC as the primary state-supported academic agency for research. In addition, the UC serves students at all levels of higher education and is the public segment primarily responsible for awarding the doctorate and several professional degrees, including in medicine and law. Joint doctoral degrees may also be awarded with the CSU.

There are ten campuses: Berkeley, Davis, Irvine, Los Angeles, Merced, Riverside, San Diego, San Francisco, Santa Barbara, and Santa Cruz. Nine of these are general campuses and offer undergraduate, graduate, and professional education. The San Francisco campus is devoted exclusively to the health sciences. The UC operates five teaching hospitals in Los Angeles, San Francisco, Sacramento, San Diego, and Orange counties. The UC has more than 800 research centers, institutes, laboratories, and programs in all parts of the state. The UC also provides oversight of one United States Department of Energy laboratory and is in partnerships with private industry to manage two additional Department of Energy laboratories.

The UC is governed by the Regents, which under Article IX, Section 9 of the California Constitution has "full powers of organization and governance," subject only to very specific areas of legislative control. The article states that "the university shall be entirely independent of all political and sectarian influence and kept free therefrom in the appointment of its Regents and in the administration of its affairs." The Board consists of 26 members, as defined in Article IX, Section 9, all of whom have a vote (in addition, two faculty members — the chair and vice chair of the Academic Council — sit on the board as non-voting members):

- 18 regents are appointed by the governor for 12-year terms.
- One is a student appointed by the Regents to a one-year term.
- Seven are ex officio members — the Governor, Lieutenant Governor, Speaker of the Assembly, Superintendent of Public Instruction, president and vice president of the Alumni Associations of UC and the UC president.

The Governor is officially the president of the Board of Regents; however, in practice the presiding officer of the Regents is the Chairman of the Board, elected from among its body for a one-year term, beginning July 1. The Regents also appoint Officers of The Regents: the General Counsel; the Chief Investment Officer; the Secretary and Chief of Staff; and the Chief Compliance and Audit Officer.

The following table displays the budgeted expenditures and positions for the UC, as proposed in the Governor's budget. Of the amounts displayed in the table, $2.4 billion in 2012-13, $2.8 billion in 2013-14, and $3.0 billion in 2014-15 are supported by the General Fund. The remainder of funding comes from tuition and fee revenue and various special and federal fund sources.

Dollars in Millions

Governor's Budget - UC Budgeted Expenditures and Positions			
	2012-13	**2013-14**	**2014-15**
Personal Services	$9,769	$9,969	$10,116
Operating Expenses and Equipment	$8,847	$9,804	$10,125
Total Expenditures	**$18,616**	**$19,773**	**$20,241**
Positions	**89,528.9**	**89,790.2**	**89,790.2**

Budgeted expenditures for the UC do not include funding for extramural programs, which are $6.2 million in 2012-13, $6.1 million in 2013-14, and $6.0 million in 2014-15.

California State University. The CSU system is comprised of 23 campuses, including 22 university campuses and the California Maritime Academy. The California State Colleges were brought together as a system by the Donahoe Higher Education Act of 1960. In 1972, the system became the California State University and Colleges; the name of the system was changed to the California State University in January 1982. The oldest campus, San Jose State University, was founded in 1857 and became the first institution of public higher education in California. The program goals of the CSU are:

- To provide instruction in the liberal arts and sciences, the professions, applied fields that require more than two years of college education, and teacher education to undergraduate students and graduate students through the master's degree.
- To provide public services to the people of the state of California.
- To provide services to students enrolled in the University.
- To support the primary functions of instruction, research, public services, and student services in the University and to ensure legal obligations related to executive and business affairs are met.
- To prepare administrative leaders for California public elementary and secondary schools and community colleges with the knowledge and skills needed to be effective leaders by awarding the doctorate degree in education.
- To prepare physical therapists to provide health care services by awarding the doctorate degree in physical therapy.
- To prepare faculty to teach in postsecondary nursing programs and, in so doing, help address California's nursing shortage by awarding the doctorate degree in nursing practice.

The Board of Trustees is responsible for the oversight of the CSU. The Board adopts rules, regulations, and policies governing the CSU. The Board has authority over curricular development, use of property, development of facilities, and fiscal and human resources management. The 25-member Board of Trustees meets six times per year. Board meetings allow for communication among the trustees, chancellor, campus presidents, executive committee members of the statewide Academic Senate, representatives of the California State Student Association, and officers of the statewide Alumni Council. The Trustees appoint the chancellor, who is the chief executive officer of the system, and the presidents, who are the chief executive officers of the respective campuses.

The following table displays the budgeted expenditures and positions for the CSU as proposed in the Governor's budget. Of the amounts displayed in the table, $2.1 billion in 2012-13, $2.3 billion in 2013-14, and $2.7 billion in 2014-15 are supported by the General Fund. The remainder of funding comes from tuition and fee revenue and various special and federal fund sources.

Dollars in Millions

Governor's Budget - CSU Budgeted Expenditures and Positions			
	2012-13	**2013-14**	**2014-15**
Personal Services	$3,774	$3,776	$3,776
Operating Expenses and Equipment	$3,999	$4,111	$4,512
Total Expenditures	**$7,773**	**$7,887**	**$8,288**
Positions	**43,762.6**	**43,031.1**	**43,031.1**

Current Reporting Requirements. AB 94 (Committee on Budget), Chapter 50, Statutes of 2013, put into place a framework for measuring performance at the UC and CSU. Specifically, Education Code Sections 89295, subdivision (b), and 92675, subdivision (b), require the UC and CSU to report the following information annually, with 2012-13 data starting in March 2014, as follows:

- Number/Proportion of Transfers.
- Number/Proportion of Low-Income Students.
- 4-year Graduation Rates for both UC and CSU and 6-year Graduation Rates for CSU (disaggregated by freshman entrants, transfers, graduate students, and low-income status)
- Degree Completions (disaggregated by freshman entrants, transfers, graduate students, and low-income status).
- First-Years On Track to Degree (i.e., what percent of first years earned a specified number of units).
- Spending Per Degree (Core Funds).
- Units Per Degree.
- Number of Science, Technology, Engineering and Mathematics (STEM) Degrees.

AB 94 also requires the UC and CSU to report biennially to the Legislature and Department of Finance (DOF), beginning October 1, 2014, on the total costs of education, on both a system-wide and a campus-by-campus basis, segregated by undergraduate instruction, graduate instruction, and research activities. Further, the costs must be reported by fund source, including: 1) state General Fund; 2) system-wide tuition and fees; 3) nonresident tuition and fees and other student fees; and 4) all other sources of income.

In addition to reporting requirements, SB 195 (Liu), Chapter 367, Statutes of 2013, set three broad state goals for higher education: 1) improving student access and success; 2) better aligning degrees and credentials with the state's economic, workforce, and civic needs; and, 3) ensuring the effective and efficient use of resources.

GOVERNOR’S PROPOSAL:

Multi-Year Funding Plan. The Governor’s budget includes $142.2 million General Fund, each, for the UC and CSU to support the Administration’s four-year investment plan in higher education that started in 2013-14, which assumes additional General Fund support for the UC, the CSU, CCCs, and Hastings College of the Law.

The multi-year plan assumes a five percent increase for UC and CSU in 2014-15 and a four percent increase in each of the subsequent two years. The continuation of the multi-year plan is predicated on the UC Regents and the CSU Board of Trustees adopting three-year sustainability plans, described below, and the expectation that the universities maintain current tuition and fee levels through 2016-17.

Sustainability Plans. The Governor’s budget includes budget bill language that requires the UC Regents and the CSU Board of Trustees to adopt three-year sustainability plans, by November 30, 2014, for fiscal years 2015-16, 2016-17, and 2017-18. Specifically, the Governor proposes that the sustainability plans include:

- Projections of available resources (General Fund and tuition and fees) in each fiscal year, using assumptions provided by the DOF.
- Projections of expenditures in each fiscal year and descriptions of any changes necessary to ensure that expenditures in each of the fiscal years are not greater than the available resources.
- Projections of enrollment (resident and non-resident) for each academic year within the three-year period.
- The University’s goals for each of the performance measures, as specified in Education Code (detailed above), for each academic year within the three-year period.

ISSUES TO CONSIDER:

The Governor’s Proposal Dilutes the Role and Authority of the Legislature by Providing for Broad Discretion on Use of New Funding. Although the sustainability plans are a step in the right direction, the only concrete outcome resulting from the additional funding proposed to be provided to the UC and CSU in the first two years of the Administration’s four-year investment plan (the 2013 budget provided $125.1 million for each segment) is the maintenance of current tuition and fee levels. The proposed sustainability plans will not be adopted until nearly half-way into the budget year and it is unclear how these plans may interact or conflict with annual fiscal plans that are currently adopted by the UC Regents and CSU Board of Trustees.

According to the LAO, the Administration’s approach diminishes the Legislature’s role in key policy decisions and allows the universities to pursue their own interests rather than the broader public interest. In its overview of the Governor’s budget, the LAO points out that while the budget requires the universities to set performance goals, it does not establish state performance expectations or link the universities' funding to meeting these expectations. In addition, the LAO points out that the sustainability plans would reflect only the Administration's resource proposals and the segments' own performance targets. The Legislature may have different ideas regarding how much to invest in higher education (both through state appropriations and tuition policies) and what outcomes to expect from the universities.

The State's Long-Term Goals for Higher Education. Coming out of the recession, California's universities face numerous critical issues that impact our state's ability to meet educational and workforce demands. The Governor's budget overview recognizes some of these issues by pointing out the high-cost structure of the UC and the low completion rates of the CSU. However, while the Governor notes that the Administration's long-term plan moves away from funding higher education based on the traditional model of enrollment targets, as previously mentioned, his budget does not explicitly tie funding to performance or specific outcome measures other than the maintenance of current tuition and fee levels.

As the state continues to reinvest in our universities, the Legislature may wish to consider how these investments address current and long-term education needs. This is particularly critical in light of a report from the Public Policy Institute of California (PPIC) regarding California's workforce demands that found that by 2025 California will face a shortfall of one million college graduates required to meet our state's skilled workforce needs. In addition, while there may be merit in moving from a funding model based on enrollment targets, the Legislature may wish to consider an eligibility study to assess how many otherwise eligible students are being denied admission to California's universities based on a lack of space. The CSU reported that, in the fall of 2012, they had to deny admission to approximately 20,000 eligible students due to lack of funding. A severe lack of available space in our universities for eligible students could result in costs to the system from students taking unnecessary community college courses, financial aid, taking longer to graduate, or students discontinuing their education altogether.

Examples From Other States. In recent years, many states have been implementing funding models that incorporate performance outcome measures. Similar to concerns that have been raised by the Administration, the PPIC points out that other states have moved to incentivizing outcome measures, shifting from funding access to funding success, due to concerns surrounding the cost of higher education. According to the PPIC, types of measures that other states are incorporating include:

- Completion (graduation rates, transfer rates, certificate rates).
- Progression (course completion, successful remediation, reaching credit milestones).
- Efficiency/Productivity (time to progression/completion, expenditures per completion, tuition, and debt).
- Graduation Outcomes (jobs, wages, grad school).

Specifically, according to information provided by the National Conference of State Legislatures, the following table provides a few examples (out of 29 examples provided) of what other states are doing:

Performance Funding – Examples From Other States			
State	**Status**	**Funding**	**Metrics**
Arizona	In place at four-year institutions	For fiscal years 2013 and 2014, $5 million allocated based on performance. Beginning in 2015, all allocations above base funding allocated pursuant to performance funding formula developed by the Board of Regents.	• Degrees awarded • Completed student credit hours • External research and public service dollars brought into the university system
Florida	In place at four-year institutions	For fiscal year 2014, $20 million was appropriated for performance funding.	• Percentage of bachelor's graduates employed and/or continuing education • Median average full-time wages of graduates • Average cost per undergraduate
Kansas	In place at two-year and four-year institutions	New state funds	Institutions submit a Performance Agreement to the Board of Regents for approval once every three years (performance is evaluated annually). There are specific performance indicators and state goals that institutions must include in their plans.
Virginia	In transition	50 percent of funding expected to be allocated based on performance and incentive funding.	The proposed formula assigns points based on the number of additional degrees awarded annually. Extra points are assigned for degrees in a STEM field, earned within 100 percent of time to degree, or awarded to a student from an under-represented population.

While California does not predicate funding on performance outcomes, the PPIC does point out that our segments do currently incorporate measures of performance, such as: student success scorecards and the salary surfer utilized by CCCs and accountability reports utilized by the UC and CSU. In addition, as previously mentioned, AB 94 established reporting requirements focused on completion, low income students, and costs. The LAO suggests that California could connect university funding with state priorities in a variety of ways, including the use of the performance results the universities are required to report in March, pursuant to AB 94. At any rate, in considering the Administration's proposals, the Legislature may wish to consider the following questions:

- Do the performance measures outlined within AB 94, sufficiently articulate and capture the Legislature's priorities?
- Does the Governor's proposal sufficiently engage the Legislature in this accountability process?
- How does the Governor's approach ensure that the additional funding will support the statewide priorities?
- Should California follow the example of other states in providing budget incentives that are tied to performance measures that are tied to statewide priorities?

Higher Education – Investing in Community College Student Success

BACKGROUND:

The California Community Colleges (CCCs) is the largest system of community college education in the United States, serving approximately 2.3 million students annually. California’s two-year institutions provide primary programs of study and courses, in both credit and noncredit categories, that address its three primary areas of mission: education for university transfer, career technical education, and basic skills. The community colleges also offer a wide range of programs and courses to support economic development, specialized populations, leadership development, and proficiency in co-curricular activities.

As outlined in the Master Plan for Higher Education in 1960, the community colleges were designated to have an open admission policy and bear the most extensive responsibility for lower-division, undergraduate instruction. The community college mission was further revised with the passage of Assembly Bill 1725 (Vasconcellos), Chapter 973, Statutes of 1988, which called for comprehensive reforms in every aspect of community college education and organization. Other legislation established a support framework, including the Matriculation Program, the Disabled Students Programs & Services (DSPS), and the Equal Opportunity Programs & Services (EOPS), to provide categorical funding and special services to help meet the needs of the diverse range of students in the CCCs.

The Board of Governors of the CCCs was established in 1967 to provide statewide leadership to California's community colleges. The Board has 17 members appointed by the Governor, subject to Senate confirmation. Twelve members are appointed to six-year terms and two student members, two faculty members, and one classified member are appointed to two-year terms. The objectives of the Board are:

- To provide direction, coordination, planning, and leadership to California's community colleges.
- To promote quality education in community colleges.
- To improve district and campus programs through informational and technical services on a statewide basis, while recognizing the community-oriented aspect of California's network of 112 community colleges.
- To seek adequate financial support while ensuring the most prudent use of public funds.

The following table displays the budgeted expenditures and positions for the CCCs as proposed in the Governor’s budget. Of the amounts displayed in the table, $3.9 billion in 2012-13, $4.0 billion in 2013-14, and $4.4 billion in 2014-15 are supported by Proposition 98 General Fund. In addition, $8.6 million in 2012-13, $9.8 million in 2013-14, and $10.9 million in 2014-15 are supported by the General Fund. The remainder of funding comes from local property tax revenue, tuition and fee revenue and various special and federal fund sources.

Dollars in Millions

Governor's Budget - CCCs Budgeted Expenditures and Positions			
	2012-13	**2013-14**	**2014-15**
Personal Services	$14	$16	$18
Operating Expenses and Equipment	$4	$6	$5
Local Assistance	$6,818	$6,940	$7,441
Total Expenditures	**$6,836**	**$6,962**	**$7,464**
Positions	**140.6**	**153.7**	**162.7**

Student Success Task Force. In January 2011, the CCC's Board of Governors embarked on a 12-month strategic planning process to improve student success. Pursuant to Senate Bill 1143 (Liu), Chapter 409, Statutes of 2010, the Board of Governors created the Student Success Task Force. The 20-member Task Force was composed of a diverse group of community college leaders, faculty, students, researchers, staff, and external stakeholders. The Task Force worked for seven months to identify best practices for promoting student success and to develop statewide strategies to take these approaches to scale while ensuring that educational opportunity for historically underrepresented students would not just be maintained, but bolstered. The Task Force issued the following recommendations:

1. **Increase Student Readiness for College**
    - Collaborate with K-12 to jointly develop common standards for college and career readiness.
2. **Strengthen Support for Entering Students**
    - Develop and implement common centralized diagnostic assessments.
    - Require students to participate in diagnostic assessment, orientation and the development of an educational plan.
    - Develop and use technology applications to better guide students in educational processes.
    - Require students showing a lack of college readiness to participate in support resources.
    - Require students to declare a program of study early in their academic careers.
3. **Incentivize Successful Student Behaviors**
    - Adopt system-wide enrollment priorities reflecting the core mission of community colleges.
    - Require students receiving Board of Governors Fee Waivers to meet various conditions and requirements.
    - Provide students the opportunity to consider attending full time.
    - Require students to begin addressing basic skills deficiencies in their first year.
4. **Align Course Offerings to Meet Student Needs**
    - Give highest priority for courses advancing student academic progress.
5. **Improve the Education of Basic Skills Students**

- Support the development of alternative basic skills curriculum.
- Develop a comprehensive strategy for addressing basic skills education in California.

6. **Revitalize and Re-envision Professional Development**
   - Create a continuum of mandatory professional development opportunities.
   - Direct professional development resources toward improving basic skills instruction and support services.
7. **Enable Efficient Statewide Leadership and Increase Coordination Among Colleges**
   - Develop and support a strong community college system office.
   - Set local student success goals consistent with statewide goals.
   - Implement a student success scorecard.
   - Develop and support a longitudinal student record system.
8. **Align Resources With Student Success Recommendations**
   - Encourage categorical program streamlining and cooperation.
   - Invest in the new Student Support Initiative.
   - Encourage innovation and flexibility in the delivery of basic skills instruction.
9. **A Review of Outcomes-Based Funding**

According to the Task Force report, which was unanimously adopted by the Board of Governors in January 2012, it was their goal to identify best practices for promoting student success and to develop statewide strategies to take these approaches to scale while ensuring that educational opportunity for historically underrepresented students would not just be maintained, but bolstered. The report noted that while a number of disturbing statistics around student completion reflect the challenges faced by the students they serve, they also clearly demonstrate the need for the system to recommit to finding new and better ways to serve its students.

SB 1456 (Lowenthal), Chapter 624, Statutes of 2013, also known as the Seymour-Campbell Student Success Act of 2012, contained statutory changes necessary for implementation of some of the recommendations of the Task Force and the 2013 budget included $50 million for community college student success efforts.

GOVERNOR'S PROPOSAL:

Investing In Student Success. The Governor's budget proposes $200 million Proposition 98 General Fund to improve and expand student success programs and to strengthen efforts to assist underrepresented students. This includes: 1) $100 million to increase orientation, assessment, placement, counseling, and other education planning services for all matriculated students, and, 2) $100 million to close gaps in access and achievement in underrepresented student groups, as identified in local Student Equity Plans. This funding is intended to allow colleges to better coordinate delivery of existing categorical programs.

For the funding provided to implement activities and goals outlined in student equity plans, the Chancellor of the CCCs is to allocate the funds in a manner that ensures districts with a greater proportion or number of students who are high-need, as determined by the Chancellor's Office, receive greater resources to provide services. In addition, as a condition of receipt of the funds, the districts are required to include in their Student Equity Plan how they will coordinate existing student support services in a manner to better serve their high-need student populations. At a minimum, their plan is to demonstrate an alignment of services funded through allocations for the following programs:

- Student Success for Basic Skills Students
- Student Financial Aid Administration
- Disabled Students
- Special Services for CalWORKs Recipients
- Matriculation
- EOPS
- Fund for Student Success

Lastly, subject to approval by a district's governing board, districts may use up to 25 percent of any of the funds allocated for Student Success for Basic Skills Students, Special Services for CalWORKs Recipients, and EOPS for other federal, state, or local programs that serve high-need student populations as identified in the district's Student Equity Plan.

Implementing Statewide Performance Strategies. The Governor's budget proposes $1.1 million non-Proposition 98 General Fund and nine positions for the Chancellor's Office to develop leading indicators of student success and to monitor districts' performance. In addition, the Governor's budget proposes $2.5 million Proposition 98 General Fund to provide local technical assistance to support implementation of effective practices across all districts, with a focus on underperforming districts.

ISSUES TO CONSIDER:

Prioritizing Investments in Student Success Services. While there is substantial merit in investing in Student Success strategies (putting funding generally into matriculation for Student Success efforts would likely allow for implementation of broader solutions that would serve many more students than could be served through a specific categorical program), it is important to note that other categorical programs that target underrepresented or disadvantaged students experienced significant funding reductions during the recent economic downturn. While the CCCs have done a significant amount through the Student Success Taskforce to refocus existing resources on better serving their student population, including students with disabilities and economically disadvantaged students, there are additional supports, beyond those identified in the Student Success and Support categorical program, that are important to the overall success of these students. In order to protect current levels of important specialized services, the Legislature may wish to examine the Governor's proposed flexibility for districts to use 25 percent of funds allocated for Student Success for Basic Skills Students, Special Services for CalWORKs Recipients, and EOPS for other purposes.

Providing for broad use of these funds for Student Success efforts may have detrimental consequences for these programs. Specifically, the Student Success for Basic Skills Students addresses one of the most challenging issues that our higher education segments face in remediation, the EOPS program provides tutoring, textbook vouchers, computer loans and other support services outside of traditional counseling to economically disadvantaged students, and the CalWORKs community college program is key to getting folks back into the workforce and towards self-sufficiency.

Will Modified Student Equity Plans Ensure Funds are Used as Intended? In order to promote student success for all students, regardless of race, gender, age, disability, or economic circumstances, the governing board of each community college district is required by regulation to maintain a student equity plan, to for each college in the district, that evaluates gaps for underrepresented student populations and develops and implements plans to address the identified gaps. As previously mentioned, as a condition of receipt of the funds that are proposed to close gaps in access and achievement in underrepresented student groups, districts will be required to include in their Student Equity Plans how they will coordinate existing student support services in a manner to better serve their high-need student populations.

The Student Success Act of 2012 only required coordination with the Student Equity Plans as one of eight items to consider in a funding formula to be developed by the Chancellor's Office for distributing matriculation funds. In addition, requirements for and components of Student Equity Plans are established in the California Code of Regulation, as opposed to statute. Although, the Governor is proposing budget bill language that requires specific modifications to the plans in order to receive the proposed funding, the Legislature may wish to consider the following questions:

- Does the proposed language provide adequate assurance that the funds will ultimately be used as intended?
- Given the ongoing nature of Student Success efforts and in order to ensure legislative objectives are met, is trailer bill language more appropriate?
- Are there appropriate reporting and oversight measure in place?

Reporting On Current Student Success Efforts not Available Until July. As previously mentioned, SB 1456 contained statutory changes necessary to implement some of the recommendations of the Student Success Task Force and the 2013 budget included $50 million in funding. While continuing to invest in Student Success efforts is consistent with recent fiscal and policy priorities of the Legislature in regards to CCCs, the Governor's proposal of $200 million that would be allocated to colleges for Student Success efforts is four times larger than the current funding level. Given that the Legislative Analyst's Office (LAO) review of the implementation of the Student Success Act (the LAO is examining the impacts of the Student Success Act on student participation, progress, and completion, disaggregated by ethnicity, age, gender, disability, and socioeconomic status) is not scheduled to be submitted to the Legislature until July 1, 2014, the Legislature may wish to consider the feasibility and/or appropriateness of adjusting funding requirements based on the findings contained in the LAO's review.

Higher Education – Innovation

BACKGROUND:

California's public higher education system involves three "segments": the University of California (UC), the California State University (CSU), and the California Community Colleges (CCC). It also includes the Hastings College of the Law and the California Student Aid Commission. The state's Master Plan for Higher Education, originally adopted in 1960, ascribes distinct missions to each of the segments and expresses a set of general policies for higher education in the state, including the state's intent that higher education remain accessible, affordable, high-quality, and accountable. Following are brief descriptions of California's three higher education segments:

- **University of California.** Drawing from the top 12.5 percent of the state's high school graduates, the UC educates approximately 243,000 undergraduate and graduate students at its ten campuses and is the primary institution authorized to independently award doctoral degrees and professional degrees in law, medicine, business, dentistry, veterinary medicine, and other programs. UC manages one U.S. Department of Energy national laboratory, partners with private industry to manage two others, and operates five medical centers that support the clinical teaching programs of the UC's medical and health sciences schools and handle more than 3.9 million patient visits each year.
- **California State University.** Drawing students from the top one-third of the state's high school graduates, as well as transfer students who have successfully completed specified college work, the CSU provides undergraduate and graduate instruction through master's degrees and independently awards doctoral degrees in education, nursing practice, and physical therapy, or jointly with UC or private institutions in other fields of study. With 23 campuses and approximately 434,000 students, the CSU is the largest and most diverse university system in the country.
- **California Community Colleges.** The CCCs are publicly supported local educational agencies that provide educational, vocational, and transfer programs to approximately 2.3 million students. The CCC system is the largest system of higher education in the world, with 72 districts, 112 campuses, and 70 educational centers. In addition to providing education, training, and services, the CCC contributes to continuous workforce improvement. The CCC also provides remedial instruction for adults across the state through basic skills courses and adult non-credit instruction.

State Higher Education Support. The Governor's budget proposes $13 billion in General Fund support for higher education in 2014-15. This includes funding for the UC, CSU, CCCs, Student Aid Commission, Hastings, and the California Institute for Regenerative Medicine and is approximately 10 percent more than the 2013-14 revised budget and 19 percent more than the 2012-13 fiscal year. The majority of funding augmentations proposed in the Governor's budget are for the second annual increase, in a four-year funding plan, which provides $142.2 million each to the UC and CSU and $1.3 million to Hastings, and $578 million in new expenditures for

CCCs, driven primarily by an increase in Proposition 98 revenue. However, even with these investments in higher education, the segments have still yet to recover from the significant funding reductions incurred during the recent economic recession.

From 2008-09 through 2011-12, the state reduced funding for the UC, CSU, CCCs, and Hastings by $2.7 billion General Fund. The most notable consequences of these reductions were significant student tuition increases, effectively increasing the share of total education costs being shifted to students, and declining course offerings, which made it difficult for students to complete their certifications and degrees in a timely manner. In 2012-13, and with the passage of Proposition 30, higher education budgets were held flat.

Current Focus on Technology and Online Education. In the 2013-14 Governor's budget, the Governor proposed budget bill language that designated $10 million, from each of the $125.1 million increases provided to the UC and CSU, for each segment to use for purposes of expanding the availability of high-demand courses through the use of technology. Ultimately, the Governor vetoed this budget bill language, consistent with the Administration's policy of not earmarking UC and CSU funds. However, the UC and CSU have nonetheless undertaken efforts to enhance online educational capabilities in the current budget year, as follows:

- **UC Online Efforts.** Through the Innovative Learning Technology Initiative, an effort that uses online education to expand access to high-demand classes and help undergraduate students complete their degrees in a timely manner, the UC recently launched a pilot that allows for cross-campus online course enrollment that is open to undergraduates at seven UC campuses (UC San Diego and UC Santa Barbara are resolving logistical issues and will be added to the program once those are resolved). The goal of the pilot is to give students more enrollment options for high-demand courses that fill quickly and can be subject to long waitlists. Available courses include introductory classes in subjects such as statistics and pre-calculus, along with a few more specialized offerings, including American cyber cultures and global climate change.
- **CSU Online Efforts.** CSU has reported that in the current year it is focusing on addressing bottlenecks (anything that limits a CSU student's ability to make progress toward a degree and graduate in a timely manner). The CSU is addressing bottlenecks through enhancements and use of online advising (eAdvising), course redesign utilizing technology, and increased availability of online courses. The four types of bottlenecks being addressed are:

    1. **Student Readiness and Curricular Bottlenecks.** A student's lack of readiness combined with current course curriculum often lead to high rates of failure or incompletes, resulting in students retaking courses to graduate. The bottlenecks are created by the enrollment demands of both new students and students repeating courses.
    2. **Place-bound Bottlenecks.** Students are often place-bound and have to wait for their campuses to schedule particular courses. These bottlenecks can be especially significant for students at smaller CSU campuses where diversity of course requirements compete for significantly limited resources.

3. **Facilities Bottlenecks.** Campus facilities can create bottlenecks for a number of courses. In particular, introductory STEM (Science, Technology, Engineering and Mathematics) courses have laboratory requirements that have restricted the number of students who can take lab sections in safe and properly equipped facilities.
4. **Advising and Scheduling Bottlenecks.** Frequently, students are not aware of the wider range of course and program options they have to complete their general education and major requirements. The bottlenecks are created when students do not receive the most-timely and informative advice about their academic pathways and course schedules.

CCC Online Efforts. The CCC Technology Center facilitates governance, planning, and provides project leadership and administration for system-wide technology. System-wide technology efforts include:

- **CCCApply** - Common application for admission.
- **eTranscript** - California eTranscript exchange.
- **California Virtual Campus -** Distance education catalog.

The 2013 Budget Act includes $16.9 million Proposition 98 General Fund for the CCCs to expand online education and expand the availability of high-demand courses through the use of technology. Budget bill language associated with this funding requires that for online-only courses, the chancellor should, to the extent possible, ensure that courses selected can be articulated across all community college districts, ensure that courses are granted transfer credit, and be made available for enrollment for all students system-wide. The chancellor is required to provide a report to the Joint Legislative Budget Committee by March 1, 2014, regarding use of these funds. One initiative that the CCCs are pursuing with these funds involves a partnership between Foothill/De Anza and Butte colleges to the develop a common course management system, an online course exchange, expand the catalog of online courses, and ease cross school enrollment.

GOVERNOR'S PROPOSAL:

Promote Innovative Models of Higher Education. The Governor's budget proposes $50 million General Fund, on a one-time basis, to create the Awards for Innovation in Higher Education program. The Governor proposes that applications for awards can be submitted by a UC, CSU, community college, or a group of any of these entities. These incentive awards are proposed to encourage and recognize models of innovation in higher education that focus on the following priorities:

1. Significantly increase the number of individuals in the state who earn bachelor's degrees;
2. Allow students to earn bachelor's degrees that can be completed within four years of enrollment in higher education; and,
3. Ease transfer through the state's education system, including by recognizing learning that has occurred across the state's education segments or elsewhere.

The Governor proposes that awards will be selected based on the extent to which an application proposes an innovative model that: 1) advances the state's priorities, as noted above, at a lower cost than existing instructional delivery models and without requiring that students pay increased tuition or fees; 2) includes broad participation by the segments and local educational entities in a manner that can have a statewide impact if expanded; and, 3) is likely to be implemented effectively and sustainably. The Administration anticipates that the awards process would be completed in the spring of 2015 and will be managed by a committee composed of:

1. The Director of Finance or his designee, either of whom shall serve as the chairperson of the committee.
2. A member of the State Board of Education selected by the Governor.
3. A member of the Board of Governors of the CCCs selected by the Governor.
4. A CSU trustee selected by the Governor.
5. A UC regent selected by the Governor.
6. An appointment of the Senate Committee on Rules.
7. An appointment of the Speaker of the Assembly.

Upon notification by the Director of Finance that it has been selected for an award, it is proposed that an entity or group shall submit a report to the Director of Finance indicating how the awarded funds will be used and commit to reporting, on January 1, 2018 and again on January 1, 2020, an evaluation of the effectiveness of the model of higher education innovation in achieving the identified priorities and the number of bachelor degrees awarded through the model.

The Administration has expressed that this incentive awards program builds on their 2013-14 request to expand the use of technology to remove course bottlenecks and reduce the costs of education. The Administration expects that the segments will continue to implement plans to expand investments in technology that lower costs at each segment and allow students to complete their degrees sooner.

ISSUES TO CONSIDER:

Current Higher Education Models Likely Unsustainable. Supported by the passage of Proposition 30 in 2012, which increased taxes on earnings over $250,000 for seven years and sales taxes by a quarter cent for four years, the state's budget has stabilized. The Governor's budget projects that General Fund revenues will annually exceed expenditures, resulting in an operating surplus of $1.7 billion in 2015-16, growing to $2.3 billion in 2017-18. However, in order to avoid devastating cuts to state programs during future economic downturns and recognizing the short-term nature of Proposition 30 revenue, the Governor is proposing to prioritize debt repayments (including CCC deferrals) and establish a rainy-day fund along with what hopefully will be sustainable restorations and investments.

Consistent with the Administration's broader prudent approach to fiscal policy, the Governor's budget recognizes that as the state reinvests in higher education, it cannot fund the business-asusual model. The Administration notes that both the UC and CSU proposed budgets for 2014-15 that call for increases in state funding of approximately 10 percent, compared to the five percent General Fund increase the Administration proposed as part of its long-term funding plan.

In its overview of the 2013-14 Governor's budget, the Legislative Analyst's Office (LAO) also discussed concerns with the costs associated with the traditional higher education delivery model in California. The LAO noted that the current model has a few basic attributes that result in high costs relative to other potential higher education models, as well as other industry models. Most importantly, the LAO found that the current model is based on a faculty member with an advanced degree teaching a relatively small number of students in a physical setting, and that these high labor and facility costs are even greater at institutions that focus heavily on research.

The LAO further noted that, not only is the traditional higher education delivery model high cost, but data suggest that costs are particularly high in California. They found that average spending per-student at the UC universities is more than 20 percent higher than at their national counterparts.

Benefits of Online Education Have Yet to be Clearly Identified. The Administration expects the segments to use the proposed innovation awards to expand technology to remove course bottlenecks, reduce the cost of education at each segment, and allow students to complete their degrees sooner. Although the UC, CSU, and CCCs are using funds in the current budget to expand use of technology, as discussed earlier, use of technology by California's higher education segments is not new. Further, ongoing and recent efforts to expand the use of online classes raise questions of whether effective online courses are less expensive than traditional models of teaching or whether certain bottleneck courses are appropriate for an online teaching model.

In the spring of 2013, San Jose State partnered with a MOOC (massive online open courses) provider for a pilot to offer three online courses for classes identified as bottlenecks (a remedial algebra course, a college-level algebra course, and introductory statistics). By measure of course completion, as compared to the traditional courses, the pilot was not successful. On the other-hand, CSU East Bay is one of the system's leading campuses in providing online learning opportunities to their students. As one of the first campuses to go online, they currently offer ten fully online degree options which allow students to participate in a bachelor's degree completion program or enroll in a master's degree program.

While online courses may create efficiencies by getting students to degree sooner, if they can be used to increase access to bottleneck courses, the examples of San Jose State and CSU East Bay raise the question of whether online courses are less expensive to administer as compared to traditional models. For example, one of the factors cited in why the San Jose State pilot may have performed so poorly was the underestimation of the need for staff support. However, in speaking with CSU East Bay faculty regarding why they have been able to have success in their online education programs, they cite the need to maintain the same level of staff involvement, pointing out that staff are still required to produce and maintain content and interact with students. However, the methods in which they perform these functions are different for online courses.

Legislature's Role in Establishing and Investing in State Higher Educational Priorities. In its overview of the Governor's budget, the LAO suggests that the Governor's proposed innovation awards could lead to some confusion about the state's higher education priorities. They point out that last year, SB 195 (Liu), Chapter 367, Statutes of 2013, set three broad state goals for higher education: 1) improving student access and success; 2) better aligning degrees and credentials with the state's economic, workforce, and civic needs; and, 3) ensuring the effective and efficient use of resources. The Governor's proposal may raise concern that the structure of the proposed awards and the method in which they are distributed may not align with these existing legislative priorities. In addition, the LAO points out that it may be premature to make investments that build off of last year's efforts to expand the use of technology, given that the results of those efforts are not yet clear.

California's Structure, or Lack Thereof, for Oversight of Efforts Across Higher Education Segments. The Governor's proposal to convene a committee of stakeholders, most of whom are proposed to be appointed by the Governor, raises a number of questions in regards to assurance that state and legislative priorities are appropriately considered in the decisions of the committee, as well as whether it would not be more appropriate for the state to have a higher education coordinating entity to oversee and provide advice on statewide higher education policy. Such an entity may also be more appropriate to make decisions on funding of statewide initiatives, such as the Governor's innovation award proposal.

In 2011, the Governor eliminated the California Postsecondary Education Commission (CPEC), through a line-item veto that zeroed out its budget. CPEC was charged with working with the higher education segments, the Governor, and the Legislature in providing analysis of, and recommendations on, statewide higher education policy and fiscal priorities. CPEC was intended to be objective, independent, and nonpartisan; however, over time there was a growing perception that it was not maintaining its objectivity, which led to an erosion of trust and confidence. However, questions remain regarding whether eliminating CPEC altogether, rather than addressing the issues the organization faced, was the most appropriate course.

A recent report by California Competes, *Charting a Course for California's Colleges*, points out that today California stands out as one of only two states nationwide (the other is Michigan) without comprehensive oversight or coordination of higher education. CCCs are governed by 72 locally-elected boards of trustees, with coordination by a relatively small central office. The 23-campus CSU and the ten-campus UC have their gubernatorially-appointed trustees and regents, respectively. And there is no state mechanism for bringing private colleges into planning or strategizing to address state and student needs. The report surmises that, by not articulating the state's needs as they relate to higher education, California is missing an opportunity to better serve its residents, institutions, and economy well. In evaluating the Governor's proposal, the Legislature may wish to consider:

- How should the state collect information across segments in order to make informed state-level planning decisions?
- Absent a higher education coordinating entity, what are the critical components necessary to coordinate cross segment initiatives and make related decisions?
- While the perspective of the segments is important, should the segments drive decisions regarding statewide policy?

SUBCOMMITTEE NO. 2

NATURAL RESOURCES, ENVIRONMENTAL PROTECTION, ENERGY, and TRANSPORTATION

Cap and Trade Funding

BACKGROUND:

The goal of the state's climate plan is to reduce Greenhouse Gas (GHG) emissions to 1990 levels by the end of this decade. The Cap and Trade program, a key element in this Administration's plan to achieve these goals, sets a statewide limit on the sources of greenhouse gases and establishes a financial incentive for long-term investments in cleaner fuels and more efficient energy use. The Cap and Trade program places a "cap" on aggregate GHG emissions from entities responsible for roughly 85 percent of the state's GHG emissions. To implement the Cap and Trade program, the Air Resources Board (ARB) allocates a certain number of carbon allowances equal to the cap. Each allowance equals one ton of carbon dioxide equivalent. The ARB provides some allowances for free, while making others available for purchase at auctions. Once the allowances have been allocated, entities can then "trade" (buy and sell on the open market), the allowances in order to obtain enough to cover their total emissions for a given period of time. As part of its program, the ARB will give free allowances to the state's large industrial emitters, as well as the state's electric utilities, in order to reduce the economic impact of the Cap and Trade program.

The ARB has conducted five auctions since November 2012 of GHG emission allowances as part of the market‑based compliance mechanism. These auctions resulted in approximately $532 million in proceeds to the state. The state plans to conduct quarterly auctions in 2014 and estimates roughly $550 million in revenues from those auctions.

Subsequent to the passage of Chapter 488, Statutes of 2006 (AB 32, Núñez and Pavley) the Legislature passed several bills related to the reduction of GHGs. These bills have provided guidance to the Administration as it continues to develop expenditure plans for auction proceeds. In addition, the Administration has issued several executive orders that, though not law, have also provided input into the development of the expenditure plan.

Select Statutory and Executive Guidance for Cap and Trade Expenditures

Statute	Summary
Global Warming Solutions Act 2006, Chapter 488 Statutes of 2006 AB 32 (Núñez and Pavley)	• Established the goal to reduce greenhouse gas emissions to 1990 levels by 2020.
Chapter 830 Statutes of 2012 SB 535 (deLeón)	• Requires 10 percent of cap and trade proceeds be invested within the most impacted and disadvantaged communities. • Requires 25 percent of auction proceeds to benefit impacted and disadvantaged communities.
Chapter 807 Statutes of 2012 AB 1532 (Pérez)	• Required the Administration to develop a three-year investment plan for auction proceeds.
Chapter 728 Statutes of 2008 SB 375 (Steinberg)	• Directs the Air Resources Board to set regional GHG reduction targets and guides sustainable community strategies.
Chapter 39 Statutes of 2012 SB 1018 (Committee on Budget)	• Provides guidance for collection and allocation of auction funds. • Requires state agencies to provide up-front information on GHG emission reductions prior to expenditure for any proposed auction-revenue funded program.

Executive Order	Summary
Executive Order B-18-12 (2012)	• Requires state agencies to reduce GHG emissions by 10 percent by 2015 and 20 percent by 2020.
Executive Order B-16-12 (2012)	• Establishes targets for zero-emission vehicles in the state. • Establishes a GHG emission reduction target of 80 percent less than 1990 levels in the transportation sector by 2050.

GOVERNOR'S PROPOSAL:

Cap and Trade Expenditure Proposal. The Governor's budget proposes to spend $850 million from cap and trade auction revenue in 2014-15. Proposals (summarized below) range from water efficiency to rail modernization. The majority of funding is directed to state agencies for both direct state projects and local assistance grant programs.

Summary of Governor's Cap and Trade Expenditure Proposal for 2014-15

Department	Activity	Amount (millions)
High-Speed Rail Authority	High-speed rail planning, land acquisition and construction	$250
Air Resources Board	Low-emission vehicle rebates and incentives for low emission vehicles	200
Strategic Growth Council	Transit oriented development grants (Sustainable Communities)	100
Community Services and Development Department	Grants for weatherization and solar installation including the Low-Income Home Energy Assistance Program	80
Caltrans	Intercity rail grants	50
Department of Forestry and Fire Protection	Fire prevention and urban forestry	50
Department of Fish and Wildlife	Wetlands restoration (state and local assistance)	30
Department of Resources Recycling and Recovery	Waste diversion	30
Department of General Services	Energy efficiency upgrades in state buildings	20
Department of Food and Agriculture	Reducing agricultural waste	20
Department of Water Resources	Water use efficiency	20
Totals		**$850 million**

Source: Legislative Analyst's Office, 2014

Transportation and Sustainable Communities. The Governor proposes $600 million for transportation-related programs and projects including:

- **High-Speed Rail (High-Speed Rail Authority).** The budget includes $250 million for the state high-speed rail project. Funding will support construction of the initial operating section. This includes $58.6 million to continue environmental planning of the Phase 1 project extending from San Francisco to Anaheim, and $191.4 million for right-of-way acquisition and construction of the initial construction segment extending from Madera to near Bakersfield. The proposal anticipates a reduction of 4.3 million metric tons of CO_2 equivalents by 2030, with an additional one million CO_2 annually thereafter. The proposal does not specify a GHG reduction target for the 2020 deadline. Trailer bill language is proposed to extend this as an ongoing funding source for the construction of high-speed rail.

- **Rail Modernization (Caltrans).** The budget includes $50 million to Caltrans to expand the existing rail program by implementing and administering the Rail Modernization Grant (RMG) program. The RMG proposes to reduce GHG emissions through traditional capital outlay projects and network integration of high-speed, intercity and commuter rail systems, and transit systems at the operation level. The program includes fare integration and payment systems, and integrated customer information systems. Grants will be administered by the State Transportation Agency and approved by the California Transportation Commission. The proposal does not specify a GHG reduction target for the 2020 deadline.

- **Low Carbon Transportation (Air Resources Board).** The budget proposes $200 million to expand the existing clean transportation programs that provide incentives for sustainable freight technology, zero-emission cars, low-emission cars in disadvantaged communities, and clean trucks and bus programs. The budget also proposes to spend $30 million from current-year proceeds for low-carbon transportation projects. This would reverse a $30 million loan from the Vehicle Inspection and Repair Fund approved in the current-year mainly for electric vehicle rebate programs. The proposal does not specify a GHG reduction target for the 2020 deadline.

- **Sustainable Communities (Strategic Growth Council).** The budget proposes $100 million ($1 million state operations and $99 million local assistance) annually for two years to establish and implement a Sustainable Communities Implementation Program. The program will support local project implementation of regional sustainable community strategy plans, compact and infill development near transit, and development which benefits disadvantaged communities. The proposal incorporates current sustainable communities and clean transportation priorities into a cohesive program, including transit and active transportation infrastructure projects. The proposal includes shifting the Strategic Growth Council from the Natural Resources Agency to the Governor's Office of Planning and Research. The proposal does not specify a GHG reduction target for the 2020 deadline.

Energy Efficiency and Clean Energy Programs. The Governor proposes $140 million for clean energy programs including:

- **Weatherization Upgrades and Local Energy Efficiency (Community Services and Development Department).** The budget proposes $80 million ($75 million local assistance and $5 million state operations) to support the expansion of existing weatherization and solar programs through local service providers, combined with the federal Low Income Home Energy Assistance Program (LIHEAP) and Weatherization Assistance Program. Services will benefit disadvantaged communities through the installation of solar photovoltaic systems, solar water heating systems, and weatherization measures. The use of energy audit tools will determine the installation of cost-effective measures such as insulation, weather stripping and caulking, water heater blankets, fixing or replacing windows, refrigerator replacement, and other specific projects. The proposal does not specify a GHG reduction target for the 2020 deadline, but does include specific outcomes and accountability metrics for number of homes weatherized and number of homes receiving solar technologies.

- **Green State Buildings (Department of General Services).** The budget proposes $20 million to support the expansion of existing energy efficiency programs to reduce GHGs and energy usage in state buildings. The department will use the existing distributed generation, energy retrofit, and zero net energy building design programs to allocate funding. The proposal also includes the establishment of a state-funded revolving loan fund for energy efficiency retrofit projects in the future. The proposal includes metrics for installation of megawatts (MW) of clean energy (solar and wind, for example) and for the conversion of buildings to zero net energy, but does not specify a GHG reduction target for the 2020.

- **Emission Reductions through Agriculture (Department of Food and Agriculture [CDFA]).** The budget proposes $20 million to support the development and implementation of three specific programs at CDFA: (1) $12 million for a dairy digester research and development program to facilitate the design and construction of dairy digester systems; (2) nitrogen research and management program to fund research and technical assistance on reducing nitrous oxide emissions, nitrification inhibitors, water and nitrogen movement in the environment, and evaluation of water and nitrogen management practices; and, (3) an alternative and renewable fuels program to develop fuel quality specifications and standards for renewable and zero emission fuels, such as biofuels produced from dairy digesters and other agricultural waste. This proposal anticipates the reduction of between 15,000 and 21,600 metric tons of CO_2 through the dairy digester program. The other programs do not specify a GHG reduction target but do include metrics for such measurement.

- **Water-Energy Efficiency Programs (Department of Water Resources).** The budget proposes $20 million annually for two years to support a new water-energy grant program and for a single State Water Project replacement and rehabilitation project. Over the two year period, the budget allocates $20 million to upgrade the State Water Project facilities at the Hyatt and Thermalito power generation sites near Oroville. The budget also allocates $20 million ($18 million local assistance and $2 million state operations) for the development and implementation of a grant program designed to reduce GHG emissions at the local level. This proposal specifies outcomes in terms of grants allocated and executed, but does not specify a GHG reduction target.

- **Wetland Restoration (Department of Fish and Wildlife).** The budget proposes $30 million ($4.2 million state operations, $25.8 million local assistance) for wetland restoration. Projects include: (1) planning and implementation of Sacramento-San Joaquin Delta and coastal restoration projects that integrate GHG reduction, flood protection, habitat restoration, and climate change readiness; (2) planning and implementation of mountain meadows restoration in the Cascade and Sierra Nevada mountain ranges including groundwater storage, stream flow stability, water supply and habitat restoration; and, (3) planning and implementation of wetland restoration and water efficiency projects on state-owned and administered lands. These projects will provide the state a dedicated program for integrating wetland restoration for fish and wildlife with water supply improvement and carbon sequestration. This proposal does not include a specific GHG reduction target, but does include metrics for measurement of reduction of GHGs through carbon update, measured in carbon per acre.

- **Forest Management and Fire Prevention (Department of Forestry and Fire Protection[CalFIRE]).** The budget proposes $50 million per year, for two years ($25.8 million state operations and $24.2 million local assistance in year one, $50 million in state operations in year two) to support existing and expanded programs at CalFIRE. These include: (1) urban and community forestry local assistance grants; (2) demonstration state forests and cooperative wildland research mainly at state forest facilities; (3) fuel reduction through CalFIRE's vegetation management program which are designed to reduce wildland fire threat through a cost-sharing program with landowners that focuses on a combination of treatment types; (4) reforestation services under the authority of the state nurseries and reforestation studies statutory guidance; (5) funding for the forest legacy program to invest in forestlands to prevent future conversion to non-forest use; and, (6) continued implementation of the forest practice program and forest pest control programs. This proposal does not include a specified GHG reduction target but does include in the proposal a plan to develop GHG reduction metrics prior to implementation.

- **Waste Reduction, Recycling, and Composting (CalRecycle).** The budget proposes $30 million annually, for two years, to support the expansion of existing recycling programs designed to reduce methane emissions at landfills and reduce further GHG in upstream management and manufacturing processes. The majority of funding ($20 million per year) will be used for grants and loans for in-state development of infrastructure to process organic materials and recyclable commodities into new value-added products. An additional $10 million per year will be used to establish a new GHG revolving loan fund to provide financial assistance through low-interest loans for recycling market development zones. This proposal includes metrics for measurement of GHG reduction and a specific target of 1-2 million metric tons of GHG reduction by the end of 2014-15.

ISSUES TO CONSIDER:

Achieving Greenhouse Gas Emission Reductions. According to the LAO, in order to minimize the economic impact of cap and trade, it is important that auction revenues be invested in a way that maximizes GHG emission reductions. Maximizing emission reductions (specifically in the capped sectors) reduces competition for allowances, thereby putting downward pressure on the price of allowances. This, in turn, reduces the overall cost for covered entities to comply with AB 32 and the potential negative economic impacts of the program on consumers, businesses, and ratepayers. It is, however, unclear to what extent the complement of activities proposed by the Governor would maximize GHG emission reductions. For example, a GHG emission analysis completed by the High-Speed Rail Authority (HSRA) indicates that once the high-speed rail system is operational in 2022, it would contribute a relatively minor amount of GHG emission reductions to the state. Moreover, the construction of the project would actually produce additional emissions (though HSRA will try to offset these emissions). Despite these findings, roughly 30 percent of the funding in the Governor's proposal goes to the high–speed rail project and at this time it is unknown how much in future cap and trade revenues the Administration seeks to commit to the project because the proposed trailer bill language has not been made public. Compared to a different mix of investments that could be made with the cap and trade revenue, the Governor's proposal is unlikely to maximize GHG emission reductions. Therefore, the Legislature will need to consider the most effective use of the cap and trade auction revenue.

Legal Considerations for GHG Reductions and the 2020 Deadline. The LAO advises that the Legislature will also want to consider the potential legal risks associated with some of the activities that the Governor proposes to fund with cap and trade auction revenue. Based on an opinion that the LAO received from Legislative Counsel, the revenues generated from ARB's cap and trade auctions are considered "mitigation fee" revenues. Thus, the use of these revenues are subject to certain legal criteria. Specifically, the LAO advises that their use is subject to the so-called Sinclair nexus test. This test requires that a clear nexus must exist between an activity for which a mitigation fee is used and the adverse effects related to the activity on which that fee is levied. Given this legal requirement, the Administration's proposal to fund activities (such as high-speed rail) could be legally risky. While the high-speed rail project could eventually help reduce GHG emissions somewhat in the very long run, it would not help achieve AB 32's primary goal of reducing GHG emissions by 2020. This issue is discussed further in the Transportation section of this report.

High Speed Rail or More Funding for Other Rail Projects? While the high-speed rail project may help the state to address future transportation needs, the project does little to achieve the goals of AB 32 and reducing GHG emissions by 2020. In fact, the construction of the project will increase GHG emissions in the near term. In addition, at this time, given various lawsuits and a lack of identified future funding for the project, the likelihood of the completion of an operational section of the project is uncertain.

Given these concerns, the Legislature may wish to modify the budget request of $300 million ($250 million for high-speed rail and $50 million for rail modernization) for rail projects and provide a greater amount of funding for the Rail Modification Grant program. Grants to intercity, commuter, and urban rail operators are more likely to result in projects that can be completed in the near-term, reduce GHG emissions, and reduce congestion and improve mobility in the state. If more funding were provided for rail modernization projects, the Legislature may wish to require that the competitive grant process considers the amount of GHG reductions the project would achieve as criteria for awarding grants. The Legislature may also wish to adopt legislation to help ensure that the program guidelines equally consider projects beyond system integration and allow for grants to fund projects, such as the electrification of rail systems or purchase of new equipment, that emits fewer GHGs.

What Should be the Mix of State Versus Local Natural Resources Programs? The three natural resources proposals (wetland restoration, water efficiency, and fire prevention) all include a mix of state-funded projects versus local assistance, mainly in the form of grants. For example, the water efficiency funding would be split 50-50 between grants to locals for water efficiency projects and a single state-owned State Water Project facility upgrade. Similarly, the forestry proposal includes $24.2 million for local assistance over two years and $75.8 million for state operations for the same time period. The wetlands restoration proposal includes about $4-5 million per year for state operations and about $25 million per year for local assistance. At the local level, there are few funding sources dedicated directly for GHG emission reductions, though efficiency is always a part of local project administration. The state also has several state conservancies dedicated to specific land and wetland restoration that are designed to have a more concerted state-local focus, however these conservancies were not included in the proposal. The Legislature should consider these natural resources proposals individually to determine whether it agrees with the state-local funding mix proposed. Without clear metrics, it is difficult to determine whether the state or locals will achieve the greater amount of GHG emission reductions before 2020.

Drinking Water Program Shift

BACKGROUND:

CURRENT REGULATION OF DRINKING WATER

Department of Public Health Drinking Water Program. The Department of Public Health (DPH) administers the federal Safe Drinking Water Act (and the parallel state statute). The DPH's overall programs are involved in a broad range of health-related activities, such as chronic disease prevention, communicable disease control, regulation of environmental health (including drinking water quality), and inspection of health facilities. The department's drinking water program (DWP) regulates 5,700 public water systems serving more than 15 service connections or 25 people. The department also oversees water-recycling projects, permits water treatment devices; and provides various technical assistance and financial assistance programs for water system operators—including bond and federally-funded programs for infrastructure improvements in public water systems—to meet state and federal safe drinking water standards. The department administers a revolving loan fund for water treatment infrastructure improvements that is funded by the US Environmental Protection Agency (US EPA). The department responds to drinking water emergencies and provides oversight, technical assistance, and training for local water agencies.

State Water Resources Control Board. The State Water Resources Control Board (SWRCB) and the nine semi-autonomous regional boards, administer the federal Clean Water Act (and the parallel state statute). Specifically, the board regulates the overall quality of the state's waters, including groundwater, to protect the beneficial uses of water by permitting waste discharges into water and enforcing water quality standards. The board administers the state's system of water rights and provides financial assistance to fund wastewater system improvements, underground storage cleanups, and other improvements to water quality. The board also administers a similar revolving loan fund for wastewater infrastructure improvements that is funded by the US EPA.

Other State Agencies Involved with Water Supply and Drinking Water. Seven state governmental departments have responsibility over the quality of the state's water; however, the DPH is the only state agency responsible for the quality of the state's *drinking* water. For example, Cal-EPA coordinates regulatory functions guiding environmental quality and public health. These entities generally focus on setting allowable concentrations of pollutants, issuing permits, and ensuring compliance with relevant statutes. A summary of state agency responsibilities is shown in the following table.

State Agencies Involved with Water Supply/Drinking Water

Department	Key Water Quality Responsibilities
Department of Public Health	• Enforces the federal and state safe drinking-water acts. • Ensures the quality of the state's drinking water from the point where water is pumped from a drinking water well or surface water intake point.
California State Water Resources Control Board and Regional Water Quality Control Boards	• Protects the quality of surface water and groundwater to the point where the water enters a drinking water well or surface water intake point.
California Department of Pesticide Regulation	• Develops mitigation measures to prevent pesticide contamination of groundwater and surface water.
California Department of Toxic Substances Control	• Ensures that groundwater and surface water at toxic sites is monitored and remediated.
Office of Environmental Health Hazard Assessment	• Performs health risk assessments related to setting drinking water standards.
California Public Utilities Commission	• Ensures that customers of regulated water utilities receive reliable service.
Delta Stewardship Council	• Improves Sacramento-San Joaquin Delta water quality for drinking, agriculture, the environment, and Delta species.

Source: Senate Office of Research, 2011

CONCERNS RAISED ABOUT THE CURRENT DRINKING WATER PROGRAM.

LAO Concerns with the Drinking Water Program. The DPH program has had several concerns raised about the effectiveness of its management. According to the LAO, several concerns with the DWP have been raised by stakeholders and others, prompting an evaluation of the current governance structure of the state's drinking water. These concerns include:

- The current location of the DWP within in DPH results in a lack of integration with overall water quality management.

- DWP's slow rulemaking process has delayed progress in meeting legislative goals, such as developing regulatory criteria for the use of recycled water, and distributing financial assistance.

- The level of fees assessed by DWP may not be sufficient to generate adequate administrative resources.

- The current structure of decision making in DWP may not be sufficiently transparent.

US EPA is Critical of DPH Financial Assistance Programs. There has been a slow distribution of financial assistance by DPH, for projects that enable public water systems to comply with safe drinking water standards. Specifically, the US EPA issued a notice to DPH for non-compliance with the Safe Drinking Water Act; its implementing regulations, and the terms and conditions of the department's revolving loan fund grant agreements funded by US EPA for federal fiscal years 2009 and 2011. In the spring of 2013, the US EPA, determined that the department had not timely and efficiently committed and expended the funds in the revolving fund, nor employed adequate financial resources to operate the fund in a sound financial manner, in violation of the terms and conditions of the grant agreements. The US EPA approved the department's corrective action plan in July 2013 and has been working with the department on allocating these funds in a more timely manner.

GOVERNOR'S PROPOSAL:

Proposal to Shift Drinking Water Program to Water Board. The Administration proposes to transfer the Drinking Water Program (DWP) from DPH to the SWRCB. As a precursor to this proposal, the Administration hosted a series of stakeholder meetings and convened a reorganization task force to solicit feedback on the proposal. The Administration plans to prepare a transition plan in February 2014 that will take into account the efforts to date.

The budget proposes to shift 291 positions and $202 million ($5 million GF) from DPH to the SWRCB, and includes an additional $1.8 million (General Fund) for one-time funds for technology and facility costs. The proposal shifts all programs (described below) and combines certain financial assistance programs.

Regulatory Program. The proposal seeks to consolidate all water quality regulation within one state agency. The DWP would be organized as a separate division under the State Water Board. Program regulatory staff would remain in locally-based offices and would not be integrated with the regional water quality control boards. The division would be overseen by a Deputy Director who would be required to have public health expertise and who would report directly to the Executive Director. The Deputy Director would have the authority to grant or deny water system permit applications. These decisions would not be subject to Board review, nor would permit issuance and enforcement be delegated to the regional water boards. The proposal does not include a proposal to extend statutorily-mandated minimum penalties for waste discharge violations to drinking water violations.

Maximum Contaminant Level (MCL)-Setting. MCLs are currently adopted as regulations by DPH. These are the health protective drinking water standards to be met by public water systems. MCLs take into account chemicals' health risks; factors, such as their detectability and treatability; and, costs of treatment. The MCLs would continue to be established through the regular rulemaking process under the Administrative Procedures Act. The Deputy Director would follow existing rulemaking procedures and the SWRCB would act on the proposed regulations in a public meeting, after which they would be subject to Office of Administrative Law review.

Recycled Water. As a result of this reorganization, the DPH functions related to recycled water would be coordinated through the SWRCB permit process. The Board does not propose to change how these permits are issued, but proposes to seek opportunities for more efficient and effective permitting of recycled water, as required by SB 322 (Hueso), Chapter 637, Statutes of 2013.

Emergency Response. The proposal plans to maintain the existing local emergency response structure of the DWP, including rotating district office duty officers, under the new division. The division would become part of the Cal-EPA Emergency Response Management Committee, which is Cal-EPA's coordinating body that assists in emergencies requiring cross-department or cross-agency solutions. For emergencies affecting water quality, such as sewage or chemical spills, the DWP would coordinate with the Regional Water Boards.

Operator Certification. The SWRCB plans to jointly manage both Operator Certification Programs within the Division of Financial Assistance (already existing at SWRCB). This will allow the DWP to take advantage of the SWRCB's new web-based data management system for wastewater operators and would expand this system to include drinking water operators.

Financial Assistance Programs. The proposal plans for the SWRCB to jointly manage the Clean Water and Drinking Water State Revolving Funds (SRFs) and both bond programs (Propositions 50 and 84) within the Division of Financial Assistance. This proposal will likely require statutory and regulatory changes to harmonize the programs. The division would combine the programs to streamline water quality infrastructure financing, in particular for application assistance for disadvantaged communities.

LAO ANALYSIS OF DRINKING WATER PROGRAM SHIFT OPTIONS:

In two separate requests from the Legislature, the LAO has analyzed two options for the transfer of the drinking water program away from DPH and to the Cal-EPA. The first option is the possible shift of the program to the State Water Resources Control Board (SWRCB). The LAO was also asked to evaluate a shift of the program to a stand-alone office at Cal-EPA, such as is the case with the Office of Environmental Health Hazard Assessment.

According to the LAO, the Federal Clean Water and Safe Drinking Water Acts allow states significant flexibility in how they structure their water management agencies. For example, 30 states have consolidated drinking water and water quality programs in a single entity. Some states have also consolidated their water quality-related revolving loan programs in agencies that focus solely on providing financial assistance. Below, the LAO describes the potential advantages and disadvantages of the two options it was asked to review.

Potential *Advantages* of Shifting the Drinking Water Program to SWRCB. Transferring DWP to the SWRCB could accomplish several key concerns raised about the current DPH-run program as outlined below.

- **Greater Policy Integration on Water Issues**. Consolidating the functions of the DWP with SWRCB's water quality and water rights regulatory activities could increase the effectiveness of the state's water regulation activities by addressing water issues more comprehensively. For example, there would be a more coordinated focus on the sources of pollution and their effects on drinking water. In addition, there may be opportunities to streamline permitting processes for entities that are currently regulated by both DWP and SWRCB.
- **Potential for Accelerated Rulemakings.** The SWRCB is authorized to make some changes to rules by updating its policy handbook—an annual process that allows for public participation through board meetings, and that can be faster than making changes to regulations that are subject to the Administrative Procedures Act, such as DWP's rulemakings.

- **Potential for Efficiencies and Increased Administrative Capacity.** Consolidation of the SWRCB's clean water and DPH's safe drinking water financial assistance programs could increase efficiency and increase administrative capacity through economies of scale. In addition, SWRCB appears to use its existing fee authority to support program administration to a greater extent than DPH. (For example, DPH has the authority to bill water systems for the costs associated with processing financial assistance applications, but it does not currently do so. The SWRCB, on the other hand, exercises its authority to assess fees on loan applicants.) These factors suggest that a SWRCB-administered drinking water program may be more likely to have the administrative resources required to adequately run the program and get financial assistance out the door in a timely manner.

- **Potential for Increased Transparency and Greater Public Participation.** The SWRCB's board structure provides for regular, structured opportunities for comments on proposed rules or other issues from all interested parties in a public process.

Potential *Disadvantages* of the Shifting Drinking Water Program to SWRCB. The LAO raised concerns about the potential shift relative to other public health programs, costs associated with the reorganization and possible disruption to certain services as described below:

- **Loss of Some Integration With Public Health Programs.** Transferring the DWP away from DPH may result in a loss of some integration of drinking water activities with other public health programs, such as those that monitor infectious diseases (including waterborne illnesses), and incidences of birth defects and cancer.

- **Temporary Disruption to Activities.** Transferring the DWP to the SWRCB may result in disruptions that temporarily reduce the program's capacity to perform regulatory activities. For example, the existing relationships between DWP staff and local primacy agencies may be disrupted.

- **Potentially Increased, Mainly Short-Term, Costs.** These costs could include relocation expenses, increased personnel costs from consolidation of classifications, and costs to integrate information technology systems.

Potential Relative *Advantages* of Shifting the Drinking Water Program to Cal-EPA. Transferring the DWP to a stand-alone entity under Cal-EPA could have several advantages when compared to transferring it to SWRCB, including: (1) less disruption to the current activities of both SWRCB and the DWP, (2) greater focus within the entity on drinking water policy and public health, and (3) potentially greater visibility for drinking water issues, as described below.

- **Less Disruption to Current Activities.** As previously noted, transferring the DWP to SWRCB could result in some temporary disruption to the activities of SWRCB as it integrates the new drinking water activities and related personnel into its existing operations, and some temporary disruption to DWP activities as DWP staff move from their current location into a new entity. While some disruption to DWP activities would still occur if DWP were transferred to a stand-alone entity under Cal-EPA, that disruption may be lessened to the extent that the existing DWP organizational structure remains largely intact.

- **Greater Internal Focus on Drinking Water Policy.** A stand-alone entity would inherently have a greater drinking water and public health focus than if the DWP were to be transferred to SWRCB. A stand-alone entity would focus exclusively on drinking water issues, whereas the SWRCB is required by statute to balance all beneficial uses of water, such as drinking water supply, agricultural supply, and environmental uses.

- **Potentially Greater Visibility for Drinking Water Issues.** Transferring the DWP to a stand-alone entity could increase the visibility of drinking water issues in policy discussions. First, there would be fewer layers of administration between the DWP and the Governor, potentially allowing the new entity to more effectively advance its perspective on policy issues within the Administration. In addition, establishing a stand-alone entity could signal that drinking water policy is a legislative priority.

Potential Relative *Disadvantages* of Transfer of the Drinking Water Program to Cal-EPA. Creating a stand-alone entity to house the DWP could have several disadvantages, relative to moving the program to SWRCB, including: (1) less integration of drinking water policies with other areas of water policy, (2) increased administrative costs and reduced potential for efficiencies, and (3) less effective financial assistance programs. These disadvantages stem, in part, from forgoing potential benefits that could be achieved by transferring the program to SWRCB.

- **Less Integration With Other Areas of Water Policy.** Transferring the DWP to a stand-alone entity in Cal-EPA could increase coordination to some degree among drinking water activities and SWRCB's water quality and water rights activities. This is because both entities would be housed under the same agency that could provide overarching policy guidance. However, the coordination and resulting benefits would be less than if the DWP were integrated into SWRCB. For example, different decision makers would be setting policy on the quality of water supplies (such as groundwater) and the quality of drinking water. Therefore, some opportunities to recognize problems or develop innovative solutions could be lost.

- **Increased Administrative Costs and Reduced Potential for Efficiencies.** As described above, establishing a stand-alone entity could increase net costs by $6 million per year because of the need for additional administrative personnel and related operational expenditures. In addition, such an entity might not achieve the same potential efficiencies through economies of scale that could result from consolidating the SWRCB's clean water and DPH's safe drinking water financial assistance programs. Both the DWP and the SWRCB support some of their activities through fees levied on water service providers. Fees charged by a stand-alone entity would likely be because additional funding would be required to cover the added administrative costs and lost potential for economies of scale described above.

ISSUES FOR LEGISLATIVE CONSIDERATION:

Does this Proposal Address the Problem of Poor Drinking Water? Among the many issues raised by stakeholders during the discussion about program reorganization is the ongoing issue of poor drinking water in certain parts of the state. For example, parts of the Central Valley have ongoing water quality problems that result in a complete lack of safe drinking water. These issues have been well-documented but have not been sufficiently addressed. This problem is not isolated to the Central Valley and persists in lower-income and disadvantaged communities. The Legislature should consider whether there are further reforms that the budget or policy committees should consider as part of this reorganization proposal.

Should the Other Environmental Health Programs Shift to Cal-EPA? The LAO has laid out a series of potential advantages and disadvantages of shifting the DWP to either the SWRCB or to a stand-alone office at Cal-EPA. While both have merit, a third option may be possible. The Governor's budget proposal attempts to address many of the concerns raised about governance, rulemaking, and public participation. However, it does not suggest further shifts of environmental programs housed in DPH to Cal-EPA. The DWP is currently housed within DPH's Center for Environmental Health, in the Division of Drinking Water and Environmental Management. Within this division are the environmental health programs that regulate the generation, handling, and disposal of medical waste; oversees the disposal of low-level radioactive waste; and protect and manage food, drug, medical device, and radiation sources. The Legislature may wish to consider both the Governor's proposal, as well as options to shift these other programs to entities within Cal-EPA. For example, shifting the environmental health programs remaining at DPH to the Office of Environmental Health Hazard Assessment (OEHHA) at Cal-EPA may result in efficiencies and would address the concern about splitting up environmental health programs.

Transparency and Public Participation. The SWRCB provides regular, structured opportunities for comments on proposed rules or other issues from all interested parties in a public process. The governance structure of a stand-alone drinking water entity would partly determine whether it could achieve the same transparency and opportunities for public participation. For example, if the new entity had a single department head, public participation and transparency could be reduced relative to that which would be achieved if DWP were transferred to SWRCB; but if it was created to mirror the board structure of SWRCB, the same benefits might be achieved. Alternatively, opportunities for public participation could be built into the new entity, as is done with some other Cal-EPA agencies. The Legislature should evaluate whether or not the budget proposal allows for sufficient transparency and public participation for the drinking water program.

Opportunity for Fee Reform. During the earlier discussion of the proposed shift of DWP to the SWRCB, concerns were raised about the differences in the way the two entities fund their programs. For the most part, the SWRCB issues permits with a specific up-front cost that is designed to meet regulatory needs. Contrarily, the DPH fee program consists of a mix of up-front fees and payment in arrears for service. While there are advantages to both, it would seem that having surety of an up-front cost might be a better option to fund basic regulatory programs that would allow both the program and the fee-payer assurance of costs annually. The Legislature may wish to consider how the two programs' fee structures should be integrated.

Coastal Climate Adaptation

BACKGROUND:

Sea Level Rise in California. According to the Administration, climate change in California during the next century is expected to shift precipitation patterns, accelerate sea level rise and increase temperatures. The country's longest continuously operating gauge of sea level, at Fort Point in San Francisco Bay, recorded a seven-inch rise in sea level over the 20th century. As has been seen throughout the country such as with Hurricane Sandy, as well as the recent "king tides" (very high tides) in Southern California, much of the developed California coast is susceptible to the impacts of sea level rise. In recent events, high tides inundated parts of the Pacific Coast Highway, Huntington Beach, and other low-lying areas of Southern California. Parts of the San Francisco Bay Area also experienced flooding, including portions of Highway One in Marin County. These very high tides are considered a good indicator of the possible impacts of sea level rise and create challenges for local planners and developers in low-lying areas.

Administration Efforts for Climate Adaptation. In 2008, Executive Order (EO) S-13-08 called on state agencies to develop California's first strategy to identify and prepare for expected climate impacts. The EO focused on the need to understand and improve how sea level rise projections would impact the state's coastal and low-lying areas. The EO required the California Natural Resources Agency (CNRA) to develop a Climate Adaptation Strategy with various state agencies through the established Climate Action Team. These efforts were designed to be complementary, but not duplicative, of the state's strategy for reducing greenhouse gas (GHG) emissions. The Office of Planning and Research, in conjunction with CNRA, was required to provide land-use planning guidance related to sea level rise and other climate change impacts.

The state subsequently undertook two new climate change assessments (a previous assessment, in 2006, examined the broad impacts of climate change on California's assets). The first assessment, completed in 2009, attempted to provide initial economic impacts of climate change. It concluded that preparing for climate impacts, in addition to efforts to reduce GHG emissions, could substantially reduce California's risk of economic losses and damages. The second assessment, completed in 2012, focused on vulnerability and adaptation discussed in the 2009 Climate Adaptation Strategy (described below). This assessment focused more specific types of response needs related to ground exposure, sensitivity, and natural and human systems.

Climate Adaptation Strategy. The California Energy Commission (CEC) has taken the lead in developing the climate assessments and adaptation strategies for the state, through use of the Public Interest Energy Research (PIER) program. The CEC and CNRA have used this research to develop an Adaptation Planning Guide (APG), a decision-making framework intended for use by local and regional stakeholders to aid in the interpretation of climate science and to develop a systematic rationale for reducing risks caused, or exacerbated, by climate change. The CEC and CNRA have also released Cal-Adapt, a web-based tool which enables city and county planners, government agencies, and the public to identify potential climate change risks in specific areas throughout California.

MULTIPLE STATE AGENCIES INVOLVED WITH COASTAL CLIMATE ADAPTATION

In addition to the state agencies previously mentioned (CEC, CNRA and Office of Planning and Research), several other state agencies have primary roles in the assessment and planning for coastal climate adaption. Below are four primary state agencies responsible for addressing aspects of sea level rise on the coast.

State Coastal Conservancy (SCC). The SCC's Climate Ready program provides a focus for the state's work protecting important coastal resources and habitats from the current and future impacts of climate change. The SCC is collaborating with local partners and other agencies to reduce greenhouse gas emissions and prepare coastal communities. SB 1066 (Lieu), Chapter 611, Statutes of 2012, gave the SCC explicit authority to work with its partners on projects to address the effects of climate change on coastal resources along the coast and within the San Francisco Bay Area, including those that:

- prepare our communities for extreme weather events, sea level rise, storm surge, beach and bluff erosion, salt water intrusion, and flooding;
- address threats to coastal communities, natural resources and infrastructure; and,
- reduce greenhouse gas emissions.

Bay Conservation Development Commission (BCDC). BCDC staff has taken a lead in developing an Adaptation Assistance Program (AAP) to provide information and resources to Bay Area local and regional governments to assist them in planning for, and adapting to, the impacts of a changing climate. These outreach efforts primarily focus on addressing the needs of land use planning, public works, park and open space districts, flood control districts and wastewater authorities, as well as resource-based managers.

The AAP aims to help San Francisco Bay Area communities achieve coordinated and region-wide adaptation to climate change impacts by building capacity within local governments to assess climate change issues, and to plan for and implement adaptation strategies.

BCDC has identified five broad program components for accomplishing this objective:

- building partnerships that cut across jurisdictional boundaries, both geographic and sectoral;
- public outreach to build community and institutional support for adaptation planning;

- education to help planners and managers develop knowledge and skills for adaptation planning;
- creation of a "one-stop shop" website and information clearinghouse; and,
- development and dissemination of strategies to improve the region's resilience and adaptive capacity.

State Lands Commission (SLC). The SLC provides stewardship of state lands, waterways, and resources through economic development, protection, preservation, and restoration. The SLC also manages state oil and gas leases in coastal areas, including offshore oil platforms, for which it receives royalties from the sale of the produced oil.

According to the SLC, sea level rise resulting from climate change is an issue that has far reaching consequences for California, including the lands under the jurisdiction of the SLC. Lands within the SLC's jurisdiction and adjacent properties are already vulnerable to a wide range of naturally occurring events, including storms and extreme high tides. While some of these lands remain undeveloped, significant portions of California's shoreline areas have been developed, including areas either pursuant to a lease from the SLC or pursuant to authorization from local government trustees of state tide and submerged lands. The SLC has an important role to play in addressing the issue of sea level rise and assuring that those decision-makers involved in proposed and existing development on the state's Public Trust lands consider the impacts of sea level rise.

California Coastal Commission (CCC). The CCC is the primary state agency responsible with administering the 1976 Coastal Act. The CCC, in partnership with coastal cities and counties, plans and regulates the use of land and water in the coastal zone. Development activities, which are broadly defined by the Coastal Act to include (among other things) construction of buildings, divisions of land, and activities that change the intensity of use of land or public access to coastal waters, generally require a coastal permit from either the Coastal Commission or the local government.

Land use planning in the coastal zone, as in the rest of the state, is the primary responsibility of local governments. However, the Coastal Act imposes a number of requirements on land use in the coastal zone. Most significantly, the act requires local governments to adopt Local Coastal Programs (LCPs) to govern development of land in their jurisdictions that lie within the coastal zone.

In preparing to develop LCPs, many local governments have chosen to divide their coastal zone territory into several segments. This is done when a local government's coastal jurisdiction encompasses several distinct regions with different land use issues. A separate LCP is developed for each coastal segment. There are currently 128 coastal segments within the 76 coastal cities and counties. A LCP must contain: (1) a land use plan, and (2) zoning ordinances to implement the land use plan. In general, LCPs must be designed to ensure maximum public access to the coast, provide recreational facilities, protect the marine environment, and otherwise promote the goals and objectives of the Coastal Act.

The Coastal Commission reviews and certifies LCPs for conformity with the act. As originally passed, the act required all local governments in the coastal zone to have submitted LCPs to the CCC by January 1, 1980. However, this deadline has been extended several times, and today some jurisdictions still have not submitted LCPs to the commission.

The Commission's status of LCP review includes:

- 92 LCP certified segments.
- 79 of 92 certified LCP segments (86 percent) were certified more than 20 years ago.
- 24 of 92 certified LCP have been comprehensively updated.

COASTAL COMMISSION ROLE IN SEA LEVEL RISE PLANNING

Updating Local Coastal Plans. The CCC has maintained a steady budget over the past several years but has struggled to make progress in updating LCPs. There are many reasons for this including: (1) funding has not been available to assist local jurisdictions in updating their coastal plans; (2) some locals are reluctant to take back coastal permitting and prefer to have the state provide this service; and, (3) recent local funding issues have, as with other areas of government, reduced their ability to do forward-thinking planning.

Sea level rise has added urgency to the issue of outdated, incomplete, and uncertified LCPs. Local planning and preparation are critical if the state is to maintain its coastal development zones and prepare for possible inundations. Creating a local plan is part of every coastal jurisdiction's responsibility, in order to determine how to preserve life and property along the California coast.

In the current year budget, the CCC received $3 million (General Fund) to update and improve LCPs relative to sea level rise. Given the number of outdated and inadequate LCPs (again, relative to sea level rise), the CCC was charged with providing locals with the funding necessary (within budget constraints) to begin to shift the CCC's role away from providing direct permitting for 36 local jurisdictions, to its intended role of an appellate function for coastal land use decisions. At the same time, the CCC was asked to provide local assistance ($1 million of the $3 million), to provide locals with funding to update their LCPs, mainly for sea level rise and climate adaptation.

REVENUE OPTIONS FOR FUNDING COASTAL CLIMATE ADAPTATION

Tidelands Oil Revenue. As previously discussed, the SLC receives royalty revenues from oil extraction activities on state tidelands. SB 271 (Ducheny and Thompson), Chapter 293, Statutes of 1997, established the principle that royalty revenues received by SLC from oil extraction activities should be dedicated, in large part, to various coastal and natural resources protections that benefit the entire state. Through subsequent legislation and budget actions, the Legislation funded various programs through the Resources Trust Fund (RTF) including marine management, natural resources infrastructure, and State Parks deferred maintenance. In 2002, the budget proposed eliminating the current statutory requirements for distributing tidelands oil revenues to various special funds to fund resource activities.

As a separate issue, a lawsuit between the state and the City of Long Beach required the City to direct funds to a Tidelands-related fund, the Oil Trust Fund, per PRC §6217.8. This fund is intended to be an abandonment reserve fund, for use when the oil production comes to an end. The maximum amount to be deposited into the fund was established at $300 million, with continued funding to be deposited as Tidelands Oil revenue and (per current law), deposited into the General Fund. The Trust Fund has reached its maximum and therefore up to $2 million per month is now being deposited into Tidelands Revenue that had not been available prior to 2013.

SB 461—An Opportunity for Improved Funding. The Legislature, in 2013, considered SB 461 (Leno), a bill to redirect SLC Tidelands Revenue to sea level rise adaptation activities. According to the committee analyses, this bill would begin to restore the principle that tidelands revenues should be used to fund activities that benefit the environment. As an example, the bill would help state agencies encourage local governments and other entities, responsible for planning under the Coastal Act; to develop and adopt updated plans that conserve and protect coastal resources from future impacts from sea-level rise and related climate change impacts such as extreme weather events. The bill was held in Assembly Appropriations.

GOVERNOR'S PROPOSAL:

Coastal Commission Funding Missing. The Governor's budget does not renew the $3 million (General Fund) funding for the CCC's local coastal plan updates. While funding was included on a one-time bases in the current year, the expectation was for this proposal to carry forward should the need continue. With that in mind, the CCC both administered the $1 million in grants to local agencies and conducted permanent hires to the Commission's staff to keep up with workload associated with the increased turnover of LCPs.

Fourth Climate Change Assessment Proposed. The Governors' budget requests $5 million (one-time, Environmental License Plate Fund) and one position at the CNRA, to carry out a fourth climate change assessment. The majority of funds are proposed to be used for research contracts to conduct the scientific research needed for the assessment. The assessment, similar to the three previous, would continue to generate data and information needed to support continued climate policy development, planning, and implementation efforts at the state, regional, and local level. The intent is to ensure that efforts to foster resilient communities and businesses are informed by the best available science.

ISSUES FOR LEGISLATIVE CONSIDERATION:

Why Cease Funding for Sea Level Adaptation? During budget hearings in 2013, and in review of the many efforts of the Administration related to climate adaptation, it became clear that the local coastal areas are not only the most vulnerable to sea level rise, but many are woefully behind in their Coastal Act-mandated local coastal plan updates. No one is more appropriate to address sea level rise than the locals themselves, as established in the Coastal Act. The statewide impact of these plans is necessarily subject to CCC review.

The Administration's efforts, to date, have focused attention on the impacts of sea level rise and the economic impacts of loss of infrastructure in coastal areas. Science has already established the trend toward sea level rise, and the impacts of recent king tides have documented the cost of such a change on local infrastructure. The lack of continued funding for the update of LCPs seems shortsighted given that $5 million would be directed to conduct further scientific studies of climate change.

The Legislature should consider re-establishing funding for the CCC, for a specific period of time, to provide locals with the funding necessary to create or update their LCPs. This funding should be temporary and fit the current model for grants to locals as established by the Commission, with an emphasis on adaptation to sea level rise.

The Legislature should also consider ongoing funding to the CCC for review and update of these plans. The CCC holds a special expertise in the development of local coastal plans and works in conjunction with local agencies to ensure that their plans meet state law and standards. Without the necessary funding for this effort, LCPs will not be updated in a timely manner.

Is it Time to Revisit Tidelands Oil Revenue Allocations? In 1997, when the Legislature first established the principle that Tidelands Oil revenues should be allocated to natural resource and coastal activities, the royalties totaled a little over $50 million. Today, due mostly to the price of oil, these funds bring between $250 and $350 million to the General Fund annually. Since 2006, all of the Tidelands royalties have been directed to the General Fund, in part for budget balancing. The addition of funds that have been directed to the Oil Trust Fund (related to the City of Long Beach abandonment reserve fund, now capped), are now included in the Administration's revenue estimates for Tidelands Oil.

Given the need for dedicated funding for sea level rise and adaptation, the Legislature should consider appropriating funding from Tidelands Oil to natural resource and coastal-related needs. Consistent with the Administration's Climate Action Strategy, it would seem that providing a dedicated funding source for coastal preparedness would be an appropriate state strategy to deal with sea level rise. A portion could be dedicated to local infrastructure, but a second subset should be directed to protect state-owned and managed assets such as roads, highways, state parks, water systems, ports, and other critical infrastructure.

Should Environmental License Plate Funds (ELPF) be Used for Climate Strategy? The Governor's proposal to spend $5 million from the ELPF for the CNRA's Climate Adaptation Assessment should be reviewed. The ELPF was designed to fund state environmental education efforts that have, to date, been funded with a variety of recycling funds and other environmental fees. The ELPF traditionally has been stretched thin, due to its use as baseline funding for the State's conservancies and various other environmental programs.

The Legislature should consider using a more appropriate fund source, such as Tidelands Oil revenues or cap and trade funding, for future climate assessments. This would allow the Legislature the option to consider other purposes for the ELPF, that can not to be funded by Tidelands Oil, such as conservancy projects, environmental education, and other programs.

Transportation

BACKGROUND:

Overview of Transportation Funding for California
The California state highway system has nearly 50,000 lane-miles of pavement, 12,599 bridges, 205,000 culverts and drainage facilities, 87 roadside rest areas, and 29,183 acres of roadside landscaping. In addition, California's 58 counties and 480 cities own and maintain 141,235 miles of local streets and roads, as well as numerous local bridges. Approximately, 200 public agencies provide some kind of public transit service that results in about 1.3 billion passenger trips each year. The modes of transit include intercity bus and passenger rail. The programs described in this section relate to state highways, local roads, and mass transit, and include the Department of Transportation (Caltrans) and the California Transportation Commission (CTC).

These areas of transportation are funded from multiple sources at the federal, state, and local level as shown in the figure below. In addition, the California Highway Patrol (CHP), the Department of Motor Vehicles (DMV), as well as various programs within the Air Resources Board (ARB), are funded with revenues from vehicle registration and driver licenses' fees. High-speed rail funding is excluded here and is discussed the following section of the *Overview*.

Major Sources of Transportation Funding
Fiscal Year 2014-15
(Dollars in Billions)

Funding Source	Annual Amount	Comments
Local Revenues	$13.2	Includes locally-imposed revenues such as add-on sales tax, property tax, developer fees, and transit fares. Some funds used to reimburse Caltrans for locally-supported work on the highway system. 2013-14 estimated revenues.
Federal Revenues	$4.8	Primarily federal gas tax revenue (18.4 cents/gallon) but augmented by General Fund. Includes funds for highways (Caltrans funds) and transit (local agency funds).
State gasoline and diesel excise tax	$5.5	Allocated to the state and local governments from the 39.5 cent state gasoline excise tax and 10 cent diesel excise tax.
Fees on cars and drivers	$3.0	Primarily from vehicle registration and driver licenses. Supports the operations of the DMV, CHP, and ARB.
Truck weight fees	$1.0	Revenue supports debt service and interest on transportation-related general obligation bonds.
Diesel sales tax	$0.6	Primarily supports local transit operators.
GO bonds	$2.8	State general obligation bonds, primarily from Prop 1B.
Total	**$30.9**	

State funding for transportation comes primarily from revenues derived from taxes and fees. The four main state revenue sources are: (1) state gasoline and diesel excise tax, (2) fees on cars and drivers, (3) vehicle weight fees, and (4) the sales tax on diesel fuel. Some of these state revenues, as well as federal revenues, used to support the transportation system have eroded over time as vehicles have become more fuel-efficient or use alternative energy sources not subject to state and local taxes. Thus, the base of these taxes has diminished over time and as a result, the traditional funding sources have not kept pace with the demands of a growing population and an aging transportation system.

In addition, the state funds transportation projects with general obligation (GO) bonds. The most recent transportation bond approved by the voters—the Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006 (Prop 1B)—provided $19.9 billion for a variety of transportation projects. Most of this funding is already committed to projects and will be expended within the next few years as these projects are completed. Moreover, going forward, structural changes at both the federal and state levels may impact the way the state funds transportation projects.

Funding Levels Outpace Transportation System Needs

Both the state's highway system and local roads are in poor condition according to various studies. The state's highway system is ranked 47th in the nation in overall efficiency and performance, and its urban interstates are ranked as the most congested in the nation. The state ranks 49th in urban interstate pavement condition and 39th in the condition of rural arterial roads. Also, the majority of California's counties now have an average pavement condition rating that is considered at risk, and projections indicate that by 2022, a quarter of local streets and roads will be in the failed category.

In recent years, various organizations have prepared assessments of the state's transportation system and its needs. In general, these studies have found that the needs are great and the funding to address those needs is inadequate. For example, in 2011, the *California Transportation Commission Statewide Transportation System Needs Assessment* found that the total cost of all system preservation, system management, and system expansion projects during the ten-year study period was nearly $538.1 billion, as shown in the figure below. Of this total, about 63 percent of the costs are for rehabilitation projects and maintenance costs based on the goal of meeting accepted standards that would bring transportation facilities into a "state of good repair" within the ten-year study period. The remaining costs were for system management and expansion projects.

Ten-Year Summary of State and Local Transportation Needs
(Dollars in Millions)

Type of Transportation	Preservation Costs	System Management and Expansion Costs	Total
Highways	$79.7	$86.3	$165.9
Local Roads	102.9	26.3	129.4
Public Transit	142.4	32.2	174.5
Inter-city Rail	0.2	6.2	6.4
Freight Rail	0.1	22.3	22.4
Seaports	4.6	7.5	12.1
Airports	10.4	5.5	15.9
Land Ports	0.9	0.0	1.0
Intermodal Facilities	0.0	5.9	5.9
Bike/Ped	0.0	4.5	4.5
Total Needs	**$341.2**	**$196.7**	**$538.0**

Source: CTC Statewide Transportation System Needs Assessment

The CTC assessment also found that the amount of funding anticipated over the next 10 years from all sources (federal, state, and local) represents less than one-half the amount needed to maintain and invest in the state's transportation system as shown below.

Ten-Year Estimate of Revenues Available to Fund Transportation Needs
(Dollars in Millions)

Revenue Source	Amount of Revenue
Federal	$30.9
State	53.1
Regional/Local	158.4
Total Revenues	**$242.4**
Net Total Needs Less Revenues Available	**$295.7**
Percent Funded	45%

Source: CTC Statewide Transportation System Needs Assessment

Similarly, the 2012 *California Statewide Local Streets and Roads Needs Assessment* prepared by the League of California Cities, California State Association of Counties, and Metropolitan Transportation Commission, evaluates the present condition and future requirements of California's pavement, bridges, sidewalks and other essential transportation components of the local streets and roads network. It determines the cost to bring the transportation system up to a best management practices condition, which is the most cost-effective and efficient condition to maintain pavement. It indicates a funding shortfall of $82.2 billion over the next ten years.

Efforts Underway to Improve Caltrans

Recent efforts to improve Caltrans have focused on budgeting, funding, and operations. These efforts include zero-base budgeting (ZBB) reviews of numerous programs, a workgroup focused on funding, and a review of Caltrans' operations.

Zero-Base Budgeting Reviews. As part of a Governor's 2013 Executive Order, Caltrans began a multi-year efficiency review that included ZBB. To date, the department has completed ZBB reviews of the following programs: Local Assistance, Planning, Equipment, Storm Water, and Aeronautics. These efforts have resulted in program efficiencies such as position reductions and program streamlining. Also, in last year's budget, the Legislature directed the Legislative Analyst's Office (LAO) and the Department of Finance (DOF) to work together to review Caltrans' direct workload for the Capital Outlay Support (COS) Program. The goal of this review was to increase the accountability and efficiency of the COS program, by identifying workload metrics, improving program processes, and using information technology tools to achieve a transparent and standardized workload-based assessment of appropriate staffing needs.

The Administration has incorporated the results of this review into the budget. The LAO is expected to release a report that includes its recommendations before spring budget hearings.

In July 2014, Caltrans plans to begin ZBB reviews of the Maintenance and Legal programs. In 2015, Caltrans plans to conduct ZBB reviews of Traffic Operations, Mass Transportation/Rail, as well as a second COS that includes indirect workload, headquarters, and a review of the results from the first COS review. Finally, reviews of the Administrative Program and Program Management are planned for January of 2016.

Funding Workgroup. Last year's budget directed the California State Transportation Agency (CalSTA) to work with stakeholders to develop transportation funding priorities and explore long-term funding options. California Transportation Infrastructure Priorities (CTIP) participants include leaders from business, labor, local transportation agencies, state departments, metropolitan planning organizations, environmental groups, and transportation related non-profits, among others. Four subgroups were formed to examine highways, mass transit, local roads, and active transportation.

Independent Review of Operations. In addition, as part of establishing the new CalSTA on July 1, 2013, the Administration contracted with experts from the independent State Smart Transportation Initiative (SSTI) to conduct an expert review of operations within Caltrans. The SSTI has conducted reviews of state departments around the country with an eye on reform that advances environmental sustainability and equitable economic development, while maintaining high standards of governmental efficiency and transparency. The review is intended to build on recent reforms and assess weaknesses and strengths within the department to help make Caltrans more effective. The SSTI will provide a formal written analysis of its review and proposed action plan in early 2014.

GOVERNOR'S PROPOSAL:

Caltrans and Related Transportation Programs
The Governor's budget proposes to increase transportation spending by allocating the remainder of the Proposition 1B bond funds, making early loan repayments from the General Fund, and using $50 million of Cap and Trade revenues. Combined, these three proposals increase transportation funding by about $1.7 billion. In addition, efforts to improve the operations of Caltrans continue.

Appropriation of Proposition 1B Bond Funds. The budget requests the appropriation of nearly $1 billion in Proposition 1B funds for capital projects. Of the amount requested, $170 million would be used for Caltrans and $793 million for the Public Transportation Modernization, Improvement, and Service Account—Local Transit program. Most of the Caltrans funding would be for making improvements to the state's intercity rail system through the purchase of new rail cars and investments in track. The budget also proposes language that would give Caltrans the authority to increase appropriation levels and allocate additional projects for programs that realize savings from prior-year appropriations so that the remaining funding capacity can be used.

Funds from Early Loan Repayments Proposed for Maintenance. The Governor proposes to repay $337 million in outstanding General Fund loans early. The repayment provides funding for the following:

- $237 million to Caltrans for pavement projects ($110 million), traffic management systems ($100 million), and highway maintenance ($27 million).

- $100 million to cities and counties for local streets and roads.

- $7.7 million to the Active Transportation Program.

- $4.4 million for the Environmental Enhancement Program Fund at the Natural Resources Agency.

Cap and Trade Revenues Proposed for Rail Modernization. The proposal seeks $50 million from the Greenhouse Gas Reduction Fund to support activities promoting greenhouse gas (GHG) emission reduction in the transportation sector. These funds will support the Rail Modernization Grant program which will be developed and administered by CalSTA, which will approve the grants. The CalSTA will confer with the California High-Speed Rail Authority (HSRA) and Caltrans on the development of the program. The program is expected to achieve further GHG emission reductions through capital outlay projects and the network integration of high-speed, intercity and commuter rail, and transit systems at the operation level, with a focus on activities such as fare integration and payment systems.

Recommendations from the Zero-Base Budgeting Review of Capital Outlay Support. As described earlier, LAO and DOF conducted a ZBB review of Caltrans' COS program. Based on the review, the Administration recommends the following to improve the COS program:

- Provide Caltrans more flexibility over its resource mix (state staff, overtime, and consultants).
- Improve annual resources request, initial project budgets, and improve monitoring of project budgets.
- Improve budget accountability.
- Improve statewide program management.

Caltrans will submit an annual update on the progress of implementing these recommendations for the next two years.

ISSUES TO CONSIDER:

Sustainable Funding for Transportation

The Administration's budget does not propose to address the long-term funding needs of the state's transportation system. It is important for the Legislature to begin this conversation and weigh the pros and cons of various approaches to increase funding for transportation and the state's mobility needs. The upcoming 2014 budget hearings could provide an opportunity for the Legislature to hear from the Secretary of CalSTA about the funding strategies identified by his workgroup, explore future funding options, discuss the opportunities and limitations of these funding sources, and identify potential strategies for going forward. As it weighs various options, the Legislature may wish to consider the following:

State is Unlikely to Ever Have Enough Funding to Address All Transportation Needs. The amount of funding necessary to maintain and improve the state's transportation system is significant. Increasing revenues and deciding where to spend those additional resources is a challenging process and it is unlikely that the amount of resources desired would ever materialize and be exclusively spent on transportation projects. It is important to note that many areas of the state's budget, such as health and human services, also have demands for additional resources. Therefore, it will be important to prioritize the use of existing resources and explore alternative ways to address the shortcomings of the current funding system.

Prioritization of Maintenance. As pavement conditions deteriorate, the cost of repair increases exponentially. Going forward, it will be important for the state to ensure that it strikes an appropriate balance between maintaining existing assets and expanding the system. Caltrans has recently implemented PaveM software, which is an IT system that can help the state prioritize its road maintenance projects. The system uses data to create a list of projects based on maintaining roads given a set of conditions, in order to ensure that 95 percent of the roads are in good condition, within specific budget constraints. Such a tool could help Caltrans prioritize the use of existing resources to help ensure that limited funds are spent on the best projects for pavement preservation and rehabilitation.

Technology to Address Shortcomings in the Current System. The performance of transportation systems can be maximized by implementing technology to monitor and manage traffic flow. Such an approach can help reduce congestion and some of the negative environmental impacts of idling vehicles. These types of systems have been implemented in parts of California and include ramp metering and providing real-time data about traffic conditions. However, existing technologies could be expanded to potentially achieve greater benefits. In addition, research is underway that explores the implementation of vehicle-to-vehicle communication and automated vehicles to increase safety and reduce the risks of accidents. It will be important to ensure that at the state level, Caltrans and others are open to the idea that technology may be able to address some of the system's shortcomings. Such an approach requires a fundamental shift in the way transportation needs are currently being met. As mentioned earlier, as a positive step, the Governor's budget proposes $100 million for these types of activities.

New Funding Sources. Some of the revenues used to support the transportation system have been eroded over time by increasing fuel economy and alternative fuel usage. New funding sources could include a greater use of tolls, mileage fees tied to the amount of vehicle travel, and congestion pricing which makes the price of traveling the highest during the times of day when the demand for (and benefit from) using roads is the greatest. These types of funding sources offer an advantage over gas taxes in that these revenues are not eroded by increases in fuel economy or alternative fuel usage. However, these funding sources can also face implementation challenges. For example, mileage-based fees present both privacy and technical obstacles.

Another potential source of funding for transportation projects is revenues from the cap and trade program. Consistent with this, the budget proposes $50 million to improve the rail program. There is great demand for this funding, such as for the construction of high-speed rail, and other projects that could potentially reduce GHGs. It will be important for the Legislature to comparatively weigh the potential of various programs and projects to reduce GHGs.

Additional Oversight With an Eye to Reform

Given that this year various recent and forthcoming reviews of Caltrans are anticipated to provide information about the department's efficiency and effectiveness, the Legislature may wish to learn more about these efforts and conduct additional oversight of Caltrans during budget hearings. The Legislature may wish to ask CalSTA about how it plans to use the recommendations coming from the reviews and what will be the next steps in the process of considering the future of Caltrans and opportunities for reform. The Legislature could also use budget hearings to learn more about the recently completed ZBB of COS. For example, a sample of Caltrans district directors could be asked to explain how they develop their COS budgets. A better understanding of this process, in conjunction with additional information from the review by DOF and LAO, could help the Legislature to potentially identify opportunities to improve Caltrans' process for budgeting for COS.

High-Speed Rail

BACKGROUND:

The California High-Speed Rail Authority (HSRA) is responsible for directing the development and implementation of an intercity high-speed rail service that would be fully coordinated with other public transportation services. In November 2008, the voters approved Proposition 1A—the Safe, Reliable High-Speed Passenger Train Bond Act for the 21st Century—which allows the state to sell up to $9.95 billion in general obligation bonds to partially fund the development (such as planning and environmental review) and construction of a high-speed rail system. Of this amount, $9.0 billion is for the high-speed rail system and $950 million to improve the connectivity of existing passenger rail systems with high-speed rail.

Up to $450 million of the $9.0 billion is available for general administration and up to $675 million is available for initial construction activities, such as environmental studies and preliminary engineering; no match is required for this $1.1 billion. The remaining $8 billion is available for construction; however, a non-bond match of at least 50 percent is required for each corridor or segment. Since the approval of Proposition 1A, HSRA has been awarded $3.5 billion in federal funds from the Federal Railroad Administration (FRA). These federal funds require a substantial state match and $2.3 billion of these funds must be spent by September 30, 2017.

The bond act specifies certain characteristics for the design of the system, including electrified trains capable of sustaining speeds of no less than 200 miles per hour and capacity to achieve travel times between San Francisco and Los Angeles Union Station of 2 hours, 40 minutes.

HSRA is led by a Chief Executive Officer, and governed by a nine-member Board, five of whom are appointed by the governor, two by the Senate Committee on Rules, and two by the Speaker of the Assembly. It currently has 177 authorized staff positions. The size of the department has more than tripled since 2012-13 and, as a result, has 76 vacancies that it is in the process of filling.

Financing High-Speed Rail

The Legislature has appropriated approximately $7.2 billion ($3.9 billion in Proposition 1A funds and $3.3 billion federal funds) for the high-speed rail project to begin development, right-of-way acquisition, and construction of the 130-mile Central Valley segment from Madera to just north of Bakersfield. However, Proposition 1A funding has not been available for expenditure because the State Treasurer's Office will not sell Proposition 1A bonds until legal uncertainties regarding the project are resolved through a "validation action" that was filed on the recommendation of the Attorney General.

In an effort to better ensure that the federal funds ($2.3 billion) are spent by 2017, the HSRA and FRA negotiated an amendment to their existing grant agreement in 2012. Rather than having state funds match federal dollars as initially agreed upon, the amendment provides for a "tapered match" in which the FRA would reimburse the HSRA for up to 100 percent of project costs at the beginning of the project. This agreement provides sufficient federal funds for the initial construction of the project, particularly those costs that were planned to be funded with Proposition 1A funds.

Recent court decisions have prevented the use of Proposition 1A bond funds. As a result, the HSRA plans to resubmit its funding plan in an attempt to address the legal concerns and remove any obstacles to the state's sale of Proposition 1A bonds. In the meantime, federal funds are being used for the project, and a loan of $26.2 million from the Public Transportation Account (PTA) has been made to provide short-term funding for the cost of state operations. In addition, in the past, the Governor has indicated that cap and trade auction revenues might be used as a fiscal backstop.

Project Progress

To date, HSRA has spent about $700 million on the high-speed rail project since 2010-11. This amount includes $600 million for capital outlay expenditures and $100 million on administration or project support costs. By the end of 2013-14, HSRA estimates it will have spent about $1.2 billion on capital outlay and administrative expenditures combined, as shown in the figure below.

High-Speed Rail Expenditures
(Dollars in Millions)

Capital Outlay Expenditures					
Funding Source	**2010-11**	**2011-12**	**2012-13**	**2013-14 (estimated)**	**Total**
Proposition 1A	$92.5	64.2	20.6	12.3	$189.6
Federal funds	84.7	57.9	160.9	556.3	859.8
Subtotal capital outlay	177.2	122.1	181.5	568.6	1,049.4
Administrative Expenditures					
Various state funds	56.6	14.7	17.8	26.4	115.5
Total	**$233.8**	**$136.8**	**$199.3**	**$596.0**	**$1,164.9**

Key areas of the project's progress are described below.

Entered into Significant Contract. In June 2013, HSRA entered into its first design-build contract for construction of 29 miles of the Merced to Fresno segment, for about $1 billion. Pre-construction work, such as acquiring properties and equipment, design, and utility relocation is currently underway. In addition, work continues to complete necessary environmental documents and other preliminary planning activities for the other segments of the system.

Right-of-Way Acquisition. Before construction can begin on a parcel of land, HSRA must acquire the land. Thus, the acquisition of land is linked to the timely completion of the project and delays could increase project costs. As of November 2013, the HSRA has completed appraisals for 264 of the 383 parcels and made first offers on 144 of the parcels it needs for the 29-mile section. It also has 35 proposed settlements with various property owners. If agreement with property owners cannot be reached, HSRA would begin eminent domain proceedings.

Environmental Approvals. The project has already encountered numerous and significant delays due to environmental review periods taking longer than anticipated. For example, completion of the environmental review process has slipped from December 2012 to the spring of 2014 for the Fresno to Bakersfield section; and for the San Francisco to San Jose section the anticipated completion of the review process has been delayed from December 2014 to the summer of 2017.

Projects in the Bookends. In 2012, the Legislature appropriated nearly $2 billion in Proposition 1A bond funds for transit, commuter, and intercity rail projects that strengthen and improve existing rail networks, while also eventually connecting them with high-speed rail. These funds will be used to leverage other funds. Projects include the electrification of Caltrain, improvements to BART tracks and purchase of new cars, and various projects for Amtrak's Capitol Corridor**.**

GOVERNOR'S PROPOSAL:

The budget includes $250 million in cap and trade auction revenues for the project. Of these funds, $58.6 million is for planning and $191.4 is for construction and right-of-way acquisition. These funds would match federal funds, as required. The budget also proposes trailer bill language that would establish cap and trade revenues as a dedicated revenue stream.

The budget proposes an additional loan of $29.3 million from the PTA to continue funding HSRA's operations which include administration, program management, outreach and communications, and fiscal and other external contracts.

The Governor also proposes $32 million in federal funds for infrastructure projects and improvements to enable Los Angeles County Metropolitan Transportation Agency (Metro) to make improvements to the Los Angeles Union Station, which it recently purchased. The FRA has tentatively agreed to fund improvements necessary to accommodate high-speed rail and facilitate connectivity with regional passenger rail service. These funds must be expended by September 30, 2017, and would be supplemented with a local agency match of $48 million.

ISSUES TO CONSIDER:

Cap and Trade for HSR

The Legislature may wish to consider whether the use of cap and trade funds would be an appropriate use of those funds. (This proposal is also discussed in the larger context of all the Governor's cap and trade proposals in the Subcommittee No. 2 “Cap and Trade” section of this report.) The Legislative Analyst's Office (LAO) argues that the use of cap and trade revenues for high-speed rail is very speculative and subject to legal constraints, based on a legal opinion from Legislative Counsel that finds the revenues generated from the cap and trade auctions would constitute "mitigation fee" revenues. Therefore, in order for their use to be valid as mitigation fees, these revenues must be used to mitigate GHG emissions. Specifically, the Administration's proposal to use cap and trade auction revenues for the construction of high-speed rail raises three primary concerns:

- ***Would Not Help Achieve GHG Emission Reductions by 2020.*** The primary goal of the cap and trade program is to reduce California's GHG emissions statewide to 1990 levels by 2020. However, under the current high-speed rail business plan, while the high-speed rail project could eventually help reduce GHG emissions somewhat in the very long run, given the project's timeline, it would not help achieve the primary goal of reducing GHG emissions by 2020. As a result, there could be serious legal concerns regarding this potential use of cap and trade revenues. It would be important for the Legislature to seek the advice of Legislative Counsel and consider any potential legal risks.

- ***High–Speed Rail Would Likely Initially Increase GHG Emissions for Many Years.*** As mentioned above, in order to be a valid use of cap and trade revenues, programs will need to reduce GHG emissions. An independent study found that—if the high-speed rail system met its ridership targets and renewable electricity commitments—construction and operation of the system would emit more GHG emissions than it would reduce for approximately the first 30 years. While high-speed rail could reduce GHG emissions in the very long run, given the previously mentioned legal constraints, the fact that it would almost certainly initially be a net emitter of GHG emissions could raise legal risks.

- ***Other GHG Reduction Strategies Likely to Be More Cost Effective.*** The LAO has recommended that the Legislature prioritize GHG mitigation programs that have the greatest potential return on investment, in terms of emission reductions per dollar invested. Considering the cost of a high-speed rail system relative to other GHG reduction strategies (such as green building codes and energy efficiency standards), a thorough cost-benefit analysis of all possible strategies is likely to reveal that the state has a number of other more cost-effective options. The Legislature may want to obtain cost-benefit information to use when evaluating the comparative merits of various programs intended to reduce GHGs.

Future Funding Continues to Be Uncertain

There is significant uncertainty about the sources of funding needed for the completion of the majority of the high-speed project. At this time, Proposition 1A bonds cannot be used for the project and it is uncertain when this legal hurdle will be cleared. In addition, it is unclear how much, if any, other non-state funds (such as local funds, and funds from operations and development, or private capital) have been secured.

If the project continues to be a priority for the Legislature, long-term stable funding sources for the project would need to be identified. While the Administration has proposed cap and trade funds as a long-term solution, there are considerable trade-offs the Legislature must weigh. For example, using a significant amount of the available cap and trade funds for high-speed rail will greatly reduce the amount of funds available for projects that are more likely to reduce GHGs by 2020 or projects that are more cost-effective.

Oversight of the Project

Oversight is critical for any infrastructure project to help ensure available funds are used in the most efficient and cost-effective manner. In general, the high-speed rail project faces significant hurdles that any large and costly infrastructure project would encounter. These hurdles potentially delay the project and HSR has already encountered significant delays from lawsuits, completion of the environmental review process, and the acquisition of right-of-way. However, in addition to these risks, some of the federal funding available for the project must be spent quickly or the funds will be lost. This introduces another element of risk. The Legislature must ensure that the right balance is struck between using available funding in the most efficient and cost-effective manner and spending the money quickly to meet federal deadlines.

SUBCOMMITTEE NO. 3

HEALTH and HUMAN SERVICES

Health

Human Services

Medi-Cal – Federal Health Care Reform

BACKGROUND:

Proposed Medi-Cal Funding and Enrollment. The Department of Health Care Services administers the Medi-Cal program (California's Medicaid health care program). This program pays for a variety of medical services for children and adults with limited income and resources.

The Governor proposes total expenditures of $73.9 billion ($16.9 billion General Fund) which reflects a General Fund increase of $670 million or 4.1 percent above the Budget Act of 2013. Generally, each dollar spent on health care for a Medi-Cal enrollee is matched with one dollar from the federal government.

Caseload is anticipated to increase by about 935,700 for a total of about 10.1 million average monthly eligibles, primarily due to the implementation of federal health care reform.

Federal Health Care Reform. AB 1 X1 (Pérez), Chapter 3, Statues of 2013-14 of the First Extraordinary Session and SB 1 X1 (Hernandez and Steinberg), Chapter 4, Statues of 2013-14 of the First Extraordinary Session, implemented aspects of the federal Affordable Care Act (ACA), federal health care reform, and expanded Medi-Cal by:

- Simplifying eligibility, enrollment, and retention rules, making it easier to enroll and stay on Medi-Cal. This is referred to as the "**mandatory expansion**."

- Expanding eligibility to adults without children and parent and caretaker relatives with incomes of up to 138 percent of the federal poverty level. This is referred to as the "**optional expansion**."

- Increasing mental health and substance use disorder benefits available in Medi-Cal.

Federal health care reform is expected to increase the Medi-Cal caseload by 1.03 million in 2013-14 and 1.36 million in 2014-15.

GOVERNOR'S PROPOSAL:

The budget includes $867.4 million ($404.9 million General Fund) for the mandatory expansion of Medi-Cal and $6.7 billion federal funds for the optional expansion in 2014-15. The federal government has committed to pay 100 percent of the costs of the optional expansion for the first three years; by 2020-21, the federal share will decrease to 90 percent and the state will pay 10 percent.

Other changes associated with the implementation of the ACA include:

- **Hospital Presumptive Eligibility** – This proposal implements SB 28 (Hernandez), Chapter 442, Statutes of 2013, which allows qualified hospitals to make Presumptive Eligibility (PE) for Medi-Cal determinations for specified populations. This provision of PE will apply to pregnant women, infants and children under the age of 19, parents and other caretaker relatives; childless adults 19-64, and former foster youth. DHCS estimates that 25,610 average monthly eligibles in 2013-14 and 31,574 in 2014-15 will receive hospital PE. The benefit costs for this change is $18.7 million ($9.2 million General Fund) in 2013-14 and $78.8 million ($37.7 million General Fund) in 2014-15.

- **Delay of Redeterminations** – Pursuant to SB 28 this proposal also requires DHCS to postpone redeterminations of Medi-Cal eligibility for the months of January through March 2014 for beneficiaries subject to new modified adjusted gross income standards. These delayed redeterminations would be completed no later than June 30, 2014. The costs related to this proposal are $6.7 million ($2 million General Fund) in 2013-14 and $668,000 ($205,000 General Fund) in 2014-15.

- **Newly-Qualified Immigrants (NQI) under ACA –** This proposal implements SB 1 X1 (Hernandez and Steinberg), Chapter 4, Statutes of 2013-14 First Extraordinary Session, that provides full-scope Medi-Cal to recent immigrant adults starting January 1, 2014. Beginning January 1, 2015, DHCS will begin transitioning new NQI from Medi-Cal into Covered California and Medi-Cal will provide a wraparound of out-of-pocket expenditures for this population. The costs related to this proposal are $14.5 million ($5.2 million General Fund) in 2013-14 and $56.9 million ($20.6 million General Fund) in 2014-15.

- **Express Lane Enrollment** – Pursuant to SB 1 X1 this proposal also would give Medi-Cal eligibility to targeted groups of individuals without the need to conduct a separate modified adjusted gross income (MAGI) based determination. These targeted groups are individuals receiving CalFresh benefits and parents based on their children’s income. It is estimated that 730,000 CalFresh adults, 156,000 CalFresh children, and 150,000 parents/caretaker relatives of Medi-Cal eligible children would be eligible under this provision. It is assumed that 30 percent of these individuals would respond and enroll in coverage. The costs related to this proposal are $71.5 million ($1.2 million General Fund) in 2013-14 and $687.2 million ($11.6 million General Fund) in 2014-15.

- **Changes to Pregnancy Coverage** - The Administration proposes trailer bill language which would provide beneficiaries with incomes under 100 percent of the Federal Poverty Level (FPL) full-scope Medi-Cal benefits (currently these individuals are only eligible for pregnancy-related services), and beneficiaries with incomes between 100 and 208 percent of the FPL with comprehensive coverage through Covered California, beginning in January 1, 2015. The Governor’s budget proposes to pay for the out-of-pocket costs for these beneficiaries electing to receive coverage through Covered California, beginning in January 2015, which will result in savings of $33.1 million ($16.6 million General Fund) in 2014-15.

Beginning January 1, 2015, DHCS estimates 8,100 beneficiaries currently receiving pregnancy-only coverage will shift into Covered California.

ISSUES TO CONSIDER:

Continued Oversight of and Attention to Implementation. In 2013-14 and 2014-15, it is estimated that over two million more individuals will enroll in Medi-Cal. As this occurs, implementation details such as the schedule for information technology system changes, the timing and text of notifications to individuals in varying circumstances, and county eligibility processes and procedures, will be critical in ensuring that the Medi-Cal expansion is successful. It will be important for DHCS to maintain open communication with consumer advocates, counties, and all involved stakeholders, including the Legislature, on critical implementation decisions.

Key Fiscal Estimate Not Included in Governor's Budget. The 2013 budget required DHCS to estimate and display, in the Medi-Cal Program Estimate, the General Fund savings attributable to the receipt of enhanced federal funding for Medi-Cal eligibles who were previously calculated as being currently eligible and for whom the state received a 50 percent federal matching assistance percentage payment. This fiscal estimate was not included in the Medi-Cal Program Estimate. The Administration indicates that it was unable to provide this figure because it did not have data (as the change occurred in January 2014) to base its assumptions and hopes to have this information in the May Revision. The Administration has a wealth of Medi-Cal data and often estimates based on unknown experiences; this information, as required by law, should be provided to the Legislature no later than the May Revision.

May Revision Will Include Updated Information Regarding Redirected County Savings for Indigent Care. The budget estimates that $300 million in 2013-14 and $900 million in 2014-15 in county savings will be realized as a result of federal health care reform (as individuals who were previously covered by county indigent health programs transition to Medi-Cal). These numbers reflect the 2013 budget and were not updated in the January budget.

These savings will be redirected to counties for CalWORKs expenditures; thereby, freeing up General Fund resources. The May Revision will include updated estimates of these savings and an understanding of how counties have implemented the county fiscal true-up mechanism required by AB 85 (Committee on Budget), Chapter 24, Statutes of 2013. This information will be critical in understanding how counties are responding to the changes in their realignment funding and how they plan to continue to provide care to individuals not eligible for any other health care coverage.

Medi-Cal – Coordinated Care Initiative

BACKGROUND:

The 2012 budget authorized the Coordinated Care Initiative[1] (CCI), which expanded the number of Medi-Cal enrollees who must enroll in Medi-Cal managed care to receive their benefits in eight counties (Alameda, Los Angeles, Orange[2], Riverside, San Bernardino, San Diego, San Mateo, and Santa Clara). CCI is composed of three major parts:

- **Long-Term Supports and Services (LTSS) as a Medi-Cal Managed Care Benefit**: CCI includes the addition of LTSS into Medi-Cal managed care. LTSS includes nursing facility care (NF), In-Home Supportive Services (IHSS), Multipurpose Senior Services Program (MSSP), and Community Based Adult Services (CBAS). This change impacts about 600,000 Medi-Cal-only enrollees and up to 456,000 persons eligible for both Medicare and Medi-Cal who are in Cal MediConnect.

- **Cal MediConnect Program**: A three-year demonstration project for persons eligible for both Medicare and Medi-Cal (dual eligibles) to receive coordinated medical, behavioral health, long-term institutional, and home-and community-based services through a single organized delivery system (health plan). No more than 456,000 beneficiaries would be eligible for the duals demonstration in the eight counties. This demonstration project is a joint project with the federal Centers for Medicare and Medicaid Services (CMS).

- **Mandatory Enrollment of Dual Eligibles and Others into Medi-Cal Managed Care.** Most Medi-Cal beneficiaries, including dual eligibles, partial dual eligibles, and previously excluded Seniors and Persons with Disabilities (SPDs) who are Medi-Cal only, are required to join a Medi-Cal managed care health plan to receive their Medi-Cal benefits.

The purpose and goal of CCI is to promote the coordination of health and social care for Medi-Cal consumers and to create fiscal incentives for health plans to make decisions that keep their members healthy and out of institutions (given that hospital and nursing home care are more expensive than home and community-based care).

[1] Enacted in July 2012 through SB 1008 (Committee on Budget and Fiscal Review), Chapter 33, Statutes of 2012, and SB 1036 (Committee on Budget and Fiscal Review), Chapter 45, Statutes of 2012, and amended by SB 94 (Committee on Budget and Fiscal Review), Chapter 37, Statutes of 2013.

[2] At the end of January 2014, the state was notified by CMS that CalOptima in Orange County could not participate in Cal MediConnect until it had corrected issues found in an audit of its Medicare Advantage D-SNP plan. All information contained in this report reflects Orange County as participating in CCI as updated information was not available at the time of this report.

Under the current system (prior to CCI), dual eligibles must access services through a complex system of disconnected programs funded by different government programs (e.g., federal CMS, DHCS-Medi-Cal, IHSS-county based). This fragmentation often leads to beneficiary confusion, delayed care, inappropriate utilization, and unnecessary costs.

Table 1: What is the Difference between Medicare and Medi-Cal?

- ***Medicare.*** Medicare is the federally operated health care program for people who are elderly or have disabilities. Medicare is the primary payer for most medical services for dual eligibles, including doctor and hospital visits and prescription drugs.

- ***Medi-Cal.*** Medi-Cal is California's Medicaid program, a state-run program that offers insurance coverage to certain people with low incomes, including the aged and persons with disabilities. For dual eligibles, Medi-Cal often is referred to as the "wrap around" benefit. Medi-Cal covers most of dual eligibles' out-of-pocket costs, such as deductibles and co-pays, and pays for some prescription drugs and durable medical equipment not covered by Medicare. Medi-Cal also pays for most long-term services and supports, including nursing home care and home- and community-based services, such as the In-Home Supportive Services program (IHSS).

Long-Term Supports and Services (LTSS) as a Medi-Cal Managed Care Benefit

CCI includes the addition of LTSS benefits into Medi-Cal managed care. LTSS includes short-term and long-term nursing facility care (NF), In-Home Supportive Services (IHSS), Multipurpose Senior Services Program (MSSP), and Community Based Adult Services (CBAS). These benefits, with the exception of CBAS, are currently provided on a fee-for-service basis. (CBAS is already a Medi-Cal managed care benefit.) These benefits will be available to a Medi-Cal enrollee as they enroll into Medi-Cal managed care under CCI.

Health Plan Readiness to Deliver These New Benefits. At the state level, the Department of Health Care Services (DHCS), the Department of Social Services (DSS), and the Department of Managed Health Care (DMHC) are responsible for ensuring that health plans are ready to integrate and deliver LTSS as a Medi-Cal managed care benefit. (DSS administers IHSS.) The state is in the process of developing additional contract requirements between DHCS, DSS, and the health plans regarding LTSS.

Additionally, as specified in an interagency agreement between DHCS and DMHC, DHCS is to provide DMHC with a list of all licensed MSSP and CBAS providers in a county and a list of all MSSP and CBAS providers under contract with each plan. DMHC would use this information to assess whether or not the plan has the network and capacity to provide these benefits.

Table 2: Medi-Cal Long Term Supports and Services in CCI

- **Nursing Facilities.** Nursing facilities provide continuous skilled and supportive care on a 24-hour basis. Such care is comprised of inpatient treatment, including physician, skilled nursing, dietary, pharmaceutical, and activity services.
- **In-Home Supportive Services (IHSS) program.** IHSS provides personal care services to about 445,000 individuals who are blind, aged (over 65), or who have disabilities.
- **Multipurpose Senior Service Program (MSSP).** MSSP provides case managed services for frail, elderly clients who wish to remain in their own homes and communities. Clients must be age 65 or older, eligible for Medi-Cal, and certified (or certifiable) as eligible to enter into a nursing home. Teams of health and social service professionals assess each client to determine needed services and then work with the clients, their physicians, families, and others to develop an individualized care plan. Services that may be provided with MSSP funds include, but are not limited to: care management, adult social day care, housing assistance, in-home chore and personal care services, respite services, transportation services, protective services, meal services, and special communication assistance.
- **Community-Based Adult Services (CBAS) program.** CBAS is an organized day program of therapeutic, social and health activities and services provided to elderly persons or other persons with physical or mental impairments. The CBAS program replaced the Adult Day Health Care (ADHC) program on April 1, 2012. AB 97 (Chapter 3, Statutes of 2011) eliminated ADHC services from the Medi-Cal program effective July 1, 2011. A class action lawsuit sought to challenge the elimination. A settlement of the lawsuit was reached that establishes a new program, CBAS.

Cal MediConnect

Cal MediConnect is a three-year demonstration for persons eligible for both Medicare and Medi-Cal (dual eligibles) to receive coordinated medical, behavioral health, and long-term supports and services through a single organized delivery system. No more than 456,000 beneficiaries would be eligible for the duals demonstration in the eight counties. This demonstration project is a joint project with the federal Centers for Medicare and Medicaid Services (CMS). The state and CMS entered into a Memorandum of Understanding[3] (MOU) on March 27, 2013 for this project. Additionally, CMS, DHCS, and each health plan entered into a three-way contract for this project.[4]

See chart below for information on Cal MediConnect counties and health plans.

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[3] http://cms.gov/Medicare-Medicaid-Coordination/Medicare-and-Medicaid-Coordination/Medicare-Medicaid-Coordination-Office/FinancialAlignmentInitiative/Downloads/CAMOU.pdf

[4] http://cms.gov/Medicare-Medicaid-Coordination/Medicare-and-Medicaid-Coordination/Medicare-Medicaid-Coordination-Office/FinancialAlignmentInitiative/California.html

Table 3: Cal MediConnect Counties and Health Plans

County	Dual Eligible Population	Health Care Plan(s)
Alameda	32,533	• Alameda Alliance for Health • Anthem Blue Cross
Los Angeles	288,399[a]	• Health Net • L.A. Care[b]
Orange	65,537	• CalOptima
Riverside	40,040	• Inland Empire Health Plan • Molina Healthcare
San Diego	55,798	• Care 1st • Community Health Group • Health Net • Molina Healthcare
San Mateo	12,371	• Health Plan of San Mateo
San Bernardino	41,930	• Inland Empire Health Plan • Molina Healthcare
Santa Clara	37,739	• Santa Clara Family Health Plan • Anthem Blue Cross
Total	**574,347[c]**	

[a] 288,399 are estimated to be eligible for Cal MediConnect in Los Angeles; however, enrollment in Los Angeles County was capped at 200,000 in the MOU.
[b] L.A. Care will be subcontracting with CareMore and Care 1st Health Plan.
[c] Enrollment into Cal MediConnect is capped at 456,000 per the MOU.

Passive Enrollment. For Cal MediConnect, the state will passively enroll dual eligibles into a health plan that combines their Medicare and Medi-Cal benefits. Passive enrollment is when the state assigns an individual to a Cal MediConnect health plan unless the individual actively chooses not to join and notifies the state of this choice. An individual may opt out of the Cal MediConnect health plan by making this selection on the 60-day notification, calling Health Care Options (HCO), or calling a toll-free Medicare phone number. (HCO assists in Medi-Cal enrollment.)

Dual eligibles who enroll in a Cal MediConnect health plan may opt out or change health plans at any time. If a dual eligible chooses to opt out of Cal MediConnect, it only applies to opting out of Medicare benefits. Dual eligibles, under CCI, must still receive their Medi-Cal benefits through a health plan, as described later.

Populations Excluded from Cal MediConnect. The following populations are excluded from Cal MediConnect:

- Individuals under age 21;
- Individuals with other private or public health insurance;

- Individuals receiving services through California's regional centers, state developmental centers, or intermediate care facilities for the developmentally disabled;

- Individuals participating in certain 1915(c) waivers;

- Individuals with a share of cost (share of cost Medi-Cal is when an individual must spend his or her own funds on medical care to a specified level in order to become Medi-Cal eligible);

- Individuals residing in one of the Veterans' Homes of California;

- Individuals living in the certain rural zip codes; and

- Individuals with a diagnosis of end stage renal disease (ESRD) at the time of enrollment and residing in Alameda, Los Angeles, Riverside, San Bernardino, San Diego, and Santa Clara, unless they are already enrolled in another product operated by the health plan. Individuals enrolled in the demonstration who are subsequently diagnosed with ESRD, as with all enrollees, they may choose to disenroll from the demonstration or may choose to stay enrolled.

Populations Excluded from <u>Passive Enrollment</u> in Cal MediConnect. The following populations may voluntarily enroll, but may not be passively enrolled into Cal MediConnect:

- Individuals residing in the certain rural zip codes in San Bernardino County in which only one Cal MediConnect Plan operates;

- Individuals enrolled in Medicare Advantage, including Dual Eligible Special Needs Plans (D-SNPs), in 2014;

- Individuals in one of the following programs may enroll only after they have disenrolled from the following 1915(c) waivers: Nursing Facility/Acute Hospital Waiver, HIV/AIDS Waiver, Assisted Living Waiver, and In Home Operations Waiver; and,

- Individuals may enroll in Cal MediConnect only after they have disenrolled from the Program of All-Inclusive Care for the Elderly (PACE) or the AIDS Healthcare Foundation.

Default Health Plan Assignment. On the 60-day notification to the enrollee (in all CCI counties except San Mateo and Orange[5]) the state will suggest a health plan that is based on a beneficiary's previous visits to a primary care doctor or specialist (referred to as "linkage"). DHCS indicates that it has Medicare Part B (physician services) and D (prescription drug) data to assist in this linkage. An enrollee can accept this default health plan assignment or can change plans at any time.

[5] San Mateo and Orange counties are County Organized Health Systems with only one health plan.

Health Plan Readiness Assessment. In preparation for implementation of Cal MediConnect, the federal CMS and DHCS conducted a readiness assessment for each health plan. This assessment process began in July. As part of this process, CMS and DHCS evaluated each plan to ensure that it could accept the increased enrollment, protect and provide the necessary continuity of care, and ensure access to all benefits. The assessment included a desk review, site visit, and network validation. CMS is responsible for the oversight of health plan networks which deliver Medicare-based services, while DHCS and the Department of Managed Health Care are responsible for Medi-Cal services. At the time of this report, DHCS indicated that health plan readiness assessments were nearing completion.

Health Risk Assessment. Cal MediConnect health plans must conduct a health risk assessment for all enrollees. This process, at a minimum, will identify referrals to appropriate LTSS and home- and community-based services; facilitate timely access to primary care, specialty care, durable medical equipment, and medications; facilitate communication across the enrollee's providers, including behavioral health providers; and identify other services that may assist an enrollee.

Benefits. Under Cal MediConnect, a health plan is responsible for providing and coordinating Medicare and Medi-Cal benefits (including LTSS, as discussed above). The health plan will receive a blended rate from the state and the federal government for these services.

Additionally, the plan must cover three supplemental benefits (these benefits are not currently covered by Medicare or Medi-Cal):

- Dental Services – This benefit includes Medi-Cal Denti-Cal services.[6]

- Vision – The enhanced vision benefits are $0 copay for one routine eye exam every year and $100 for eyeglasses (frames and lenses) or up to $100 for contact lenses every two years. (Generally, Medicare does not cover eyeglasses or contact lenses unless the beneficiary has had cataract surgery that implants an intraocular lens.)

- Non-Emergency Transportation – This includes transportation to medical services provided by persons not registered as Medi-Cal providers. Members will have access to 30 one-way trips per year. In most cases, prior authorization and/or referrals are not required.

Finally, Care Plan Options (CPO) services are optional services that a Cal MediConnect health plan may provide that are above and beyond LTSS that could enhance a member's care, allowing them to stay in their homes safely and preventing institutionalization. These services could vary based on the needs of the consumer and the care plan developed for this person. Because these optional services are not part of covered Medi-Cal benefits and are at the plan's discretion, they are not subject to the Medi-Cal appeals process. These CPO services may include, supplemental

[6] These services were eliminated in 2009 AB5 X3 (Evans), Chapter 20, Statutes of 2009-10 of the Third Extraordinary Session, and will be partially restored to all Medi-Cal adults effective May 2014 through AB 82 (Committee on Budget), Chapter 23, Statutes of 2013. However, when CCI was enacted, these benefits were not provided by Medi-Cal.

personal care services (above authorized IHSS), nutritional supplements and home delivered meals, home maintenance and minor home adaptation, and medical equipment.

Care Coordination. Cal MediConnect is premised on the concept that coordination of services will lead to improved health and cost savings. To facilitate this, health plans will have a care coordinator that is responsible for providing care coordination services, which include assuring appropriate referrals and timely two-way transition of enrollee information; obtaining reliable and timely information about services other than those provided by the primary care provider; participating in the initial assessment; and supporting safe transitions in care for enrollees moving between settings. The care coordinator serves on one or more Interdisciplinary Care Teams (ICT) and coordinates and facilitates ICT meetings. An ICT is comprised of the primary care provider, the care coordinator, and other providers, at the discretion of the enrollee. Every Cal MediConnect enrollee will have a care coordinator while DHCS estimates that only 10 percent of Cal MediConnect enrollees will require an ICT.

Contract Management Team. As part of Cal MediConnect, a team of representatives from DHCS, the CMS regional office, and the CMS national office will be established to provide oversight of the plans participating in Cal MediConnect to ensure compliance with all relevant Medicare, Medi-Cal, and other state requirements, assure compliance with the health plans' contract requirements, and promote plan performance in meeting the needs and preferences of enrollees. DHCS indicates that this team will use a "rapid cycle improvement" process by which, at least initially, this team will assess various factors on a weekly basis. These factors include the number of health risk assessments completed by a plan, the number of enrollments and disenrollments from a plan, and complaints and grievances.

Continuity of Care. Pursuant to the requirements of the statutes that established the dual eligible demonstration project, DHCS established a specific continuity of care policy for Cal MediConnect. This policy includes certain consumer protections that are specific to this demonstration. For example, a beneficiary who is a long-term resident of a nursing facility prior to enrollment in Cal MediConnect will not be required to change his or her nursing facility during the duration of the demonstration project (as long as the facility is licensed and meets quality standards). In addition, an enrollee can see an out-of-network physician if the beneficiary has seen an out-of-network primary care provider at least once or an out-of-network specialty care provider at least twice during the 12 months prior to the date of enrollment for a non-emergency visit and the plan and provider are able to enter into a contract or letter of agreement.

Rates, Risk Corridor, and Shared Savings. Health plans will receive one blended rate from the state and CMS. DHCS indicates that these rates will be posted on its website. The rates are county-specific and will be categorized into four risk adjustment populations: (1) Institutionalization, (2) Home- and Community-Based Services High Level of Need, (3) Home- and Community-Based Services Low Level of Need, and (4) Community Well. Additionally, risk corridors have been established to provide a level of protection to the health plans and the state against uncertainty in rate-setting that could result in either overpayment or underpayment.

One of the purposes of Cal MediConnect is to lower health care costs by coordinating care. To recognize these cost savings, the state and CMS have developed a savings mechanism. For the state, savings percentages (at a minimum the savings percentages are one percent in year one, two percent in year two, and four percent in year three) would be applied to the aggregate health plan payment. Essentially, the state has initially developed a rate for Medi-Cal services based on fee-for-service and some managed care data and will reduce the rate by the savings percentage. This reduction is made because under the demonstration, plans have the flexibility and incentive to ensure that the beneficiary is served, as appropriate, in the lower cost, home- and community-based setting.

Quality Withhold. CMS and the state will withhold a percentage of their respective components of the capitation rate. The withheld amounts will be repaid, subject to the health plan's performance, consistent with established quality thresholds. These thresholds are based on a combination of certain core quality withhold measures, as well as state-specified quality measures including behavioral health coordination and planning, and ensuring physical access to buildings, services, and equipment.

Grievances and Appeals. For at least the first year of the demonstration, each program, Medicare and Medi-Cal, will maintain their existing grievance and appeals processes. However, over the period of the demonstration project, CMS and the state agree to develop a unified set of requirements for health plan grievances and appeals processes that incorporate Medicare Advantage and Medi-Cal managed care requirements and to create a more beneficiary-friendly and easily navigable system.

Mandatory Enrollment into Medi-Cal Managed Care

Enrollment. Dual eligibles and most other previously excluded Medi-Cal enrollees (e.g., those receiving long-term services in a nursing facility) must enroll in Medi-Cal managed care for their Medi-Cal benefits. This change impacts about 600,000 Medi-Cal-only enrollees and up to 456,000 persons eligible for both Medicare and Medi-Cal who are in Cal MediConnect.

The Medi-Cal-only enrollees will receive only Medi-Cal benefits from the health plan. These enrollees include full dual eligibles excluded from Cal MediConnect, partial dual eligibles, and senior and persons with disabilities. See table below for enrollment projections by county.

Table 4: Number of Eligible Medi-Cal-Only Enrollees into Medi-Cal Managed Care in 2014-15

County	Number of Eligible Medi-Cal-Only Enrollees
Alameda	48,000
Los Angeles	317,000
Orange County	51,000
Riverside	46,000
San Bernardino	54,000
San Diego	64,000
San Mateo	14,000
Santa Clara	38,000
Total	**632,000**

Populations Excluded from Mandatory Enrollment into Medi-Cal Managed Care. The following populations are excluded from mandatory enrollment into Medi-Cal managed care:

- Individuals under age 21;
- Medi-Cal only individuals exempted from managed care due to an approved Medical Exemption Request;
- Individuals living in the certain rural zip codes;
- Individuals receiving services through intermediate care facilities for the developmentally disabled in all counties except Orange and San Mateo;
- Individuals residing in one of the Veterans' Homes of California;
- Individuals in the Program of All-Inclusive Care for the Elderly (PACE) or the AIDS Healthcare Foundation.

Individuals with HIV/AIDS and American Indian Medi-Cal enrollees will be enrolled into Medi-Cal managed care, but can opt out at any time.

GOVERNOR'S PROPOSAL:

CCI Savings. The Governor's budget includes a net General Fund savings of $159.4 million in 2014-15 as a result of the CCI, including the General Fund savings from the sales tax on managed care organizations (MCO). Without the MCO tax revenue, CCI would have a General Fund cost of $172.9 million in 2014-15. See table below for more information.

Table 5: Coordinated Care Initiative Fiscal Summary

Coordinated Care Initiative (CCI)		
	2013-14	**2014-15**
(In thousands)	General Fund	General Fund
SAVINGS		
Local Assistance Costs Total	**$13,998**	**$440,067**
Payments to Managed Care Plans	$61,273	$2,022,202
Savings from Reduced Fee for Service Utilization	-$25,302	-$1,582,135
Payment Deferrals Total	**-$41,891**	**-$269,706**
Defer Managed Care Payment	-$45,054	-$312,287
Delay 1 Checkwrite	$3,163	$42,581
Revenue Total	**-$124,216**	**-$332,269**
Increased MCO Tax from CCI (All Revenue)	$0	-$86,732
Increased MCO Tax from non-CCI (Incremental increase from 2.35 to 3.93 percent)	-$124,216	-$245,537
Savings Sub-Total	**-$152,109**	**-$161,908**
COSTS		
DHCS Administrative Costs Total	**$2,546**	**$2,543**
Costs Sub-Total	**$2,546**	**$2,543**
Net Savings Impact to DHCS	**-$149,563**	**-$159,365**

These figures reflect the following assumptions resulting from CCI: (1) inpatient care will be reduced by 8.9 percent, (2) long-term care institutional services will be reduced by 4.2 percent initially and then grow to a reduction of 10.9 percent annually, and (3) IHSS and CBAS will be increased by 3.5 percent initially and then increase by 2.8 percent annually. Additionally, the Administration estimates that 33 percent of eligible Cal MediConnect enrollees will opt-out of the demonstration; and consequently 381,000 dual eligibles will be enrolled in Cal MediConnect.

Enrollment Timeline. In addition, the Administration proposes changes to the implementation timeline. (The CCI timeline has been delayed multiple times since enacted in 2012.) Generally, the updated timeline reflects:

- Cal MediConnect dual eligibles in Medicare fee-for-service will be passively enrolled for Medicare and Medi-Cal benefits beginning on April 1, 2014, in Orange, Riverside, San Bernardino, San Diego, and San Mateo counties. Cal MediConnect individuals in these counties received a 90-day notification in January about this change.

- In Los Angeles County, dual eligibles may voluntarily enroll in Cal MediConnect or opt out, beginning April 2014; and the remaining dual eligibles will be passively enrolled into Health Net beginning in July 2014 and into L.A. Care no sooner than December 2014.

- Alameda will passively enroll dual eligibles no sooner than July 2014.

- Santa Clara will passively enroll dual eligibles no sooner than January 2015.

However, this timeline varies on other factors, such as the individual's current coverage. Please see table on the next page for the specific enrollment details.

Table 6: Coordinated Care Initiative Timeline

	Cal MediConnect (CMC)				Medi-Cal Managed Care and LTSS as Managed Care Benefit					
Start Date	Full Duals in Medicare FFS enrolled already in Medi-Cal Managed Care plan **(enrolled all in one month)**	Full Duals in Medicare FFS and Medi-Cal FFS **(enrolled by birth month)**	MSSP Benes eligible for Cal Medi-Connect **(enrolled in one month)**	Full duals in a MA plan / Part D LIS **(enrolled in one month)**	Full Duals who opt out of CMC and in Medi-Cal FFS **(enrolled by birth month)**	Full Duals in MA plan or excluded from CMC (ESRD, Kaiser, 1915c waiver) and in Medi-Cal FFS **(enrolled by birth month)**	Full Duals who opt out of CMC, in a MA plan/Part D LIS, or excluded CMC pop (ESRD, Kaiser, 1915c waiver) in Medi-Cal managed care plan **(benefit added in one month)**[1]	MSSP Beneficiaries in Medi-Cal managed care or Medi-Cal FFS **(enrolled in one month)**	Partial Dual/SPD already in Medi-Cal managed care **(enrolled in one month)**[1]	Partial Dual/SPD in Medi-Cal FFS **(enrolled by birth month)**
4/1/2014	Riverside, San Bernardino, San Diego, and San Mateo (Orange members will be enrolled over 12 months)	Riverside, San Bernardino, and San Diego[2]	San Mateo		Riverside, San Bernardino, and San Diego		Los Angeles, Orange, Riverside, San Bernardino, San Diego, and San Mateo	San Mateo - Full Duals in MA plan or excluded CMC pop (ESRD, Kaiser, 1915c waiver)		
05/01/14						Los Angeles, Riverside, San Bernardino, and San Diego[3]				
7/1/2014	Alameda and Los Angeles	Alameda and Los Angeles	Alameda, Orange, Riverside, San Bernardino, & San Diego		Alameda and Los Angeles	Alameda and Santa Clara	Alameda and Santa Clara	Alameda, Los Angeles, Orange, Riverside, San Bernardino, San Diego, San Mateo (Partials and SPDs), and Santa Clara	Alameda, Los Angeles, Orange, Riverside, San Bernardino, San Diego, San Mateo, and Santa Clara	Alameda, Los Angeles, Orange, Riverside, San Bernardino, San Diego, San Mateo, and Santa Clara
01/01/15	Santa Clara	Santa Clara	Los Angeles and Santa Clara	Alameda, Los Angeles, Orange, Riverside, San Bernardino, San Diego, San Mateo, Santa Clara	Santa Clara					

1. Enrollees already in a Medi-Cal managed Care plan will receive one notice 45 days prior to the change in benefit.
2. There are no FFS Medi-Cal Enrollees in Orange and San Mateo counties.
3. Enrollees with April and May birthdays will be enrolled in May 2014. Then follow enrollment schedule by birth month.

Acronyms : ESRD-end stage renal disease, FFS-fee-for-service, LIS-Low Income Subsidy, MA-Medicare Advantage, MSSP-Multipurpose Senior Services Program

Los Angeles Enrollment. As highlighted in the chart above, the Los Angeles County enrollment strategy differs substantially from the other counties. The Administration proposes a voluntary enrollment period from April – June, followed by passive enrollment into Health Net starting in July, and then passive enrollment into L.A. Care starting no sooner than December 2014.

Since L.A. Care received a Low Performing Icon (LPI) for Medicare Part D services for 2014 (based on service in 2012), the federal CMS does not allow passive enrollment into this plan. Consequently, until the LPI is removed (the soonest would be December 2014) passive enrollment into this plan cannot occur.

Passive Enrollment of Medicare Advantage Enrollees into Cal MediConnect. As part of the Governor's January budget proposal, the Administration indicated that it would be proposing trailer bill language to no longer exempt dual eligible enrollees of Medicare Advantage plans from Cal MediConnect enrollment, effective January 2015. (Medicare Advantage is a Medicare managed care plan and includes D-SNPs which are special types of Medicare Advantage plans offered to dual-eligible individuals.) However, on a recent CCI stakeholder call, DHCS indicated that it is still evaluating its proposal regarding Medicare Advantage plans. Under current law, these individuals are exempt from passive enrollment in Cal MediConnect in 2014.

Health Care Options – Specialized Call Center. The Governor's budget includes "costs" for a specialized call center for CCI. According to DHCS, this call center would have a dedicated toll free number and would direct consumers to a specialized team of CCI experts who will guide them through the enrollment process and be able to answer Medi-Cal and Medicare questions. DHCS expects that this call center will be up and running in February. At the time of this report, no additional information on this call center was available.

Cal MediConnect Ombudsman Program. The state has received a federal grant of about $1.5 million (over three years) to develop a Cal MediConnect Ombudsman Program. The Cal MediConnect Ombudsman Program would assist Cal MediConnect managed care enrollees by resolving issues with Cal MediConnect managed care plans, offering individual advocacy services, and conducting impartial investigations of member complaints. The Department of Managed Health Care intends to award funds mid-February so that this program can be implemented by April 2014.

ISSUES TO CONSIDER:

Complicated Enrollment Strategy. As exemplified by the chart above, the Administration's proposed enrollment strategy is complicated and difficult to explain. Multiple factors would be used to determine when an individual is enrolled in CCI. Perhaps, most importantly, the enrollment dates for the various components of CCI are not the same within a county and depend on an individual's situation.

The Administration acknowledges that this enrollment strategy is not simple when viewed from the state level and that it is difficult to explain; however, it contends that enrollee notifications will be very personalized and that each individual will have enough information to understand the changes and take action.

This strategy does not take into account how important it is for the enrollment process to be simple and understandable for providers, patient navigators, consumer advocates, and other individuals, such as family members, who might assist an enrollee. This important lesson was learned during the transition of Seniors and Persons with Disabilities (SPDs) to Medi-Cal managed care. During this transition, SPDs often contacted their providers with questions on the transition and providers did not have the information necessary to assist SPDs in making decisions. Without a simple policy, it will be more difficult to ensure that providers understand the timeline.

A recent report by the UCLA Center for Health Policy Research[7] indicates that many seniors find out about changes to their medical and supportive benefits thought a variety of sources, including mail, media, community meetings, providers, and word of mouth. As such, this report highlights the need for this type of information to be disseminated broadly through multiple venues and in multiple formats. Disseminating this complicated enrollment strategy in multiple venues and in multiple formats would appear to be very difficult.

Confusing Los Angeles County Enrollment Strategy. One component of the enrollment proposal that is particularly confusing is the enrollment strategy for Los Angeles County. As stated above, Cal MediConnect and mandatory enrollment into Medi-Cal managed care for LTSS enrollment would be voluntary from April through June. The timeline for notifying individuals of this voluntary enrollment option has not yet been determined (at the time of this report). The passive enrollment period would begin in July for one plan and no sooner than December for the other plan. This strategy appears to be more motivated on getting CCI implemented in Los Angeles County than on making the process understandable and simple for the consumer and for consumer assistors.

Meaningfulness of Health Plan Readiness Reviews in Question. As discussed above, CMS and DHCS have been conducting Cal MediConnect health plan readiness reviews since the summer of 2013. Based on these assessments, CMS, DHCS and the plans have entered into contracts for Cal MediConnect. The signing of these contracts and the notification to about 14,000 individuals about benefit changes occurring in April were portrayed as a signal that CMS, the state, and the health plans were ready for this demonstration and that no significant issues remained outstanding.

However, the state was just notified (at the end of January) that CMS will not permit CalOptima to participate in Cal MediConnect. This is because of CMS's concern that "CalOptima's conduct poses a serious threat to the health and safety of Medicare beneficiaries" with its Medicare D-SNP product (based on an audit conducted in November 2013).

[7] UCLA Center for Health Policy Research, "Disconnected?: Challenges of Communicating Cal MediConnect to Low-Income Older Californians." January 2014.

Eligible enrollees in Orange County were notified of the Cal MediConnect change occurring in April, but now enrollment in Orange County has been postponed. (The state will be mailing out retracting notifications to these enrollees.)

This situation calls into question the meaningfulness of the health plan readiness review assessment and three-way contract and whether or not these plans are qualified and ready to participate in the demonstration, particularly, given that the audit revealed that "CalOptima's performance issues are widespread and systematic in nature."

As a result of CMS's audit, DHCS plans do an audit of CalOptima's Medi-Cal product in the next couple weeks but has not provided information on how this might impact the implementation of the other components of CCI in Orange County.

Ready for LTSS as a Medi-Cal Managed Care Benefit? It appears that the Administration's focus has been on preparing for Cal MediConnect while tasks to evaluate a health plan's readiness for the delivery of LTSS remain to be completed. For example, contract provisions between the state and the health plans regarding LTSS have not been agreed to or signed. Concerns have been raised that guidance and policies regarding the inclusion of IHSS, in particular, as a managed care benefit are not yet available. DHCS anticipates sending these contract provisions to the plans in February, but this may not provide sufficient time for the plans and IHSS providers to establish policies and procedures.

Additionally, DMHC only recently received CBAS and MSSP provider information from DHCS and has not yet evaluated the overlap of a county's existing provider network with the networks that a health plan has established (via contracts) with these providers.

As was learned when CBAS became a Medi-Cal managed care benefit in 2012, significant efforts regarding system changes and billing procedures, for example, must be made between the plans and providers to ensure a smooth transition.

Unprepared and Underfunded Consumer Assistance Programs. Concerns have been raised that more resources and attention need to be provided to consumer assistance programs. For example:

- ***Increased Consumer Assistance for Changes to Medi-Cal Managed Care Lacking.*** The new Cal MediConnect Ombudsman Program only applies to individuals enrolled in Cal MediConnect. The Administration does not include any proposal to increase resources related to the existing Medi-Cal Managed Care Ombudsman Program which would be responsible for the approximately 500,000 Medi-Cal-only individuals that would be enrolled in Med-Cal managed care per CCI. These individuals will have questions regarding the new LTSS benefits in managed care and how this impacts their current eligibility and receipt of these services. In addition, the Medi-Cal Managed Care Ombudsman Program will likely receive additional workload from the increased enrollment resulting from the expansion of Medi-Cal to adults without minor children and the additional Medi-Cal benefits provided under state legislation[8] implementing the federal Affordable Care Act.

[8] AB1 X1 (Pérez) and SB1 X1 (Hernandez and Steinberg), Chapters 3 and 4, Statutes of 2013

- ***Federal Funding for Consumer Counseling Not Yet Distributed.*** The 2013 budget provided additional expenditure authority to the Department of Aging of $660,000 to reflect a one-time federal grant to provide training for Health Insurance Counseling Program (HICAP) staff and one-one-one dual eligibility health insurance counseling related to Cal MediConnect. At the time of this report, these funds had not yet been distributed to the local HICAP offices. HICAP provides free and objective information and counseling about Medicare. Volunteer counselors assist individuals understanding their rights and health care options.

- ***Health Care Options (HCO) Not Prepared.*** Concerns have been raised that HCO is not currently prepared to assist consumers in the Cal MediConnect enrollment process. In early January of this year, 14,000 notifications were sent to individuals eligible for Cal MediConnect. On this notification, the HCO phone number and website are listed as a resource for Cal MediConnect questions. However, at the time of this report, no information regarding Cal MediConnect had been posted on the HCO website.

Continuity of Care Concerns with Mandatory Enrollment of Medicare Advantage Enrollees. The Administration indicates that it is still developing its proposal regarding the passive enrollment of Medicare Advantage enrollees into Cal MediConnect in 2015. There are over 150,000 Medicare Advantage D-SNP enrollees who are dual eligibles in the CCI counties. These individuals have voluntarily elected to enroll in a managed care plan for their Medicare benefits. Requiring these individuals to enroll in Cal MediConnect could have major implications for their continuity of care for medical services. These enrollees were exempted from Cal MediConnect passive enrollment in 2014 because the state did not want to disrupt the care of these high-needs patients. It is unclear why the Administration would now want to disrupt the care of high-needs patients.

Number of Cal MediConnect Enrollees Requiring Interdisciplinary Care Teams Seems Low. The Administration's estimate that only 10 percent of Cal MediConnect dual eligibles will require an Interdisciplinary Care Team (ICT) appears low. This underestimate could jeopardize the planning for care coordination as plans and providers estimate and allocate resources to this important function.

When the Administration initially proposed CCI, it argued that dual eligibles represent some of the most expensive and medically complicated health cases and that coordinating care, across the full spectrum, would lead to better health outcomes at lower costs. DHCS estimates that roughly 40 percent of the Cal MediConnect population is age 75 or older, and about 39 percent is disabled, and that these individuals are likely to be suffering from multiple co-occurring chronic conditions.[9] Additionally, it is estimated that 13 percent of the Cal MediConnect population with one or more chronic condition has dementia and other cognitive disorders and 10 percent have schizophrenia. The combination of physical and mental health chronic conditions results in some of the most and complex health care cases.

[9] RASB, *Medi-Cal's CCI Population: Combined Medicare and Medi-Cal Cost, Utilization, and Disease Burden*, November 2012,http://www.dhcs.ca.gov/dataandstats/statistics/Documents/Dual%20Data%20Sets%20Medicare.pdf

Designing successful care coordination programs will require careful planning and resources and the collaboration of multiple programs and caregivers throughout the healthcare system.

Missing Continuity of Care Protections for Medi-Cal Only Enrollees for LTSS. A specific continuity of care policy has been established for Cal MediConnect; one of the protections outlined in this policy is the provision that a beneficiary who is a long-term resident of a nursing facility prior to enrollment in Cal MediConnect will not be required to change their nursing facility during the duration of the demonstration. This prevents disruption in care for an individual. This same protection does not apply to a Medi-Cal only individual who would be required to enroll in Medi-Cal managed care to receive LTSS benefits. It is unclear if DHCS plans to address this missing continuity of care protection for Medi-Cal only enrollees.

State Has No Authority Over Medicare. Cal MediConnect is a joint project with the federal government. Issues regarding Medicare (medical services) are the responsibility of the federal government. The state has no authority and cannot dictate how plans provide Medicare services, the adequacy of these networks, or the rates for these services. Consequently, the success of Cal MediConnect will also rely on the federal government's ability to rapidly address issues that may arise.

Medi-Cal – Provider Payment Reductions

BACKGROUND:

As a result of the state's fiscal crisis, AB 97 (Committee on Budget), Chapter 3, Statutes of 2011, required the Department of Health Care Services (DHCS) to implement a 10 percent Medi-Cal provider payment reduction starting June 1, 2011. This 10 percent rate reduction applies to all providers with certain exemptions and variations. Certain exemptions were specified in AB 97 and some are a result of an access and utilization assessment. AB 97 provides DHCS the ability to exempt services and providers if there are concerns about access.

On October 27, 2011, the federal Centers for Medicare and Medicaid (CMS) approved California's proposal to reduce Medi-Cal provider reimbursement rates. As part of this approval, CMS required DHCS to (1) provide data and metrics that demonstrated that beneficiary access to these services would not be impacted and (2) develop and implement an ongoing healthcare access monitoring system.

DHCS had been prevented from implementing many of these reductions due to a court injunction. On June 14, 2013, the United States Court of Appeals for the Ninth Circuit denied the plaintiffs' motion for a stay of mandate in this case, allowing the implementation of all of the AB 97 Medi-Cal provider 10 percent payment reductions. For the enjoined providers, DHCS began implementation of the retrospective payment reductions on a staggered basis by provider type starting in September 2013.

GOVERNOR'S PROPOSAL:

The Governor's budget continues these payment reductions and recognizes $489 million ($244.5 million General Fund) in ongoing annual savings and $76.6 million ($38.3 million General Fund) in savings from the recoupment of certain retroactive reductions (that are not forgiven as discussed below) in 2014-15. The 2013 budget included $849.3 million ($424.6 million General Fund) in annual ongoing savings. The differences between the 2013 budget act and the Governor's proposal are described below.

Forgives Certain Retroactive Obligations. In addition, the Governor's budget forgives certain retroactive provider payment reductions for physicians/clinics, specialty drugs, dental, intermediate care facilities for the developmentally disabled (ICF/DDs), and medical transportation.

This results in an $11.6 million ($5.8 million General Fund) increase in 2013-14 and a $72.6 million ($36.3 million General Fund) increase in 2014-15. The total cost of these recoupments is $434.2 million ($217.1 million General Fund), which will be forgiven over the next several years. The Administration finds that implementation of both the retrospective and prospective reduction for these provider types would have a negative impact on access to these services for Medi-Cal enrollees. See table below for a summary.

The Administration indicates that federal CMS has no concerns with the proposal to forgive retroactive obligations and has provided guidance on the ability to draw down federal funds to help pay (based on a 50:50 split) for this proposal. Previously, the Administration indicated the federal funds would not be available to address retroactive reductions and consequently would have been all General Fund.

Table 1: Medi-Cal Provider Payment Reduction Summary

Medi-Cal Provider Payment Reductions (AB 97) Summary

Provider Type	Retroactive Savings Period	Total Retroactive Savings	Estimated Savings from AB 97 Reduction			
			2013-14		2014-15	
			On Going	Retro	On Going	Retro
Nursing Facilities - Level A	6/1/11-6/30/12	$245,754	$253,544	$122,877	$253,544	$20,480
ICF/DDs	8/1/12-10/31/13	forgiven	$11,603,317	$0	$17,404,975	$0
DP/NF-B	6/1/11-9/30/13	$83,437,273				$15,170,413
Phase 1 Providers (1)	6/1/11-12/20/11	$28,753,171	$55,208,892	$14,376,585	$56,136,663	$0
Physician 21 yrs+	6/1/11-1/9/14	forgiven	$24,873,072	$0	$49,746,144	$0
Medical Transportation	6/1/11-9/4/13	forgiven	$12,051,092	$0	$14,461,310	$0
Medical Supplies/DME	6/1/11-10/23/13	$39,427,840	$11,595,992	$1,251,677	$17,393,988	$7,510,065
Dental	6/1/11-9/4/13	forgiven	$35,451,470	$0	$64,733,864	$0
Clinics	6/1/11-1/9/14	forgiven	$9,255,850	$0	$18,511,701	$0
Pharmacy	6/1/11-2/6/14	$296,621,286	$47,382,359	$0	$113,717,663	$53,931,143
CHDP Providers (2)	6/1/11-10/31/13	forgiven	$1,609,367	$0	$2,414,050	$0
Managed Care			$100,675,930	$0	$134,234,574	$0
Grand Total (Federal&GF)		**$448,485,324**	**$309,960,885**	**$15,751,139**	**$489,008,476**	**$76,632,101**
General Fund		**$224,242,662**	**$154,980,443**	**$7,875,570**	**$244,504,238**	**$38,316,051**

Notes:
(1) Phase I includes providers not specified above, generally ancillary services, such as laboratory and radiology.
(2) Child Health and Disability Prevention Program (CHDP)

Key Changes from 2013 Budget Act. In addition to the forgiveness of certain retroactive obligations, key changes to the implementation of the AB 97 reductions since the enactment of the 2013 budget include:

- Certain Prescription Drugs – The budget includes the implementation of the exemption of certain prescription drugs (or categories of drugs) that are generally high-cost drugs used to treat extremely serious conditions. The 2013 budget included $271.9 million ($135.9 million General Fund) in ongoing annual savings from pharmacy, whereas, the proposed budget only includes $113.7 million ($56.8 million General Fund) in ongoing annual savings from the implementation of this reduction. On March 30, 2012, DHCS submitted a State Plan Amendment to the federal CMS for this change and it is still pending CMS approval.

- Distinct Part Nursing Facilities (DP/NFs) – On a prospective basis, DHCS exempted rural DP/NFs as of September 1, 2013 based on access and SB 239 (Hernandez and Steinberg), Chapter 657, Statues of 2013 exempted all DP/NFs from these reductions as of October 1, 2013. The 2013 budget included $38.2 million ($19.1 million General Fund) in ongoing annual savings from this reduction. The proposed budget does not include any ongoing savings from DP/NFs.

- Managed Care Rates – The 2013 budget included $267.5 million ($133.8 million General Fund) in ongoing annual savings from this rate reduction on managed care rates. The Governor's 2014-15 budget only includes $134.2 million ($67.1 million General Fund) in ongoing annual savings from implementation of this reduction on managed care plans. This is discussed in more detail below.

- Pediatric Dental Surgery Centers (for profit and nonprofit) – DHCS exempted most nonprofit dental pediatric surgery centers effective September 1, 2013; and most for-profit dental pediatric surgery centers effective December 1, 2013.

ISSUES TO CONSIDER:

Shift to Managed Care and Actuarial Soundness of Rates. The 2013 budget act assumed that the ongoing savings on an annual basis from the imposition of this payment reduction on managed care plans would be $267.5 million ($133.8 million General Fund). However, as the chart above reflects, it is now estimated that the annual ongoing savings from this reduction on managed care would be $134.2 million ($67.1 million General Fund). There was no change in circumstance or exemption applied to managed care plans. This loss in savings is a result of the requirement that managed care plan rates be actuarially sound. As such, managed care rates can only be reduced by AB 97 on an actuarial basis and must support the required services.

Consequently, as more and more individuals shift into Medi-Cal managed care, the negative impact of these reductions to access of Medi-Cal services is reduced. This is because health plans must meet access standards *and* a health plan's rate must be actuarially sound (i.e., generally, the rate cannot be reduced to a level that does not support the required services).

How to Evaluate the Impact of Provider Payment Reductions on Access? As the Legislature evaluates the impact of these reductions on access to services, the following factors and examples may be considered:

- **Does Payment Cover the Cost?** In March 2012, DHCS proposed exempting certain drugs because it found that the Medi-Cal payment for these drugs (with the 10 percent reduction) would not cover the costs of these drugs. (Federal approval is still pending for this change.)

- **Is Medi-Cal a Large Portion of the Line-of-Business?** The Governor's budget proposes to forgive the retroactive recoupment of payment reductions for medical transportation because DHCS found that non-emergency medical transportation providers serve mostly Medi-Cal clients and that these providers do not have the cash available (i.e., these providers cannot cost-shift) to sustain retroactive recoupments and the prospective payment reduction.

- **What is the Geographic Capacity of a Service/Provider?** DHCS exempted Community Based Adult Service (CBAS) centers in rural parts of the state from the provider payment reduction due to geographic access and utilization analyses.

Federally-Required Access Monitoring. The federal CMS requires DHCS to continually monitor to ensure that access (based on geographic location) is not impacted. DHCS uses call-center information, real-time information provided by provider groups, and cost data, for example, to evaluate impact. Additionally, DHCS has established an ongoing access monitoring system that considers 23 access measures (e.g., primary care physician ratios). However, given that most of the payment reductions have not been in effect due to court injunctions, the available access monitoring reports do not reflect the implementation of these payment reductions. As the provider payment reductions are put into effect, these access monitoring reports will be critical in assessing the impact on Medi-Cal enrollees.

In-Home Supportive Services (IHSS)

The IHSS program provides personal care services to approximately 453,000 qualified low-income individuals who are blind, aged (over 65), or who have disabilities. Services include feeding, bathing, bowel and bladder care, meal preparation and clean-up, laundry, and paramedical care. These services help program recipients avoid or delay more expensive and less desirable institutional care settings. A proposed budget of $7.1 billion ($2 billion General Fund) for services and administration includes funding for compliance with new federal overtime regulations. However, significant reductions in IHSS recipient hours remain.

BACKGROUND:

Service delivery. County social workers determine IHSS eligibility and perform case management after conducting a standardized in-home assessment of an individual's ability to perform activities of daily living. In general, most social workers reassess annually recipients' need for services. Based on authorized hours and services, IHSS recipients are responsible for hiring, firing, and directing their IHSS provider(s). If an IHSS recipient disagrees with the hours authorized by a social worker, the recipient can request a reassessment, or appeal their hour allotment by submitting a request for a state hearing to the Department of Social Services (DSS). According to DSS, around 73 percent of providers are relatives or "kith and kin."

A SNAPSHOT OF IHSS

- ❖ There are around 453,000 IHSS recipients who are aged, blind, or who have disabilities.
- ❖ Services include personal care domestic, and related activities.
- ❖ In 2012-13, IHSS services are estimated to cost an average of around $12,000/year per client.

In 2013, IHSS providers' combined hourly wages and health benefits vary by county, and range from $8.00 to $15.38 per hour. Prior to July 1, 2012, county public authorities or nonprofit consortia were designated as "employers of record" for collective bargaining purposes on a statewide basis, while the state administered payroll and benefits. Pursuant to 2012-13 trailer bill language, however, collective bargaining responsibilities in the eight counties -- Alameda, Los Angeles, Orange, Riverside, San Bernardino, San Diego, San Mateo, and Santa Clara -- participating in Coordinate Care Initiative (CCI) will shift to an IHSS Authority administered by the state. The CCI is discussed further below and in the Health Section of this report.

Funding. The average annual cost of services per IHSS client is estimated to be around $12,000 for 2012-13. The program is funded with federal, state, and county resources. Federal funding is provided by Title XIX of the Social Security Act. Prior to July 1, 2012, the state and counties split the non-federal share of IHSS funding at 65 and 35 percent, respectively. A 2012-13 budget trailer bill changed this structure as of July 1, 2012, to base county IHSS costs on a maintenance of effort (MOE) requirement. The change was related to enactment of the CCI, also called the Duals Demonstration project.

Coordinated Care Initiative. CCI requires Cal Medi-Connect to coordinate medical, behavioral health, long-term institutional, and home and community-based services; and, to administer IHSS according to current program standards and requirements. The intent of CCI is to improve integration of medical and long-term care services through the use of managed health care plans and to realize accompanying fiscal savings. As IHSS becomes a Medi-Cal managed care benefit in the eight counties, the county is responsible for paying a MOE amount, not a percentage of program costs.

Other policies. Several recent policies have also impacted the IHSS program, including:

- **Reductions in IHSS recipient hours.** A legal settlement from *Oster v. Lightbourne* and *Dominguez v. Schwarzenegger*, resulted in an 8 percent reduction to authorized hours, effective July 1, 2013. Beginning in July 1, 2014, the reduction in authorized service hours will be reduced to 7 percent.

- **Minimum wage increases.** Assembly Bill 10 (Alejo) Chapter 351, Statutes of 2013, increased the minimum wage from $8 per hour to $9 per hour in July 2014, with gradual increases until the minimum wage meets $10 per hour by January 2016. 17 counties will be impacted by the minimum wage increase for this fiscal year: Alpine, Amador, Butte, Colusa, Glenn, Humboldt, Lake, Lassen, Modoc, Mono, Nevada, Plumas, Sierra, Siskiyou, Tehama, Trinity, and Tuolumne. All non-federal IHSS provider wage costs will be funded by the General Fund, around $5.7 million total for this year.

- **Fair Labor Standards Act (FLSA) - Final Rule.** FLSA is the primary federal statute dealing with minimum wage, overtime pay, child labor, and related issues. Under current law, some provisions of the FLSA do not apply to certain employees, including the "Companionship Services Exemption" for domestic service employees who: 1) provide babysitting services on a casual basis, or 2) provide "companionship services" to individuals who are unable to care for themselves. Federal regulations define "companionship services" as services that provide fellowship, care, and protection for a person who, because of advanced age or physical or mental disability, cannot care for his or her own needs. These services may include household work, such as meal preparation, bed making, washing of clothes, and other similar services that can be provided through IHSS. General housework may also be included, subject to some limitations. Current regulations exempt employees of third-party agencies and live-in domestic service employees who provide companionship services from overtime regulations in FLSA.

  In September 2013, the U.S. Department of Labor (US-DOL) issued a Final Rule, effective January 1, 2015, which redefines "companionship services;" limits exemptions for "companionship services" and "live-in domestic service employees" to the individual, family, or household using the services (not a third party employer); and, requires compensation for activities, such as travel time between multiple recipients, wait time associated with medical accompaniment, and time spent in mandatory provider training. Under the Final Rule, employers must pay at least the federal minimum wage ($7.25) and overtime pay at one and a half times the regular pay if a provider works over 40 hours per work week.

GOVERNOR'S 2014-15 BUDGET PROPOSALS:

The Governor's budget recognizes the new FLSA regulations, effective January 1, 2015, and provides that implementation of federal requirements will cost $208.9 million ($99.1 million General Fund) in 2014-15 and $327.9 million ($153.1 million General Fund) annually thereafter. The $208.9 million breakdown is as follows:

- Approximately $68.6 million for FLSA regulations and creating a provider backup system (around $7.5 million would be allocated to modify CMIPS-II data software to maintain workweek agreements; track provider hours; update policies, instructions, and provider timesheets; and, add new activities, such as wait time during medical accompaniment and mandatory training);
- $87 million for FLSA compliance[1] (medical accompaniment wait time, travel time, and mandatory provider training); and,
- $53.3 million to implement overtime restrictions (social workers in county welfare departments work with IHSS recipients to create and review workweek agreements for all recipients).

Prohibits providers from working overtime. The budget prohibits providers from working overtime, except for documented emergency circumstances. Providers who work beyond work week limitations are subject to disciplinary action, including termination. The budget assumes that unauthorized overtime costs $6.17 per hour.

Establishes a Provider Backup System. The budget assumes that a notification must be mailed to current IHSS providers and recipients, explaining the new policy and workweek agreement. The recipient must monitor his or her workweek agreement, so that IHSS providers do not exceed 40 hours per week. If a recipient's regular provider exceeds, or is approaching, the limitation on hours, a recipient should contact his or her substitute backup provider. If the recipient's substitute backup provider is unavailable, the recipient is authorized to contact the provider Backup System for assistance. Services provided by a backup provider would be deducted from the recipient's authorized hours. The cost of adding providers to the Public Authority registry and backup is $34.50 per provider.

ISSUES TO CONSIDER:

Overtime compensation. The Governor's budget proposes to prohibit overtime pay for domestic workers, except for emergency documented circumstances. In deliberating this proposal, the Legislature may wish to consider the following:

- **Increased workforce.** According to the Department of Finance, between 30,000 to 40,000 additional providers and workers are needed to meet the needs of the over 160 hours per month population. County workers would help IHSS recipients develop a

[1] The budget provides that 85 percent of recipients will have a provider accompany them to medical visits, where providers will spend three hours per month waiting for recipients to complete their appointments. Each month new providers will attend a two-hour mandatory orientation training.

workweek agreement and would monitor compliance with the agreement. The budget assumes wage cost per hour for social workers of $60.55 per hour, and for clerks, $16.80 per hour. Consistent with the intent of an 8 hour workday/40 hour work week, the new federal regulations attempt to protect the health and safety of providers for IHSS recipients, ensuring that providers are rested and able to care for and supervise the health of IHSS recipients.

- **Impact on family caregivers and providers.** According to DOF, over 48,000 recipients receive over 160 hours per month (11 percent of the total IHSS population). Around 37,000 of the 48,000 recipients (77 percent) have only one provider. Overall, approximately 73 percent of IHSS providers are family members. If California were to implement FLSA regulations, as well as fund current allotments, the budget estimates full implementation to cost over $600 million. The Legislature may wish to consider whether limiting overtime is appropriate, as well as the impact of a second provider entering a home on the recipient.

- **Provider Backup System.** Los Angeles County currently operates a Back-Up Attendant Program, which matches eligible IHSS recipients with homecare workers to assist on a short-term basis when a recipient's long-term provider and designated substitute provider are unavailable. The program provides a wage of $12 per hour for providers listed on the registry as backup providers, and $9 per hour for all other providers. The Governor's budget proposes to create a Provider Backup System, where the IHSS recipient monitors his or her assessed hours, and could request a provider from the Provider Backup System when his or her regular caregiver is nearing the assessed hour limit and a substitute is unable to provide services. The budget also outlines a higher wage cost for providers in the Backup System than a standard provider due to providing services on short notices. However, the Governor's proposal does not provide details about wage rates for providers on the Backup System.

- **A broader perspective.** The IHSS program was created in 1973 to enable elderly, blind, and individuals with disabilities the ability to live independently in the community, not intentionally designed as financial support for caregivers -- though it has evolved as such. Further, as more individuals age in place and prefer home-like, independent, and non-institutional care, the program's recipients and needs continue to change. As more IHSS recipients select in-home care, California's IHSS program may experience a programmatic shift in formalizing care for a family member as employment, as well as a shift in the types of services provided to recipients.

- **Stakeholder process.** The budget proposal assumes a stakeholder process to inform providers and recipients of the impending changes to implement federal regulations, as well as in developing the workweek agreement. The Legislature may wish to consider the timing of conducting a stakeholder process, given the state's required implementation of federal regulations by January 1, 2015.

- **Other states.** Some states, such as New Mexico, Kentucky, and Pennsylvania, have contracted with organizations for counseling services and fiscal agents; and use a "cash and counseling" model, also known as "participant direction." In a Cash-and-Counseling program, the government provides recipients a monthly monetary allowance based on an assessment of needs. Recipients prepare a plan for spending the allowance on permissible goods and services, hire and pay the providers, and receive counseling to help make decisions about developing back-up plans. The Legislature may wish to consider whether allocating its resources to create a provider back-up system to comply with FLSA regulations may be better spent on a new delivery system altogether.

Community Care Licensing

BACKGROUND:

Community Care Licensing (CCL) oversees the licensure or certification of approximately 66,000 licensed community care facilities, and has responsibility for protecting the health and safety of individuals served by those facilities. Facilities licensed by CCL include childcare centers, family childcare homes, foster family and group homes, adult residential facilities, and residential care facilities for the elderly. As shown in the figure below, CCL does not license skilled nursing facilities, which instead, are licensed by the Department of Health Care Services; or, facilities that provide alcohol and other drug treatment.

Table 1: Types of Facilities CCL Licenses

Facility Type	Description
Child Care Licensing	
Family Child Care Home	24 hr. non-medical care in licensee's home.
Children's Residential Facilities	
Crisis Nursery	Short-term, 24-hr., non-medical care for eligible children under 6 years of age.
Group Homes	24-hr., non-medical care to children in structured environment; facilities are of any capacity.
Small Family Homes & Foster Family Home	24-hr. care in the licensee's home for 6 or fewer children, who have disabilities.
Transitional Housing Placement	Provides care for 16+ yrs. old in independent living.
Adult & Elderly Facilities	
Adult Day Programs	Community based facility/program for person 18 years old or older.
Adult Residential Facilities (ARF)	24-hr. non-medical care for adults, 18-59 years old.
Adult Residential Facility for Persons with Special Healthcare Needs	24-hr. services in homelike setting, for up to 5 adults, who have developmental disabilities, being transitioned from a developmental center.
Residential Care Facilities for the Chronically Ill	Facilities with maximum capacity of 25.
Residential Care Facilities for the Elderly (RCFE)	Care, supervision, and assistance with activities of daily living to eligible persons, usually 60+ yrs. old. Facilities range from 6 beds or less, to over 100 beds.
Continuing Care Retirement Communities (CCRC)	Long-term continuing care contract; provides housing, residential services, and nursing care.
Social Rehabilitation Facilities	24-hr. non-medical care in group setting to adults recovering from mental illness.
Special Agencies	
Certified Family Homes (CFH)	CFHs are certified by foster family agencies.

Background Check. Applicants, licensees, adult residents, and employees of community care facilities who have client contact must receive a criminal background check. An individual submits fingerprint imaging to the California Department of Justice (DOJ). The Caregiver Background Check Bureau, within CCL, processes and monitors background checks. If an individual has no criminal history, DOJ will forward a clearance notice to the applicant or licensee and to the Caregiver Background Check Bureau within the Community Care Licensing Division. If an individual has criminal history, DOJ sends the record to the Bureau, where staff reviews the transcript and determines if the convictions for crimes may be exempt.

For individuals associated with a facility that cares for children, an additional background check is required through the Child Abuse Central Index.

According to the Department of Social Services (DSS), approximately 200,000 background checks are completed annually, with approximately 1,200 (0.6 percent) individuals denied criminal record clearance or exemptions.

Facility licensing practices and requirements. All facilities must meet minimum licensing standards, as specified in California's Health and Safety Code and Title 22 Regulations. According to DSS, around 1.4 million Californians rely on CCL enforcement activities to ensure that the care they receive is consistent with standards set in law.

DSS must conduct pre- and post-licensing inspections for new facilities, including when a previously licensed facility changes hands. In addition, DSS must conduct unannounced visits to licensed facilities under a statutorily required timeframe. Prior to 2003, these routine inspection visits were required annually for all facilities except family child care homes, which received at least triennial inspections. According to DSS, around 462 licensing analysts monitor the activities of approximately 66,000 licensed community care facilities. DSS makes over 24,000 annual inspections and investigates over 13,000 complaints involving licensed care.

In 2003, AB 1752 (Committee on Budget), Chapter 225, Statutes of 2003, reduced CCL's budget by $5.6 million and also reduced the frequency of these inspections. As a result, CCL must visit a small number of specified facilities and conduct random, comprehensive visits to at least 10 percent of the remaining facilities annually. Ultimately, the Department must visit all facilities at least once every five years -- less frequently than required in other states.[1] In addition, there is a "trigger" by which annually required inspections increase if citations increase by 10 percent from one year to the next. Finally, CCL must, within 10 days of receipt of a complaint, make an unannounced visit to the facility to investigate, and may conduct related onsite investigations. On average, according to DSS, CCL is currently visiting facilities once every 29 months. The budget assumes there are 70,382 licensed facilities -- 6,626 county and 17,096 state licensed facilities that provide 24-hour care; and 60 county and 46,600 state licensed facilities that provide day care.

[1] For more information about other states' assisted living regulations regarding frequency of inspections, please visit http://projects.propublica.org/tables/assisted-living-regulations

Key Indicator Tool. After the 2003 changes and because of other personnel reductions[2], CCL has fallen behind in meeting the new requirements. In response, DSS designed and implemented the key indicator tool (KIT), which is a shortened version of the CCL's comprehensive licensing inspection instruction, for all of its licensed programs. The KIT complements, but does not replace, existing licensing requirements. A KIT measures compliance with a small number of rules, such as inspection review categories and facility administration and records review, which is then used to predict the likelihood of compliance with other rules. Some facilities, such as facilities on probation, pending administration action, or those under a noncompliance plan, are ineligible for a key indicator inspection and will receive an unannounced comprehensive health and safety compliance inspection.

Recent events. Several high-profile cases in child and adult residential facilities recently surfaced, pertaining to the following:

- **2011 Bureau of State Audits Report**.[3] In October 2011, the California State Auditor issued a report, which found that more than 1,000 addresses for licensed facilities and out-of-home child placements matched with addresses for registered sex offenders in the DOJ's Sex and Arson Registry. DSS immediately began legal actions against eight licensees and issued 36 exclusion orders, barring individuals from licensed facilities; counties also removed children and ordered sex offenders out of homes. While county child welfare service agencies performed the required background checks, the audit report found that they did not consistently notify DSS of deficiencies or forward required information to DOJ.

- **Castro Valley Assisted Living Facility.** In October 2013, DSS closed Valley Springs Manor, a Residential Care Facility for the Elderly (RCFE) located in Castro Valley, but news articles reported that more than a dozen elderly residents were left in the facility more than two days after the state ordered the facility to be closed.

Consumer interest. If an individual is interested in determining whether a facility has met its licensing requirements, he or she must contact a county licensing office or local regional office and request to review the licensee's facility file. Currently, no information is readily available online.

GOVERNOR'S 2013-14 BUDGET PROPOSALS:

The Governor's budget includes $7.5 million ($5.8 million General Fund) and 71.5 positions for quality enhancement and program improvement measures. The additional positions and resources seek to improve the timeliness of investigations; help to ensure the CCL Division inspects all licensed residential facilities at least once every five years, as statutorily required; increase staff training; and, establish clear fiscal, program, and corporate accountability. Specifically, the budget includes the following components:

[2] CCL estimates that over 15 percent of its staff was lost due to retirements, transfers, and resignations, as well as a prolonged period of severe fiscal constraints.

[3] Full text of the 2011 report can be found at http://www.bsa.ca.gov/pdfs/reports/2011-101.1.pdf.

- **Additional positions.** The 71.5 positions include: six special investigator assistants; 21 associate governmental program analysts; one office services supervisor and one office technician; one nurse practitioner; five licensing program managers, of different management levels; five staff services managers, of different levels; 30.5 licensing program analysts; and, one attorney. 70.5 positions are requested to be made permanent.

- **Staff training and development.** The budget provides for increased training for new field staff and training for supervisors and managers by expanding the Licensing Program Analyst academy, implementing ongoing training, and strengthening the Administrator Certification Section. The Governor's budget proposes that DSS will assist with policy and practice development for medical and mental health conditions in community facilities, as follows:
  - **Establish medical expertise resources.** Although CCL has no staff with medical expertise, DSS licenses facilities that do allow for incidental medical care. Also, DSS has historically maintained a contract with a nurse consultant to provide medical expertise on specific complaint investigations. The Governor's budget proposes to utilize its one Nurse Practitioner position to develop a process and regulations regarding medical conditions and treatments that can be maintained and provided in community care settings, such as chemotherapy.

  - **Create a Mental Health Populations Unit.** With the upcoming Affordable Care Act, and SB 82 (Budget and Fiscal Review Committee), Chapter 34, Statutes of 2013[4] implementation, the Governor proposes to create a Mental Health Populations Unit, which would provide technical assistance to enforcement staff and licensees, as well as to individuals who reside in facilities who have increasing mental health care needs. Specifically, the unit would review and develop bill analyses for proposed legislation on Social Rehabilitation Facilities, coordinate interdepartmental communications, and develop regulations with stakeholders to meet additional program needs.

  - **Establish a Corporate Accountability Unit.** With increased applications for Residential Care Facilities for the Elderly and corporate mergers and acquisitions for facilities, the additional attorney and associate governmental program analyst would perform the following duties: identify and address systemic noncompliance and ensure corrective actions; create management reports that identify patterns and trends; make corrective action recommendations; and, follow-up on corrective action plans to ensure that licensees with poor compliance patterns do not support operational expansions.

- **Specialized complaint hotline.** Currently, 462 LPAs in 26 licensing offices throughout the state review incoming complaints. Depending on workload, a LPA may remain in the office instead of in the field performing licensing visits. Additionally, every LPA must spend two days a month conducting intake and assessing complaints and incidences, as well as respond to general inquiries. The budget establishes a specialized and centralized

[4] SB 82 triples the number of social rehabilitation facility (SRF) beds, or crisis stabilization beds, for individuals with higher mental health acuity needs.

toll-free public complaint hotline, which can help acquire better initial information, conduct consistent prioritization, and dispatch incoming complaints to regional offices.

- **Centralizing application processing.** Currently, 779 Adult and Senior Facility applications for licensure are pending. Applications can take from six months, up to a year or more, to process. The budget proposes centralizing applications for Adult and Senior Care facilities, which would is expected to increase inspections of licensed facilities to at least once every two years.

- **Establish statewide Quality Assurance Unit.** The current information technology system does not allow for documents and reports to track information statewide, including complaints, actions, or performance. It does not also provide aggregate data to review and identify patterns. The budget proposes to establish a Quality Assurance Unit to identify immediate health and safety risks to clients, develop a statewide quality assurance review model, coordinate licensing case file responses to Public Record Act requests, and identify training needs for quality assurance review.

- **Increased civil penalties.** According to DSS, because the current civil penalty structure is related to a "per violation" event, the current maximum civil penalty, even in response to serious injury or death of a resident, is $150. The Governor's budget proposes to increase civil penalties for three different types of serious noncompliance, for all facility categories, except foster family homes, specifically:

    - **Zero Tolerance Violations.** Currently, the assessed immediate civil penalty is $150 per day, per violation until corrected. As proposed, an immediate civil penalty assessment[5] would be imposed equal to five times (500 percent) of the licensee's annual fee per day, per violation, until and including the day the deficiency is corrected. The budget also proposes to amend language -- but, does not specify how -- pertaining to violations that result in a client's injury, illness, or death.

    - **Repeat Violations.** The budget proposes to authorize DSS to impose an initial immediate civil penalty assessment on repeat violation equal to three times (300 percent) the licensee's annual fee, per violation, in addition to a civil penalty assessment equal to 1.5 times (or 150 percent) the annual license fee per day, per violation, until and including the day the deficiency is corrected.

    - **Failure to Correct.** Currently, the assessed civil penalty is $50 per day, per citied violation, up to a maximum of $150 per day. The budget proposes that if the facility fails to correct a deficiency by the identified due date, a civil penalty equal to 25 percent of the annual fee per day, per violation, until and including the day the deficiency is corrected would be imposed.

[5] Examples of violations that would qualify for an immediate civil penalty assessment include: absence of supervision; fire clearance violations; accessible firearms; presence of an excluded person; and, accessible bodies of water.

If two or more civil penalties are applicable, the budget proposes to assess the facility, or individual, at the higher penalty rate.

- **Increased licensing fees.** Currently, all facilities, except for foster family homes, must pay application and annual fees set by statute. The budget proposes a ten percent increase in licensing and application fees, which could result in $1 million additional revenues in the first year. The fees would then be adjusted annually with the Consumer Price Index.

ISSUES TO CONSIDER:

Shifting needs of an aging population. In the past, Assisted Living and Residential Care Facilities for the Elderly (RCFEs) were distinguished from skilled nursing facilities because of the medical (skilled nursing facilities) and non-medical needs of the residents. However, as more individuals age in place and prefer home-like, independent, and non-institutional care, the line has increasingly blurred. With demand for health delivery in a home-care setting, the state is at a crossroads to update CCL's current regulatory framework. The Legislature may wish to examine CCL Division's role in licensing these facilities and necessary related staff training, to ensure that residential care for individuals, including dementia or mental health care, is provided safely.

Discussion about the key indicator tool (KIT). The KIT was developed to focus and maximize CCL's limited resources, and to assist in identifying facilities' compliance with state regulations. Given the Governor's proposal of increased staff and additional funding, the Legislature may wish to ask the Administration the following questions:

- Will the CCL Division continue to use the key indicator tool in its assessments?
- If so, how will the tool be coordinated with the schedule of a full assessment?
- Do facilities, which have demonstrated success in meeting the key indicators assessment over time, continue to receive a KIT assessment or a full assessment?

California State University Sacramento's Institute for Social Research is contracted with CCL to provide guidance, design, develop, analyze, and implement the key indicators model. However, there is no formal evaluation on the KIT yet. If there remains interest in using the KIT in conjunction with regular assessments, the Legislature may wish to request a study that assesses whether the KIT has been successful and accurate in identifying compliance or non-compliance and makes recommendations to improve it. Further, the Legislature may wish to refine the KIT, so that indicators that are likely associated with poor outcomes are used; and, that recommendations to change the KIT are incorporated.

Licensing report. Currently, if an RCFE is inspected, the licensing program analyst (LPA) issues a licensing report, which can include any cited deficiencies and a plan of correction, if applicable. Because the deficiency is facility-specific, the plan of correction is also specific to the facility. If an LPA inspects a different facility, owned by the same licensee, the LPA can observe and cite the same violation, without knowing that it could reflect a widespread problem with that licensee. The Legislature should ask CCL how its inspection process could be modified to help better ensure its inspectors can identify widespread problems across a single licensee.

The Future of State Developmental Centers

The state Department of Developmental Services (DDS) owns and operates four state developmental centers (DCs), which include residential programs licensed and certified as Skilled Nursing Facility, Intermediate Care Facility for Individuals with Intellectual Disabilities (ICF/IID), and General Acute Care hospitals. As of December 2013, these four institutions collectively serve approximately 1,352 individuals with significant physical or behavioral developmental disabilities. Additionally, DDS leases and operates one smaller community-based ICF/IID, serving approximately 52 residents with developmental disabilities and challenging behaviors.

BACKGROUND:

California has served persons with developmental disabilities in state-owned and operated institutions since 1888. At its peak, the developmental center system housed over 13,400 individuals in seven facilities. Of the four remaining facilities, the oldest is Sonoma Developmental Center (1891) and the youngest is Fairview Developmental Center (1959). The decline in developmental center use is consistent with the development of a community-based network of services and supports that promote successful integrated living in California communities and reflects national trends that support reduced reliance on institutions and greater support for community-based integrated services, directed in part by changes in state and federal law, and multiple court cases, including the United States Supreme Court's 1999 decision in *Olmstead v. L.C., et al.*

DC Quick Facts

- Approximately 1,569 residents were served in state developmental centers, at an average per resident cost of $349,000, in FY 2012-13.
- 67% of residents have a severe or profound intellectual disability.
- 72% of residents are over the age of 42. 20% are over the age of 61.
- 47% of residents have lived in a DC for more than 30 years.
- 45% of DC residents have significant medical needs.
- 16.4% of DC residents have significantly complex and challenging behaviors.
- 13% of DC residents have had some involvement with the criminal justice system.

Numerous changes to the regional center planning and service development process have further reduced use of developmental centers. Person-centered planning has resulted in more appropriate and successful community-based services and supports for individuals who utilize regional center services. Additionally, regional centers have used an annual community planning and placement (CPP) allocation, $67 million (total funds) in the current year, to develop community-based services and supports for individuals moving out of a developmental center, and to deflect new placements into developmental centers. On average, 175-200 individuals move out of developmental centers to the community each year.

Statutory changes adopted as part of the 2012-13 state budget AB 89 (Committee on Budget), Chapter 25, Statutes of 2012, in part a response to a new trend of increasing developmental center placements, restricted new developmental center admissions, except under specified conditions, including commitments under the state's Incompetent to Stand

Trial statute. Additionally, individuals who are in crisis can be placed temporarily at the Fairview Developmental Center.

The declining DC population, along with its aging infrastructure, has led to increasingly high per resident costs associated with maintaining this model of residential care.

A Model Developmental Center Closure. In 2003, the Administration proposed the closure of Agnews Developmental Center (ADC). Unlike previous closures, where a large number of residents were moved to another developmental center, the ADC closure was based on an extensive closure plan, developed with input from an advisory committee made up of system stakeholders. As a result, the ADC closure was achieved through intensive individualized planning for its residents, the development of sufficient community capacity, new service and support options in the community, innovative housing and staffing models, and partnerships between the Department of Health Care Services (DHCS), DDS, regional centers, and designated health plans to ensure the health care needs of residents could be met in the community, among other innovations. As a result, 327 of the 347 ADC residents had moved successfully into the community when the facility was finally closed in 2009. According to the final satisfaction survey conducted to measure the success of the transition of ADC residents to the community, 100 percent of family respondents reported satisfaction with the services and supports the consumer were receiving, and that the community-based resident and day settings were healthy and safe environments.[1]

Lanterman Developmental Center Closure. In January 2010, DDS proposed the closure of Lanterman Developmental Center (LDC), and a closure plan was adopted along with the Budget Act of 2010. The LDC closure plan borrowed heavily from the process employed to close ADC, including the use of Adult Residential Facilities for Persons with Special Health Care Needs (ARFPSHN); improved health care through managed care plans for persons transitioning from LDC to the community; implementation of a temporary outpatient clinic at LDC to ensure continuity of medical care and services as individuals transfer to new health care providers; and the use of LDC staff to provide services in the community to former LDC residents. Since the approval of the closure plan, 248 LDC residents have transitioned to community living arrangements and 99 remain at LDC (as of January 16, 2014). The Governor's budget assumes all remaining residents will have transitioned to the community by January 1, 2015.

Loss of Federal Certification at Sonoma Developmental Center. State DC's are required to meet federal standards set by the federal Centers for Medicare and Medicaid Services (CMS), in order to receive federal financing participation under the Medicaid program. In January 2013, four out of 10 Intermediate Care Facility (ICF) units at Sonoma Developmental Center (SDC) were withdrawn from federal certification by DDS, in response to notice that the federal government was moving to decertify the larger group of ICF units. These actions came on the heels of widely reported revelations of multiple instances of abuse, neglect, and other lapses in caregiving at the institution. The loss of federal certification for these units at SDC, and the loss of associated federal funding, has cost the state General Fund approximately $1.4 million each month.

[1] Bay Area Quality Management System, Consumer Survey and Family Guardian Survey Results, Consumers Transitioned to the Community, Final Report, Prepared by Human Services Research Institute, May 2007.

In March 2013, DDS entered into a Program Improvement Plan (PIP) agreement with the state Department of Public Health (DPH), which was accepted by the federal Centers for Medicare and Medicaid Services. As a condition of the PIP, DDS contracted with an outside consultant to conduct a root cause analysis of the problems at SDC and develop an action plan to ensure SDC is in compliance with federal and state licensing and certification requirements.

On October 31, 2013, the DPH accepted the SDC action plan and the Department of Finance submitted a request to the Joint Legislative Budget Committee for current year supplemental funding of $3.6 million General Fund ($7.2 million total funds). According to the Governor's budget, the full year costs associated with the action plan at SDC will be $9.2 million ($5.1 million General Fund). The action plan includes the opening of a new ICF unit, 118.5 new staff positions, three new wheelchair transport vehicles, and extensive staff training. Should these efforts sufficiently correct the identified deficiencies, federal financial participation will be restored. The Governor's budget assumes this will occur in July 2014.

New Quality of Care Concerns Raised at Remaining State Developmental Centers. Over the course of the summer and fall last year, DDS was notified of DPH's intent to decertify the ICF units at Fairview Developmental Center (FDC), Porterville Developmental Center (PDC), and Lanterman Developmental Center (LDC). In each case, DPH found significant lapses in caregiving, similar to those identified at SDC.

In mid-January, DDS and CDPH reached agreements to stay the decertification action and maintain federal funding of approximately $4.1 million each month. The agreement will require the development of a root cause analysis and action plan for PDC and FDC, similar to what occurred at SDC. For LDC, the agreement requires DDS to contract with an independent monitor to provide oversight, among other requirements.

GOVERNOR'S 2014-15 BUDGET PROPOSALS:

The Governor's budget proposes expenditures of $556 million (total funds) and 1,242 positions in the current year (an increase of $13 million and 118.5 positions over the approved current year budget); and $526 million (total funds) and 1,110 positions in the budget year.

The increase in the current year is primarily associated with collectively-bargained employee compensation augmentations, new employer retirement contribution rates, and implementation costs associated with the PIP implementation at SDC.

The decrease in the budget year is primarily associated with the closure of Lanterman Developmental Center in the budget year and the assumed restoration of full federal financial participation at SDC.

Lanterman Developmental Center Closure. The Governor's budget assumes savings of $38 million (total funds) related to the anticipated residential population being zero on December 31, 2014; and costs of $15.3 million (total funds) for the numerous activities associated with the closure of LDC and separation of staff.

Decertification of SDC Units. The decertification of four ICF units at SDC has cost the General Fund $1.4 million in the current year and will total $15.7 million in the budget year. However, the Governor's budget assumes full federal financial participation will commence again in July 2014. However, full year costs associated with the required action plan at SDC will be $9.2 million ($5.1 million General Fund).

Potential Decertification of Other Developmental Centers. The Governor's budget assumes the DDS and DPH will resolve the issues surrounding the potential decertification of the remaining developmental centers, and thus no loss of federal funds will occur. It is expected that the January agreement between DDS and DPH will require implementation of an action plan at FDC and LDC, similar to that agreed to for SDC; and a more modified action plan for LDC.

Plan for the Closure of Developmental Centers in California. On January 13, 2014, the Secretary of the California Health and Human Services Agency released her "*Plan for the Closure of Developmental Centers in California*" (Plan). The Plan was developed pursuant to trailer bill language adopted last year that required the Secretary to submit to the Legislature a master plan for the future of DCs by November 15, 2013; and to submit to the Legislature, by January 10, 2014, the Administration's resulting plans to meet the needs of all current residents in DCs. The Plan submitted January 13th meets the requirements of the master plan; however, more specific plans to implement the recommendations of the master plan have not yet been submitted.

The Plan was developed in consultation with a task force comprised of a broad cross-section of system stakeholders, including individuals with developmental disabilities, family members, regional center directors, consumer rights advocates, labor representatives, legislative representatives, and DDS staff. The Plan provides six consensus recommendations of the task force and the Secretary, as follows:

"Recommendation 1: More community style homes/facilities should be developed to serve individuals with enduring and complex medical needs using existing models of care.

Recommendation 2: For individuals with challenging behaviors and support needs, the State should operate at least two acute crisis facilities (like the program at Fairview Developmental Center), and small transitional facilities. The State should develop a new "Senate Bill (SB) 962 like" model that would provide a higher level of behavioral services. Funding should be made available so that regional centers can expand mobile crisis response teams, crisis hotlines, day programs, short-term crisis homes, new-model behavioral homes, and supported living services for those transitioning to their own homes.

Recommendation 3: For individuals who have been involved in the criminal justice system, the State should continue to operate the Porterville DC-STP and the transitional program at Canyon Springs Community Facility. Alternatives to the Porterville DC-STP should also be explored.

Recommendation 4: The development of a workable health resource center model should be explored, to address the complex health needs of DC residents who transition to community homes.

Recommendation 5: The State should enter into public/private partnerships to provide integrated community services on existing State lands, where appropriate. Also, consideration should be given to repurposing existing buildings on DC property for developing service models identified in Recommendations 1 through 4.

Recommendation 6: Another task force should be convened to address how to make the community system stronger."

ISSUES TO CONSIDER:

The Secretary's Plan Sets a Good Course but a Detailed Road Map, Including a Timeline and Funding Strategy, is Necessary. The Plan developed by the Health and Human Services Agency provides a good analysis of the future viability of the current developmental center system and the Secretary's successful effort to identify and build consensus among divergent perspectives is commendable. The Plan provides significant and important recommendations to transition the developmental center system in order to better meet individual needs, provide greater opportunities for participation in community life, and ensure stable, quality living arrangements and associated services and supports. To achieve these goals, a detailed road map that sets a timeline, establishes a budget, and assigns roles and responsibilities must be developed. Trailer bill language adopted last year directs the Health and Human Services Agency to submit to the Legislature a more detailed report that includes a timeline for future closures and the statutory and regulatory changes that may be needed to ensure the delivery of cost-effective, integrated, quality services. This report was due in January but has not yet been delivered.

Regaining and Maintaining Federal Funding Participation at State Developmental Centers Will Require Significant Investments. The Action Plan agreed to by DDS, in order to achieve recertification of four ICF units at SDC, will require the hiring of 118.5 new staff, among other requirements, for a current year cost of $7.2 million ($3.6 million General Fund) and a budget year cost of $9.2 million ($5.1 million General Fund). Similar enhancements are likely to be required at FDC and PDC; with more modified requirements at LDC, due to its pending closure. Although the amount is not yet known, the cost to implement these additional action plans will result in increased costs in the budget year. However, up to $4.1 million in federal funds each month for LDC, FDC and PDC, combined, would be at risk if the plans are not successfully implemented.

Aging Infrastructure Needs. The Governor's budget proposes $10 million General Fund to address deferred infrastructure maintenance needs. However, the cost of meeting all of the pending infrastructure needs in these aging facilities is likely significantly higher.

Legal and Administrative Challenges to the DC Model. For more than seven years, the United State Department of Justice (USDOJ) Civil Rights for Institutionalized Persons Act (CRIPA) have conducted investigations at SDC and LDC. These cases have not been closed and the USDOJ could pursue resolution, particularly in light of recent licensing actions and unfavorable media reports. Additionally, multiple lawsuits have been filed over the years based primarily on the belief that large, institutional facilities violate the rights of persons with disabilities under the federal Americans with Disabilities Act, the state Lanterman Act, and the federal *Olmstead* decision.

Support for Continuing State Role in Serving Persons with Challenging Behaviors, Involved in the Criminal Justice System, or in Crisis. Currently, PDC operates "secure treatment units" that house approximately 240 individuals in the mild to moderate range of intellectual disability, and have come in contact with the legal system, have been determined to be a danger to themselves or others and/or incompetent to stand trial, and have been determined by the court to meet the criteria requiring treatment in a secure area. Additionally, DDS operates a smaller community-based facility serving persons with challenging behaviors and provides temporary crisis residential services at FDC. The Task Force Report sees a continued role for the state in providing services to persons served by these programs.

SUBCOMMITTEE NO. 4

STATE ADMINISTRATION and GENERAL GOVERNMENT

State Administration and General Government

Information Technology Procurement

BACKGROUND:

State IT Oversight and Procurement Has Undergone Many Changes

Information Technology (IT) oversight and procurement have suffered a long and troubled history in the state. Prior to the early 1990's a sub-unit within the Department of Finance (DOF) performed oversight of IT projects. However, the management of IT projects was highly decentralized and the Department of General Services (DGS) was responsible for the procurement of IT-related services and products. In response to criticism that this approach was inadequate as the state's investment in IT grew, the California Department of Information Technology (DOIT) was created in 1995 to oversee the planning and the development of IT projects.

The DOIT was instrumental in securing a six-year, $95 million contract with Oracle for enterprise software. The no-bid, sole-source deal was widely scorned and triggered an investigation by the State Auditor in 2002, who issued a scathing report that alleged, among other things, that the state might have saved $41 million if it had obtained the software without the contract. In 2002, the state cancelled the contract and the Legislature allowed the statutes that had created DOIT to sunset. Functions supporting IT projects were then scattered throughout the state.

Four years later, in 2006, a new law established the Office of the State Chief Information Officer (OCIO) and charged it with coordinating government information technology efforts. In 2007, the office's responsibilities were expanded to include planning and project approval. In 2009, the Legislature further consolidated statewide technology functions under the office. Following that, AB 2408 (Smyth and Huber) Chapter 404, Statutes of 2010, combined the OCIO, the Office of Information Security, the Department of Technology Services, and the Department of General Services' Telecommunications Division into a single unit. On September 28, 2010, the Governor signed legislation renaming the office as the California Technology Agency and extended its sunset provision to 2015.

During consideration of the 2013-14 budget some significant changes were made to the IT procurement process. SB 71 (Budget and Fiscal Review Committee), Chapter 28, Statutes of 2013, modified the way that the state purchases IT enhancements. Prior to the passage of SB 71, as had long been the process, the DGS was responsible for IT-related procurement for most state agencies. SB 71 transferred procurement authority for all IT-related enhancements and the DGS staff responsible for this function to the Department of Technology, formerly known as the California Technology Agency.

IT Expenditures Are Significant

Throughout the history of the state's management of projects the size and scope of IT projects has continued to grow. That growth is reflected in the state's significant investment in IT upgrades, which was roughly $1.3 billion 1994, and totals more than $3.9 billion in the budget year. The suspension of several high-cost, IT upgrades, which accounted for nearly $1.0 billion, has significantly decreased the state's overall investment in IT modernization, which totaled nearly $5.0 billion at this time last year.

Specifically, the contract with the vendor responsible for integrating the IT upgrade for the state's payroll disbursement system, the 21st Century Project, was terminated in February 2013 after investing approximately $250 million. Similarly, the $208 million planned upgrade to the Department of Motor Vehicles IT platform was also cancelled in March 2013. These recent IT modernization failures, and others, seem to be more symptomatic of the process, rather than specific to any one particular project.

State Procurement Process

The process for IT procurement is generally the same regardless of the cost and scope of the project. The review and approval process begins with the state entity seeking the IT project developing a feasibility study report (FSR). The FSR is essentially the business justification for undertaking a project. The FSR is translated into a budget proposal that is submitted to the Legislature for review and action.

Upon receiving the authority to procure IT enhancements, as provided by SB 71, the Department of Technology reviewed existing procurement processes and determined that the current IT modernization process was often viewed as cumbersome to both the vendor and the end-user, required too much time for decision making, and often relied on outdated data. The Department of Technology modified the IT procurement process with the intent of improving the quality, value, and likelihood of success for IT projects undertaken by the state.

As part of its improvement process, the Department of Technology has introduced the Stage/Gate model for IT projects. While state entities must still complete an FSR, the initial information that they are expected to provide will be different. The introduction of the Stage/Gate model is designed to be more informative on the front-end of the request, and departments/agencies must provide a more accurate project budget estimate and more clearly define the business case that led them to request an upgrade to their IT portfolio. The Department of Technology expects that the introduction of the Stage/Gate model will reduce the need for change orders mid-project. Technology Letter (TL) 13-02 introduced the changes, which all state entities are subject to, into the IT project approval lifecycle.

The Stage/Gate model also will break the IT procurement process into multiple stages. Each subsequent stage will be separated by a deliverable, or a gate. After each stage, the Department of Technology will conduct an analysis to determine whether or not the investment remains practical, and if the project should continue. The Stage/Gate model has the potential to reduce the complexity of future IT projects in the state by breaking the project into multiple discrete phases. According to a recent study conducted by the University of Oxford, the longer a project is scheduled to last, the more likely it is to run over time and over budget, with every additional year increasing the cost by 15 percent.

ISSUES TO CONSIDER:

Recent Changes May Be Positive
The recent changes to the procurement process may be positive, but only time will tell. The introduction of the Stage/Gate model represents a change to the procurement process that was likely necessary. There are certain advantages to utilizing the proposed model, and the Stage/Gate model is a commonly accepted practice in the IT industry. However, there are certain risks that will arise from its use. One of the disadvantages of using the Stage/Gate model is that it limits creativity and ingenuity. The process to move from one gate to the next is very structured and the focus to move to the next gate may limit creativity. Additionally, it is unclear if every project will have clearly defined deliverables or gates, or if an agency will attempt to do too much in one phase.

Opportunity Exists for Additional Improvements to the Procurement Process
In addition, because of some of the potential shortcomings of the Administration's recent changes and the importance to the state of delivering successful IT projects, the Legislature may wish to consider additional changes to the IT procurement process in order to better ensure their success. Below, are four issue-areas the Legislature may wish to explore further.

Consider Opportunity for Expanded Oversight. The Legislature may wish to expand the oversight of IT projects and consider compulsory auditing for future IT modernization efforts if the project's estimated costs exceed a certain amount, or for projects that are expect to last beyond a certain number of years. For example, per Government Code Section §15849.22(e), the State Auditor is required to independently monitor the Financial Information Systems of California (FI$Cal) and report annually to the Legislature. Oversight of FI$Cal, which is the state's effort to modernize the functions of budgeting, accounting, procurement, financial management and cash management, has helped the Legislature to make informed decisions on the project's progress. FI$Cal continues to progress towards full implementation, and is currently projected to cost significantly less than originally anticipated (original cost estimates were $1.6 billion and the project is currently projected to cost a total of $656 million). While it is difficult to draw conclusions from the outcomes of any one project, applying a greater level of oversight prior to project failure may help the Legislature make more informed budget-related decisions.

In addition to increasing the oversight of specific projects, the Legislature may wish to more generally increase its oversight efforts. Currently, the Legislature relies on a decentralized approach to provide oversight to IT upgrade requests. The Technology Department and the requesting state entity that requests an IT modernization project is responsible for oversight of the project. Placing a greater level of emphasis on the oversight aspect of the IT project approval lifecycle may ensure that the Legislature is better equipped to make a budget-related decision for each particular project. To address this, the Legislature may wish to discuss whether a greater level of resources or, a reviewing entity within the legislative body, is necessary for IT project budget requests.

Balance Information Asymmetry. Cost estimates for each IT project vary wildly from the final project's budget, many times significantly greater than originally anticipated. Cost-overruns are not unique to government contracting, nor is it unique to IT projects. However, with proper knowledge prior to reaching a contract agreement, the risk of cost-overruns can be reduced.

The majority of the technical knowledge about IT modernization exists outside of state government. There is a significant level of information asymmetry that exists between state government and the private sector. This information asymmetry can enable the vendor to overcharge for services, or provide a bid so low that it is unlikely to be met. This can lead to a higher number of change-orders throughout the project's lifecycle, and will ultimately increase the cost of a project. The Department of Technology has taken steps to address this by requiring a more thorough assessment of a solution prior to bidding for a project. However, the Legislature may wish to consider ways to recruit and retain more highly skilled IT professionals that will provide the state with a more level playing field with the private sector.

Help Ensure Due Diligence. The state has had a difficult time incorporating the poor performance history of a vendor into the evaluation process for IT procurements. Creating a centralized repository of vendor-related performance may limit the number of repeat performances by vendors that have not provided the state with satisfactory services. To some extent, this data currently exists in the Project Status Reports (PSR) that the Department of Technology issues. The "Milestone" and "Deliverable" hit rates are tracked by the Department of Technology in each IT project's PSR, but this data is not collected and made available to state entities to use when evaluating bids from vendors on IT projects. Furthermore, providing data about the past performance of IT vendors in a public setting may encourage a higher level of accountability.

Researching the past performance of a prospective bidder also could benefit the state's efforts to deliver IT projects on time and on budget. For example, the upgrade for the payroll disbursement system suffered a number of setbacks. The original systems integrator's contract was cancelled and the project was ultimately suspended after the second systems integrator failed to satisfy contractual agreements. Had the requesting entity researched past performance of the bidding entity it would have found a number of instances of cost overruns that should have been of concern. The Legislature may wish to consider appointing an entity within state government to maintain a repository of vendor performance data that can be accessed by state entities and require state entities to use this information in their evaluation of potential vendors.

Consider Alternative Contracting Methods. The state's use of a single, prescriptive, procurement process for IT projects might not be the best fit for larger, more complex projects that constitute much of the state's annual IT procurement budget. More complex IT systems might be able to avoid some cost-overruns if the state were able to utilize a multi-stage procurement process that integrated multiple layers of review throughout the process. Unlike the more traditional contract award process that the state regularly uses; a multi-stage procurement process initially could have multiple vendors awarded contracts for the same project. These vendors would then be charged with building a small-scale version of their product for review by the customer, who, in turn, would decide which vendor would be awarded the full contract. Through increased dialogue and interaction it is likely that the state would achieve some cost reductions, yet, it is worth noting that the procurement timeline would likely need to be extended due to the nature of this type of contracting. Such an approach might help to enhance the dialogue between the vendor and the state entity and potentially reduce the risk of cost-overruns.

Traditionally, the state has used a fixed-price procurement process IT projects. The process is highly prescriptive and is designed to ensure that all vendors have an equal footing during the bid process. Due to the difficult nature of forecasting the exact cost of a project during the bid process, the state regularly amends the contract to account for any additional changes that may be necessary. When changes are necessary the state often undertakes costly renegotiations between the vendor and the end-user to determine who is ultimately responsible for the extra costs that are to be incurred. This can be an inefficient mechanism for governing complex IT projects. The Legislature may wish to explore a “responsibility principle” that recognizes that there is a shared sense of responsibility in cost-overruns and both parties could bear some level of financial risk.

Business Connect Project

BACKGROUND:

The Secretary of State is responsible for the management of over 150 different types of filings of business entities in California. The Business Programs Division, which is responsible for the management of business filings, is comprised of three sections: the Business Entities Section; Notary Public/Special Filings Section; and, the Uniform Commercial Code/Statement of Information section.

The Secretary of State receives more than one million business filings annually, and its current systems rely on antiquated methods, such as index cards and other paper documentation, to process and maintain records. Many business filings and other requests for services must be conducted in-person or by mail. These technologically dated methods result in very slow processing times, preventing new businesses from opening their doors and creating jobs. Processing times for the office have been as long as 117 days, preventing new companies from beginning operations and creating delays and uncertainty for existing companies.

To address this, the Secretary of State proposed automating many of the filing functions within the Business Programs Division. In March 2011, the Secretary of State submitted a Feasibility Study Report (FSR) that outlined the goals for this project. At that time, it was estimated that total project costs would be approximately $21.36 million with annual ongoing maintenance and support costs totaling $1.8 million. Resources to support the project would be directed from the Business Fees Fund.

Business Fees Fund

Under current statute, the Secretary of State collects filing fees paid by businesses that are deposited into the Business Fees Fund. Statue requires that a $5.00 disclosure fee be paid at the time domestic stock and foreign corporations file their annual statements of information with the Secretary of State’s Business Programs Division. Pursuant to California Corporations Code sections 1502 and 2117, one-half of the disclosure fees must be utilized to enhance program services. Existing law authorizes the Secretary of State to utilize the Business Fees Fund to perform business-related functions for the state. Pursuant to Government Code Section 12176, any amount in excess of $1.0 million in the Business Fees Fund is transferred to the General Fund.

Business Fees Fund
Resource History
(Dollars in Thousands)

Category	2012-13	2013-14	2014-15
Total Resources	$33,867	$42,261	$53,831
Expenditures	$32,866	$41,805	$53,049
Transferred to General Fund	$14,643	$2,336	$11,799

Additional Resources for Fund. In March 2013, the Legislature approved AB 113 (Blumenfield), Chapter 3, Statutes of 2013. AB 113 amended the 2012 Budget Act and provided the Secretary of State's Business Programs Division with an additional $1.6 million in reimbursement authority from the Business Fees Fund. At the time, the Secretary of State's office estimated that filing processing times could be reduced to 5-10 days with the additional funding. According to the December 2013 report issued by the Secretary of State, filing times for both business entities and statements of information have been reduced to an average of four days. The appropriation provided the Secretary of State's office with the resources to address the backlog that had accrued within the Business Programs Division, but did not provide resources to accelerate the development of the Business Connect Project.

GOVERNOR'S PROPOSAL:

The Secretary of State's office completed their review of vendor bids and has identified a systems integrator for the Business Connect Project. It is anticipated that the contract will be awarded on February 25, 2014, to coincide with the budget cycle. Implementation of the project remains on schedule. The Secretary of State, in conjunction with the Department of Technology, has posted an updated Special Project Report with a revised timeline, indicating that the project will be fully deployed by mid-2016. The most recent schedule for the Business Connect Project is shown below.

Business Connect Project Schedule

Project Phases Approved per December 2013 SPR	Estimated Completion Date	Phases Proposed in Original FSR	Estimated Completion Date
FSR Approval	April 1, 2011	FSR Approval	April 1, 2011
Release RFP	August 29, 2012	Release RFP	August 29, 2012
Contract Award	February 25, 2014	Contract Award	February 22, 2013
Project Initiation and Planning	April 30, 2014	Validate Requirements and Design Database	August 23, 2013
Design	March 16, 2015	LP&LLC and Misc Filing Entities	June 30, 2016
Development	December 31, 2015	Corporations	June 30, 2016
Testing	May 23, 2015	Trademarks	June 30, 2016
Deployment	June 30, 2016	UCC	June 30, 2016
Maintenance and Operations	June 30, 2017	Maintenance and Operations	June 30, 2017
Post Implementation Evaluation Report	June 30, 2017	Post Implementation Evaluation Report	June 30, 2017

The Governor's budget requests a total of $7.2 million in reimbursement authority to support the development of the Business Connect Project. The Business Connect Project has $2.9 million in existing resources, leaving a total of $4.3 million in new resources required for the development of the project. To date, a total of $4.6 million has been approved.

The project's overall cost has been revised in an updated Special Project Report (SPR) that was issued in December 2013 to reflect the selection of a vendor. Even though project costs associated with systems integration and the purchase of hardware and software are lower than originally anticipated, project costs will increase due to a greater need for offsite backup and disaster recovery. Total project costs are now estimated to be $22.2 million, reflecting an increase of approximately $800,000 from the originally approved FSR amount.

The Secretary of State anticipates that the upward revision in funding will largely be offset by the elimination of 45 positions that are currently associated with the Business Connect Project, and the expiration of 54 limited-term positions that support the Business Programs Division, that will no longer be needed once the filing process is automated. The Secretary of State's Office estimates that total net benefit of reduced position authority amounts to approximately $7.1 million.

ISSUES TO CONSIDER:

Implementation Process

When a new information technology system is introduced to an organization there are multiple methods of implementation. These include big bang adoption, phased adoption, and parallel adoption. Each approach has its particular advantages and disadvantages the Secretary of State's office has chosen to utilize the big bang adoption process. This means that every aspect of the Business Programs Division that is associated with business filings and statements of information will need to move over to a fully functioning Business Connect on a given date, which, in this case, is June 30, 2016.

Expectations of staff and its ability to adapt to a new business process should be accounted for in the project timeline. Given the proposed timeframes, there may be fewer opportunities for staff to familiarize themselves with the functionality of the new system. Processes will change, and if project staff members are not familiar with their role at the point of implementation, the big bang rollout will not occur as planned. The Administration and the Legislature will need to continue to monitor the progress of the Business Connect Project to ensure that the project's timeline is being met.

As noted elsewhere, the deployment of large information technology systems for the public sector has an unfortunate recent track record. The proposed systems for Secretary of State's office is not as large and complex as some state systems that have encountered with delays, cost overruns, or instances of mismanagement. Still, the project warrants careful and regular review to maintain reasonable costs, timely deployment, and full functionality.

California Department of Veterans Affairs

BACKGROUND:

California has the largest state population of veterans in the country. A September 2012 study, conducted by the United States Department of Veterans Affairs (USDVA), indicated that there are 1.79 million veterans living in California. The state's veteran population continues to grow, partially as a result of returning veterans. It is estimated that approximately 35,000 veterans will return from military service to the state annually, over the next few years.

The California Department of Veterans Affairs (CDVA) is the principal agency for state-based veterans' services. CDVA performs three primary functions to support the needs of California's veterans and their families:

- Providing guidance and representation relating to the disability and benefits claims process;
- Making direct loans for the purchase and improvement of farms and homes; and,
- Providing long-term residential and medical care at California Veterans Homes.

The Governor's budget proposes total spending of $399.66 million ($334.1 million General Fund) for the CDVA in 2014-15. This proposal reflects a $28.9 million dollar increase over expenditures for 2013-14.

Summary of Expenditures
(Dollars in Thousands)

Program	2013-14	2014-15
Farm and Home Loans to Veterans	$59,484	$60,485
Veterans Claims and Rights	17,455	14,454
Care of Sick and Disabled Veterans	293,473	324,617
Other	317	101
Total	**$370,729**	**$399,657**

Veterans Homes of California
A primary responsibility of CDVA is to provide qualified veterans with long-term residential care at one of the eight veterans homes of California. CDVA maintains campuses in Barstow, Chula Vista, Lancaster, Ventura, West Lost Angeles, Yountville, Fresno, and Redding. Fresno and Redding represent the most recent additions to CDVA's portfolio of veterans homes in California. The funding for these two homes, was provided in AB 1497 (Committee on the Budget), Chapter 29, Statutes of

2012, and both homes are actively phasing in staff to begin the admissions process. The funding provided in 2012 supported the staffing and phased-in operations of both homes. Prior to their establishment, a study conducted by the USDVA had identified both Redding and Fresno as healthcare hubs that were underserved areas in need of long-term care facilities.

Each veterans campus is capable of providing varying levels of care, in accordance with USDVA standards, ranging from domiciliary care to skilled nursing support. Overall, there are approximately 2,500 licensed beds, and CDVA maintains a physical capacity of almost 3,000 beds. However, projected census totals show that there will be slightly less than 2,000 residents within the CDVA Veterans Homes network. The table below provides a more in-depth breakdown of the capacity and care level of each campus.

Veterans Homes of California
Census and Level of Care Summary

Campus	Physical Capacity	Licensed Beds	2014-15 Census	Skilled Care	Intermediate Care	Residential Care	Domiciliary Care	Adult Services
Yountville	1,184	1,184	994	x	x	x	x	
Barstow	400	344	212	x	x	x	x	
Chula Vista	400	400	290	x		x	x	
West LA	396	240	362	x		x	x	
Ventura	60	60	86			x		x
Lancaster	60	60	86			x		x
Redding	150	x	124	x		x		
Fresno	300	x	132	x		x		
TOTAL	**2,950**	**2,288**	**2,286**	**732**	**151**	**419**	**933**	**52**

A significant portion of CDVA's overall budget is dedicated to the operation of the eight Veterans Homes of California. In the budget year, approximately 80 percent of CDVA's budget will be dedicated to the operation of the eight veterans homes within CDVA's network. In fact, the majority of the budgeted increase in expenditures can be attributed to the additional hiring of staff at the Redding and Fresno veteran's homes. However, the General Fund impact is significantly less than the figure displayed in the Governor's budget due to CDVA returning revenues to the General Fund. According to the table below, CDVA anticipates reverting $95 million to the General Fund, which would reduce the overall General Fund impact to slightly over $200 million for the operation of the state's veterans homes. CDVA reimburses a portion of its budget to the General Fund using the following sources; federal VA per diem, aid and attendance, resident fees, Medicare, Medi-Cal, and income from leased property.

Veterans Homes of California
General Fund Support
(Dollars in Thousands)

	Current Year 2013-14	Budget Year 2014-15	Net Change
General Fund Expenditures	$261, 056	$297,377	$36, 321
General Fund Reversion	$76, 632	$95, 113	$18,481
Net General Fund Impact	$184, 424	$202, 264	$17,840

Community-Based Adult Services
CDVA intends on offering Community-Based Adult Services (CBAS) level of care at the Lancaster and Ventura facilities by mid-2014, as noted in the table on the previous page. This level of care is designed to provide an outpatient day program for eligible veterans with a variety of services geared towards restoring or maintaining the veteran's capacity for self-care. At this time, it is unclear whether or not CDVA intends on expanding CBAS level of care to other facilities.

Veterans Farms and Home Loans Program
In the wake of World War I, CDVA began making low-interest financing options available to eligible veterans. The program was designed to assist the state's eligible veterans with the purchase of either a farm or a home. Funding to support the program is provided by a mix of both voter-approved revenue bonds and general obligation bonds. Currently, there is approximately $238.6 million authorized, but unissued, bond authority from the Veterans Bond Act of 2000. Subsequently, voters approved the Veterans Bond Act of 2008, which authorized the issuance of an additional $900 million in bonds.

During periods when interest rates for fixed-rate home loans have been high, the program has presented an attractive option for creditworthy veterans. However, since interest rates for the loan program are determined when the bonds are issued (which occurred in a higher interest rate environment), the attractiveness of the program has waned as prevailing interest for home loans has declined. As of June 30, 2013, the program has interest rates on outstanding loans ranging from 3.9 percent to 9.75 percent. The table below represents the number of outstanding loans and loans issued annually and reflects the overall reduction in program activities.

Veterans Farms and Home Loans
Outstanding and Originated Loans

Year	Outstanding Loans	Originated Loans
2004	17,643	1,942
2005	15,462	1,242
2006	14,481	1,228
2007	13,716	921
2008	13,130	1,116
2009	11,840	770
2010	10,415	212
2011	9,208	153
2012	7,913	83
2013	6,600	82

ISSUES TO CONSIDER:

Homeless Veterans Population

Among the states, California has the largest population of veterans in the country, as well as having the largest population of homeless veterans. Fortunately, most recently, the population of homeless veterans has declined somewhat. According to a study conducted by the U.S. Department of Housing and Urban Development (HUD) in 2013, there were approximately 15,179 homeless veterans in the state. This reflects a decrease in this population of over eight percent from the HUD estimate of 16,500 homeless veterans in the state for 2012.

Some of this decrease can be attributed to the efforts of the California Department of Veterans Affairs (CDVA), which has made a coordinated effort to address the state's homeless veteran population. CDVA has a total of 84 beds in the Los Angeles area dedicated to transitional housing within the Los Angeles area veterans homes network. The Los Angeles area has the highest concentration of homeless veterans in the state. According to CDVA, nearly a third of the veterans admitted to one of the homes within the Los Angeles area were homeless admissions.

While progress is being made, a higher level of services will be required if the state intends to meet its target of eliminating the homeless veteran population by 2015. Beyond additional services, a greater level of collaboration with non-profit organizations that are dedicated to addressing the needs of homeless veterans will be needed. The Legislature should consider identifying areas where a greater level of collaboration will be necessary in order to continue to drive down the number of homeless veterans in the state.

Veterans Homes of California

With a physical capacity of over 2,950 beds within the entire veterans homes network, CDVA has a significant amount of underutilized space. As noted earlier, nearly 80 percent of CDVA's total budget is dedicated to the operation of the state's eight veterans homes. As the overall census within the homes continues to grow, the Legislature and the Administration will be faced with additional fiscal challenges to operate the homes at full, or near full, capacity. The Legislature should consider discussing areas within the CDVA's veterans homes that could achieve a greater level of efficiency. Leveraging available space, partnering with non-profits that support CDVA's broader mission, and determining the proper mix of beds should all be considered by the Legislature, in order to best maximize the resources within CDVA's veterans homes.

As noted earlier, the Los Angeles area is home to the largest population of homeless veterans in the state. CDVA recognized that some of the underutilized capacity of veterans homes within the Los Angeles region could be dedicated to transitional housing for homeless veterans. CDVA was able to connect an underserved population with an underutilized resource. The Legislature may wish to explore if other regions of the state could benefit from underutilized capacity at the state's other five veterans homes.

Veterans Farm and Home Loans Program

The program has faced a steady decline over the past couple of decades. In 1998, the Legislative Analyst's Office (LAO) outlined the decline that the program was facing in a report that recommended phasing out the department's home loan program and seeking voter approval to utilize the existing bond authority to support other veterans programs. The LAO noted that there are other financing mechanisms that offer more competitive rates than available through the department's home loan program.

Modifications to the Veterans and Farm Home Loan Program have been made by the Legislature. In 2011, the Legislature passed AB 1084 (Davis) Chapter 377, Statutes of 2011, which authorized CDVA to issue loans that support shared cooperatives, often referred to as co-ops. The intent behind the legislation was to allow specific groups, such as the elderly, veterans, or low-income families to become homeowners. In 2013, CDVA only issued 82 loans, and in 2012 issued 83. Thus, the program continues to slowly contract. While some modifications have been made, it does not appear that the changes have increased interest in utilizing CDVA's Farm and Home Loans Program. The Legislature may wish to consider what, if any, changes can be made to the Farm and Home Loans Program to address the needs of today's veterans.

Restitution Fund

BACKGROUND:

The California Victims Compensation Program (CalVCP) is responsible for providing compensation to victims of crimes that have been injured, or face the threat of injury. The program provides an array of services, including mental health and medical, that otherwise may not have been covered by a victim's insurance policy. While a victim is eligible to apply directly to the board, victims are usually referred to the board by local government. Advocates working closely with district attorneys often refer victims to the board. The program is administered by the Victims Compensation and Government Claims Board, which is comprised of the Secretary of the Government Operations Agency, the State Controller, and a public member who is appointed by the Governor.

The Restitution Fund is the primary source of funding for CalVCP. The Restitution Fund is an important component of the California Victim Compensation Program (CalVCP) that provides funding to assist victims of crime. The Restitution Fund receives the majority of its revenue from restitution fines, diversion fees, orders and penalties paid by criminal offenders. For example, when a defendant is found guilty of a crime, as part of the court's ruling, they may be ordered by the court to pay a series of fines and penalties. The money that is collected is divided among several parties, in accordance with state law. Depending on the situation, the compensation can be provided directly to the victim, or to the provider of services and a portion of the money collected by defendants is deposited directly into the Restitution Fund.

Restitution Fund revenues are used as a match to draw down federal funds under the federally administered Victims of Crime Act (VOCA) grant program. CalVCP receives 60 cents in matching federal VOCA grant funding for each dollar spent to provide victims with services. Beyond the CalVCP, the Restitution Fund is also a funding source for programs operated by the Office of Emergency Services (OES), the Department of Justice (DOJ), the Board of State and Community Corrections (BSCC), and the Controller's Office.

GOVERNORS PROPOSAL:

For Budget Year 2014-15, revenues for the Restitution Fund will total $100.5 million, and expenditures for the Restitution Fund will total $110.4 million. There is approximately a $10 million structural deficit that exists within the fund, which is made up by the use of existing reserves. In the short-term the fund remains stable, however, in the long-term, there are solvency issues that may need to be addressed. The table below illustrates the current condition of the Restitution Fund. The Governor's budget does not include a proposal to address the Restitution Fund's structural deficit.

Restitution Fund Balance
(Dollars in Thousands)

	2012-13	2013-14	2014-15
Total Revenues	$107,386	$101,752	$100,488
Total Expenditures	$95,234	$110,092	$110,371
Fiscal Effect on Fund Balance	$12,152	$(8,340)	$(9,883)
Fund Balance	$79,904	$71,564	$61,681

ISSUES TO CONSIDER:

Forecasting Difficulty

As noted above, revenues fluctuate from year to year. The actual revenue and expenditures for the Restitution Fund in fiscal year 2012-13 represent a significant shift from projected expenditures and revenue from the 2013-14 and Budget Year 2014-15. For fiscal year 2012-13, revenue exceeded expenditures. Estimated expenditures of fiscal year 2012-13 were estimated to be approximately $120 million, which is significantly less than the actual expenditures of $95 million. Forecasting for the fund has historically overstated expenditures and overstated revenues. When faced with solvency concerns in the past, CalVCP has had to reduce payments to victims to ensure that the fund remained solvent.

Better data collection could increase forecasting. Currently, counties are responsible for the collection of court-ordered debt. Including the fines and penalties that support the Restitution Fund, however, there is very limited data available on the collection efforts at the county level. This makes it very difficult for CalVCP to estimate revenues available for expenditures in the Restitution Fund. The Legislature may wish to explore ways that the estimate of revenues going into the Restitution Fund could be improved. For example, what data could counties report that would provide CalVCP with better data to forecast revenues.

Enhancing collection efforts could improve Restitution Fund revenues. There is little incentive for counties to collect fines and penalties in a more efficient manner. While data is limited, we do know that courts within the state that focus a greater amount of energy on collecting debt that is in the early stages of arrears are much more efficient. The Legislature may wish to consider methods of incentivizing the county collection process, which could increase the amount of revenues going into the Restitution Fund.

Local Economic Development

BACKGROUND:

The last few years have seen numerous changes in the types of tools that are available to local governments—largely cities and counties—for economic development purposes. In general, the changes have been the result of an objective to concentrate state-level financial resources and the local property tax on essential state and local services, such as education and public safety. While the steps that have been taken by the Legislature have resulted in additional resources being made available for these essential purposes, they have also left local governments without all the tools that many feel are necessary for local governments to establish and maintain healthy and vibrant economies.

Elimination of Redevelopment
The Governor initially proposed eliminating redevelopment agencies (RDAs) as part of the 2011-12 Budget, in an effort to redirect available property taxes from RDAs to cities, counties and school districts. The Governor's proposal was anchored by the perspective that the diversion of over $5 billion of property tax increment to redevelopment projects was no longer financially feasible, and such revenues should go to cities, counties and school districts to provide public services. While the Governor's proposal called for outright elimination, previous policies had directed payments from RDAs to local governments and local schools either through pass-through payments or one-time shifts of revenue.

Along with the dissolution legislation embodied in AB 26 X1 (Blumenfield), Chapter 5, Statutes of 2011, the Legislature fashioned an alternative proposal in AB 27 X1 (Blumenfield), Chapter 6, Statutes of 2011, that would have retained RDAs in exchange for voluntary payments to K-14 education. The California Redevelopment Association challenged the constitutionality of the measures adopted by the Legislature and signed by the Governor. The result of this litigation was that the Legislature's alternative proposal was deemed unconstitutional with the consequence that RDAs were eliminated. While the legislation, and subsequent statutory changes, did allow for some projects already initiated to continue and allowed for certain flexibility for the use of existing assets, the legislation dissolved RDAs and eliminated them as an on-going local economic development tool.

The elimination of RDAs resulted in substantial General Fund budgetary relief, with the amount expected to grow significantly over time as RDA debt is retired. Property tax increment that would otherwise have flowed to fund various redevelopment projects, has been instead channeled to local schools, reducing the amount of General Fund support required to fund the Proposition 98 guarantee. The Legislative Analyst's Office (LAO) indicates the additional property taxes going to schools as a result of the dissolution of RDAs will be $763 million in 2013-14 and rise to $1.9 billion by 2019-20. In the short-term, additional property tax support for K-14 education was generated by shifting existing RDA financial assets to schools.

Tax Incentives Reformulation

As a component of the 2011-12 budget, the Governor proposed outright elimination of the enterprise zone (EZ) credits and related tax incentives. The Governor's proposal was taken in the context of the state's fiscal situation at the time, and the proposal would have provided additional General Fund relief of several hundred million dollars annually. In addition to this rationale, the Administration based its proposal on the well-documented ineffectiveness of EZ incentives in generating new economic activity and a desire to move local economic development efforts from the state level to the local level. In May of that year, the Administration withdrew its proposal to eliminate EZ incentives and instead proposed a series of largely regulatory reforms for the program.

With the costs of the program, in terms of reductions in tax revenue to the state from the personal income tax and corporation tax, on track to soon pass $1.0 billion, the Governor again proposed significant reforms. As part of the 2013-14 budget, the Governor proposed a series of reforms that were intended to address some of the most egregious abuses of the program including: limiting 'retro-vouchering' of employees; requiring third-party verification of eligible employees; streamlining the vouchering process for designated employees; and, creating more robust zone audit procedures. The budget documents also noted that the Administration would pursue further EZ reforms through legislation.

The tax incentive measures that were agreed to through the budgetary and policy process called for a phase-out of the EZ incentives and the adoption of a sales tax exemption for equipment purchases, a hiring credit for designated areas, and targeted tax assistance exercised through the Governor's Office of Business and Economic Development (GO-Biz). The various measures were embodied in AB 93 (Committee on Budget), Chapter 69, Statutes of 2013; SB 90 (Galgiani), Chapter 70, Statutes of 2013; SB 100 (Committee on Budget and Fiscal Review), Chapter 360, Statutes of 2013; and, AB 106 (Committee on Budget), Chapter 355, Statutes of 2013. The principal components of the measures:

- Allow for an exemption from the state portion (General Fund and Education Protection Fund) of the sales and use tax, beginning July 1, 2014, and before July 1, 2022, for certain purchases by qualified purchasers that are used in designated activities. These combined rates are currently 4.19 percent. The exemption will be limited annually to the first $200 million of otherwise eligible purchases by a qualified purchaser.

- Initiate a new hiring tax credit under the personal income tax and corporation tax, from January 1, 2014 to January 1, 2021, for additional hiring of employees in defined geographic areas of the state. The hiring credit will be available in the geographic areas largely covered by the existing EZs and similar incentive areas, and includes a designation by GO-Biz of five pilot areas where eligible wages could be lower than required for the standard hiring credit.

- Establish the California Competes Tax Credit Committee (CCTCC). Consisting of the State Treasurer, Director of the Department of Finance (DOF), the Director of GO-Biz, and a representative of the Senate and Assembly, the CCTCC may approve written agreements to award California Competes tax credits through the personal income tax and the corporation tax, up to a specified amount.

- Eliminate EZ incentives and the New Jobs Credit. Programs related to tax incentives for activities in EZs and similar areas, will generally no longer be effective beginning January 1, 2014. However, with respect to the EZ hiring credit, for employees employed by the qualified taxpayer prior to January 1, 2014, the wages paid with respect to those employees will continue to qualify for the credit for any of the remaining portion of the five-year eligibility period. In addition, credits claimed, or earned, under the EZ program and carried-over from prior years, could continue to be applied to tax liabilities for up to 10 years.

GOVERNOR'S PROPOSAL:

As a means of addressing concerns related to local economic development, the Governor proposes expanding the tax increment financing tool utilized by infrastructure financing districts (IFDs) for a broader array of uses than those currently authorized. Under current law, IFDs are empowered to use tax increment financing to finance tax allocation bonds and use the proceeds for local development. IFDs may also exercise eminent domain powers while they are in existence. IFDs are less flexible than RDAs in the types of projects that they may fund, with financed projects generally limited to highways and transit projects; water, flood control, sewer, and solid waste projects; child care facilities, and libraries and parks. Furthermore, unlike RDAs, affected cities, counties, and special districts have the option to participate in the IFDs while schools cannot, resulting in no Proposition 98 impacts for IFDs. IFDs require a two-thirds vote by the affected electorate to be created.

The Administration proposes legislation that is designed to ease the formation of IFDs and broaden the application of this financing tool. Specifically, the proposal would:

- Expand the types of projects that IFDs can fund to include military base reuse, urban infill, transit priority projects, affordable housing, and associated necessary consumer services. The goal is to maintain the IFD focus on projects which have tangible quality-of-life benefits for the residents of the IFD project area.

- Allow cities or counties that meet specified benchmarks to create these new IFDs and issue related debt, subject to receiving 55 percent voter approval, instead of the current two-thirds vote requirement.

- Allow new IFD project areas to overlap with the project areas of the former RDAs, while strictly limiting the available funding in those areas to dollars available after payment on all of the former RDA's approved obligations.

- Maintain the current IFD prohibition on the diversion of property tax revenues from K-14 schools, which will ensure any usage will have no state General Fund impact, and require entities that seek to establish an IFD to gain the approval of the county, cities, and special districts that would contribute their revenue, including residual revenue, to the IFD.

The proposal notes that the expansion of the use of IFDs should not come at the expense of the continuing RDA dissolution process. If the establishing city or county formerly operated an RDA, the expanded IFD tool would be available to them only when they meet the following benchmarks:

- Receipt of a Finding of Completion from DOF, which demonstrates that the city or county has remitted all of the unencumbered cash assets of its former RDA to the affected taxing entities.
- Compliance with all State Controller's Office (SCO) RDA audit findings.
- Conclusion of any outstanding legal issues between the successor agency, the city or county that created the RDA, and the state.

ISSUES TO CONSIDER:

The initiatives adopted by the Legislature with respect to both the dissolution of RDAs and the reformulation of tax incentives have served to provide General Fund relief in the short-run in the hundreds of millions of dollars, and allowed for a focus of efforts on core services of state-wide interest. The elimination and reform of these programs will provide growing additional General Fund relief in the out-years in the low billions of dollars, as bonds secured by property tax increment under RDA law are retired and tax credits earned under the EZ program are used up. This will allow for additional investment in statewide programs benefiting education, infrastructure, public safety, and other activities.

The new tools made available under the tax incentive reformulation will provide some additional resources for local government. Specifically, the new hiring credit will provide incentives for employers to locate within certain areas that were former EZs, and the pilot projects will serve additional areas in need of development. However, these programs will be more difficult for employers to qualify for and be much more curtailed in terms of the level of state support in foregone revenues. The GO-Biz credits may be a useful statewide tool in particular circumstances with particular firms, but they will not necessarily address specific areas of the state most in need of development assistance.

Although these various policy changes have been successful in focusing revenues on essential state services, some suggest that they have also left local governments without the necessary tools to address issues related to economic development. The argument that the state's resources need to be concentrated for statewide services is a reasonable one. Just as reasonable is the position that additional tools need to be made available to local governments to address local concerns.

Numerous tools have been suggested as a means for local governments to generate the resources necessary for local economic development efforts without jeopardizing state financial resources. While the focus and the operations of RDAs and EZ tax incentives were very different, they both provided support for local economic development and are now no longer long-term options. Given this, there are a number of issues that are related to economic development and the situation in which local governments currently find themselves. Two of the most important of these issues are the status of the RDA wind-down and alternative local economic development programs.

Winding-Down Redevelopment

The process of winding down redevelopment was not expected to be a straightforward process without uncertainty and controversy. Yet, the extreme complexity of dissolving the program has befuddled many. In particular, allowing for the continuation of certain projects that meet pre-established criteria has been more complicated than most observers initially believed. As we noted last year, projects which are partially complete or require changes to existing agreements pose particular problems, and these problems have persisted through the past year. Local governments with various projects have raised questions regarding the application of the criteria, the consistency with which the criteria are applied, and what constitutes a reasonable level of state involvement with respect to local projects. Some local governments have expressed the view that the Administration has attempted to curtail projects in too aggressive a manner, given the intent of the enabling statutes, and sought to establish on-going state review of various projects.

AB 662 (Atkins) was one of the measures adopted by the Legislature to address some of these issues. For example, the bill would have clarified the flexibility of a successor to the RDA to enter into and alter contracts and agreements related to enforceable obligations, as long as additional tax increment is not committed to the project. The bill would also have allowed reasonable estimates and projections to be used to support payment amounts for enforceable obligations. The bill contained several other provisions that would have clarified the process for partially completed projects, provided flexibility to the RDA successors, and potentially paved the way for a less contentious process for the dissolution of RDAs. The bill was vetoed by the Governor, after Department of Finance indicated that unintended General Fund costs could occur. As confusion and conflict over the dissolution process continues, the Legislature may want to revisit these issues again, either in the budget or through policy committees, in order to assure that RDA dissolution continues on a fair and reasonable track consistent with legislative intent.

New Development Tools

The end of RDAs has prompted interest in developing a replacement program and a discussion of important elements that such a program might contain. There are some existing programs—business improvement districts (BIDs), infrastructure improvement districts (IFDs), property tax debt overrides, Mello-Roos financings, assessment levies, or other parcel taxes. However, none of these current local financing tools have all of the elements that made redevelopment so attractive and valuable to California cities and counties. Specifically, RDAs provided the sponsoring government with considerable resources and did so without requiring the approval of local voters or business owners; directly imposing increased costs on local residents or business owners; or requiring additional voter approval prior to issuing debt. Of course, they also caused a substantial diversion of property taxes from local schools and increased pressure on the General Fund.

There have been alternative proposals that allow local discretion in community development efforts and provide accompanying fiscal tools, but eliminate the fiscal exposure to the state. We noted that last year, two such measures—SB 1156 (Steinberg) and AB 2144 (Pérez, et al)—were adopted by the Legislature but vetoed by the Governor on the basis that the time was not right, given the continuing RDA dissolution process. In 2013, SB 1 (Steinberg) took a related approach with the proposed establishment of investment authorities that would be allowed to receive a non-school property tax increment if agreed to by the local government that would otherwise have received the property tax revenue. This measure was not ultimately adopted by the Legislature.

Budget Proposal Addresses Some Local Concerns
The Governor's proposal is an attempt to address some of the local economic development needs. By expanding the nature of the types of projects that IFDs can finance, the flexibility and usefulness of this tool is improved. However, it is not intuitively apparent why certain other public improvements could not be included as well, or more decision-making left to local discretion in terms of projects to fund. Similarly, lowering the voting threshold to 55 percent approval will make the IFD tool more accessible; however, other legislative proposals—such as SB 214 (Wolk)—would have eliminated the voter requirement for a city or county to create an IFD. The Governor's veto message for SB 214 indicated that expanding the scope of IFDs was premature, but expressed no concern regarding the vote elimination.

The Governor's proposal ties the expanded and reformed IFD to the status of RDA wind-down and the state budget, even though the actual linkage is rather indirect, at best. In addition, the proposal specifies that local governments meet DOF's criteria regarding compliance with SCO audits and legal proceedings involving the state. Given that many RDA dissolution issues are still winding their way through the court system, the revised IFD offered by the Governor is not likely to have widespread application in the near future. In addition, the proposed requirement that local governments comply with SCO audits, while reasonable on its face, can be a significant hurdle for local governments, since only 115 of approximately 400 audits have even been completed. Given this, the Legislature may want to consider adjusting these compliance requirements, while retaining their overall spirit.

In addition, there may be some rationale for state support for local economic development. This must ultimately hinge on getting the state's budget on a strong fiscal track and be measured against other budgetary demands. In some cases an argument may be made for state support for projects of a regional or statewide benefit—such as transportation improvements, housing, or open space—or joint projects that benefit local schools in some manner. Such state support could be based on grants or loans, or possibly by using a pre-designated fixed amount of property tax increment, or an equivalent amount derived from state resources. Projects eligible for some degree of state support could be selected based on the degree to which they meet a certain level of state or regional impact—with greater support for those with a higher degree of regional or state impact.

Local Government Mandates

BACKGROUND:

The proposed funding for non-education mandate payments to local governments is included in the budget of the Commission on State Mandates (Commission). The Commission is responsible for determining whether a new statute, executive order, or regulation contains a reimbursable state mandate on local governments, and for establishing the appropriate reimbursement to local governments from a mandate claim. The Constitution generally requires the state to reimburse local governments when it mandates that they provide a new program or higher level of service. Activities or services required by the Constitution are not considered reimbursable mandates. The Constitution, as amended by Proposition 1A of 2004, generally requires that the Legislature either fund or suspend local mandates. In most cases, if the Legislature fails to fund a mandate, or if the Governor vetoes funding, the legal requirements are considered suspended pursuant to the Constitution. However, there are two exceptions to this rule:

- Payments for mandate costs incurred prior to 2004 can be repaid over time, but statutorily required to be fully paid by 2020-21.

- Payment of costs of labor relations-related mandates may be deferred while still retaining the mandate's requirements.

Mandate reimbursement claims are filed with the Commission for the prior fiscal year—after that fiscal year is completed and actual costs are known. The state pays the mandate claims in the following fiscal year. For example, local costs incurred in 2012-13 are reported and claimed in 2013-14, and the state will reimburse locals for these costs as part of the 2014-15 budget. Suspending a mandate does not relieve the state of the obligation of reimbursing valid claims from prior-years, but it does allow the state to defer payment. For example, several elections-related mandates were suspended for the first time in the 2011-12 budget. This means the activities for locals were optional in 2011-12 and locals cannot claim reimbursement for any new costs incurred in 2011-12. However, the mandate claims for these costs in 2009-10 and 2010-11 are still due—either over time or all at once in a year when the mandate suspension is lifted.

The state owes local governments approximately $1.8 billion in non-education mandate payments. Of this, about $900 million (which includes interest of $120 million) is associated with pre-2004 mandate claims. The Governor proposes paying off the pre-2004 mandate costs in 2015-16 and 2016-17 as part of his Wall of Debt elimination plan.

GOVERNOR'S PROPOSAL:

Funded Mandates

The Governor's mandate proposal is a continuation of the status quo in terms of mandates in effect and mandates not in effect. The budget proposes expenditures of $38.1 million ($35.5 million General Fund) related to non-education mandates, which includes $1.9 million for the staff of the Commission. The budget would continue to fund the 13 mandates that were kept in force for 2013-14, the payments on which constitute the bulk of the General Fund cost. The most significant cost change is for the mandate regarding Sexually Violent Predators, which declined by over $14 million due to a reduction in activities deemed to be reimbursable by the state as a result of the passage of Proposition 83 in 2006 (Jessica's Law). The mandates funded in the budget all relate to public safety or property taxes and are listed in the following table.

Mandate Funding in Governor's Budget
General Fund
(Dollars in Thousands)

Mandate Title	Amount
Allocation of Property Tax Revenue	$520
Crime Victim's Domestic Violence Incident Reports	175
Custody of Minors-Child Abduction and Recovery	11,977
Domestic Violence Arrests and Victim's Assistance	1,438
Domestic Violence Arrest Policies	7,334
Domestic Violence Treatment Services	2,041
Health Benefits for Survivors of Public Safety Officers	1,780
Medical Beneficiary Death Notices	10
Peace Officer Personnel Records	690
Rape Victim Counseling	344
Sexually Violent Predators	7,000
Threats Against Police Officers	3
Unitary Countywide Tax Rates	255
Total	**$33,567**

Budget Savings

The budget incorporates a total of $887.2 million in savings from maintaining mandate suspensions or deferring payment of claims. The savings breakdown is as follows: (1) $301.1 million from deferring payment of post-2004 mandate claims for mandates that have since expired or are otherwise not in effect; (2) $513.8 million by continuing the suspension of certain local mandates and the initial suspension on two new mandates with a statewide cost estimate (Local Agency Ethics and Tuberculosis Control); and (3) $72.2 million from deferring payment on employee-rights mandates in effect. In prior years, there have been proposals to repeal certain mandates, but no such repeal is proposed in the budget. Repealing mandates does not offer any additional budget savings relative to suspension; however, if the mandate will otherwise be suspended indefinitely, the repeal of statutory provisions cleans up the code, improves statutory transparency, and provides more certainty to local governments.

ISSUES TO CONSIDER:

Determining whether a particular requirement is a state-mandated local program, and the process by which the reimbursable cost is determined, is an extensive, time-consuming, and multi-stage undertaking. State and local officials have expressed significant concerns about the mandate determination process, especially its length and the complexity of reimbursement claiming methodologies.

Delays in the Process
According to a Legislative Analyst's Office (LAO) review a few years ago, it took the Commission over five years to complete the mandate determination process for a successful local government test claimant. The review of new mandates claims found that the Commission took almost three years, from the date a test claim was filed, to render a decision as to the existence of a state-reimbursable mandate. The Commission took about than another year to adopt the mandate's claiming methodology, and almost another year to estimate its costs and report the mandate to the Legislature. Because of the current backlog, the delay can be even longer. The Commission has submitted a budget change proposal for 2013-14 to address the backlog issue and speed up the mandate process but the resulting improvements are still not expected to meet the statutory time frame.

This lengthy period presents several difficulties that affect both the state and local governments. Among the most important are flip sides of the same coin, specifically:

- Local governments must carry out the mandated requirements without reimbursements for a period of some years, plus any additional time associated with development of the mandate test claim, appropriation of reimbursement funds, and the issuance of checks.

- State mandate liabilities accumulate during the determination period and make the amount of state costs reported to the Legislature higher than they would be with an expedited process. Policy review of mandates is hindered because the Legislature receives cost information for a mandate years after the debate regarding its imposition.

Transparency and Reform
One of the more troubling aspects of mandate law, and the mandate process, is the lack of transparency regarding the obligations of local governments. The process of mandate suspension, which allows the state to not fund the mandate, leaves in place the statutory requirement regarding the activity. Consequently, a reading of the relevant statute would indicate that such a mandated activity is required to be carried out by local governments; however, unless the mandate is funded in the budget, it is deemed to be suspended, relieving local governments of the obligation to conduct the activity. The LAO has gone on record regarding the confusion and misunderstanding caused by this inconsistency for local governments and the public.

There have been two recent attempts to reconcile this information and eliminate the inconsistency with respect to suspended mandates. As part of the 2012-13 budget, the Governor proposed repealing 32 of 56 long-suspended mandates. Although the proposal was heard in appropriate subcommittees, ultimately the Legislature did not act on the proposal through the budget process, with the general view expressed that the policy process was the appropriate venue.

As part of the 2013-14 budget, the Governor approached the mandate issue with a more nuanced proposal and the Legislature, to a large extent, agreed to this more surgical approach. In budget trailer bill, the Administration proposed ‘making permissive’ five mandates that had been suspended at least since 1990, consisting of: Adult Felony Restitution, Minors’ Victims Statements, Deaf Teletype Equipment, Pocket Masks, and Domestic Violence Incident Reporting. All were initially approved to be made permissive, but the Domestic Violence Incident Reporting statutory language was subsequently reinstated. The nature of the discussion in the media clearly indicated confusion as to the effect of mandate suspension and a lack of awareness that reinstating the statutory language would have no practical impact on local government activities. The process involving mandated portions of the Open Meetings Act displayed a similar lack of complete understanding of the mandate process.

Other Issues

In addition to the delays that characterize the mandate review and determination process, there are other significant issues. On the cost determination side, since most mandates relate to expanding existing programs (rather than instituting completely new ones), local governments have difficulty in measuring the marginal costs. The complexity of the claiming methodologies means local governments’ claimed costs frequently are not supported by source documents showing the validity of such costs, or are not allowable under the mandate’s reimbursement methodology. Accordingly, the State Controller's Office has disallowed a significant number of reimbursement claims over the last few years, leading to frequent appeals, more uncertainty and mounting bills.

Last year, the Administration indicated in the Governor’s Budget that it would pursue policies to improve the mandate process, including deferring decisions to local government decision-makers and allowing for maximum flexibility. The proposal to make permissive was part of this effort. In addition, the LAO has in the past recommended a ‘best practices’ approach for various local activities and requirements. The Legislature could consider these approaches and compare their advantages to policies adopted at the state level and the likely costs of such mandated programs.

Budget Reserve Funds

BACKGROUND:

As the state continues its economic and budgetary recovery from the Great Recession, there has been increased focus on how the state might cushion itself against severe budgetary stress in the future. As a result of the economic recession, beginning in fiscal year 2007-08 and continuing through 2011-12, the state was forced to embark on a series of maneuvers designed to balance the state budget. Lacking a meaningful reserve during the last several years of fiscal stress, the state has been forced to rely on several other methods to balance its budget, including mid-year expenditure reductions, internal and external borrowing, tax and fee increases, and contingent expenditure reductions—also known as 'trigger cuts.' An earlier period of fiscal stress, beginning in 2002, relied heavily on budgetary borrowing, leading to creation of the Wall of Debt. Each of these approaches to balancing the budget has resulted in significant political, economic and fiscal costs.

Instead of these costly approaches, one of the significant alternative means through which budgetary balancing can be achieved is through establishing and maintaining an adequate budget reserve. Such a reserve—known as a budget stabilization account or a rainy day fund—can simultaneously address multiple budget and policy goals, including:

- Protecting expenditure programs during economic downturns, thus retaining the integrity and continuity of essential government-financed programs.

- Reducing ongoing spending commitments that cannot be sustained over the long-term, avoiding over-commitments and boom and bust funding.

- Avoiding cyclical reinforcing budget reductions and cutting programs that would otherwise provide economic stimulus and activity during economic downturns.

- Providing permanent improvement in the financial condition of the state by improving credit ratings and lowering borrowing costs.

- Allowing budget planning to occur using reasonable revenue projections by addressing the 'risk asymmetry' associated with fiscal forecasting.

Establishing and maintaining a budget stabilization fund is not without its own identifiable drawbacks, including the possibility that such funds could alternatively be used for such items as capital spending or tax reductions. In addition, it is highly unlikely that a reasonably funded reserve would ever be adequate to completely address fiscal challenges of the magnitude experienced in the last few years. Still, most states maintain some type of budget stabilization account, as discussed below, and state fiscal experts are virtually unified in the belief that such set-aside funds should be established and maintained as one of the tools available to states to deal with budget uncertainty. The question for the Legislature is the design of such a budget reserve, given alternative use of funds, the state's revenue system, and political realities.

State Approaches to Budget Reserves

According to the National Conference of State Legislatures (NCSL), almost all (47) states have established budget reserve funds. Only Arkansas, Kansas, and Montana do not maintain such reserves. Budget stabilization funds vary in design and purpose from state to state, but their underlying role is to receive deposits when capacity to generate revenue is strong, and use such funds for budgetary relief when revenue generation is weak.

State budget stabilization funds are created either through statutory or constitutional authorization. While most states' budget stabilization funds are statutorily created, 11 states (Alabama, Alaska, Delaware, Louisiana, Missouri, Oklahoma, Oregon, South Carolina, Texas, Virginia and Washington) have constitutionally authorized funds. Five states (Alabama, Alaska, California, Oregon and South Carolina) have one statutorily and one constitutionally authorized budget stabilization fund. Eight states (Alabama, Alaska, California, Iowa, New York, Oregon, South Carolina and South Dakota) maintain at least two separately operating budget stabilization funds. States have often created multiple funds to house certain sources of unanticipated revenues—for example, a one-time carve-out of oil and gas royalty funds or money received from mineral extraction litigation and dispute settlements. In addition, multiple funds can address differences in revenue sources, since personal income, corporate income, sales, motor fuels, and severance taxes all react differently to fluctuations in economic and business cycles.

Generally, deposits to a budget stabilization fund stem either from a line-item appropriation in the budget or from a portion of a fiscal year-end surplus. Some states' constitutional or statutory language prescribes what percentage of the surplus must be deposited into the budget stabilization fund. Other states require a deposit of a determined percent of general state revenues each fiscal year—regardless of economic conditions—to the budget stabilization fund until the balance reaches a specified percent of estimated general fund revenues. In other states deposits are triggered when state revenues or economic growth exceed specified levels.

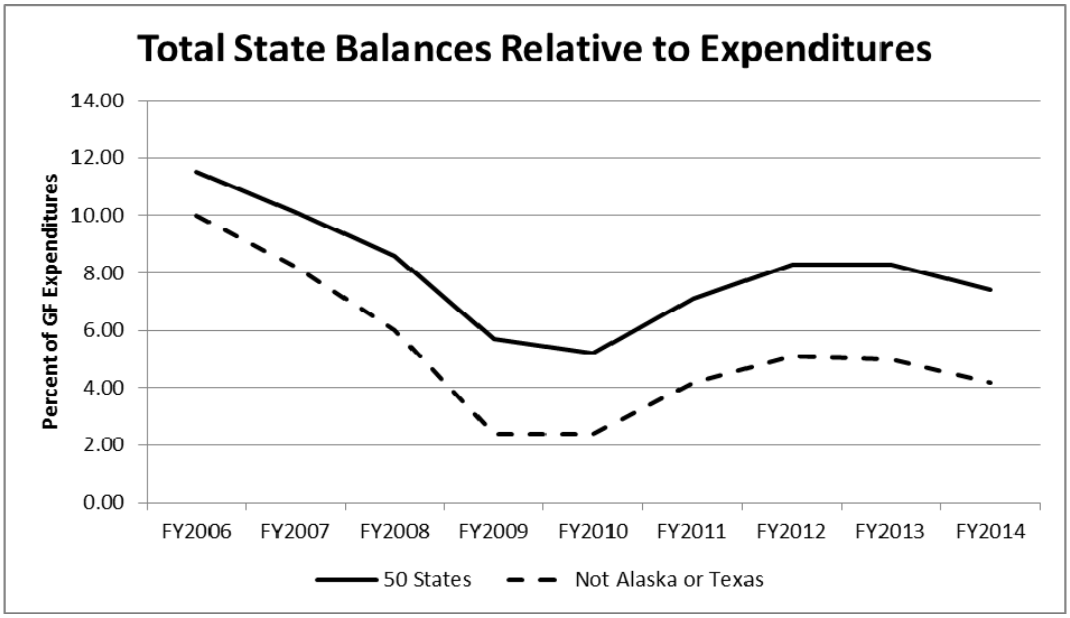
Budget stabilization funds exist to provide stability to state budgets experiencing economic fluctuations; 'revenue shortfall' or 'budget deficit' are the most common conditions for using budget stabilization funds, with 35 states using such a test. Typically, withdrawals are made, pending approval of the legislative body, when revenues are insufficient to meet budget obligations. In 16 states, authorization for a withdrawal requires a supermajority of the legislature. Other states give their governors authority to make transfers from their budget stabilization funds to prevent cash shortfalls that occur during the fiscal year. In a handful of states, withdrawals are triggered when anticipated revenues or other economic indicators fall below specified levels, for example, a withdrawal in order to meet cash flow deficits or when the annual growth rate in personal income is below a certain level. In the event a withdrawal is made, some states have in place a cap, based either on the size of withdrawal or in relation to the fund balance.

Fifteen states require withdrawals to be repaid to their budget stabilization fund. The terms and conditions under which withdrawals must be repaid typically contain a due date for repayment or a statutorily prescribed repayment schedule. For example, in some states, withdrawals must be repaid by the end of the fiscal year in which the withdrawals occurred. In other states, withdrawals must be repaid within a certain number of years of the date the withdrawals occurred. Some outline specific schedules for repayment while others specify that such repayment is to be made only after an upturn in the economy or fiscal position.

The great majority of states limit the size of their budget stabilization funds by capping the funds in relation to state general fund revenues or appropriations. For example, New Jersey limits its reserve to five percent of total anticipated general fund revenues, while Connecticut's cannot exceed 10 percent of net general fund appropriations for the fiscal year, and Minnesota caps its budget reserve and cash flow accounts at specific dollar amounts. Historically, a reserve capped at five percent of expenditures has been considered the standard recommended level. Among other entities, NCSL and the major rating agencies have suggested or used this as the standard. However, appropriate levels vary according to individual state circumstances, specific economic conditions, revenue profiles, or access to atypical revenue sources. Many analysts caution against "a one-size-fits-all' approach because of the "heterogeneity among state economic conditions and tax codes." States with elastic revenue sources, such as California, with its progressive income tax system, might opt for larger balances because revenues from this source tend to display greater fluctuations during economic swings. Since 2000, and especially since the sharp economic downturn, many states have raised the percentage caps on their funds, allowing for their funds to play a larger role in the event of economic and fiscal downturns.

Use of Budget Stabilization Funds.

The recent economic and fiscal downturn, from which most states are slowly emerging, provides important lessons regarding design of reserve accounts. Based on surveys by the National Association of State Budget Officers (NASBO), total balances as a percent of General Fund expenditures had reached 11.5 percent in 2006, but plummeted to 5.2 percent by 2010 (and less than half that if Alaska and Texas are excluded). The change in the level of budget reserves is shown in the figure below.



Source: NASBO Fiscal Survey of States

Researchers from NASBO, academia, and other organizations have been able to draw several conclusions regarding the role of reserve funds during period of economic decline and fiscal stress. Among the most important of these conclusions are:

- Reserve funds played an essential role in cushioning the effect of revenue downturns. Many states relied on reserve funds to avoid more severe cuts to essential state services and programs.
- Reserve funds were not fully sufficient to withstand the fiscal impacts of the recession. Given the severity of the downturn, this is not surprising, but suggests that larger reserves may be warranted.
- The appropriate level for a reserve fund depends partly on the revenue system. States with more volatile or elastic revenue sources should hold more in a reserve to withstand economic downturns.
- Sources of reserve funds should be considered prior to using them. Using reserves based on required regular contributions, as opposed to one-time windfalls, poses less of a risk of structural imbalance.
- State revenue collections have become more volatile in recent years. States benefit from elastic revenue sources, such as the income tax, but these sources have become more volatile, suggesting that capital gains or other revenues could be used as reserve deposits.
- Budget reductions generally occur along with the use of reserves. Combining the use of budget reductions and reserves can assist in maintaining the most critical areas, while preserving the ability to tap into reserves if a downturn lasts for an extended period.

California's Budget Reserves
Article XIII B, Section 5.5 of the California Constitution directs the Legislature to establish a 'prudent' reserve that it deems reasonable and necessary. However, the Constitution does not specify the size of the reserve or the conditions under which funds must be placed into the reserve. The reserve for 2013-14 was budgeted at $1.1 billion upon the adoption of the budget, and later reduced to approximately $700 million based on additional budget actions related to corrections. This general reserve is known as the Special Fund for Economic Uncertainties (SFEU).

In addition to this regular annual reserve, voters established an additional reserve account, the Budget Stabilization Account (BSA), with the passage of Proposition 58 in March of 2004. The proposition requires that three percent of estimated annual General Fund revenues be transferred into the BSA, beginning in 2008-09 and continuing thereafter. Transfers to the BSA are required until the account balance reaches $8.0 billion or five percent of General Fund revenues, whichever is greater. The annual transfer requirement is in effect whenever the balance in the BSA falls below either the $8.0 billion or the five percent threshold. During the time the Economic Recovery Bonds (ERBs) are outstanding, 50 percent of the annual transfers to the BSA are to be used for paying off the bonds.

Spending from the fund may occur by transferring moneys from the BSA to the General Fund through a majority vote of the Legislature and approval of the Governor. In addition, there is significant flexibility regarding transfers to the BSA, with the ability to suspend or reduce such transfers for a fiscal year by an executive order. The state deposited funds to the reserve twice (in 2006-07 and 2007-08) but subsequently used the funds during each of those years. The state has suspended the transfer of moneys to the BSA since that time and the BSA currently has a zero balance. The budget proposed by the Governor includes a deposit of three percent of General Fund revenues, to bring the balance in the BSA to $1.6 billion.

Assembly Constitutional Amendment 4
In 2010, the Legislature approved ACA 4 (Gatto and Niello), Chapter 174, Statutes of 2010, a Constitutional amendment establishing an additional state reserve requirement, for placement on the June 2012 ballot. This election date was later changed pursuant to SB 202 (Hancock) Chapter 558, Statutes of 2011, to place the amendment on the November 2014 ballot.

The amendment would involve tightening up certain aspects of the BSA account requirements, including the following:

- Limit the ability of the Governor to suspend three percent annual transfers to the BSA.

- Increase the target amount for the BSA from five percent to 10 percent of revenues, and eliminate the $8.0 billion threshold.

- Divide evenly the three percent transfer into the BSA and Supplemental BSA (capital and debt service).

- Limit use of 'unanticipated revenues' to Proposition 98 (K-14 education) obligations and transfers to BSA.

- Restrict withdrawals from the BSA to emergencies and years of insufficient revenue, not to exceed 50 percent of fund balance.

- Provide a limited menu of uses for revenues amounts that are received over the cap, including additional deposits to BSA, debt reduction, or tax rebates.

Legislative Analyst's Office Perspective
The Legislative Analyst's Office (LAO) has been consistent in its view that the state should increase the level of its reserves, urging the incorporation of regular contributions, as well as one-time revenues in this effort. In its previous reviews of the state's reserve policies, the LAO has recommended building off of the framework of Proposition 58, which established the BSA, and layering additional requirements that would make the establishment and maintenance of the reserve more robust. In general, the LAO's views are congruent with many of the changes to BSA that are found in the current version of ACA 4; however, there are certain aspects of the ACA 4 proposal about which it has raised concerns.

The LAO has indicated that targeting a 10 percent reserve would be a good long-term goal, even if the process occurs over a number of years, suggesting that the state's volatile revenue structure is an argument in favor of this size of a reserve. In addition, the LAO has noted that the funds in the BSA could be made less accessible, for example by requiring the passage of a separate bill (outside the budget process) or requiring a super majority to approve the withdrawal of funds. It also views favorably the effort to transfer excess revenues into the BSA, but recommends that a relatively high threshold be reached before such 'excess funds' are directed to the reserve.

The LAO has also warned against overly-proscriptive budgetary formulas—especially if placed in the Constitution—warning that such formulas can have significant unintended impacts, are often based on imperfect information, and can result in a diminution of legislative prerogative and a shift in budgetary authority to the executive branch. For example, LAO notes in particular the potential issues related to ACA 4's linear regression formula, which—while mechanically straightforward—nevertheless requires the incorporation in inputs, adjustments, assumptions—all compiled by the Administration. It cautions that "…(while) the estimates would be subject to legislative review, future governors may well premise their approval of state budget bills on legislative agreement with their administrations' formula calculations."

GOVERNOR'S PROPOSAL:

In the budget, the Governor proposes a constitutional amendment to create a new reserve fund—termed the Rainy Day Fund (RDF)—which largely builds off of the existing BSA. In addition, the Governor proposes a payment of three percent to the existing BSA, as a beginning to building the state's reserves. There are no particularly novel concepts in the proposal, as virtually all the components have been discussed and proposed in various permutations since the early

2000s. The proposal is nevertheless a sound contribution that can help frame the discussion of a budget reserve. The Governor's proposal for the RDF includes the following requirements:

- Basing deposits on when capital gains revenues rise to more than 6.5 percent of General Fund tax revenues.
- Creating a Proposition 98 reserve, whereby spikes in funding would be retained for future years of decline, smoothing school spending to prevent damaging cuts, while making no changes to the Proposition 98 guarantee.
- Doubling the maximum size of the Rainy Day Fund from five percent to 10 percent of revenues.
- Allowing supplemental payments to the Wall of Debt, or other long-term liabilities, in lieu of a year's deposit.
- Limiting the maximum amount that may be withdrawn during the first year of a recession to half of the fund's balance, ensuring that the state does not overly rely on the fund at the start of a downturn.

The Governor indicates that Proposition 58's BSA has several weaknesses, such as no restrictions on when deposited amounts can be withdrawn and the requirement to make deposits in both lean and abundant years. He also notes that the proposed ACA 4 suffers from other drawbacks, including not giving an option to the state for paying off liabilities, not addressing the sharp ups and downs of Proposition 98 requirements, and basing deposits on the long-term trend rather than capital gains spikes.

LAO's preliminary observations of the Governor's proposal are consistent with its historical views. While generally complimentary of the proposal, LAO notes again the state's complex constitutional budget rules which "are difficult to fathom," likely unintended consequences of formulaic budget requirements, lack of adequate real-time data and other information, counterintuitive interactions with Proposition 98 requirements, and a potential shift in power to the executive branch.

ISSUES TO CONSIDER:

California's fiscal experience during the sharp economic downturn has highlighted the value of establishing and maintaining an adequate budget reserve. While the experience in other states indicates that a reasonably-sized reserve would be unable to absorb all of the fiscal stress that can result from an extended and severe economic downturn, a reserve can be structured to help provide a cushion for such budget blows. Used in tandem with other budget solutions, a reserve can be a valuable addition to responsible budgeting. In addition, California's particular revenue structure—with its comparatively large reliance on volatile revenue streams—suggests that a significant reserve fund would be of sizeable benefit to the state.

The Governor's proposal to strengthen the state's reserve policy through the establishment of a new RDF is a welcome contribution and provides a reasonable starting point for further discussions relating to the specific structure of a reserve. However, the proposal remains largely conceptual in nature, and as implied by the Governor's discussion regarding the problematic features of Proposition 58 and ACA 4, details matter immensely in this technical area. The particular design characteristics of a reserve are vital considerations in order to ensure that an established fiscal cushion is adequate, accessible and functional. The constitutional nature of the proposal warrants its careful consideration and extensive vetting, especially given the relative difficulty of making alterations in response to changing circumstances. Utilizing Administration's top-level criteria in characterizing of its RDF proposal, the Legislature may want to consider the following questions and issues:

Source of Fund Deposits

Under the Administration's proposal, the source of RDF deposits is limited to a slice of personal income tax revenues related to capital gains realizations. Given the volatility and importance of capital gains taxes for the state fisc, this is not unreasonable, but may be too limited as a source of funds. As noted in this discussion, there can be numerous sources of unexpected or volatile revenues.

- Dividends and business income together contributed about as much to the General Fund over the long-term as capital gains income, and in previous years—although not the most recent period—they can be just as volatile. If the federal government were to alter its treatment of dividend income to lessen what some consider its double taxation (at the corporate and the personal income levels), this could increase these volatile income sources relative to capital gains. Similarly, bonus income, which is included in the wages and salaries income component, has also shown significant volatility in the past.

- Corporation tax revenues have become exceptionally difficult to forecast, with substantial variation between expected and actual liabilities. In fact, the DOF has recently acknowledged the large swings in tax liabilities related to this tax. The estimating difficulties have increased in recent years as the relationship between corporate income and tax liabilities has increasingly diverged. Changes in the behavior of multi-state corporations and changes in tax treatment of earnings can result in wide swings in corporation income.[1]

- Legal judgments can result in sizeable revenue or expenditure swings. In recent years, the state has seen increases in expenditures pursuant to legal proceedings related to corrections, various budget cuts, and potential tax refunds. But it is also possible these one-time impacts could work in a positive direction. If the state were to prevail in a significant legal proceeding—perhaps related to the dissolution of redevelopment agencies—this could free up additional unexpected resources or provide General Fund relief that could allow for additional reserve deposits.

[1] As one example, it is estimated that between $1.0 and $2.0 trillion in corporate earnings sits in off-shore holding companies. If the federal government were to institute either a tax 'holiday' or provide a one-time reduction in tax rates that stimulated the repatriation of these earnings, this action would likely trigger a significant upswing in corporation earnings and a corresponding increase in the state tax liability of California corporations.

These and similar issues related to one-time, unexpected or volatile revenue considerations may warrant a consideration of broadening the potential sources of funds required to be deposited to the reserve.

Capital Gains Deposits

The Administration's proposal to calibrate fund deposits based on capital gains revenues in excess of 6.5 percent of the General Fund raises a number of complicated issues, specifically:

- The threshold of 6.5 percent is actually below the average contribution of such revenues to the General Fund of about seven percent since the mid-1990s. Given this, the 6.5 percent threshold could have the impact of depressing expenditures below the long-term average. There is also no guarantee that 6.5 percent—or any other specific threshold—will be the 'magic' number in the future. For example, if capital gains were to shrink as a revenue source relative to other forms of alternative income—such as bonuses—the designated threshold might well warrant a similar downward adjustment.

- Using capital gains revenues as a percent of General Fund revenues ignores the role of tax treatment of capital gains realizations. If California were to tax certain such gains preferentially (through some variant of the Qualified Small Business Stock exclusion), this would have an impact on General Fund revenues by driving down the associated tax liability on such gains and potential reserve deposits. Furthermore—and perhaps more important—changes at the federal level (over which the state has no direct control), such as altering what can be considered as 'capital gains,' could substantially alter the capital gains tax base in California.[2]

- Revenues from taxpayers with capital gains are not known until at least 18 months after the state receives such revenues. In fact, most taxpayers with capital gains file extended returns and as a result such information is likely not available until 24 months after the revenues are received. This delay implies that deposits to the fund would need to be estimated, with a 'true-up' mechanism instituted to address shortfalls or excess deposits. The timing problems are easily discernable. If a true-up calculation required additional deposits to the reserve years after an underestimate, and the state was in a fiscally challenging position, the required 'true-up' could add to the fiscal stress. Alternatively, if the estimated deposit to the reserve was too high, this would result in an 'opportunity cost' for not having used those inappropriately reserved funds for a higher and better use.

[2] For example, so-called 'carried interest', representing a portion of the return based on capital investment by private equity firms and hedge funds in an investment fund, is now generally treated as a capital gain and consequently receives preferential tax treatment at the federal level. Many tax analysts indicate that only a portion of carried interest represents a 'true' capital gain, with the larger portion of carried interest representing labor compensation that should be taxed as ordinary income (see, for example, *'The Tax Policy Briefing Book,'* Tax Policy Center of the Urban Institute and Brookings Institution). If proposals to disaggregate the returns directly related to capital contribution from the portion that is ordinary income are adopted, this would likely reduce capital gains and increase ordinary income. Since California generally conforms to federal tax law, this would result in a similar diminution of capital gains and the associated state tax liability.

Supplemental Payments
The Administration's proposal allows for supplemental payments to the state's budgetary debt and long-term liabilities, but does not provide any parameters or limitations under which such alternative use of funds could occur.

- Given the Administration's itemization of such liabilities (which includes deferred capital maintenance) it is not clear whether or not capital investment and infrastructure might be allowed under this exception, and if so, what types. One approach might be to develop a hierarchy of priorities that could be funded through this mechanism of supplemental payments.

There are a multitude of other important issues related to the structure of the proposed RDF that warrant close legislative scrutiny, including:

- The flexibility and size of the Proposition 98 reserve, and how this fund would relate to the general reserve and be allocated during periods of fiscal stress.

- The appropriate maximum size of the reserve, especially given that no practically feasible amount would have provided adequate cushioning for the precipitous revenue declines experienced over the last five years.

- How binding would be the limitations on fund withdrawals, including whether emergencies such as natural disasters could result in the release of funds in excess of the 50 percent ceiling.

The issues raised above can certainly be addressed through both policy and additional detailed mechanisms; however, it is important to acknowledge these complex issues 'up-front' and address them in a direct manner. Generally, additional reserve safeguards and mechanisms can reduce the amount of legislative and administrative discretion, but also make the undertaking and eventual approach to establishing a reserve a more complicated endeavor than it otherwise would be. More fundamentally, an unduly prescriptive policy—particularly a constitutional one—can result in constraints that inhibit the state's ability to respond to unexpected and unforeseen fiscal disruptions in the future. In the end, the design of a functional budget reserve should carefully balance legislative discretion and administrative safeguards.

One approach that the Legislature could consider is to work from the foundation established by Proposition 58. The Governor, after all, is facilitating the implementation of the BSA established by the proposition by depositing three percent of General Fund revenues into the reserve (and using half this amount to pay off the ERBs). Certain additional features could be implemented to address the magnitude and frequency of BSA withdrawals, the required process for such withdrawals to occur, as well as the allowable frequency of deposit suspensions. In addition, the Legislature could consider whether the three percent of General Fund is adequate, or should take into account other factors, for example, the receipt of one-time funds through an 'April Surprise.'

Establishing and maintaining a budget reserve is a both a technical and a political exercise that involves balancing demands of current expenditures with the need to set funds aside for a fiscal 'rainy day.' California's spending demands and requirements are substantial, and include restoring various human services programs, rebuilding and enhancing public education, and improving the state's physical infrastructure. Given these competing demands, the Legislature should carefully weigh the appropriate design of a state reserve, and in particular, give careful consideration to how to provide funding for the reserve, the level of such funding, the requirements for withdrawing funds, and the timing and process for replenishing the fund.

General Obligation Bonds

BACKGROUND:

The state uses general obligation bonds (GO bonds) to borrow funds for spending—primarily for infrastructure and other capital investments. The use of bonds to accelerate capital projects is a commonly-used practice of government entities. Bonds must be approved by voters and bond proceeds are either continuously appropriated (immediately available for expenditure) or require an appropriation from the Legislature. All bond debt service is continuously appropriated and, therefore, not appropriated in the annual budget bill. The state has $80.7 billion in outstanding GO bond debt (including self-liquidating bonds such as the Economic Recovery Bonds [ERBs]). Another $28.3 billion in bonds are authorized, but remain unissued. In most instances, bonds are sold at different lengths of maturity such that repayment is spread over about 30 years. The chart below indicates the authorized, but unissued, reservoir of bonds.

General Obligation Bonds Authorized and Not Issued
(Dollars in Millions)

Authorized Bond Program	Unissued Amount
Prop 1A of 2008: High-Speed Rail	$9,244
Prop 1B of 2006: Transportation	7,023
Prop 84 of 2006: Safe Drinking Water	2,958
Prop 1E of 2006: Disaster Prep and Flood Prevention	1,819
Prop 71 of 2004: Stem Cell Research	1,560
Prop 46 of 2002 & Prop 1C of 2006: Housing	1,392
Prop 55 of 2004 & Prop 1D of 2006: Education Facilities	1,201
All other	3,134
Total	**$28,331**

The state generally goes to market to sell GO bonds twice annually—once in the spring and once in the fall. Bond structures are often tailored to meet market demand and investor appetite. This tailoring includes tinkering with variables such as fixed and variable rates, call features and premiums, and various security enhancements. Bonds are sold in amounts necessary to meet expenditure needs, plus an additional cash cushion to account for flexibility regarding how fast projects will expend funds and uncertainty about the timing of the next bond sale. As of December 2013, about $4.5 billion in bond cash was on-hand from prior bond sales, as shown in the following table.

General Obligation Bonds Current Cash Proceeds
(Dollars in Millions)

Authorized Bond Program	Bond Proceed Cash Remaining as of Dec 2013
Prop 1B of 2006: Transportation	$921
Prop 1E of 2006: Disaster Prep and Flood Prevention	896
Prop 84 of 2006: Safe Drinking Water	567
Prop 1C of 2006: Housing	293
Prop 1D of 2006: Public Education Facilities	354
Prop 50 of 2002: Water Security	447
Prop 13 of 1996: Clean Water and Watershed	204
All others	817
Total	**$4,499**

GOVERNOR'S PROPOSAL:

General Obligation Bonds and Debt Service
Expenditure of bond proceeds is reflected in the budgets of individual departments, with the payment of bond debt service consolidated in Item 9600 in the Governor's budget. It is the repayment of bond debt that is reflected as a General Fund expense. Some bond costs are offset by special funds or federal funds. Other bonds are 'self-liquidating,' or have their own dedicated revenue. For example, the ERBs receive a quarter-cent of the sales tax as a component of the 'triple flip' enacted as part of the 2004 budget package.

The Governor's budget includes $5.3 billion in General Fund costs for GO bond debt service and related costs, or a total of $6.8 billion when the debt service costs of the ERBs are included. This amount does not include the proposed supplemental payment of $1.6 billion for ERBs that would result in them being paid off by the end of 2014-15. In addition, $1.1 billion in debt costs are scheduled to be funded from special funds. Finally, federal bond subsidies, through the Build America Bonds (BABs) program, will provide $327 million in 2014-15 allowing for a reduction in General Fund expenses. The Governor's proposed budget includes $106.8 billion in General Fund available resources (not including carry-over balances), so the net General Fund bond debt service as a percentage of General Fund resources is about 5.0 percent.

Governor's Budget for General Obligation Bond Debt
(Dollars in Millions)

Category	2012-13 Actual Cost	2013-14 Estimated Cost	2014-15 Forecasted Cost
General Fund Cost	$3,997	$4,916	$5,298
Other Funds Cost	788	1,052	1,133
Federal Subsidy (Build America Bond Program)	340	324	327
Total Debt Service	**$5,125**	**$6,292**	**$6,758**
Economic Recovery Bonds (ERBs, not included above because indirect GF cost)	$1,313	$1,539	$1,614

The ERBs are not included directly in General Fund costs for bond debt service. As noted above, repayment of these bonds is financed from a quarter cent sales tax that was temporarily redirected from local government. Local government revenue is backfilled through a diversion of property tax revenues and an increase from the state General Fund in Proposition 98 education funding. The Governor's budget reflects special fund expenditures of $1.6 billion for ERB debt service in 2014-15, and the Proposition 98 budget reflects increased General Fund expenditures of $1.6 billion. Paying off the ERBs in 2014-15 will reduce the state's General Fund expenditures for Proposition 98 by roughly $1.5 billion in 2015-16.

The budget plan includes an assumption that $2.8 billion in GO bonds will be sold in the spring of 2014, and that $2.1 billion more will be sold in the fall of 2014. Among these planned sales are $2.7 billion for transportation and related capital facilities, $1.4 billion for various education facility bonds, and $618 million for various natural resources bonds.

California's Five-Year Infrastructure Plan
The Administration released its 2014 Five-Year Infrastructure Plan along with the budget. The plan identifies total statewide deferred maintenance costs of $64.6 billion ($59 billion, or 91 percent, is for the state's roads). The plan proposes to invest $56.7 billion in capital funding over the next five years and, of this amount, $32.3 billion is from federal funds, $12.1 billion from various special funds, $6.1 billion from bond funds, and $5.9 billion from other funds. Most (94 percent) of the capital investments proposed are for the state's transportation system.

The budget proposes to spend, on a one-time basis, $815 million ($800 million General Fund) to address critical deferred maintenance needs in the following areas:

- $337 million for Caltrans
- $188 million K-12 Schools Emergency Repair Program
- $175 million for California Community Colleges
- $43 million for Parks and Recreation
- $20 million for Corrections and Rehabilitation
- $15 million for Judicial Branch
- $10 million for Developmental Services

- $10 million for State Hospitals
- $7 million for General Services
- $5 million for State Special Schools
- $3 million for Forestry and Fire Protection
- $3 million for Military
- $2 million for Food and Agriculture

The expenditure proposal does not include specific deferred maintenance projects for these departments. Instead, for most of these departments (excludes Caltrans, K-12 Schools, Community Colleges, and the Judicial Branch), in order for these funds to be allocated, departments would provide a list of proposed deferred maintenance projects to the Administration, who would approve or reject the projects, and then notify the Legislature of its approved list of projects 30 days prior to allocating any funds.

ISSUES TO CONSIDER:

Budget and Bonds

Paying GO bond debt is a significant General Fund expense. State and federal tax exemptions for interest income received by investors ensure that GO bond debt is a low-cost financing alternative. To the extent bond costs do not exceed a government's long-term ability to fund other commitments, bonds allow the public to enjoy the benefits of infrastructure investment more quickly than would otherwise be the case. The LAO indicates that the state's debt service requirements for infrastructure will climb steadily over the next several years, to about $7.1 billion in 2019-20. As a percent of General Fund revenues, debt service is estimated to remain at about 5.9 percent.

Voters approved over $40 billion in new bonds on the 2006 ballot, just prior to the national recession. The bonds have allowed the state to invest in infrastructure while the need for economic stimulus is most acute, while borrowing costs are low, and while construction procurement is favorable. Despite the benefits of bonds, they come with the cost of many years of debt service. Assuming that a bond carries an interest rate of 5 percent, the cost of paying it off with level payments over 30 years is close to $2 for each dollar borrowed—$1 for repaying the amount borrowed and close to $1 for interest. This cost, however, spread over a 30-year period, after adjusting for inflation is considerably less—about $1.40 for each $1 borrowed. That bond cost crowds out alternative expenditures over the life of the bond. The Legislature can prioritize or limit bond funding through the budget process as overall expenditures are prioritized. This question may be particularly acute as the economy begins to recover and interest costs climb as a result of increased demand for capital.

Five-Year Infrastructure Plan

The state has failed to invest in deferred maintenance and, as a result, many areas of the state's infrastructure have critical and costly needs. When repairs to key building and infrastructure components are put off, facilities can eventually require more expensive investments, such as emergency repairs (when systems break down), capital improvements (such as major rehabilitation), or replacement. As a result, while deferring annual maintenance needs avoids expenses in the short run, it often results in substantial additional costs in the long run.

The Governor's proposal to provide funding for deferred maintenance is a positive first step toward addressing the problem. However, the proposed process for the allocation of these funds (which in some cases could be for projects costing tens of millions of dollars) may not provide for adequate Legislative oversight.

The process proposed for most of the departments that would receive funding would not provide the Legislature with an understanding of how each department prioritized projects. For example, it would be unclear if a department's prioritization process emphasized important factors, such as if the projects could leverage additional federal or local funds, or if they would help to generate revenue for the state. Project prioritization could also be based on if the project addresses fire, life, and safety issues, or prevents future greater state costs. The proposed process also would not allow the Legislature an opportunity to provide its input on other projects that it considers to be high priority. Finally, this process also would not allow the Legislature to consider other potentially appropriate funding sources for deferred maintenance projects, such as using bond funds or user fees, rather than state General Funds. Given these considerations, the Legislature may want to develop an alternative approach to allocating some of the funding proposed for deferred maintenance projects.

In addition, the Administration's five-year plan has some shortcomings. Rather than being a rigorous evaluation of the state's needs and how to fund them, it is instead a sketch of needs without a well-articulated long-term funding plan. The Legislature may wish to obtain additional information about the analysis used to identify capital and deferred maintenance projects. Given the state's existing debt burden and General Fund constraints, the Legislature may want to have the Administration provide an analysis of the use of General Fund-backed debt that explores alternatives to the reliance on voter-authorized GO bonds. In addition, a well thought out plan would also include a discussion of the ease of implementation of various projects, and associated risks, and how those were taken into consideration in the development of the plan. Finally, it will be important for the Legislature to understand how the Administration plans to incorporate this plan into the annual budget process in the future.

Bond Management

As the state's cash situation deteriorated with the most recent recession, the Administration changed the methodology for managing bond cash. Prior to the recession, reserve cash funded project costs in advance of bond sales, and then bond sales replenished cash reserves. When reserve cash declined, the state had to instead sell bonds in advance of expenditures. Due to project expenditures occurring slower than anticipated at the time of bond sales, large bond cash balances developed—about $9.7 billion as of December 2011. The Administration recently implemented a plan to utilize commercial paper to aid cashflow, and reduce the need to carry large bond cash balances, as well as requiring GO bond programs to demonstrate an immediate need for additional bond proceeds prior to issuing new bonds. Progress has been made to reduce bond cash, and the cash reserves have dropped to about $3.5 billion as of October 2013, excluding the recent fall 2013 GO bond sales. At budget hearings, the Administration could be asked to discuss their management of bond proceeds, forecasts of project expenditures, and the optimal level of cash balances.

Budgetary Borrowing and Loan Repayment

BACKGROUND:

Through budget actions over the last decade, the state has borrowed from special funds and deferred various payments in order to close budget deficits. By the close of 2010-11, the Department of Finance (DOF) indicates that a total of $34.7 billion in loans and deferrals had accumulated and remained unpaid. The Governor defines this as the 'wall of debt,' and includes in his definition adjustments related to his budget proposals. This amount largely represents the debt overhang from prior year budgets adopted under the previous Administration. By the end of the current year, this amount is expected to be reduced to $24.9 billion.

Some obligations included in the wall of debt have required repayment in specified years due to constitutional requirements or due to scheduled bond debt service. An example of a rigid remittance requirement is the annual Economic Recovery Bond (ERB) payment of approximately $1.5 billion through 2016-17. Other debt payments are more flexible and can be repaid over time as the budget situation allows, such as school payment deferrals, and as long as borrowing does not interfere with the activities that a special fund loan supports. In either case, the wall of debt represents a budget challenge, as payments on these accumulated debts restrict legislative discretion and displace funding for ongoing or expanded program costs.

GOVERNOR'S PROPOSAL:

The Governor proposes to pay down $11.0 billion of the remaining $24.9 billion wall of debt by the end of 2014-15. In addition, the Governor's multi-year budget plan proposes to fully repay wall of debt obligations by the end of 2017-18. Assuming this plan is adhered to, the 2018-19 budget and ongoing budgets would be increasingly free of these debt pressures and expenditures would be more in line with annual revenues. The estimated wall of debt repayment schedule is presented in the following table. Additional detail is provided in the Appendix to this Overview.

Governor's Wall of Debt and Proposed Repayment
(Dollars in Millions)

Wall of Debt Item	Outstanding Balance, Close of 2013-14	Current-year Supplement Payments	Proposed Repayment in 2014-15	Remaining (Paid by 2017-18)
Deferred Payments to Schools and Community Colleges	$6,164	$3,690	$2,474	$0
Economic Recovery Bonds	3,914	0	3,165	0
Loans from Special Funds	3,880	0	927	2,953
Mandate Payments to Local Governments	5,382	0	0	5,382
Underfunding of Proposition 98	2,391	598	0	1,793
Deferred Medi-Cal Costs	1,773	0	60	1,713
Deferral of State Payroll Costs	783	0	0	783
Deferred Payments to CalPERS	411	0	0	411
Proposition 42 Borrowing from Transportation Funds	168	0	83	85
Total	**$24,866**	**$4,288**	**$6,709**	**$13,120**

The planned payments for ERBs and Proposition 42 borrowing are constitutionally required or dictated by bond debt service. However, the Governor's proposal to retire ERBs a year early by making a one-time supplemental payment of $1.6 billion is discretionary, as is the payment of loans from special funds. The Administration indicates that repayment of roughly half of the special fund loans allows the state to make critical investments in maintaining the state's highways and roads, and addressing climate change. The amount of special fund loans proposed for repayment in the Governor's budget is $927 million, plus total interest costs of $54 million. Interest is required on most special fund loans and is paid when the principal is repaid.

Governor's Proposal for Repayment of Special Fund Loans
(Dollars in Millions)

Affected Department and Special Fund	Principal Amount
Transportation—Highway Users Tax Account Loan Repayment	$328.3
Trial Courts—State Courts Facility Construction Fund	130.0
Air Resources Board—Greenhouse Gas Reduction Fund	100.0
Resources—California Beverage Container Recycling Fund	82.3
Public Utilities Commission—California High Cost Fund B Administrative Committee Fund	59.0
Transportation—State Highway Account, State Transportation Fund	56.0
Resources—Electronic Waste Recovery and Recycling	27.0
Health—Hospital Building Fund	20.0
General Services—Public School Planning, Design, and Construction Review Revolving Fund	20.0
Consumer Affairs—Vehicle Inspection Repair Fund	14.0
Justice—False Claims Act Fund	12.7
Health—Health Data and Planning Fund	12.0
Emergency Services—Victim-Witness Assistance Fund	10.1
Consumer Affairs—Enhanced Fleet Modernization Subaccount	10.0
Secretary of State—Victims of Corporate Fraud Compensation Fund	10.0
Other Departments, Funds and Accounts	35.6
Total	**$927.0**

ISSUES TO CONSIDER:

The Governor's continued emphasis on repaying budgetary debt, specifically the ERBs and special fund loans, is sound fiscal policy and would continue California's progress towards strong fiscal footing. The plan to repay the wall of debt over the next four years is timed to coincide with the expiration of the state's receipt of revenues from temporary taxes established by Proposition 30 in November 2012. In addition, paying of the ERBs early would free up sales tax resources now dedicated to General Fund bond repayment, most likely beginning in 2015-16. Overall, the rate of repayment is somewhat more aggressive in 2014-15 and 2015-16, about $6.7 billion and $5.9 billion respectively, than in the final two budget years of repayment which are about $3 billion in 2016-17 and 2017-18. However, this approach neglects to address needs in other areas of the state's budget, as discussed below.

Balancing Loan Repayments, Other Liabilities, and Reinvestments

Roughly up to $2.6 billion (including the supplemental ERB loan repayment of $1.6 billion and the nearly $1 billion proposed for the repayment of special fund loans) could be distributed differently than the Governor proposes. It will be important for the Legislature to consider if the Governor's budget strikes the right balance between repaying budgetary debt and using additional General Funds for things such as funding long-term liabilities and program restorations. The Legislature may want to consider special fund loan repayments in the context that some of the funds proposed for loan repayments could be used to accomplish other Legislative priorities. Alternatively, repaying a greater amount of certain special fund loans could help the Legislature to achieve other policy objectives that are a priority.

For example, the Legislature may wish to consider making down payments towards the California State Teachers Retirement System (CalSTRS), which has an approximately $80 billion dollar unfunded liability. The CalSTRS estimates it needs an additional $4.5 billion a year, from various sources, to fund the system's current unfunded liability. Similarly, in recent years budget cuts have forced the Legislature to make reductions to some health and human services programs that could be considered for restoration. It is also possible that repaying a greater amount of the Greenhouse Gas Reduction Fund loan, proposed for partial repayment in 2014-15, could help the state to further achieve its greenhouse gas reduction goals.

Prioritization of Special Fund Loan Repayments
Some of the loans proposed by the Administration for repayment are necessary to make, some of the loans could be repaid earlier to help meet the desired program objectives, and some of the proposed loan repayments are unnecessary at this time, as the programs have been operating for many years without these funds.

In order to assess which loans justify repayment, it will be important to apply specific criteria to each loan proposed for repayment. One way to do this during budget hearings is to ask key questions of departments that have outstanding special funds loans such as:

- Do expenditures consistently exceed revenues?
- Are special fund programs cost-effective?
- What is an appropriate fund balance?
- Is a substantial, one-time cost anticipated, such as deferred capital projects or maintenance?
- Are reductions in fees justified?
- Does the department, board, or bureau have performance targets?
- What interest rate is the General Fund paying to borrow from this special fund?
- How would the repayment funds be used by the program?

In addition, the Legislature can scrutinize the current and budget year spending projections to determine if the fund balance, as presented by the Administration, is accurate. One way to do this is to request that the Governor provide updated fund condition statements, at the time of the May Revise, for those loans that are proposed for repayment. This is not the current practice and more up-to-date information would help the Legislature to better examine the expenditure needs of the affected departments and programs, assess the projected trend of spending, and the "need" for repayment.

Our analysis of a selection of loans from a variety of program areas found that one of the loans proposed for repayment could be delayed and two other special funds could benefit from an early loan repayment as described below. These are examples only and it is possible that a more comprehensive review of all outstanding special fund loans could find additional loan repayments that could be delayed or advanced.

High-Cost Fund-B Administrative Committee Fund Loan Unnecessary at This Time. In October 1996, the California Public Utilities Commission (CPUC) established the California High-Cost Fund-B Administrative Committee Fund (CHCF-B) Program to provide subsidies to larger telephone companies serving high-cost areas. The purpose of the program was to reduce the disparity in rates charged by these telephone companies. The CHCF-B is funded by a surcharge on telephone customers who have services such as "call waiting" or "caller ID" on their phones. The budgeted surcharge rate—which is set administratively by the CPUC by resolution—has varied significantly from a high of 3.8 percent on the cost of services in 1999 to a low of 1.4 percent in 2002. Currently, the rate is 2 percent.

The budget proposes to repay a $59 million loan from CHCF-B in the budget year. At this time, the fund has a balance of $156.7 million. With annual expenditures declining from $29.5 million to $22.2 million, the necessity of this funding is not demonstrated in the near future and therefore, repayment of this loan could be delayed.

Hazardous Waste Control Account Could Benefit from Early Loan Repayment. Within the Department of Toxic Substances Control (DTSC), the Hazardous Waste Management Program is funded primarily from the Hazardous Waste Control Account (HWCA). Many of DTSC's core efforts, including hazardous waste facility inspections, criminal investigations, enforcement of hazardous waste laws, and other hazardous waste-related activities are funded by HWCA. DTSC is responsible for ensuring hazardous wastes generated are managed safely and properly to prevent harm to public health and the environment.

HWCA is supported primarily by hazardous waste fees and corrective action/cost recoveries. The hazardous waste fees come from a complex system of fees paid by a broad spectrum of businesses that generate or manage hazardous wastes. This fee system, which is vital to allowing DTSC to continue to fulfill these essential public health and environmental protection responsibilities, is facing challenges due to changing businesses and industrial trends. During the 2013-14 budget discussion, DTSC argued that its hazardous waste fee system currently is "complex and difficult to administer…It has also yielded inconsistent revenues, which has resulted in expenditures exceeding revenues for a number of years, requiring program reductions and significantly reducing the available fund balance."

The budget proposes to repay a $13 million loan from the HWCA to the General Fund in 2015-16. The HWCA currently has a structural deficit of approximately $10 million per year and a fund balance of less than $20 million. Due to the volatility of this fund and the pressing need for fee reform, the Legislature should consider repaying this loan in the budget year.

Enhanced Fleet Modernization Subaccount Could Benefit From Early Loan Repayment. The Enhanced Fleet Modernization Program (EFMP) was established by AB 118 (Nunez), Chapter 750, Statutes of 2007. The program allows for the voluntary retirement of passenger vehicles and light-duty and medium-duty trucks that are unable to pass biennial smog check inspections. Under this program, the state provides qualified consumers, whose income does not exceed 225 percent of Federal Poverty guidelines $1,500, to retire a vehicle. Non-low income individuals receive $1,000 for the retirement of a vehicle that has not passed the state's Smog Check

Program. The Bureau of Automotive Repair (BAR), the entity responsible for the administration of this program, estimates that during Fiscal Year 2013-14 approximately 25,000 vehicles were retired.

The Enhanced Fleet Modernization Subaccount, which provides funding for EFMP, currently, has an outstanding loan to the General Fund of $40 million. According to BAR, the demand for this program consistently far exceeds the amount of funds available to consumers. Providing an accelerated repayment of the outstanding General Fund loan may contribute to the retirement of older, higher-polluting vehicles and help the state reduce its greenhouse gas (GHG) emissions. The BAR reports that 25 percent of the motor vehicles on California's roadways account for 75 percent of the emissions. The Legislature may wish to accelerate the repayment of this loan to help the state achieve its goal of reducing GHG emissions to 1990 levels by 2020.

Cash Management

BACKGROUND:

The state's receipts and disbursements of cash occur unevenly throughout the fiscal year. As a consequence, the General Fund borrows for cashflow purposes in most years, even though each budget is balanced when enacted and funds are repaid within the fiscal year. Given that the state receives revenues on an uneven basis throughout the year, the state's cash position varies, with the typical low points occurring in July, October, and November. Maintaining an adequate cash balance allows the state to pay its bills in a timely fashion. Interest is paid on both internal borrowing (such as cashflow loans from special funds) and for external borrowing (such as Revenue Anticipation Notes [RANs]). For the current year, the state issued RANs in August of 2013 of $5.5 billion. The RANs are payable in May and June and carry an expected interest cost of $16 million.

Total monthly borrowable internal resources from some 700 plus funds are typically in the range of $20 billion. The state also established a new cashflow tool in the form of the Voluntary Investment Program (VIP) in 2012. This measure provided an additional means to assure cashflow continuity by establishing a new account for voluntary participation by local governments. Another cash management tool of the state is the State Agency Investment Fund (SAIF), which attracts deposits from entities not otherwise required to deposit funds with the state. The VIP and SAIF were not used in the current year.

An additional tool in managing cash is deferrals of payments within the fiscal year to K-12 and higher education, local governments, and other entities. In recent years, flexible deferrals have been enacted in statutes that allow specified deferrals if necessary to maintain a prudent balance for bond debt and other priority payments. For the current year, there were deferrals allowed for K-12 education, higher education, and local government payments. The fiscal impact of these deferrals varies from entity to entity, depending upon their own cash positions.

GOVERNOR'S PROPOSAL:

In order to cover the low points in the state's cash position, the Governor's budget anticipates engaging in internal and external borrowing. The budget reflects the state's improved cash position and includes funding for the interest costs of cashflow borrowing from special funds and RANs. Given the improvement in the cash status, no new education or other payment deferrals are incorporated in the budget. Based on the cashflow statements of the Administration, the cash low points will occur in October, December, and March, when unused borrowable cash resources are estimated to be $4.5 billion, $4.2 billion and $5.0 billion, respectively. By way of comparison, and reflective of the uneven flow of receipts and disbursements, the cash and borrowable resources in June of this year are estimated to be $20.8 billion.

Cashflow Borrowing

The state anticipates engaging in its typical internal cash-borrowing pattern, with all internal cashflow borrowing managed such that the intent is that all programs supported by the special funds are completely unaffected. In order to supplement the state's internal borrowing within the budget year, the Administration has proposed a RAN initially sized at $3.5 billion. This provides an additional cashflow cushion to the existing availability of internal resources. Without the external borrowing, there would be insufficient cash reserves and other funds during the months of October, November, December, and March. The budget includes $120 million General Fund for the interest costs associated with these two borrowing methods—$60 million for the RAN and $60 million for internal borrowing costs. There is no anticipated need for the VIP or the SAIF in the Governor's Budget.

Payment Deferrals and Smoothing

The Administration has not incorporated any new deferrals as part of the budget plan. However, there is the continuation of a $500 million within-the-year deferral to UC and a deferral of up to $250 million of CSU's annual General Fund appropriation. In addition, the Governor's Budget assumes the continuation of smoothing of payments to UC and CSU that have been carried out in recent years. The continuation of this policy, proposed for budget bill language, would smooth payments over ten months with the remaining amount owed remitted in the final two months of the year.

ISSUES TO CONSIDER:

Maintaining an emphasis on cashflow borrowing from special funds is good fiscal policy that reduces the need for more expensive external borrowing. Cash deferrals to other government units are generally among the least desirable of the cash management tools, in that these can cause cashflow stress on other governmental entities. Although this may have been necessary in the past—especially in order to limit the magnitude of external borrowing—not having to rely on this measure in the coming year is positive. The Administration's proposal appears to be a suitable approach to cashflow management. The anticipated reduction in the size of external borrowing will reduce the state's interest costs and reflects the state's overall improved fiscal health. The Governor's plan to reduce the wall of debt will help the state's cash management and reduce the need for payment deferrals in the future.

SUBCOMMITTEE NO. 5

CORRECTIONS, PUBLIC SAFETY, AND THE JUDICIARY

Public Safety and the Judiciary

Three-Judge Panel

BACKGROUND:

The California Department of Corrections and Rehabilitation (CDCR) is responsible for the incarceration of the most serious and violent adult felons, including the provision of training, education, and health care services. As of December 31, 2013, CDCR housed about 134,000 adult inmates in the state's prison system. Most of these inmates are housed in the state's 33 prisons and 42 fire camps. Almost 120,000 of those inmates are in the state's prisons, which results in those institutions currently being at 145.5 percent of their design capacity. Approximately 9,000 inmates are housed in out-of-state contracted prisons, 2,400 are housed in in-state contracted facilities, and 4,100 are housed in fire camps. The CDCR also supervises and treats about 47,000 adult parolees.

In 2009, a federal three-judge panel declared that overcrowding in the state's prison system was the primary reason that the CDCR was unable to provide inmates with constitutionally adequate health care. The court ruled that in order for CDCR to provide such care, overcrowding would have to be reduced. Specifically, the court ruled that by June 2013 the state must reduce the inmate population to no more than 137.5 percent of the design capacity in the 33 prisons operated by CDCR. Design capacity generally refers to the number of beds CDCR would operate if it housed only one inmate per cell and did not use temporary beds, such as housing inmates in gyms. Inmates housed in contract facilities or fire camps are not counted toward the overcrowding limit. In May 2011, the U.S. Supreme Court upheld the three-judge panel's ruling. Under the population cap imposed by the federal court, the state must reduce the number of inmates housed in its 33 state prisons by about 34,000 inmates relative to the prison population at the time of the ruling.

In October 2012, the federal three-judge panel ordered the state to present two plans for how it would further reduce the state's prison population either by the original deadline of June 2013, or by a deadline of December 2013. On January 7, 2013, the Administration released its response to the court. The Administration requested that the court modify or vacate its population reduction order altogether. While the three-judge panel did not issue judgment on whether to vacate the population limit, it did extend the deadline for meeting the limit from June 2013 to December 2013. It also ordered the Administration to continue working towards meeting the limit in December but did not order the Administration to take any specific actions.

In June of 2013, the court ordered Governor Brown to reduce the prison population by 9,600 inmates by the end of the year. The state's response was reflected in part by the passage of SB 105 (Steinberg and Huff), Chapter 310, Statutes of 2013. The measure authorizes $315 million to meet the court's order either through increasing prison bed capacity or, to the extent the court grants more time for California to meet the court's order, increasing California's cost-effective investments in evidence-based practices and policies to reduce recidivism.

On September 24, 2013, the three-judge panel issued an order directing the state to meet with inmate attorneys to discuss how to implement a long-term overcrowding solution. The order also prohibits the state from entering into any new contracts for out-of-state housing without an order of the court. A subsequent order moved back the deadline for meeting the population cap to April 18, 2014, and required that both parties in the case work to reach an agreement on how to best reach the 137.5 percent goal.

Unfortunately, the parties were unable to come to agreement on a long-term solution by the deadline provided by the court. On January 13, 2014, the court noted the failure of the plaintiffs and the defendants to find a solution and the court ordered both sides to submit plans that they believe will allow the state to achieve compliance with the court ordered population cap of 137.5 percent of design capacity. The court is expected to rule by mid-February on whether or not it will grant the state's most recent request for a two-year extension of the deadline to reduce the prison population.

SB105 (Steinberg and Huff), Chapter 310, Statutes of 2013. In September 2013, the Legislature passed, and the Governor signed, SB 105 to address the federal three-judge panel order requiring the state to reduce the prison population to no more than 137.5 percent of design capacity by December 31, 2013. SB 105 provides the CDCR with an additional $315 million in General Fund support in 2013-14 and authorizes the department to enter into contracts to secure a sufficient amount of inmate housing to meet the court order and to avoid the early release of inmates which might otherwise be necessary to comply with the order. The measure also requires that if the federal court modifies its order capping the prison population, a share of the $315 million appropriation in Chapter 310 would be deposited into a newly-established Recidivism Reduction Fund. The Governor's proposed budget (discussed below) assumes the state will receive a two-year extension, allowing for $81.1 million to go into the Recidivism Reduction Fund.

GOVERNOR'S PROPOSAL:

Court-Ordered Prison Population Cap. The Governor's budget assumes the Federal Courts will grant California a two-year extension on meeting the court-imposed population cap of 137.5 percent of system-wide design capacity. Based on this assumption, the Governor's budget reflects total expenditures of $228 million from the $315 million appropriated in AB 105 (Steinberg and Huff), Chapter 310, Statutes of 2013. The proposed plan would set aside $81.1 million for the following recidivism reduction efforts.

- $11.8 million to expand substance use disorder treatment to ten additional state prisons.

- $9.7 million to expand substance use and cognitive behavioral treatment to in-state contracted facilities.

- $11.3 million to increase the number of slots in the Integrated Services for Mentally Ill Parolees program from 600 to 900.

- $8.3 million for the design and planning necessary to convert a 600-bed facility in Stockton into a reentry hub over the next two years.

- $40 million to support state reentry programs in the community, either through programs provided in jails or for services provided within communities.

The proposed budget also states the intent of the Administration to immediately begin implementing measures required by the federal court pertaining to expanded medical parole, elderly parole, and credit enhancements. Initial estimates suggest that this may result in the release of approximately 2,000 inmates over the next two years.

ISSUES TO CONSIDER:

Governor's Budget Assumption. As noted above, the Governor's budget assumes that the federal court will provide two additional years for the state to reach the 137.5 percent of capacity required by the court. If that extension is not approved, the Legislature will need to adopt funding and policy changes which will allow the state to reach the population cap by the end of April 2014.

Priorities for the Recidivism Reduction Fund. The Governor's budget outlines his priorities for spending the $81.1 million available in the recidivism reduction fund. The funding is primarily used for capacity building in the form of re-entry beds. The Legislature may wish to consider investing the money in other types of programming that have proven to be both cost-effective and successful in terms of reducing recidivism. For example, evidence suggests providing individuals intensive substance abuse and mental health treatment while they are incarcerated and continuing those services upon their release reduces the likelihood of recidivism, provided those services are provided to a population that has been given a thorough assessment of their criminogenic needs. In addition, the Legislature may wish to consider investing in supportive housing for individuals upon their release. However, any investment in programming or rehabilitation services should include any necessary data and reporting requirements that will allow the Legislature and the Administration to measure the success of such programs at reducing recidivism rates.

Public Safety Realignment

BACKGROUND:

In 2011, the state approved a broad realignment of public safety, health, and human services programs from state to local responsibility. Included in this realignment were sentencing law changes requiring that certain lower-level felons be managed by counties in jails and under community supervision rather than sent to state prison. Generally, only felony offenders who have a current or prior offense for a violent, serious, or sex offense are sentenced to serve time in a state prison. Conversely, lower-level felons convicted of non-violent, non-serious, and non-sex-related crimes (colloquially referred to as "non-non-nons") serve time in local jails under realignment. In addition, of those felons released from state prison, generally only those with a current violent or serious offense are supervised in the community by state parole agents, with other offenders supervised by county probation departments. Responsibility for housing state parole violators was also shifted from state prisons to county jails.

In adopting this realignment, the Legislature had multiple goals, including reducing the prison population to meet the federal court-ordered cap and reducing state correctional costs. Another stated goal of realignment was to improve public safety outcomes by keeping lower-level offenders in local communities where treatment services exist and where local criminal justice agencies can coordinate efforts to ensure that offenders get the appropriate combination of incarceration, community supervision, and treatment. Realignment was based on the confidence that coordinated local efforts are better suited than the state for assembling resources and implementing effective strategies for managing these offenders and reducing recidivism. This was rooted partly in California's successful realignment reform of its juvenile justice over the last 15 years and the success of SB 678 (Leno), Chapter 608, Statutes of 2009, which incentivized evidence-based practices for felony probationers through a formula that split state prison savings resulting from improved outcomes among this offender population.

In order to implement realignment and achieve improved outcomes at the local level, the Legislature shifted some sales tax revenues to counties. In addition, those funding streams for counties are permanent and constitutionally protected. Funding for the realignment of lower-level offenders both in county jails, and on probation, is estimated to be approximately $1 billion in 2013-14 and 2014-15. While this amount is less than would be needed to incarcerate and supervise this population at the state level, the estimated revenue for the counties assumes that the counties will rely less on incarceration and more on community supervision and treatment programs than had been the case under the state.

Estimates suggest that realignment has successfully reduced the state's prison population by about 25,000 inmates per year.

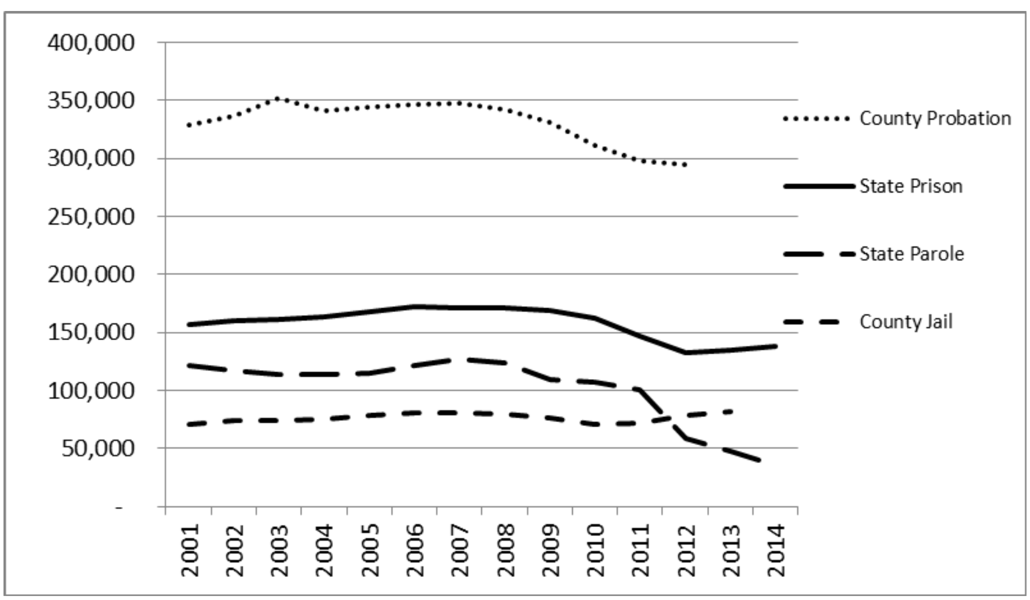
Crime Rates. According to the California Attorney General's most recent report, violent and property crimes both increased slightly from 2011 to 2012. However, the 2012 rates remain at half of the rate seen 20 years ago. The homicide rate remained at a rate 18 percent lower than the average homicide rate for the prior ten years. In addition, the forcible rape and aggravated assault rates remain 7.1 and 2.7 percent lower than their respective rates two years ago. Finally, the motor vehicle theft crime rate decreased 26 percent from 2007 to 2012, the largest decrease of all the violent and property crimes. [1]

Arrest Rates. In 2012, the arrest rate in California overall was 2.9 percent lower than the arrest rate in 2011. The majority of the decline was due to an 18.1 percent decline in juvenile arrests. The overall violent offense arrest rate decreased by 3 percent while property and drug offense arrest rates increased by 2.6 and 4.3 percent, respectively. Despite the year-over increase in property and drug arrests, both arrest rates continue to be significantly lower in 2012 than they were in 2007, with a decrease of 25.3 percent and 19 percent, respectively. In 2012, 68.5 percent of adult felony arrests resulted in a conviction.[2]

County Jail Population. After reaching a high of 84,000 inmates in September 2007, the monthly average daily jail population (ADP) declined quite steadily to a low of 69,000 in May 2011—a decrease of over 17 percent. After realignment, the jail population began to rise and now stands at approximately 82,000 inmates. Of those inmates, 51,000 are awaiting sentencing. Based on the BSCC's Jail Profile Survey from the 2nd Quarter of 2013, the percentage of inmates in jail awaiting sentencing varies from a high of 83 percent to a low of around 50 percent for larger counties. The statewide average is 63 percent, down from a high of 71 percent in 2010.

According to data provided by the California Probation Officers of California (CPOC), between October 2012 and March 2013, the ADP for realigned inmates incarcerated in county jails was approximately 15,000 inmates. The state and counties are still in the process of determining the average length of jail sentences for the realigned population.

State and Local Corrections Populations



1 (California Department of Justice 2012)
2 (California Department of Justice 2012)

GOVERNOR'S PROPOSAL:

Realignment Funding. As noted above, the Governor's budget estimates that there will be approximately $1 billion in revenue available to counties in the Community Corrections Subaccount in 2013-14 and 2014-15 to fund the population realigned to county supervision and jails.

Changes to Realignment. The Administration is proposing trailer bill language requiring that any county jail felony sentence be a split sentence unless the court finds it to be in the interests of justice to impose a straight sentence. Under current law, judges are authorized to impose a straight sentence of time in jail or a split sentence of incarceration followed by a mandatory term of supervision for offenders convicted of a non-serious, non-violent, non-sex-related offense. This proposed change is intended to increase the use of split sentencing in order to reduce the amount of time offenders spend in jail.

The Administration is also proposing trailer bill language that moves all inmates with a sentence over 10 years from county jails back to state prison. The Administration specifies that this proposed change is only to be implemented if the Administration is successful in its efforts to meet its court-ordered population cap. The Administration assumes that sentencing practices will not be altered by this change and that it would affect approximately 300 offenders annually.

ISSUES TO CONSIDER:

Should the Legislature adopt a sentencing cap? The Governor's proposed budget requests a fundamental change in determining whether or not a person convicted of a felony serves time in a county jail or state prison. For the most part, under current law, the determination is by the type of crime. As noted above, individuals convicted of non-violent, non-serious, non-sex-related crimes are currently sentenced to serve time in a county jail, unless they have served time for a previous felony that was violent, serious, or sexual. In that case, they would be sent to state prison. The Governor proposes altering the criteria to cap the sentences of those serving time in county jails at less than ten years.

The concept of setting a maximum length of sentence for the realigned population is not a new one. In 2010, the prior Administration proposed sending non-serious and non-violent felons who were sentenced to three years or less of incarceration to a county jail rather than state prison. The Legislature debated and rejected that proposal. One of the primary concerns raised during those discussions was that determining where an inmate should serve time based upon the length of their sentence, rather than solely on the nature of their crime, could cause local charging practices to be altered in a way that would increase sentences and lead to more people serving time in state prison than otherwise would under the current policy. The Governor's proposal could create the same kinds of incentives.

Given the fact that the revenue for realignment is constitutionally protected and remains with counties, any policy change that results in fewer individuals being incarcerated in counties and more being incarcerated in prisons effectively results in the state paying twice for the same inmate once through the realignment revenue being redirected to counties to serve lower level felons and a second time to pay for their incarceration in state prison.

Jail Construction

BACKGROUND:

Since 2007, the Legislature has approved two measures authorizing a total of $1.7 billion in lease–revenue bonds to fund the construction and modification of county jails. Assembly Bill 900 provided $1.2 billion to help counties address jail overcrowding. SB 1022 (Committee on Budget and Fiscal Review) Chapter 42, Statutes of 2012, authorized an additional $500 million to help counties construct and modify jails to accommodate longer–term inmates who would be shifted to county responsibility under the 2011 realignment of lower–level offenders. The Board of State and Community Corrections (BSCC) is responsible for managing the jail construction funding program authorized by these measures, which includes developing requests for proposals, rating applications, awarding and administering funds, and overseeing compliance with the conditions of the awards. The State Public Works Board (SPWB) is tasked with issuing the bonds, as well as approving and overseeing the scope and cost of approved projects.

Lease-Revenue Bond Financing. Bond financing is a type of long-term borrowing that state and local governments frequently use to raise money, primarily for long-lived infrastructure assets. They obtain this money by selling bonds to investors. In exchange, they promise to repay this money, with interest, according to specified schedules. The interest the state has to pay investors on the bonds it issues for public infrastructure is exempt from their federal and state income taxes, which makes the state's interest cost on the bonds less than it otherwise would be. Unlike general obligation bonds backed by the full faith and credit of the state, lease-revenue bonds are not, and they may be authorized by law without voter-approval.

The Long-Term Cost of Bond Financing. Funding infrastructure through the use of bonds is significantly more costly than direct appropriations, due to the interest that has to be paid. This extra cost depends primarily on the interest rate and the time period over which the bonds have to be repaid. For example, in the case of the $1.7 billion already provided for local jail construction, if the terms of the bond require payment over 25 years, the General Fund impact will be approximately $137 million per year in debt service payments. By the time the bonds are repaid, they will have cost approximately $3.4 billion in General Fund. In this case, since the funding is for local jails, the buildings funded by the bonds are not state assets, they will belong to the counties.

Please see the General Government section of this publication for a detailed discussion on the state's general obligation bonds and debt service.

AB 900 (Solorio), Chapter 7, Statutes of 2007. AB 900, as amended by subsequent legislation, authorized funding in two phases. Under the first phase, AB 900 required counties applying for a grant to fund at least 25 percent of the construction project's costs. In deciding which counties would be awarded funding under the first phase, the bill required the state to give preference to those counties that agreed to help site a state reentry facility or provide mental health treatment to former parolees. (The Legislature later eliminated funding for the construction of state reentry facilities, and counties who received awards were not required to fulfill this requirement.) Counties receiving funds under the second phase of AB 900 must provide a 10 percent match, and preference for awards was given to counties who committed the most inmates to state prison in 2010. Under both AB 900 and SB 1022 (discussed below), counties with populations of less than 200,000 can request an exemption from the statutorily-required match.

The BSCC has approved 20 jail construction projects under the first two phases of AB 900. The BSCC estimates suggest that these construction projects will result in a total of about 10,000 jail beds, as well as make improvements at existing jails. Some of the 10,000 beds will be replacements for existing beds and do not result in additional capacity. The table provides detail on those construction projects.

AB 900 Jail Construction Funding
(Dollar Amounts in Millions)

County	Award Amount	Number of Beds	Estimated Completion Date
Phase I			
Amador	$23	165	To be determined
Calaveras	$26	160	August 2013
Madera	$30	144	September 2013
San Bernardino	$100	1,368	January 2014
San Diego	$100	1,270	2016
San Luis Obispo	$25	198	2015
Solano	$62	362	April 2014
Total	**$366**	**3,667**	
Phase II			
Imperial	$33	228	tbd
Kings	$33	252	April 2016
Los Angeles	$100	1,604	tbd
Madera	$3	1	September 2013
Monterey	$80	576	tbd
Orange	$100	512	tbd
Riverside	$100	1,250	tbd
Santa Barbara	$80	376	February 2018
Siskiyou	$24	150	tbd
Stanislaus	$80	456	December 2016
Sutter	$10	42	tbd
Tulare	$60	514	tbd
Yolo	$36	161	tbd
Total	**$739**	**6,122**	
Total Both Phases	**$1,105**	**9,789**	

SB 1022 (Committee on Budget and Fiscal Review), Chapter 42, Statutes of 2012. SB 1022 authorized an additional $500 million in lease-revenue bonds to fund the construction of local jail facilities. As with AB 900, this legislation required BSCC to administer the program with consideration given to counties that are seeking to replace existing compacted, outdated, or unsafe housing capacity or seeking to renovate existing buildings or build new facilities that provide adequate space for the provision of treatment and rehabilitation services, including mental health treatment. In addition, the legislation specified that a participating county could only add capacity using this authority if it clearly documented an existing housing capacity deficiency and does not lease housing capacity to any other public or private entity for 10 years. As with AB 900, counties applying for jail construction funding under SB 1022 will have to provide a 10 percent match, and awards will be given to counties who are determined by BSCC to be the most prepared to successfully proceed with their projects in a timely manner.

Thirty-six counties applied for construction funding through SB 1022, asking for a total of $1.3 billion in funding. Of those proposals, 15 counties were awarded funding on January 16, 2014. The following two tables provide detail on all of the counties that submitted funding applications and those projects that were awarded funding.

SB 1022 Total Funding Application Requests
(Amounts in Millions)

County	Requested Amount	Awarded Amount
Butte	$40	$0
Colusa	$15	$0
Contra Costa	$80	$0
Del Norte	$9	$0
Fresno	$79	$79
Glenn	$14	$0
Humboldt	$18	$0
Imperial	$18	$0
Kings	$20	$20
Lake	$20	$20
Los Angeles	$80	$0
Madera	$19	$0
Mendocino	$10	$0
Merced	$40	$0
Modoc	$8	$0
Monterey	$23	$0
Napa	$13	$13
Orange	$80	$80
Riverside	$80	$0
Sacramento	$80	$57
San Bernardino	$80	$0
San Francisco	$80	$0
San Joaquin	$40	$33
San Mateo	$24	$24
Santa Barbara	$39	$39
Santa Cruz	$25	$25
Shasta	$20	$20
Solano	$23	$23
Sonoma	$24	$0
Stanislaus	$40	$0
Tehama	$20	$7
Trinity	$16	$0
Tulare	$40	$40
Tuolumne	$20	$20
Ventura	$41	$0
Yolo	$40	$0
Total	**$1,318**	**$500**

SB 1022 Funding Awards
(Dollar Amounts in Millions)

County	Award Amount	Number of Beds	Additional Construction or Renovation
Fresno	$79	300	Program space, medical/mental health services, video visitation, laundry
Kings	$20	24	Kitchen, vocational space, program rooms
Lake	$20	79	Stand-alone medical/mental health building, administration building
Napa	$13	18	Counseling rooms, job search rooms, warming/prep kitchen
Orange	$80	384	Program space, warehouse and maintenance structures
Sacramento	$57	26	Mental health treatment building, kitchen, laundry, pharmacy, program space
San Joaquin	$33	384	Classrooms, vocational space, education program center, medical exam rooms
San Mateo	$24	46	Mental health treatment center, mental health wellness pod, recreation yard
Santa Barbara	$39	228	Treatment and program space for transitional re-entry
Santa Cruz	$25	64	Transitional housing unit, program and vocational space, security upgrades
Shasta	$20	64	Behavioral program space, medical screening, counseling room, intake
Solano	$23	-	New programming facility
Tehama	$7	64	Day reporting center, program space
Tulare	$40	384	Day reporting center, vocational training center
Tuolumne	$20	198	Service rooms, exercise yards, security center, kitchen, laundry, intake
Total	**$500**	**2,263**	

Realignment. In 2011, the state approved a broad realignment of public safety, health, and human services programs from state to local responsibility. Included in this realignment were sentencing law changes requiring that certain lower-level felons be managed by counties in jails and under community supervision, rather than sent to state prison. Generally, only felony offenders who have a current or prior offense for a violent, serious, or sex offense are sentenced to serve time in a state prison. Conversely, lower-level felons convicted of non-violent, non-serious, and non-sex-related crimes (colloquially referred to as “non-non-nons”) serve time in local jails under realignment. In addition, of those felons released from state prison, generally only those with a current violent or serious offense are supervised in the community by state parole agents, with other offenders supervised by county probation departments. Responsibility for housing state parole violators was also shifted from state prisons to county jails.

County Jail Population. After reaching a high of 84,000 inmates in September 2007, the monthly average daily jail population (ADP) declined steadily to a low of 69,000 in May 2011—a decrease of over 17 percent. After realignment, the jail population began to rise and now stands at approximately 82,000 inmates. Of those inmates, 51,000 are awaiting sentencing. Based on the BSCC's Jail Profile Survey from the 2nd Quarter of 2013, the percentage of inmates in jail awaiting sentencing varies among counties from a high of 83 percent to a low of around 50 percent for larger counties. The statewide average is 63 percent, down from a high of 71 percent in 2010.

According to data provided by the California Probation Officers of California (CPOC), between October 2012 and March 2013, the ADP for realigned inmates incarcerated in county jails was approximately 15,000 inmates. The state and counties are still in the process of determining the average length of jail sentences for the realigned population.

GOVERNOR'S PROPOSAL:

The Governor's budget proposes an additional $500 million in lease-revenue bond financing for "SB 1022-type" facilities. The proposal would give priority to county applications for construction funding that include documentation that the county uses a risk assessment instrument to determine who to release pending trial in order to reduce overcrowding in the jails. The General Fund payments on these bonds would be approximately $41 million per year over a 25-year period. Once fully paid off, the cost to the state General Fund will be a total of approximately $1 billion.

ISSUES TO CONSIDER:

Does the State Need to Invest in More Jail Construction? As noted by the Legislative Analyst's Office in their *Overview of the Governor's Budget*, the Administration has not yet provided an analysis of county jail needs or other rationale for why the level of funding proposed is needed for jail projects or what criteria would be used to award the lease-revenue funding. For example, it is not clear whether funding would be awarded in a manner to alleviate crowding or to build additional facility space for programs, such as substance abuse treatment classes. Without such information, it will be difficult for the Legislature to assess whether the additional funding will be allocated in a manner that is cost effective and in line with state priorities. The Legislature should consider requiring the Board of State and Community Corrections (BSCC) provide a needs assessment before approving any additional jail construction funding.

Are These the Right Local Facilities In Which to Invest? Rather than adding $500 million in lease-revenue bond financing to the $1.7 billion that is currently being distributed, the Legislature may want to consider following the examples of states like Texas, that chose to invest in building treatment facilities rather than expanding capacity. Texas found that by adding probation and parole treatment beds, halfway house beds, mental health pre-trial diversion beds, and outpatient drug treatment slots, along with increased funding for programs, they were able to reduce their prison population and save money. Studies by the Texas Public Policy Foundation found that the alternatives to incarceration implemented since 2007-08 had reduced the incarceration rate by 4.5 percent, while nationally the average state incarceration rate increased by almost one percent.

CDCR *Blueprint* Update

BACKGROUND:

The California Department of Corrections and Rehabilitation (CDCR) is responsible for the incarceration of the most serious and violent adult felons, including the provision of training, education, and health care services. As of December 31, 2013, CDCR housed about 134,000 adult inmates in the state's prison system. Most of these inmates are housed in the state's 33 prisons and 42 conservation camps. Approximately 9,000 inmates are housed in out-of-state contracted prisons and 2,400 are housed in in-state contracted facilities. The CDCR also supervises and treats about 47,000 adult parolees.

For years, California's prison system has faced costly and seemingly endless challenges. Decades-old class-action lawsuits challenge the adequacy of critical parts of its operations, including its health care system, its parole-revocation process, and its ability to accommodate inmates with disabilities. In one case, a federal court seized control over the prison medical care system and appointed a Receiver to manage its operations. The Receiver remains in place today. The state's difficulty in addressing the prison system's multiple challenges was exacerbated by an inmate population that—until recently—had been growing at an unsustainable pace. Overcrowded prison conditions culminated in a ruling, in the spring of 2011, by the United States Supreme Court ordering California to reduce its prison population by tens of thousands of inmates by June 2013. At the same time that prison problems were growing, the state's budget faced significant challenges exacerbated by CDCR's rapidly growing budget.

It is within this context that the Legislature and the Governor enacted realignment, shifting responsibility for certain lower level, non-violent, felony offenders from the state to the counties. In addition to realignment, in 2012 the Administration proposed a comprehensive, long-term plan, *The Future of California Corrections* — the *Blueprint* — to improve the effectiveness of the state's prison system. The Legislature adopted the plan, based on the understanding that over time, it would significantly reduce CDCR's budget and the prison population, and it approved the necessary funding and statutory changes.

In April 2012, CDCR released the *Blueprint* detailing the Administration's plan to reorganize various aspects of CDCR operations, facilities, and budgets in response to the effects of the 2011 realignment of adult offenders, as well as to meet federal court requirements. The blueprint was intended to build upon realignment, create a comprehensive plan for CDCR to significantly reduce the state's investment in prisons, satisfy the Supreme Court's ruling to reduce overcrowding in the prisons (to 145 percent of design capacity as proposed by the Administration at the time as an alternative of 137.5 percent), and get the department out from under federal court oversight. In the introduction to the blueprint, the Administration states:

Given the ongoing budget problems facing California it has become increasingly important to reexamine the mission and priorities of the corrections system. With dedicated funding directed to county governments to manage lower level offenders, realignment allows the state to focus on *managing the most serious and violent offenders. And it allows counties to focus on community-based programs that better promote rehabilitation. Not only is this good corrections policy, but it also allows the state to achieve significant budgetary savings from a department whose share of General Fund expenditures had grown from 3 to 11 percent over the last 30 years.*

As a result of the declining populations, the state will be able to save nearly half a billion dollars by closing the California Rehabilitation Center—one of its oldest, most costly, and inefficient prisons to operate—and ending contracts for out-of-state prison facilities. The savings contemplated in this plan will be attained by safely reclassifying inmates, housing inmates in facilities that are commensurate with their custody level, and working to reduce recidivism. Capitalizing on the opportunities created by realignment will create a safer, more effective correctional system, and allow the state to regain control of its prison system by satisfying federal court requirements.

Combining the actual budget savings with the avoided expenditures that would have been required without realignment, over a ten year span the state will have saved and avoided over $30 billion in General Fund costs that may now be used to help balance the state budget or for other critical areas such as education and health care.

As noted above, the Legislature, through the Budget Act of 2012 and its related trailer bills, approved funding augmentations and reductions associated with the blueprint and adopted necessary statutory changes. In addition, the Legislature made several changes to the blueprint to increase transparency and accountability, including creating a separate budget item for CDCR's rehabilitative programs and giving the Office of the Inspector General (OIG) oversight over the implementation of certain aspects of the blueprint.

CDCR's Blueprint and Progress Toward Implementation. The blueprint contained the following major goals:

> **Reduce State Spending on Adult Prison and Parole Operations.** In total, the Administration asserted that the blueprint would reduce state spending on adult prison and parole operations by $1 billion in 2012-13 as a result of 2011 realignment. The plan estimated that these savings would grow to over $1.5 billion by 2015-16 and assumed an on-going annual savings of over $3 billion. Over ten years, the blueprint projected a state General Fund savings of approximately $30 billion.
>
> > ***Current Status.*** While CDCR has been able to reduce General Fund expenditures in certain areas of their budget, overall the Governor's budget proposes a $700 million increase between 2012-13 and 2013-14. The proposed budget further increases funding for 2014-15 by another $400 million, resulting in a $1.1 billion increase from 2012-13 to 2014-15.
>
> **Reduce the Prison Population.** The blueprint assumed that the prison population would continue on a downward trend. In addition, it assumed that two programmatic changes would result in a reduction of 500 inmates. First, the Administration proposed ending the Civil Addict Program beginning in 2013. (This program allows courts to civilly commit

offenders to prison to receive substance abuse treatment.) The Administration also proposed expanding the eligibility criteria for the Alternative Custody for Women program, which allows certain female offenders to serve their sentence in the community rather than in state prison.

The blueprint projected a total population of 133,746 inmates as of June 2012. By the end of 2014-15 that population was projected to be 123,149. Of the 123,149 inmates, 117,565 were projected to be housed in adult institutions (the remaining inmates would be housed in fire camps or contract facilities), which would result in the state being at 142.3 percent of prison capacity.

> ***Current Status.*** The most recent population projections estimate that the average daily population in the state's prisons will be 136,617 by the end of 2013-14 and will grow to 139,199 by the end of the next year. The projected population is over 16,000 inmates more than estimated in the blueprint. The most recent population reports show that as of December 31, 2013, the state's prisons were at 145.5 percent of capacity.

Return Out-of-State Inmates. The department began sending inmates out-of-state when overcrowding was at its worst in 2007. At the time of the blueprint, there were more than 9,500 inmates housed outside of California. The blueprint committed to ending all out-of-state contracts by 2015-16. The blueprint projected that by 2014-15 there would be 1,864 inmates remaining in out-of-state contract beds. Returning out-of-state inmates to in-state facilities was expected to save the state $318 million annually.

> ***Current Status.*** SB 105 (Steinberg and Huff), Chapter 310, Statutes of 2013, authorized CDCR to increase its level of contracted beds both in state and out of state. The 2014-15 budget proposed by the Governor assumes that almost 9,000 inmates will remain in out-of-state facilities.

Improve Access to Rehabilitation. This blueprint required the department to improve access to rehabilitative programs and place at least 70 percent of the department's target population (approximately 36 percent of the total prison population) in programs consistent with their academic and rehabilitative needs. The blueprint further set June 30, 2015, as the completion date for reaching that goal.

Toward that end, the blueprint required the establishment of reentry hubs at certain prisons to provide intensive services to inmates as they get closer to being released. It also required the creation of enhanced programming yards, which will incentivize positive behavior. For parolees, the blueprint increased the use of community-based programs to serve, within their first year of release, approximately 70 percent of parolees who need substance-abuse treatment, employment services, or education.

> ***Current Status.*** The OIG's October 2013 report on the implementation of the blueprint finds that only 13 percent of the targeted in-prison population received all of the necessary rehabilitation services during the fourth quarter of 2012-13.

Standardize Staffing Levels. Realignment's downsizing left the department with uneven, ratio-driven staffing levels throughout the system. The blueprint proposed adopting a standardized staffing model for each prison based on factors such as the prison's population, physical design, and missions. For the most part, prison staffing levels would remain fixed unless there were significant enough changes in the inmate population to justify opening or closing new housing units. In contrast, historically, prison staffing levels were adjusted to reflect changes in the inmate population regardless of the magnitude of those changes.

> ***Current Status.*** The OIG's October 2013 report found that standardized staffing levels had been largely achieved. Specifically, at 64 of the 66 institutions they reviewed, they found that staffing patterns closely matched the standardized staffing reports.

Increase In-State Prison Capacity. As noted above, the blueprint required the return of all inmates who were being housed outside of California. In order to accommodate the return of those inmates and the closure of the California Rehabilitation Center (discussed below). The blueprint outlined a plan for increasing in-state prison beds through the modification of existing facilities and the construction of three new infill-projects.

The blueprint called for the construction of additional low-security prison housing at three existing prisons. The proposed projects would have capacity for 3,445 inmates under the 145 percent population cap proposed by the blueprint (design capacity of 2,376 beds) and would include space to permit the operation of inmate programs such as mental health treatment and academic programs. In addition, the blueprint called for the renovation of the DeWitt Nelson Youth Correctional Facility to house adult offenders. The facility would serve as an annex to the California Health Care Facility (CHCF) currently under construction in Stockton. Under the proposed 145 percent population cap, the DeWitt facility would have capacity for 1,643 lower-security inmates (design capacity of 1,133 beds). Finally, the blueprint proposed converting the Valley State Prison for Women into a men's facility and the conversion of treatment facilities at Folsom Women's Facility into dormitory housing.

> ***Current Status.***
>
> **Expansion of the Dewitt Nelson Youth Correctional Facility.** In the 2012-13 budget, the Legislature authorized $167 million in AB 900 (Solorio), Chapter 7, Statutes of 2007,lease-revenue authority to establish the Dewitt Nelson Correctional Annex. The annex will have the capacity to house 1,133 adult male inmates with medical needs which require them to have access to the adjoining California Health Care Facility or who will be working in the facility. Construction of the facility is scheduled to be completed and occupancy begun in March 2014.

Conversion of Valley State Prison for Women. The conversion has been completed and currently, Valley State Prison houses approximately 3,300 male inmates. This equates to 166.3 percent of its design capacity.

Conversion of the Folsom Transitional Treatment Facility. In the 2012-13 budget, the Legislature authorized the expenditure of $2.8 million for capital improvement projects for the facility to enable women to be housed there. The facility was activated in January of 2013 and currently 341 female inmates are housed there, which equates to 84.6 percent of its capacity.

Construction of Three New Dormitory-Style Housing Units. The 2012 Budget Act included an additional $810 million of lease-revenue bond financing authority for the design and construction of three new level II dormitory housing facilities at existing prisons. Two of these new dormitory housing facilities will be located adjacent to Mule Creek State Prison in Ione, and the third will be located adjacent to Richard J. Donovan Correctional Facility in San Diego. Solicitation of design-build proposals is currently underway. The Administration anticipates that the contracts will be awarded in spring 2014 and construction will be completed in late 2015 or early 2016.

Close the California Rehabilitation Center (CRC). The blueprint assumes that one prison, CRC (Norco), will be closed in 2015-16. This planned closure was due to the fact that CRC is in need of significant maintenance and repair. In addition, the Administration proposed that the savings achieved from closing CRC would offset the costs of operating the new infill beds (mentioned above).

Current Status. SB105 (Steinberg and Huff), Chapter 310, Statutes of 2013 (discussed in detail below), suspended the closure of CRC pending a review by CDCR and the Department of Finance to determine whether or not the facility can be closed. The most recent weekly population report (January 22, 2014) shows that just over 3,000 inmates are housed at CRC, which has a design capacity of 2,491. Not closing CRC, as proposed in the blueprint, results in additional ongoing costs for CDCR of approximately $150 million and unknown repair and maintenance costs.

GOVERNOR'S PROPOSAL:

CDCR Population. The 2013 Budget Act projected an adult inmate average daily population of 128,885 in the current year. The current year adult inmate population is projected to exceed Budget Act projections by 6,101 inmates, a 4.7 percent increase, for a total population of 134,986. The budget year adult inmate population is projected to be 137,788, a 6.9 percent increase of 8,908 inmates. The current projections also reflect an increase in the parolee population of 3,439 in the current year compared to Budget Act projections, for a total average daily population of 45,934. The parolee population is projected to be 36,652 in 2014-15, a decrease of 5,843.

California Department of Corrections and Rehabilitation (CDCR). Proposes total funding of $9.8 billion ($9.5 billion General Fund and $320 million other funds) in 2014-15. This represents a $400 million increase over 2013-14 and a $1.1 billion increase over 2012-13.

ISSUES TO CONSIDER:

The Prison Population Reduction and General Fund Costs Savings Envisioned in the Blueprint Have Not Materialized. As noted in the background, the long-term plan for the state's corrections system was developed in the context of restructuring the prison system in response to realignment and the federal court's ongoing requirement that the state reduce its prison population to 137.5 percent of capacity. However, instead of reducing the state's investment in the correction's system, as promised by the blueprint that investment continues to grow at a significant rate. The Legislature may want to reassess agreements that were made two years ago in the context of adopting the blueprint and consider alternative, sustainable, long-term solutions that will both reduce the prison population and the growing General Fund costs associated with incarcerating large numbers of Californians for significant periods of time.

Alternatives could include programs that have been successful in other states, including the increased use of diversion for people in need of intensive substance abuse and mental treatment. In addition, the Legislature may need to consider some level of sentencing review, particularly as it pertains to sentence enhancements. Finally, any changes to rehabilitation programs or additional funding toward efforts to reduce recidivism should include mechanisms that will allow the Legislature and the Administration to measure the success of the effort.

Trial Court Funding

BACKGROUND:

The judicial branch is responsible for the interpretation of law, the protection of an individual's rights, the orderly settlement of all legal disputes, and the adjudication of accusations of legal violations. The branch consists of statewide courts (the Supreme Court and Courts of Appeal), trial courts in each of the state's 58 counties, and statewide entities of the branch (the Judicial Council, Judicial Branch Facility Program, and the Habeas Corpus Resource Center). The branch receives revenue from several funding sources including the state General Fund, civil filing fees, criminal penalties and fines, county maintenance-of-effort payments, and federal grants.

Due to the state's fiscal situation, the judicial branch, like most areas of state and local government, received a series of General Fund reductions from 2008-09 through 2012-13. Many of these General Fund reductions were offset by increased funding from alternative sources, such as special fund transfers and fee increases. A number of these offsets were one-time solutions (such as the use of trial court reserves) and for the most part, those options have been exhausted. In addition, trial courts partially accommodated their ongoing reductions by implementing operational actions, such as leaving vacancies open, closing courtrooms and courthouses, and reducing clerk office hours. Some of these operational actions resulted in reduced access to court services, longer wait times, and increased backlogs in court workload.

Key Legislation
AB 233 (Escutia and Pringle), Chapter 850, Statutes of 1997, enacted the Lockyer-Isenberg Trial Court Funding Act of 1997, to provide a stable and consistent funding source for the trial courts. Beginning in 1997-98, consolidation of the costs of operation of the trial courts was implemented at the state level, with the exception of facility, revenue collection, and local judicial benefit costs. This implementation capped the counties' general purpose revenue contributions to trial court costs at a revised 1994-95 level. The county contributions become part of the Trial Court Trust Fund, which supports all trial court operations. Fine and penalty revenue collected by each county is retained or distributed in accordance with statute.

AB 1732 (Escutia), Chapter 1082, Statutes of 2002, enacted the Trial Court Facilities Act of 2002, which provided a process for the responsibility for court facilities to be transferred from the counties to the state, by July 1, 2007. It also established several new revenue sources, which went into effect on January 1, 2003. These revenues are deposited into the State Court Facilities Construction Fund (SCFCF) for the purpose of funding the construction and maintenance of court facilities throughout the state. As facilities were transferred to the state, counties began to contribute revenues for operation and maintenance of court facilities, based upon historical expenditures.

SB 1407 (Perata), Chapter 311, Statutes of 2008, authorized various fees, penalties and assessments, which were to be deposited into the Immediate and Critical Needs Account (ICNA) to support the construction, renovation and operation of court facilities. (ICNA is discussed in more detail below.)

SB 1021 (Committee on Budget and Fiscal Review), Chapter 41, Statutes of 2012, altered the administration of trial court reserves by limiting the amount of the reserves individual courts could carry from year to year to one percent of their funding and establishing a statewide reserve for trial courts, which is limited to two percent of total trial court funding.

In enacting these changes, the Legislature sought to create a trial court system that was more uniform in terms of standards, procedures, and performance. The Legislature also wanted to maintain a more efficient trial court system through the implementation of cost management and control systems.

Trial Court Funding

Trial court General Fund support reductions and offsets are shown in the chart below. However, at this point, almost all one-time solutions have been exhausted or are no longer available.

Trial Court Funding Reductions and Offsets
(Dollars in Millions)
Source: Legislative Analyst's Office, 2014

Trial Court Reductions	**2008-09**	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**
One-time reduction	-$92	-$100	-$30	$0	-$418	$0	$0
Ongoing reductions (ongoing)	$0	-$261	-$286	-$606	-$724	-$664	-$564
Total	**-$92**	**-$361**	**-$316**	**-$606**	**-$1,142**	**-$664**	**-$564**
Funding Offsets	**2008-09**	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**
Transfer from other funds	$0	$135	$160	$302	$401	$107	$107
Trial court reserves	$0	$0	$0	$0	$385	$200	$0
Increased fines and fees	$0	$18	$66	$71	$121	$121	$121
Statewide programmatic changes	$0	$18	$14	$19	$21	$18	$18
Total	**$0**	**$171**	**$240**	**$392**	**$928**	**$446**	**$246**
Total Trial Court Reductions	**-$92**	**-$190**	**-$76**	**-$214**	**-$214**	**-$218**	**-$318**

In 2013-14, the budget package included an ongoing augmentation of $60 million to improve public access to trial court services. This reduced the trial courts' ongoing funding reductions to $664 million. The Governor's budget proposal of an additional $100 million augmentation for trial court operations would further reduce the courts' ongoing funding reductions to $564 million. However, approximately $200 million in one-time solutions from trial court reserves, previously used to offset such ongoing reductions, will no longer be available in 2014-15. Thus, under the Governor's budget, trial courts will continue to need to absorb reductions on an ongoing basis, which could include further operational actions that reduce access to court services.

Budget impacts on trial court services. Under Government Code (GC) Section 68106, courts must provide written notice to the public and to the Judicial Council at least 60 days before instituting any plan to reduce costs by designating limited services days. The council, in turn, must post all such notices on its internet site within 15 days of receipt. Since this requirement went into effect on October 19, 2010, the Judicial Council has received notice of the following reductions:

- 51 courthouses closed.
- 205 courtrooms closed.
- 30 courts with reduced public service hours.
- 37 courts with reduced self-help/family law facilitator services.

Impacts on court construction funding. The judicial branch's two primary court construction funds receive funding from fees and penalty assessments. The Governor's budget projects a fund balance for SCFCF of $361 million for 2014-15, which includes a $130 million General Fund loan repayment. The budget also assumes $133 million in expenditures from that fund in 2014-15. The ICNA was originally established to support 41 trial court construction projects, deemed to be immediate and critical by the Judicial Council. Due to the economic downturn, and the subsequent redirection of funding to support trial court operations, this program has been significantly impacted. Of the 41 court construction projects funded through ICNA, two have been cancelled, 11 have been indefinitely delayed, and several others have faced temporary delays during their design phase. The proposed budget projects a $316 million fund balance in 2014-15, and proposes expending $237 million in ICNA funds.

The Chief Justice's Blueprint for Trial Court Funding

The Chief Justice has proposed a three-year blueprint that she believes will enable California to return to a more robust, fully functioning court system. According to the blueprint, the trial courts need a total budget of approximately $2.6 billion to operate a fully functioning court system. By her estimates, the current shortfall stands at approximately $875 million. The Chief Justice is asking for an additional $612 million in 2014-15 growing to an on-going increase of $1.2 billion by 2016-17. A breakdown of the first-year of enhanced funding is included in the chart below.

Year-One Trial Court Blueprint Funding Details
(Dollars in Millions)

Purpose	Amount
Closing the funding gap	$353
Trial court employee costs	$96
Trial court judgeships	$83
Court facilities	$36
Dependency counsel	$33
State judicial branch employee costs	$6
Appellate court justices	$2
Habeas representation	$2
Supreme court workload	$1
Total	$612

The Chief Justice argues that an additional $1.2 billion per year will fully restore the court system and will allow them to focus on four key areas:

- Increase access to courts.
- Provide additional judgeships.
- Modernize court technology.
- Eliminate the trial court funding gap.

GOVERNOR'S PROPOSAL:

The Governor's proposed budget includes $3.3 billion ($1.3 billion General Fund and $2 billion in other funds) in 2014-15 for the judicial branch. Of that amount, $2.5 billion is provided to support trial court operations.

The Governor proposes an ongoing General Fund augmentation of $100 million to support trial court operations, and the budget also proposes a $5 million augmentation to support state level court and Judicial Council operations. The proposed budget requires that the $100 million allocation to the trial courts be based on the new workload-driven funding formula recently adopted by the Judicial Council. However, the trial courts would have flexibility in how these funds are spent.

In the five-year infrastructure plan, the Governor proposes a total of $1.3 billion ($237 million in 2014-15) to fund the final phases of the remaining 15 projections on the Judicial Council's ICNA list. The plan also includes an additional $15 million from the SCFCF to support deferred maintenance and modification projects.

ISSUES TO CONSIDER:

$100 million may not forestall additional reductions in court services. In their *Overview of the Governor's Budget*, the Legislative Analyst's Office (LAO) notes that the $100 million proposed by the Governor may not result in a substantial restoration of access to court services, in part because the funding is not directed toward services. In addition, the LAO points out that current year funding for the courts includes $200 million in one-time funds that will no longer be available in 2014-15, thus requiring the trial courts to absorb this reduction on an on-going basis. The courts will also be faced with increased pension and benefit costs estimated to be approximately $65 million in 2014-15.

In the past, the Legislature has expressed frustration with the fact that they lack sufficient information to determine exactly how budget reductions and augmentations are likely to impact the publics' access to court services. Typically, individual courts have broad discretion to determine how they use funding appropriated for trial court operations. The Legislature may wish to consider targeting any augmentations in order to ensure it is used to improve access to trial court services.

The Chief Justice's Three-Year Blueprint lacks detail. If the Legislature is interested in augmenting the judicial branch's budget based upon the blueprint released by the Chief Justice, they may wish to ask for more detail on her funding request. For example, it would be important to receive information that specifically outlines how services are currently being impacted and how the augmentations proposed by the Chief Justice in the first year for various services and programs (see chart above) would directly improve the current level of service. The need for more detailed information is especially great in regards to the largest portion of the funding request, $353 million, which would go toward "closing the funding gap." The Legislature may wish to ask specifically how closing the funding gap would directly improve services. Could the courts demonstrate that providing that funding to close the gap would result in the reopening of 51 courthouses and 205 courtrooms?

In addition, it would be important to understand why the $600 million would need to grow to $1.2 billion by the third year and exactly how that additional funding would be spent and how that would directly impact court services.

Finally, it is not possible to reconcile the funding in the blueprint with the funding proposed in the Governor's budget. The blueprint states that $1.5 billion is budgeted for the state's trial courts and that the need is $2.6 billion. However, the Governor's budget proposes funding the states trial courts at a level of $2.5 billion. The blueprint does not provide enough detail to reconcile the document with the Governor's budget. Given this discrepancy, it is difficult to understand the magnitude of the problem or determine whether or not an additional augmentation is necessary beyond the Governor's proposal.

APPENDIX

TIMELINE FOR THE 2014-15 BUDGET BILL

Thursday	January 9	Governor submits State Budget to the Legislature.
Thursday	January 9	Committee releases *Quick Summary of Governor's Proposed Budget.*
Monday	January 13	Legislative Analyst submits *Overview of the Governor's Budget.*
Thursday	January 23	Committee conducts overview hearing of the budget. Department of Finance presents budget and the Legislative Analyst provides initial review.
Monday	February 3	Committee releases *Overview of the 2014-15 Governor's Budget.*
Thursday	January 30	Full Budget Committee holds oversight hearing on Corrections and Rehabilitation: Realignment, Court Oversight and Legislative Options.
Thursday	February 6	Joint hearing of Full Budget Committee and Senate Health on Oversight of the Coordinated Care Initiative.
Thursday	February 13	Full Budget Committee holds oversight hearing on the Governor's Proposed 2014-15 Expenditures for Cap and Trade Auction Revenues.
Thursday	February 27	Full Budget Committee holds oversight hearing on State Budget Reserve Funds: Principles and Alternatives.
Thursday	March 6	Subcommittee hearings may begin.
Tuesday	April 1	Department of Finance submits Finance Letters.
Thursday	April 10	Spring Recess begins.
Monday	April 21	Legislature reconvenes from Spring Recess.
Thursday	May 1	Department of Finance submits final capital outlay revisions.
Wednesday	May 14	Governor delivers May Revision to the Legislature.
Sunday	June 15	Legislature must pass budget to meet constitutional deadline for passage of the budget.

STAFF ASSIGNMENTS

BUDGET CONDITION	Mark Ibele
CORRECTIONS/PUBLIC SAFETY	Julie Salley-Gray
EDUCATION	
K-12	Jennifer Troia
Higher Education	Joe Stephenshaw
Child Care	Samantha Lui
ENERGY	Catherine Freeman
ENVIRONMENTAL PROTECTION	Catherine Freeman
JUDICIARY	Julie Salley-Gray
LABOR & EMPLOYEE COMPENSATION	Joe Stephenshaw
LOCAL GOVERNMENT	Mark Ibele
HEALTH	Michelle Baass
HUMAN SERVICES	Samantha Lui Peggy Collins
RESOURCES	Catherine Freeman
REVENUES	Mark Ibele
STATE ADMINISTRATION	Brady Van Engelen Farra Bracht Mark Ibele
TRANSPORTATION	Farra Bracht
VETERANS AFFAIRS	Brady Van Engelen
COMMITTEE ASSISTANT	Sandy Perez
RECEPTIONIST	Mary Teabo

CALIFORNIA STATE BUDGET HISTORY

14 Fiscal Year	Bill and Chapter No.	Date Passed and Chaptered		Total Budget ($ Billions)
1965-66	AB 500/757	6-18	6-30	4.0
1966-67[a]	SB 1XX/2	6-30	6-30	4.7
1967-68	AB 303/500	6-29	6-30	5.0
1968-69	SB 240/430	6-28	6-29	5.7
1969-70	SB 255/355	7-3	7-3	6.3
1970-71	AB 525/303	7-4	7-4	6.6
1971-72[b]	SB 207/266	7-2	7-3	6.7
1972-73[c]	SB 50/156	6-15	6-22	7.4
1973-74	AB 110/129	6-28	6-30	9.3
1974-75	SB 1525/375	6-28	6-30	10.3
1975-76	SB 199/176	6-26	7-1	11.5
1976-77	SB 1410/320	7-1	7-2	12.6
1977-78	AB 184/219	6-24	6-30	14.0
1978-79	AB 2190/359	7-5	7-6	18.8
1979-80	SB 190/259	7-12	7-13	21.5
1980-81	AB 2020/510	7-16	7-16	24.5
1981-82c	SB 110/99	6-15	6-28	25.0
1982-83	AB 21/326	6-30	6-30	25.3
1983-84	SB 123/324	7-19	7-21	26.8
1984-85c	AB 2313/258	6-15	6-27	31.0
1985-86c	SB 150/111	6-13	6-28	35.0
1986-87c	AB 3217/186	6-12	6-25	38.1
1987-88	SB 152/135	7-1	7-7	40.5
1988-89	AB 224/313	6-30	7-8	44.6
1989-90	SB 165/93	6-29	7-7	48.6
1990-91	SB 899/467	7-28	7-31	51.4
1991-92	AB 222/118	6-20/7-4	7-16	55.7
1992-93	AB 979/587	8-29	9-2	57.0
1993-94	SB 80/55	6-22	6-30	52.1
1994-95	SB 2120/139	7-4	7-8	57.5
1995-96	AB 903/303	8-2	8-3	56.8
1996-97	SB 1393/162	7-8	7-15	61.5
1997-98	AB 107/282	8-11	8/18	67.2
1998-99	AB 1656/324	8-11	8-21	71.9
1999-00	SB 160/50	6/16	6/29	81.3
2000-01	AB 1740/52	6/22	6/30	99.4
2001-02	SB 739/106	7/21	7/26	103.3
2002-03	AB 425/379	9/1	9/5	98.9
2003-04	AB 1765/157	7/29	8/2	98.9
2004-05	SB 1113/208	7/29	7/31	105.3
2005-06	SB 77/38	7/7	7/11	117.3
2006-07	AB 1801/47	6/27	6/30	131.4
2007-08	SB 77/171	8/21	8/24	146.5
2008-09	AB 1781/268 & AB 88/269	9/16	9/23	144.5
2009-10	SBx3 1/Ch 1 & ABx4 1/Ch 1	2/20	7/28	119.2
2010-11	SB 870/Ch 712	10/7	10/8	125.3
2011-12	SB 87/Ch 33	6/28	6/30	129.5
2012-13	AB 1464/Ch 21 & AB 1497/Ch 29	6/15	6/27	142.4
2013-14	AB 110/Ch 20	6/14	7/1	145.3

[a] *1966 Second Extraordinary Session.*
[b] *First year budget was to be enacted by June 15.*
[c] *June 15 constitutional deadline met (6).*

GENERAL FUND MULTI-YEAR PROJECTION at 2014-15 Governor's Budget

(Dollars in Millions)

	2013-14	2014-15	2015-16	2016-17	2017-18
RESOURCES:					
Prior Year Balance	$2,528	$4,212	$1,922	$2,620	$3,327
Revenues/Transfers	$100,147	$106,094	$111,436	$117,421	$123,168
Prop 58 Transfer to the Budget Stabilization Account (for rainy day)		-$1,591	-$1,000	-$1,000	-$1,000
Total Resources	$102,675	$108,715	$112,358	$119,041	$125,495
EXPENDITURES:					
Proposition 98	$40,948	$45,062	$46,504	$48,214	$49,658
Non-Proposition 98	$57,515	$60,140	$63,234	$67,500	$71,187
Prop 58 Transfer to the Budget Stabilization Account (for ERB payoff, ends in 2014-15)		$1,591			
Total Expenditures	$98,463	$106,793	$109,738	$115,714	$120,845
FUND BALANCES:	$4,212	$1,922	$2,620	$3,327	$4,650
Reserve for Encumbrances	$955	$955	$955	$955	$955
Special Fund for Economic Uncertainties	$3,257	$967	$1,665	$2,372	$3,695
Budget Stabilization Account/Rainy Day Fund		$1,591	$2,591	$3,591	$4,591
Operating Surplus/Deficit with BSA Transfer	$1,684	-$2,290	$698	$707	$1,323

General Fund Revenues as of 2014-15 Governor's Budget

(Dollars in Millions)

		2013-14	2014-15	2015-16	2016-17	2017-18
1	**Major Revenues**					
2	Alcoholic Beverage Taxes and Fees	350	357	364	371	379
3	Corporation Tax	7,971	8,682	9,331	9,654	9,833
4	Cigarette Tax	89	86	84	81	79
5	Horse Racing (Parimutuel) License Fees	1	1	1	1	1
6	Insurance Gross Premiums Tax	2,143	2,297	2,530	2,616	2,705
7	Trailer Coach License (In-Lieu) Fees	20	20	20	21	21
8	Motor Vehicle License (In-Lieu) Fees	0	0	0	0	0
9	Personal Income Tax	64,287	69,764	73,504	77,376	81,346
10	Retail Sales and Use Taxes	22,920	24,071	25,777	26,338	26,846
11	**Total Major Revenues**	**$97,781**	**$105,278**	**$111,611**	**$116,458**	**$121,210**
12	**Minor Revenues/Transfers**					
13	Misc Revenue from Local Agencies	198	198	198	198	198
14	Income from Pooled Money Investments	23	32	51	138	236
15	State Lands Royalties	325	280	269	241	217
16	Abandoned Property	421	446	454	441	429
17	Miscellaneous Revenue	159	159	159	159	159
18	Tribal Gaming Revenues	237	237	237	237	237
19	Settlements/Judgments	426	3	3	3	3
20	Loan Repayments to Other Funds	-721	-487	-1,371	-682	-37
	Pay Down Loans from Other Funds		-440	-650	-250	37
21	All Other Transfers and Loans	1,067	163	245	246	246
22	Transfer to BSA for Rainy Day Funds	0	-1,591	-1,000	-1,000	-1,000
23	Remaining Others	231	225	230	232	233
24	**Total Minor Revenues/Transfers**	**$2,366**	**-$775**	**-$1,175**	**-$37**	**$958**
25	**Total Revenues**	**$100,147**	**$104,503**	**$110,436**	**$116,421**	**$122,168**

General Fund Prop 98 Expenditures at 2014-15 Governor's Budget

(Dollars in Millions)

	2013-14	2014-15	2015-16	2016-17	2017-18
Proposition 98 guarantee (GF)	33,911	37,814	37,083	39,507	41,538
Education Protection Account	7,037	7,248	7,902	7,107	6,483
Local Property Tax	15,865	16,497	19,552	20,383	21,613
Total Prop 98 guarantee	56,813	61,559	64,537	66,997	69,634
Percent Change	-2.62%	8.35%	4.84%	3.81%	3.94%
Prop 98 Test	3	1	2	3	3
General Fund Base	33,911	37,814	37,083	39,507	41,538
Education Protection Account	7,037	7,248	7,902	7,107	6,483
QEIA Payment [1/]	0	(410)	0	0	0
Williams Settlement [1/,2/]	0	(188)	(274)	0	0
Settle up for old years [1/]	0	0	1,519	0	0
Mandates Payment [2/]			(1,245)	1,600	1,637
Total General Fund	40,948	45,062	46,504	48,214	49,658
Prop 98 Obligations					
Maintenance Factor Created/Paid (+/-)	2,096	-3,372	-1,186	291	432
Outstanding Maintenance Factor	7,910	4,549	3,488	3,927	4,539
Settle-Up Balance	1,519	1,519	0	0	0
Budgetary Deferrals Balance	2,474	0	0	0	0
QEIA Balance	410	0	0	0	0
Williams Settlement Balance	462	274	0	0	0

[1/] The amount reflected is proposed to be appropriated to fund prior-year Prop 98 commitments. Since this amount is attributable to prior year obligations, the actual expenditure is reflected as a Prior Year Adjustment to the beginning General Fund balance once the amount is proposed to be appropriated.

[2/] In 2015-16, the amounts reflected in parentheses are obligations proposed to be paid with the settle-up payment.

General Fund Non Prop 98 Expenditures by Agency at 2014-15 Governor's Budget

(Dollars in Millions)

	2013-14	2014-15	2015-16	2016-17	2017-18
N98 excludes Capital Outlay, Debt Service					
Legislative, Executive	$1,108	$1,164	$1,100	$1,091	$1,094
Courts	$1,460	$1,560	$1,572	$1,584	$1,597
Business, Consumer Services, and Housing	$21	$25	$25	$25	$24
Transportation	$81	$83	$85	$0	$0
Natural Resources	$1,071	$1,134	$1,088	$1,088	$1,088
Environmental Protection	$43	$50	$58	$58	$58
Health and Human Services	$28,169	$28,644	$29,496	$32,264	$36,220
Affordable Care Act County Offset	(-300)	(-900)	(-1,300)	(-1,300)	(-1,300)
Federal Funds Offset [1/]	(-482)	(-344)	(-200)	(0)	(0)
Corrections and Rehabilitation	$8,959	$9,119	$9,339	$9,395	$9,452
Receiver's Cost	(1,635)	(1,654)	(1,684)	(1,709)	(1,734)
AB 109 Savings	(-1,317)	(-1,458)	(-1,544)	(-1,544)	(-1,544)
Education	$8,590	$9,610	$10,172	$10,698	$11,231
STRS Contribution	(1,360)	(1,424)	(1,530)	(1,593)	(1,643)
Labor and Workforce Development	$298	$268	$236	$174	$117
Government Operations	$753	$683	$652	$658	$643
General Government	$1,518	$3,716	$3,516	$4,615	$3,739
Non-Agency Departments	(460)	(556)	(1,326)	(692)	(484)
Tax Relief/Local Government	(420)	(437)	(437)	(437)	(427)
Statewide Expenditures	(638)	(1,132)	(1,753)	(3,486)	(2,828)
Supplemental Payment to Economic Recovery Bonds	(0)	(1,591)	(0)	(0)	(0)
Total PERS Contribution (GF) (Excluding CSU)	(1,645)	(1,842)	(1,886)	(2,608)	(2,423)
Capital Outlay	$111	$74	$84	$148	$81
Debt Service	$5,333	$5,601	$5,811	$5,702	$5,843
Total N98 Expenditures	**$57,515**	**$61,731**	**$63,234**	**$67,500**	**$71,187**

[1/] Hospital finance waiver (Bridge to Reform) expires in 2015.

Wall of Debt
2014-15 Governor's Budget
(Dollars in Millions)

		Outstanding (as of end of 2010-11)	Outstanding (as of end of 2013-14 based on 2013 Budget Act policies)	Proposed Supplemental Payments to 2013-14 and Earlier	2014-15 impact	2015-16 impact	2016-17 impact	2017-18 impact	Remaining Amount
1	Deferred Payments to Schools and Community Colleges	$10,430	$6,164	$3,690	$2,474	$0	$0	$0	$0
2	Economic Recovery Bonds	7,100	3,914	0	3,165	0	0	0	0
3	Loans from Special Funds	5,100	3,880	0	927	2,021	932	0	0
4	Unpaid Costs to Local Governments, Schools and Community Colleges for State Mandates	4,300	5,382	0	0	1,993	1,752	1,637	0
5	Underfunding of Proposition 98	3,000	2,391	598	0	1,793	0	0	0
6	Borrowing from Local Governments (Proposition 1A)	1,900	0	0	0	0	0	0	0
7	Deferred Medi-Cal Costs	1,200	1,773	0	60	40	0	1,673	0
8	Deferral of State Payroll Costs from June to July	759	783	0	0	0	783	0	0
9	Deferred Payments to CalPERS	524	411	0	0	0	411	0	0
10	Borrowing from Transportation Funds (Proposition 42)	417	168	0	83	85	0	0	0
11	**Total**	**$34,730**	**$24,866**	**$4,288**	**$6,709**	**$5,932**	**$3,878**	**$3,310**	**$0**