

P. A.



County of Los Angeles CHIEF ADMINISTRATIVE OFFICE

713 KENNETH HAHN HALL OF ADMINISTRATION • LOS ANGELES, CALIFORNIA 90012
(213) 974-1101
<http://cao.co.la.ca.us>

DAVID E. JANSSEN
Chief Administrative Officer

February 22, 2006

Board of Supervisors
GLORIA MOLINA
First District

YVONNE B. BURKE
Second District

ZEV YAROSLAVSKY
Third District

DON KNABE
Fourth District

MICHAEL D. ANTONOVICH
Fifth District

To: Mayor Michael D. Antonovich
Supervisor Gloria Molina
Supervisor Yvonne B. Burke
Supervisor Zev Yaroslavsky
Supervisor Don Knabe

From: David E. Janssen
Chief Administrative Officer

SACRAMENTO UPDATE

LEGISLATIVE ANALYST'S OFFICE (LAO) REPORT: THE 2006-07 BUDGET: PERSPECTIVES AND ISSUES

Today, the LAO released the first of a two-part analysis of the Governor's proposal, The 2006-07 Budget: Perspectives and Issues (P&I), which contains an overview of the economic assumptions, revenue projections, and major expenditure proposals in the Governor's budget, as well as a discussion of the major issues it poses for the Legislature. On Thursday of this week, the LAO will release its detailed analysis of the Governor's Budget. The complete report is available at <http://www.lao.ca.gov>.

The basic message of the LAO's report is that the State has benefited from \$11 billion in additional revenues since the FY 2005-06 budget was enacted, and that the Legislature has an "important budget opportunity" to help solve the State's chronic, structural budget problem. However, while the Governor's Budget proposes \$1.4 billion in prepayments of outstanding debt related to transportation and deficit reduction, it does not solve this long term problem. According to the LAO, operating shortfalls under the Governor's Budget Proposal are projected to be \$5 billion in FY 2006-07, \$4 billion in FY 2007-08, and \$5 billion in FY 2008-09.

A further opportunity to reduce the structural shortfall is possible because the LAO projects additional revenue of \$2.3 billion that was not anticipated in the Governor's Budget which, after accounting for \$340 million in additional costs, would result in \$2 billion more in revenue than the amount forecast in the Governor's Budget. Added to the \$600 million year-end reserve proposed by the Administration, this would leave FY 2006-07 with an ending balance of \$2.6 billion.

The LAO believes that these extra funds either should be held in reserve, or used to reduce the State's budgetary debt. This would strengthen the State's fiscal condition over the long term and enhance its ability to address high priority issues and withstand future economic slowdowns. Below is a summary of the State's outstanding obligations at the end of FY 2006-07 under the Governor's Budget proposal.

Outstanding Borrowing After FY 2006-07	
Private Placement Bonds (deficit financing and tobacco)	\$15 billion
Special Funds (Prop 42)	\$2.4 billion
Deferred Mandates	\$1.4 billion
Prop 98 Settle-up	\$1.3 billion
Total	\$20.1 billion

The Economic/Revenue Outlook

The LAO and the Governor are in basic agreement on the key economic growth assumptions that drive the revenue forecast for the budget year. However, the LAO, based on year-end estimated corporate tax filings, and January estimated personal income tax payments, which were not available to the Governor when he developed his budget proposal, is projecting \$1.3 billion in additional revenue in the current year, and an additional \$1 billion in the budget year. This gain is predicted to come from stronger growth in personal income tax, sales and use taxes, corporate taxes, and insurance taxes. The LAO is predicting that this healthy growth in revenues for FY 2006-07 will continue at a slightly slower pace in FY 2007-08. The LAO cautions that 25 percent of personal income taxes are from non-wage income such as capital gains, stock options and other business income which is very sensitive to the income of a small percentage of tax payers. As a result, a small decline in economic growth could result in a substantial reduction in revenue to the General Fund.

State Expenditures

Total spending would increase to \$122.9 billion in FY 2006-07, including \$97.9 billion from the General Fund and \$25.0 billion from special funds. Overall, General Fund spending would increase 8.4 percent, largely in response to increases in education programs (\$4.887 billion) and transportation programs (\$997 million, primarily to repay loans under Proposition 42).

Major Issues of County Interest

The LAO identified the following major issues facing the Legislature in FY 2006-07. The issues of interest to the County include the restructuring of the AB 3632 Program, which

provides mental health services for special education children, and the growing costs of retiree health insurance and the funding obligations faced by the State and local governments. The other issues are the State's emergency preparedness and response system, and the implementation of the new Federal Transportation Funding Act.

Mental Health Mandates - AB 3632 Program. The Governor's FY 2006-07 Proposed Budget does not include a specific proposal to redesign the AB 3632 Program, but the Administration has indicated its intent to work with education and mental health agencies to eliminate the AB 3632 mandates and establish a new categorical program for the same purpose. The Administration plans to include its proposed program changes in the May Revision. The LAO agrees with the Administration's underlying assumption that the reform of AB 3632 is unlikely to generate enough savings to bring the Governor's proposal into alignment with the level of funding included in the FY 2006-07 Proposed Budget. In addition, the LAO points out that the current program raises a number of policy and fiscal issues that require the Legislature's attention.

The LAO recommends that at least four issues should be addressed as part of any reform of the AB 3632 Program:

- **Lead Administrative Agency.** The choice of a county mental health or education agency would affect the program's orientation towards mental health or education.
- **Funding Mechanism.** A new AB 3632 Program should require a funding formula that balances incentives for efficient delivery of services with the Federal mandate that all special education students who need mental health services must receive them. The LAO also recommends that the Legislature avoid the use of mandates to finance the new program.
- **Local Coordination of Services.** The State needs to create better mechanisms and incentives for joint planning between county mental health and education agencies.
- **Accountability and Oversight.** As long as the State maintains fiscal responsibility for the AB 3632 services, it needs an accountability mechanism to ensure that local programs are effectively addressing student mental health needs. Also, State agencies should play a larger role in encouraging local collaboration.

The LAO also offers two options to address the major issues affecting the AB 3632 Program. First, the LAO recommends shifting the responsibility for AB 3632 services to a K-12 categorical program, which they believe would alter the financing and governance for mental health services sufficiently to address the shortcomings of the current system. The LAO prefers this option because it would provide a block grant to support mental health services, thereby creating strong incentives for educators to operate efficient programs, and making the education system responsible for the program. The LAO made the same recommendation last year, as part of its *Analysis of*

the 2005-06 Budget Bill. Second, the LAO recommends that the Legislature examine the idea of creating a new categorical program operated by counties. The new program could be designed to take advantage of the strengths of county mental health agencies while recognizing the responsibility for shared services, and include local accountability mechanisms to improve the quality of services to students.

Retiree Health Care: A Growing Cost for Government. According to a survey conducted by the California State Association of Counties, most counties provide some level of health care coverage for its retirees. Pursuant to the provisions of Statement 45 released by the Government Accounting Standards Board (GASB) all counties and states will have to disclose the liabilities associated with non-pension retiree benefits. Counties will need to quantify this unfunded liability in their financial reports no later than FY 2007-08. Entities will be required to identify their normal (currently accrued) costs and unfunded liability (previously accrued but unfunded) costs. In addition, local governments will also need to disclose the amounts that are needed to address these liabilities. As most governments have not adequately funded these liabilities, under the provisions of GASB 45 they will now be identifying a substantial liability on their financial statements and indicating how they plan to address the problem.

Perspective on Emergencies and Disasters in California. The LAO finds that many of the Governor's proposals to improve the State's preparedness and response to emergencies and disasters are warranted. For example, public health scientific expertise needs to be strengthened, State laboratories require additional staffing, and the creation of a science and technology unit within the Office of Homeland Security using Federal funds appears to be reasonable. The LAO also agrees with proposals for the Department of Health Services and Emergency Medical Services Authority to administer three medical assistance teams; purchase and stockpile antivirals, vaccines, and medical supplies; and purchase equipment for ambulance units.

However, the LAO recommends rejecting a number of the Governor's proposals, contending that other funds exist for these purposes. These proposals are aimed largely at two areas, public health and agriculture, and include: \$4.3 million for food and water disasters and the healthcare infection control program; \$18.6 million for State and local response to pandemic influenza; and \$7.2 million to increase the safety of the State's food supply. The LAO also indicates that \$14.3 million proposed for a public education and media campaign overlaps with existing efforts. The LAO rejects establishing an Office of Homeland Security as a separate entity, recommending instead that it be established as a division within the Office of Emergency Services.

The LAO also recommends reducing risk for emergencies and disasters through investment in infrastructure including flood control and hospital seismic safety, and by influencing land use decisions to discourage population growth in agricultural areas and encouraging local governments to make fire-safe planning decisions. Finally, the LAO acknowledges the continuing lack of a Statewide plan for an interoperable radio system

to provide immediate and reliable access to information for public safety agencies to respond effectively to emergencies and disasters.

Transportation Funding: The New Federal Act. The LAO summarizes the major provisions of the new Federal Transportation Act, the Safe, Accountable, Flexible, Efficient, Transportation Equity Act: A Legacy for Users (SAFETEA-LU), and its implications for California. SAFETEA-LU will provide \$23.4 billion in Federal funds to California through 2009 for highway, transit, and transportation safety projects, of which \$3.7 billion is for earmarked projects throughout the State. The LAO indicates that SAFETEA-LU also presents opportunities for financing transportation through non-traditional fund sources and expediting project delivery.

While recognizing that SAFETEA-LU will significantly increase the amount of Federal dollars spent on transportation projects in the State, the LAO recommends that the Legislature: 1) estimate the nonfederal funds required to fully finance earmarked projects and identify how federally earmarked funds align with statewide funding priorities; 2) authorize Caltrans to pursue design-build contracting on a pilot basis; and 3) authorize additional public-private partnerships in order to take advantage of SAFETEA-LU's innovative financing opportunities, such as increasing private investment in nationally or regionally significant surface transportation projects by providing Federal credit assistance, and private sector use of tax-exempt bonds when partnering with a public agency to construct transportation facilities.

We will provide a report on the LAO's Analysis of the Budget Bill when it becomes available on Thursday.

We will continue to keep you advised.

DEJ:GK
MAL:SK:MR:EW:MS:cc

c: Executive Officer, Board of Supervisors
County Counsel
Local 660
All Department Heads
Legislative Strategist
Coalition of County Unions
California Contract Cities Association
Independent Cities Association
League of California Cities
City Managers Associations
Buddy Program Participants