

S T A T E O F C A L I F O R N I A

GOVERNOR'S BUDGET

May Revision

2005-06

Introduction

The new estimates contained in this May Revision reflect a restored faith in the California economy. Revenues are increasing in the 2004-05 estimated personal income tax, and in the 2005-06 corporate tax. The state's unemployment rate has dropped a full point from 6.4 percent a year ago to 5.4 percent in the latest month report. And with a more vibrant economy, the populations of those receiving assistance from the state have declined, allowing further budget savings. Savings in workers' compensation are beginning to be realized in the cost of doing business. The reported earnings of California companies are up. The prospect of a Governor willing to use his veto pen to preserve a healthy economic environment for California has been observed in the job-creating community. The fact that this budget does not include tax increases also sends a signal of tremendous value to those with jobs to offer: California has come to grips with its spending problems. The state won't run away from the spending habits that got us into trouble by patching things over with a tax increase.

Nevertheless, national economic trends point toward a slowing of the recovery, nationally, and in California, after 2006. It is difficult to predict economic trends more than a year out; but to the extent we can, they show continued economic growth at a slower pace. The result is that the new revenue we see cannot be counted on for the years thereafter. Accordingly, the



Introduction

prudent thing is to treat the largest portion of the new revenue predicted since January as one-time rather than permanent.

The wisest action to take when a state has one-time money is to borrow less. The May Revision has no new borrowing at all. We do not make any further borrowings from the Economic Recovery Bonds authorized by the taxpayers in Proposition 57. Leaving more room for those bonds should difficulties arise in future years demonstrates fiscal responsibility. And we are able to pay back 50 percent of the Vehicle License Fee Gap due to local governments. That infusion of about \$600 million dollars will further help local units of government to respond to their needs.

Further, the state is able to make a substantial boost in rebuilding its infrastructure by allowing all the money in the Proposition 42 account to go to its intended purpose. This will help cities and counties immensely as they cope with the growing demands on their roads, bridges, ports, utilities, and airports.

This is a budget that builds: it builds confidence in the restoration of our fiscal system in California, builds roads and infrastructure for our state's vital needs, and builds on the positive relationship between local government and the state started in Proposition 1A by restricting the state from raiding local government. It also builds on our state's schools, our human infrastructure for years to come. We are able to fund fully all the population growth, inflation, and cost shifts schools will encounter, and dedicate a substantial sum to reducing class size, rewarding good teachers, and improving teacher preparation as well.

Despite this good news, systemic budget problems remain. We started this fiscal year with a budget gap of \$8.6 billion. With this budget, we reach balance with no new borrowing. But next fiscal year, we start all over again—likely beginning the year in deficit as automatic spending formulas continue to demand higher amounts of spending whether or not the revenue is there to support those levels.

We should strive to fix the budget process of California not just in this year, but for the long-term as well. We can do it; this budget points the way to how.

The Economy

After growing briskly in 2004, output of the national economy grew at a slower pace in the first quarter of 2005. Consumer spending rose only moderately as consumers spent less on motor vehicles and parts. A jump in imports and a smaller gain in purchases of equipment and software by businesses also contributed to the slowdown in economic growth. Increased inventory accumulation by businesses and a pickup in export growth limited the slowdown. Monthly job gains were somewhat smaller, on average, in the first quarter of 2005 than in 2004 as a whole. But a big job gain in April pushed the 2005 average above last year's average gain. Housing markets and residential construction continued to be robust in the first quarter, when the weather cooperated, but manufacturing lost some steam. Higher energy prices, a modest increase in interest rates, and a lack of fiscal stimulus were expected to slow economic growth in 2005, but the onset of this slowing was stronger than expected. As a result, the major stock market indexes lost ground and consumers became less confident in the first four months of the year. The Federal Reserve has tightened monetary policy throughout this year, demonstrating that it is not overly concerned by the slowdown in economic growth in the first quarter.

California's economy continued to generate new jobs in the first quarter of 2005, and the state's unemployment rate fell considerably. Total housing permits granted were down slightly from a year earlier. But existing home sales remained brisk, and the value of nonresidential permits increased. The state's tourism industry continued to improve, as evidenced by increased airport passenger counts and higher hotel/motel occupancy rates. Personal income picked up solidly in the fourth quarter of 2004. Exports of made-in-California merchandise and port data on exports and imports remained strong in the first two months of 2005. Signs of improvement were seen in the San Francisco Bay Area economy, but that economy is far from recovered.

The expansions of the national and California economies decelerated somewhat in the first quarter of 2005, in part due to surging oil prices. Given the big gains in jobs and light vehicle sales in the nation in April, this slowdown may well turn out to be nothing more than a "soft patch" like the one in the second quarter of 2004. Nevertheless, the risks to the outlook have increased in the last four months.

The Nation

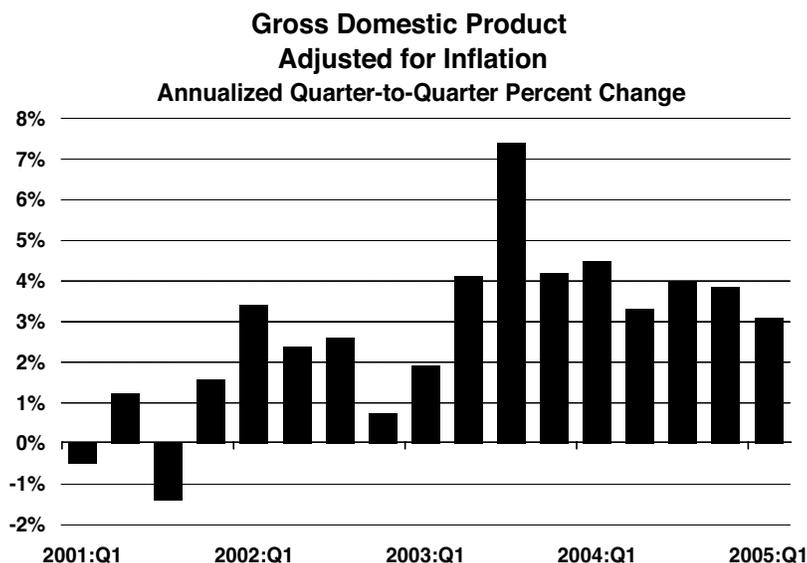
The U.S. Commerce Department's first estimate of the growth of inflation-adjusted gross domestic product (GDP) in the first quarter of 2005 was an annualized 3.1 percent, down from the 3.8 percent growth in the fourth quarter of 2004 (Figure ECO-01). Slower growth in consumer spending played a significant role in the decline in real GDP growth. In particular, the value of consumers' purchases of durable goods was unchanged from the fourth quarter of 2004, as higher oil prices, less favorable incentive programs, and poor weather in January depressed light vehicle purchases. Light vehicle sales bounced back in April, however, suggesting that higher gasoline prices have not prevented consumers from buying new vehicles. Consumers are concerned, however. Consumer sentiment fell in each of the first four months of the year.

Slower growth in spending by businesses on equipment and software was also instrumental in the decline in real GDP growth. Investment in transportation equipment and industrial equipment was particularly weak. Purchases of new information-processing equipment and software, on the other hand, were very strong. Residential construction made a small contribution to real GDP growth, and nonresidential construction, a slight subtraction. Inventory investment made a big contribution to real GDP growth. Nondefense capital goods orders fell sharply in March—an indication that capital spending may fall in the coming months. In addition, three consecutive months of declining total nondurable goods orders and five consecutive months of declines in the Institute for Supply Management's composite manufacturing index reflect a manufacturing sector that is not growing nearly as quickly as it was in the first half of 2004.

Net exports (exports minus imports) fell for the sixth consecutive quarter in the first quarter of 2005. However, the more recent report on the trade deficit in March showed an unexpected decline, meaning first-quarter net exports did not fall as much as initially estimated. As a result, the U.S. Commerce Department will increase net exports when they revise their estimate of first-quarter real GDP in late May.

Nonfarm payroll employment increased for the twenty-third consecutive month in April. Gains in the first three months of this year were somewhat smaller than those in the fourth quarter of 2004, but the large April gain pulled the average monthly gain for 2005 above the average gain for all of 2004. Job gains continue to be widespread across major industry sectors. The national unemployment rate has trended downward for almost two years and was 5.2 percent in April.

Figure ECO-01



Housing markets remained strong in the first quarter of the year, although re-sales were not quite as strong as they were in the fourth quarter of 2004. New home sales reached a record high in March, on a seasonally-adjusted basis.

Higher inflation has become a risk to the outlook. Sharply higher oil prices have driven up general inflation measures considerably in the last year. But a greater concern is that other prices are also increasing. For example, the Consumer Price index that strips away food and energy prices—the so-called core CPI—was 2.3 percent higher in March than a year earlier. This measure reached its cyclical low of 1.1 percent in November 2003 and has trended upward ever since. Core inflation is still quite low compared to historical averages, but the Federal Reserve is clearly concerned about the upward trend of the last year and a half. The central bank’s interest rate committee has raised its target for the federal funds rate by one-quarter percentage point in each of its last eight meetings. And it is widely expected to continue bumping up its target interest rate at its remaining meetings this year. This tightening of monetary policy has not yet had much effect on long-term interest rates, but it likely will in time. Then, interest rate-sensitive spending, like home and durable goods purchases, will begin to slow, restraining growth in the economy.

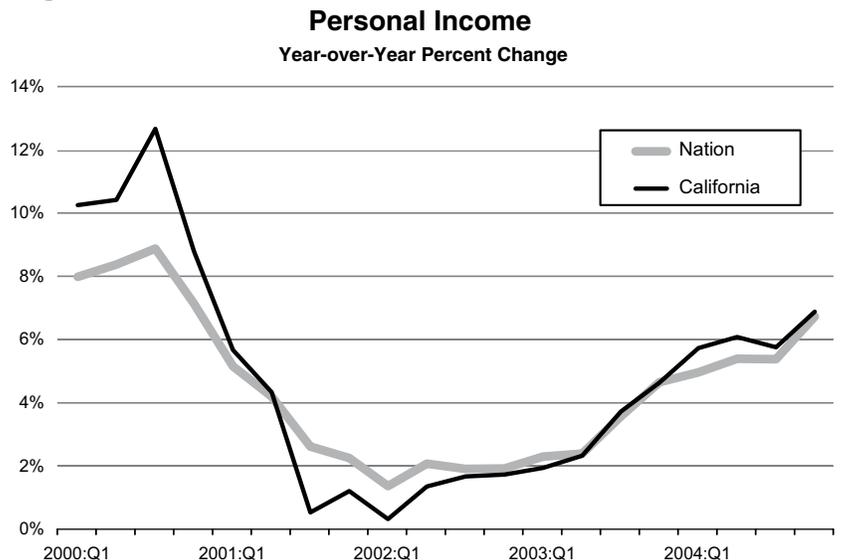
California

Statistics released since January put in sharper focus the significant improvement in the California economy during 2004. The annual benchmark revision of employment statistics revealed that more jobs were created in the state during the year than initially thought. In addition, taxable sales estimates have been revised upward. And the first estimate of fourth-quarter personal income was strong, cementing the view that personal income growth picked up considerably in 2004. As recently as the second half of 2003, personal income was growing at a 4.1 percent year-over-year pace. By the second half of 2004, the pace had accelerated to a 6.3 percent pace, although about one half of a percentage point of the more recent

pace was due to an unprecedented dividend payment. In addition, California’s personal income growth has outstripped the nation’s as a whole since the fourth quarter of 2003 (Figure ECO-02).

Made-in-California exports expanded substantially in 2004, reaching their highest level since 2000. Building on solid growth in the final months of 2003, exports surged by 17 percent during 2004. High-tech exports expanded by more than 15 percent, and exports of both nonelectrical

Figure ECO-02



The Economy

machinery and transportation equipment grew by more than 30 percent. State exports expanded to all major markets, led by sharp gains in shipments to Mexico, Japan, Mainland China, South Korea, Taiwan, Canada, Singapore, and the United Kingdom. California deliveries to Mainland China grew by over 25 percent in 2004, the fastest pace among the state's major trading partners.

California's residential real estate markets made impressive gains in 2004, but cooled somewhat during the first quarter of 2005. Buoyed by job market gains, improved personal income gains, and low mortgage rates, home sales were robust throughout 2004, and the median single-family home price appreciated by over 21 percent from 2003. While real estate markets remained vigorous in early 2005, sales and price gains are not likely to be as big in 2005 as in 2004. During the first three months of 2005, both the inventory of homes for sale and the time it took to sell a home rose substantially from a year earlier.

A much welcomed development in 2004 was the renewal of employment growth. Over 250,000 new nonfarm payroll jobs were created during 2004, the first good gain since 2000. (The average level of nonfarm payroll employment was 147,000 higher in 2004 than in 2003.) On a percentage basis, job gains were highest in the San Joaquin Valley. Southern California was a close second. The San Francisco Bay Area trailed considerably but has posted year-over-year job gains since July 2004.

The Forecast

Higher energy prices, somewhat higher interest rates, and a lack of fiscal stimulus are expected to slow economic growth in 2005. In fact, growth in consumer spending slowed in the first quarter, largely because of weak light vehicle sales in January. Light vehicle sales have since bounced back, with April bringing a good increase. In addition, inflation-adjusted disposable income continues to grow at a good clip that is supportive of consumer spending. Consumer confidence remains above average levels of past expansions even after falling in the first four months of the year. There is no denying, however, that consumers' debt loads are high and that a sharp increase in interest rates would put a good number of consumers in a bind. But sharply higher interest rates are not expected. In fact, after eight tightening steps by the Federal Reserve, long-term interest rates are slightly lower. But the best news for consumer spending was the large increase in nonfarm payrolls in the nation in April. On balance, the fundamentals for consumer spending remain quite good.

For 2005 as a whole, real U.S. GDP will grow by 3.6 percent, down from 4.4 percent in 2004, but still sufficient to allow for improved job growth (Figure ECO-03). Output growth will slow further in 2006, to 3.0 percent, as consumer spending and business investment grow less quickly. Corporate profits will be strong in 2005 before declining slightly in 2006.

On an annual average basis, job growth will improve to 1.7 percent in California in 2005 and 2006 (Figure ECO-04). Unemployment was 5.8 percent in January and February and 5.4 percent in March, and is not expected to change much during the rest of 2005 and in 2006. Growth in total state personal income will dip slightly in 2005 before edging up in 2006. Housing permits will trend downward.

Figure ECO-03

Selected U.S. Economic Indicators

	2004 (Est.)	2005 (Projected)	2006 (Projected)
Real gross domestic product, (2000 dollar) (Percent change)	4.4	3.6	3.0
Personal consumption expenditures	3.8	3.3	2.7
Gross private domestic investment	13.2	6.7	2.6
Government purchases of goods and services	1.9	2.3	2.0
GDP deflator (2000=100) (Percent change)	2.2	2.4	2.2
GDP, (Current dollar) (Percent change)	6.6	6.1	5.2
Federal funds rate (Percent)	1.4	3.2	4.2
Personal income (Percent change)	5.6	5.6	5.9
Corporate profits before taxes (Percent change)	12.7	41.9	(3.6)
Nonfarm wage and salary employment (Millions)	131.5	133.6	135.4
(Percent change)	1.1	1.6	1.4
Unemployment rate (Percent)	5.5	5.2	5.2
Housing starts (Millions)	2.0	1.9	1.8
(Percent change)	5.4	(2.5)	(7.1)
New car and light truck sales (Millions)	16.8	16.6	16.9
(Percent change)	0.9	(0.9)	1.4
Consumer price index (1982-84=100)	188.9	193.7	198.0
(Percent change)	2.7	2.6	2.2

Forecast based on data available as of April 2005.
Percent changes calculated from unrounded data.

Figure ECO-04

Selected California Economic Indicators

	2004	Percent change	Projected			
			2005	Percent change	2006	Percent change
Personal income (\$ billions)	1,257.0	6.1%	1,329.0	5.7%	1,406.5	5.8%
Nonfarm W&S employment (thousands)	14,537.2	1.0%	14,789.9	1.7%	15,048.6	1.7%
Natural resources and mining	22.6	1.5%	23.0	1.8%	23.9	4.3%
Construction	849.1	6.7%	886.0	4.3%	908.1	2.5%
Manufacturing	1,531.0	-1.1%	1,544.8	0.9%	1,562.8	1.2%
High technology	396.4	-0.9%	402.7	1.6%	409.3	1.6%
Trade, transportation, & utilities	2,751.4	1.2%	2,800.1	1.8%	2,841.6	1.5%
Information	484.0	1.6%	489.2	1.1%	500.6	2.3%
High technology	208.8	-3.2%	210.7	0.9%	214.9	2.0%
Financial activities	900.6	1.7%	915.1	1.6%	923.6	0.9%
Professional and business services	2,099.5	0.9%	2,170.7	3.4%	2,225.3	2.5%
High technology	261.0	-0.5%	269.1	3.1%	277.4	3.1%
Educational and health services	1,562.0	1.7%	1,593.3	2.0%	1,632.3	2.4%
Leisure and hospitality	1,442.1	3.0%	1,477.7	2.5%	1,508.6	2.1%
Other services	504.6	0.0%	511.8	1.4%	520.1	1.6%
Government	2,390.4	-1.4%	2,378.4	-0.5%	2,401.6	1.0%
Unemployment rate	6.2%		5.7%		5.7%	
Housing permits (thousands of units)	213	7.6%	190	-10.5%	186	-2.1%
Consumer price index (1982-84=100)	195.3	2.6%	200.9	2.9%	205.7	2.4%

Forecast based on data available as of April 2005.
Percent changes calculated from unrounded data.

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Revenue Estimates

General Fund Revenues

Chapter 226, Statutes of 2004, created a personal income tax, corporate tax, and sales and use tax amnesty program for 2002 and prior tax years. Penalties were waived for taxpayers who applied for amnesty during the amnesty period of February 1, 2005 to March 31, 2005. Although they had to apply within this time frame, taxpayers have until the end of May 2005 to submit their tax returns and pay amounts owed. At the conclusion of amnesty, taxpayers who could have applied for amnesty but didn't are subject to higher penalties if found to owe additional amounts for amnesty years.

The effect of amnesty on the accounting for General Fund Revenues has been distortive. This is because amnesty payments made for years before the current year are accounted as a "prior year adjustment" to the current year, rather than carried back to those earlier years which are now closed. And much of the money that came in during the amnesty period was in the form of protective payments—amounts submitted to avoid the extra penalty, but that would have come in any way in future years, or that will prove not to have been due at all, as some taxpayers will win their disputes. These amounts will lower revenue estimates in the current year, budget year and beyond—even though they apply to payments received that are accounted for as "prior year adjustments."

We can estimate that the state will gain about 5 percent of the funds submitted as protective claims that it would not otherwise (later) have received. That yields about \$200 million more than was expected in January, measured over both the current year and the budget year.

The most important component of change in General Fund estimates is more traditional: the effect of economic growth on personal income tax, corporation tax, sales tax, and other tax revenues. As will be detailed more precisely below, greater personal income tax growth in the current year, greater corporate tax growth in the budget year, and lower sales tax revenues in the current year, all compared with January, yields about \$3.7 billion more in revenue.

The conclusion is that the General Fund has about \$3.9 billion more in one-time revenue over the 2004-05 and 2005-06 time periods. However, we must caution that the accounting rules require reporting \$4.8 billion—since \$900 million is expected to reduce revenues in years after the budget year. It will be essential to create a notation on the state's surplus account in the nature of escrow to hold that \$900 million until the amount to be paid back to taxpayers in future fiscal years has been settled and the remainder can be prudently used.

Revenue Estimates

The May Revision estimates represent a gain of \$2.2 billion in the current year from the time that the 2004-05 budget was enacted. In addition, the increase in revenue in 2005-06 is another \$4.4 billion, for a two-year gain of \$6.6 billion.

Personal Income Tax

The personal income tax forecast has been increased by \$2.367 billion in 2004-05 and by \$319 million in 2005-06. The current year estimate includes about \$480 million in revenue acceleration due to the amnesty program, which will be a prior year adjustment since these collections are attributable to several prior tax years. The budget year estimate includes \$200 million in additional amnesty receipts that are expected to come in as installment payments. The due date for amnesty payments is May 31, 2005. Those with an installment agreement, however, have until June 30, 2006, to pay their outstanding liability and interest.

General Fund collections received in April and the first days of May, when final payments for the 2004 tax year were due, were \$1.2 billion over the Governor's Budget forecast, which suggests that taxable income was stronger than expected for the year. The 2003 tax data indicate higher income and liability growth for taxpayers with adjusted gross income over \$100,000 than for those with income under \$100,000. The forecast assumes that this growth distribution continued in 2004. In addition, this forecast estimates that capital gains income growth in 2004 was 32.5 percent; which is on top of the 34 percent growth that occurred in 2003. We believe net capital gains, including stock option income, are primarily responsible for the 2004-05 increase. Capital gains income in 2005 is expected to continue posting growth but at a more moderate rate of 5 percent.

The Financial Accounting Standards Board has issued a regulation which will require expensing of employee stock options on company financial statements. This is expected to diminish the use of stock options and result in a loss of revenue. This forecast incorporates a reduction in revenue of \$30 million in 2006-07, \$130 million in 2007-08, and \$230 million annually thereafter due to this factor.

Sales and Use Tax

The sales and use tax forecast has been decreased by \$75 million in the current year and increased by \$4 million in the budget year. Through March, sales tax receipts were slightly below the 2005-06 Governor's Budget estimate and the May Revision forecast anticipates that only a portion of this shortfall will be recovered over the remainder of the year.

Current law specifies that certain state revenues from the sales tax on gasoline and diesel fuel sales be transferred to the Public Transportation Account (PTA). The Governor's Budget proposed to maintain the base level of transfers to the PTA, but specified that any excess sales tax revenues on gasoline, which would otherwise be designated as PTA "spillover," be credited to the General Fund for 2005-06. This is expected to increase General Fund revenues by \$380 million in 2005-06, an increase of \$165 million from the Governor's Budget, due to higher gasoline and diesel prices.

Corporation Tax

Largely because of the accounting rules for amnesty, the corporation tax forecast has been decreased by \$1.117 billion in 2004-05 and \$198 million in 2005-06. The profits outlook is somewhat better for 2005-06 than estimated in January. Without the accounting effect of amnesty-related revenues, projected 2005-06 revenues from this tax would be above the Governor's Budget forecast by about \$1 billion. However, the forecast changes primarily reflect higher refunds and lower payments due to the large protective payments submitted by corporations in the current year. The cash gains in 2004-05 are accounted for as a prior year adjustment because these gains are for tax years 2002 and prior.

Figure REV-01

GENERAL FUND REVENUE FORECAST				
Reconciliation with the 2005-06 Governor's Budget				
(Dollars In millions)				
Source	Governor's Budget	May Revision	Change Between Forecasts	
Fiscal 03-04				
Personal Income Tax	\$36,399	\$36,399	\$0	0.0%
Sales & Use Tax	23,847	23,847	0	0.0%
Corporation Tax	6,926	6,926	0	0.0%
Insurance Tax	2,115	2,115	0	0.0%
Other Revenues	4,762	4,762	0	0.0%
Transfers	713	713	0	0.0%
Total	\$74,762	\$74,762	\$0	0.0%
Fiscal 04-05				
Personal Income Tax	\$39,527	\$41,894	\$2,367	6.0%
Sales & Use Tax	25,168	25,093	-75	-0.3%
Corporation Tax	8,678	7,561	-1,117	-12.9%
Insurance Tax	2,230	2,230	0	0.0%
Other Revenues	2,301	2,478	177	7.7%
Transfers	315	239	-76	-24.1%
Total	\$78,219	\$79,495	\$1,276	1.6%
Change from Fiscal 03-04	\$3,457	\$4,733		
% Change from Fiscal 03-04	4.6%	6.3%		
Fiscal 05-06				
Personal Income Tax	\$42,895	\$43,214	\$319	0.7%
Sales & Use Tax	26,947	26,951	4	0.0%
Corporation Tax	9,015	8,817	-198	-2.2%
Insurance Tax	2,300	2,300	0	0.0%
Other Revenues	2,071	2,384	313	15.1%
Transfers	544	201	-343	-63.1%
Total	\$83,772	\$83,867	\$95	0.1%
Change from Fiscal 04-05	\$5,553	\$4,372		
% Change from Fiscal 04-05	7.1%	5.5%		
Three-Year Total			\$1,371	

These figures exclude \$3.885 billion which will be a prior year adjustment.

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K-12 Education

Focus On Student Achievement

California's academic standards are among the highest in the nation. In classrooms throughout the state, students are being taught a rigorous curriculum based on these standards. Governor Schwarzenegger is firmly committed to continuing standards-based reforms. To this end, the May Revision proposes the following major initiatives:

- Expansion of Class Size Reduction
- Teacher Recruitment, Retention, and Recognition Block Grant
- Supplemental Instruction for the High School Exit Exam
- Expanding Beginning Teacher Support

Meeting the Challenges Of The No Child Left Behind Act Of 2001

More than ever California supports the goals of the federal No Child Left Behind Act of 2001: raise student achievement across the board, narrow and then close the achievement gap and ensure that each child has a highly qualified teacher. Accountability and transparency continue to be crucial elements to improve student and school academic performance.

The federal government has recognized that accountability systems which are excessively rigid will break from want of adequate flexibility. The Governor, in conjunction with the State Department of Education, and the State Board of Education, will work with federal authorities to align California's accountability system with the national accountability system in a transparently fair manner.

We will do so while maintaining intact our academic standards, acknowledged as among the highest in the nation.

Change In Total K-12 Funding

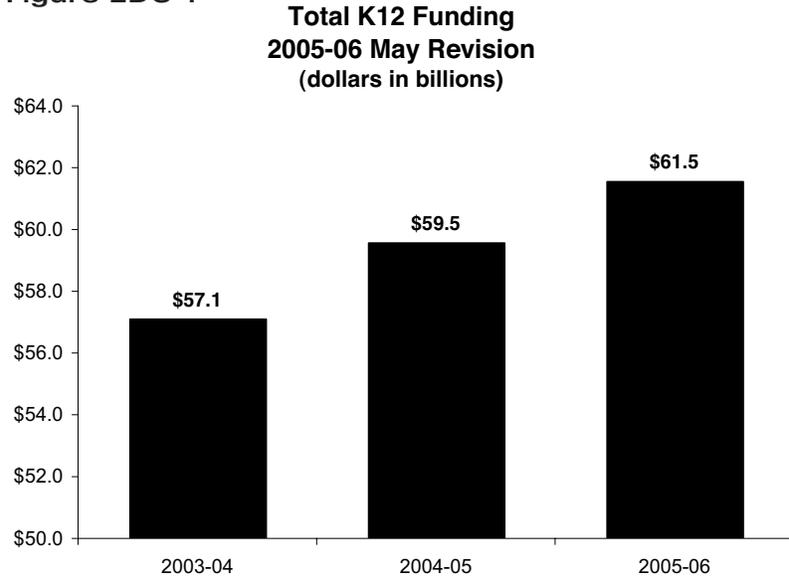
2004-05	\$207.0 million
2005-06	\$385.4 million

Expenditures: **K-12 Education**

The total of funding from all sources available to kindergarten through grade 12 (K-12) education continues to increase. For 2004-05, the May Revision reflects an increase of \$207 million from the Governor's January Budget level of \$59.3 billion. For 2005-06, an increase of \$385.4 million brings total funding to \$61.5 billion. From 2004-05 to 2005-06, total General Fund support increases \$1.8 billion, local property taxes increase by \$186.3 million, and federal funds grow by \$16.9 million. Also included in the May Revision, but not in these totals, is \$251.8 million in prior year Proposition 98 settle-up.

Funding per pupil from all sources for 2005-06 relative to the Governor's January Budget increases \$117, from \$10,084 to \$10,201. Revised per pupil funding of \$9,940 in 2004-05 represents an increase of \$76 from the Governor's January Budget level of \$9,864. The revised year-over-year per pupil increase is now \$261, rather than the \$220 estimated as of the Governor's January Budget.

Figure EDU-1



Proposition 98 Guarantee

2004-05	\$46,941.3 million
2005-06	\$49,967.6 million

Faced with continuing structural fiscal constraints, the Governor's January Budget maintained 2004-05 Proposition 98 appropriations for K-12 schools and community colleges at the same level reflected in the 2004 Budget Act. However, for 2005-06, the Governor's January Budget included an increase of approximately \$2.9 billion above that level, bringing total Proposition 98 spending to nearly \$50 billion.

The May Revision maintains Proposition 98 appropriations, K-12 schools, and community colleges at the level proposed in the Governor's Budget for 2005-06, despite a reduction in the minimum guarantee calculation. Since the release of the Governor's January Budget, changes in population, General Fund revenues, and per capita personal income have resulted in the Proposition 98 formula going from a Test 2 to a Test 3 calculation and a resultant \$509.3 million decrease in the minimum required for the Proposition 98 guarantee for 2005-06. However, rather than reduce appropriations to this lower minimum guarantee, the May Revision maintains the higher level of total Proposition 98 appropriations. The May Revision also provides \$251.8 million towards prior year Proposition 98 settle-

Expenditures: **K-12 Education**

up obligations owed for the 1995-96 and 1996-97 fiscal years. These funds are proposed for one-time activities associated with various initiatives, described below, and are in excess of what the Governor's January Budget had provided.

In addition, as a result of revised estimates of the shift in property taxes resulting from the Vehicle License Fee backfill, the amount of General Fund necessary to maintain the total Proposition 98 funding at the Governor's Budget level increases by \$283.5 million.

Changes in Proposition 98 factors similarly result in the 2004-05 minimum guarantee being \$141.9 million lower than estimated in the Governor's January Budget, with the General Fund contribution decreasing by \$114.5 million mostly due to changes in Average Daily Attendance.

Figure EDU-2

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

2004-05	January Estimates	May Revision	Change
General Fund	\$34,123,805	\$34,009,289	-\$114,516
Local Revenue	12,959,387	12,932,043	-27,344
Total Guarantee	\$47,083,192	\$46,941,332	-\$141,860
2005-06	January Proposal	May Revision	Change
General Fund	\$36,532,334	\$36,815,833	\$283,499
Local Revenue	13,435,286	13,151,787	-283,499
Total Guarantee	\$49,967,620	\$49,967,620	\$0
Settle-Up Payments	0	\$251,811	\$251,811
Total Funding Including Settle-Up	\$97,050,812	\$97,160,763	\$109,951

K-12 Education Proposition 98 Funding

2004-05 \$42,070.4 million
2005-06 \$44,644.4 million

The May Revision reflects a Proposition 98 General Fund increase of \$2.4 billion, and a local revenue increase of \$185.7 million, over revised 2004-05 levels for K-12 education. Total Proposition 98 General Fund allocations of \$33.3 billion for K-12 education now represent 40.5 percent of the state's State Appropriation Limit (SAL) General Fund revenues.

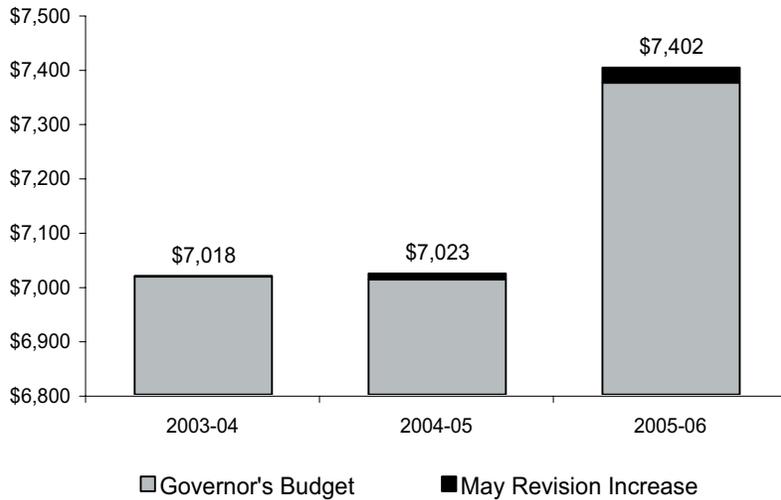
Funding per pupil from Proposition 98 sources for 2005-06 relative to the Governor's January Budget increases \$28, from \$7,374 to \$7,402. Revised per pupil funding of \$7,023 in 2004-05 represents an increase of \$11 from the Governor's Budget level of \$7,012. The revised year-over-year per pupil increase is now \$379, rather than the \$362 estimated as of the Governor's January Budget.

Achieving High Standards

The May Revision builds on the initiatives introduced in the Governor's January Budget. Significant new funding is allocated to initiatives included in the Governor's January Budget such as Career Technical Education, Smaller Learning Environments, School Nutrition, and Physical Education. In addition, funding is added for new initiatives such as teacher recruitment and training, class size reduction, and supplemental instruction for students who have failed or are at risk of failing the high school exit exam.

Figure EDU-3

Proposition 98 K-12 Per Pupil



Teacher Recruitment, Retention, and Recognition

The May Revision provides \$49.5 million in one-time Proposition 98 prior year settle-up funds for a block grant to allow schools to recruit and retain teachers and principals in schools in the bottom three deciles, based on 2004 Academic Performance Index (API) results. This block grant would be used for purposes such as recognition pay, staff development, and teacher or principal mentoring, among other things. While one-time funds are used for this purpose, the Administration proposes to evaluate program implementation to determine the appropriate focus and magnitude of ongoing funding in subsequent budgets. This funding is subject to the enactment of legislation for this purpose during the 2005-06 Regular Session.

Expanding Beginning Teacher Support Through The Teacher Credentialing Block Grant

The May Revision provides \$30 million in one-time Proposition 98 prior year settle-up funds to expand the Teacher Credentialing Block Grant to provide additional services for teachers beyond the first and second years of teaching. The amount proposed would provide funding for an additional 8,100 teachers. While one-time funds are used for this purpose, the Administration proposes to evaluate program implementation to determine the appropriate focus and magnitude of ongoing funding in subsequent budgets. This funding is subject to the enactment of legislation for this purpose during the 2005-06 Regular Session.

Class Size Reduction Expansion

The May Revision provides \$175.4 million (\$123 million in ongoing Proposition 98 funding and \$52.4 million in settle-up funding) to expand the class size reduction program to additional classes for deciles 1, 2, and 3 schools. Approximately 2,400 schools will be eligible based on 2004 API scores. While some one-time funds are used for this purpose, the Administration proposes to evaluate program implementation to determine the appropriate focus and magnitude of ongoing funding in subsequent budgets. In addition, it is intended that some of the settle-up funding will be available to address facilities needs for participating schools.

Career Technical Education For Grades 7 And 8

The May Revision proposes \$30 million in one-time Proposition 98 prior year settle-up funds to establish a pilot program for career exploration coursework in the 7th and 8th grades. This program would allocate grant funding to schools operating 7th and 8th grades for the purpose of introducing students to a variety of careers and professions. While one-time funds are used for this purpose, the Administration proposes to evaluate program implementation to determine the appropriate focus and magnitude of ongoing funding in subsequent budgets. This funding is subject to the enactment of legislation for this purpose during the 2005-06 Regular Session.

Smaller Learning Environments

Many recent studies have shown that smaller learning communities coupled with rigorous standards-based reforms have had great success in both motivating high school students to succeed academically and in effectively preparing them for college, work, and citizenship. Creating small learning communities provides for greater individualized attention and also builds a sense of community at a school. The May Revision includes \$1.6 million from prior year Proposition 98 settle-up funds for the first year of a three-year effort totaling \$5 million to encourage schools to establish these smaller learning environments, to be guided by legislation enacted on or before January 1, 2006. Funding decisions for the remaining two years can be made based on the effectiveness of the program.

Supplemental Instruction For The High School Exit Exam

The May Revision provides \$57.5 million in one-time Proposition 98 prior year settle-up funds for a Supplemental Instruction–High School Exit Exam Initiative to provide additional supplemental instruction to pupils who have failed or are at risk of failing the High School Exit Exam. It is intended that these funds supplement, not supplant, the existing Supplemental Instruction Program funds. While one-time funds are used for this purpose, the Administration proposes to evaluate program implementation to determine the appropriate focus and magnitude of ongoing funding in subsequent budgets. This funding is subject to the enactment of legislation for this purpose during the 2005-06 Regular Session.

Fruits and Vegetables For School Breakfast Programs

The May Revision provides \$18.2 million in one-time Proposition 98 prior year settle-up funds to increase the amount of fruits and vegetables served in the School Breakfast Program. The state annually provides approximately 172 million free or reduced priced breakfasts for qualifying pupils. This proposal would provide funds to ensure that school breakfasts include fruits or vegetables. Of the \$18.2 million, \$1 million will be set aside to provide breakfast start-up grants for schools that currently do not have breakfast programs. While one-time funds are used for this purpose, the Administration proposes to evaluate program implementation to determine the appropriate focus and magnitude of ongoing funding in subsequent budgets.

Physical Education Testing

The May Revision provides \$2.2 million in one-time Proposition 98 prior year settle-up funds for expanding physical fitness testing to grade 3 and notifying parents or guardians of pupil test results. Specifically, the May Revision provides \$650,000 to expand physical fitness testing to grade 3 so that pupils would be tested in grades 3, 5, 7, and 9. Additionally, the May Revision provides \$1.5 million to allow for grade 3, 5, 7, and 9 physical fitness testing results to be mailed to parents or guardians. While one-time funds are used for this purpose, the Administration proposes to evaluate program implementation to determine the appropriate focus and magnitude of ongoing funding in subsequent budgets.

Discretionary Funding For Schools

The May Revision includes a \$2.2 billion increase in discretionary funding for schools. This includes a \$83.8 million increase for attendance growth and a \$1.8 billion cost of living adjustment (COLA). In addition, the May Revision continues to include \$328 million to restore almost half of the outstanding deficit factor owed as a result of reductions to apportionments made by the prior Administration.

Categorical And Block Grant Program Transfer Flexibility

To provide school districts with greater flexibility in meeting the educational goals of those students with the greatest needs, the May Revision includes an amendment to Control Section 12.40 to increase flexibility provisions to allow up to 50 percent of former mega-item programs to be transferred out to other specified programs and transfers-in not to exceed 150 percent of the amount of state funding allocated for that program in the fiscal year. Further, the Administration is proposing legislation that would align the transfer provisions for four of the six block grants created by AB 825 (Chapter 871, Statutes of 2004) with the proposed increase in transfer amounts.

Other Major Budget Adjustments

Attendance Changes

The May Revision includes an estimated 2004-05 K-12 average daily attendance (ADA) growth of 0.52 percent, down from the 0.97 percent in the Governor's Budget. General Fund costs for school district and county office of education revenue limits decrease by \$114.5 million, resulting primarily from lower than expected ADA figures. The call on the General Fund, however, is also increased by lower than expected local property tax revenue. In 2005-06, the revised ADA growth rate is down from 0.79 percent to 0.69 percent (approximately 32,000 ADA lower than the January estimate). The total number of ADA is estimated to be 5,990,000 in 2004-05 and 6,031,000 in 2005-06.

Cost Of Living Adjustment Changes

The May Revision includes an additional \$113.1 million to fund an increase in the estimated Cost of Living Adjustment (COLA) factor, from 3.93 percent to 4.23 percent. This COLA factor is set by statute to be based on the State and Local price deflator, not the consumer price index, which would be lower. The result requires adjustments of \$78 million for apportionments, \$10.1 million for special education, \$4.7 million for K-3 class size reduction, and \$3.9 million for various child care programs.

Revenue Limits

Revenue limit funding constitutes the basic funding source for classroom instruction. The May Revision provides a net decrease compared to the Governor's January Budget of \$2.4 million to school district and county office of education revenue limits, which includes a decrease of \$307.2 million in anticipated ADA growth, an increase of \$79.8 million due to a change in the COLA factor from an estimated 3.93 percent to an actual 4.23 percent, and an increase of \$225 million General Fund to account for revised local revenues.

Deferred Maintenance

The May Revision provides an additional \$522,000 for the Deferred Maintenance Program above the level proposed in the Governor's January Budget. This brings the funding level for the Deferred Maintenance Program to \$267.9 million and provides full funding of the state's anticipated share.

Special Education

The May Revision maintains the year-over-year state aid funding commitment to special education. It provides a net General Fund increase of \$3.5 million and a net decrease of \$4.6 million in federal funding under amounts proposed in the Governor's January Budget. These changes include adjustments for growth and an increase to 4.23 percent in the COLA. The total year-over-year increase

Expenditures: **K-12 Education**

in federal Special Education Funds is \$59.9 million. These funds are proposed to be allocated as follows: \$1.6 million for various state operations needs (State Special Schools transportation, Mental Health and Non-Public Schools (NPS)/Licensed Care Institutions (LCI) Monitoring), \$39.3 million as an augmentation to the base level of funding for Special Education Local Planning Areas (SELPAs), \$4 million for the contractual provision of mental health services, and the remaining \$15 million to increase the current year NPS/LCI funding level.

Individuals with Disabilities Education Act Required Mental Health Services

The May Revision includes \$190 million for special education mental health services. This is an increase of \$90 million over the Governor's January Budget proposal. The Administration also proposes to repeal the mandate on county mental health agencies (CMH) for the provision of mental health services related to individualized education plans, allow SELPAs to contract with CMHs to provide these services, and amends Chapter 482, Statutes of 2004 (SB 1895), to ensure that special education pupils continue to have access to appropriate mental health services. (Counties will receive an additional \$90 million over the January budget on a one-time basis to help with the services provided to this population that might not be picked up by school districts.)

The May Revision continues to provide \$100 million in special education funding for mental health services to SELPAs as required by the Federal Individuals with Disabilities Education Act. Of this funding, \$35 million (\$4 million of which is specifically targeted for the provision of mental health services and \$31 million of the general funds to provide pre-referral mental health services for children with exceptional needs) is Proposition 98 General Fund and \$65 million is in federal funds. Additionally, \$90 million in non-Proposition 98 General Fund is allocated to CMHs to fund prior mandate claims. It also is intended that the State Controller will audit CMH mandate claims to determine both the appropriateness of prior claims and distinguish educationally necessary claims from those that are not educationally necessary on a going-forward basis.

Accountability

The federal No Child Left Behind (NCLB) Act 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 Program Improvement and becomes subject to interventions. Currently, there are 144 districts and at least 1,620 schools identified as Program Improvement.

The May Revision proposes \$154.5 million in federal NCLB grant carryover funds from a variety of programs to assist schools and districts who have been identified as Program Improvement to build a foundation of activities and services that will bring their students, particularly those identified as limited English proficient, migrant, low-performing, or low income, to a level of academic skill defined as

proficient under NCLB. These funds shall be available for expenditure consistent with a plan submitted by the State Board of Education and approved by the federal government.

The Governor's Budget included \$45 million for a second cohort of schools to participate in the High Priority Schools Grant Program (HPSGP). Based upon revised estimates of available funding, the May Revision now proposes that up to \$60 million be made available for this purpose, with funds contingent upon legislation being enacted authorizing that cohort and clarifying the criteria and timeframes for participating schools to exit the program. Approximately \$10 million also is included to fund sanctions for HPSGP schools, contingent upon legislation defining those sanctions and authorizing the allocation of funding for that purpose.

Pupil Testing

In April 2005, the federal government denied California's waiver request to exempt English language learners in kindergarten and grade 1 from assessments of their progress in attaining English reading and writing skills. In order to comply with this NCLB requirement, the May Revision shifts \$1.4 million in federal Title III funds from state operations to local assistance for the development of reading and writing assessments for these students as part of the California English Language Development Test (CELDT).

Also related to the CELDT assessment, the May Revision includes \$2.2 million on a one-time basis from the Proposition 98 Reversion Account to cover overlapping contract costs resulting from the transition from the current California English Language Development Test contract, which is in the process of closing out, to the beginning of the new contract that was recently awarded.

Additionally, one position and \$100,000 in federal Title VI funds is provided for the Department of Education to support new workload for the Standardized Testing and Reporting Program (STAR) generated by anticipated new flexibility provisions from the U.S. Department of Education. This flexibility is expected to allow states to develop an alternate assessment for students who have been unable to reach grade level because of disabilities such as moderate mental retardation or severe emotional disturbance. This assessment would be geared to the approximately 2 percent of students for whom the California Alternate Performance Assessment (for students with significant cognitive disabilities) or the California Standards Tests (for most students) are not necessarily the most appropriate assessments.

Finally, \$2 million in federal Title I funds is provided for the State Board of Education to contract for an independent evaluation of whether California complies with NCLB assessment requirements. This evaluation also is required to comply with federal student monitoring requirements, and is expected to be a multi-year effort.

California Longitudinal Pupil Achievement Data System

The May Revision includes \$844,000 for state operations for the Department of Education for the development of a Request for Proposals in the next phase of the development of the California Longitudinal Pupil Achievement Data System database to allow for the longitudinal collection of student data.

Pupil Retention Block Grant And Supplemental Instruction Program Realignment

To allow for increased flexibility to transfer funds between supplemental programs, the May Revision removes the Low STAR or At-Risk of Retention for Grades 2-6 and the Core Academic, Grades K-12 supplemental instruction programs from the Pupil Retention Block Grant and places them in the Remedial Supplemental Instruction Program. This transfer would take \$86.3 million from the Pupil Retention Block Grant and place it in the Remedial Supplemental Instruction Program allowing flexibility to transfer the funds between the supplemental programs to ensure that demand is met.

Advancement Via Individual Determination

The May Revision proposes to increase funding for the Advancement Via Individual Determination Program by \$840,000 to rescind the across-the-board reduction proposed for the program.

Charter Schools Facilities Grants

The May Revision provides a total of \$28.5 million for charter school facility needs to provide sufficient funds to reimburse charters for facility costs incurred in 2004-05 and to provide additional funding for the 2005-06 fiscal year need. This funding includes \$9 million in one-time Proposition 98 Reversion Account funding for the Charter Schools Facilities Grant Program that will match a new federal Charter Schools Facilities Incentive Grants program administered by the California School Financing Authority (CSFA) which can be used for both construction of new facilities or for lease payments on existing facilities. The first two years of federal funding are provided in the amount of \$19.5 million in the CSFA budget, with one-half proposed to be used with the state match to fully fund the need for reimbursements for 2004-05 facility costs estimated by the Department of Education at over \$18 million per year. The remainder will be available to reimburse 2005-06 fiscal year costs.

High School Coach Training

The May Revision provides \$500,000 in one-time Proposition 98 prior year settle-up funds to implement a program that requires coaches involved in athletics, to attend training on the identification, risks, and effects of performance-enhancing substances in an effort to increase awareness and eliminate the use of performance-enhancing substances by student athletes. While one-time funds

are used for this purpose, the Administration proposes to evaluate program implementation to determine the appropriate focus and magnitude of ongoing funding in subsequent budgets.

California Local Education Accountability Program

The May Revision provides \$5.6 million in one-time Proposition 98 Reversion Account funding to provide grants to school districts participating in the California Local Education Accountability Reform (CLEAR) program, a voluntary pilot project providing flexibility for participating districts to plan and implement programs to increase pupil academic achievement and to meet accountability targets by delegating budgetary and academic decision-making and accountability to the school site level. The May Revision also proposes \$1.2 million in state operations funds to the State Board of Education to implement and oversee the CLEAR program.

Commission On Teacher Credentialing

2004-05	\$0
2005-06	\$2.7 million General Fund

The May Revision proposes \$6.4 million in expenditure reductions and \$2.7 million from the General Fund on a one-time basis to address structural imbalances in the Commission on Teacher Credentialing's (CTC) Teacher Credentialing Fund (TCF) and the Test Development and Administration Account (TDAA). The adjustments include:

- -\$580,000 in printing, equipment, and other economies in operations costs in the TCF.
- -\$5.8 million, primarily for a technical adjustment to transition to revenue-only contracts in the TDAA and minor state operations cost reductions.
- \$2.7 million in General Fund augmentation for operating expenses.

The cost saving reductions and General Fund augmentation will enable CTC to perform its existing functions while the state continues to work on a more comprehensive solution to its budget imbalance.

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Higher Education

The May Revision for higher education remains consistent with the 2004 Higher Education Compact, includes workload increases and a policy change for the Cal Grant program and introduces the first phase of the Science and Math Teacher Initiative designed to increase the supply of highly qualified teachers in these subject areas. Overall General Fund and related Proposition 98 growth for higher education increases 7.7 percent over the current year revised level in the May Revision, as compared with the 6.9 percent growth increase provided in the Governor's Budget.

Science and Math Teacher Initiative

In 2002-03, all segments of California higher education collectively awarded 1,389 mathematics degrees, yet the total need for new math teachers that year was 2,131. Also, recent studies have shown that California is falling behind the rest of the nation in teaching science and math skills to its students and is finding it difficult to meet the needs in all classrooms. In response, the Compact calls for the University of California (UC) to work with the California State University (CSU) and others, including California industry, to develop a major initiative to improve both the supply and quality of science and mathematics teachers in California. Developing a workforce with the knowledge and critical skills required by an economy increasingly reliant on science, technology, engineering, and mathematics is essential for California and its industries to remain competitive.

To help meet these challenges, the May Revision includes \$1 million to establish the first phase of the new Science and Math Teacher Initiative. This augmentation also includes funds for CSU to work with UC to complement UC's effort. With the segments matching the state investment, adequate funding will be available to operate the UC centers to oversee student advising, school placements, monitor student progress, coordinate student transportation, and provide program assessment data for accountability. The May Revision also proposes to expand the Assumption Program of Loans for Education (APLE) program by authorizing 350 new awards in the budget year for students recruited by participating campuses in these new science and math teacher preparation programs (refer to discussion in the California Student Aid Commission section).

May Revision Adjustments:

University of California

2004-05	-\$88,000
2005-06	\$19.6 million

Current Year

- Updated debt service information decreased the lease-revenue payments in 2004-05 by \$88,000.

Budget Year

- The May Revision proposes to increase UC's General Fund by \$750,000 to provide funds to implement the first phase of the Science and Math Teacher Initiative at UC by providing matching funds to establish at least six Science and Math Resource Centers.
- The May Revision also proposes to increase UC's General Fund by \$18.9 million for revised lease-revenue payment estimates, reflecting both adjustments from the 2004 Budget Act Control Section 4.30 and updated debt service information.

California State University

2004-05	-\$97,000
2005-06	\$381,000

Current Year

- Updated debt service information decreased the lease-revenue payments in 2004-05 by \$97,000.

Budget Year

- The May Revision proposes to increase CSU's General Fund by \$250,000 to provide funds to implement the first phase of the Science and Math Teacher Initiative at CSU by enabling CSU to work with UC to complement UC's effort.
- The May Revision also proposes to increase CSU's General Fund by \$131,000 to reflect revised lease-revenue payments in the budget year to reflect 2004 Budget Act Control Section 4.30 and updated debt service information.
- In addition, the May Revision proposes an addition of \$26 million from existing General Obligation bonds to fund capital renewal projects. The use of bond funds for this purpose will address critical system replacements to maintain instructional capacity without increasing the overall demand for General Obligation bonds for capital outlay.

California Student Aid Commission

2003-04	-\$14.0 million
2004-05	\$9.2 million
2005-06	\$6.9 million

Prior Year

- Additional savings of \$14 million are recognized based on close out of Cal Grant Entitlement awards that were issued in 2003-04.

Current Year

- An increase of \$9.2 million is estimated for current year Cal Grant Entitlement awards. This reduces the savings anticipated in January from \$44.8 million to \$35.6 million.

Budget Year

The May Revision proposes a net General Fund augmentation of \$6.9 million over the level proposed in the 2005-06 Governor's Budget, as noted below:

- An augmentation of \$15.7 million associated with revised estimates of the number of Cal Grant Entitlement awards that will be issued in 2005-06 including transfer and high school entitlement awards.
- An augmentation of \$7.5 million to restore the maximum Cal Grant award for students attending private universities and colleges from the \$7,449 proposed in January to the current year maximum award level of \$8,322.
- A technical adjustment of \$200,000 to defer funding for 100 National Guard Assumption Program of Loans for Education (NG APLE) warrants until 2006-07.
- A reduction of \$16 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 (SLOF) to cover a portion of the costs associated with the Cal Grant program in 2005-06. This proposal increases the one-time General Fund savings proposed in the Governor's Budget from \$35 million in January to \$51 million. Conservative projections indicate a sufficient reserve will be available for EdFund's ongoing cash management in the budget year.
- Authorization for up to 350 APLE warrants for students who participate in the Science and Math Teacher Initiative. Funding for these warrants will be provided when necessary in future budgets following the completion of required service in public schools. Trailer bill legislation is proposed to establish the new APLE program for these new programs.

In addition, the May Revision proposes the following changes to non-General Fund items for 2005-06:

Expenditures: **Higher Education**

- An augmentation of \$1.6 million in SLOF and 2.5 positions for state operations to enhance the Grant Delivery System, including \$1.3 million in one-time funds.
- An augmentation of \$150,000 SLOF to provide temporary help funds for the increased Customer Service Call Center workload for a two-year period until the Grant Delivery System and improvements in automated answering programs are fully implemented.
- An augmentation of \$7.6 million in local assistance reimbursement authority and \$200,000 in state operations reimbursement authority for the operations of the Chafee Foster Youth Program provided through federal funds to the Department of Social Services.

California Community Colleges

2004-05	\$10.0 million
2005-06	\$141.0 million

Current Year

- The May Revision proposes an augmentation of \$10 million one-time for the California Community Colleges (CCC) from Proposition 98 settle-up local assistance funding for additional marginal cost support, equipment, and infrastructure related costs that will allow districts to increase nursing program enrollment capacity by at least 1,800 additional slots to respond to the nursing shortage as part of the Governor's Nursing Initiative. While one-time funds are used for this purpose, the Administration proposes to evaluate program implementation to determine the appropriate magnitude of ongoing funding in subsequent budgets. Additionally, two (five-year) limited term positions and \$150,000 in increased federal reimbursements are proposed in 2005-06 to assist the Chancellor's Office with the implementation of this initiative.

Budget Year

In addition, the May Revision proposes the following major budget adjustments for the CCC, which will increase total General Fund local assistance and state operations program support by \$151.1 million over the two-year period relative to the January Governor's Budget, inclusive of additional General Fund support to backfill decreases in projected local property tax revenues and local student fee revenues. Excluding these offsetting adjustments, the May Revision provides a net increase of \$83.8 million from these sources over the Governor's January Budget. Major General Fund adjustments for the CCC include the following:

- An increase in the Community College's share of Proposition 98 funding is provided, rising from 10.35 percent in the Governor's Budget to 10.46 percent at the May Revision.
- An increase of \$40 million Proposition 98 General Fund for Equalization. The Budget Act of 2004 provided \$80 million to begin equalizing disparities in funding per credit full-time equivalent student (FTES), with the goal of equalizing credit rates to the 90th percentile pursuant to the statutory formula. This funding will bring total support for equalization to \$120 million over two years, or approximately one-half of the total cost to achieve this goal.

Expenditures: **Higher Education**

- Restoration of \$31.4 million Proposition 98 General Fund to reflect agreement between the Administration and the CCC to implement a meaningful, district-specific accountability framework pursuant to Chapter 581, Statutes of 2004 (AB 1417). Additionally, four positions and \$417,000 in General Fund are proposed for state operations to design and implement the statewide accountability framework, provide ongoing reporting and evaluation of district-specific performance, and identify underperforming districts that may require technical assistance. Both augmentations are contingent upon passage of trailer bill legislation to implement the proposed accountability framework.
- An increase of \$17.4 million in one-time local assistance from the Proposition 98 Reversion Account on top of the \$20 million provided in the Governor's Budget to expand the Governor's Career-Technical Education Initiative for a total of \$37.4 million. These additional funds will be used to support additional quick start and capacity building efforts. The Administration also proposes three (two-year) limited term positions and \$360,000 in federal reimbursement authority to implement and administer this initiative. While one-time funds are used for this purpose, the Administration proposes to evaluate program implementation to determine the appropriate focus and magnitude of ongoing funding in subsequent budgets.
- Increases of \$14.1 million for apportionments and \$830,000 in Proposition 98 General Fund for selected categorical programs, to reflect an increase in the COLA factor from 3.93 percent to 4.23 percent.
- An increase of approximately \$2 million in ZProposition 98 General Fund for the Board Financial Aid program to reflect 2005-06 base adjustments provided to local districts as a result of re-estimated student fee revenues.
- A decrease of \$359,000 Proposition 98 General Fund for selected categorical programs to reflect a revised statutory growth rate of 1.76 percent.
- An increase of \$54.3 million Proposition 98 General Fund to offset a reduced 2005-06 property tax estimate. This adjustment reflects revised property tax growth rates, changes in estimated Educational Revenue Augmentation Fund (ERAF) resources, as well as updated projections of basic aid revenues retained by community college districts.
- An increase of \$12.9 million Proposition 98 General Fund, to offset a reduced estimate of student fee revenues for 2005-06.

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Health & Human Services

Maintaining a Strong and Responsible Safety Net

The Governor's May Revision maintains a strong and responsible safety net for our state's most vulnerable residents by continuing the reform proposals and initiatives included in the Governor's January Budget. These reform efforts strike a reasonable and responsible balance between the need to maintain essential services for Californians in need, while implementing strategies to manage and control program costs better over the long term. At the same time, the May Revision identifies a number of additional targeted investments. These proposed investments address emerging issues and promote continued access to services and structures that are critical to supporting the health and well being of the people of California.

May Revision Adjustments—Highlights

- **West Nile Virus**—Experts anticipate that in 2005, California will face increased and widespread West Nile Virus (WNV) activity across the state. In response to the continued public health challenges presented by the WNV, the Administration proposes to provide the Department of Health Services (DHS) with additional resources for allocation to local mosquito control agencies and for state-sponsored abatement activity, especially in areas without local services. The increased funding will support California's comprehensive public education, surveillance, and mosquito control efforts to protect public health and prevent WNV related illness and death.
- **CalWORKs**—To emphasize the work orientation of CalWORKs and to promote self-sufficiency of recipients, the Administration has changed from the position of the Governor's January Budget in order to maintain California's earned income disregard at its current levels. The Administration also proposes investing additional Temporary Assistance for Needy Families (TANF) funds to incentivize counties to develop and implement work-oriented strategies as part of the Pay for Performance initiative proposed in the Governor's January Budget.
- **Enrolling More Children in the Healthy Families Program**—Recognizing the importance of facilitating the enrollment of children eligible but unenrolled in the Healthy Families and Medi-Cal programs, the Governor's Budget proposal called for the restoration of funding for certified applicant assistants to assist in the enrollment of eligible children. Consistent with the Governor's commitment to maximize enrollment of eligible children, the May Revision increases estimated enrollment in the Healthy Families Program by over 100,000 children by the end of 2005-06.

Expenditures: **Health & Human Services**

- **Affordable Prescription Drugs for the Uninsured: Cal Rx**—To promote access to low-cost prescription medicines for lower-income uninsured residents, the Administration proposes additional resources for the design, development, and implementation of the Cal Rx initiative, including the pre-funding required to provide rebates to pharmacies before rebates are collected from manufacturers.
- **Tobacco Control, Disease Prevention, and Indigent Care**—To expand California's effective tobacco control activities and efforts to reduce smoking, to maintain important asthma prevention and intervention activities, and to provide increased support for health care services for low-income Californians supported by the Rural Health Services and California Healthcare for Indigents programs, the May Revision proposes to use available Proposition 99 (tobacco tax) funds to provide one-time increased investments in these programs.
- **Chronic Homelessness Initiative**—The passage of Proposition 63, the Mental Health Services Act (MHSA), provides a unique opportunity for collaboration between the California Health and Human Services Agency and the Business, Transportation and Housing Agency to reduce chronic homelessness among the mentally ill. The May Revision redirects \$40 million from existing housing bonds and \$10 million from the California Housing Finance Agency (CalHFA), along with seed money from the MHSA, to create 400-500 units of permanent housing with services for chronic mentally ill populations.
- **Community Care Licensing**—This program promotes the health and safety of children and adults residing or spending a portion of their time in out-of-home settings. The May Revision proposes to maintain current law that calls for an increase in the sample size of random visits to licensed facilities if the number of citations issued by the Department of Social Services (DSS) increases by more than 10 percent over the previous year. A more comprehensive review is necessary to determine appropriate policy to improve oversight, increase compliance with health and safety standards, and ensure quality care in this program.
- **Medicare Modernization Act Transitional Funding**—To facilitate continuity of care and assist in the transition from Medi-Cal prescription drug coverage to the new Medicare Part D prescription drug benefit, the Administration proposes to fund outreach, training, and support for the approximately one million Medi-Cal beneficiaries who will begin receiving their prescription drug coverage through the new Medicare Part D program on January 1, 2006.
- **Long-term Care Rate Increases**—To ensure continued access to quality long term care services, the Administration proposes a rate increase to certain long-term care facilities in recognition of their increasing costs.
- **Access for Infants and Mothers Rate Increase**—In recognition of the need to provide access to quality healthcare for mothers and infants, the May Revision funds an average 7.2 percent rate increase for pregnant women, an average 1.6 percent rate increase for infants up to one year of age, and an average 3.9 percent rate increase for infants from one to two years of age in the Access for Infants and Mothers Program.
- **Healthy Families Rate Increase**—To continue strong health plan participation in the program, the May Revision funds an average 2.9 percent rate increase for managed care plans participating in the Healthy Families Program.

- **CalOptima Rate Increase**—To maintain the viability of Orange County’s County Organized Health Plan, CalOptima, the May Revision funds a 3 percent increase in the Medi-Cal reimbursement rate for CalOptima

Medicare Modernization Act

Under the terms of the federal Medicare Modernization Act (MMA), on January 1, 2006, approximately one million Californians who are eligible for both Medicare and Medi-Cal will begin receiving prescription drug coverage from the Medicare Part D program. These people, known as dual eligibles, currently receive drug coverage through the Medi-Cal program. This population includes many of the most vulnerable and frail people in California; any break in prescription coverage during this transitional period could have significant negative healthcare outcomes for them. While the transition of drug coverage for dual eligibles is a federal responsibility, the May Revision proposes a significant investment in resources to ease this transition for California’s dual eligible population. This investment crosses several departments as follows:

- **California Health and Human Service Agency (CHHSA)**—\$100,000 General Fund and one position is provided for coordination and leadership to assure a common statewide approach to the MMA implementation.
- **Department of Health Services (DHS)**—\$3.9 million (\$1.6 million General Fund) is provided to fund outreach activities. In addition, the May Revision proposes \$94 million (\$47 million General Fund) to continue providing drugs now covered by Medi-Cal for dual eligibles where federal matching funds are available as those classes of drugs are not covered by Medicare.
- **Department of Developmental Services (DDS)**—\$11.7 million General Fund and 23 positions are provided to ease the transition of the very fragile population in Developmental and Regional Centers. The funds will be used to provide training, outreach, and support to consumers, staff, and providers in both the Regional Centers and Developmental Centers. In addition, funding will be used to provide transitional drug coverage.
- **Department of Mental Health (DMH)**—\$875,000 (\$569,000 General Fund) and ten positions are provided for outreach and support to patients in the state hospitals, to develop new billing systems and software, and to fund transitional drug coverage.

Department of Health Services

Medi-Cal

2004-05	–\$480.1 million
2005-06	\$514.9 million

Expenditures: **Health & Human Services**

Current Year

The May Revision includes total Medi-Cal expenditures of \$33.4 billion (\$11.7 billion General Fund), a decrease of \$480.1 million (\$262.4 million General Fund) below the Governor's January Budget. General Fund expenditures for Medi-Cal have increased by \$1.8 billion, or 17.7 percent over the 2003-04 level.

The average monthly Medi-Cal caseload in 2004-05 is expected to decrease by 15,400 beneficiaries to 6,623,900 eligibles. This represents a decrease of 0.2 percent below the level projected in the 2005-06 Governor's Budget. The revised caseload is 1.7 percent above 2003-04 caseload.

The net General Fund decrease below the 2005-06 Governor's Budget includes the following significant adjustments:

- A \$99 million decrease due to the delay of the nursing facility quality assurance fee and the associated rate increase (AB 1629) from 2004-05 to 2005-06. These dollars are now reflected in 2005-06 projected expenditures.
- A \$68.9 million decrease in projected pharmacy expenditures due to higher than expected savings from the 2004-05 pharmacy cost control initiative and the withdrawal of Vioxx.
- A \$94.5 million net decrease for various cost and utilization changes.

Budget Year

The May Revision includes total Medi-Cal expenditures of \$34.6 billion (\$13.0 billion General Fund), a net total funds increase of \$514.9 million (\$16.1 million General Fund) from the Governor's January Budget.

The average monthly Medi-Cal caseload is expected to decrease from the Governor's January Budget by 74,900 beneficiaries to 6,734,900 eligibles. This represents a decrease of 1.1 percent below the 2005-06 Governor's January Budget.

The budget year includes the following significant General Fund adjustments:

- A one-time \$135.6 million decrease due to the federal decision to have states pay the Medicare Part D "clawback" beginning in February 2006 instead of January 2006.
- A \$94.3 million decrease in projected pharmacy expenditures due to higher than expected savings from the 2004-05 pharmacy cost control initiative and the withdrawal of Vioxx.
- A \$144.6 million increase due to the delay of the nursing facility quality assurance fee and the associated rate increase (AB 1629) from 2004-05 to 2005-06.
- To help ensure the viability of LA County's health care system, the May Revision assumes the continued cost-based payment of LA County's outpatient and clinic care for Medi-Cal beneficiaries. This assumption will not result in increased costs from the Governor's January Budget.
- A \$101.4 million net increase for various cost and utilization changes.

**Affordable Prescription Drugs for the Uninsured:
California RX (Cal RX)**

The Governor’s January Budget included resources to implement the Cal Rx program, which will provide discounted drugs to California’s low-income uninsured families and individuals.

The Governor’s January Budget included \$3.9 million General Fund for the following components of the Cal Rx proposal. The May Revision proposes an additional \$7.8 million for the following:

- \$4.1 million one-time General Fund for additional systems development costs for a total of \$5.1 million.
- \$300,000 General Fund for additional ongoing fiscal intermediary costs in 2005-06. It is now estimated that the annual ongoing fiscal intermediary costs would be \$2.9 million.
- \$3.4 million General Fund to allow pharmacies to be reimbursed before the state receives rebates from manufacturers.

Public Health

2004-05	-\$7.9 million
2005-06	-\$3.2 million

Current Year

Caseload Programs

The May Revision includes a decrease of \$17.9 million General Fund, or 12.5 percent, below the \$143.2 million provided in the Governor’s January Budget, due to a decrease in caseload and health care costs in the California Children’s Services (CCS), Child Health and Disability Prevention (CHDP), and the Genetically Handicapped Persons Program (GHPP).

The May Revision includes an increase of \$3.3 million from the AIDS Drug Assistance Program (ADAP) Rebate Fund, or 1.3 percent, above the \$244.8 million provided in the Governor’s January Budget to fund increased program costs resulting from steadily increasing drug prices and increased access to covered drugs by ADAP clients. Current year caseload at the May Revision has not changed from the Governor’s January Budget.

Budget Year

Caseload Programs

The May Revision includes a decrease of \$31.7 million General Fund, or 20.4 percent, below the \$155.7 million provided in the Governor’s January Budget, due to adjustments in caseload and health care costs in the CCS, CHDP, and GHPP. This decrease also reflects the following two policy decisions:

Expenditures: **Health & Human Services**

- **Accrual to Cash Basis of Budgeting for GHPP**—GHPP accounting will shift from an accrual to a cash basis. This results in one-time General Fund savings of approximately \$15.6 million.
- **Fasting Blood Sugar and Cholesterol Screenings for CHDP**—Adding fasting blood sugar and cholesterol screenings to the CHDP health assessments, and redirecting existing funds from the Governor’s Obesity Initiative to CHDP and CHDP Gateway for this cost, will result in General Fund savings of approximately \$46,000.

The May Revision also includes an increase of \$4.7 million ADAP Rebate Fund, or 1.8 percent, above the \$263.6 million provided in the Governor’s January Budget, to fund increased program costs resulting from steadily increasing drug prices and increased access to covered drugs by ADAP clients. Budget year caseload at the May Revision has not changed from the Governor’s January Budget.

Cigarette and Tobacco Products Surtax Fund—Proposition 99

Increased Proposition 99 revenues and other available one-time funds make it possible for California to expand support for important tobacco control and smoking prevention activities, to fund tobacco related disease (asthma) prevention efforts and to bolster funding for health care services supported by the Rural Health Services Program and the California Healthcare for Indigents Program.

The May Revision generates one-time Proposition 99 fund savings while maintaining funding for the Major Risk Medical Insurance Program at the current level by partially funding the program with a \$20 million balance in the Major Risk Medical Insurance Fund (MRMIF). The balance is related to a reconciliation of claims for years 1991-2002. In addition, since the Governor’s January Budget estimate, Proposition 99 revenues have increased by \$11 million in the current year and \$12 million in the budget year, for a total of \$329 million in the current year and \$321 million in the budget year. The increased revenue appears to be due to a reduction in tax evasion for other tobacco products. Until a more reliable revenue trend is established, the increased revenues should not be dedicated to ongoing expenditure increases.

In light of the new, one-time, available Proposition 99 funds, input from the Legislature and constituent groups regarding the Governor’s Budget Proposition 99 expenditure plan, and the Administration’s interest in funding important public health and health care services programs, the May Revision includes a revised proposal for Proposition 99 expenditures. The proposal maintains or increases expenditure for Proposition 99 supported health care programs, maintains the Proposition 99 and General Fund savings, and alters expenditures and transfers for programs within the Managed Risk Medical Insurance Board, the Department of Mental Health, and Department of Health Services, as follows:

- Fund the Access for Infants and Mothers (AIM) program with Proposition 99, and use Proposition 99 funds to match the State Children’s Health Insurance Program (SCHIP) federal match in 2004-05 and 2005-06.
- Fund AIM and Every Woman Counts caseload increases using Proposition 99 funds in 2004-05 and 2005-06.

Expenditures: **Health & Human Services**

- Fund the New Qualified Aliens Program and the Department of Mental Health (DMH) using General Fund, instead of Proposition 99 funds, in both 2004-05 and 2005-06.
- Provide Proposition 99 funding to support state costs resulting from the Orthopaedic Hospital settlement in 2004-05 and 2005-06.
- Fund increased expenditures for the California Healthcare for Indigents Program and the Rural Health Services program on a one-time basis.
- Provide a one-time increase to support expanded tobacco control and smoking prevention activities, including community-based organization efforts targeting special populations, with high tobacco use rates, media efforts directed to priority populations, and evaluation efforts.
- Provide a one-time increase to support surveillance, and community and school-based case management, and quality assurance efforts to better manage asthma and avoid unnecessary hospitalization and missed school and work days resulting from this disease.

The May Revision proposes policy legislation to amend Proposition 99 to authorize the use of Proposition 99 funding to draw down federal financial participation. This legislation will allow California to maximize federal funding for health services programs. Similar to Proposition 99 amendments enacted by the Legislature in previous years, this legislation requires approval by a 4/5 vote.

West Nile Virus—Prevention and Control

In 2004, West Nile Virus (WNV) spread from six southern California counties to all 58 California counties, causing 830 human infections and leading to 28 deaths. Experts anticipate that in 2005, California will face increased and widespread WNV activity across the state. In anticipation of a threat of early, intense, and widespread WNV disease in 2005, the May Revision provides \$12 million to enhance and expand mosquito control efforts across the state. This one-time investment will build on California's effective mosquito control program by supplementing the resources of existing mosquito control programs and expanding mosquito control programs to cover currently unserved areas of the state. Funding will support mosquito control and abatement activities in WNV high risk areas and provide for emergency mosquito control in WNV hot spots. The increased funding will support California's comprehensive public education, surveillance, and mosquito control efforts to protect public health and prevent WNV related illness and death.

Managed Risk Medical Insurance Board

2004-05	-\$10.0 million
2005-06	\$78.5 million

Healthy Families Program

Current Year

The May Revision includes an overall expenditure increase of \$3.1 million (\$818,000 General Fund). This represents a 0.4 percent increase. This expenditure increase is primarily based on new data projections as transition issues with the new administrative vendor were resolved and an assumption that AB 1396 will be enacted during May 2005 to restore the Certified Application Assistance Program in the current year. The Healthy Families Program (HFP) is expected to serve a total of 740,835 children by June 30, 2005, which is 26,959 more than the caseload anticipated in the Governor's Budget.

Budget Year

The May Revision projects overall expenditures to increase by \$64.4 million (\$22.2 million General Fund) above the level anticipated in the Governor's Budget. This represents a 7.2 percent increase. This change is due to natural growth, capitation rate increases, and earlier implementation of the Certified Application Assistance Program. Consistent with the Administration's goal to cover more of California's uninsured children, year-end children's caseload is expected to reach 867,418 children, which is 78,117 children more than the caseload projected in the Governor's Budget.

Access for Infants and Mothers Program

Current Year

Average monthly enrollment in the Access for Infants and Mothers program is expected to be 13,007 women and infants, compared to 13,314 as originally estimated in the Governor's Budget. This represents a 2.3 percent decrease. Current year expenditures are expected to increase by \$7.9 million (\$24.2 million General Fund decrease, \$26.6 million Proposition 99, \$5.5 million federal funds), due to increased enrollment of women in the program. The May Revision also reflects the shift of the state match from General Fund to Proposition 99 funds.

Budget Year

Average monthly enrollment is expected to be 7,858 women and infants, compared to 7,574 as originally estimated in the Governor's Budget. This represents an increase of 3.7 percent due to natural enrollment increases. Budget year expenditures are expected to increase by \$15.1 million (\$27.4 million General Fund decrease, \$31.6 million Proposition 99 increase, \$10.9 million federal funds increase) due to higher enrollment and capitation rate increases. The May Revision also reflects the shift of the state match from General Fund to Proposition 99 funds.

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 (SCHIP) funds to provide health care for children with family incomes between 250 percent and 300 percent of the federal poverty level and for parents with family incomes up to 200 percent of the federal poverty level. Current year expenditures are expected to decrease by \$1 million (\$367,000 CHIM Fund, \$682,000 federal funds), due to the lower than anticipated use of these programs by the counties. Similarly, due to adjustments in local funding amounts, budget year CHIM expenditures are expected to decrease by \$1 million (\$350,000 CHIM Fund, \$650,000 federal funds).

Department of Developmental Services

2004-05 **–\$81.4 million**

2005-06 **–\$61.1 million**

Developmental Centers

Current Year

The May Revision includes a net reduction of \$2.1 million (\$625,000 General Fund) for Developmental Centers. This net change is due primarily to the following adjustments:

- **Population**—Population in the Developmental Centers is projected to decrease by 105 residents from the level in the Governor’s Budget, resulting in \$8.4 million (\$4.9 million General Fund) savings and a reduction of 119.0 positions.
- **Redirection of Population Savings**—Population savings of \$4.7 million (\$2.7 million General Fund) are redirected to fund baseline employee compensation costs and other nondiscretionary costs that exceed available funding. This includes \$1.9 million for employee compensation, \$800,000 for payment of two legal settlements, \$430,000 for janitorial contract costs at a higher blended rate established by the Department of Personnel Administration, and \$1.6 million for utilities.

Budget Year

The May Revision includes a net increase of \$9.4 million (\$6.1 million General Fund) for Developmental Centers. Major changes include:

- **Population**—Population in the Developmental Centers is anticipated to decrease by 55 residents from the Governor’s Budget level, resulting in \$6.1 million (\$3.6 million General Fund) savings and a reduction of 93.0 positions.

Expenditures: **Health & Human Services**

- **Agnews Staffing Restoration**—Restoration of 43.0 non-Level-of-Care positions and \$3.2 million (\$1.7 million General Fund) that was reduced in the Governor’s Budget in the standard budgeting adjustment for population decline. These resources are essential to ensure adequate staffing of Agnews Developmental Center during the transition to closure.
- **Workers' Compensation**—An increase of \$4.9 million (\$2.8 million General Fund) to settle select workers’ compensation claims and reduce ongoing liabilities.
- **Quality Management**—An increase of \$664,000 (\$369,000 General Fund) for five positions to assist in a comprehensive review of quality management practices in the Developmental Centers pursuant to federal requirements.

Regional Centers

Current Year

Compared to the Governor’s Budget, the Regional Centers community caseload is projected to decrease by 1,900 consumers, to an updated caseload of 197,355 consumers. The May Revision includes a net decrease of \$62.5 million (\$69.6 million General Fund) for Regional Centers as a result of the following adjustments:

- **Operations**—An overall reduction of \$13.5 million (\$14.7 million General Fund) for Regional Centers operations reflecting legislative denial of a proposed \$10.6 million augmentation for improving Regional Centers case management ratios and a decrease of \$3.0 million due to updated caseload.
- **Purchase-of-Services**—An overall reduction of \$49.0 million (\$54.9 million General Fund) for Regional Centers purchase-of-services due to updated caseload, utilization, and expenditure data and costs for community placement plan and placement continuation. Temporary cost containment strategies, such as rate freezes, unallocated reductions, and other measures, have slowed the annual rate of program growth.

Budget Year

Compared to the Governor’s Budget, the Regional Centers community caseload is projected to decrease by 2,865 consumers, to an updated caseload of 205,155 consumers. The May Revision includes a net decrease of \$31.0 million (\$78.5 million General Fund) as a result of the following changes:

- **Operations**—An overall increase of \$17.7 million (\$4.9 million General Fund) for Regional Centers operations. This net change reflects several adjustments:
 - **California Developmental Disabilities Information System (CADDIS)**—\$2 million is set-aside for proposed functional changes to CADDIS with expenditure contingent upon Department of Finance (Finance) approval. Further changes to CADDIS are on hold pending an independent assessment of the project conducted in the current year under the oversight

Expenditures: **Health & Human Services**

of Finance, and the California Health and Human Services Agency. This assessment will determine if the current CADDIS design reflects the project objectives as represented in the original project Feasibility Study Report and Request for Proposal. The review will also consider whether CADDIS will meet Department of Developmental Services (DDS) and Regional Centers business practice requirements and objectives, including objectives related to federal compliance.

- **Compliance with Home and Community-Based Services Waiver**—A net increase of \$9.7 million (decrease of \$1.8 million General Fund) for Regional Centers to meet federally required case management ratios. This increase is due to increased federal financial participation for the proposed new regional center positions.
- An increase of \$189,000 due to updated caseload data.
- **Purchase-of-Services**—An overall decrease of \$47.9 million due to updated caseload, utilization, and expenditure data and costs for community placement plan and placement continuation. Cost containment strategies are continued in the budget year to slow the rate of program growth to sustainable levels.

Agnews Developmental Center Closure

There is a reappropriation of \$11.1 million General Fund from the current year to the budget year for development of community-based housing related to closure of Agnews Developmental Center. These funds are needed in the budget year pending DDS approval of the three Bay Area Regional Centers housing proposals consistent with AB 2100.

Department of Mental Health

2004-05	\$18.6 million
2005-06	\$165.8 million

Long-Term Care/State Hospitals

Current Year

The May Revision includes a net increase of \$1.9 million (\$18.6 million General Fund increase) in 2004-05 for long-term care and state hospitals. The General Fund increase is comprised primarily of the following:

- **State Hospital Population**—There is no change in the state hospital patient population in the current year; however, the proposed realignment of Proposition 99 funding shifts \$16.7 million in state hospital population growth costs from Proposition 99 funding to the General Fund. This additional General Fund need is lowered by \$500,000 due to a redirection of savings from Coalinga State Hospital activation.

Expenditures: **Health & Human Services**

Budget Year

Funding for long-term care and state hospitals is anticipated to increase by a net \$47.0 million (\$67.1 million General Fund) and 233 positions (221.4 personnel years) in 2005-06. Significant General Fund adjustments are as follows:

- **State Hospital Population**—The May Revision includes an increase of \$19.3 million General Fund reflecting an increase of 188 new judicially committed/penal code (JC/PC) patients (\$10.1 million) and 100 pre-commitment Sexually Violent Predators (SVPs) that will not be transferred to local custody as was proposed in the Governor’s January Budget (\$9.2 million). Caseload is projected to increase from 5,454 to 5,742 patients. The May Revision also includes an increase of \$20.5 million General Fund and a corresponding \$20.5 million decrease in reimbursements to shift costs of state hospital population growth from Proposition 99 funding to the General Fund.
- **Court-Ordered Conditional Release Program**—A General Fund decrease of \$436,000 to reflect an updated projection of patients to be released from state hospitals into community treatment programs pursuant to a court order for conditional release. The May Revision projects a caseload of nine SVPs, down from 14 projected in the Governor’s January Budget, and 720 other patients, down from 730 in the Governor’s January Budget.
- **SVP Evaluations and Court Testimony**—A reduction of \$102,000 General Fund due primarily to a decrease in the estimated number of SVP recommitment evaluations.

Community Mental Health Services

Current Year

The May Revision includes a reduction of \$73.9 million in reimbursements for community mental health services in 2004-05. The change is comprised of the following major adjustments:

- **Early and Periodic Screening, Diagnosis, and Treatment (EPSDT) Program**—The May Revision includes a reduction of \$71.9 million in reimbursements (\$32.4 million General Fund in the DHS budget), reflecting a revised caseload projection. The May Revision projects a 19.9 percent rate of growth from FY 2003-04 to FY 2004-05, down from 33.1 percent estimated in the Governor’s January Budget. The projection is based on approved claims from FY 2002-03 and FY 2003-04.
- **Healthy Families Program**—Funding for mental health services for Healthy Families Program participants is proposed to decrease by \$2.3 million. This change reflects updated claiming information and county administrative costs.

Budget Year

The May Revision includes an increase of \$128.0 million (\$98.7 million General Fund) in 2005-06 for community mental health services compared to the Governor’s January Budget. Major adjustments include the following:

Expenditures: **Health & Human Services**

- **Mental Health Services to Special Education Pupils (AB 3632)**—An increase of \$90 million General Fund to reimburse counties for prior years costs claimed for the Services to Handicapped Students and Emotionally Disturbed Pupils (AB 3632) mandates. In addition, resources are provided to the State Controller for a multi-year effort to audit county claims for these mandates.
- **EPSDT Program**—The May Revision includes a net increase of \$21.4 million in reimbursements (\$12 million General Fund in the DHS budget) for the EPSDT program. This change reflects two adjustments:
 - Savings of \$117.9 million (\$55.7 million General Fund) due to a decrease in projected claims. The May Revision projects a 4.7 percent rate of growth in 2005-06, down from 10.6 percent estimated in the Governor’s January Budget.
 - An increase of \$139.4 million (\$67.7 million General Fund) for final settlement of county EPSDT cost reports for 2002-03.
- **Mental Health Managed Care Program**—There is a net increase of \$17.4 million (\$8.6 million General Fund) for Mental Health Managed Care. This change primarily reflects the following adjustments:
 - Significant one-time costs of \$19.3 million (\$9.7 million General Fund) to produce and distribute informing materials to Medi-Cal households pursuant to federal Medicaid notification requirements. This is a condition of the Medi-Cal Specialty Mental Health Services Consolidation Waiver that was approved by the federal Centers for Medicaid and Medicare Services (CMS) in April 2005. This outcome is the result of extensive negotiations between the DMH and the CMS to provide partial relief from the original federal requirement, which would have cost over \$350 million to implement.
 - A net decrease of \$2.1 million (\$1.0 million General Fund) for caseload changes such as a decrease in Medi-Cal eligibles and increased inpatient costs.
- **Healthy Families Program**—Funding for mental health services for Healthy Families Program participants is proposed to decrease by \$2.5 million. This change reflects updated claims information and county administrative costs.

Proposition 63 Funds for the Governor’s Chronic Homelessness Initiative

The passage of Proposition 63 provides a unique opportunity for departments within the Health and Human Services and Business, Transportation and Housing Agencies to come together to leverage service dollars and capital bond financing to form the Governor’s Chronic Homelessness Initiative. Existing dollars in the Department of Housing and Community Development (HCD) and the California Housing Finance Agency (CalHFA) along with new Proposition 63 funding will be used to provide resources for the Governor’s Initiative. Proposition 63 will provide \$2.4 million of new funding. These funds would be available for expenditure for two years and would be used for rent subsidies (\$2 million) and to establish collaboratives (\$400,000) at the local level to assist counties in developing projects to promote stable housing for homeless persons. These Proposition 63 funds are in addition to resources provided by HCD and CalHFA to create 400 to 500 units of permanent housing

Expenditures: **Health & Human Services**

with services for chronic homeless populations (veterans, mentally ill, emancipated youth, and drug-addicted individuals).

Department of Alcohol and Drug Programs

2004-05	-\$1.5 million
2005-06	-\$1.1 million

Current Year

Caseload Programs

The May Revision includes a decrease of \$1.6 million General Fund, or 2.7 percent, below the \$58.8 million provided in the Governor's January Budget. This reduction is primarily due to revised estimates for caseload and units of service.

- **Regular Drug Medi-Cal**—Costs are expected to be \$2.7 million General Fund lower than projected in the Governor's January Budget. Caseload is estimated to be 0.5 percent higher than projected in the Governor's January Budget.
- **Perinatal Drug Medi-Cal**—Costs are expected to be \$1.1 million General Fund higher than projected in the Governor's January Budget. Caseload is estimated to be 5.9 percent higher than projected in the Governor's January Budget.

Pursuant to Provision 1 of Items 4200-102-0001 and 4200-103-0001 of the 2004 Budget Act, \$626,000 (\$313,000 General Fund, \$313,000 reimbursements) has been transferred from the Regular Drug Medi-Cal program to the Perinatal Drug Medi-Cal program to mitigate the need for a current year supplemental appropriations bill.

Budget Year

Caseload Programs

The May Revision includes a decrease of \$1.1 million General Fund, or 1.8 percent, below the \$62.8 million provided in the Governor's January Budget. This reduction is primarily due to revised estimates for caseload and units of service. Budget year costs reflect the Governor's Budget proposal to continue funding 2005-06 Drug Medi-Cal rates at the 2002-03 levels.

- **Regular Drug Medi-Cal**—Costs are projected to decrease by \$2.3 million, or 3.7 percent, below the Governor's Budget due to changes in caseload and average units of service. Caseload is projected to increase by 3,229, or 1.9 percent, above the Governor's January Budget. This net change in caseload reflects an increase of 4,351 clients in the Outpatient Drug Free Program, the lowest-cost modality in Regular Drug Medi-Cal, and a decrease of 1,267 in the Narcotic Treatment Program, the highest-cost modality in Regular Drug Medi-Cal.

Expenditures: **Health & Human Services**

- **Perinatal Drug Medi-Cal**—Costs are projected to increase by \$1.2 million General Fund above the Governor’s Budget due to increased estimates for caseload and average units of service. Caseload is projected to increase by 534, or 8.1 percent, above the Governor’s January Budget. This change in caseload reflects a net caseload increase of 643 in the Outpatient Drug Free, Day Care Rehabilitative, and Narcotic Treatment programs, and a decrease in caseload of 109 in the Residential Program.

Dependency Drug Courts

Dependency drug courts help to reduce foster care costs and increase permanency and stability for children by providing substance abuse treatment to parents involved in dependency court cases. These courts have expanded access to substance abuse treatment for parents involved in the child welfare services system. The benefits include increasing the number of families that are reunified, shortening the time to reunification, and reducing the length of stay in foster care. The May Revision includes a one-time augmentation of \$1.1 million in federal Promoting Safe and Stable Families funding to provide continued support to the dependency drug court expansion pilot project in 2005-06 and to fund an evaluation of the cost-effectiveness of the pilot. Specifically, the May Revision includes \$900,000 for the Department of Alcohol and Drug Programs to restore the 2005-06 funding level to \$1.8 million, consistent with the 2004-05 appropriation, and \$200,000 for the Department of Social Services to fund an evaluation of the pilot.

Department of Social Services

2004-05	–\$158.8 million
2005-06	–\$48.7 million

CalWORKs

The 2004-05 average monthly CalWORKs caseload of 491,700 represents a 2.3 percent increase from 2003-04, revised from the Governor’s January Budget estimate of 3.0 percent growth. For 2005-06, the caseload is now expected to be 483,500, a 1.7 percent decrease from the projected 2004-05 caseload. Although the number of cases projected for 2005-06 increased by 10,500 compared to the Governor’s January Budget, the number of persons per case is lower than previously estimated resulting in savings compared to the January estimate.

The May Revision continues to meet the federally required combined state and county Temporary Assistance for Needy Families (TANF) maintenance-of-effort (MOE) of \$2.7 billion. For 2004-05, total CalWORKs-related expenditures are estimated to be \$6.7 billion including the transfer to the Department of Education for child care and county expenditures. For 2005-06, total CalWORKs-related expenditures are anticipated to be \$6.8 billion.

The availability of federal TANF Block Grant funds in May has allowed the Administration to re-evaluate CalWORKs reductions that were previously required to maintain expenditures within the limited

Expenditures: **Health & Human Services**

resources available in January. To emphasize the work orientation of CalWORKS and to promote self-sufficiency of recipients, the Administration proposes to maintain California's earned income disregard at current levels and to invest additional TANF funds to incentivize counties to develop and implement work-oriented strategies as a part of the Pay-for-Performance initiative proposed in the Governor's Budget.

Major changes proposed for 2005-06 include the following:

- **CalWORKs Income Disregard Reduction**—The May Revision includes an increase of \$79.5 million to maintain the CalWORKs income disregard at current levels. The income disregard is a factor in determining CalWORKs continuing eligibility and grant levels, and offers a significant incentive to individuals who comply with program requirements and achieve work.
- **CalWORKs Grant Reduction**—The Governor's January Budget savings of \$212.3 million are reduced by \$52.7 million due to shifting the implementation date for the proposed 6.5 percent reduction in grant levels from July 1, 2005, to October 1, 2005. The three-month delay would allow counties sufficient time to adjust their payment systems to reflect the new grant levels.
- **CalWORKs Sanction Policy**—The Governor's January Budget targeted \$12 million in savings from a strengthened sanction policy, and anticipated a specific proposal this spring following the review of a statutorily required report on the current sanction policy. Due to the vendor's delay in releasing the report, the Administration lacks sufficient information to develop a specific proposal to achieve the targeted savings. Although the May Revision restores the \$12 million in targeted savings, the Administration, upon receipt of the report, will work with advocates, counties, and the Legislature to develop a revised policy that better promotes personal responsibility and self-sufficiency.
- **Pay-for-Performance**—The Administration proposes to set aside \$30 million in TANF Block Grant funds in 2005-06 for allocation to counties in 2006-07 who meet specific CalWORKs program outcomes, instead of withholding 5 percent of the counties' 2005-06 single allocation. This proposal is expected to better focus counties on the goals of increasing both the number of hours worked by CalWORKs recipients and their earnings.

Supplemental Security Income/State Supplementary Payment Program

Total General Fund expenditures for the Supplemental Security Income/State Supplementary Payment Program (SSI/SSP) program are \$3.4 billion in 2004-05 and \$3.5 billion in 2005-06, representing decreases of \$26.7 million in 2004-05 and \$45.4 million in 2005-06 compared to the Governor's January Budget due to lower than expected caseload growth. Caseload for the SSI/SSP program is projected at 1,186,000 recipients in 2004-05 and 1,214,200 recipients in 2005-06, which represents a year-to-year caseload growth of 2.4 percent. These caseload estimates reflect a decrease of 0.2 percent in each year from the Governor's Budget projection. Significant changes in SSI/SSP General Fund expenditures include:

Expenditures: **Health & Human Services**

- A reduction of \$27.6 million in 2004-05 and \$35 million in 2005-06 due to lower caseload and average monthly grant expenditures since the Governor's January Budget.
- Increased General Fund savings of \$12 million in 2005-06 from the Administration's proposal to capture General Fund savings equivalent to the January 2006 SSI/SSP federal cost-of-living adjustment. This is due to a higher federal cost-of-living adjustment factor.
- An increase of \$0.9 million in 2004-05 and \$1.6 million in 2005-06 to reflect costs associated with the delayed implementation of the Cash Assistance Program for Immigrants (CAPI) advocacy services by counties. This program is designed to shift individuals that currently receive state-only CAPI benefits to the federal SSI program.

In-Home Supportive Services

Total General Fund expenditures for the In-Home Supportive Services (IHSS) program are \$1.2 billion in 2004-05 and \$1.0 billion in 2005-06, which represents a decrease of \$5.6 million in 2004-05 and an increase of \$4.4 million in 2005-06 compared to the Governor's January Budget. Caseload is projected to be 348,800 recipients in 2004-05 and 375,000 in 2005-06, which represents a year-to-year caseload growth of 7.5 percent. Significant General Fund adjustments include the following:

- An increase of \$10.6 million General Fund in 2005-06 to continue funding costs associated with applying Medi-Cal share-of-cost rules to certain IHSS recipients. This is consistent with the Administration's intent to protect recipients' access to services under last year's federal Waiver. The Departments of Social Services and Health Services continue to work with counties to implement the Waiver with as little disruption to recipients as possible.
- An increase of \$4.3 million General Fund in 2004-05 due to counties that increased IHSS wages and/or health benefits since the Governor's January Budget. The Administration's proposal to roll back state participation in wages/benefits to the June 30, 2004 levels protects the state from the \$10.5 million General Fund cost in 2005-06 that would result from these increases.
- Decreases of \$9.4 million in 2004-05 and \$6.5 million in 2005-06 due to a lower caseload projection since the Governor's Budget.

The Governor's January Budget included a proposal to develop and implement an IHSS worker telephone tracking system as a means to minimize fraud and abuse in the IHSS program. It was recently determined that the savings realized by other states using similar systems may not be achievable in California given the state's comprehensive Quality Assurance efforts underway. The Administration is withdrawing this proposal at this time to further evaluate the benefits of a telephone tracking system.

Automation Projects

In recognition of the need to mitigate implementation difficulties, such as those experienced by Sacramento County, the May Revision includes an increase of \$3.9 million General Fund in 2005-06 for the Welfare Client Data System (WCDS) project. This funding will provide implementation support for the bulk of the remaining counties yet to convert to the WCDS. These resources will allow for

Expenditures: **Health & Human Services**

a vendor support team, increased training for county expert coaches, and a higher ratio of coaches to caseworkers prior to and during conversion. For those counties that feel extended support for transition activities is necessary, the state will make additional funding available, with a 40 percent county share of the non-federal cost, to maintain support for one month post conversion.

Foster Care

Total General Fund expenditures for the Foster Care Program are \$490.3 million in 2004-05 and \$426.8 million in 2005-06, which represent decreases of \$11.9 million in 2004-05 and \$19.1 million in 2005-06 compared to the Governor's January Budget. Caseload growth in the Foster Care program continues to slow and flatten, indicating reduced entries and increasing exits from the system. The combined \$31 million General Fund decrease is primarily due to a reduced caseload projection and a slight reduction in average grants since the Governor's January Budget. The year-to-year caseload growth is projected to decline 0.5 percent.

Child Welfare Services

Total General Fund expenditures for Child Welfare Services (CWS) are \$589.7 million in 2004-05 and \$629.5 million in 2005-06, which represent decreases of \$23.1 million in 2004-05 and \$15.6 million in 2005-06 compared to the Governor's January Budget. Caseload growth in the CWS program continues to slow and is reporting declines in certain components of the program. The combined \$38.7 million General Fund decrease is due primarily to a lower caseload projection and the transfer of additional federal TANF Block Grant funding to the federal Social Services Block Grant (Title XX) for eligible Family Reunification and Permanent Placement activities since the Governor's January Budget. State law permits Title XX funds to be used in CWS to offset General Fund costs without affecting county funds. The caseload for all CWS program components is projected to decrease by 1.2 percent from 2004-05 to 2005-06.

CWS Outcome Improvement Project

CWS is evolving into an outcome-focused program with the implementation of the new California Outcome and Accountability System (AB 636). The May Revision proposes to redirect 2005-06 funding and any 2004-05 savings to establish a CWS Program Improvement Project. The CWS Program Improvement Project activities reflect an updated implementation strategy developed in consultation with counties and other key stakeholders. The revised strategy better utilizes available resources to improve outcomes for children. Specifically, the revised plan would:

- Continue the implementation and evaluation of CWS Program Improvement Plan (PIP) initiatives that focus on improved safety assessments and increased opportunities for early intervention that are currently underway in the first cohort of 11 counties, funded at the 2004-05 appropriation level.
- Delay the expansion of improvement activities to the second cohort of counties pending a thorough evaluation of the first pilot group.

- Redirect \$5.9 million (\$3.7 million General Fund) originally proposed for PIP expansion activities to support efforts identified by counties in their System Improvement Plans (SIPs) that are intended to improve AB 636 performance and federal improvement measures. Priority will be given for projects and activities that have a positive impact on the safety of children.

The May Revision also includes the reappropriation of unspent federal Promoting Safe and Stable Families and State Children's Trust Fund funding from 2004-05 to 2005-06 to support activities associated with implementation of specific county action plans needed to improve program performance and ongoing PIP initiatives. This revised proposal funds implementation of these county SIPs within budgeted resources and provides sufficient funding to continue critical PIP activities to achieve compliance with federal performance requirements and avoid federal penalties.

Community Care Licensing

The Governor's Budget proposed to eliminate a new statutory requirement to increase the number of visits to licensed community care facilities if citations issued by the Department of Social Services (DSS) exceed the previous year's total by 10 percent. The May Revision proposes to rescind the request to eliminate the statutory requirement. The DSS is currently evaluating data on visits conducted and citations issued in 2004-05. A more comprehensive review is necessary to determine appropriate policy to improve oversight, increase compliance with health and safety standards, and ensure quality care for vulnerable clients in community care facilities. It is important to note that while the ongoing review continues, the DSS will improve the safety of individuals receiving services in licensed facilities by filling nearly 100 vacant positions and taking steps to improve efficiency. The Administration will complete its review and address operational efficiencies and program improvements as part of the 2006-07 Governor's Budget.

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Corrections and Law Enforcement

Youth and Adult Correctional Agency

2004-05	—
2005-06	\$3.1 million

Juvenile Justice Reform—The May Revision proposes \$3.1 million General Fund to begin implementation of a major reform of juvenile justice programs in California, particularly the state’s approach to addressing youthful offenders who pose the greatest risk to public safety. This reform effort will take a long-term strategic approach to reinventing California’s broken juvenile corrections system.

Office of the Inspector General for the Department of Corrections and Rehabilitation

2004-05	—
2005-06	\$7.5 million

Operations of the Office of the Inspector General—The May Revision proposes \$4.1 million General Fund to meet the resource needs of the Office of the Inspector General (OIG) based on a methodology developed to produce a workload-based budget as required by Chapter 733, Statutes of 2004. The OIG has experienced increased workload to meet federal court and statutory demands for additional oversight of the internal affairs and management operations of the California Department of Corrections (CDC) and the California Department of the Youth Authority (CYA).

Youth and Adult Correctional Agency Reorganization Workload—The May Revision proposes \$3.4 million General Fund to implement the additional workload resulting from the Youth and Adult Correctional Agency reorganization. Under this reorganization, the OIG will be required to perform pre-appointment reviews of prospective wardens, audits of each adult correctional institution at least once every four years, and a one year post-appointment audit of new wardens.

Department of Corrections

2004-05	\$19.7 million
2005-06	\$191.4 million

The May Revision proposes an increase of \$191.4 million General Fund for the CDC, which includes the following:

Inmate/Parolee Population/Caseload Changes

Current Year

Based upon the CDC's spring estimates, as well as the most recent actual population data, the May Revision reflects an estimated institutional Average Daily Population (ADP) of 163,025 inmates. This is six more than projected in the Governor's January Budget.

The projected parolee ADP is 113,600. This is an increase of 10,108 from the number projected in the Governor's January Budget.

The Governor's January Budget reflected the impact of the Parole Accountability programs on the institution and parole populations. Specifically, the projected institution and parole populations were revised downward by 465 and 9,862, respectively, in the current year. The May Revision projection reflects a reversal of those impacts and accounts for forecasted population changes. As such, the inmate and parolee population projections are reflective of the current trends, impact of parole programs that have been implemented to date, and a restoration of the 465 institution and 9,862 parole population adjustments assumed in the Governor's January Budget. The net effect of these population changes, as well as current year savings that did not materialize, are increases to the General Fund of \$20.3 million and reimbursements of \$34,000, and a decrease of \$61,000 to the Inmate Welfare Fund.

Budget Year

Based upon the CDC's spring estimates, the May Revision reflects an estimated institutional ADP of 165,249 inmates in 2005-06. This is 2,494 more than projected in the Governor's January Budget.

The projected parolee ADP is 110,335. This is an increase of 13,733 from the number projected in the Governor's January Budget.

Similar to the discussion regarding the current year population projection methodology, the Governor's January Budget reflected revisions to the budget year projections of 1,738 and 15,379 to the institution and parole populations, respectively, associated with the implementation of the Parole Accountability programs. The budget year projection reflects a restoration of those adjustments. In addition, the CDC projects increases to the inmate population due to an increase in new admissions from court and

Expenditures: **Corrections and Law Enforcement**

parole violators returned with new terms (PV-WNT), offset by a decrease in parole violators returned to custody (PV-RTC). In addition, the number of new admissions from court during 2004 was 48,938, a 6.2 percent increase over the previous year. There were also 9,214 PV-WNT returns during the period from July to December 2004, an increase of 1,156 (14.3 percent) compared to the same time period one year earlier. With respect to the parole population, the CDC indicates that the parole population is expected to increase, due to an increase in new admissions to prison and a decrease in the length of stay in prison. The net effect of the population changes, as well as projected savings that did not materialize, are increases of \$85.4 million to the General Fund, \$570,000 to the Inmate Welfare Fund, and \$79,000 to Reimbursements.

Critical Staffing and Facility Needs at the California Institution for Men—An increase of \$5.8 million General Fund to increase staff, improve staff and inmate safety, and address critical physical plant deficiencies. A review of the California Institution for Men’s reception center staffing indicated that it was comparatively less than similarly designed reception centers of the same age. As such, 46 positions are included as critical for the timely and safe processing of inmates in the reception center and related areas. This is consistent with the audit findings from the Board of Corrections (BOC) and the OIG.

In addition, funding for modifications and repairs to the physical plant in the reception areas is proposed. Specifically, the funding is to modify the cell doors with cuff ports and replace cell and dayroom windows with security windows.

Revised Unallocated Reduction and Program Augmentation—The Governor’s January Budget proposed a \$95.3 million General Fund unallocated reduction to the CDC. At that time, the reduction was directed towards inmate and parolee programs, but specific areas and positions were not identified. The Administration has reviewed the current parolee and inmate programs and proposes to reduce and/or eliminate those programs that have proven extremely difficult to implement and do not improve public safety, as outlined in the Youth and Adult Correctional Agency Strategic Plan. Therefore, the Administration has revised the proposed reduction and identified specific areas that will be impacted. Special consideration was given to those programs that have demonstrated an ability to achieve the goals defined in the adopted Strategic Plan. Consistent with this approach, the Administration proposes to restore \$51.2 million General Fund, resulting in a net reduction of \$44.1 million General Fund to the CDC budget.

Furthermore, the Administration proposes to return to the Legislature with a plan to provide inmates and parolees with expanded evidence-based programs that improve public safety and reduce victimization by reducing recidivism and preparing inmates to transition back into the community. As such, the May Revision proposes an augmentation of \$15 million General Fund (\$30 million ongoing), for the purpose of increasing and/or modifying existing programs or developing new programs that meet the goals of the Strategic Plan. These funds will not be available for expenditure by the CDC until such time as the plan has been submitted to the Legislature.

Expenditures: **Corrections and Law Enforcement**

Improvements in the Dental Program—The May Revision proposes an increase of \$17.3 million General Fund to implement improvements in the dental program as an effort to prevent a class action lawsuit. These funds will provide additional dental assistants and office technicians, establish the Dental Quality Management Assessment Team, and provide dental equipment and supplies to begin implementation of a comprehensive dental health delivery system.

Changes in Mental Health Services and Staffing—In order to comply with a court order issued under the Coleman lawsuit on March 7, 2005, the May Revision proposes an increase of \$5.2 million General Fund. These funds will be used to implement the revised guidelines for the mental health service delivery system in the Administrative Segregation Unit and Security Housing Unit at the California State Prison-Corcoran and to fund recruitment and retention pay differentials for mental health positions at 12 institutions.

Reduction of Plata Settlement Costs—The May Revision reflects \$10.6 million in General Fund savings to the Plata settlement costs that were included in the Governor’s January Budget. This is due to the updated information that resulted in decreased staffing needs and contracting costs.

Department of the Youth Authority

2004-05	\$18.8 million
2005-06	\$13.5 million

The May Revision proposes an increase of \$13.5 million General Fund for the CYA, which includes the following:

Ward/Parolee Population/Caseload Changes

Current Year

For 2004-05, the May Revision estimate for the year-end institution population is 3,040, a decrease of 390 wards from the projection included in the Governor’s January Budget. Despite this population decline, due to a decrease in the level of county reimbursements, a need to adjust the reimbursement base in other areas to reflect actual collections, and errors identified in the way the CYA budgeted prior year institution closures, a General Fund increase of \$15.1 million will be needed and reimbursements will be decreased by \$11.5 million. In addition, the Governor’s January Budget had included the anticipated closure of three fire camps effective March 1, 2005. Due to labor issues, the May Revision now reflects a June 1, 2005 closure date, and an increase of \$1.5 million General Fund. In addition, the year-end parole population is projected to be 3,775, a decrease of 15 parolees from the Governor’s January Budget projection. However, due to an increase in the number of parolees that require more staff intensive re-entry services, an increase of \$27,000 General Fund is proposed. The net impact of the population adjustment is an increase of \$3.6 million, composed of an additional \$15.1 million General Fund and a \$11.5 million decrease in reimbursements.

Expenditures: **Corrections and Law Enforcement**

Budget Year

For 2005-06, the year-end institution population is projected to be 2,615, a decrease of 715 wards from the projection included in the Governor's January Budget. Additionally, the year-end parole population is now estimated to be 3,375, a decrease of 75 parolees since the Governor's January Budget estimates. These decreases will result in a net program reduction of \$3.3 million. However, due to a decrease in the level of county reimbursements, a need to adjust the reimbursement base in other areas to reflect actual collections, and errors identified in the way the CYA budgeted prior year institution closures, a General Fund increase of \$6.6 million will be needed and reimbursements will be decreased by \$9.8 million.

Farrell v. Allen Remedial Plans—In 2002, the Prison Law Office sued the State of California over the conditions of confinement at facilities statewide. The lawsuit, *Farrell v. Allen*, sought a comprehensive overhaul of CYA programs. In July 2004, the state entered into a consent decree to settle this lawsuit. The consent decree requires CYA to develop and implement remedial plans that address various deficiencies in CYA's education programs, medical care, mental health services, sex offender treatment, accessibility for wards with disabilities, and general ward safety and welfare.

The May Revision includes \$6.8 million General Fund to implement remedial plans submitted to the court in April and May 2005. These plans address the areas of mental health, sex offender treatment, and disabilities. An April 1 Finance Letter was also submitted requesting funding for the implementation of the education remedial plan that was submitted to the court in March 2004. Final remedial plans in the areas of medical care, mental health, and general ward safety and welfare are currently being developed and are not due to the court until fall of 2005. Until these plans are complete, the fiscal implications of these plans will not be known.

Juvenile Justice Crime Prevention Act

2004-05	—
2005-06	\$1.1 million

The Governor's January Budget proposed a reduction of \$75 million General Fund in the Juvenile Justice Crime Prevention Act (JJCPA) funding, previously budgeted as part of Local Government Financing, and shifted the remaining \$25 million General Fund to the BOC. The May Revision proposes to restore this funding, but achieve a one-time General Fund savings of \$73.9 million General Fund by adjusting the timing of the allocation of JJCPA funding to local governments to be more consistent with the time frames in which it is actually spent. This will not result in any reductions in the local JJCPA programs.

Due to the way this program was initially implemented, counties receive these funds early in the fiscal year, but are not able to expend them until their JJCPA expenditure plan is approved by the BOC in April or May each year. As a result, state funding for this program is distributed to counties almost a

Expenditures: **Corrections and Law Enforcement**

year in advance of when it is actually needed. Prior to expenditure, counties can collect interest on these funds as long as the additional income is ultimately spent on the JJCPA programs. In order to achieve one-time savings and restore full funding for this program in future years, the May Revision proposes the following:

- Shift \$25 million General Fund in JJCPA funding from BOC back to the Local Government Financing budget for allocation on April 1, 2006, providing only the three months of funding needed to fund these programs during the Fiscal Year.
- Increase the Local Government Financing budget by \$1.1 million General Fund on a one-time basis to provide counties with interest lost on the nine months of funding they will not receive in fiscal year 2005-06.
- Restore the full \$100 million General Fund allocation for JJCPA beginning in fiscal year 2006-07.

Additionally, the Administration proposes to withdraw the Trailer Bill proposal that would have de-linked the JJCPA and Citizens' Option for Public Safety (COPS) funding and propose necessary Budget Bill language to ensure that the one-time change in JJCPA allocations can occur without affecting the proposed level of COPS funding.

Board of Prison Terms

2004-05	—
2005-06	\$1.9 million

The May Revision proposes a net increase of \$1.9 million General Fund for the Board of Prison Terms, which includes the following adjustment:

Parole Revocation Caseload—The May Revision proposes \$2.1 million General Fund to meet the increased caseload projection for processing parole revocation cases. The parole revocation caseload projection reflects an increase from 85,000, as proposed in the Governor's January Budget, to 89,656.

Department of Corrections and Rehabilitation

2004-05	—
2005-06	—

The May Revision reflects the Governor's Reorganization Plan for the consolidation of the departments and boards under the Youth and Adult Correctional Agency into the new Department of Corrections and Rehabilitation (DCR). This is reflected through the deletion of the current appropriations for the Youth and Adult Correctional Agency, Department of Corrections, Board of Corrections, Board of Prison Terms, Department of the Youth Authority, and the Commission on Correctional Peace Officer's Standards and Training and the addition of appropriations for the DCR.

Department of Justice

2004-05	\$1.8 million
2005-06	\$2.0 million

DNA Fingerprint, Unsolved Crime, and Innocence Protection Act (Proposition 69)—With the passage of Proposition 69, DNA information for every felon, including those currently incarcerated or on probation or parole, will be collected and contained in the state’s DNA Data Bank. The January Governor’s Budget proposed \$11.2 million from the DNA Identification Fund and 45.6 positions in 2005-06 for the Department of Justice (DOJ) to address workload resulting from expanded collections of DNA, palm prints, and thumbprints. Based on an increased number of DNA samples that the DOJ expects to process in 2005-06, the May Revision includes an augmentation of \$6.7 million, comprised of \$2 million General Fund and \$4.7 million DNA Identification Fund, and 24.7 positions.

Office of Homeland Security

2004-05	—
2005-06	—

Establishing the Office of Homeland Security—The Administration is proposing legislation that would establish the California Office of Homeland Security (OHS) as a new state agency. Currently, the OHS exists as a program within the Office of Emergency Services (OES). In addition, the Administration is proposing to increase Federal Trust Fund authority for OHS activities by \$146.4 million. The proposed increase includes \$29.3 million Federal Trust Fund for state operations to support homeland security activities performed by other state agencies and provide an additional 20 positions to ensure that the OHS has sufficient resources to operate as an independent agency. The remaining \$117.1 million will be allocated to budget to local agencies for homeland security activities for fiscal year 2005-06.

Office of Emergency Services

2004-05	\$22.3 million
2005-06	\$40.1 million

Southern California Winter Storms—The May Revision proposes a \$35 million General Fund increase in 2005-06 for the estimated costs of response and recovery efforts related to recent federally declared disasters in Southern California. Two heavy storms caused flooding, debris flows, and building and infrastructure damage to seven counties in Southern California in late 2004 and early 2005. This increase will fund the state’s share of the costs associated with these disasters. The increased costs of these disasters in 2004-05 are funded through statutory authority.

Expenditures: **Corrections and Law Enforcement**

Fire Engines for Mutual Aid Support—The May Revision proposes an increase of \$5 million General Fund in 2005-06 to purchase new fire engines for mutual aid support, consistent with the recommendations of the Governor’s Blue Ribbon Fire Commission which was formed following the 2003 Southern California wildfires. These engines will be housed at local fire departments and staffed by local personnel. Additional engines placed in communities throughout the state will improve the ability of state and local agencies to respond to wildfires, particularly those in Wildland/Urban Interface areas where fires can have a devastating effect on people, property, and communities. There is a related issue under the Resources and Energy section in this report which also proposes \$5 million General Fund for the California Department of Forestry and Fire Protection to purchase fire engines.

Resources and Energy

CALFED Bay-Delta Program

Effective management of our water resources is essential to the future of California's economy and environment. The recently released public review draft of the California Water Plan outlines a new vision for California's water resources. The Water Plan recognizes our progress and provides a framework to build upon past accomplishments. It identifies many important water management strategies throughout the state that must be developed, maintained, and financed to meet the needs of Californians into the 21st century. The Secretary for Resources has been directed to work with the Secretaries for Food and Agriculture, Environmental Protection, and the Chair of the California Bay-Delta Authority to develop a long-term strategy for stable water resource investment funding. This long-term funding strategy will ensure that we continue to improve water supply reliability, protect water quality, and restore our ecosystems to support California's needs.

The CALFED Bay-Delta Program continues to play an important role in meeting California's future water needs. CALFED must be a part of the long-term water resource investment strategy for the state. Consistent with the commitment in the Governor's Budget, a three-point plan has been developed that will allow the CALFED Program to move forward and focus on addressing the highest priority issues associated with the conflicts in the Delta:

Independent Review—Consistent with the recommendations of the California Performance Review (CPR), the May Revision calls for an independent program and fiscal review of the CALFED Program to ensure accountability, highlight accomplishments, determine program status, and guide adjustments to the Program. The May Revision proposes to increase the Resources Agency budget by \$300,000 for purposes of contracting to support this review.

Program Priorities—Re-focus the efforts of the California Bay-Delta Authority and the other CALFED state agencies on solving conflicts associated with Delta water supply, water quality, levee stability, and the environment. Program priorities will be reinforced in a ten-year action plan as described below.

Financing—The CALFED Program needs a credible budget for the coming year and it needs a clear plan for the next ten years. The Governor is calling for the development of a ten-year action plan, to be developed in coordination with stakeholders and our federal partners. This action plan must focus on solving the highest priority Delta issues, link future water user payments to specific program actions

Expenditures: **Resources and Energy**

that improve water supply reliability, balance statewide actions with regional water management, and include funding from the state, federal, and local levels consistent with the beneficiaries-pay principle. This plan will include payments from water users to the Ecosystem Restoration Program and other programs in proportion to the direct benefits derived.

While the ten-year action plan is being developed, it is essential to have a credible budget for the coming year. This budget must reflect contributions from water users. The May Revision requests an increase of up to \$30 million in reimbursement authority in the budget of the Department of Fish and Game to accommodate user contributions which may be necessary to further the recovery of at-risk native fish.

The federal government is California's partner in the implementation of the CALFED Program. Working with the California Bay-Delta Authority, the Governor plans to request an additional \$40 million in the federal fiscal year 2006 federal budget for the CALFED Program, for a total request of \$100 million.

A major benefit of the CALFED Program has been a reduction in conflict and an increase in certainty regarding program implementation and balance. Over the next two years, water user and federal contributions to support the Program will be focused on actions that support the existing Conservation Agreement as described in the CALFED Record of Decision.

Related Activities—CALFED programs must be further integrated into our resource management efforts. To further this integration, the Governor is directing the CALFED implementing agencies to work diligently on related efforts such as:

- Implementation of the Lower Yuba River Accord to improve environmental conditions for native fish species and provide the first long-term Environmental Water Account asset as directed in Proposition 50.
- Negotiation of partnerships south of the Delta, including development of long-term EWA assets, in order to produce integrated improvements for water supply reliability, water quality, and ecosystem health.
- Legacy investment of bond funds to ensure continuing measurable benefits for, and recovery of, at-risk native fish species, and creative assistance for regions as they implement integrated regional water management.

Frontier Transmission Line Project

The May Revision proposes an increase of \$2.5 million Energy Resources Programs Account for California's participation in the Frontier Transmission Line Project.

In April 2005, the governors of California, Nevada, Utah, and Wyoming signed an agreement to create a four-state partnership to develop a transmission line originating in Wyoming with terminal connections in the other three states. The agreement specified that each state would contribute initial funding to support the Coordinating Committee and hire the necessary technical and legal consultants

to begin work on the project and bring it to a point where developer(s) will take over and fund the remaining feasibility work. In the long-run, the new line will provide Northern and Southern California with additional power to meet its future energy needs.

Tidelands Oil Revenues

California receives a share of the revenues that result from the sale of oil recovered from state tidelands. The major site of recovery is Long Beach, where the state, the City of Long Beach, and a private oil company have partnered to recover oil in an environmentally safe manner. One issue that has arisen in relation to this activity is the question of how to pay for the future costs of abandoning the oil field. These costs, which will likely include the removal of several man-made islands off the coast of Long Beach, are expected to be several hundred million dollars. In order to prepare for this cost, the City of Long Beach, which manages the field, began to set aside about \$2 million per month in an Abandonment Fund. Although the state challenged this practice, and requested that the \$83 million already set aside be returned to it, the California Court of Appeal ruled that the City's action is permissible under state law. As a result, the state's Tideland Oil revenues will be \$47.3 million lower in the current year than anticipated in the 2004 Budget Act. In 2005-06, the City will set aside \$4 million per month, which will cause the state's Tideland Oil revenues to fall by \$48 million. Since these revenues would otherwise have gone to the General Fund, the City's action will result in a two-year loss of General Fund revenue totalling \$95.3 million.

Paterno Settlement

A 1986 levee break in Yuba County flooded 7,000 acres of land in the communities of Linda and Olivehurst. Residents and businesses filed suit against the Department of Water Resources, which was found responsible for the break by the California Court of Appeal even though it did not build the levee and was not responsible for its maintenance. Settlement negotiations led to an agreement that the state would pay \$464 million in three segments: \$11 million for damages to the Peach Tree Mall; \$25 million for damages to the tenants of the Peach Tree Mall; and \$428 million for damages to approximately 3,000 individuals. The plaintiffs have agreed to sell their claim for the latter amount for a lump sum to Merrill-Lynch. The first year's payment, of \$67 million, will be made during 2005-06.

Enhancing Fire Fighting Capability

After the extensive wildfires in Southern California during 2003, the Blue Ribbon Fire Commission evaluated California's ability to respond to wildfires, and recommended options for improvement. One of the highest priority actions recommended by the Commission is the replacement of 155 obsolete fire engines. The Governor's Budget included \$10.8 million to enable the Department of Forestry and Fire Protection to begin this effort by funding up to 40 fire engines. This funding will continue in future years, with a goal of eventually replacing all outmoded fire engines and ancillary fire fighting

vehicles. In order to accelerate this process, the May Revision proposes to spend \$5 million more to replace an additional 19 engines, thereby enhancing the Department's ability to respond quickly to wildfire threats. In a related action to improve California's fire protection, the May Revision restores a \$6.7 million unallocated reduction in the Department's budget, thereby assuring the maximum number of fire fighters will be available during the 2005-06 fire season.

Carl Moyer Program

The May Revision proposes an augmentation of \$12.5 million Air Pollution Control Fund for the Carl Moyer Program, which provides incentive grants to reduce emissions from heavy-duty diesel-powered vehicles and equipment. The Carl Moyer Program assists projects that produce emission reductions from diesel sources such as on-road vehicles, agricultural pumps, forklifts, marine vessels, off-road equipment, and locomotives. Including the \$86 million proposed in the Governor's Budget, a total of \$98.5 million of state funding will be available for Carl Moyer grants in 2005-06. This funding demonstrates the Administration's commitment to reducing air pollution and ensuring the state meets air quality standards.

Business, Transportation, and Housing

Office of the Secretary of Business, Transportation, and Housing

2004-05	—
2005-06	\$0.5 million

Cinema Scout—The May Revision proposes \$500,000 for an upgrade of the servers and software that support the state’s film location database to make it quicker and easier for filmmakers to find sites for filming in California.

Department of Transportation

2004-05	—
2005-06	\$1.3 billion

California’s transportation funding, even including the local sales taxes enacted in many areas of the state, has been falling behind the rate of increase of driving for decades. More and more of the revenues have been used just to maintain what is an aging infrastructure and to make seismic safety upgrades, rather than to build new roads. This has led to significant increases in congestion. In recognition of this, the voters passed Proposition 42 in 2002, requiring that state sales and use taxes on the sale of motor vehicle fuel be used for public transportation, city and county street and road repairs and improvements, and state highway improvements. Proposition 42 was partially suspended in the 2003 Budget Act and fully suspended in the 2004 Budget Act. With the revenues produced by the improving California economy, the May Revision proposes full funding of Proposition 42 in 2005-06. Combined with \$1 billion promised from tribal gaming revenues when they become available and \$250 million previously budgeted for state staff and operations costs that have been freed up by the new leadership of Caltrans, almost \$2.6 billion more in funds for transportation projects would be provided. This will further expand California’s economy by producing construction jobs in the short run and reducing congestion to speed up goods movement and allow people to spend less time sitting on the freeway and more time with their families at home.

Expenditures: **Business, Transportation, and Housing**

The Governor's current legislative budget control proposal, ACA 4, First Extraordinary Session, would prohibit further suspension of Proposition 42, beginning in 2007-08. Furthermore, ACA 4, First Extraordinary Session, provides for repayment of all past Proposition 42 suspensions in equal annual increments no later than 2021-22.

Proposition 42 Transfer—The Governor's January Budget proposed the full suspension of the 2005-06 Proposition 42 sales tax transfer with repayment over 15 years. The availability of additional one-time revenues now instead permits the Administration to propose \$1.313 billion, the full amount of the Proposition 42 transfer to the Transportation Investment Fund with the following allocation, pursuant to existing law:

- \$678 million to the Traffic Congestion Relief Fund.
- \$254 million to the Transportation Investment Fund (for State Transportation Investment Program projects).
- \$127 million to the Public Transportation Account.
- \$254 million for local streets and roads.

These funds, in combination with the proceeds of the tribal gaming bonds when they become available, would provide nearly a 28 percent increase in state budget funds for transportation over the 2004-05 level. In allocating any additional transportation monies, the Business, Transportation and Housing Agency will work with the California Transportation Commission to give priority to projects with the highest economic impact.

Caltrans Operational Savings—Caltrans has achieved \$51.6 million in current year operational savings, and will achieve permanent savings of \$50 million beginning in 2005-06. These savings are proposed to be redirected towards transportation projects, and would result in the California Transportation Commission being able to program \$251.6 million in additional capital outlay projects in the 2006 Fund Estimate. This more than offsets the reduction in Tribal Gaming revenues discussed below.

Tribal Gaming Bonds—Due to litigation that has been filed against the state, the Governor's January Budget assumed the bonds would be sold in 2005-06 rather than in 2004-05 as was originally anticipated. The Governor's January Budget also assumed that there would be additional compacts negotiated so that the bond proceeds would be sufficient to repay the entire loan amount due to the Traffic Congestion Relief Fund no later than June 30, 2006. The May Revision proposes to reduce the amount that the tribal gaming revenue securitization is expected to generate by \$222 million, reflecting the absence of any new compacts at this time, while not intending to suggest that there will not be additional compacts adopted. Our new assumption is that the bonds and revenues collected prior to issuance will generate \$1 billion. The remaining \$222 million will either be repaid from additional compact revenues to be dedicated to transportation when they are negotiated, or no later than 2021 under the provisions of ACA 4, First Extraordinary Session.

Expenditures: **Business, Transportation, and Housing**

GoCalifornia Legislation—The Administration has sponsored three pieces of legislation related to its GoCalifornia initiative:

- **AB 850**—This proposal will allow Caltrans to accept private sector investment and authorize franchise agreements with the private sector so that they may then charge tolls to recoup their investment. This proposal would authorize Caltrans to construct and operate value-pricing programs involving High Occupancy Toll (HOT) lanes. In High Occupancy Vehicle (HOV) lanes where ample space is available and travel time can be reduced, HOT lanes can provide an alternative source of revenue by allowing single occupancy vehicles access to those lanes at a flat rate.
- **AB 1266**—Design-sequencing is an approach to construction projects that permits construction activities to begin prior to the full completion of the design phase. This approach is used today in the private sector very successfully.
- **SB 705**—The design-build process will allow Caltrans to select a contractor that will complete both the project design and construction under one agreement. Currently, Caltrans uses the “design-bid-build” process, which utilizes Caltrans engineers to design the project and then awards the construction to a private firm.

The May Revision proposes that these measures be considered budget trailer bills and link their passage to the availability of the Proposition 42 funds. The three-bill GoCalifornia legislative package, along with the Governor’s proposed budget reform Constitutional Amendment, will streamline project delivery, allow for innovative financing, and protect transportation funding.

The Governor’s Budget acknowledged the interrelationship between transportation policy and transportation investment and responsible land use policy. The Governor’s Budget stated the following:

“Transportation policy and investment also must be linked to responsible land use policy. Poor coordination of job generation and housing production has led to more vehicle miles traveled and growth in single-occupant vehicle trips. Community planning should foster more accessibility to services by alternative transportation systems, including pedestrian and bike traffic. The congestion that results from disconnected policy and planning threatens Californians’ health, economy, and environment. Better community design will reduce vehicle trips and decrease demand on the transportation system, helping relieve congestion and lowering pollution emissions. Needed investments in road construction can then have the greatest impact on mobility and economic prosperity.”

Regional Blueprint Plans—To facilitate better community design, the May Revision also proposes to increase federal authority by \$5 million to provide grants to metropolitan planning organizations (MPOs) to produce regional “blueprint” planning documents. MPOs, in cooperation with the Councils of Government, may voluntarily apply for grants to develop plans that will guide future development and land use decisions to promote economic development, while protecting the environment, promoting healthy cities, and reducing unnecessary travel demand. Additionally, the Administration is working with local government and other stakeholders to develop legislation to authorize a revolving

Expenditures: **Business, Transportation, and Housing**

loan program to fund local General Plan revisions to accommodate more housing, consistent with the improved transportation planning.

Department of Motor Vehicles

2004-05	—
2005-06	\$4.1 million

Verification of Insurance—The May Revision proposes \$4.1 million and 9.5 positions to implement Chapter 920 (SB 1500) and Chapter 948 (AB 2709), Statutes of 2004, which provide for mandatory electronic reporting of vehicle insurance changes and making this information available to law enforcement. The Administration also proposes trailer bill language to extend the implementation of the registration suspension provisions to July 1, 2007, in order to provide the Department of Motor Vehicles (DMV) sufficient time to implement the mandates imposed by these measures.

Chapter 920 requires the DMV to verify insurance has been obtained within 30 days after issuance of a registration card and to suspend, cancel, or revoke the registration of a vehicle when it is determined that the vehicle registration was attained by providing false evidence of financial responsibility or upon notification by an insurance company that the required coverage has been canceled and not reinstated within designated timeframes. Chapter 948 requires the DMV to develop methods by which law enforcement officers may verify that the DMV has received an electronic notification that a policy or bond for the motor vehicle has been issued.

Funding is proposed in the 2005-06 fiscal year for information technology systems development to prepare to implement the bills' provisions.

Department of Housing and Community Development

2004-05	—
2005-06	\$1.0 million

Addressing the Chronically Homeless Initiative—The May Revision includes \$750,000 from the General Fund for technical assistance and predevelopment loans to assist in the creation of shelter and services for chronically homeless persons. As much as \$40 million remaining unused from the last housing bond will be redirected to lend to developers of housing for the mentally ill. These funds will leverage existing tax credits and local funding. Integrated with this is a redirection of \$2.4 million of new Proposition 63 funds to provide rent subsidies and establish collaboratives at the local level to assist counties in developing projects to promote stable housing for homeless persons. It is expected that local government will also contribute from their Proposition 63 funding to provide needed services. The May Revision also includes \$250,000 from the General Fund for interagency coordination of efforts to assist the homeless.

General Government

Office of the State Inspector General

2004-05	—
2005-06	\$2.3 million

Office of the State Inspector General—The May Revision proposes \$2.3 million to establish the Office of the State Inspector General. The Office will be available to conduct audit, investigation and program review functions to provide increased accountability, integrity, and oversight of Executive Branch agencies and to identify and deter illegality and waste. The Office will be led by the State Inspector General, who will report directly to the Governor. The State Inspector General will be appointed by the Governor, subject to confirmation by the Senate. The State Inspector General will report the findings of the Office’s work to the Governor, the Legislature, agency administrators, and the public. The State Inspector General will also report criminal investigative matters to the appropriate law enforcement and prosecutorial agencies. Within 60 days of the end of each fiscal year, the State Inspector General will issue an annual report that separately lists audit and review reports and other investigative or assistance efforts completed during the fiscal year. The report will be provided to the Governor, the Legislature, and the public. The jurisdiction of the Office of the State Inspector General extends to the Governor, his staff, state agencies, departments, boards, commissions, and any other entities appointed, employed, controlled, directed, or subject to the authority of the Governor, with the exception of the Department of Corrections and Rehabilitation, and its constituent entities, which will continue to be under the jurisdiction of the Inspector General for the Department of Corrections and Rehabilitation.

Approximately 50 percent of the costs of the Office of the State Inspector General will be recovered through assessments on special and federal funds.

Employment Development Department

2004-05	—
2005-06	\$5.0 million

Expenditures: **General Government**

Nursing Education Initiative—The May Revision proposes to augment the Employment Development Department by \$5.0 million, to provide loan forgiveness to graduate nursing students who commit to serve as nursing faculty, and to create regional simulation laboratories that will offer greater student access to clinical education facilities. This augmentation, coupled with an additional commitment of \$5.0 million in Employment Training funds for nursing pre-apprenticeship programs, is estimated to generate an additional 1,360 nurses each year.

Department of Veterans Affairs

2004-05	—
2005-06	\$0.9 million

The May Revision proposes partial restoration of the unallocated reduction proposed in the Governor's January Budget. In order to prevent a reduction in services to veterans residing in California's Veteran's Homes, the May Revision includes \$876,000 General Fund.

Department of Consumer Affairs

2004-05	—
2005-06	\$0.4 million

Identity Theft Education and Outreach—The May Revision proposes to augment the Office of Privacy Protection by \$446,000 to implement recommendations from the Governor's recent statewide summit on identity theft. The recommendations call for an aggressive education and outreach program, to protect consumers against identity theft.

Franchise Tax Board

2004-05	—
2005-06	-\$2.9 million

Phase III Office Complex Debt Service Payments—The May Revision proposes an increase of \$1.9 million General Fund to make payments on bonds issued to pay for the construction of the Phase III Office Complex.

Reduction in Phase III Office Complex Occupancy Costs—The Franchise Tax Board has lowered its estimate of Phase III Office Complex occupancy costs from \$7.6 million General Fund to \$3.8 million General Fund. The May Revision proposes to reduce the Board's budget by \$3.8 million to reflect the revised occupancy cost estimate.

California Child Support Automation System (CCSAS) Carryover Adjustment—The May Revision proposes a decrease of \$1.2 million General Fund in the amount proposed for the CCSAS project in 2005-06. This reflects the availability of a like amount of carryover funds from 2004-05.

Other minor changes bring the total changes in the Franchise Tax Board’s budget to a net savings of \$2.9 million.

Office of Administrative Law

2004-05	—
2005-06	\$0.2 million

Enforcement of Underground Regulations—The May Revision includes an augmentation of \$224,000 General Fund and 2.0 positions for the Office of Administrative Law to implement a 2003 Executive Order to determine whether particular state rules, guidelines, and other documents, are in fact regulations subject to the regulatory review process and to enforce provisions of the Government Code that restrict state agencies from issuing, utilizing, or enforcing “underground regulations.”

Tax Relief

2004-05	—
2005-06	\$136.6 million

Senior Citizens’ Property Tax Assistance Program—The May Revision proposes to restore \$40.6 million in funding for the Senior Citizens’ Property Tax Assistance Program and withdraw the proposal to replace this program with an increase in the Property Tax Deferral Program (a reduction of \$4.7 million).

Senior Citizens’ Renters’ Tax Assistance Program—Full funding is also proposed to be restored for the Senior Citizens’ Renters Tax Assistance Program. Thus, this item is increased by \$100.8 million.

Local Government Financing

2004-05	-\$3.2 million
2005-06	\$614.4 million

Partial Vehicle License Fee Gap Loan Repayment—The May Revision proposes to repay cities and counties for \$593.4 million (about half) of the vehicle license fees (VLF) that they did not receive in 2003-04 due to suspension of the VLF offset. Payment of the VLF gap loan is not required until 2006-07, but prepaying half of it in 2005-06 will relieve state budget pressure in that year by reducing debt and spreading the additional revenues to local governments over two fiscal years.

Expenditures: **General Government**

Property Tax Administration Grant Program—The May Revision proposes an increase of \$2.5 million General Fund. This partially restores a reduction made in the Governor’s January Budget. Counties where Grant funds result in increased property tax revenues to offset the state’s Proposition 98 General Fund costs will be funded at the statutory level. Funding for counties not generating savings to the state is proposed to be eliminated as follows:

- Elimination of \$3 million in Grant funds for Marin and San Mateo Counties. Since these are basic aid counties, none of the property tax revenues that they generate with Grant funds are available to offset the state’s Proposition 98 General Fund obligation.
- Elimination of \$182,000 in Grant funds for five counties that have not submitted applications since the inception of the Grant Program. The five impacted counties are Alpine (\$3,124), Inyo (\$100,080), Mariposa (\$46,476), Sierra (\$7,383), and Trinity (\$24,913).

Small/Rural Sheriffs’ Program—The May Revision proposes to restore \$18.5 million in funding for the small and rural sheriffs’ program, which provides \$500,000 grants to the county sheriffs of 37 specified counties.

State Personnel Board

2004-05	—
2005-06	\$18.1 million

Peace Officer Procedural Bill of Rights Mandate—The May Revision proposes to provide funding for the Peace Officer Procedural Bill of Rights (POBOR) mandate. This mandate has been deferred since fiscal year 2001-02. The POBOR provides a series of rights and procedural protections to peace officers who are subject to interrogation or discipline by their employer.

Statewide Issues

Augmentation for Employee Compensation

2004-05	No Change
2005-06	-\$36.2 million (\$18.0 million all funds)

The Governor's Budget includes funding for salary increases required under current contract obligations for a number of bargaining units, including highway patrol, correctional peace officers, firefighters, engineers, crafts and maintenance, and psychiatric technicians. An increase of \$63.6 million (\$2.5 million General Fund) is included for Bargaining Unit 9 (Engineers) as required by the salary parity provisions in their contract. An increase of \$11.5 million (\$3.8 million General Fund) for Bargaining Unit 12 (Crafts and Trades) will increase the state's contributions for health care as a result of an arbitration settlement that, if not resolved, would have resulted in significant increases in expenditures for the Department of Corrections.

A savings of \$13.6 million from the Motor Vehicle Account is a result of a lower than estimated salary increase for Bargaining Unit 5 (Highway Patrol) based on the results of the annual highway patrol salary survey. Because the contract for Unit 6 is tied to the adjustments for Unit 5, there will be an associated reduction of \$44.7 million General Fund in the amount required for the contract.

The Administration is continuing to bargain with the exclusive representatives of the 13 collective bargaining units whose contracts have already expired or will expire in July 2005. The Administration is willing and prepared to engage in meaningful negotiations with the goal of achieving the areas of reform identified in the Governor's Budget, while recognizing that this is a bilateral process. It is the Administration's desire that these negotiations be completed in time to include any costs and savings in the 2005-06 final Budget.

Health and Dental Benefits for Annuitants

2004-05	\$8.4 million
2005-06	\$34.5 million

Current year enrollments are higher than estimated in the Governor's Budget. An increase of \$8.4 million is required to fund fully the costs of health care contributions for retirees.

Expenditures: **Statewide Issues**

The Governor's Budget proposed a reduction of \$34.5 million from this appropriation for 2005-06 in anticipation of savings in pharmaceutical costs resulting from the Medicare Modernization Act. It has since been determined that the savings will not accrue during the 2005-06 fiscal year. The savings will be in the form of reimbursements from the federal government that will not be received before September 2006. While the Medicare Modernization will provide savings in the future, those savings will not reduce the state's costs for annuitants' health care during 2005-06.

Rural Health Care Equity Program

2004-05	No Change
2005-06	\$1.1 million

An increase of \$1.1 million is provided to meet increased enrollments and an increase on the Medicare Part B premiums for retirees. The unexpended balances from prior year appropriations for the Rural Health Care Equity Program Administration totaling \$15.3 million will revert to the General Fund on June 30, 2005. The Administration proposes to appropriate, without regard to fiscal year, that amount to satisfy the state's continuing obligation to this program. Based on historical data, no new expenditures are expected from this new appropriation, but if there is a need for such expenditures in the future, there will be an appropriation to which they can be charged.

Section 3.60 CalPERS Rate Adjustments

2004-05	No Change
2005-06	-\$152.7 million (-\$251.5 million all funds)

On April 19, 2005, the Board of Directors for the California Public Employees' Retirement System (CalPERS) adopted a new policy for calculating the actuarial value of assets, spreading market value asset gains and losses over 15 years as opposed to the current 3 years; and changing the corridor limits for the actuarial value of assets from 90 percent–110 percent of market value to 80 percent–120 percent of market value. The effect of this new policy will be to reduce the state's 2005-06 contributions to CalPERS by \$152.7 million (\$251.5 million all funds). This change does not reflect any differences that would be caused by the Governor's policy proposals in this area.

Strategic Sourcing

2004-05	-\$48 million
2005-06	-\$96 million

The May Revision proposes to eliminate the target savings set aside for the California Strategic Sourcing Initiative and amend Control Section 33.50 to allow the Department of Finance periodically to reduce departmental appropriations when actual savings data become available. While we continue

to believe this effort will result in substantial savings to the state over the long term, implementation delays and data collection difficulties in the current year have resulted in the inability to estimate savings accurately by department. The Department of General Services estimates current year savings of \$4.9 million and 2005-06 savings of \$46.8 million from all funds. In order to ensure that the state Budget does not depend on savings that cannot be estimated with reasonable accuracy, the May Revision proposes to revise Control Section 33.50 to allow actual savings to be captured on a periodic basis.

2005-06 State Appropriations Limit Calculation

Pursuant to Article XIII B of the California Constitution, the 2005-06 State Appropriations Limit (SAL) is estimated to be \$68.890 billion. The revised limit is the result of applying the growth factor of 6.64 percent. The revised 2005-06 limit is \$411 million above the \$68.479 billion estimated in January. This increase is due to changes in the following factors:

	January Percentage Growth	May Revision Percentage Growth
Per Capita Personal Income	4.50	5.26
State Civilian Population	1.65	1.50
K-14 Average Daily Attendance	1.15	1.05

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 civilian population estimate until April, the Department of Finance uses its own estimate for the Governor's January Budget. The May Revision reflects the BEA's estimate.

The SAL for 2004-05 does not change since it was statutorily established by Control Section 12.00 of the 2004 Budget Act.

Boards and Commissions

As part of its continued effort to streamline state government, the Administration proposes to eliminate 13 of the state's boards and commissions. The 13 boards and commissions proposed to be eliminated are as follows:

1. Advisory Committee on Managed Health Care
2. Agriculture Bargaining Association Advisory Board
3. Child Development Policy and Advisory Committee
4. Clinical Advisory Panel
5. Commission of the Californias (Office of California-Mexico Affairs)

Expenditures: **Statewide Issues**

6. Credit Union Advisory Committee
7. Departmental Transportation Advisory Committee
8. Heritage Preservation Commission
9. Interagency Aquatic Invasive Species Council
10. Mexican-American Memorial Beautification and Enhancement Commission
11. Mortgage Bankers Advisory Committee
12. Real Estate Advisory Commission
13. Small Business Reform Task Force

Summary Charts

Summary Charts

General Fund Budget Summary May Revision (Dollars in Millions)

	<u>2004-05</u>	<u>2005-06</u>
Prior Year Balance	\$7,200	\$6,714
Revenues	\$79,256	\$83,666
Transfers	\$239	\$201
Economic Recovery Bonds	\$2,012 ^{1/}	-
Total Resources Available	\$88,707	\$90,581
Non-Proposition 98 Expenditures	\$47,732	\$51,709
Proposition 98 Expenditures	\$34,261	\$36,816
Total Expenditures	\$81,993	\$88,525
Fund Balance	\$6,714	\$2,056
Budget Reserves:		
Reserve for Liquidation of Encumbrances	\$641	\$641
Special Fund for Economic Uncertainties	\$6,073	\$1,415 ^{2/}

^{1/} For the purposes of this chart, this amount is included in General Fund resources to provide better comparability. It was budgeted as a reduction in expenditures in the 2004 Budget Act.

^{2/} Includes a \$900 million set aside for refunds/accelerations of amnesty related revenue in 2006-07.

2005-06 Revenue Sources

(Dollars in Millions)

	<u>General Fund</u>	<u>Special Funds</u>	<u>Total</u>	<u>Change From 2004-05</u>
Personal Income Tax	\$43,214	\$683	\$43,897	\$1,749
Sales Tax	26,951	4,368	31,319	2,082
Corporation Tax	8,817	-	8,817	1,256
Highway Users Taxes	-	3,441	3,441	84
Motor Vehicle Fees	21	5,039	5,060	192
Insurance Tax	2,300	-	2,300	70
Liquor Tax	315	-	315	3
Tobacco Taxes	116	931	1,047	-28
Other	2,133	9,565	11,698	741
Total	\$83,867	\$24,027	\$107,894	\$6,149

Note: Numbers may not add due to rounding.

General Fund Expenditures by Agency

(Dollars in Millions)

	<u>2004-05</u>	<u>2005-06</u>	<u>Change</u>	<u>%</u>
Legislative, Judicial, Executive	\$2,906	\$3,120	\$214	7.4%
State and Consumer Services	541	576	35	6.5%
Business, Transportation & Housing Resources	374	1,702	1,328	355.1%
Environmental Protection	1,064	1,352	288	27.1%
Health and Human Services	78	78	-	0.0%
Corrections and Rehabilitation	25,010	26,834	1,824	7.3%
K-12 Education	6,987	7,259	272	3.9%
Higher Education	34,541	36,118	1,577	4.6%
Labor and Workforce Development	9,378	10,171	793	8.5%
General Government	87	92	5	5.7%
Total	1,027	1,223	196	19.1%
Total	\$81,993 ^{1/}	\$88,525	\$6,532	8.0%

^{1/} For purposes of this chart, the use of Economic Recovery Bonds (\$2.012 billion) is included in resources to provide better comparability. It was budgeted as a reduction in expenditures in the 2004 Budget Act.

Note: Numbers may not add due to rounding.

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