GOVERNOR'S BUDGET

MAY REVISION

2004–05

ECONOMIC RECOVERY— A WORKOUT PLAN THAT'S WORKING

When Governor Schwarzenegger took office, the State of California had accumulated an inherited debt of more than $22 billion, representing policy and budgetary decisions made by the Legislature and the prior Administration. In the absence of corrective actions to change these policies, the State would continue incurring annual operating deficits, estimated at $14 billion in fiscal year 2004-05.

In response to such massive and growing debt, the Governor proposed a four-part economic recovery plan. In the four months since the plan was announced, there has been major progress in every one of its elements:

- In March, the voters approved Proposition 57—The Economic Recovery Bond Act—to refinance a portion of the inherited debt.
- In March, the voters also approved Proposition 58—a constitutional amendment to require balanced budgets with prudent reserves in the future.
- In April, the Legislature passed and the Governor signed a comprehensive reform of the State's workers compensation system, which is the first step in the Governor's plan to improve the business and jobs climate in order to revitalize the State's economy and improve revenue growth over time.
- Finally, the May Revision proposes a budget for 2004-05 that moves toward structural balance.

A Budget That Moves Toward Structural Balance

2004-05 Budget

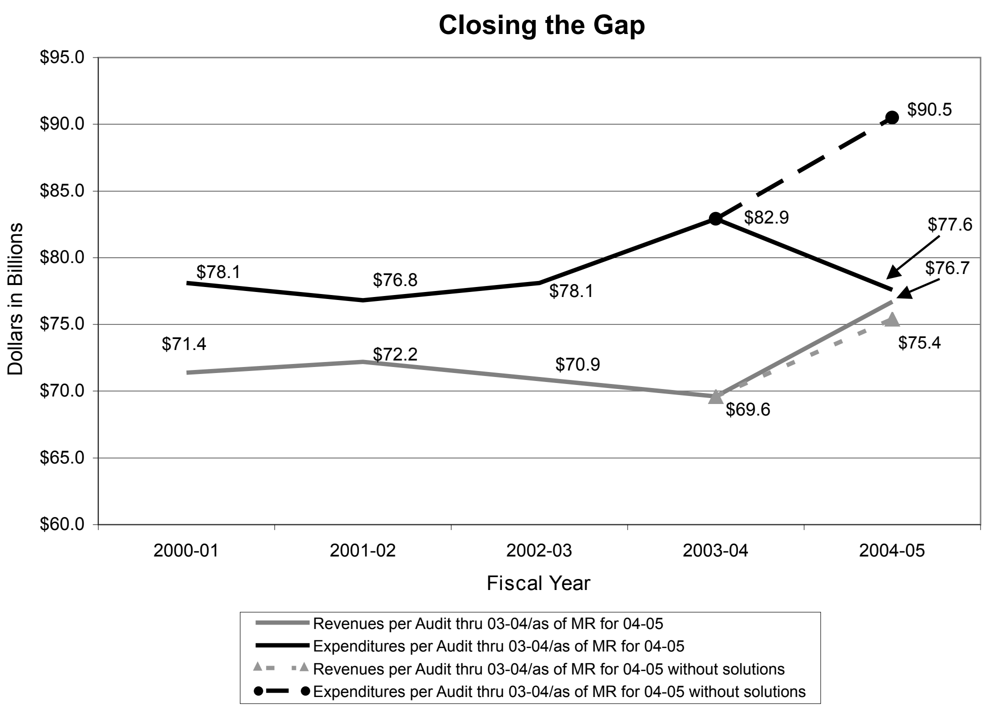
The Governor's Budget for 2004-05 identified an operating deficit of $14 billion (meaning that expenditures were on track to exceed revenues during the fiscal year by that amount) and year-end deficit of over $26 billion (representing the cumulative effect of the operating deficit and the carried forward deficit from 2002-03). In order to eliminate the deficit and create a small reserve, the budget proposed $12.3 billion in proceeds from the Economic Recovery Bonds and $14.6 billion in various other solutions.

Since the release of the Governor's Budget, State revenues have increased slightly, but this has been offset by additional pressures on the General Fund primarily due to caseload increases, an increase in the Proposition 98 guarantee, and court cases. The net effect of the changes together with policy changes included in the May Revision increased the reserve at the end of 2004-05 from $635 million projected in the Governor's Budget to $998 million. The table below reflects the major changes that account for the increase in the reserve:

Changes in General Fund Reserve
(Dollar in Millions)

June 30, 2005, Reserve at Governor's Budget	$635
Revenue Increases—Current	1,211
Revenue Increases—Prior Year Adjustments	1,945
Reduction in Economic Recovery Bonds	–1,000
Medi-Cal Rate Increase Court Case	–947
Caseload and Estimate Increases	–691
Increased Proposition 98 Expenditures	–581
Major Restorations	–945
Erosions to solutions due to legislative inactions on mid-year proposals (excludes Medi-Cal provider rates)	–419
Renegotiate with collective bargaining units for additional savings	464
Use of Punitive Damage Fund to offset General Fund expenditures	450
Alternative Savings in Health and Human Services	292
Redirection of Education Fund Surplus	134
School Districts Loan Refinancing	111
Strategic Sourcing and Procurement Reform	96
Asset Management and Surplus Property Reform Revenues	50
Other Changes	193
Revised Reserve at May Revision	$998

The chart below illustrates how the $15.1 billion of solutions close the gap.



Significant Progress Toward Structural Balance

The Governor's Budget proposed a measured, long-term approach to put the State on the path to eliminate the State's operating deficit. Two key elements in this approach are (1) to use one-time revenues only for one-time expenditures (in order to avoid increasing the operating deficits in future years) and (2) the implementation of structural reforms that will have their greatest impact in the future. Examples of longer term reforms are Strategic Sourcing, Procurement Reform, savings from which are projected to double in 2005-06, the Parole Accountability Reform, and Medi-Cal Reform, both of which should produce major savings beginning in 2005-06.

In February, the Legislative Analyst projected that the State would face a structural deficit of $7 billion in 2005-06, even assuming the enactment of all of the savings and other solutions proposed in the Governor's Budget. As a result of the changes proposed in the May Revision, the Department of Finance now estimates that the deficit the by the end of 2005-06 will be eliminated.

Proposed Budget Process Reforms

2003-04 No Change

2004-05 New Statutory Requirements

The Administration is pursuing various budget process reforms identified below. These budget process reforms will ensure that the budget process is more efficient and allows greater citizen access to budget information. Additionally, these budget process reforms will streamline the budget process and ensure limited State resources are used judiciously.

- Develop requirements for State agencies and departments to prepare long-range strategic plans.
- Incorporate Performance Based Budgeting principles into the State budget planning process.
- Implement a process to generate savings by providing incentives for State agencies and departments to reengineer business processes and increase operating efficiencies.
- Develop a web-based Governor's Budget to ensure greater citizen access. This is the first step towards developing a transparent budget.
- Consolidation of fiscal related statutes for greater accessibility.
- Implement an Asset Management Program.
- Establish an Economic and Revenue Consensus Conference for the purpose of obtaining an Administration/Legislature consensus of estimated economic and revenue forecasts.
- Implement a process to control the release of appropriations to avoid over-spending in cases where revenues do not materialize as originally projected, and to improve savings opportunities, thus ensuring prudent fiscal management.
- Ensure Finance executive orders to implement budget adjustments are processed in a timely manner to order to carry out programs in accordance with law.
- Review and evaluate the timing of the submission of the Governor's Budget, revisions to the Governor's Budget, and adequate review by the Legislature.

The Economy

National economic output grew strongly in the first quarter of 2004, extending a period of faster growth that began in the third quarter of 2003. Consumer spending, business investment in information processing equipment and software, national defense, exports, and investment in private inventories were the major contributors to the gain in first-quarter output. Other economic indicators portrayed a surging manufacturing sector, near-record home sales, strong wholesale sales, and a healthy services sector. But inflation turned up, and despite a string of small job gains, labor markets remained weak.

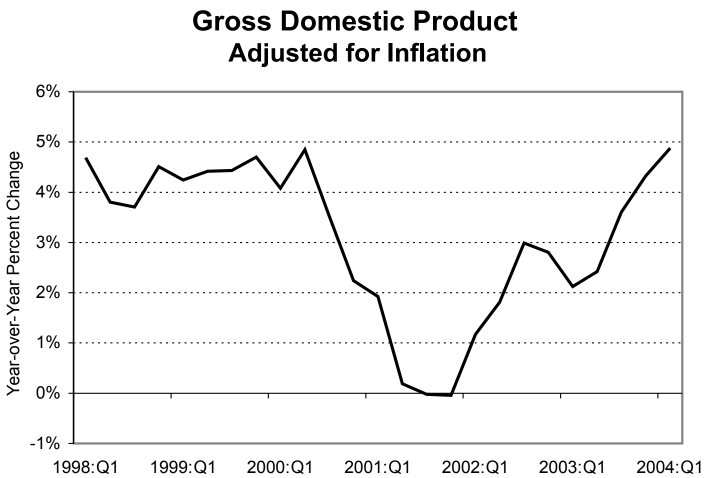
California's economy also improved. Most encouraging, personal income growth picked up solidly in the fourth quarter of 2003. In addition, taxable sales grew for the sixth quarter in a row. And, exports of made-in-California merchandise turned around in the second half of last year after declining for almost three years. More recently, residential construction and housing markets remained strong in the first quarter of 2004. But, as in the nation, labor markets remained weak, particularly in the San Francisco Bay Area.

The strengthening of both economies almost guarantees that 2004 will improve on 2003. However, this outlook is not without risks. Long-term interest rates jumped one half-percentage point in April on signs that the stronger national economy was putting pressure on prices. Sharply higher interest rates would slow residential construction, cool real estate markets, and reduce the mortgage refinancing that has fueled a considerable amount of consumer spending in the last three years. In addition, the economies will not be able to maintain their faster pace of the last nine months unless job growth picks up. If these risks can be avoided, the next two years should bring improved economic performance.

The Nation

Adjusted for inflation, gross domestic product (GDP) rose at a robust 4.2 percent annualized rate in the first quarter of 2004. Coming in the wake of strong economic growth in the second half of 2003, first-quarter real GDP was 4.9 percent higher than the year-earlier level, making it the strongest four-quarter gain since 1984 (Figure ECON–1). As a measure of the economy's recent acceleration, first-quarter

FIGURE ECON–1



2003 real GDP was only 2.1 percent above the year-earlier level.

Buoyed by large federal income tax refunds, last year's tax cuts, mortgage refinancing, and improved optimism about the economy, consumers spent 3.8 percent more at an annualized rate in the first quarter. They favored food, clothing and shoes, gasoline, fuel oil, and other (petroleum-based) goods, and medical care while cutting back on motor vehicles and parts. Consumer confidence has trended slowly upwards since March 2003 with signs of an improving economy out-weighing disappointment over high gasoline prices and concern over the escalating conflict in Iraq.

Business investment also continued to grow strongly in the first quarter, although it was concentrated in a few categories. Investment in information processing equipment and software grew at a double-digit annualized rate for the fifth consecutive quarter. Spending on industrial equipment was up, but remained at levels much below that of 2000 and early 2001. Investment in transportation equipment remained depressed, falling slightly. Construction of nonresidential structures slipped for the 11th time in the last 13 quarters. Residential investment was up, but much more modestly than in recent quarters. And business inventories rose modestly.

Government spending rose 2 percent, largely on a surge in national defense spending. Public sector spending has closely followed the ups and downs of national defense spending in the last three years. State and local government expenditures fell for the second consecutive quarter.

Net exports (exports minus imports) increased in the first quarter, as exports of goods and services increased slightly more than imports of goods and services. The weaker dollar likely played a role in this improvement in the trade deficit, as did the strengthening economies of major trading partners of the United States.

Monthly statistics since the beginning of 2004 reflect the strengthening of the economy in the first quarter and point to additional improvement in the second quarter. The Institute for Supply Management's survey of national manufacturing indicated that manufacturing activity expanded for 11 consecutive months through March 2004. Additionally, the Federal Reserve's industrial production index posted eight consecutive gains before falling slightly in March and is up 3.4 percent over last year. The Institute for Supply Management's nonmanufacturing index depicted a nonmanufacturing sector that has grown for 13 consecutive months.

Nonfarm payroll employment increased for seven consecutive months through March 2004. The gains were small, on average, and left employment below its level at the end of the 2001 recession. But they, along with declining initial claims for unemployment insurance benefits and declining layoff announcements, point toward better labor markets ahead.

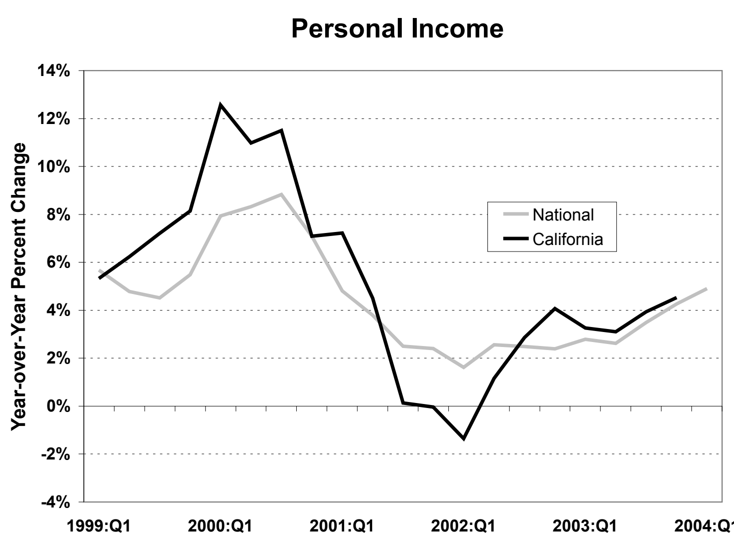
While residential construction grew more slowly in the first quarter, home markets soared. Boosted by favorable weather and low mortgage rates, existing home sales in March reached their second highest level on record and new home sales jumped to a new record.

While still very low, inflation appears to be turning up. The Consumer Price Index jumped a higher-than-expected 0.5 percent in March. While surging energy prices were instrumental in the gain, a variety of non-energy prices also played a role—apparel, lodging, and medical care. Also, the Producer Price Index jumped in March in response to rising energy prices, higher food prices, and increasing prices of cars and trucks. In addition, there were large increases in crude and intermediate goods prices. The advance GDP report showed that the price index for gross domestic purchases, which measures prices paid by U.S. residents, increased at a 3.2 percent annualized rate in the first quarter, compared with an increase of 1.3 percent in the fourth quarter of 2003. Excluding food and energy prices, the price increase was 2.3 percent in the first quarter as compared with 1.5 percent in the fourth quarter.

California

Since the release of the Governor's Budget, positive signs in the economy have increased and troubling ones have grown fewer. Foremost among the positive signs is a pick-up in state personal income growth. In the second quarter of 2003, personal income was 3.1 percent higher than a year earlier; two quarters later it was 4.5 percent ahead of a year ago (Figure ECON–2). And once again, personal income is increasing more quickly in the state than in the nation.

FIGURE ECON–2



Wages and salaries tell a similar story of improvement, as do state personal income tax withholdings. The latter look particularly strong, up almost 9 percent through the first four months of 2004. About a percentage point and a half of that gain is due to two extra days of collections in March 2004. Yet even net of that, the gain is quite striking.

State taxable sales are also improving with six consecutive quarters of year-over-year growth through the fourth quarter of 2003. The most current county taxable sales data are for the first quarter of 2003. While quite dated, they show taxable sales declined in every major San Francisco Bay Area county and increased in every major Southern California and Central Valley county.

Exports of California-made merchandise recovered enough in the third and fourth quarters of 2003 to push the yearly total slightly ahead of the 2002 level. In the fourth quarter of 2003, exports of California-made computer and electronics products were more than 10 percent higher than a year earlier—a sign that the worldwide high-tech recession is over. For the year as a whole, however, high-tech exports were lower than in 2002. Exports of transportation equipment, chemicals, agricultural products, and food and kindred products grew considerably in 2003. By major markets, state exports to Mexico and Taiwan fell considerably in 2003, while those to Japan, Canada, mainland China, Hong Kong, and Italy grew appreciably.

Low mortgage rates kept residential real estate markets strong in the first quarter of 2004. The median price of homes sold in Southern California hit a new record of $371,000 in March, up 23.3 percent from a year earlier—the strongest year-over-year gain in over 15 years. Sales were up over 17 percent from a year ago. Despite a weak economy, home price appreciation and sales were also strong in the San Francisco Bay Area. The median price of homes sold was a record $474,000 in March, up 13.1 percent from a year earlier. Sales were up 25 percent from a year ago.

The foremost missing ingredient in California's economic recovery is strong job growth. California nonfarm payroll employment was revised down a moderate amount in the annual revision of the state's employment statistics. Unfortunately, the hard-hit San Francisco Bay Area accounted for almost all of the downward revision; payroll employment was revised up in all major Southern California metropolitan areas except Los Angeles County. (Sacramento metropolitan area nonfarm payroll employment was revised up considerably.) Even with the downward revisions, it appears that Bay Area employment will start to grow around year-end. In March 2004, nonfarm employment was down 1.6 percent from a year earlier; just three months earlier, it was down 2.9 percent. At that rate of improvement, nonfarm payroll employment will be even with the year-earlier level near the turn of the year. That includes Santa Clara County—the county hit hardest by the high-tech recession.

The Forecast—For more than a year, the chief worry about both economies was that improved job growth would not come in time. Today that is less of a concern. While job growth remains anemic, other measures of labor market conditions have improved considerably—fewer claims for unemployment insurance benefits, smaller announced layoffs, and greater help wanted advertising. Stronger job growth is close at hand. How strong it becomes is difficult to predict because of uncertainty about longer-run productivity growth in the economy. The huge investment in high-tech equipment and software in the second half of the 1990s resulted in much higher productivity in recent years, allowing companies to produce more with the same number or fewer employees. This extraordinarily high productivity growth cannot last much longer, though the new level of long-run productivity growth should be somewhat higher than average productivity growth before the boom in high-tech equipment and software. But just when this will happen and where it settles is difficult to predict.

The recoveries of the national and California economies accelerated in the last nine months. The improvement is evident in broad measures of the economy—Gross Domestic Product, sales, personal income, business investment, business profits, and international trade, among others.

The national economy will continue to grow strongly during the remainder of 2004. For the year as a whole, real GDP will increase 4.6 percent (Figure ECON–3). Output growth will slow somewhat in 2005 as consumer spending and business investment grow less quickly. Other than insufficient job growth, the primary risks to the outlook are higher interest rates and inflation. Both have moved up in recent months.

On an annual average basis, job growth will be only 0.8 percent in California in 2004 because labor markets did not improve early in the year (Figure ECON–4). Job creation will build as the year proceeds and will average 2.1 percent in 2005.

Growth in total state personal income will improve from 5.4 percent in 2004 to 5.6 percent in 2005. California faces the same major economic risks as the nation.

FIGURE ECON-3

Selected U.S. Economic Indicators

	2003	Forecast 2004	2005
Real gross domestic product, (2000 dollar) (Percent change)	3.1	4.6	3.5
Personal consumption expenditures	3.1	3.8	2.8
Gross private domestic investment	4.2	10.1	4.3
Government purchases of goods and services	3.3	2.7	2.1
GDP deflator (2000=100) (Percent change)	1.7	1.7	1.4
GDP, (Current dollar) (Percent change)	4.8	6.5	4.9
Federal funds rate (Percent)	1.13	1.13	2.28
Personal income (Percent change)	3.3	4.7	5.0
Corporate profits before taxes (Percent change)	15.0	20.6	32.7
Nonfarm wage and salary employment (Millions)	129.9	130.9	133.3
(Percent change)	-0.3	0.7	1.9
Unemployment rate (Percent)	6.0	5.6	5.5
Housing starts (Millions)	1.85	1.84	1.69
(Percent change)	8.0	-0.2	-8.5
New car and light truck sales (Millions)	16.6	16.9	17.0
(Percent change)	-0.8	1.7	0.7
Consumer price index (1982-84=100)	184.0	188.0	191.4
(Percent change)	2.3	2.2	1.8

Forecast based on data available as of April 2004.
Percent changes calculated from unrounded data.

FIGURE ECON-4

Selected California Economic Indicators

	2003	Percent change	Forecast 2004	Percent change	2005	Percent change
Personal income ($ billions)	$1,197.6	3.7%	$1,262.4	5.4%	$1,333.1	5.6%
Nonfarm W&S employment (thousands)	14,408	-0.3%	14,525	0.8%	14,832	2.1%
Natural resources and mining	22	-5.2%	22	-0.8%	22	-0.9%
Construction	788	1.8%	824	4.5%	868	5.3%
Manufacturing	1,543	-5.8%	1,517	-1.7%	1,538	1.4%
High technology	399	-9.2%	388	-2.9%	394	1.7%
Trade, transportation, & utilities	2,715	-0.3%	2,723	0.3%	2,747	0.9%
Information	471	-5.2%	467	-0.9%	487	4.2%
Financial activities	886	3.9%	904	2.0%	926	2.4%
Professional and business services	2,114	0.0%	2,174	2.8%	2,247	3.4%
Educational and health services	1,538	2.6%	1,576	2.5%	1,625	3.1%
Leisure and hospitality	1,399	1.2%	1,424	1.8%	1,453	2.0%
Other services	505	-0.1%	505	-0.1%	514	1.8%
Government	2,427	-0.8%	2,391	-1.5%	2,408	0.7%
Unemployment rate (percent)	6.7		6.3		6.1	
Housing permits (thousands of units)	199	18.6%	200	0.6%	200	0.0%
Consumer price index (1982-84=100)	190.4	2.3%	195.2	2.5%	199.7	2.3%

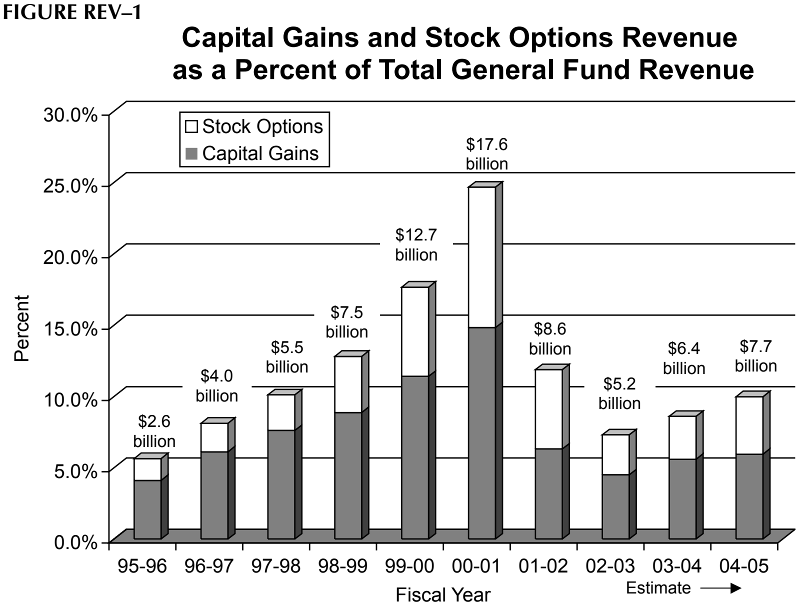
Forecast based on data available as of April 2004.

Revenue Estimates

General Fund Revenues

General Fund revenues are expected to be below the Governor's January Budget by $36 million in 2003-04 and above the Governor's Budget by $281 million in 2004-05. Over the two years, the increase is $245 million. These figures do not include gains from prior year adjustments, which are described below. For the major taxes only, the May Revision forecast has improved since the Governor's Budget—revenues are up $780 million in 2003-04 and up $604 million in 2004-05, for a two-year change of $1.4 billion. The most significant change was in the personal income tax. Strong April payments and consistent growth in withholding suggest an improving economy. In addition, market-related income such as capital gains and stock options appear to have bottomed-out in 2002-03, and the May Revision estimate assumes growth in these components in 2003-04 and 2004-05. This can be seen in Figure REV–1. Higher expectations for income tax revenues were partially offset by reduced expectations for sales tax receipts. Over the two years, corporation tax receipts are $185 million above the Governor's Budget forecast.

FIGURE REV–1



Note: An assumed tax rate of 9 percent was used to calculate the tax revenue from capital gains and stock options.

The forecast also includes the effect of the May Revision proposals to address the inherited budget problems and put the State back on track. These proposals include the following:

- Maintaining the base level of transfers to the Public Transportation Account (PTA), but specifying that any excess sales tax revenues on gasoline, which would otherwise be designated as PTA spillover, be credited to the Traffic Congestion Relief Fund as partial repayment of transportation loans. An estimated $140 million in revenue is expected.

- Abusive tax shelter audit activities are expected to increase revenues by $67 million in 2004-05.

- A personal income tax and corporation tax amnesty program during 2004-05 is expected to increase revenues by $185 million. (See the Franchise Tax Board in the General Government section for additional detail on this program.)

Significant positive prior year revenue adjustments are included in the May Revision. Revenue gains that total $945 million and are attributable to prior years improve the General Fund condition. Most of these gains are due to personal income tax and corporation tax gains due to the Voluntary Compliance Initiative (VCI). Chapter 656, Statutes of 2003, made numerous changes to curtail abusive tax shelters. One of the changes was the VCI, which allowed taxpayers to file amended returns and pay the tax and interest to avoid all current penalties and additional penalties provided by this Chapter. The VCI period was from January 1, 2004, through April 15, 2004, for years prior to the 2003 tax year. Personal income tax and corporation tax revenue gains of $1.225 billion are attributable to the VCI. The May Revision also makes a prior year adjustment of $185 million that is attributable to a May Revision proposal for a tax amnesty program to take place in 2004-05. Finally, revenue losses of $465 million due to the Farmer Brothers Company lawsuit partially offset the positive prior year adjustments. Including the $245 million revenue gain for 2003-04 and 2004-05 with the prior year adjustments results in additional revenues of $1.2 billion since the Governor's Budget.

Personal Income Tax

The personal income tax forecast has been increased by $949 million in 2003-04 and by $559 million in 2004-05. The current year estimate does not include the revenue collected from the VCI, which amounted to $738 million at the time the forecast was prepared, because these collections are attributable to several prior tax years, and therefore, will be a prior year adjustment. The budget year estimate includes the effect of the Administration's proposals identified above as well as an adjustment for the resumption of net operating loss usage, which had been suspended for 2002 and 2003.

Cash receipts associated with the 2003 tax year were higher than expected and this accounts for the upward revision in 2003-04. Through April, total personal income tax revenues, not including VCI collections, were $285 million above the Governor's Budget forecast. This strength is assumed to be at least due, in part, to the upturn in the stock market that began in mid-2003. In 2002, capital gains were 70 percent below the 2000 peak level. Our estimate assumes the market has bottomed out and will continue on an upward trend. After the initial rebound of 30 percent from the 2002 low, capital gains are projected to grow at a 10-percent annual rate. The year-to-date strength in withholding, which was $142 million above the Governor's Budget estimate, has been an encouraging sign. Total withholding from January through April was 8.8 percent above the year-ago level. Since withholding is based on current wages, it is a good indicator of current activity and this forecast assumes that the recent strength is real and ongoing.

Sales and Use Tax

The sales and use tax forecast has been decreased by $105 million in the current year and $417 million in the budget year. Through March, sales tax receipts were $36 million below the 2004-05 Governor's Budget forecast. Taxable sales in the fourth quarter of 2003 were slightly below the January forecast and it appears first quarter 2004 sales are also somewhat below estimate.

Of the $417 million reduction in 2004-05, $175 million is due to an increased transfer to the Public Transportation Account (PTA). The PTA estimate has increased because gasoline and diesel fuel prices are higher than estimated in January. However, as previously discussed, $140 million of this amount will be credited to the Traffic Congestion Relief Fund. The remaining amount is due to more modest expectations of taxable sales growth. For calendar year 2004, taxable sales are expected to grow by 4.1 percent, while 5.2 percent growth is expected for calendar year 2005.

On March 2, 2004, California voters approved Proposition 57, a bond act authorizing issuance of up to $15 billion of Economic Recovery Bonds to fund the accumulated State budget deficit. To repay these bonds, a new one-quarter cent sales tax will become effective July 1, 2004. This sales tax will automatically cease as soon as the bonds are repaid. Because the local portion of the sales tax will decrease on July 1, 2004, the total base statewide sales tax will remain at 7.25 percent. Revenues from the one-quarter cent sales tax are estimated at $1.136 billion in 2004-05, and approximately $1.3 billion annually thereafter.

Corporation Tax

The corporation tax forecast has been decreased by $173 million in 2003-04 and increased by $358 million in 2004-05. The $173 million reduction in 2003-04 reflects an increase attributable to a more positive corporate profits outlook for 2004, but which was more than offset by weakness in the final payments for the

2003 year. The $487 million in recent cash collections related to the VCI is accrued to prior years, and so it does not affect the estimated total. The $358 million increase in 2004-05 reflects a more positive corporate profits outlook and proposals to increase audit activities related to abusive tax shelters. The forecast anticipates continued improvement in corporate profits after three years of flat or negative growth.

FIGURE REV-2

General Fund Revenue Forecast

Reconciliation with Governor's Budget
(Dollars in millions)

Source	Governor's Budget	May Revision*	Change Between Forecasts	
Fiscal 02-03				
Personal Income Tax	$32,710	$32,710	$0	0.0%
Sales & Use Tax	22,415	22,415	0	0.0%
Corporation Tax	6,804	6,804	0	0.0%
Insurance Tax	1,880	1,880	0	0.0%
Other Revenues	4,728	4,728	0	0.0%
Transfers	2,785	2,785	0	0.0%
Total	**$71,322**	**$71,322**	**$0**	**0.0%**
Fiscal 03-04				
Personal Income Tax	$35,117	$36,066	$949	2.7%
Sales & Use Tax	23,714	23,609	-105	-0.4%
Corporation Tax	7,466	7,293	-173	-2.3%
Insurance Tax	1,985	2,085	100	5.0%
Other Revenues	4,825	4,807	-18	-0.4%
Transfers	1,520	731	-789	-51.9%
Total	**$74,627**	**$74,591**	**-$36**	**0.0%**
Change from Fiscal 02-03	$3,305	$3,269		
% Change from Fiscal 02-03	4.6%	4.6%		
Fiscal 04-05				
Personal Income Tax	$38,043	$38,602	$559	1.5%
Sales & Use Tax	25,022	24,605	-417	-1.7%
Corporation Tax	7,609	7,967	358	4.7%
Insurance Tax	2,078	2,170	92	4.4%
Other Revenues	2,858	2,769	-89	-3.1%
Transfers	797	575	-222	-27.9%
Total	**$76,407**	**$76,688**	**$281**	**0.4%**
Change from Fiscal 03-04	$1,780	$2,097		
% Change from Fiscal 03-04	2.4%	2.8%		

**These figures exclude the following amounts, which will be prior year adjustments:*
$1.225 billion from the Voluntary Compliance Initiative
$185 million from the tax amnesty proposal
-$465 million from the Farmer Brothers Company lawsuit

K–12 EDUCATION

Proposition 98 Guarantee

2003-04 $266.8 million
2004-05 $275.2 million

The 2004-05 Governor's Budget was based upon Test 2, which adjusts the prior guarantee level for growth in attendance and the change in per capita personal income. However, in recognition of the State's fiscal condition, the Administration and the education community agreed to rebase the 2004-05 Proposition 98 funding guarantee by $2 billion and direct available funding to specific priorities. The May Revision maintains this agreement. Despite the proposed rebasing of the guarantee, approximately $2.4 billion in additional funding capacity within the Proposition 98 budget is available for 2004-05 compared to the 2003-04 enacted Budget. This results from the natural growth in the guarantee, the release of funds used for one-time prior-year obligations, and other changes such as caseload adjustments in various programs and child care reforms. The amount of maintenance factor owed to schools and community colleges in future years as economic conditions improve remains at $4 billion.

A slight decline in the K–12 average daily attendance (ADA) growth rate, from 1.02 percent to 0.95 percent, a decrease in the growth in per capita General Fund revenues from 4.4 percent to 4.2 percent, and slightly increased General Fund revenues subject to the State Appropriation Limit results in an increase of $275.2 million to the 2004-05 guarantee. Additionally, the 2003-04 guarantee is $266.8 million higher than the level in the Governor's Budget.

As shown in Figure K–12-1, the General Fund contribution to the guarantee increases by $4.3 billion, while the local revenue contribution (property taxes) is reduced by $3.9 billion. This large fund shift reflects the recent agreement with California's local governments to eliminate the VIF tax relief payments to local government (keeping taxpayer rates the same) and replacing those revenues with additional property tax allocations, and hold schools harmless by providing additional

General Fund moneys and reallocating local property taxes. Additionally, there is modest growth in the underlying property tax estimate and the portion of school property tax shifted to cities and counties for the deficit bond financing arrangement ('triple flip') is reduced by $200 million from the Governor's Budget estimate due to timing of the implementation of the shift.

FIGURE K–12-1

Proposition 98
January vs. May Revision
(Dollars in thousands)

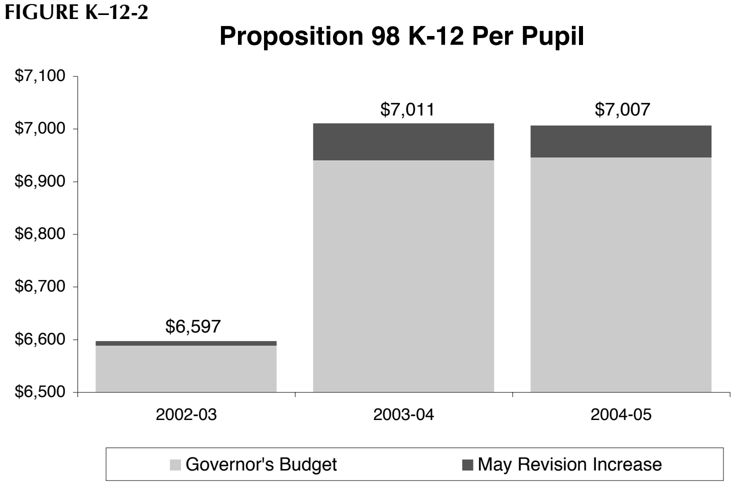
2003-04	January Estimates	May Revision	Change
General Fund	$30,166,130	$30,422,562	$256,432
Local Revenue	15,778,671	15,789,049	$10,378
Total Guarantee	$45,944,801	$46,211,611	$266,810

2004-05	January Proposal	May Revision	Change
General Fund	$29,739,800	$34,003,307	4,263,507
Local Revenue	16,973,852	12,985,590	-3,988,262
Total Guarantee	$46,713,652	$46,988,897	$275,245
Total Two-Year Funding	$92,658,453	**$93,200,508**	**$542,055**

K–12 Per Pupil Funding

Funding per pupil under Proposition 98 continues to increase as shown in Figure K–12-2. Increased appropriations for 2003-04 will raise the funding level from $6,940 to $7,011 per pupil. Of the 2003-04 amount, $45 per pupil is proposed to be appropriated for the one-time purpose of reducing deferred appropriations, bringing the funding into the

FIGURE K–12-2



2004-05 fiscal year. Since this does not impact classroom funding, a more comparable 2003-04 figure is $6,966 per pupil. Per pupil funding of $7,007 in 2004-05 represents an increase of $62 from the Governor's Budget level of $6,945 and an increase of $41 from the comparable 2003-04 figure and a growth of $410 per pupil from the 2002-03 level.

Implementing the Agreement

The May Revision reflects the further implementation of the Administration's agreements with the K–12 education community. The agreements provide that Proposition 98 funding will be reduced by approximately $2 billion below the level provided by the Constitutional formula. The Administration has agreed that the priorities for spending any amounts above the levels needed for programs funded in the 2003-04 fiscal year are: (1) growth in enrollment and cost-of-living adjustments (COLAs), (2) restore general purpose revenue limit funding reductions made in the 2003-04 Governor's Budget, (3) pay valid State-mandate claims, and (4) provide additional general purpose funds and funding for State priorities in a 75 percent to 25 percent ratio.

In April, the Governor's Budget proposal was adjusted to shift more funding to restore prior-year reductions in general purpose funding and provide growth and COLA adjustments to additional programs by reducing funding for revenue limit equalization for K–12 and Community Colleges, instructional materials, and deferred maintenance. It was agreed that if the Proposition 98 guarantee calculation provided more funding in May that these reductions would be restored to the extent possible with equalization funding having a priority.

Current revenue estimates, as well as other factors in the Proposition 98 formula, provide increased funding of $256 million in 2003-04 and $275 million in 2004-05 for K–14 education above the Governor's Budget level. Consistent with the agreements for 2004-05, the Administration proposes full funding for K–12 and Community College growth and cost-of-living adjustments, restoration of K–12 and Community College equalization funding to the levels proposed in January, and significant increases in K–12 deferred maintenance and instructional materials funding above the levels proposed in April. Separate legislation will be proposed to appropriate the additional funding available in 2003-04 as a partial settle-up of the State's Proposition 98 obligations for that year.

K–12 Categorical Reform

The May Revision incorporates $36 million of growth and COLA adjustments into the proposal to shift the funding for 22 categorical programs into local educational agency general purpose funding allocations. This will provide a total of $2.1 billion for districts to use more flexibly than current program requirements allow. The Administration continues to believe that student achievement will be improved if schools have more discretionary funding to allocate to meet the unique needs of each school. The shift of this funding to revenue limits provides a significant opportunity for school districts to implement more participatory budgets including budgets allowing school site decision-making and using funding that follows the student. The Administration continues to support additional public disclosure of school budgets and opportunities for participation in school budgeting by school site leaders, parents, teachers, and community members, as provided in the Administration's categorical reform bill, AB 2824 (Runner).

Allowing flexible use of such a significant portion of school funding in 2004-05, approximately 5 percent of K–12 Proposition 98 resources, also provides opportunities for the fiscally stressed school districts to preserve their most important core educational functions.

The Administration continues to support improved systems of accountability and assistance to help students achieve high academic goals and is working with the Legislature and other parties to develop a coordinated and effective approach synthesizing the existing State and federal approaches.

School Fiscal Conditions

Although revenues from all sources available to schools in 2004-05 have increased by $819 million, or 1.5 percent over the Governor's Budget level, school budgets will continue to operate under significant fiscal pressures. This is reflected in the steady increase in the number of school districts with negative and qualified certifications of their interim budget reports, rising from no more than 26 from 1995-96 through 2000-01 to 57 at the first interim report for 2003-04. To meet both State and federal academic achievement goals, school districts will need to increase services to students.

In recognition of this, the Administration has sponsored AB 2756 (Daucher) to improve school district budgeting, fiscal analysis, and oversight of school fiscal conditions. This legislation also improves existing provisions of law that deal with the conditions for receiving emergency loans when districts become insolvent. The goal is to prevent insolvencies, and, if emergency loans and temporary State takeover of a few districts becomes necessary, to correct the problems as quickly as possible and return decision-making authority to the district boards while achieving educational quality.

The May Revision reflects an estimated balance of $181 million in emergency loans to school districts by the end of 2003-04, including $60 million for a new loan recently requested by Vallejo Unified School District. These funds are drawn from the non-Proposition 98 portion of the General Fund and thus reduce resources available for health and human services, higher education, and other programs. The Administration proposes to refinance the initial General Fund loans with lease-revenue debt secured by school district property. This financing will be arranged through the State's Infrastructure Bank under new authority to be provided in proposed legislation. This will reduce 2004-05 General Fund expenditures by a net of $167 million in 2004-05.

K–12 Education Proposition 98 Funding

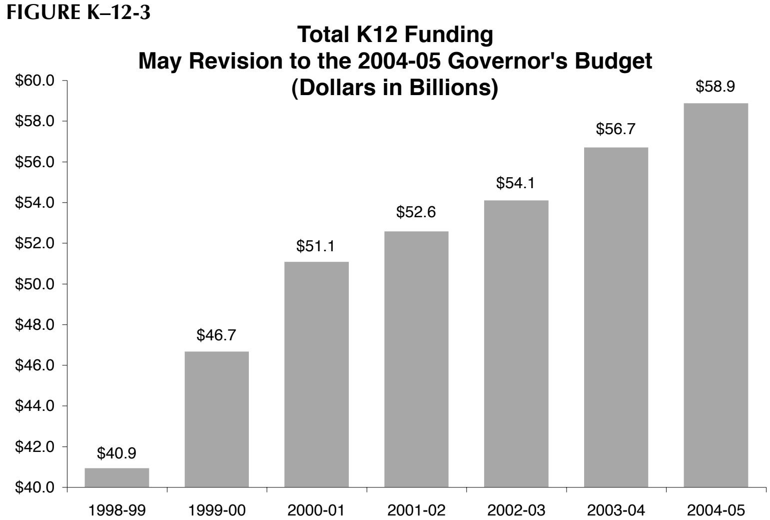
2003-04	**$41,721.2 million**
2004-05	**$42,087.3 million**

The May Revision increases funds from the Governor's Budget level for K–12 education by $230.4 million in 2003-04 and $145.3 million in 2004-05. Proposition 98 General Fund increases by $3.6 billion, while the local revenue contribution declines by $3.5 billion. Total General Fund allocations of $30.9 billion for K–12 education now represents 39.8 percent of the General Fund budget.

Total K–12 Funding

The total of funding from all sources is increasing as shown in Figure K–12-3. For 2003-04, the May Revision reflects an increase of $524.1 million from the Governor's Budget level of $50.2 billion. For 2004-05, an increase of $818.7 million brings total funding to $58.9 billion.

FIGURE K–12-3



From 2003-04 to 2004-05, General Fund increases $4.2 billion, while local property taxes fall by $2.4 billion and federal funds grow by $480.1 million. Major General Fund changes include:

- An increase of $3.6 billion to Proposition 98 General Fund.
- An increase of $157.1 million in the use of Proposition 98 Reversion Account General Fund.

Attendance Changes

The May Revision includes estimated 2003-04 K–12 ADA growth of 0.75 percent, down from 1.23 percent in the Governor's Budget. General Fund costs for school district and county office of education revenue limits decrease by $43.6 million, owing primarily to lower than expected ADA figures, which are partially offset by lower than expected local property tax revenue.

In 2004-05, the revised ADA growth is down, from 1.02 percent to 0.95 percent (32,309 ADA lower than the January estimate). The total number of ADA is estimated to be 5,950,626 in 2003-04 and 6,006,898 in 2004-05.

Revenue Limits

Revenue limit funding constitutes the basic funding source for classroom instruction. The May Revision reflects an increase of over $3.4 billion in General Fund to replace property taxes shifted to local government as part of the local government revenue swap. The May Revision includes a decrease in growth of $118.2 million reflecting lower than anticipated ADA, and an increase of $168.8 million reflecting the change from an estimated 1.84 percent COLA to an actual of 2.41 percent.

Basic Aid District Conforming Funding Reduction

The May Revision proposes to reduce categorical funding to basic aid districts by $2.7 million. This would effectively reduce General Fund support for the districts by an amount commensurate with a 0.3-percent revenue limit reduction. Basic aid districts fund their revenue limits exclusively through local revenues, and they are therefore not affected by the revenue limit deficit factor applied to all other districts. This reduction would conform to current year practice.

Equalization

Consistent with the agreement reflected in the April Finance Letter, as more Proposition 98 funds have become available than anticipated at that time, we propose restoring equalization funding to the original Governor's Budget level. The May Revision provides $27.8 million to fund school district revenue limit equalization at $110 million. In April, funding for equalization was proposed for reduction as part of an adjustment to reduce the revenue limit deficit factor from 1.2 percent to 0.3 percent and fund growth and cost-of-living adjustments for additional items. The Administration intends that these funds to be allocated in the manner specified in SB 1298 (Brulte).

Instructional Materials

The May Revision provides $100 million to partially restore funding for the purchase of standards-aligned Instructional Materials to the level proposed in the Governor's Budget. In January, $188 million was budgeted for this purpose in addition to the $175 million base amount that is proposed to be shifted to revenue limits. In April, the $188 million augmentation was proposed for deletion as part of an adjustment to reduce the revenue limit deficit factor from 1.2 percent to

0.3 percent and fund growth and cost-of-living adjustments for additional items. As noted above, the agreement allows an increase in Proposition 98 funds available above the amount anticipated in January to be used to make a restoration of the initial augmentation.

Deferred Maintenance

The May Revision provides an additional $107.1 million for the Deferred Maintenance Program above the adjusted level proposed in an April Finance Letter. This brings the proposed funding level for the Deferred Maintenance Program to $184.1 million. As noted above, the agreement allows an increase in Proposition 98 funds available above the amount anticipated in January to be used to make a restoration of the augmentation proposed in the Governor's Budget.

Special Education

The May Revision provides a General Fund increase of $44.0 million and also includes an additional $63.7 million in federal funding over amounts proposed in the Governor's Budget. The General Fund increase is caused by the reduction in property taxes due to the local government revenue swap. These increases allow for full funding of growth at 0.95 percent, COLA at 2.41 percent, and maintains the State funding commitment at the 2003-04 level, consistent with federal requirements. In addition, $31 million in federal funds is allocated to schools as a permanent increase to the base funding level for the special education program to assist in continuing the provision of federally required mental health related services, as discussed in greater detail below. Further, the May Revision provides $38.4 million to partially fund a revised formula for allocating funding for pupils with exceptional needs placed in non-public, non-sectarian schools (NPS) who reside in licensed children's institutions (LCI).

Individuals with Disabilities Education Act (IDEA)-Required Mental Health Services

The May Revision sets aside $31 million, in addition to the $69 million in federal funds already included in the Governor's Budget, to provide mental health services for children with exceptional needs, as required by the IDEA. The Administration plans to work with the Legislature and interested parties to develop legislation that will ensure the provision of these services and do the following:

- Encourage cost containment.
- Outline clear roles and responsibilities among local agencies and other service providers for the provision of Individualized Education Plan (IEP)-related mental health services.

- Provide clarification as to what distinguishes “educationally necessary” treatment from “medically necessary” treatment.
- Address quality control issues, perhaps through the formation of a special entity to hear appeals.
- Allow for reasonable flexibility from IEP specifications. There should be allowances for providers, in accordance with professional standards, to alter the frequency and duration of treatments based on the pupil’s response.

NPS/LCI Funding Reform

The May Revision proposes a $38.4 million augmentation for the funding of pupils with exceptional needs that reside in licensed children’s institutes and attend non-public schools. This augmentation is intended to reform the current funding system from a 100-percent reimbursement system that incentivizes inappropriate placements to one that allocates funds through a weighted formula that focuses on pupil needs. Allocation of the funding is subject to pending legislation.

Charter Schools Facilities Grants

The May Revision provides $7.7 million in one-time Proposition 98 Reversion Account funding to fully meet the legislative intent to fund the Charter School Facilities Grant Program for three years. The program’s authorizing legislation stated the intent to fund grants for classroom-based charter schools that primarily serve low-income populations from the 2001-02 fiscal year through the 2003-04 fiscal year, but only two years have been funded due to the delay of the program’s startup and ultimate deletion of funding for the 2001-02 fiscal year. The funding proposed would match the current year level.

Public School Library Materials

The May Revision provides $95.1 million in one-time Proposition 98 Reversion Account funding for the provision of classroom or school library materials. As the State’s recent budget difficulties have led to significant reductions in this program, the Administration believes it is appropriate to expend some of the available one-time resources to replenish and refresh classroom or school library materials. This will provide a one-time funding level of $99.4 million for these purposes in 2004-05.

Accountability

The May Revision continues to provide $77.4 million, including federal funds, for the third year of implementation funding for schools in the Immediate Intervention/Underperforming Schools Program that made significant progress but did not meet their growth targets and $208.6 million, including federal funds, for the third year of funding for schools participating in the High Priority Schools Grant Program.

The May Revision provides $67.9 million in federal Title I School Improvement funds pursuant to legislation to fund accountability activities. The federal No Child Left Behind Act of 2001 requires states to ensure that all schools and school districts are meeting adequate yearly progress benchmarks. If a Title I school or school district fails to make adequate yearly progress for two consecutive years, it is identified as a Program Improvement school, and subject to interventions. Currently, 1,199 schools have been identified for Program Improvement. Beginning in September 2004, the State will be required to identify Program Improvement school districts as well.

The May Revision also proposes $2.5 million in federal funds for increased support of the Statewide System of School Support, which provides assistance to schools, school districts, and county offices of education that are in need of improvement.

Pupil Testing

The May Revision continues funding of $109.2 million, including federal funds, for various statewide exams. These assessments provide valuable information to parents, teachers, schools, and the State regarding pupil performance, and are the foundation of the State's accountability system for both State and federal purposes.

- **Standardized Testing and Reporting (STAR) Exam—**This exam, which serves as the primary indicator for the State's Academic Performance Index and the federal measure of Adequate Yearly Progress, measures pupil performance on various State-adopted content standards, coupled with a national norm-referenced exam in grades 3 and 8. The May Revision includes $66 million for this exam, an increase of $535,000 over the funding level proposed in the Governor's Budget. Because the STAR program currently has a January 1, 2005, sunset date, the Administration will be working with the Legislature to ensure that this sunset date is extended. SB 1448 (Alpert) would extend the sunset to January 1, 2011.

- **High School Exit Exam (HSEE)—**This exam helps to ensure that pupils who graduate from public high schools can demonstrate grade level competency in English-language arts and mathematics. Commencing with the Class of 2006, all pupils must pass the HSEE in order to receive a diploma. The May Revision includes $21.2 million for this exam.

- **California English Language Development Test (CELDT)—**This exam is required to be administered to pupils whose primary language is not English within 30 days of enrollment and annually thereafter to pupils identified as English language learners. This assessment allows schools to ensure pupils are being taught using the correct curriculum. The May Revision reflects

$21.9 million for this exam, an increase of $3.1 million over the funding level proposed in the Governor's Budget. This increase includes $2.5 million for CELDT apportionments funding and $563,000 for contract costs.

Alternative Education Facilities

Consistent with the discussion in the Governor's Budget Summary, the Administration proposes legislation in the May Revision to reform the State's funding practices for alternative school facility construction for County Office of Education (COE) operated schools. In all cases except the Juvenile Court school programs, school districts may opt out of providing instruction and alternatively enroll certain students in alternative schools operated by the COEs. Under current school facility funding policy, COEs receive financial hardship funding for facilities construction because they do not have the taxing authority of school districts; thus no local match is provided and the State funds 100 percent of the cost. The Administration proposes that the appropriate school districts share the local match in proportion to the students referred from their attendance areas. This will restore the appropriate level of responsibility for the local match requirement in the School Facilities Program. Even with the passage of Proposition 55, known demand for modernization and new construction exceeds the availability of current bond authorizations with consequent pressure on State debt service. Failure to correct this policy flaw will exacerbate the pressure.

Child Care Programs

The May Revision includes a comprehensive Legislative proposal to address the issues of fiscal integrity including both overpayments and fraud as promised in the Governor's Budget. Additionally, the Administration proposes several revisions to policies within the January child care reform proposal, reduces the calculated savings from those reforms, reflects reduced caseload in Stages 2 and 3 based on current year experience, and makes numerous technical adjustments to the funding sources for various programs to utilize additional one-time, prior year savings that have become available since the January budget. Significant highlights are discussed below:

Comprehensive Fiscal Integrity Legislation

As part of the January Governor's Budget, the Administration committed to work with the State Department of Education (SDE) in the development of an anti-fraud proposal that will ensure that services are available to the neediest eligible families. The May Revision delivers on that promise, including a proposal that for the first time clearly defines fraud in child care programs, standardizes fraud prevention efforts and overpayment collection processes, authorizes the investigation and prosecution of fraud by county special investigative units, establishes sanctions, and provides for compliance monitoring by the SDE. No budget savings are achieved by this proposal, which simply strengthens the fiscal integrity of the State's child care system and ensures that increasingly scarce dollars are used appropriately.

In addition to a package of necessary statutory changes, this proposal includes an increase of $1.6 million in one-time federal funds relative to the Governor's Budget for the following purposes:

- $530,000 for the establishment of 5.5 positions for SDE to conduct compliance monitoring and audits of providers and to annually quantify the results of its findings of overpayments and fraud. This will provide the State with increased information about how and where fraud occurs, aiding future refinements to this fiscal integrity proposal.

- $3.1 million in reimbursements from SDE to the Department of Social Services (DSS) to fund 31 county investigator equivalents throughout the State that will be dedicated to the prevention and prosecution of fraud in all child care programs.

Child Care Reform Revisions

CalWORKs Stage 3—The Administration is aware of CalWORKs Stage 3 out-year cost pressures and equity issues for access to non-time limited services among the cash-aided populations and other working poor families. While the Governor's Budget originally proposed a one-year time limit for Stage 3 child care, effective July 1, 2004, the May Revision reflects an amended proposal in response to concerns raised by citizens, the Legislature, and other stakeholders.

This amended proposal will create a significant expansion in the number of non-time-limited slots in the Alternative Payment (AP) program, and provide greater opportunity for equitable access to services for both populations in the longer run. Moreover, it will provide a longer transition for those CalWORKs families whose income has increased over time due to past policies that prevented their application for regular child care waiting lists when they entered the work force. Finally, the proposal is conditioned upon the enactment of legislation in the 2004 session that permanently reforms Stage 3 and implements the reasonable reimbursement limit, family fee, and eligibility reforms proposed in January to address future cost pressures. The four essential parts of the amended proposal for Stage 3 include the following:

- Consistent with the original Governor's Budget proposal, all families in CalWORKs will be able to place their names on waiting lists for general child care programs once they have earned income.

- Also, consistent with the Governor's Budget, families in Stages 1 and 2 that are still receiving cash aid as of June 30, 2004, will continue be eligible to receive services in Stage 3 for up to one more year once they enter that Stage.

- However, families in Stage 3 on June 30, 2004, will be shifted to the non-time limited AP program, with no loss of funding or service. As those slots are vacated, the funding remains available for families on waiting lists.

- Families in Stages 1 and 2 that are not receiving cash aid as of June 30, 2004, will be eligible to receive services in Stage 3 for up to two years, instead of one year, once they enter that Stage.

As a result of this policy change, $249 million in federal Child Care and Development Block Grant funds are shifted from Stage 3 into the AP program.

Limitations on Training—Families pursuing an education currently have indefinite eligibility for child care, if child age and family income criteria are met. The Governor's Budget would have limited this education eligibility to two years, but it is recognized that many education programs, such as nursing, take longer to complete. The May Revision therefore expands this proposal to include an additional eligibility criteria for child care, consistent with criteria proposed for the CalWORKs program: If the first 20 hours of child care eligibility are for work activities, then education activities can be used as the need basis for child care services beyond those 20 hours, without a two-year limit.

Tiered Reimbursement Based on Accreditation—The Administration is proposing to allow not only accreditation, but also results from the use of accepted environmental rating scales to measure high quality, to qualify child care providers for the highest rates within the proposed tiered reimbursement structure. Several counties already implement ratings through local child care advisory entities utilizing Proposition 10 funds and other sources. This addresses the problem of limited accrediting agency capacity.

After School Programs to Address 11 and 12 year olds—In an April 1 Finance Letter, the Administration proposed provisional language authorizing the Superintendent of Public Instruction to waive grant caps for 21st Century Community Learning Center after school programs to create additional slots for 11 and 12 year-old children redirected from State and federally funded subsidized child care programs as a result of proposed reforms. Additional proposals for May include:

- **State Funded After School Program—**The May Revision proposes to expand this grant cap waiver authority to State-funded after school programs.

- **21st Century Community Learning Center After School Programs—**The Administration requests SDE to accelerate the annual allocation of funds to programs serving children, in an effort to increase services and minimize the potential future loss of federal resources. In order to avoid returning unused funds to the federal government on September 30, 2004, the May Revision proposes to utilize $25.4 million in one-time federal funds for the following purposes, in the following priority order:

1. Increase slots for 11 and 12 year-olds in existing programs.
2. Allow existing programs to expand days of service.
3. Allow existing programs with waiting lists and available capacity to serve more children during 2004-05.
4. Provide one-time allocations for standards-aligned instructional and reading materials.

Child Care Budget Adjustments

Included in the May Revision are several budget adjustments that contribute to increasing total funding for SDE-administered child care programs by $50.7 million:

Recalculation of Reform Savings—The May Revision reflects a reduction of $45.3 million to the $164.8 million in proposed savings associated with recalculating child care reforms proposed in the Governor's Budget. While the revised reforms discussed earlier do not have a budget year fiscal impact, the Administration's re-estimation of savings expected from child care reforms is now $119.5 million. The majority of this cost ($39.3 million) results from changing assumptions regarding the number of 11- and 12-year olds that will find alternative services in after school programs. The additional costs are split between the Stage 1 DSS budget ($13.0 million) and the SDE budget for Stages 2, 3 and other programs ($32.3 million).

Reduced Caseload Estimates for CalWORKs Stages 2 and 3—Total costs for Stage 2 are $501.8 million from all sources, a net reduction of $13.5 million from the Governor's Budget. A projected decline in average monthly caseload from 93,900 to 86,700 and other adjustments reduced federal Temporary Assistance for Needy Families (TANF) funds by $31.5 million.

Total costs for Stage 3 are $86.0 million from all sources, including a $45.0 million reduction in Proposition 98 General Fund resources to reflect a decline in the projected average monthly caseload for Stage 3 from 59,900 to 52,700 and the subsequent shift of $249.0 million to the AP program for those currently in Stage 3.

Additional One-time Funding Sources from Prior Year Savings—The May Revision includes a $4.6 million increase in reappropriations of one-time General Fund resources, a reduction of $3.1 million in one-time federal funds reappropriated in the Governor's Budget for Stage 3 that are no longer expected to materialize, and other shifts from General Fund to federal funds resulting in a net decrease of $1.4 million.

21st Century Community Learning Center After School Programs—An April 1 Finance Letter increase of $61.8 million, plus a May Revision increase of $25.4 million in one-time funding, result in total funding of $162.8 million for this program in 2004-05.

Growth and COLA Adjustments—Proposition 98 General Fund adjustments of $243,000 for growth and $7.5 million for COLA for various programs are included in the May Revision.

State Department of Education Support

2003-04	**$615,000**
2004-05	**–$375,000**

Support expenditures in 2003-04 to reflect current estimates to complete several projects funded in prior years. The 2004-05 expenditures reflect the Department's response to the Administration's request for 3 percent reductions totaling $375,000 and including reductions in interstate organization memberships, arts technical assistance, and program support for high school and adult programs and demographic research and reporting.

Scholarshare Investment Board

The May Revision General Fund reserve includes a prior year adjustment of $50 million from funds previously set-aside for earned but unclaimed Governor's Scholars awards. Specifically, the proposed prior year adjustment would disencumber the funds ($13 million from 2000-01, $12 million from 2001-02, and $25 million from 2002-03) until such time that eligible students claim their awards along with earned interest. The Board retains $6 million for expected claims from these groups of students in the next year. Enabling trailer bill language would continue the authority to provide awards to students who have already successfully earned an award—when the students enroll at eligible higher educational institutions. This proposal would hold eligible students harmless, as they would continue to receive their awards and interest at the currently authorized amounts.

California State Library

2004-05	**–$1,406,000**

Public Library Foundation

The 2004-05 expenditures reflect the Department's response to the Administration's request for 3 percent reductions, thus, the May Revision proposes to reduce Public Library Foundation grants to local libraries by $1,406,000. This leaves a total of $14,360,000 in remaining foundation resources to be provided for the libraries most in need on a fiscal basis.

Telephonic Reading Services

The May Revision also provides $441,000 to fully fund the Telephonic Reading Program, which provides access to newspapers and other time-sensitive reading materials for the blind. In the Governor's Budget, $40,000 had been provided for this program to be funded from the California Teleconnect Fund. Since legal authority to use that fund for this purpose has expired and funding capacity is limited, the May Revision proposes to shift the funding to the Deaf and Disabled Telecommunications Program fund, pursuant to proposed legislation, and to increase the total amount in order to fully restore the program to previous service levels.

Higher Education

The Administration recognizes that the University of California (UC) and the California State University (CSU) are integral to California's economic success, and that they have made tremendous efforts to maintain program quality under very difficult fiscal circumstances. In order to continue the high level of quality and accessibility to these great institutions, the Administration has entered into a new Higher Education Compact with UC and CSU, beginning in 2005-06 and lasting through 2010-11. This agreement will both stabilize then improve the ability of the segments to meet the ideals of the Master Plan. This Compact is based on the value the Governor has placed on institutions of the UC and CSU, but more importantly, it reflects the tremendous value he places on the students attending the State's public universities. The Compact's elements include:

Annual Base Budget Adjustments

- Annual fixed increases in base State General Fund support, to be used for activities including core instruction, academic and institutional support, faculty and staff salary and benefit increases, inflation, and facility maintenance.

- The annual increases will be 3 percent in 2005-06 and 2006-07, increasing to 4 percent in 2007-08, and then to 5 percent in 2008-09 through 2010-11. The additional 1-percent increase provided beginning in 2008-09 will be specifically for core academic support needs, including instructional equipment, instructional technology, libraries, and ongoing maintenance.

- Consistent with current practice, a commitment to provide annual funding for ongoing basic costs including annuitant health and dental benefits, employer retirement contributions, and debt service obligations.

- Depending on the State's fiscal condition, there may be initiatives mutually agreed upon by the segments, the Governor and the Legislature, either through legislation or through the budget process, that may also be funded.

Enrollment Growth Funding

- Enrollment growth funding sufficient to sustain 2.5-percent annual growth will be provided. This is equivalent to an annual increase of 5,000 full-time equivalent students (FTES) at UC, and 8,000 FTES at CSU.

- Enrollment growth funding will be provided at the agreed-upon marginal cost rate.

Student Fees

- A commitment from UC and CSU to increase undergraduate fees by no more than an average of 10 percent a year over the next three years. Because the governing boards of both segments believe they must mitigate the proposed graduate level fee increase of 40 percent proposed in the Governor's Budget for 2004-05, they have asked for this flexibility. Therefore, the Administration recognizes the segments 2004-05 short-term needs in this area so the Compact specifies that fee increases in 2004-05 will be 14 percent, but no more than 8 percent in both 2005-06 and 2006-07. Beginning in 2007-08, the segments will increase fees by the rate of growth in per capita income, unless fiscal conditions require larger increases as determined by the segments in consultation with the Administration.

- In context of the concerns expressed by the governing boards for relief on graduate students, a commitment from UC and CSU that they will phase in progress toward the Administration's policy goal for graduate fees to be 50 percent higher than undergraduate fees. This goal more accurately reflects the higher cost associated with instructing these students and the benefits received.

- Of the annual revenues generated by fee increases, the segments will set aside from 20 to 33 percent for financial aid purposes.

Outreach

As part of the Compact, the Governor has negotiated an assurance that between the UC and CSU, an amount greater than half of the reduced funding will be restored so that they can continue to be engaged in outreach programs to improve the academic preparation of K-12 and community college transfer students. The Governor is also asking the UC and CSU to supplement these resources by seeking out matching private sector funds in order to maximize the resources available for these programs, and further mitigate the original reductions.

UC Merced

For UC, a commitment that the State will continue to provide one-time funds needed for initial development and the 2005 opening of the Merced campus. These funds will phase out in 2010-11, when the campus is expected to reach enrollment levels sufficient to be sustained within systemwide growth funding.

Capital Outlay and Facility Maintenance

- For capital outlay purposes, the Administration will support $345 million per year per segment from general obligation bond funding to finance high-priority projects. Should voter-approved general obligation bonds not be sufficient to meet this level, the Administration will consider lease revenue bonds, within prudent State debt limitations, to finance high-priority projects.
- A commitment from the State that, as the fiscal situation permits, one-time funds may be provided to address high-priority infrastructure needs such as capital renewal of facilities and deferred maintenance.

A Commitment to Accountability

In return for these funding commitments, the UC and CSU have committed to provide comprehensive annual reports on a variety of student outcome-based performance measures as well as measures of resource utilization and student level data. The segments also have agreed to the meet state-level priority goals identified below:

- To maintain quality educational programs for students meeting Master Plan based admission goals.
- To maintain the most effective academic preparation (outreach) programs, UC will provide no less than $12 million per year from existing resources. CSU will provide no less than $45 million per year from existing resources for this same purpose, including EOP programs.
- To ensure sufficient course offerings are available, so students may earn their degrees expeditiously.
- To ease the process for qualified students to transfer from the California Community Colleges (CCC) to UC and CSU. Toward this end, one of the goals UC and CSU will achieve is an improvement in degree major course articulation, the area most needed at this time to ensure CCC students know which courses are transferable to the specific UC or CSU campus they wish to attend.
- To contain administrative growth to levels proportional to overall funding levels.

- UC, in collaboration with CSU, will implement a major initiative to encourage and prepare more highly qualified undergraduate students to teach mathematics or science in the K-12 public school system.
- CSU will continue to improve the quality and efficiency of teacher preparation programs to meet the challenge of this state's rigorous content standards and needs for highly qualified teachers, with particular attention to meeting demand for special education and English and language arts instructors.

May Revision Adjustments

University of California (UC)

2003-04	**No Change**
2004-05	**$20.2 million**

The May Revision proposes increasing the UC's General Fund by $20.2 million from the level proposed in the 2004 Governor's Budget, as outlined below:

An augmentation of $1.3 million associated with a recalculation of the revenues associated with an undergraduate fee increase.

An augmentation of $6.7 million associated with a recalculation of the revenues associated with a graduate fee increase.

An augmentation of $8.2 million associated with a recalculation of the savings associated with the proposal to eliminate the General Fund subsidy for students who take in excess of 110 percent of the units required for their degree.

An augmentation of $4 million based on a recalculation of the General Fund moneys available for outreach activities.

As mentioned above in the Compact discussion, the UC has indicated they intend to implement fee increases of 14 percent for undergraduates. They also plan fee increases of 20 percent for academic graduate students in this context. While the Governor's Budget proposed increases of 10 percent and 40 percent, respectively, the UC will increase undergraduate fees by no more than 8 percent in the next two fiscal years in order to maintain a three-year average increase of no more than 10 percent which conforms to the Governor's fee policy.

California State University (CSU)

2003-04 No Change

2004-05 $623,000

The May Revision proposes increasing the CSU's General Fund by $623,000 from the level proposed in the 2004 Governor's Budget, as outlined below:

An augmentation of $623,000 associated with a recalculation of the revenues associated with an undergraduate fee increase.

As mentioned above in the Compact discussion, the CSU has indicated they intend to implement fee increases of 14 percent for undergraduates. They also plan to implement fee increases of 20 percent for teacher preparation graduate students and 25 percent for other graduate students in this context. While the Governor's Budget proposed increases of 10 percent and 40 percent, respectively, the CSU will increase undergraduate fees by no more than 8 percent in the next two fiscal years in order to maintain a three-year average increase of no more than 10 percent which conforms to the Governor's fee policy.

California Student Aid Commission (CSAC)

2003-04 $42.6 million

2004-05 –$73.3 million

Current Year

An anticipated deficiency of $42.6 million is acknowledged. This is associated with revised estimates of the number of Cal Grant Entitlement awards that will be issued in 2003-04.

Budget Year

In context of the significant General Fund structural problems and pressures for other spending, the May Revision proposes a net General Fund reduction of $73.3 million from the level proposed in the 2004-05 Governor's Budget, as noted below:

An augmentation of $34.2 million associated with the elimination of the proposal to decouple Cal Grant award amounts from fee increases at UC and CSU. This amount will be sufficient to increase Cal Grant awards to cover the 14-percent undergraduate fee increases the segments plan to implement in 2004-05.

An augmentation of $31.9 million associated with revised estimates of the number of Cal Grant Entitlement awards that will be issued in 2004-05.

A reduction of $134 million on a one-time basis associated with the use of a like amount of surplus funds from the Commission's Student Loan Operating Fund to cover a portion of the costs associated with the Cal Grant program in 2004-05.

A reduction of $5.4 million associated with reducing from 22,500 to 16,875 the number of Cal Grant Competitive awards CSAC is authorized to issue in 2004-05.

California Community Colleges (CCC)

2003-04	**$30.8 million**
2004-05	**$623.7 million**

Current Year

The May Revision proposes a one-time (settle-up) augmentation of $28.4 million from Proposition 98 General Fund for the Scheduled Maintenance, Special Repairs, Instructional Equipment and Library Materials Block Grant.

Also included in the May Revision is a reappropriation of $2.4 million in one-time Proposition 98 Reversion Account funds, offset by a decrease in special fund support, for the Foster Parent Training Program. Replacing these special fund expenditures for two years with Proposition 98 Reversion Account funds will ultimately result in non-Proposition 98 General Fund savings, as discussed below.

Budget Year

The May Revision proposes the following major budget adjustments for the California Community Colleges (CCC), which will increase available program funding by $46.2 million relative to the January Governor's Budget, after offsetting adjustments for property taxes, other fund shifts, and student fee re-estimates:

An augmentation of $492.6 million Proposition 98 General Fund, offset by a local revenue reduction of the same amount, reflecting the recent agreement with California's local governments to eliminate their support from the Vehicle License Fee (VLF) offset, replace those revenues with additional property tax allocations, and hold schools harmless by providing additional General Fund moneys.

Increases of $23.8 million Proposition 98 General Fund for apportionments, and $1.5 million Proposition 98 General Fund for selected categorical programs, to reflect an increase in the COLA factor from 1.84 percent to 2.41 percent.

Consistent with the Agreement reflected in the April Finance Letter, as more Proposition 98 funds have become available, the Administration proposes restoring $20.2 million Proposition 98 General Fund for equalization of the per pupil credit instruction rate, returning the total 2004-05 proposal to $80 million for this purpose.

An increase of $17.9 million Proposition 98 General Fund is also proposed, to reflect a reduced estimate of student fee revenues. Updated information from the Chancellor's Office indicates that the CCC system did not utilize growth funding provided in 2003-04, resulting in a lower number of projected students for 2004-05. However, the growth funding provided in 2003-04 remains in the budget to support additional growth beyond the 3-percent growth already included in the Governor's Budget for 2004-05.

Repeating the action also proposed for the current year, the May Revision proposes to replace expenditures from the Foster Parent Training Fund in 2004-05 with $3 million from Proposition 98 Reversion Account resources. These actions will allow the requested transfer of a total of $5.4 million from the special fund to the General Fund, creating non-Proposition 98 General Fund savings without adversely affecting this important program.

An increase of $492,000 Proposition 98 General Fund to reflect an increased estimate of Board of Governors (BOG) fee waiver recipients. Despite a projected drop in the total number of students relative to the Governor's Budget, more recent information provided by the Chancellor's Office indicates increasing utilization of BOG waivers by CCC students in the 2003-04 fiscal year.

A decrease of $442,000 Proposition 98 General Fund for selected categorical programs to reflect a revised statutory growth rate of 1.66 percent.

Finally, the Chancellor's Office has identified a total of $9.5 million from three prior fiscal years that is proposed to be reverted to the Proposition 98 Reversion Account.

HEALTH & HUMAN SERVICES

Preserving Critical Programs through Reform and Alternative Solutions

The May Revision proposes to preserve critical health and human services programs by continuing the reform efforts proposed in the Governor's Budget and identifying alternative solutions to the State's ongoing fiscal challenges. These alternatives are necessary given the number of solutions that have not been implemented by the Legislature, and will allow the State to continue providing critical support for California's most vulnerable and at-risk residents and address the State's significant fiscal challenges.

Major Reform Efforts

The May Revision provides further detail on the Administration's proposals to restructure and reform a number of health and human services programs, including Medi-Cal, In-Home Supportive Services (IHSS), CalWORKs, Foster Care, services provided to developmentally-disabled persons, and Healthy Families. The Administration has convened a number of key stakeholder meetings and has incorporated constructive feedback from a variety of stakeholders. The guiding principles for these reforms are as follows:

- Maintain essential services to those most in need.
- Recognize children as a priority.
- Promote personal responsibility.
- Encourage work participation.
- Enhance program effectiveness and accountability.

These reform proposals strike a responsible and reasonable balance between the twin imperatives of maintaining essential services for our state's most vulnerable and at-risk residents, while implementing strategies to better manage and control program costs over the long term.

Alternative Solutions

The May Revision proposes alternative solutions to address the State's ongoing fiscal challenges. These solutions preserve critical programs while maximizing federal funds, promoting fiscal incentives to encourage local control, and providing administrative strategies to increase efficiency and reduce waste. The most significant solutions are listed below, and under each department.

- **IHSS—**To maximize federal funds, the Administration is pursuing a federal Independence Plus Waiver to establish a federal share-of-cost in lieu of eliminating the IHSS Residual Program. To increase efficiency and reduce waste, the Administration is proposing an IHSS Quality Assurance Initiative, which will improve the quality of IHSS needs assessments and reduce overutilization of service hours.

- **Medi-Cal—**To promote more accurate and appropriate compensation, the Administration proposes to align pharmacy reimbursement levels with costs by increasing the discount to the average wholesale price to set drug ingredient payments and increase the pharmacy dispensing fee. In addition, Medi-Cal provider payments will be temporarily delayed by one week at the end of 2004-05, which will result in one-time budget year savings.

- **Early and Periodic Screening, Diagnosis, and Treatment (EPSDT) Program—** To encourage the appropriate utilization of services and program management, the Administration proposes to increase the EPSDT county match from 10 percent to 20 percent in lieu of updating the EPSDT maximum provider rates.

- **Child Welfare Services (CWS)—**Due to the ongoing fiscal challenges, the Administration can no longer afford to waive the 30-percent nonfederal county share-of-cost for the CWS Augmentation.

- **Coalinga State Hospital—**To maximize the use of temporary bed capacity, the Administration proposes to delay activation of Coalinga State Hospital by one month, and reduce the number of activated beds.

By proposing these alternative solutions, which emphasize better management and administration of public programs, the Administration has the ability to avoid implementing other reductions that would have more directly affected the state's most vulnerable residents. These solutions replace certain proposals that are being withdrawn, including the following:

- Medi-Cal Provider Rate Reduction.

- Enrollment Caps and Co-Payments for Various Health and Human Services Programs.

- Block Grant for Immigrant Programs.

- Healthy Families Two-Tiered Benefit Proposal.
- Eliminate IHSS Residual Program.
- Update EPSDT Maximum Provider Rates.

The Administration's alternative solutions also allow the following high-priority programs to be funded:

- **West Nile Virus—**In response to an anticipated outbreak of West Nile Virus, the Administration proposes to provide the Department of Health Services (DHS) and local agencies with the capacity to conduct various scientific tests, create a geographic information system to predict risk, and produce professional outreach and educational materials.
- **Community Challenge Grants—**To reduce the number of teenage and unintended pregnancies, the Administration proposes to restore funding for this comprehensive teen pregnancy prevention program.
- **Transitional Food Stamp Program—**To promote work participation and allow those families to spend income on other items that generate State tax revenue, the Administration proposes to fund this program which provides Food Stamp benefits to families transitioning from CalWORKs.
- **Medi-Cal Rate Increase for County Organized Health Systems (COHS)—** To maintain the viability of the Medi-Cal COHS health plans, the Administration proposes a 3 percent increase in the Medi-Cal reimbursement rate for these health plans.

Department of Health Services

Medi-Cal

2003-04	**$182 million**
2004-05	**$339 million**

Current Year

The May Revision includes total Medi-Cal expenditures of $28.7 billion ($9.9 billion General Fund), a decrease of $491 million below the Governor's Budget. General Fund expenditures for Medi-Cal have increased by $181.9 million, or 2 percent.

The estimate of the number of persons eligible for Medi-Cal in 2003-04 is expected to decrease by 59,000 to 6,561,000 eligibles due to more recent data. This represents a decrease of 0.9 percent below the level projected in the Governor's Budget. The revised caseload is 2.9 percent above 2002-03 caseload.

The net General Fund increase includes the following significant adjustments:

- $282.2 million increase due to erosions of the Mid-Year Spending Reduction Proposals. These erosions are the result of caseload adjustments, legislative delays in enacting certain proposals, legal challenges, and the Administration's rescission of certain proposals.
- $20.3 million decrease in fiscal intermediary expenditures.
- $19.9 million decrease in county administration expenditures.

Budget Year

The May Revision includes total Medi-Cal expenditures of $32.8 billion ($11.9 billion General Fund), a net total funds increase of $1.6 billion from the Governor's Budget. General Fund expenditures for Medi-Cal have increased by $339 million.

The average monthly Medi-Cal caseload is expected to decrease by 144,000 beneficiaries to 6,695,000 eligibles. This represents a decrease of 2.1 percent below the Governor's Budget.

The budget year includes the following significant General Fund adjustments:

- $624.5 million increase due to erosions of the Mid-Year and Governor's Budget Spending Reduction Proposals. These erosions are the result of caseload adjustments, legislative delays in enacting certain proposals, legal challenges, and the Administration's rescission of certain proposals.
- $15.2 million increase as a result of a 3 percent rate increase for County Organzied Health Systems.
- $267.2 million decrease as a result of alternative solutions.

Major Program Reform

The May Revision reaffirms the need to redesign the Medi-Cal program, and the DHS will concurrently provide the goals and objectives of the Medi-Cal Redesign project as well as an update on the redesign effort. Medi-Cal redesign is absolutely necessary if California is to continue to provide health care coverage to California's low-income children and adults. General Fund costs have increased by $3.1 billion over the past five years, and California cannot afford similar increases in the future given the ongoing structural imbalance between revenues and expenditures. Redesign is essential to maintaining the long-term financial viability of the program, and will maintain eligibility and improve the program for beneficiaries.

Given the time required to comprehensively redesign Medi-Cal, develop a waiver and secure statutory authority, the 2004-05 Governor's Budget does not assume any savings related to Medi-Cal redesign. The Administration intends to submit to the Legislature the waiver proposal and requisite statutory changes on August 2, 2004. Submitting a separate proposal for the Legislature's consideration will allow the 2004 Budget Bill to move forward on schedule, and allow legislators, stakeholders and the Administration the necessary time an undertaking of this scope and complexity requires. The Administration looks forward to working collaboratively with all parties to secure the necessary statutory changes before the end of the legislative session. Recognizing the need to achieve Medi-Cal savings in budget year 2005-06, if legislative approval of programmatic and financing reforms are not secured by the end of the legislative session, the Administration will work with the federal government in September to secure any necessary plan amendments or waivers and return to the Legislature in January 2005 for its concurrence.

Medi-Cal Redesign Goals and Objectives

To restructure Medi-Cal, the State will need relief—i.e., a waiver—from federal statutory and regulatory mandates. With a federal waiver, California will have the flexibility to redesign the Medi-Cal program. Two overriding goals—both aimed at ensuring the continued provision of health care services to low-income residents—are central to the Administration's efforts:

- Maintain current eligibility of low-income populations.
- Contain costs and maximize efficiencies.

The Administration's efforts seek to advance five principal objectives are as follows:

- Expand the use of organized systems of care that increase access, improve outcomes, and contain costs.
- Revise the Medi-Cal eligibility and enrollment process to make it more efficient and improve customer service.
- Tailor benefits to the needs of distinct Medi-Cal populations.
- Incorporate beneficiary cost sharing that promotes personal ownership and responsibility, aligns Medi-Cal with other publicly funded health programs, and encourages appropriate utilization of services.
- Stabilize financing of the State's "safety net" to ensure that hospitals have the resources to care for low-income and uninsured Californians.

General Fund Adjustments

The Administration has developed alternative proposals that implement strategies to better manage and control program costs over the long term. Without these alternatives, the Administration would not have the ability to rescind the enrollment cap proposals and make other changes to ensure access to essential services for people in need.

The May Revision proposes the following savings:

- **Quarterly Medi-Cal Eligibility File Reconciliation—**$9 million to require counties to reconcile eligibility data discrepancies on a quarterly basis. The reconciliation process compares the Medi-Cal Eligibility Data System (MEDS) records with the county records to identify any data discrepancies. Eligibility reconciliation is required on cases that are shown as active in the MEDS, but are not eligible in the county system.

- **Los Angeles County Reconciliation—**$33.3 million to reflect a reconciliation of State and county eligibility records within Los Angeles County.

- **Third-Party County Eligibility Validation—**$2.6 million to reflect the establishment of a third-party vendor contingency fee contract for validation of accuracy of the county eligibility determination process.

- **Pharmacy Reimbursement Realignment—**$79.3 million to reflect a lower drug-cost reimbursement to average wholesale price minus 20 percent and, in conjunction, raising the dispensing fee from an average of $3.59 to $8.30.

- **Delay Medi-Cal Checkwrite by One Additional Week—**One-time General Fund savings of $143 million reflecting the delay of the last checkwrite to the next fiscal year. This will reduce an additional checkwrite in 2004-05, while minimizing the impact on providers by delaying only one payment and not delaying all payments an additional week.

Public Health

2003-04	**–$1.9 million**
2004-05	**$11.5 million**

Current Year

Caseload Programs

The May Revision includes a decrease of $1.9 million General Fund, or 1 percent, below the $201.8 million provided in the Governor's Budget, due to a decrease in caseload and health care costs in the California Children's Services (CCS), Child Health and Disability Prevention, and Genetically Handicapped Persons programs (GHPP).

Budget Year

Caseload Programs

The May Revision includes an increase of $8.7 million General Fund, or 4.4 percent above the $198.3 million provided in the Governor's Budget, due to an increase in caseload and health care costs in the CCS and GHPP.

AIDS Drug Assistance Program (ADAP)

Total funding for the ADAP is $234.2 million, an increase of 13 percent since the 2004-05 Governor's Budget. This reflects an increase of $27 million total funding (General Fund [$2.8 million], Reimbursements [$21 million], and federal funds [$3.2 million]) to fully address projected caseload and eliminate the proposed enrollment caps in 2004-05. General Fund resources are budgeted at the level necessary to maintain expenditures at the Ryan White Care Act maintenance-of-effort (MOE) requirement.

Cigarette and Tobacco Products Surtax Fund—Proposition 99

Proposition 99 revenues for the budget year are projected to increase by approximately $8.2 million. These increases result in additional resources in the Health Education Account ($1.4 million), the Hospital Services Account ($2.4 million), the Physician's Services Account ($679,000), the Research Account ($340,000), the Public Resources Account ($340,000), and Unallocated Account ($1.7 million). In addition to the revenue increase, additional Proposition 99 savings from the Access for Infants and Mothers program and the Healthy Families Infants Program are available. These savings are attributable to using General Fund and federal State Children's Health Insurance Program (S-CHIP) funds to support these programs in lieu of Proposition 99 funds. Proposition 99 savings can then be used to offset costs within the Department of Mental Health that were previously funded by the General Fund without reducing Proposition 99 funds for local programs.

To reflect these increases, the May Revision proposes to augment the following programs: Breast Cancer Early Detection ($1.7 million), Competitive Grants ($411,000), Local Lead Agencies ($432,000), Anti-Tobacco Media Campaign ($418,000), and the California Healthcare for Indigents Program ($611,000).

Medical Marijuana Identification Card (MMIC) Program

Consistent with the requirements of Chapter 875, Statutes of 2003, the May Revision includes a $983,000 loan from the Health Statistics Special Fund and 8.0 positions to establish and implement the MMIC program and registry. Implementation will include the development of regulations and printing of new applications and identification cards related to the establishment and collection of the new fee.

Reversion of Prior Year Savings In Public Health Programs

The May Revision proposes to revert the unencumbered balance of prior year appropriations for various public health programs, including drinking water, cancer detection, county health services, and primary care and family health programs. This reversion totals $31.5 million General Fund and $16.3 million Tobacco Settlement Fund, and will be captured as savings in 2004-05.

California Nutrition Network Reconciliation

The May Revision includes $28.1 million to address an inconsistency in the Reimbursements scheduled for the Nutrition Network Program. Though the Department of Social Services' (DSS) subvention estimate projected total funding of $90 million in 2004-05, the DHS's budget reflects only $61.9 million. This proposal would align the DSS and DHS budgets.

West Nile Virus—Prevention and Control

The May Revision includes approximately $1 million and 2.0 positions for the development of a long-term, strategic plan and program for West Nile Virus surveillance, prevention, and control. This proposal would provide the DHS and local agencies with the capacity to conduct various scientific tests, create a geographic information system to predict risk, and produce professional outreach and educational materials. The cost to manage West Nile Virus outbreaks in states that failed to prepare in advance amounted to hundreds of millions of dollars.

Community Challenge Grants—Restoration

The May Revision includes $20 million in Reimbursements to restore funding for Community Challenge Grants. Promoting responsible parenting and reducing the number of teenage and unintended pregnancies assist in offsetting future costs associated with welfare dependency. Temporary Assistance for Needy Families (TANF) block grant funding through the DSS has been restored, resulting in the opportunity to restore the Community Challenge Grants.

Managed Risk Medical Insurance Board

2003-04	**–$3.8 million**
2004-05	**$13.5 million**

Healthy Families Program

Current Year

The May Revision includes an overall expenditure decrease of $9.4 million ($3.5 million General Fund). This expenditure decrease is primarily due to lower-than-anticipated caseload attributed to the Child Health and Disability Prevention Gateway Program. The HFP is expected to serve a total of 714,000 children by June 30, 2004, which is 18,000 less than the caseload anticipated in the Governor's Budget.

Budget Year

The May Revision projects overall expenditures to increase by $33 million ($13.6 million General Fund) above the level anticipated in the Governor's Budget. This change is primarily due to a caseload increase associated with the rescission of the enrollment cap and the rescission of the Block Grant for immigrants enrolled in the HFP and other social service programs, which were originally proposed in the Governor's Budget. Year-end children's caseload is expected to reach 774,000 children, which is 37,000 children more than the caseload projected in the Governor's Budget.

HFP Premium Increase Proposal

The Administration proposes to rescind the Governor's Budget Two-Tiered Benefit Proposal for higher income families, but retain the proposed increase in premiums for all HFP children with family incomes above 200 percent of the FPL, effective July 1, 2005. Subscribers at all income levels would be offered the same benefit package, but subscribers above 200 percent of the FPL would be charged higher monthly premiums for HFP benefits. The monthly premiums would be increased from $9 per child and $27 for three or more children to $15 per child and $45 for three or more children. Even with this proposed premium increase, families' total out-of-pocket costs (premiums and co-pays) would not exceed the 5 percent maximum allowed under federal regulations. The revised proposal will require the same level of administrative start-up costs as required for the Two-Tiered Benefit Proposal.

Access for Infants and Mothers Program

Current Year

Average monthly enrollment in the Access for Infants and Mothers program is expected to be 13,000 women and infants, compared to 14,000 as originally estimated in January. This represents a 7.2 percent decrease. Current year expenditures are expected to decrease by $5.4 million ($284,000 General Fund, $4.6 million Proposition 99, $528,000 federal funds), due to lower than anticipated enrollment of women and infants in the program.

Budget Year

Average monthly enrollment is expected to be 12,500 women and infants, compared to 14,100 as originally estimated in January. This represents a decrease of

11.3 percent. The expenditure savings due to the decline in enrollment growth is offset by additional costs for monthly capitation rate increases. As a result, net budget year expenditures will increase by $1.4 million ($81,000 General Fund decrease, $1.6 million Proposition 99 increase, $150,000 federal funds decrease).

County Health Initiative Matching Fund Program

The County Health Initiative Matching Fund Program, established by Chapter 648, Statutes of 2001 (AB 495, Diaz), allows county or local public agency funds to be used to match unused federal State Children's Health Insurance Program (S-CHIP) funds to provide health care for children with family incomes between 250 and 300 percent of the federal poverty level (FPL), and for parents with family incomes up to 200 percent of the FPL. Due to delays in federal approval for this program, matching S-CHIP funds have not yet been provided to counties and local agencies, although it is anticipated that federal approval will be received in the budget year.

Department of Developmental Services

2003-04	**–$80.2 million**
2004-05	**$46.4 million**

Current Year

The May Revision includes total Department of Developmental Services expenditures of $3.2 billion ($2.0 billion General Fund), a decrease of $68.4 million below the Governor's Budget. General Fund expenditures have decreased $80.2 million General Fund, or 3.9 percent.

Budget Year

The May Revision includes total Department of Developmental Services expenditures of $3.5 billion ($2.2 billion General Fund), an increase of $ 68.0 million above the Governor's Budget. General fund expenditures have increased $46.4 million, or 2.1 percent.

Regional Center Cost Containment

The May Revision provides additional detail on the $100 million General Fund savings for proposed cost containment measures in the Regional Centers purchase-of-services budget. The 2004-05 savings are associated with the following:

- Statewide Purchase-of-Services Standards ($11.9 million). Annualized savings will grow to $35.8 million when fully implemented.
- Family Cost-Participation Program ($570,000).

- Ongoing impact of temporary cost containment measures implemented in 2003-04 ($67.5 million).
- Decreased rate of program growth ($11.3 million).
- An offset from increased federal funds ($8.7 million).

Developmental Centers

Current Year

The May Revision includes a net reduction of $3.2 million General Fund for Developmental Centers as a result of the following adjustments:

- **Caseload—**Caseload in the Developmental Centers is projected to decrease by 44 consumers from the level in the Governor's Budget, resulting in $2.3 million General Fund savings.
- **Bay Area Project—**The Budget proposes a one-year delay in the expected date for closure of Agnews Developmental Center, from July 2005 to July 2006. This results in a one-time savings of $5 million General Fund. This reflects reversion of funding appropriated in 2003-04 for closure-related activities conducted by the Bay Area Project.
- **Employee Compensation—**Employee compensation increases effective in 2003-04 generate additional General Fund costs of $4.1 million. These costs are included in Senate Bill 1842, the Omnibus Deficiency Bill.

Budget Year

The May Revision includes a net increase of $26.2 million ($19.4 million General Fund) for Developmental Centers as a result of the following changes:

- **Caseload—**Caseload in the Developmental Centers is anticipated to decrease by 60 consumers from the Governor's Budget level, resulting in $1.2 million General Fund savings.
- **Bay Area Project—**Timely closure of Agnews Developmental Center by July 2006 requires preparation activities in 2004-05. A General Fund increase of $11 million is provided for facilities improvement at Sonoma Developmental Center and for miscellaneous costs to transition consumers from Agnews into other settings.
- **Employee Compensation—**The budget year impact of increased employee compensation costs in 2003-04 necessitates an increase of $7.3 million General Fund.

- **Janitorial Contract—**An increase of $1.8 million General Fund is provided for newly bid and awarded janitorial contracts.

- **Delayed Contracting Out Food Services—**Delayed implementation of the Administration's proposal to contract out food services in the Developmental Centers results in an increase of $910,000 General Fund.

- **Medi-Cal Base Funding Adjustment—**The annual adjustment in Medi-Cal base funding results in a reduction of $476,000 General Fund and an equivalent increase in Reimbursements.

- **Life Services Alternative Project—**Funding for the Life Services Alternative Project is increased by $750,000 in Reimbursements from the Regional Centers budget to help transition consumers from Agnews Developmental Center into community settings.

Regional Centers

Current Year

The May Revision includes a net decrease of $68.2 million ($77 million General Fund) for Regional Centers as a result of the following adjustments:

- **Purchase-of-Services—**Updated expenditure data show a decrease in purchase-of-services expenditures for savings of $47 million. The decrease in expenditures is likely due to the temporary cost containment measures implemented in the current year, including various rate freezes and a $10 million unallocated reduction.

- **Community Placement Plan—**Costs of placing consumers in the community decreased by $8.3 million. Although the number of placements increased by 32 consumers to 262 placements, overall placement costs decreased due to placement of consumers later in the fiscal year.

- **Placement Continuation—**Updated placement continuation plans from the Regional Centers show a $10.4 million reduction in expenditures.

- **Community Care Facilities—**Updated expenditure data indicate the 2003-04 residential rate freeze will achieve a higher level of savings than originally estimated, allowing for a $1.8 million reduction.

- **Other Agency Costs—**Updated expenditure data show savings of $700,000 for reduced costs passing through the Regional Center budget to other agencies.

Budget Year

Compared to the Governor's Budget, the Regional Centers population is projected to decrease by 40 consumers, to an updated population of 199,255 consumers. The May Revision includes a net increase of $40.3 million ($25.7 million General Fund) as a result of the following changes:

- **Operations—**An increase of $6.7 million is provided for Regional Centers to implement the purchase-of-services cost containment proposals and $2.8 million for accelerated Medicaid Waiver enrollments. In addition, $6 million is provided for updated project costs including implementation of the California Developmental Disabilities Information System.

- **Purchase-of-Services—**An overall increase of $26.2 million is provided for purchase-of-services. This net change reflects several adjustments:

  - An increase of $17.4 million is provided for increased utilization based on updated expenditure data.

  - An increase of $12.6 million is provided for Community Placement Plan and Continuation costs.

  - A reduction of $2 million is made to reflect updated savings due to the Community Care Facilities and Average Cost Increase rate freezes.

  - A reduction of $1.8 million is achieved due to decreased need for Gap Resource Development.

- **Habilitation Services—**A reduction of $1.4 million is made in habilitation services. This net change reflects two adjustments:

  - A reduction of $3.1 million reflects a decrease in caseload based on updated data.

  - An increase of $1.7 million is provided for day program placement of consumers that cannot be accommodated into habilitation programs, since some habilitation groups will not convert their group size from 1:3 to 1:4 by July 1 as required by statute. The consumers in these groups will likely be placed into day programs until a suitable habilitation program can be identified.

Department of Rehabilitation

2003-04 –$5.5 million

2004-05 –$0.09 million

Current Year

The May Revision reflects a net General Fund savings of $5.5 million. Significant adjustments include the following:

- Savings of $1.4 million in the Vocational Rehabilitation Program (VRP) resulting from an estimated decrease in caseload.
- Savings of $5.8 million in the Habilitation Services Program attributable to a projected decline in caseload and an increase in Home and Community-Based Waiver reimbursements.
- A reappropriation of $1.7 million to provide a technical correction to pay outstanding claims for 2002-03.

Budget Year

The May Revision reflects a net General Fund decrease of $90,000, resulting from the following:

Caseload Projection and Redirection of Savings

Revised projections for the VRP reflect savings of $5.4 million in combined General Fund and federal funds. Although caseload is projected to increase, the expenses are offset by efficiencies in program delivery and improved expenditure data reflecting the cost of services at a lower level than originally estimated.

Of the savings, $4 million ($856,000 General Fund) is proposed to backfill a reduction in Social Security Reimbursement (SSR) expenditures necessary to offset declining SSR revenues in 2004-05. The Department of Rehabilitation receives SSRs when it assists recipients of Social Security Disability Insurance (SSDI) and Social Security Income (SSI) to attain employment and discontinue SSI/SSDI payments. The 2004-05 Governor's Budget projected revenues at a greater rate than are materializing. Thus, revenues are less than expenditures, and an April 1, 2004 Finance Letter was provided to the Legislature to reduce SSR expenditures by $4.3 million in order to correct the structural deficit in 2004-05. However, while these reductions were permanent, they only provide SSR solvency through 2004-05. Therefore, this proposed redirection of savings is required to provide a permanent solution for the structural deficit, and the remaining $1.4 million ($90,000 General Fund) is proposed as a savings in 2004-05.

Department of Mental Health

2003-04	$15.7 million
2004-05	$14 million

Long-Term Care/State Hospitals

Current Year

The May Revision includes a net increase of $14.7 million ($15.9 million General Fund) for state hospitals. The General Fund increase is comprised of the following:

- **State Hospital Employee Compensation—**An increase of $15.5 million General Fund is provided for increased employee compensation costs beginning in 2003-04. These costs are included in Senate Bill 1842, the Omnibus Deficiency Bill.

- **State Hospital Population—**The May Revision projects a state hospital caseload reduction of 11 forensic patients from the level in the Governor's Budget. Caseload is expected to decline from 4,434 to 4,423 patients. The net change includes an increase of 14 Judicially Committed/Penal Code (JC/PC) patients for a General Fund cost of $361,000. This reflects the rescission of the Governor's Budget proposed enrollment caps on Not Guilty by Reason of Insanity (NGI) and Incompetent to Stand Trial (IST) patients, since legal challenge would likely prevent any savings in 2004-05. The population increase is offset by a 25-bed decrease in the number of beds purchased by the Department of Corrections (CDC), for a $1.2 million reduction in Reimbursements. These changes result in a reduction of 11.5 positions (10.9 personnel years) for state hospitals.

Budget Year

Funding for long-term care and state hospitals is anticipated to increase by a net $19.5 million ($14.2 million General Fund). Significant General Fund adjustments are as follows:

- **State Hospital Population—**The May Revision projects a net state hospital increase of 253 JC/PC patients from the level in the Governor's Budget, for an increase of $15.7 million General Fund. Caseload is expected to increase from 4,327 to 4,580 patients. The net change reflects a reduction of 25 beds purchased by the CDC, the rescission of the enrollment cap on the NGI population, and an additional increase of 222 JC/PC patients. These changes result in an increase of 134.1 positions (127.4 personnel years) for state hospitals.

The impact of the $15.5 million General Fund increase for employee compensation costs is also included, as is the reduction of 25 beds that were to be purchased by the CDC beginning in 2003-04.

- **Delay Activation of Coalinga State Hospital—**A reduction of 90.3 positions (87.7 personnel years) and savings of $9.5 million General Fund is achieved from delaying activation of Coalinga State Hospital from August 2005 to September 2005 and reducing the number of beds initially activated from 575 to 200. The activation of Coalinga State Hospital cannot be delayed any longer in order to maintain staff and patient safety and to safeguard the licensure of Atascadero and Patton State Hospitals, as the overbedding of these two facilities will continue until Coalinga's activation.

- **Shift Proposition 99 Revenues to Fund State Hospital Growth—**Savings of $5.9 million General Fund and a corresponding $5.9 increase in Reimbursements to reflect a shift in Proposition 99 (Tobacco Tax) funding for the costs of state hospital population growth. This shift is made possible by additional Proposition 99 savings in the Unallocated Account. The savings are the result of using General Fund to match federal funds in the Access for Infants and Mothers program and Healthy Families Infants Program.

- **Conditional Release Population Increase/Sexually Violent Predators (SVPs) Community Services—**A General Fund increase of $218,000 for SVPs released from state hospitals into community treatment programs pursuant to a court order for conditional release. This funding includes treatment, living, and monitoring expenses for five SVPs that have been or will be released from Atascadero State Hospital by July 2004 and half-year funding for six SVPs to be released in the budget year.

- **SVP Evaluations and Court Testimony—**A reduction of $1.5 million General Fund due to a decrease in the estimated number of evaluations and court testimony appearances. This level of funding assumes adoption of the Administration's proposal for the indeterminate commitment of SVPs.

- **County Payment for IST Patients—**Savings of $360,000 General Fund is expected by enforcing county payment of amounts owed to the State for services provided in the budget year to IST patients committed to state hospitals pursuant to Penal Code § 1372.

Community Mental Health Services

Current Year

The May Revision includes a reduction of $44.4 million ($250,000 General Fund) for community mental health services in 2003-04:

- **Early and Periodic Screening, Diagnosis, and Treatment (EPSDT)—**The May Revision includes a reduction of $43.9 million ($18.2 million General Fund in the DHS budget), reflecting a revised caseload projection. The May Revision projects a 10 percent rate of growth in 2003-04, down from 20 percent as estimated in the Governor's Budget. The projection is based on claims filed January 2001 through September 2003, and excludes three months of unreliable data due to county restructuring of claiming systems.

- **Mental Health Managed Care Requirements—**The May Revision includes a reduction of $500,000 ($250,000 General Fund) in 2003-04 to reappropriate those funds in budget year for development of Medi-Cal beneficiary informing materials pursuant to federal Managed Care requirements.

Budget Year

The May Revision includes a net reduction of $21.8 million ($143,000 General Fund) in 2004-05 for community mental health services compared to the Governor's Budget. Major adjustments include the following:

- **EPSDT—**The May Revision includes a net decrease of $21.5 million in Reimbursements ($12.8 million General Fund within the DHS budget) for the EPSDT. This change reflects several significant adjustments, including the following:

  - $98.4 million ($42.8 million General Fund) in natural savings due to a decrease in the projected caseload. The May Revision projects a 10 percent rate of growth over 2003-04, down from 16 percent estimated in the Governor's Budget.

  - Restoration of $60 million ($40 million General Fund) by rescinding both the Governor's Budget proposals to rebase maximum provider rates and the public provider exemption for obtaining federal reimbursement above the state rates. Before rebasing can occur, an alternative formula is needed to correct methodological problems and to prevent significant reductions in rates that could affect access to services. An additional $25 million in federal funds is also restored to beneficiary services.

  - $12.6 million savings (General Fund in DHS budget) by increasing the county share of costs from 10 percent to 20 percent, excluding small counties. Counties will have increased incentive to manage costs and operate more efficiently. Based on recent changes in the rate of growth, it appears that instituting the county match contributed to slowing the rate of growth. The State will seek additional federal reimbursement in 2004-05 for counties to offset their higher-match requirement.

  - Restoration of $4.5 million ($2.6 million General Fund) by updating the estimated savings associated with the Governor's Budget proposed EPSDT audits. Technical adjustments reflect a change from accrual-to-cash accounting, discounting for the county share, and applying the 2003-04 federal/State-sharing ratio.

- **Managed Care Adjustment—**Funding for Mental Health Managed Care is proposed to decrease by a net $960,000 ($480,000 General Fund). This reflects a decrease in Medi-Cal eligibles, increased inpatient costs, an increase in Breast and Cervical Cancer eligibles, and start-up costs for Solano County Mental Health Plan to implement the new federal Managed Care regulations.

- **Waiver Requirements—Medi-Cal Specialty Mental Health Services Consolidation—**The May Revision includes a one-time $675,000 ($337,000 General Fund) increase for contracts to develop Medi-Cal beneficiary informing materials and provide technical assistance and training to counties related to External Quality Reviews under the Managed Care regulations.

Department of Alcohol and Drug Programs

2003-04	**$0.1 million**
2004-05	**–$0.4 million**

Current Year

General Fund costs for the Department of Alcohol and Drug Programs will increase by $114,000, reflecting an estimated caseload increase of 8,170 in the Drug Medi-Cal program. Current year costs reflect funding Drug Medi-Cal rates at 2003-04 levels.

- **Regular Drug Medi-Cal—**Caseload is expected to be 6.2 percent higher than projected in the Governor's Budget. Costs will increase by $209,000 General Fund, or 0.4 percent, above the Governor's Budget.

- **Perinatal Drug Medi-Cal—**Caseload is expected to decrease by 0.9 percent, or 55 clients, from the Governor's Budget. Costs will decrease by $95,000 General Fund, or 5 percent.

Budget Year

General Fund costs will decrease by $450,000. At the same time, the Drug Medi-Cal caseload is estimated to increase by 6,048 clients. Budget year costs reflect the Governor's Budget proposal to fund 2004-05 Drug Medi-Cal rates at the 2002-03 levels.

- **Regular Drug Medi-Cal—**Caseload is projected to increase by 5,846, or 4.1 percent, above the Governor's Budget. This net change includes a decrease of 1,665 in the Narcotic Treatment Program, the highest-cost mode of treatment in Regular Drug Medi-Cal. A declining Narcotic Treatment caseload, combined with lower dosing and counseling rates in 2004-05, contributes to a reduction of $414,000 in General Fund costs for Regular Drug Medi-Cal.

- **Perinatal Drug Medi-Cal—**Caseload is projected to increase by 202 clients, or 3.1 percent, over the Governor's Budget. This net change reflects an increase of 324 clients in the Outpatient Drug-Free Program, the second lowest-cost mode of treatment in Perinatal Drug Medi-Cal, and caseload decreases in the other modes of treatment. The combined effect is a $36,000, or 1.6 percent reduction, in costs from the Governor's Budget.

Department of Social Services

2003-04	**$90.7 million**
2004-05	**$143.5 million**

CalWORKs

The 2003-04 average monthly CalWORKs caseload of 473,900 represents a 1.8-percent decrease from 2002-03. For 2004-05, the caseload is expected to be 465,400, which is 3,700 below the Governor's Budget projection and a 1.8-percent decrease from the 2003-04 projection.

The May Revision continues to meet the federally required combined State and county Temporary Assistance for Needy Families (TANF) maintenance-of-effort (MOE). For 2003-04 and 2004-05, the MOE will be met at $2.7 billion. For 2003-04, total CalWORKs-related expenditures are estimated to be $6.9 billion including the transfer to the Department of Education for child care and county expenditures. For 2004-05, total CalWORKs-related expenditures are anticipated to be $6.4 billion.

Major changes proposed for 2004-05 include the following:

- **Community Challenge Grants—**The May Revision reflects the transfer of $20 million TANF Block Grant funds to the Department of Health Services to fund Community Challenge Grants in 2004-05. By promoting responsible parenting and reducing the number of teenage and unintended pregnancies, this program assists in offsetting future costs associated with welfare dependency.

- **Adjustment to Child Care Reform Savings—**The May Revision reflects an increase of $13 million TANF Block Grant funds to reflect a reduction in savings resulting from the proposed child care reform, primarily due to a revised number of 11 and 12 year-olds for which after school programs would be available. Please refer to the Child Care Programs portion of the State Department of Education.

Supplemental Security Income/State Supplementary Payment Program

Total General Fund expenditures for the SSI/SSP program are $3.2 billion in 2003-04 and $3.4 billion in 2004-05, which represents increases of $11.9 million in the current year and $25.3 million in the budget year, compared to the Governor's Budget. Caseload for the SSI/SSP program is projected at 1,158,300 recipients in 2003-04, and 1,185,700 recipients in 2004-05. Significant General Fund adjustments include:

- Increases of $11.4 million General Fund in 2003-04 and $24.5 million General Fund in 2004-05, due to higher-than-anticipated caseload growth and a higher average grant in the SSI/SSP program. The year-to-year caseload growth is projected at 2.4 percent.

In-Home Supportive Services

General Fund expenditures for the IHSS program are above the levels reflected in the Governor's Budget by $83.4 million in 2003-04 and $124.8 million in 2004-05. Caseload is projected to be 330,000 recipients in 2003-04 and 358,400 in 2004-05. Significant General Fund adjustments include the following:

- An increase of $88.8 million General Fund in 2003-04 due to delayed action on the Governor's Budget proposal to eliminate the IHSS Residual Program.

- An increase of $135.2 million General Fund in 2004-05 to pursue a federal Independence Plus Waiver for the IHSS Residual Program in lieu of eliminating the Residual Program. The Waiver will allow the federal government to pick up a share-of-cost for the program estimated at $264 million in the budget year. Although this proposal would result in less potential savings than elimination of the Residual Program, it would allow individuals to continue to receive services through the program rather than through more costly health facilities, nursing homes, or Regional Centers. The May Revision includes funding for 9.5 positions in the DSS budget and 5.0 positions in the DHS budget to implement and manage the Independence Plus Waiver. Without these resources to address necessary oversight, federal financial participation would be at risk.

- A decrease of $14 million General Fund in 2004-05 resulting from implementation of an IHSS Quality Assurance (QA) Initiative. In addition to performing program oversight and fraud investigation activities, training State monitoring staff, and establishing a statewide training contract and training academy for county staff, the Initiative would implement authorization controls for protective supervision. These savings are net of $860,000 General Fund to support 18.0 positions and $4.1 million General Fund in local assistance funding to implement the Initiative. When the QA procedures are fully implemented in every county, annual ongoing savings are estimated to be $92.3 million General Fund beginning in 2006-07.

Food Stamp Program

The May Revision includes an increase of $1.2 million in 2003-04 and $3.5 million in 2004-05 due to rescinding the Governor's Budget proposal to repeal legislation that expanded eligibility for the Transitional Food Stamp program. These changes to the food stamp program are estimated to increase federal Food Stamp program and California Food Assistance Program caseloads by 81,000 and increase the amount of federal food coupons the State receives by $203 million. This would allow families to spend income that otherwise would have been spent on food to be spent on other items, including taxable goods. These purchases are estimated to generate ongoing annual revenue of $4.5 million General Fund, which outweighs the cost of the legislation.

Block Grant for Immigrant Programs

The May Revision includes an increase of $5.7 million due to rescinding the Governor's Budget proposal to combine funding for the California Food Assistance Program, Cash Assistance Program for Immigrants, and CalWORKs benefits for recent documented immigrants in a block grant. This will allow the full benefits to continue to be provided to this population without altering the administrative structure of these programs.

Foster Care

General Fund expenditures will decrease by $17.6 million in 2003-04, due primarily to a reduced caseload projection. The remaining General Fund decrease is due to the prospective shift in the state-only foster care population to the federal foster care population resulting from the *Rosales v. Thompson* court decision, which broadened the linkage requirements for federal foster care eligibility.

For 2004-05, the May Revision reflects a net decrease of $10.7 million General Fund, due primarily to a reduced caseload projection and a slight reduction in average grants. Included in the budget year decrease is $18.9 million due to caseload adjustments, offset by an increase in foster care payments and administration due to the retroactive applicability of the final *Rosales v. Thompson* court decision.

Foster Care Reform

The May Revision continues a series of new foster care reforms proposed in the Governor's Budget to promote the care of more children in a family home environment and to shorten the period of time children spend in foster care, particularly in more restrictive placements such as group homes. These reforms are estimated to achieve $15.2 million General Fund savings. Additionally, a number of ongoing current reforms will generate additional savings of $17.3 million General Fund in 2004-05 due to reduced caseload in Foster Family Homes, Group Homes, and Foster Family Agencies (FFAs). The overall reform package, comprised of new and ongoing strategies, will result in savings of $32.5 million General Fund in 2004-05.

New reform options that will achieve savings of $15.2 million General Fund include the following:

1. Strategies to establish equity in foster care payments and to standardize rates paid to FFAs.
2. Stronger incentives for relatives to commit to adoption and guardianship.
3. Reducing the administrative requirement for redetermination of federal foster care eligibility from every six months to annually, with no effect on child welfare services or social worker activities.
4. A series of audit reforms designed to improve the level of services received by children placed in Group Homes and FFAs through increased accountability of foster care providers.

Foster Care caseload projections have decreased significantly from the Governor's Budget, indicating reduced entries and increasing exits from the system. This positive change in caseload is partially due to efforts by the State and counties in implementing reforms initiated by the Adoptions and Safe Families Act, California's Program Improvement Plan, and the new California Child Welfare Outcomes and Accountability System (Chapter 678, Statutes of 2001 [AB 636, Steinberg]).

Efforts such as Family-to-Family, implemented in 17 counties, and the development of tools and processes associated with the CWS Redesign, along with other programmatic efforts have generated improved prevention strategies, reducing the need for placement of children in out-of-home care and shortening the lengths of stay in placement. These ongoing efforts are projected to save approximately $17.3 million General Fund in 2004-05.

Additionally, the May Revision includes $2.3 million ($1.3 million General Fund) and 14.0 limited-term staff in 2004-05 to support the development of two long-term reform proposals (Performance-Based Contracts and a Title IV-E Child Welfare Waiver Project) that were identified in the Governor's Budget as promising strategies.

Child Welfare Services

Due to the ongoing fiscal challenges, the Administration can no longer afford to waive the county share-of-cost for the Child Welfare Services (CWS) Augmentation. Specifically, the Budget includes a decrease of $17.1 million General Fund to reflect the addition of a 30 percent nonfederal county share-of-cost to the CWS Augmentation. This is the same as the county share-of-cost for the core CWS program. This discretionary augmentation to the core CWS program provides for additional county social workers in recognition of the funding and staffing need identified in the workload study completed pursuant to the requirements of Chapter 785, Statutes of 1998 (SB 2030, Costa). This proposal would maintain the total expenditures for this augmentation.

Department of Child Support Services

2003-04 –$0.7 million
2004-05 $8.2 million

Current Year

The May Revision includes a decrease of $715,000 General Fund compared to the Governor's Budget. Savings result from a $2.9 million decrease in the Alternative Federal Penalty levied by the federal government for failure to implement a statewide automated child support system and additional federal incentives of $102,000 for ongoing Child Support Program activities, which offset General Fund costs. These savings are partially offset because the Collections Enhancement Project realized $2.3 million less than expected in federal incentives.

Budget Year

The May Revision includes a net increase of $8.2 million General Fund, comprised of the following major adjustments:

- $6.2 million for interface modifications to local automation systems necessary to achieve federal certification for the California Child Support Automation System (CCSAS).
- $888,000 because of an anticipated decrease in federal incentives. A General Fund backfill of these incentives is necessary to maintain local program administration funding at the level proposed in the 2004-05 Governor's Budget.
- $711,000 reappropriated from the Budget Act of 2003 because of a revision of an automation project schedule. Two local systems are proposed for conversion in order to position the State to apply for federal certification of the CCSAS.
- $440,000 for electronic data processing hardware equipment that the federal government requires to be depreciated over a five-year period.

Child support collections are projected to be $2.33 billion in 2003-04 and $2.37 billion in 2004-05. Collections are expected to decrease by $30.1 million, or 1.3 percent, for 2003-04 and $38.2 million, or 1.6 percent, for 2004-05, below the level projected in the Governor's Budget.

Emergency Medical Services Authority

2003-04	**—**
2004-05	**—**

Budget Year

Emergency Medical Services Terrorism Response Training

The May Revision includes an increase of $250,000 in reimbursements and 1.0 limited-term position for the development of standards for Emergency Medical Services terrorism training courses, and a system of oversight for these courses. This federal grant funding provides an opportunity to ensure that terrorism training courses include the latest information on appropriate medical responses to terrorist attacks involving chemical, biological, radiological, nuclear and explosive devices, and self-protection techniques for personnel responding to terrorist attacks.

Department of Aging

2003-04	**—**
2004-05	**—**

Budget Year

Aging and Disability Resource Center

The California Department of Aging (CDA) has been awarded an $800,000 three-year federal grant from the Aging and Disability Resource Center Program to develop two “one-stop” aging and disability resource centers. The program is part of President Bush’s New Freedom Initiative that works to overcome barriers to community living for people with disabilities of all ages. The centers will provide citizen-centered “one-stop shop” entry points serving individuals who need long-term support, their family caregivers, and those planning for future long-term support needs. The 2004-05 Governor’s Budget includes $267,000 for this purpose.

Additional Funding for the Older Americans’ Act (OAA) Program

The May Revision includes $2.6 million in federal funds to augment State activities supporting the OAA program. This includes $2.5 million for block grant programs at the local level and $68,000 for administration. The CDA currently administers various programs under the federal OAA, which provide services for seniors such as Supportive Services, Congregate Nutrition, Home-Delivered Nutrition, Ombudsman, and Family Caregiver Support. Of the augmentation for local block grants, $1.1 million is included on a one-time basis. Additionally, one new position will be added to develop monitoring tools and oversight for the Family Caregiver Support Program.

CORRECTIONS & LAW ENFORCEMENT

Youth and Adult Correctional Agency

2003-04	**—**
2004-05	**$ 1.7 million**

Restructuring the Youth and Adult Correctional Agency—The May Revision proposes an increase of $1.7 million to provide increased oversight and policy direction to departments under supervision of the Youth and Adult Correctional Agency (YACA). Funding for this proposal is provided through corresponding reductions to the California Department of Corrections ($1.5 million) and the California Department of the Youth Authority ($200,000).

Office of the Inspector General

2003-04	**—**
2004-05	**$4.9 million**

Expand the Office and Add the Office of Independent Review—The May Revision proposes $4.9 million to provide additional staff and resources to enhance and strengthen the Office's operations, and to establish the Office of Independent Review, to meet federal court demands for additional oversight of the internal affairs operations of the California Department of Corrections *(Madrid v. Woodford),* and the California Department of the Youth Authority.

During 2004-05, the Office will develop a methodology to adjust its budget based on a change in workload. This methodology will take into account the number and types of investigations, length of investigations, and staffing required by type of investigation, and will be used to adjust the Office's budget beginning in 2005-06.

Department of Corrections

2003-04 $114.6 million
2004-05 $167.7 million

Inmate/Parolee Population/Caseload Changes

Current Year

Based upon the Department of Corrections' (CDC) Spring estimates, the May Revision reflects an estimated institutional Average Daily Population (ADP) of 161,876 inmates in fiscal year 2003-04. This is 5,240 more than projected in the 2004-05 Governor's Budget.

The projected parolee ADP is 114,227. This is a decrease of 5,120 from the number projected in the 2004-05 Governor's Budget.

The main reason for the increase in institutional projections and the decrease in parolee projections is that the ADP estimates for the reductions included in the 2003 Budget Act have declined since the release of the Governor's Budget. Due to delays in transitioning teachers into a new education program, negotiating and securing contracts with local jails for drug treatment beds, and obtaining conditions of use permits for drug treatment furlough facilities, as well as securing realistic estimates of the potential short-term savings, the estimate of potential savings has decreased in the current year. In addition, while there was a significant drop in the number of parolees returned to custody for parole violations, the Department experienced a significant increase in the number of new admissions to state prisons. After five consecutive years of a decline in the number of new admissions, CDC felon admissions from Superior Court commitments were up by 8.3 percent in 2002-03, and 14.5 percent for the first half of 2003-04. Based on current projections, the number of new admissions will peak in 2004-05, with slight decreases in subsequent years. The net effect of these population changes, as well as current year savings that did not materialize, is a cost of $114.6 million to the General Fund and $358,000 to the Inmate Welfare Fund.

Budget Year

Based upon CDC's Spring estimates, the May Revision reflects an estimated institutional ADP of 157,259 inmates in fiscal year 2004-05. This is 8,387 more than projected in the 2004-05 Governor's Budget.

The projected parolee ADP is 117,813. This is a decrease of 6,411 from the number projected in the 2004-05 Governor's Budget.

The key reason for the increase in institutional projections and the decrease in parolee projections is that since the release of the Governor's Budget, CDC has more realistic ADP estimates for the reductions included in the 2003 Budget Act related to items such as parole sanctions, drug treatment furlough, and education in reception centers. Also, as noted above, the CDC is projecting a continued increase in new admissions to state prison in 2004-05.

The net effect of the population changes, as well as projected savings that did not materialize, is a cost to the General Fund of $175.8 million and a cost to the Inmate Welfare Fund of $1.7 million.

Budget Savings

The 2004-05 Governor's Budget discussed the development of program enhancements and other budget adjustments that would result in savings within the CDC budget. The May Revision includes the details of the savings proposal totaling $476.7 million as follows:

Operational Efficiencies

These proposals include reducing energy expenditures, serving two hot meals on weekends and holidays instead of two hot meals and a sack lunch, consolidating the purchase of some correctional equipment and various goods, the elimination of some vacant positions at headquarters, streamlining various processes at headquarters and in the Classification Services Unit, and savings associated with the need to only train one class of cadets at the Basic Correctional Officer Academy. These proposals are estimated to save $36.6 million in 2004-05.

In addition, included in the setaside for Control Section 4.30 is a reduction of $6.8 million for CDC's Lease Revenue Item, of which $3.1 million is attributable to the refinancing of bonds for Pleasant Valley State Prison and High Desert State Prison and $3.7 million is the result of decreased project costs and interest earnings.

Medical Improvements

Hepatitis C Clinical Management—$1.2 million savings as a result of using CDC physicians to perform liver biopsies in CDC medical facilities instead of contracting for this service.

Pharmacy and Medication Management—A reduction of $4.8 million to result from the modification of the CDC's prescription practices for four high-cost drug categories, without compromising therapeutic benefits or quality care standards.

Reclassify Psychiatrists to Nurse Practitioners—$1.4 million savings associated with the reclassification of 23.5 Staff Psychiatrist positions to Nurse Practitioners to perform certain mental health functions more appropriately performed by Nurse Practitioners. The use of Nurse Practitioners to provide mental health services will be based on standardized procedures and a comprehensive training program developed by the Department of Mental Health (DMH) who currently utilizes Nurse Practitioners in lieu of Staff Psychiatrists.

Response to Bureau of State Audits Report on Contract Medical Services— A reduction of $26.1 million to reflect implementation of the recommendations of the April 2004 Bureau of State Audits report regarding CDC's contract medical practices, as well as other program enhancements intended to reduce costs while maintaining appropriate levels of inmate health care.

In an effort to bring about standardized rates for medical services, the Administration proposes to link the rates paid by CDC for medical services to Medi-Cal rates. The following proposals represent areas that will be pursued.

Ambulance Emergency Medical Services (EMS) at Medi-Cal Rates—A reduction of $250,000 from the enactment of legislation requiring "911" ambulance providers to be reimbursed at Medi-Cal rates.

Hospital EMS at Medi-Cal Rates—$1.7 million savings to result from the enactment of legislation that would require emergency hospital providers to be reimbursed at Medi-Cal rates.

All Hospital Services Reimbursed at Medi-Cal Rates—$12.5 million savings to result from the enactment of legislation requiring that all hospitals be reimbursed for medical services to CDC inmates at Medi-Cal rates.

Additionally, the YACA and the CDC will look beyond the budget year to evaluate the delivery of inmate health services. Ultimately, the CDC will seek structural changes focused on program accountability, improved cost effectiveness, and access to quality medical care. To implement these changes, YACA and the Department propose to:

- Establish a position of Deputy Secretary for Health Care at YACA and recruit a qualified individual with practical experience managing in large health care systems.

- Support the Deputy Secretary for Health Care in forming a select group of State managers to develop solutions to the health care delivery problem encompassing the following areas: primary care medical, specialty medical care, community hospitals, pharmacy (procurement, inventory management, prescription, and dispensing management), mental health, dental, laboratory services, and utilization management (including invoice reviews) for CDC and the California Department of the Youth Authority (CYA).

- Explore the expansion of DMH services for mental health inpatients and consider a statutory requirement that DMH be responsible for this care.

- Explore the option for contracting with the University of California for the gradual take-over of the entire health care provider system for CDC/CYA beginning with a defined region.

- Cooperate with the findings and recommendations to be made by the Corrections Independent Review Panel, chaired by former Governor George Deukmejian.

Program Changes

Community Protection through Parole Accountability—The Administration's goal is to improve public safety and reduce victimization by lowering the rate of recidivism among parolees. The plan is to add tools to law enforcement and parole agents to adequately supervise by expanding the range of sanctions for parolees and enhancing services where appropriate.

California has not, unlike many other states, developed a continuum of services and sanctions that can be used to respond to parole violators who may benefit from remaining in the community. California must start using risk-assessment to address the appropriate disposition of a parole violator.

Therefore, the Administration is proposing to implement programs that will increase the accountability of parolees in California's Parole System. On the day offenders enter prison, an evaluation should begin to prepare them for successful parole in the community. Institutional programming should be focused on addressing the barriers to successful parole that have historically contributed to excessively high recidivism rates among the parole population. Parole policies should promote effective pre-release planning, re-entry transition into the community, supervision and enforcement strategies, swift and appropriate sanctions for parole violations, and discharge practices that provide incentives for successful reintegration into the community.

In addition to the initial step of adding tools for law enforcement and parole agents, it is the Administration's focus to evaluate the existing delivery of academic and vocational education, treatment programs, as well as in-prison job opportunities, to ensure that these programs are predicated upon evidenced-based practices proven to improve the re-entry success rate of inmates when they eventually are released to parole.

As a result of these changes, the Budget assumes a savings of $85.4 million associated with a reduction in parole recidivism.

Renegotiation

Savings of $300 million is anticipated from renegotiation of certain aspects of the current Memorandum of Understanding with Bargaining Unit 6. However, due to the nature of negotiations, there are no details available regarding how $300 million of savings will be achieved.

Fiscal Accountability and Assurance of Adequate Funding

In addition to the savings proposals listed earlier, the CDC is currently implementing a new allotment process that more accurately aligns institutional budgets with actual expenditures. In addition, the CDC will be required to reconcile staffing patterns to budgeted authority, and submit this reconciliation to the Department of Finance. The goal of these processes is to increase fiscal accountability of the institutions and the wardens.

While the above proposals are intended to generate savings within the CDC, there remain a small number of issues that must be addressed to ensure that the budget is adequately funded. The following augmentations are proposed:

***Valdivia v. Schwarzenegger* Remedial Plan—**$22.2 million to provide sufficient staffing and resources to implement the Valdivia Remedial Plan, which will enhance the provision of due process to parolees held on suspicion of violation.

Administrative Segregation Overflow—$16.8 million to establish Administrative Segregation units at those institutions that show an ongoing need for additional beds. Additionally, funding will be provided to headquarters to address overflow needs on a case-by-case basis. Also, the CDC will develop a strategy to more effectively use Administrative Segregation and Security Housing Unit beds.

Medical Guarding and Transportation—$18.2 million to provide proper staffing and funding for guarding and transportation of inmates in need of medical attention outside of the prisons.

Business Information System (BIS)—$4.6 million to begin procurement of BIS, an Enterprise Resource Planning system, that will integrate financial, human resources, procurement/contract, and litigation data into one cohesive management system.

Investigative and Employee Discipline Remedial Plan—$1.9 million to provide for vertical prosecution in employee disciplinary matters, and to improve the quality and timeliness of investigations.

Department of the Youth Authority

2003-04	**$3.1 million**
2004-05	**$9.8 million**

Ward/Parolee Population/Caseload Changes

Current Year

For 2003-04, the May Revision estimate for the year-end institution population is 3,950, a decrease of 57 from the projection included in the Governor's Budget.

The overall rate of population decline, which was less than anticipated in the fall, combined with a decrease in the level of county reimbursements, will result in a General Fund increase of $2.7 million. In addition, the CYA projects a year-end parole population of 4,100, an increase of 75 from the projection included in the Governor's Budget, resulting in a General Fund increase of $360,000. The net impact of the population adjustment is a General Fund increase of $3.1 million in 2003-04.

Budget Year

For 2004-05, the year-end institution population is projected to be 3,895, which is 318 more than anticipated in the Governor's Budget. The effect of this increase in population is a General Fund increase of approximately $6.2 million. CYA projects a year-end parole population of 3,755, a decrease of 55 from the level assumed in the Governor's Budget, resulting in a General Fund decrease of $132,000. The net impact of the population adjustment is a General Fund increase of $6.0 million in 2004-05.

Relief Factor—The May Revision proposes $3.5 million to increase the existing budgeted relief coverage for posted positions. Of this amount, $2.5 million is to provide post relief coverage for employees attending off-post training as required in the current Memorandum of Understanding with the California Correctional Peace Officers' Association.

Expert Reports and Litigation—Currently, the Prison Law Office is suing the CYA in several areas regarding the treatment of wards. These areas include general corrections issues, mental health, sex offender, health care, disabilities, and gangs. CYA, under the direction of the YACA, will develop funding proposals related to the deficiencies identified by the experts in response to this lawsuit once there is a consent decree. Until these negotiations are complete, the exact requirements that will be included in the settlement will not be known, nor will the fiscal implications. Once complete, however, CYA anticipates that some immediate funding will be required to address initial activities spelled out in the settlement.

CYA has been leveraging their current resources and identifying positions and dollars that may be available for redirection towards mitigating some deficiencies identified in the lawsuit. The CDC has been successful in implementing some expert recommendations (e.g. elimination of Secure Program Areas and the closure of the Tamarack living unit).

Board of Prison Terms

2003-04	**—**
2004-05	**$35.5 million**

Hearing Workload Adjustment—An increase of $117,000 in 2004-05 is proposed to fund increased life prisoner population related workload.

Valdivia Remedial Plan—An augmentation of $35.4 million in 2004-05 is proposed to provide sufficient resources for the implementation of the Valdivia Remedial Plan, which will enhance the provision of due process to parolees held on suspicion of violation.

Board of Corrections

2003-04	**—**
2004-05	**$0.5 million**

Juvenile Justice/CYA Reforms—An increase of $500,000 is proposed to provide planning for Juvenile Justice Reforms. As part of a comprehensive effort to address the need for major juvenile justice reform, the Administration convened the "Juvenile Justice Reform/CYA Task Force" earlier this year. The series of meetings, with representatives from all major stakeholders in the juvenile justice continuum, focused on several significant issues dealing with juvenile crime, delinquency, and detention at both the state and local level.

Department of Justice

2003-04	**-$2.7 million**
2004-05	**$11.5 million**

The Administration and the Attorney General have worked together toward the following revisions:

Flood Litigation Workload—An increase of $1.5 million General Fund and 9.4 positions to address litigation from the California floods of 1986 and 1997.

Structural Deficit—An augmentation of $7.3 million General Fund to support increased litigation workload in the Criminal Law, Civil Law, and Public Rights Divisions. A structural deficit of $11.3 million has been created by increased litigation workload. A revision to the Department's billing methodology will capture $4 million of reimbursements to reduce the deficit to $7.3 million.

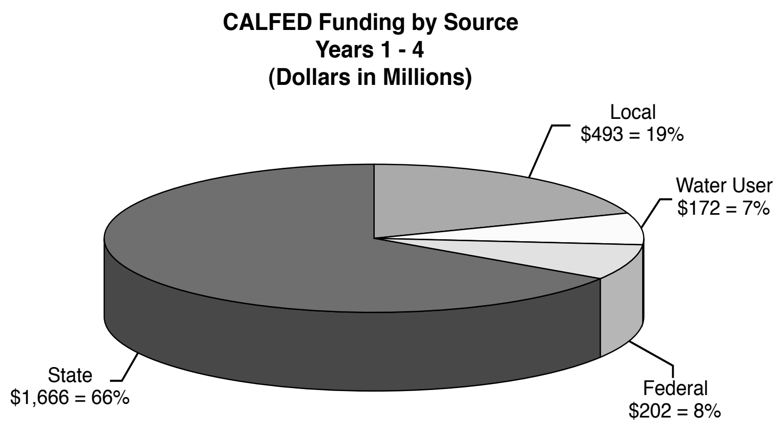
Armed Prohibited Persons System Reappropriation—A reappropriation of $2.7 million General Fund to complete work on the Armed Prohibited Persons Database System. $3.4 million General Fund was provided in 2003-04 to continue the project, however, project delays require funding in 2004-05 to continue development of the database.

The May Revision also proposes trailer bill language that would require the Department of Justice to obtain Department of Finance approval prior to expenditure of funds deposited into the Litigation Deposit Fund, and would provide that any unexpended balance in the fund be transferred to the General Fund on an annual basis.

RESOURCES

CALFED Bay-Delta Program

The May Revision proposes an additional $10.1 million Proposition 13 bond funds for CALFED projects to improve drinking water quality. With this request, the Budget will provide a total of $381 million for the CALFED Program.



Since the CALFED Record of Decision (ROD) was adopted in 2000, over $2.5 billion has been invested in water supply, water quality, and ecosystem restoration programs and projects in the 50 counties that depend on the Bay-Delta system for all or part of their water needs. Of the $2.5 billion, $1.7 billion has been contributed by the State. This amount is almost twice the proportionate share of State CALFED funding envisioned in the ROD. Federal and local agencies have not contributed comparable levels of funding. With the depletion of bond funding and diminished availability of general funds, the State can no longer afford to pay a disproportionate share for these programs.

The Administration will seek additional federal contributions and will support the enactment of a water user fee consistent with the “beneficiary pays” principle of the ROD. This will ensure that important water supply, water quality, environmental, and levee stability programs continue and receive appropriate levels of funding from all partners in the CALFED effort.

Timber Harvest Plan Fees

The 2003 Budget Act reduced the California Department of Forestry and Fire Protections (CDF) budget by $10 million General Fund in anticipation of a new fee for timber harvest plan review (THP) to partially cover the costs of these reviews. The THP fees, however, were never enacted, which created of a $10 million shortfall in CDF's budget. If this structural deficit is not addressed, CDF will be forced to significantly reduce THP review and approval. Failure to provide funding for THP review and approval would greatly reduce the states timber harvests and have a devastating effect on the state's timber industry.

California's complex system of regulating forest use places a heavy burden on the timber industry to comply with prescriptive operational requirements and prepare timber harvest plan documents. In California, the THP is a blueprint submitted by the landowner to CDF outlining what timber they want to harvest, how it will be harvested, and the steps that will be taken to prevent and mitigate potential damage to the environment. THPs are prepared by certified licensed foresters, geologists, and environmental consultants and can range from about 100 pages to more than 500 pages. Once submitted, the plans go through a review process that takes an average of 65 days statewide (85 days for THPs submitted from the northern coastal region). A recent case study shows an average cost of $42,954 per plan. As a comparison, in Oregon, landowners must notify the State Department of Forestry of their intent to harvest timber. If there are streams or other sensitive sites involved, such as wetlands or endangered species habitat, a written plan must be approved. This plan is usually 1 to 2 pages and can sometimes be completed during an office visit to the Department of Forestry.

The Administration recognizes that an increase in fees would place an additional financial hardship on an already weakened industry and may result in a further decline in California's timber production. Lumber and other forest products are essential to the state's economy. Timber we do not produce here must come from elsewhere rather than from California's own business community. Also, much of the timber California will be forced to import comes from foreign countries that do not have the environmental safeguards imposed in California and do not practice sustainable yield policies that ensure future generations will also have forests to enjoy and utilize. Therefore, the Administration proposes to balance the impact of new THP fees by streamlining California's overly burdensome timber harvest regulations.

The Administration's plan proposes modifications to the current regulatory structure that should, over the long run, reduce the number and complexity of THPs. Some of these modifications include the extension of the THP effective period, allowing plans to cover entire watersheds, and reducing the paperwork that must be completed by landowners.

These reforms will not reduce environmental protection of forestlands. THPs will still be subjected to a multidisciplinary review that includes the Department of Conservation for soil and geologic issues, the Department of Fish and Game for fish and wildlife habitat issues, and the State Water Resources Control Board for water quality issues. Professional foresters, biologists, geologists, hydrologists and archaeologists review THP mitigation measures in order to reduce any significant environmental impact, and to the extent possible, incorporate these mitigation measures into the THP. Additionally, any significant issues raised by the public or any agency must receive a written response prior to approval of a THP.

Business, Transportation, and Housing

Secretary for Business, Transportation, and Housing

2003-04	**—**
2004-05	**$0.6 million**

Fund Transfers

The May Revision includes the following transfer to the General Fund:

Film California First Fund—$1.1 million available for transfer back to the General Fund since the fiscal year 2004-05 budget does not propose any activity in this program.

Augmentation

California Film Commission Online Film Permit Issuance System—An increase of $600,000 to develop an online film permitting system for the California Film Commission to streamline the permit operations and to enhance customer service. Funding for this system is derived from a portion of the transfer of the balance of the Film California First Fund to the General Fund.

Department of Housing and Community Development

2003-04 —
2004-05 —

Fund Transfers

The May Revision includes the following transfers to the General Fund:

Child Care and Development Facilities Direct Loan Fund and Child Care and Development Facilities Loan Guaranty Fund—$629,000 and $65,000, respectively, available for transfer back to the General Fund, the original source of these funds because no new loans or loan guarantees are proposed to be issued by the program.

School Facilities Fee Assistance Fund—$7.3 million for transfer back to the General Fund due to the availability of the housing bond funds for this program.

Special Transportation Programs

2003-04 —
2004-05 —

Budget Adjustment

The May Revision includes an increase of $15.9 million which reflects new revenue projections and a revised funding level of $117.4 million.

Department of Transportation

2003-04 —
2004-05 $383 million

Budget Adjustment

Transportation Loan Repayment—The Governor's Budget proposed the suspension of the 2004-05 Proposition 42 transfer with no repayment. The availability of anticipated one-time tribal gaming revenues permits both the conversion of the 2004-05 suspension to a loan and the repayment of the outstanding General Fund obligations to be accelerated. These early loan repayments are being made in order to begin road construction projects as a stimulus to the economy. The repayment of the 2004-05 suspension is proposed for 2007-08 reflecting the Governor's commitment that transportation is a high priority for new funding in the future.

The 2004-05 repayment is proposed to be structured as follows:

- Transfer $243 million from the General Fund to the Traffic Congestion Relief Fund (TCRF).
- Deposit $140 million from estimated 2004-05 "spillover" revenues to the TCRF. To the extent the spillover revenues exceed this amount, it is proposed that the excess would be retained in the General Fund.
- Establish a budget control section to authorize the allocation of one-time revenues resulting from the renegotiation of tribal gaming compacts toward repayment of the 2005-06 obligation, to the extent those revenues are realized.
- Repay $184 million to the State Highway Account from the TCRF toward the outstanding $374 million loan. Additional capital outlay expenditure authority is proposed for these resources.
- Repay $36 million to the Public Transportation Account from the TCRF toward the outstanding $275 million loan. Additional capital outlay expenditures are proposed for these resources.
- Repay as much of the outstanding 2003-04 loan as possible.

Traffic Congestion Relief Program (TCRP) Projects—The May Revision includes $163 million in expenditures for the 2004-05 costs of projects with existing allocations. Prior to the California Transportation Commission (CTC) allocating funds for additional projects, the Administration intends that the Business, Transportation and Housing Agency (BTHA), in cooperation with the CTC, conduct a review of the TCRP projects based on the following criteria:

- Economic impact, including job creation.
- Impact on goods movement.
- Leveraging of local, federal and private funds.

It is further intended that the criteria be applied by the CTC in cooperation with the BTHA to determine which projects will receive future funding. Trailer bill language is proposed that links the program operability to the completion of the project review and funding availability.

Mid-Year Proposals—The December 2003 Mid-Year Spending Reduction Proposals included several transportation-related components, including changing the funding of the local transportation projects to conform to State project accounting (accrual to cash) to achieve an estimated one-time influx of $800 million in federal fund reimbursements over the 2003-04 and 2004-05 fiscal years. It was further proposed to spend $406 million of those receipts to reimburse the General Fund for prior debt service on transportation-related general obligation bonds, and to loan $200 million of the receipts to the General Fund as a Proposition 2 loan. The State Highway Account was to retain the remaining $194 million to meet other transportation expenditure needs.

The Administration continues to support the change in accounting from accrual to cash because this change will free up additional resources on a one-time basis. However, as implementation has moved forward, it has become clear that the anticipated level of resources available to move to the General Fund will not be realized primarily due to lack of federal access to apportionments, delayed federal reauthorization, and the complexity of matching apportionments to projects. It is still likely that roughly $200 million will be available from this effort. Accordingly, the Administration is modifying its Mid-Year request to retain the benefit of these efforts with transportation, rather than accruing any of the benefit to the General Fund.

The Mid-Year Proposals included transferring $189 million of the Traffic Congestion Relief Fund (TCRF) to the General Fund concurrent with the proposal to repeal the Traffic Congestion Relief Program (TCRP) projects, rescind allocations and repeal letters of no prejudice. One-time General Fund resources are anticipated that will allow a partial repayment of the General Fund loan due to the TCRF in 2005-06 to be accelerated. As such, this Mid-Year proposal is withdrawn.

The Mid-Year Proposals included retaining additional “spillover” sales tax revenue in the General Fund that was projected to be available in 2003-04. Current revenue estimates now indicate that additional spillover revenue will not be realized in the current year. As such, this Mid-Year proposal is withdrawn.

Major Budget Adjustments

The May Revision proposes the following adjustments:

Project Delivery Workload—An increase of $180.3 million and 324 positions and 306.2 personnel years relative to the Governor’s Budget and an increase of 726 PYEs to reflect project delivery workload. This adjustment is an increase of 63 positions and 500 PYEs over the current year adjusted level of resources.

Restoration of Positions—An increase of $8.4 million and 89.0 positions and 89 personnel years to restore positions for critical workload related to toll operations, traffic management operations, and maintenance activities.

Authorize Additional Capital and Program Expenditures—Provide authority to increase expenditures for specified programs, contingent upon receipt of additional funds with 30 days notice to the Legislature. Caltrans anticipates that additional federal funds may be available for expenditure.

GARVEE Program—The May Revision continues to support a prudent increase in committing future federal funds to support current transportation needs. A growing debt portfolio does, however, require attentive monitoring. To that end, the May Revision proposes to include language to require that the California Transportation Commission, before allocating projects in fiscal year 2004-05 that would result in the issuance of notes pursuant to Section 14553 of the Government Code that exceed $800 million, consult with the Business, Transportation and Housing Agency, the Department of Transportation, and the Department of Finance pursuant to the requirements of Government Code Section 14553.8, to determine and report to the Governor and the Legislature the effect of such issuances on future federal funding commitments. Concurrently, the May Revision proposes to eliminate the cap on the amount of GARVEEs that can be allocated in 2004-05.

Department of Motor Vehicles

2003-04 —

2004-05 —

Fund Transfers

The May Revision includes the following transfer to the General Fund:

Smog Impact Fee Refund Account—$10.9 million transfer to the General Fund pursuant to Chapter 32, Statutes of 2000, which provides that any unencumbered balance remaining in the account on or after June 30, 2004, shall revert to the General Fund.

Data Center Consolidation

2003-04 —

2004-05 —

Fund Transfers

Stephen P. Teale Data Center Revolving Fund—The May Revision includes the transfer of $3.5 million from the Stephen P. Teale Data Center Revolving Fund to the General Fund to meet the requirements of Chapter 225, Statutes of 2003.

Control Section 15.00 will authorize the transfer and also provide requisite authority for the following:

- The transfer of an estimated $7.1 million to other funds from which Teale charges are paid by State departments.
- A consolidation of the State's general-purpose data center functions and activities (primarily those of the Stephen P. Teale Data Center and Health and Human Services Agency Data Center).
- The implementation of recommendations that may derive from the California Performance Review (CPR).

Judicial Branch

Judiciary

2003-04 —
2004-05 **$4.3 million**

Judges Salary and Benefits—An increase of $531,000 to address the increases in judges salary and benefits costs.

Administrative Office of the Courts Employees' Salary—An increase of $1.5 million to address the increased salaries of the employees of the Administrative Office of the Courts.

Security Costs—An increase of $953,000 for increases in the costs of contract security services provided to the Judicial Council and the Appellate Courts by the California Highway Patrol.

Unallocated Reduction Partial Restoration—A restoration of $1.3 million to reduce the unallocated reduction proposed in the Governor's Budget to $8.5 million. Of this, $5.5 million is one-time and $3 million is proposed on-going.

State Trial Court Funding

2003-04 —
2004-05 **$89.6 million**

The May Revision reflects the agreement reached between the Governor and the Judicial branch on a plan for trial court funding and restructuring of the collective bargaining process to ensure there is State-level approval of local employee union negotiations which require additional funding. This agreement will provide $99.4 million to address increases in various court operational costs as follows:

Court Staff Retirement—An increase of $23.1 million for the additional costs associated with retirement rate changes that impact various courts.

Court Security—An increase of $28.8 million for the costs of court security contracts with Sheriffs. This reflects the increased salaries and benefits negotiated by the local sheriffs departments that were passed on to the courts.

Judges Salary and Benefits—An increase of $8.1 million for existing labor agreements that have an increase scheduled in 2004-05.

Salary and Benefits Contract Costs—An increase of $9.6 million for existing labor agreements that have an increase scheduled in 2004-05. This includes salaries and salary-driven benefits for 14 courts with multi-year agreements.

Non-Salary Driven Benefit Increases—An increase of $11.5 million for known changes in court employee benefit plans. These are typically the same plans as county employees and the courts do not have control over changes.

County Charges—An increase of $1.5 million for increases in the amounts charged by counties to provide various services to courts. These are typically services performed by county employees for the courts where the increased costs are driven by increasing county employee salaries and benefits. Services include: janitorial, county fiscal and accounting, human resources, information technology, and communications systems.

Judges Retirement System I Funding—An increase of $27.6 million for the 2004-05 increased Judges Retirement System costs. The Governor's Budget proposed to fund this increase from the Trial Court Trust Fund, as opposed to a direct transfer from the Judges' Retirement Fund. The May Revision proposes to reverse the Governor's Budget and instead provide direct funding via the Judges' Retirement Fund.

Unallocated Reduction—A decrease of $11 million to increase the $59 million unallocated reduction included in the Governor's Budget for a total proposed unallocated reduction of $70 million, $50 million of which is one-time and $20 million on-going.

Homicide Trials—An increase of $254,000 to fund the costs of extraordinary homicide trials incurred by the courts. This increase in funding is proposed to offset a reduction in the item for Payment to Counties for Costs of Homicide Trials (Item 8180-101-0001).

The May Revision also includes the following Administration proposals which will result in savings in operational costs of $9.8 million:

Electronic Reporting—A reduction of $6.4 million associated with the increased use of this technology, but only through attrition of currently employed court reporters.

Eliminate Governmental Exemption from Civil Court Filing Fees—A reduction of $312,000 associated with the elimination of the exemption for all governmental agencies from paying court filing fees except for state agencies.

Reduce Peremptories in All Case Types—A decrease of $372,000 associated with the reduction of the number of peremptory challenges.

Implement Smaller Jury Panel Sizes Statewide—A reduction of $241,000 associated with the reduction of jury panel size to 35 jurors.

Decrease Jury Size in Limited Civil Cases—A decrease of $173,000 associated with the reduction to 8 jurors (currently 12) for limited Civil Cases, those in which the amount in controversy does not exceed $25,000.

Eliminate Juror Pay for Governmental Employees—A reduction of $2.3 million for the elimination of jury duty pay to local, state, and federal governmental employees.

Collective Bargaining—The May Revision also proposes trailer bill language to require the Judicial Council to establish a working group to amend the current local court and local employee union negotiation process to ensure there is State-level approval of negotiations which require additional funding.

General Government

Department of Personnel Administration

2003-04 No Change

2004-05 –$259,000

The Department of Personnel Administration is reduced by $259,000 and five positions in an effort to reduce General Fund expenditures wherever possible. The reductions include: one position that supported the Rural Health Care Equity Program that will sunset on January 1, 2005; one position that provided support to the Labor Relations Program was eliminated; two positions that provided general classification, pay, and human resources support to departments; and one legal secretary position was eliminated from the Legal Division.

Department of Finance

2003-04 No Change

2004-05 Provisional Language

For the first time, the Administration presented the 2004-05 Governor's Budget in an electronic medium, rather than as a printed document. Even though the 2004-05 Governor's Budget was published in an electronic medium, the process to produce the document was the same as in prior years with the Office of State Publishing creating a text-based document that could be either printed or transferred to an electronic medium. The Administration is proposing to present the 2005-06 Governor's Budget using web-based technologies. This new process will provide a budget document that is more readily accessible to the public and is less expensive to produce than the traditional text-based document. Funding for publishing the Governor's Budget is included in the Department of General Services' budget. The Administration is proposing control language to give the Director of Finance authority to transfer appropriation authority from the Department of General Services to the Department of Finance to pay the costs of producing the new web-based Governor's Budget.

State-Local Government Agreement

2003-04	**—**
2004-05	**–$1,300 million**

The Administration and representatives from local government have reached agreement on a major proposal to revise the State-local fiscal relationship in order to achieve the following goals:

- Provide $1.3 billion in General Fund savings in 2004-05 and 2005-06.
- Make the current car tax cut permanent.
- Provide revenue stability for local governments.
- Reform the mandate process.
- Allow for future reform on program realignment.

This agreement will cut the car tax rate from 2 percent to 0.65 percent of the value of the vehicle. This will ensure that taxpayers will retain the current tax relief that they are receiving, but permit the elimination of the General Fund offset program. In order to protect local governments, the reduction in vehicle license fees to cities and counties from this rate change will be replaced by an increase in the amount of property tax they receive.

For 2004-05 and 2005-06 only, the replacement property taxes that cities and counties receive will be reduced by $700 million. In future years, local governments will receive the full value of the vehicle license fees that they would have received under current law. Also for these two years, redevelopment agencies will shift $250 million in property tax revenue that they would otherwise receive to schools, and special districts will shift $350 million.

A constitutional amendment will protect local governments' property, sales, and vehicle license fee revenues in future years.

The non-education mandate process will be reformed by accelerating the mandate determination process and providing for repeal of unfunded mandates. Under this proposal, within one year of the filing of a mandate claim by local governments, a statewide estimate of cost would have to be prepared. If this cost estimate is not fully funded in the subsequent State Budget, the mandate would be repealed. Also, the existing mandate debt would be repaid to local governments over five years, beginning in 2006-07.

The agreement also states the intent for another program realignment between the State and local governments in 2006-07.

This agreement replaces the proposal in the 2004-05 Governor's Budget for an additional $1.3 billion shift to the Education Revenue Augmentation Fund.

Local Government Financing

2003-04 —
2004-05 —

The May Revision proposes to add budget bill language requiring the Citizens Option for Public Safety funds to initially be used to cover mandated costs associated with the Peace Officer Procedural Bill of Rights mandate as imposed by Chapter 675, Statutes of 1990. Any remaining funds would be used in accordance with current law.

Board of Equalization

2003-04: —
2004-05: $6.7 million

Augmentations

Salary Savings Reduction—An increase of $8.3 million ($5.4 million General Fund, $2.9 million Reimbursements) in order to mitigate the adverse consequences on the Board of Equalization (BOE) from reductions that were required in the 2003 Budget Act. Without this action, the BOE indicates it would need to layoff 105 positions with an associated revenue loss of $29.7 million ($19.3 million General Fund and $10.4 million local revenue). In addition, this action will allow the BOE to fill 55 collector positions, which is estimated to generate an additional $8.4 million ($5.5 million General Fund and $2.9 million local revenue) in 2004-05 and $18.9 million ($12.3 million General Fund and $6.6 million local revenue) in 2005-06 at a cost of $2.7 million.

Alternative Cigarette Tax Stamp, Chapter 881, Statutes of 2002 (SB 1701)— An increase of $4.9 million ($564,000 General Fund, $4.3 million special funds) to replace the current cigarette tax stamps and meter impressions with a stamp or meter impression that can be read by a scanning or similar device in order to decrease tax evasion. The BOE estimates increased revenue of $28.2 million ($5.6 million General Fund) annually from both excise and sales taxes as a result of decreased tax evasion.

450 N Street Exterior Curtainwall Repairs—A $1.2 million ($718,000 General Fund, $489,000 other funds) increase in order to begin the process of repairing the exterior curtainwall and precast panels on the BOE headquarters office building. The neoprene gaskets that hold the glass inside the aluminum frames of the 25-story building have deteriorated and are allowing excessive water intrusion into the building. Damage to ceilings, equipment, and furnishings continues to increase. The study will determine the most cost-effective method of repair, and funding will be requested in 2005-06.

Franchise Tax Board

2003-04: —
2004-05: **$21.8 million**

Augmentations

California Child Support Automation System (CCSAS)—An increase of $17.5 million ($6 million General Fund and $11.5 million Reimbursements) to provide funding for nine positions and for vendor payments in order to continue the CCSAS project Child Support Enforcement component development phase. The vendor payment schedule has been revised to reflect the current anticipated payment dates. Project deliverables have been coming in sooner and better than expected, so the State is incurring these costs earlier than expected. This augmentation does not reflect an increase in total contract cost.

Tax Amnesty—An increase of $10.2 million and 72 temporary positions to administer a personal income and corporate tax amnesty program. For the period from February 1, 2005, until March 31, 2005, taxpayers who come forward and voluntarily pay back taxes and interest they owe for tax years prior to 2003, would have the penalties forgiven. At the end of the amnesty program, penalties and the interest rate imposed on underpayments would increase. The Franchise Tax Board estimates this program would result in additional General Fund revenues of $185 million in 2004-05, a reduction in revenues of $15 million in 2005-06, and revenue gains of $10 million in 2006-07 and $20 million in 2007-08.

Taskforce on Abusive Tax Shelters—An increase of $4.3 million for contracts with tax shelter experts and to backfill 42 audit positions that are being redirected by the Franchise Tax Board to work on abusive tax shelter cases. Economists and financial experts will assist in developing strategies and criteria for identifying tax shelters. They will also provide litigation support to help sustain assessments. Expert assistance is needed because Franchise Tax Board staff do not yet have sufficient experience in this area. Backfilling the auditor positions will preserve the revenue that these auditors have been generating on other audit caseload. This augmentation would result in an estimated $28 million General Fund revenue increase in 2004-05 and $390 million through 2008-09.

Litigation Costs—An increase of $1.3 million and 2 limited-term positions to defend a lawsuit filed by a taxpayer in the State of Nevada. These funds will pay for Nevada counsel, analytical support, and various related expenses. The State's potential liability in this case is approximately $200 million. The Department of

Justice notified the Franchise Tax Board that they will no longer be representing the Franchise Tax Board in this case and granted the Franchise Tax Board permission to retain private counsel. The case is scheduled for trial in Nevada in August 2006. The estimated cost to the State to defend itself in this litigation over the next three years is estimated to be $3.8 million. Further funding could be required if either party appeals and the case extends beyond 2006-07. Through 2003-04, the Department of Justice budget has been augmented by nearly $4.4 million for litigation expenses related to this case.

Department of Veterans Affairs

2003-04	**—**
2004-05	**$2.1 million**

The May Revision proposes to reduce Reimbursements at the Yountville Veterans Home by $2 million, with a corresponding increase in General Fund. The Home has been unable for several years to collect the amount of reimbursements budgeted, leading to unrepaid General Fund loans and deficiencies. This proposal would reduce reimbursements to the level that the Home is projected to receive. The Department of Veterans Affairs has demonstrated that factors out of its control, such as declining Medicare reimbursement rates, have led to decreasing reimbursement levels.

Office of Emergency Services

2003-04	**-$28.1 million**
2004-05	**-$4.1 million**

Southern California Wildfires—The May Revision proposes a reduction of $28.1 million in 2003-04 and $4.1 million in 2004-05 to reflect the most recent estimates related to the Southern California Wildfires. These new estimates are based on a more detailed inspection of damage and a new assessment of program eligibility at the federal level.

California Law Revision Commission

2003-04	**—**
2004-05	**-$256,000**

The May Revision proposes elimination of the California Law Revision Commission, effective January 1, 2005, in order to achieve General Fund savings and because the essential functions of the Commission can be transferred to the Legislature. The workload currently performed by the Commission would have to be prioritized with other legislative workload under the spending limits imposed by Proposition 140.

Statewide Issues

Reform the State's Real Property Asset Management Process

2003-04	**No Change**
2004-05	**$50 million increased revenues**

California's management of its real property assets, administration, governance, and decision-making is spread out among a dozen boards, conservancies, commissions, and departments. Each has the authority to negotiate acquisitions, trades, development, and disposal of real property assets for various State programs. This leads to inconsistent, inefficient, and uncoordinated activities related to the investment in, use of, and disposition of the State's many real property assets.

California's current asset management structure makes it very difficult to determine the true potential for generating revenue from the sale of surplus property and to manage property in a way that allows existing assets to be appropriately identified to meet current and future programmatic needs at the statewide level.

To improve the State's management of real property assets for potential future savings and increase revenue from the sale of surplus property, the May Revision proposes that trailer bill language be adopted to do the following:

- Establish a policy and process to consolidate the management of the State's real property assets, with the primary authority for asset management activities vested in a single entity.
- On an interim basis, direct departments to immediately begin operating in a more centralized fashion, including obtaining approval from the State Public Works Board for any new acquisition, disposal, lease, or major capital alteration of real property assets owned by the State.
- Direct the State and Consumer Services Agency to implement these reforms.

- Grant the Director of General Services the authority to declare property surplus and provide notice to the Legislature of this determination prior to disposing of the property.
- Eliminate existing requirements to offer surplus property to local governments prior to public sale.
- Eliminate existing requirements that the State sell surplus property to local government entities for less than market value under certain circumstances.

This reform will allow the State to better identify and focus on high value properties that are no longer needed by the State. The Administration believes that this trailer bill will result in increased General Fund revenue of approximately $50 million in 2004-05 and significantly higher amounts in subsequent years associated with the sale of additional surplus property.

In order to implement this statewide reform, one-time funding of $2.8 million from the Property Acquisition Law Account is proposed. The Department of Finance will be authorized to distribute these funds to various State agencies involved in the implementation of the asset management reforms. While the cost of many of the activities necessary to implement these reforms on a statewide basis will be absorbed within existing department budgets, some one-time resources will be necessary to update the State Property Inventory, perform workload associated with additional State Public Works Board approvals, and prepare newly identified properties for disposal.

Augmentation for Employee Compensation

2003-04	**No Change**
2004-05	**–$465.4 million (–$857.8 million all funds)**

Considering the severe shortfall in funding for the State Budget, the Administration recommends that the Legislature exercise its authority to reduce the costs of the collective bargaining agreements beginning in 2004-05.

It is the Administration's desire that negotiations culminate in new agreements before legislative action on the budget is complete. New agreements covering affected employee bargaining units will allow for restoration of a lesser appropriation for employee compensation increases than presented in the Governor's Budget.

In the absence of negotiated changes to existing contracts, the Legislature could exercise its authority to disapprove the expenditure of funds otherwise provided in the current agreements. The Governors' Budget submitted in January included funding to implement employee compensation increases consistent with existing collective bargaining agreements. Under the terms of these agreements, the

Legislature reserves the authority to approve, reduce, or eliminate funding for the annual increases in the contracts. If the annual increases are eliminated, this will result in General Fund savings of $465.4 million ($857.8 million all funds). The Administration is also proposing that the Legislature adopt control language to prohibit the State Controller, the Department of Personnel Administration, the Department of Finance, or any department director from taking any action to compensate employees beyond the levels of compensation approved for the current year.

Judges' Retirement System I

2003-04 $7.9 million

2004-05 No Change

The Judges' Retirement System I (JRS I) submitted a current year deficiency in the amount of $4.2 million in the fall. This deficiency has been revised to a total of $7.9 million to fund a current year shortfall in the JRS I. The JRS I is a pay-as-you-go system that has experienced a higher number of judges retiring, an increase in benefit levels, and an increase in refunds. These factors require that the JRS I be augmented in the current year.

Health and Dental Benefits for Annuitants

2003-04 No Change

2004-05 –$1.6 million

Funding for Health and Dental Benefits for Annuitants is reduced by $1.6 million to reflect lower-than-anticipated increases in the cost of dental premiums for retirees. The Governor's Budget estimated the new dental rates to be 5 percent higher than rates for the 2004 calendar year. The dental rates for 2005 are now expected to increase by only 2 percent.

Statewide Reductions

2003-04 No Change

2004-05 No Change

The Administration is proposing a new control section giving the Director of Finance authority to reduce appropriations in 2004-05, as proposed in the Governor's Budget, by $150 million (General Fund). The of Director Finance would work with Agency Secretaries to determine how best to effect reductions in each Agency. The Director of Finance would determine the amounts of the reductions for departments not under an agency secretary. The reductions would not apply to the Legislature, the Courts, higher education, debt service, health benefits for annuitants, and other expenditures that cannot be reduced.

Control Section 5.50/Contract Savings

2003-04 $50.0 million

2004-05 $50.0 million

The 2003 Budget Act included Control Section 5.50, which authorized the Administration to generate and capture savings of up to $100 million ($50 million General Fund) through operational efficiencies in areas such as contracting, leasing, and procuring goods and services. The May Revision reverses these assumed savings for 2003-04 and 2004-05 because these savings were not achieved. Though the Department of General Services made significant progress related to renegotiation of facility lease costs for state departments, many of these savings were counted toward other budget reduction efforts, primarily Control Section 4.10. Therefore, though these savings were accrued to the departments and captured elsewhere in the budget, this specific control section did not yield any savings.

Punitive Damages

Compensatory damages are awarded by the court to compensate for loss or injury sustained by the complaining party. Punitive damages are awarded in addition to the award of compensatory damages, and are awarded for the sake of example, to punish a defendant who has been found to have acted maliciously, and to deter future such actions. Since the award of compensatory damages compensates the complaining party for their loss or injury, the award of punitive damages, as intended to punish the defendant and set an example, should more appropriately be awarded to the State where it can be used for public good purposes that are consistent with the nature of the award. At least eight states (Alaska, Georgia, Illinois, Indiana, Iowa, Missouri, Oregon, and Utah) have split-award statutes in which a share of the punitive damage award goes to the state to be used to benefit society.

The May Revision proposes trailer bill language to amend existing law related to punitive damages by limiting the number of punitive damages that may be recovered from a defendant to one. It would also allow the State to receive 75 percent of the punitive damage awards. The annual revenue is estimated to be $450 million, and is proposed to be deposited in a special fund, the Public Benefit Trust Fund. A control section is proposed to allow the revenue to be appropriated annually, up to the balance of the fund, for State programs and purposes consistent with the punitive nature of the award. Savings are estimated to be $450 million in 2004-05.

Strategic Sourcing

2003-04	**—**
2004-05	**-$96.0 million**

The May Revision proposes Control Section 33.50, Strategic Sourcing. This Control Section authorizes the Director of Finance to reduce amounts in items of appropriation in the 2004-05 fiscal year to the extent that savings are achieved through Strategic Sourcing. Strategic Sourcing is a procurement methodology for purchasing goods and services on a statewide basis with an emphasis on saving through purchasing in bulk. This Control Section also requires the Director of Finance to submit an implementation timeline, including a report of proposed savings, to the Legislature at least 30 days prior to the implementation of the Control Section. The May Revision assumes General Fund savings of $96 million resulting from Strategic Sourcing.

2004-05 State Appropriations Limit Calculation

Pursuant to Article XIIIB of the California Constitution, the 2004-05 State Appropriations Limit (SAL) is estimated to be $64.588 billion. The revised limit is the result of applying the growth factor of 4.60 percent. The revised 2004-05 limit is $611 million above the $63.977 billion estimated in January. This increase is due to changes in the following factors:

	January Percentage	May Revision Percentage
Per Capita Personal Income	2.24	3.28
State Civilian Population	1.62	1.52
K-14 Average Daily Attendance	1.34	1.40

For SAL purposes, per capita personal income is defined as calendar fourth quarter California personal income, as estimated by the US Bureau of Economic Analysis (BEA), divided by California civilian population, estimated by the California Department of Finance. Since BEA does not release its estimate until April, the Department of Finance uses its own estimate for the Governor's Budget. The May Revision reflects the BEA's estimate.

The SAL for 2003-04 does not change since it was statutorily established by Section 12.00 of the 2003 Budget Act.

SUMMARY CHARTS

General Fund
Budget Summary
May Revision
(Dollars in Millions)

	2003-04	2004-05
Prior Year Balance	$3,837	$2,816
Revenues and Transfers	$74,591	$76,688
Economic Recovery Bonds	$2,012	$0
Total Resources Available	**$80,440**	**$79,504**
Expenditures	$75,612	$79,590
Transfer to and Use from Deficit Recovery Fund	$2,012	-$2,012
Total Expenditures	$77,624	$77,578
Fund Balance	**$2,816**	**$1,927**
Budget Reserves		
Reserve for Liquidation of Encumbrances	$929	$929
Special Fund for Economic Uncertainties	$1,887	$998

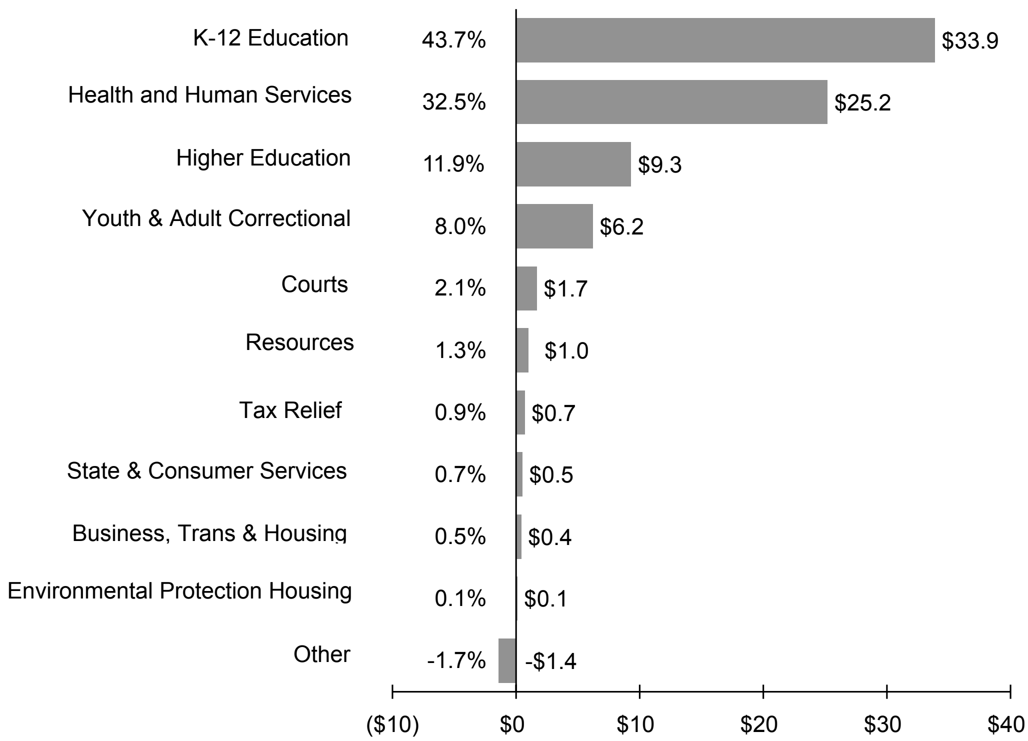
2004-05 Revenue Sources
(Dollars in millions)

	General Fund	Special Funds
Personal Income Tax	$38,602	--
Sales Tax	24,605	$4,092
Corporation Tax	7,967	--
Highway Users Taxes	--	3,322
Motor Vehicle Fees	16	3,575
Insurance Tax	2,170	--
Estate Taxes	135	--
Liquor Tax	303	--
Tobacco Taxes	118	917
Other	2,772	8,746
Total	**$76,688**	**$20,652**

General Fund Expenditures in Major Program Areas
(Dollars in Millions)

	2003–04	2004–05	Difference
Legislative, Judicial, and Executive	$2,548	$2,725	$177
State and Consumer Services	471	508	37
Business, Transportation, and Housing	516	376	–140
Resources	967	974	7
Environmental Protection	91	69	–22
Health and Human Services	22,967	25,196	2,229
Youth and Adult Correctional	5,424	6,215	791
K-14 Education	31,673	37,274	5,601
Debt Service Savings (ERAF)	0	–1,136	–1,136
Higher Education	6,390	5,990	–400
Labor and Workforce Development	112	85	–27
Vehicle License Fee Backfill	2,672	0	–2,672
STRS Contribution	510	1,057	547
General Government	1,271	257	–1,014
Use of Deficit Recovery Fund	2,012	–2,012	–4,024
Totals	**$77,624**	**$77,578**	**–46**

2004-05 General Fund Expenditures (Dollars in Billions)



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