Chapter I

BUDGET OVERVIEW

I. CALIFORNIA ECONOMIC TRENDS AND DEMOGRAPHICS

California's gross state product—now at $1.4 trillion—is the largest of the fifty states; if California were a separate nation, it would rank sixth in the world, behind just the U.S., Japan, Germany, the United Kingdom, and France.[1] After the down period of 1991–94, the state's economy pulled up strongly until 2001, when a contraction began, exacerbated by the events of September 11. The state's unemployment rate has steadily increased during and since 2001, reaching a high of 6.9% in December 2002; as of February 2004, the rate had dropped somewhat to 6.2%, but remains substantially above the nation's average.[2] California's personal income in 2002–03 was $1.16 billion; it increased 3.8% to $1.2 trillion in the current 2003–04, is estimated to grow another 5.4% to $1.26 trillion in 2004–05, with a further 5.6% increase projected for 2005-06.[3] (See Table 1-A.) The Department of Finance has estimated the state's inflation to be 2.4% for 2003, 1.9% for 2004, and 2.7% in 2005.[4]

A. Income Distribution

In terms of wealth and income distribution, the gap between the rich and the poor continues to widen. In 1999, the top 1% earners nationwide received as much after-tax income as the bottom 38% combined.[5] California's division between rich and poor is even more pronounced. It is among the most extreme in the nation, and continues to grow. By the late 1990s, California's wealthiest 20% was eleven times richer than her poorest 20%.[6] The share of total adjusted gross income attributable to the top 20% of taxpayers has consistently increased, going from 41.7% in 1975 to 56.7% by 1998. During this same period, the share of income at the very top end of the income distribution—for taxpayers with incomes exceeding 99% of the taxpayer population—nearly tripled, going from 7% to almost 20%.[7] The share of income attributable to each of the four remaining quintiles has fallen, with the share attributable to the bottom quintile declining by half—*i.e.*, the bottom 20% accounted for only 7.2% of the state's income in 1975, and fell further to 3.5% by 1998.[8]

Other recent studies confirm the severity and continuing trend, and document that

- inequality is increasing mostly because of the precipitous drop in income for families at the mid-to-bottom income levels;[9]
- over the last decade, income inequality has increased more in California than in 48 other states;[10]

- industry wage data from 1989 through 1998 indicates that wages in the top 25% of industries (ranked in terms of their average wages at the beginning of the period) have grown three times as fast as wages for the bottom 25% of industries during this period;[11] and
- the decline in income at the middle to lower end of the economic spectrum is affected by both immigration of low-income workers, and most markedly by the collapse in jobs and pay for those without high school diplomas, and increasingly without vocational or other higher education.[12]

The trend in wealth and income distribution is dividing the state into three groups: a top 5% enjoying unprecedented wealth, a middle class declining from 80% of the population to 60%, and an underclass increasing from 15% of the population to 35%. The latter projection is based on the current percentage of California children in families at or near the poverty line—substantially below income for family self-sufficiency. Since 1989, safety net reductions, tax changes, employment opportunities, and educational investment have been increasingly responsive to wealthy and upper middle class interests. The size of the underclass, its degree of poverty, and the barriers it confronts for upward mobility are at unprecedented levels since the 1950s.

The new underclass is predominantly young. The percentage of children born into families with incomes below the federal poverty line grew from 21.6% in 1989 to 28.2% in 1994–96, falling to a still high 24.7% in the current year and projected to increase slightly to 24.8% in 2004–05.[13] In 2000, almost one-half of California's young children lived at below 185% of the poverty rate, a level below self-sufficiency.[14] Youth unemployment is almost four times working-age adult levels,[15] and the child poverty rate is more than double that of senior citizens (see detailed discussion in Chapter 2).

	1979-80	1989-90	2000-01	2001-02	2002-03	2003-04	2004-05
Population (1,000s)	23,257	29,142	34,040	34,727	35,336	35,934	36,474
State Employees per 1,000 Pop.	9.5	8.7	9.1	9.3	9.1	8.9	8.7
Personal Income (Billions)	$252.2	$606.7	$1,100.7	$1,129.9	$1,155.2	$1,199.0	$1,262.4
Expenditures per $100 of Personal Income:							
General Fund	**$7.35**	**$6.50**	**$7.09**	**$6.79**	**$6.71**	**$6.51**	**$6.13**

Sources: Governor's Budget Summary

TABLE 1-A. California Population, Personal Information Data, 1979–2004

In addition to age, rural location correlates with poverty and unemployment. The state has the greatest rural versus urban disparity in the nation in terms of unemployment, employment growth, and earnings. Home prices are now beginning to rise again, from a base already substantially above the national average. These high costs constitute an important barrier to upward mobility for poor and young residents; California ranks 48th among the 50 states in home ownership rates (behind only Hawaii and New York).[16] Only 58.2% of Californians owned their homes in 2001, compared to a national average of 67.8%.[17]

B. Child Demographics

Since 1989–90, the state's overall population has grown by 23%. There is a bolus of additional children aged 10–18 now moving through middle and high school and who require unprecedented higher education expansion in order to secure productive employment in the evolving international economy. As discussed in Chapter 7, that capacity expansion is not occurring. A 1999 national study of juvenile population found that from 1995–2015, California will increase her juvenile population more than any other state in the nation; the 0–17 group will increase by 34% (with a national average increase of 8%) and the 18–24 group will increase 57% (with a 22% national average growth).[18] School enrollment growth has already reflected these new numbers, with K–12 enrollment currently 33.8% higher than in 1989–90.[19]

Table 1-B presents population data relevant to children, including numbers from 1989 by age and poverty status. The number of children living in poverty has increased substantially faster than has the child population. As of February 2004, the federal poverty line for the benchmark family of three is an annual income of $15,670.[20] In 1980, 15.2% of California's children lived below the poverty line. In 1989, the state's child poverty percentage reached 21.6%. By 1994–95, the level reached a record high 28.2%. The number of impoverished children increased from 1.87 million in 1989 to 2.8 million in 1997–98, a 51% increase. The percentage of children in poverty has declined somewhat as the state continues to pull out of its recession. However, the gains from the economic upturn are disproportionately enjoyed by the upper middle class and wealthy populations, and the number of children living in poverty is currently over 2.6 million—still close to it historical high. Although currently comprising 30% of the population, children make up over 57% of Californians living in poverty (see Table 1-B).

	Budget Year										
	1989-90	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05
State Population	29,142,279	31,711,000	31,962,000	32,452,000	32,862,000	33,417,000	34,040,000	34,727,000	35,336,000	35,934,000	36,474,000
Child Population (0–19)	8,643,846	9,774,045	9,933,186	10,062,428	10,175,372	10,305,644	10,234,571	10,338,851	10,546,543	10,707,426	10,871,679
Young Children (0–4)	2,425,480	2,753,496	2,712,417	2,689,023	2,677,063	2,678,091	2,486,981	2,518,583	2,550,587	2,582,997	2,615,819
Children share of pop'n	29.7%	30.8%	30.1%	31.0%	31.0%	30.8%	30.0%	29.9%	29.8%	29.8%	29.8%
K-12 Enrollment	4,668,495	5,367,926	5,512,155	5,633,646	5,748,344	5,865,057	5,967,170	6,068,928	6,176,698	6,246,193	6,308,289
Overall Poverty Rate	12.9%	16.7%	16.9%	16.6%	15.4%	14.2%	12.8%	12.6%	13.1%	12.9%	12.9%
Poverty population	3,759,354	5,295,737	5,401,578	5,387,032	5,060,748	4,745,214	4,357,120	4,375,602	4,629,016	4,635,486	4,705,146
Child Poverty Rate	21.6%	28.2%	27.1%	28.0%	26.0%	25.0%	24.3%	24.3%	24.7%	24.8%	24.8%
Child poverty population	1,867,071	2,756,281	2,691,893	2,817,480	2,645,597	2,576,411	2,487,000	2,524,490	2,604,996	2,655,442	2,696,176
Child share of poverty	49.7%	52.0%	49.8%	52.3%	52.3%	54.3%	57.0%	57.7%	56.3%	57.3%	57.3%

Sources: Governor's Budget Summaries and Appendix A.

TABLE 1-B. California Child Population, Poverty Rates

Family demographics have changed as poverty levels have increased. As discussed in Chapter 2, the most dramatic and damaging change has been the growth in the number of single-parent households; almost one-third of the state's children are born to unwed mothers. At present, only a minority of children now being born will spend most of their childhood in homes with their biological fathers. Notwithstanding recent increases, less than 30% of the 2.4 million absent biological fathers tracked by district attorney family support divisions contribute anything financially for their children. About 50% of children living with mothers as the single head of their households live below the poverty line.[21]

Related to economic barriers are serious language obstacles for many. In 1984, 483,000 California school children were identified as limited English proficient (LEP); in 2002, the number was 1.6 million—25.4% of California's total K–12 population, and over one-third of all students in K–3, both record highs.[22]

California leads the nation as a home to immigrants, with 25% of the state's residents foreign-born. The largest concentration in the nation (20%) reside in Los Angeles, Orange, and Riverside counties. About one-half are from Latin America and one-fourth are from Asia.[23] These arrivals account for some of the growing income disparity between the wealthy and impoverished, with the most recent study attributing about one-third of the income disparity growth to international immigration, and finding the bulk of the growth in inequality to be "the rising value of skills such as schooling and labor market experience," underlining adequate K–12 graduation and higher education capacity as critical.[24]

C. State Budget: Source of Funds

Figure 1-A below presents the major sources of state funds for the current 2003–04 fiscal year. Except for a few programs (such as federal Head Start), almost all federal money for children is channeled through state accounts and is spent by state, county, or school district officials. Similarly,

most local taxes generated for children are from local property taxes collected for schools, and are included in the state education accounts discussed in Chapter 7.

In general, federal funds are allocated within specific program categories, bonds are expended for enumerated capital projects (*e.g.,* prisons or university buildings), and special funds are committed by law to a particular use (*e.g.,* highway construction or regulatory agencies). Special fund spending, currently at $19.4 billion, has more than doubled over the past ten years. The three tobacco tax funds (Proposition 99, tobacco settlement fund monies, and Proposition 10 revenues) total about 9% of the special fund total. All of the Proposition 10 portion and about 2/3 of the other two funds will benefit children.[25] But aside from this 6% to 7% share of special funds, child investment primarily comes from general fund spending, often with federal match augmentation.

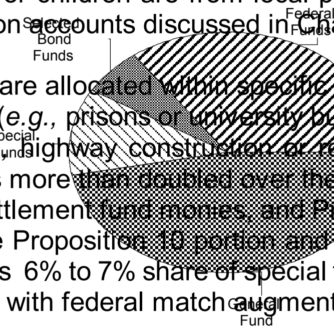

FIGURE 1-A. State Budget by Source of Funds, 2003–04

	Budget Year					Estimated*	Proposed*	Percent Change	
	1989-90	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05	'89-'03	Proposed
General Fund	$39,455,870	$66,494,042	$78,052,949	$76,751,710	$77,482,135	$77,624,000	$77,578,000	96.7%	–0.1%
Special Funds	$7,872,449	$15,787,110	$13,971,535	$19,448,131	$18,282,052	$19,406,356	$21,143,762	146.5%	9.0%
Gov't Costs Totals	*$47,328,319*	*$82,281,152*	*$92,024,484*	*$96,199,841*	*$95,764,187*	*$97,030,356*	*$98,721,762*	*105.0%*	*1.7%*
Selected Bond Funds	$1,265,897	$2,582,955	$4,357,076	$3,020,238	$11,014,509	$10,444,161	$1,937,905	725.0%	–81.4%
Gov't Cost/ Bond Funds Total	*$48,594,216*	*$84,864,107*	*$96,381,560*	*$99,220,079*	*$106,778,696*	*$107,474,517*	*$100,659,667*	*121.2%*	*–6.3%*
Federal Funds	$18,658,467	$37,303,266	$41,272,772	$46,622,619	$54,732,625	$57,971,771	$55,000,430	210.7%	–5.1%
Total State/Federal	$67,253,000	$122,167,373	$137,654,332	$145,842,698	$161,511,321	$165,446,288	$155,660,097	146.0%	–5.9%
Adjusted Total	$113,719,996	$141,035,208	$152,602,051	$155,822,787	$166,885,126	$165,446,288	$150,641,921	45.5%	–8.9%
Adj. General Fund	$66,717,359	$76,763,548	$86,528,625	$82,003,868	$80,060,121	$77,624,000	$75,077,037	16.3%	–3.3%

Dollar amounts are in $1,000s. Sources: Governor's Budgets. *Reflects general fund expenditures as proposed in the 2004 May Revise.
Adjusted to California population and deflator (2003–04=1.00). Adjustments by Children's Advocacy Institute

TABLE 1-C. California State Spending Plan (Excluding Nongovernmental Cost Funds)

D. State Public Revenue and Spending Trends

In April 2004, the Tax Foundation reported that the "tax burden" imposed by California had declined from 8th in the nation to 26th. While the numbers used by this business-backed organization have been historically disputed as inflating the stated tax burden, its recognition of substantial state revenue retraction is widely accepted. The Foundation would set California's state and local taxation at 9.8% of income against a national average of 10% as of 2004.[26]

California has reduced the number of state employees from 9.9 per 1,000 population in 1977–78 to 8.9 in the current year and 8.7 as proposed for 2004–05 (see Table 1-A). The state has among the lowest level of state employees/population in the nation—notwithstanding a 37% increase in employees engaged in public safety (primarily incarceration-related).[27]

Almost all state public spending for children comes from the general fund (see discussion of federal spending routed through the state budget and of relevant special funds below). An important measure of adult investment in children is the percentage of personal income committed to schools, health, child care and safety net protection, and other general fund spending. This indicator normalizes automatically for population and inflation. As real income rises, one would expect the percentage of such monies invested in children to increase somewhat, as the amount of disposable income above basic adult needs is more easily met. The trend in California—particularly over the last five years—has been contrary. As Table 1-A indicates, the percentage of personal income contributed in 1978–79 (one generation ago) for all general fund spending amounted to 7.35%. Trend analysis prior to 1978 requires major adjustment for the Proposition 13 and the famous *Serrano* school financing decision routing property tax monies through the state general fund. The general fund commitment dropped during the late 1980s and early 1990s, but again approached the 1978 levels by 2000–01. The widely publicized "spending binge" of the state Legislature allegedly occurred during the first four years of the new millennium—leading to the major theme of Governor Arnold Schwarzenegger's recall campaign, and a consistent thesis of the Republican Legislative Caucus— that California taxation has been too high, and its spending uncontrolled. As a result, new revenue sources have been eschewed—to the point of categorical dismissal. However, as Table 1-A indicates, and as repeated in Appendix 25 of the Governor's *2004-05 Budget Summary*, general fund spending as a percentage of personal income from 2001–02 to the current 2003–04 fiscal year arrays chronologically as follows: 7.1%, 6.8%, 6.7%, 6.5%. Governor Schwarzenegger's 2004–05 budget— after the 2004 May Revise increase—proposes general fund spending at 6.13% of personal income.

The data do not support the oft-repeated thesis of excessive spending over the prior four years, but the reverse—tax and revenue reductions, including the Governor's momentous Vehicle License Fee cut from extant 1998 levels, and tax expenditures (deductions and credits) now amounting to almost $30 billion annually, as discussed below. If the 2004–05 budget were to commit the same percentage of personal income for general fund spending as adults did 25 years ago, the general fund budget would total $93.34 billion—$15.8 billion more than is proposed.[28] The percentage of personal income measure does not include capital gains, reducing the actual percentage of total income and asset gain by the wealthy and upper middle class below these percentage figures.

This decline in general fund spending omits the coextensive reduction in the proportion of general fund spending committed to children. The general fund allocation trend over the last 25 years has favored seniors and law enforcement/corrections. For example, as discussed in Chapter 9, in 1978 California had 20,000 adult prisoners incarcerated—it currently has over 170,000, a remarkable increase of over eight times during one generation. The appropriations of general fund monies necessarily reflects such corrections inmate increases, further enhanced by the pay, benefit, and pension enhancements won by the politically powerful prison guard association. The electorate enacted Proposition 98 in 1988 to protect the education budget by specifying a minimum floor of the general fund for K–14 spending under a complicated formula. As Chapter 7 discusses, this floor has become a ceiling, with any spending overages deducted in subsequent general fund spending for education. Although some of the years during the 1990s reflected low general fund spending as a percentage of personal income (with the percentage during the decade ranging from 5.5% to 6.5%), the 25-year trend has been markedly down, as have levels since 2000. At the same time, the percentage of general fund spending committed to children has declined. The two in combination suggest substantial child disinvestment.

II. FEDERAL INVESTMENT IN CHILDREN

A. Federal to State Delegation: "Devolution"

The state budget channels almost all federal funds received to the local level through state budgetary accounts. Hence, reliance on federal funds extends to local assistance spending for children; the federal share of local spending increased from 28% in 1989–90 to 40% in 1993–94, and has since declined, with federal diminution generally, to 35%.[29]

The June 13, 1996 congressional budget resolution (H.R. Cong. Res. 178) implemented substantial reductions extending to 2003 and since extended annually. Most of this decline focuses on child-related spending, and largely takes the form of a multi-year effective freeze in absolute spending through a new block grant format—replacing what had traditionally been an "entitlement" concept, with spending provided based on qualified need. The block grant format instead gives to the states a static and predetermined sum. Because the block grants are not adjusted by population/inflation, they will accomplish an automatic 3% to 5% annual reduction in constant dollar resources. That accumulating amount continues to grow year to year, and implies a 30% adjusted reduction in this funding after eight years and to budget year 2003–04.

The largest such block grant program is the Personal Responsibility Act of 1996 (federal welfare reform). States have not been required to cut safety net levels because rolls have declined more than the 30% reduction in population/inflation adjusted federal assistance. However, the underlying resource has moved from entitlement spending based on need, to a capped entitlement, with the cap constricting year to year (assuming inflation and population change in the normal course). As discussed in Chapter 2, a substantial number of families leaving such rolls have not succeeded at obtaining employment; in fact, most have not achieved self-sufficiency, and many—now deprived of basic safety net support—are subsisting below 50% of the poverty line. Of comparable concern, should an economic downturn reinflate these rolls, the accumulated reductions from 1996 will jeopardize safety net assurance unless independently financed by the state. And the further reauthorization of block grant amounts, without adjustment for population/inflation, will continue that constriction year to year.

Numerous programs receiving federal match or assistance are relevant to children. Beyond the job training, child care, and Temporary Aid to Needy Families (TANF) grants within the Personal Responsibility Act noted above are other spending programs subject to block grant treatment after 1996, including child support enforcement, Medicaid, school meals, food stamps, substance abuse prevention and treatment, special education, local agency education grants, the social services block grant, and Head Start. Reductions to California *vis-a-vis* previous per child constant dollar spending levels will total \$17.248 billion from 1997–2002,[30] and will approximate \$6 billion in 2004–05 *vis-a-vis* appropriations adjusting for population/inflation. Such an adjusted reduction assumes constant need for the programs, and some may warrant no increase, or a decrease, where numbers needing help are successfully reduced. However, these reductions are not so based, but are simply imposed by formula. Their cumulative nature means that increased need reflecting nothing more than normal population and inflation growth will not be matched in public spending response.

Federal Reductions: 1997	Federal Reductions: 2002	Total Federal Reductions 1997–2002
$676.1 million	$5.515 billion	$17.248 billion

The 1996 congressional budget resolution was then followed by the Balanced Budget Act of 1997. Although providing substantial funds to allow states to expand child health coverage, the measure imposed huge cuts in less visible support for the medical infrastructure supporting uninsured children—some of whom will not be reached by the expansion funding (see, *e.g.*, Chapter 4's discussion of reductions to clinics serving impoverished populations). Nationally, net reductions will total \$36.9 billion over ten years in Medicaid-related cuts.[31] Hence, although California was to receive \$859 million per year in federal grant funds to expand child health care each year until 2003 (since extended at a reduced level), the state will suffer cuts averaging \$1.34 billion in its proportionate share of Medicaid, giving it an annual loss averaging \$480 million annually over the next five years. That reduction hit with a vengeance in 2002–03, with a \$400 to \$700 million Medicaid subtraction.

The overall federal disinvestment is underlined further by four related concerns:

1. Capture of Federal Monies for Child Benefit

California's plans to implement child health coverage expansion have been and are being further delayed, and have sacrificed unprecedented federal funds available at a 2–1 match, as discussed below.

2. Post-2002 Reauthorization Amounts and Restrictions

The various federal grants theoretically ran out in 2003, and the reauthorization debate continuing into 2004 centers around the Bush Administration's required minimum of 40 hours of work per week for TANF parents, with sanctions to families, loss of lifetime allocation, and loss of state compliance credit for each month if such hours do not accrue. Hence, the many parents able to work 20–35 hours per week (usually because of job availability, transportation, health, or child care limitations) are vulnerable to sanctions and, after sixty months of such shortfall, lifetime termination of federal TANF safety net assistance for their children. Each person working under the 40-hour weekly minimum does not count as employed for purposes of meeting the federal participation target. At the same time, that participation target is altered to require a high percentage of a different base for compliance—changes that make California's qualification for federal funds without penalty problematic.

3. Supplantation/Diversion of Federal Monies

The state is diverting a significant amount of federal money from Congressional intent to general fund reduction. For example, much of the federal funds from the No Child Left Behind Act's $738 million allocation will not supplement California education spending, but will instead supplant current general fund spending to allow its reduction (see Chapter 7). Another example is the federal increase in special education funding, much of which has been recently proposed for offset of previous and planned general fund contribution (see Chapter 5).[32]

4. Federal Tax Breaks and Future Capacity for Devolution Investment

Future devolution depends upon general fund monies available to invest in children. New tax deductions, credits, and other expenditures deplete such funds. Such tax breaks continue unless affirmatively ended, and unlike the devolution "block grants," are not static sums, but have their own built-in population and inflation adjusters. They increase each year in foregone monies available for public investment.

In 1997, the Congress granted tax relief to wealthy, middle class, and elderly taxpayers in a heavy "back-end benefit" pattern—with the tax expenditures growing as time passes. California's *pro rata* share of this tax spending—unavailable for children needing public investment—amounted to $2 billion per year by 2000, and growing to $4 billion per year since 2002.

B. Federal Tax Reductions in 2001

The 1997 reductions were then supplemented by unprecedented cuts in 2001, followed by additional reductions in 2003. The national economic recovery over the last half decade, combined with an end to the Cold War, had created a projected budget surplus by the year 2000 for the federal government to allocate during 2001–11. Those monies could be returned to taxpayers, or invested in societal assets, such as the environment, service infrastructure, education, and children. The national tax and spend decisions made in 2001and thereafter reflect societal priorities. What is important to us? How much do we invest or return and for whom? Experts examining the $1.35 trillion eleven-year tax reduction final plan contend:

- The eleven-year cost of the plan is $1.9 trillion, not $1.35 trillion. The lower level was advertised to give tax cut opponents a public relations victory by artificially "sunsetting" many of the cuts before the 11th year (so they would not be counted in the total), with the practical arrangement that they would in fact continue.[33]

- The revenue reduction will require increased interest payments on the debt, which brings the total cost to $2.3 trillion.

- In the following 2012–21 ten-year period, the cost will rise to $4.3 trillion, excluding substantially increased interest payments.[34]

As currently enacted, the tax cut will reduce non-defense spending by 2011 to the lowest percentage of gross domestic product since the data was collected in 1962.[35] Such a reduction mandates a further spiraling down of public investment in children as a percentage of our personal income.

The distribution of the new tax forbearance excludes impoverished children. In terms of wealth distribution, the one percent at the income top receive about 40% of the tax benefits, the bottom 80% would receive 29%, and the bottom 20% would receive a negligible amount. An estimated 12.2 million low- and moderate-income families with children (31.5% of all families with children) would not receive any tax reduction. The cuts exclude benefit to the working poor and lower middle class families covering 33.5% of the nation's children.[36]

The exclusion is not the result of simply giving a greater tax reduction to those who pay the most in taxes. The issue is which taxes are reduced and how. For example, payroll taxes, which the working poor pay off the top of the first paycheck they receive yield no reductions. Such taxes for a family of two parents and two children earning $25,000 currently amounts to at least $3,825. In contrast, the inheritance/estate tax is phased out entirely by 2010 (after having already exempted the first $1.5 million in 2001). Half of all estate taxes are currently paid by the 2,400 largest estates, and the elimination of this tax confers a benefit on that number a tax expenditure averaging $3.5 million each. The defenders of the abolition claim that family-owned businesses or farms are lost to family succession, but only 3% of taxed estates have substantial family-owned farm or business assets, and these paid less than one-half of one percent of existing estate taxes.[37] As discussed in Chapter 2, African-American children inherit less than one-fifth the average amount of white children. Some child advocates argue that equality of opportunity principles require society to avoid giving one group of children millions of dollars in resources based on nothing more than the circumstances of their birth. Whatever the merits of allowing inheritance to compromise equality of opportunity, the new tax policy takes the extreme position of foreclosing the partial sharing of such inherited advantage with children not fortunate enough to be born to wealthy parents.

The distribution of benefits to exclude working poor parents and families occurs in the context of record income disparities between the top and the bottom. Nationally, income disparities are at their widest point since World War II, and as indicated above, California incomes are among the most disparate. From 1977–95, the *after tax* income of the bottom fifth of the population fell 14% in constant dollars. The after-tax income of the top fifth of households rose 27%, while the after-tax income of the top 1% increased by 87%. These widening after-tax disparities form the context for the tax changes enacted by the Congress in 2001.

Other elements of the tax package favor corporate interests and the elderly. For example, substantial new tax benefits are implemented for private pension subsidies. And spending plans are now being formulated to commit millions for prescription drug coverage for the elderly and to bolster Medicare generally. In addition, Social Security general fund cross-subsidies are likely given the now-projected shortfall. The only alternative is likely to be payroll tax adjustments, which will increase burdens on the working poor. Much of these expenditures will come on top of the $2.3 trillion in tax reductions and expenditures discussed above. Finally, the likelihood of deficit re-inflation is great with even a small economic downturn. That deficit will constitute a debt to be paid by children for benefits received by a current generation of adults.

Some of the elements of the 2001 federal tax plan have benefits for children and families, chiefly the doubling of the dependent tax credit from $500 to $1,000, but as with other administration's tax proposals, it is a non-refundable credit. It does not benefit those who pay payroll and property taxes but earn below the personal income tax line. Moreover, such dependent credits start to phase out as income rises above $110,000, but the 2001 tax system raises that ceiling to $200,000—assuring full benefit to the latter level. Hence, for a substantial share of families above $100,000, the credit will mean a new (previously unavailable) tax reduction of $1,000 per child.

It is not just the poverty line working poor who are excluded. While the plan reduces marginal tax rates generally, they are not reduced at all for working families with children earning from $13,000 to $20,000. For each additional dollar these families earn, they lose up to 21 cents in Earned Income Tax Credit phase-out, 15.3 cents in payroll taxes, and 24–36 cents in lost food stamp benefits and child care credits.[38] As Chapter 2 discusses in detail, tax and social benefit policies establish a barrier near and just above the poverty line, prohibiting working families from reaching self-sufficiency and ultimately the middle class.

C. 2003 Federal Tax Reductions

In May 2003, the Congress enacted another round of tax cuts. Although the popularly advertised national cost of the reductions was $350 billion, the actual cost is between $800 billion and $1 trillion. The lower figure is obtained by technically placing a “sunset” date on seven of the eight tax reductions in 2004, 2005, or 2008.[39] But it is unlikely that the Congress will terminate the cuts before the 2013 terminus of the overall plan, and the Bush Administration favors continuation of all of the reductions. Adding increased interest payments to the cost, the sum grows to $1.9 trillion.[40] Using the more conservative estimate of $807 billion, the average annual reduction for California taxpayers is $10.5 billion per year until 2013, unless some are terminated.

The 2003 changes benefit children—and in particular, impoverished and lower middle class children —even less than did the 2001 cuts discussed above. The reformulation did expand to a minor degree the lowest tax bracket, and reduced slightly two income joint return rates (the so-called marriage penalty revision). It also conferred a one-time grant of $20 billion for state fiscal relief; California’s share was approximately $2.44 billion. This amount was divided evenly into two accounts: “flexible grants” and enhanced Medicaid funding. Further, it is spread over two years, with the 2004–05 budget benefitting from $576 million in flexible grants and $668 million in Medicaid additions. These benefits are a small percentage of the total reductions to the state’s federal taxpayers. They compensate for part of the direct state diminution in California tax revenue from the state’s adoption of new federal tax breaks in 2001 (with state replication of special deductions and reductions commonly practiced). Most important, the offset terminates entirely after 2004–05.

The distribution of the tax benefits have favored the wealthy. Nationally, the IRS released data in 2003 concerning the taxation of the wealthiest 400 American taxpayers from 1992–2000. In 1992, that group averaged $46.8 million in income and paid 26.4% in taxes; in 2000, the group averaged $174 million in income and paid 22.3% in taxes. These figures comprise part of the context for the tax reductions decisions of 2001 and 2003. If these cuts had been in effect in 2000, the $38.8 million they paid would have been $26.8 million. The tax rate of the extremely wealthy currently averages well below 15%—a record low and substantially below rates (including payroll taxes) paid by working poor families at the bottom 40% of average family income (see discussion of regressivity of taxes in Chapter 2).

As the upper middle class and elderly were the major beneficiaries of the 2001 federal tax revision, the same groups— with multi-national corporations added—were the major beneficiaries in 2003. The most costly three changes were (1) the capping of dividend income and capital gains profits, (2) top-income bracket rate reductions, and (3) immediate deduction of an extraordinary 50% of new investment in equipment and facilities. Tax filers with incomes above $1 million will average $93,500 in reductions, those in the middle fifth of income will average $217 in benefit, those in the bottom fifth will gain, on average, $1.[41]

As discussed in Chapter 2, the most child-beneficial part of the reduction was an enhanced child tax credit. However, its baffling design caps its benefits for working poor parents. A family with four children earning $60,000 and paying $7,000 in taxes will be able to take the full $4,000 tax credit. The same family earning $34,000 and paying $4,000 in taxes can claim only $2,350—the same amount available prior to the 2003 increase. A family earning $20,500 can claim only $1,000.

The total of the 2001 and 2003 Congressional reductions is $37.7 billion per year in reduced federal personal income taxes for California’s adults. This estimate assumes that the tax cuts will not be sunsetted and will continue as enacted—as favored by the Bush Administration. These tax reductions, as well as tax deductions for specific purposes, do not shrink each year from inflation and population gain as do federal and state spending. Rather, they apply per person, and automatically adjust for inflation, escalating in raw numbers as time passes. In contrast, public officials have engaged in a consistent pattern of raw number maintenance in child account spending at the federal (and state) levels. The federal (and state) conversion from entitlement formats to "block grant" static amounts reflects this trend. Hence, as tax savings raw numbers increase 20%–30% over a five-year period, spending is set at a static raw number level, yielding over the same period a 20%—30% reduction in per person constant dollar investment.

Overall federal revenue as a percentage of gross domestic product are now at their lowest level (15.8%) since 1950; in 2000, the percentage was 20.7%. Spending on discretionary programs, where most child-related spending occurs, reached a modern-era record low of 3% in year 2000; in 2004, it dropped to 2.6%.

This *California Children's Budget 2004–05* suggests investing a fraction of the federal income tax gain for California's children—with assurances that it would be so invested and be properly subject to independent outcome measurement. A surcharge on state personal income levels at one-third the reduction at the federal level would approximate such an allocation. That sum could largely hold children harmless from the revenue crisis, and allow implementation of many of its elements, including a modest earned income tax credit, the lowering of class size in grades 4–12 to the national average, adequate higher education slots for future employment of youth, proper care for abused children in foster care, medical coverage for all children, and a major public campaign on the right of children to be intended by two adults. Those monies would be expended at the state rather than the federal level and adult taxpayers would still enjoy a substantial tax reduction.

D. Federal Spending for Children

1. Promised Federal Child Investment

As noted above, the federal government faced the new millennium with a projected budget surplus of $2.3 trillion available for new public investment in 2001–11, a sum averaging $218 billion per year, with California's share at $27 billion per year. However, under both the Clinton Administration and Bush Administration plans, virtually all of this new money was to be expended on three accounts: Social Security, Medicare/Medicaid, and private pension subsidies. The new federal spending initiatives for children were confined to two much-heralded initiatives: a State Child Health Insurance Program (SCHIP) to cover children living in working poor families who are often uncovered by employer benefits, and the education-related "No Child Left Behind" investment. The total sums authorized for these two purposes represented under 3% of the anticipated surplus—with the remaining 97% directed toward adults, and primarily to senior citizen benefits. Apart from this, major new spending in Social Security and Medicare are planned for the elderly. Impoverished children received none of those resources.

As discussed in Chapter 4, Congress responded to the failure to use federal SCHIP funds to cover children as intended by reducing the original $855 million per annum for California by a total of $1.5 billion through 2006. Rather than covering children effectively, the state is maintaining a "sign-up/enroll/qualify" system with premium payments required of parents living just above the poverty line. Some new enrollments are accomplished, but over one million of the state's children will remain uncovered and much of the federal money may not be used at all, or may be used to cover additional parents while large numbers of inexpensively insured children remain uncovered.

Only 5.7% of the state's children lack private coverage and are ineligible for public coverage (undocumented immigrant children or children whose parents lack dependent coverage but earn over 250% of the poverty line). Rather than covering all children and billing parents of this group *post hoc* where substantial medical services are rendered and a parent earns over that limit, the state continues on a course of individual sign-ups, required premiums (in addition to co-payments), and seventeen separate, confusing programs for possible qualification, run by seven different, largely uncoordinated agencies. Although well intentioned, this federal investment has increased child coverage to some extent, but its promise has not been implemented effectively in California.

Beyond the promised SCHIP health program, generic Medicaid (Medi-Cal in California) is scheduled for substantial federal reductions over the next ten years. The House resolution proposed in late 2003 would impose $470 billion in entitlement cuts from fiscal 2004–13. The reduced spending would focus on children, with Medicaid and Food Stamps bearing most of the weight. The cuts are fashioned to compensate for the $400 billion in augmented medical prescription drug benefits for the elderly. As discussed in Chapter 4, although a case may be made for enhanced elderly medical benefits, over one million children in California have no medical coverage, while the elderly enjoy substantial basic benefits. Child medical coverage costs less than one-fifth the per person cost of coverage for older adults, and children suffer from more than double the poverty rate of the elderly.

The education investment in children formed a substantial basis of President Bush's presidential campaign. As described in Chapter 7, his spending plan includes accountability requirements (similar to those already taking effect in California), but it does not add substantial new resources. Rather, the actual spending increase is 2.9%, less than the average annual increases over the previous five years. As Chapter 7 discusses, the emphasis behind the No Child Left Behind Act is primarily "stick" rather than "carrot," with required accountability standards, performance, revenue penalties, student transfer allowance from low-performing schools, and other measures that involve demands for improved test results—without substantial new investment in smaller classrooms or teacher supply/quality enhancement. The Congress allocated $5.97 billion to the Act in fiscal 2003, $6.69 billion in current 2004, and a proposed $6.73 billion in proposed fiscal 2005. The current proposal represents a 3.5% adjusted decrease. The invested amount represents a fraction of monies promised and authorized. The total requested for 2005 represents less than one month of the Iraq War cost over the first two years of occupation.

2. The Bush Administration 2005 Budget

President Bush's proposed 2005 budget of $2.4 trillion would increase defense and homeland security funding by 17%. Other domestic discretionary funding is increased 0.5%, accomplishing a population/inflation adjusted cut of just over 3%. The most substantial increases are in faith-based grants outlined in Chapter 8 below—with $101 million added for teaching sexual abstinence to youth, marriage incentives, and paternal responsibility (Promoting Safe and Stable Families). The Child Abuse Prevention and Treatment Act (CAPTA) would increase from $90 million to $134 million, with much of it allocated to family responsibility grants similar to the Promoting Safe and Stable Families expansion. Independent Living Programs to help emancipated foster youth are proposed for increase from $45 million to $60 million, but are in a format focusing on tuition assistance that offers California youth less help than would increased rent help, given the state's relatively low tuition and high housing costs.

Most of the basic accounts remain at the same raw number levels for a seventh or eighth straight year, and now impose an effective 30% to 35% adjusted cumulative reduction. This finding is applicable in particular to the block grant programs of the middle 1990s, including the Personal Responsibility Act discussed in Chapter 2. Temporary Aid to Needy Families (TANF), the child care and development block grant (CCDBG), and Head Start all stay at the same funding level—without population or cost-of-living adjustment. Funding for child nutrition and Medicaid programs is unchanged. Funding for the federal housing voucher program (HUD Section 8) is decreased by $789 million in raw numbers, depriving as many as 150,000 families with children housing assistance at a time of record housing cost inflation.

The Social Services Block Grant is the largest source of state assistance for child protection. Funding for this program was cut from $2.8 billion to $1.7 billion in 2003, and is scheduled by the President for funding at this reduced level through 2005.

Juvenile justice programs are cut from $308 million to $180 million, a momentous 40% raw number decrease. Moreover, that subtraction is on top of momentous 2004 budget reductions for juvenile justice, and especially prevention programs. The Juvenile Accountability Block Grant (JABG) program, funded previously at $250 million, was cut to $60 million in 2004 (the President had proposed zero and repeats that elimination request in 2005). Title V Juvenile Prevention funding was reduced from $95 million to $80 million in 2004 and is proposed for additional cuts to $38 million in 2005.

Child care was cut by an amount depriving 100,000 children of assistance in the current 2004 year; the 2005 budget increases the reduction to another 200,000 children.

The President proposes to revert back to the federal Treasury $1.15 billion in State Child Health Insurance Program (SCHIP) funds—rather than allow these unspent monies to roll-over for effective coverage of children eligible but not receiving basic medical coverage. As discussed in Chapter 4, California has one million such children who remain eligible but remain uncovered despite the availability of a 2–1 federal match under SCHIP. Instead of making that one-third investment, the Governor's January 2004–05 budget proposed to cap enrollment in the SCHIP-funding Healthy Families program—thus assuring the loss of hundreds of millions in federal funds.

In the child welfare area alone, several child investment initiatives remain stymied in the Congress. These include: (1) the Family Opportunity Act (S.622), to stimulate adoptions; (2) the Keeping Families Together Act (S. 1704 and H.R.3243), which would create a state family support grant program; (3) the Child Protective Services Improvement Act (H.R. 1534), an alternative to the proposed foster care block grant; (4) the Indian Child Access to Foster Care Protection (H.R. 443, S.331, HR 2750); (5) the Adoption Equality Act (S. 1129, H.R. 3361), to delink adoption assistance for disabled children from the current irrational requirement that their parents must qualify for historical AFDC; (6) the Child Protection and Alcohol and Drug Partnership Act (S. 614); (7) loan forgiveness for social workers and certain teachers in short supply (S. 409, H.R. 734, S. 407), (8) the Child Protective Services Workforce Improvement Act (H.R. 2437), to improve quality standards and outcomes, and (9) child welfare staff improvement (H.R. 1378), providing short-term training.

The President's 2005 budget proposes to expand the "block grant" approach to Medicaid, foster care, and housing vouchers. This method of funding removes entitlement status and eliminates investment in children based on merit-based qualification. It allows a static sum to be given to the states—a sum that generally does not increase with population and inflation. Where current spending levels are the guidepost for grant levels, the system then operates without population/inflation adjustment and accomplishes an annual 4%–5% annual reduction in real spending, accumulating year by year without comparable block grant amount adjustment. The extension of such a principle to child welfare (involving the protection of children from abuse and neglect) raises a basic ethical question. The President's proposal would cap Title IV-E foster care funds. No proposal has been presented to cap the number of prisoners who may be incarcerated, or the number of children who may be admitted to public school, but the defined expenditure approach in protecting injured or molested children—where need may increase— necessarily implies funding denial.

Similarly, the block grant approach to Medicaid takes the notion of entitlement to basic medical coverage and rations it unrelated to need. Importantly, the current system of health care confines those lacking coverage to emergency room treatment *post hoc*, with limited preventive health care. Because organized health plans may bargain for rates at the marginal cost of providing treatment, hospitals and providers commonly charge uncovered individuals two to four times the bargained prices for procedures—in an attempt to recover the significant hospital overhead costs from less organized purchasers. Standard tests, relatively routine surgery, or an extended stay as a hospital in-patient at such extraordinary prices can exhaust the life savings of many working poor families lacking coverage. Such consequences may regrettably induce parents to postpone or forego medical treatment for their children.

Beyond the expansion of the block grant format, the Bush Administration proposes to retract current block grant commitment where that methodology is currently in place. Beyond appropriation levels is the often larger question of new and restrictive eligibility requirements. For example, the Personal Responsibility Act reauthorization proposed in 2004 will require all TANF parents to work not the current minimum of 32 hours per week, but a full 40 hours. While such full-time employment is preferable, for many parents it is not realistic because of employer needs, physical constraints, or child care limitations. But the Administration's proposal ignores the realities facing parents who are new entrants to the workforce, and punishes their families with benefit reductions and loss of all safety net support for their children after sixty months of benefits. That ultimate lifetime ban does not discriminate between a parent who fails to work entirely and one who worked 32–36 hours per week for the entire period. Both families are cut off. In addition, the formula for required federal "percentage employed" targets is altered in a way to make compliance in many states—including California—virtually impossible, particularly where an economic downturn increases need. Such non-compliance will then yield federal penalties that will further jeopardize the safety net for affected children.

After 2005, the budget and tax plans of the Bush Administration suggest continuation of the themes of solicitude for the wealthy, the upper middle class, the elderly, and the defense establishment. The Center on Budget Policies and Priorities estimates that as many as 447,000 children will lose child care assistance by 2009 based on currently proposed spending levels. Although the Child Abuse and Prevention Treatment Act (CAPTA) benefits from some of the "family strengthening" monies noted above in 2005, future projections for 2006 anticipate substantial reductions

Of particular concern to child advocates is the "Pay as You Go" design principle advanced by the Bush Administration. This concept requires any spending increase in a particular area to be matched by a reduction in another area. While that philosophy protects future taxpayers from additional deficits, the Administration refuses to apply it to tax reductions. Hence, tax deductions and credits for various purposes need not receive countervailing revenue increase. The asymmetrical approach, when combined with continued support for additional tax reductions, may presage deficit growth on the tax side of greater consequence than likely through spending increases. Most important, defense and security spending is within the "discretionary spending" category of almost all child investment spending, and hence any increase in these powerfully-lobbied and patriotism-assisted accounts would require comparable reductions among those accounts with long-range implications for children—a group without substantial lobbying or campaign contribution influence. Under the current Pay as You Go procedure, it would take a 60-vote Senate supermajority to increase the cap and excuse such child-related reductions. As noted, tax reductions invoke no countervailing revenue obligation, and require no such supermajority.

E. Other Federal Priorities and Commitments

Over three quarters of federal spending is committed to seven programs: Social Security, Medicare, Medicaid, defense, public pensions, veterans, and interest on the debt. Children directly benefit from a portion of Medicaid spending, but the vast majority of these large commitments benefit the elderly. Recent and projected spending trends suggest radically increased investment in defense, security, Iraq, Social Security and Medicare prescription drugs. Children are foreclosed from new investment, will suffer substantial reductions, and are scheduled to bear the brunt of deficit interest and repayment. Much of this spending will come from lower paid youth, as they enter the job market and pay increased and disproportionately high payroll taxes.

First among federal priorities is defense spending. Despite the end of the cold war, U.S. defense spending has stopped contraction and is re-inflating, with the 2003 budget reaching $390 billion. The next nearest defense budget in the world is Russia's—at $60 billion. As of 2003, U.S. military spending exceeded the combined sum expended by the world's other 47 nations with appreciable military budgets.[42] This count does not include the Homeland Security spending accelerating after fiscal 2002, and it does not include the non-defense budget sum expended on Iraq—most of $87.5 billion for 2003 and $79.5 billion for fiscal 2004. The fiscal 2005 defense budget request is for $450 billion—a level substantially above the total military spending by the rest of the world. In April 2004, the White House announced that on top of existing defense and home security spending, the Iraq war will require additional spending outside of the current or proposed 2005 budget of at least $25 billion to be approved prior to the November election—with another $50 billion extra appropriation anticipated for fiscal 2005 beyond the current request. Defense and related spending may reasonably be projected at $600 billion by fiscal 2006. Given some contraction in the defense budgets of other nations, the U.S.—with 4.6% of the world's population—will account for approximately 60% of the world's cumulative military-related spending.

To the extent the spending-only Pay as You Go requirements are followed, the defense and other increases may have to be matched with discretionary program cuts—primarily likely to involve already reduced child investment accounts (*e.g.*, child welfare, education, juvenile justice, TANF, child care, Head Start, Medicaid, and SCHIP).

1. Deficit

During the Clinton Administration, budgetary policies anticipated a surplus of $5.6 trillion over fiscal years 2002 to 2011. That surplus allowed limited new spending for children, with education and health the initial recipients. The Congressional Budget Office then revised the estimate to a reduced $1.6 trillion surplus in January of 2002.[43] The tax cuts and defense/security spending decisions noted above have eliminated the surplus entirely and now substitute in its place a deficit of $374 billion in the current 2003-04 federal budget, exceeding the previous deficit record of $290 billion in 1991. The Congressional Budget Office predicted that annual budget shortfalls would total a cumulative $1.4 trillion over the next decade, and then during 2004 revised the estimate to a projected $4.2 trillion if the tax cuts remain in place consistent with the policy of the Bush Administration.

2. Long-Term Burden

The reversal of a $1.6 trillion surplus to a $4.2 trillion deficit represents a $5.8 trillion reversal in assets available for child investment. Child advocates have long waited for the Cold War military spending to moderate sufficiently to allow the kind of health coverage, safety net assurance, child protection, and education investment common in European nations of somewhat lower per capital personal income or gross domestic product. However, current policy retracts the first stage of such promised investment, and substitutes in its stead a burden of deficit interest and repayment. Of additional and even greater concern is the prospect of much larger deficit burdens emanating from the entitlement obligations to the elderly, particularly veterans' benefits, Social Security and Medicare. U.S. Comptroller General David Walker stated in September 2003 that this additional burden—separate and apart from the $4.2 trillion projected cumulative deficit—would total "tens of trillions of dollars." Walker commented that the funding gap is "likely to exceed $100,000 in additional burden for every man, woman and child in America today."[44]

The federal accounting sleight of hand allows current Social Security surpluses to moderate the actual deficit artificially. For example, the current year $374 billion deficit is actually $534 billion, and is offset by the subtraction of $160 billion from the alleged Social Security surplus. The Social Security system is a "defined benefit" plan, not a "defined contribution" plan. In other words, the amount to be paid is politically determined separate and apart from contributions. Retired adults and adults about to retire will receive many times their contribution—and those benefits will be subsidized by today's children. The actuarial liability in the system currently to make those payments amounted to $10.1 trillion at the beginning of 2002. Interest on this accruing amount would properly place the actual current year federal deficit not at $374 billion or $534 billion, but at least at $930 billion.

These calculations do not include the Medicare obligations, with pharmacy benefit enhancements adding appreciably to this total. In 2003, the Congress added $400 billion in future annual prescription drug benefits for the elderly. Social Security, Medicare, and Medicaid spending is projected to increase dramatically as a share of gross domestic product by 2040—from 19.9% to at least 27.1%. That 36% increase in adjusted (population and inflation) monies allocated for these three accounts will increase the deficit well beyond the $4.2 trillion from current spending projections, and will impose a substantial and unprecedented burden on current and future children. If one were to impose the projected annual sum required after 2013 in today's dollars, a tax increase seven times the size of the Bush Administration's income tax rate cuts would be required to pay its annual bill.[45]

Federal regulatory agencies require proper "accrual accounting" of private business in their financial reporting, but the federal budget understates federal assets and liabilities to obscure the prospective transfer of wealth from the young to the old.[46] Child advocates argue that proper accounting would reveal an unfunded liability of well over $30 trillion—separate from and in addition to the predicted $4.2 trillion direct budget deficit. This amount will accrue unless as yet unplanned and politically unlikely intervention alters it. The brunt of this unfunded liability is likely to fall on the working poor given the concentration of Social Security and Medicare payment through "off the top" payroll deductions. These subtractions, imposed with each paycheck at a set percentage of income, are capped as income approaches $100,000, regressively burdening the middle and lower classes. The level of these assessments may be projected at three to five times current percentage deductions—and will amount to substantially more than likely personal income tax liability for the vast majority of taxpayers before the end of the next decade.

III. State Tax Sources and Burdens

A. Tax Sources

Most state revenue comes from three sources, as follows:

	1998–99	1999–00	2000–01	2001-02	2002-03	2003-04	2004-05 (proposed)
Personal income tax	$34.5	$39.6	$44.8	$33.0	$32.7	$35.1	$38.0
Sales and use tax	$19.0	$21.2	$21.5	$21.4	$22.4	$23.7	$25.0
Bank and corporate tax	$5.7	$6.6	$6.6	$5.3	$6.8	$7.5	$7.6

Source: *Governor's Budget Summary 2004–05* (numbers in billions).

TABLE 1-E. California General Fund Sources of Revenue

The personal income tax is the largest source of state-generated revenues; that tax and the sales tax combine to bring in over 70% of state-generated revenues. Bank, corporate, and insurance tax revenues have increased only one-half as much as has income tax over the past two decades. Other major revenue sources include vehicle fees, where increases since 1977 matched personal income collection increases until 1998–99, when they were reduced as described above. Estate, inheritance, and gift taxes were reduced substantially in 1984 and have increased less than one-fifth as much as has income tax collection. Although alcohol taxes were increased in 1992, tax revenues have increased at less than one-third the rate of personal income tax gain, and substantially below sales tax collection increases for other products. Tobacco taxes were similarly below other taxation rates until the increases recently imposed by Proposition 10; total tobacco tax revenue was estimated to be $1.136 billion in 2001–02 and $1.119 billion in 2002–03.[47] Additionally, the state received $386.4 million in 2000–01 from the tobacco litigation Master Settlement Agreement, and expected to receive $475 million and $474.4 million from this source in 2001–02 and 2002–03.[48]

Property tax revenues are considered local funds and finance county, city, and special district spending on police, fire, and other services.[49] However, about one-half of these taxes is expended on child-related education and, because of the *Serrano* case[50] requiring a roughly equal base of spending for public education among schools, is allocated through the state budget in a separate account (discussed in Chapter 7). Total property tax revenue is estimated to be $29 billion in 2003–04.[51] Property taxes proposed for K–12 public education amount to $12.7 billion in 2002–03, ranking as the second major source by amount in state controlled revenues (see Chapter 7).

Personal income tax revenues have borne an increasing proportion of the state tax burden, projected at $38 billion (49.7%) of state general fund revenues projected for 2004–05. Corporate sources of revenues have declined substantially in relative terms, particularly the taxation of alcohol. Although sales tax rates have increased, revenue increase has been somewhat moderated by the shift of the economy from goods toward services,[52] and may decline further as Internet sales commonly avoid taxation. Since 1989–90, state public spending has relied on increasing federal spending, taxes on personal income, and motor vehicle registration fees; the state realizes declining relative revenue from banks and corporations, real estate property owners, inheritance/estates, and alcohol.[53]

B. Tax Expenditures

In addition to annual spending, California's tax system expended almost $30 billion in foregone revenues from particularized deductions and credits, up from $24 million in 2000–01.[54] These "tax expenditures" amount to 40% of all state general fund spending. There are now 268 tax expenditure programs (197 at the state level and 71 local). In 1985, the Legislature required the Legislative Analyst to review tax expenditures every two years, but those reports were suspended with the 1990 passage of Proposition 140 (which imposed term limits and reduced the Legislature's budget), and were not resumed until February 1999.

Newly-enacted tax relief measures from 1996–2003 cost the state $6.1 billion in reduced taxes annually by the current year; about $2 billion of that total comes from new tax expenditures, with the $190 million refundable child care tax credit one of the few to benefit children. Most beneficiaries are special interests and the elderly, including $146 million added in 2002–03 in still additional pension fund deduction enhancements.[55]

Such special exemptions now amount to about $20 billion applied to state personal income taxes—or over 60% of the total tax collected. They total over $3 billion in corporate tax offsets, reaching 54% of corporate taxes paid the state, and amounting to 27% of sales and use taxation.

Each of the state's tax expenditures continues unless it is ended affirmatively by legislative act. Further, since ending a tax benefit is a form of "tax increase," each requires a two-thirds vote of the

Legislature under California's current rules. Accordingly, tax breaks achieved by Sacramento lobbyists are a special prize—a locked-in benefit that will continue indefinitely, independent of justification.

C. Tax Burdens

As Table 1-A above indicates, the personal incomes of Californians have increased above inflation since 1989. In raw numbers, total personal income has increased from $606.7 billion in 1989 to $1.155 trillion in 2002–03, an estimated $1.199 trillion in 2003–04, and a projected $1.262 trillion in 2004–05.

State general fund spending is the discretionary source of funding for most child-related accounts. General fund spending has increased 17% from 1989–90 to the current year when adjusted for general population and general inflation; however, there has been virtually no increase in relation to child population growth.[56] Table 1-A presents California state general fund spending in relation to the personal income of its residents. General fund spending has fallen from $7.35 per $100 in personal income in 1979–80 to $6.51 in current 2003–04 and would drop to $6.13 in 2004–05 under the Governor's proposed budget as revised in May 2004.

As noted above, the state general fund comes primarily from personal income taxes and state sales taxes. Unlike most of the spending accounts affecting children, state income taxes are now "indexed" to inflation; as inflation occurs, the tax schedules are reduced so that increased taxes are paid only where there is actual "spending power" increase. In addition, the tax expenditures automatically adjust to inflation, and have been arranged to increase substantially beyond inflation to 2010 ("out year" growth). California has reduced the personal income tax rate for the highest bracket from 11% to 9.3% (by failing to extend the sunset date of a previous increase). Those earning more than $100,000 in adjusted income gain over $1 billion in the current and proposed years. AB 4 (Chan), currently pending before the Legislature, would reinstate somewhat higher tax rates for the highest tax bracket.

Notwithstanding this decline in progressivity, the state personal income tax remains more progressive than other state taxes, which are generally regressive (costing the poor a higher percentage of their income). In particular, sales and excise taxes are regressive. Viewing all state and local taxes together, the lowest one-fifth of households with average income of $15,300 per year pay the highest tax rate, at 12.1%.[57] The total tax burden as a percentage of income lessens by quintile to the top 1%, earning over $434,000 per year, and who contribute an average of 7.8%.[58] Over the last fifteen years, generally progressive inheritance, estate, corporate, and property taxes have declined substantially in relation to personal income and other revenue sources. Regressivity has been increasing since at least 1985.[59]

California's personal income tax system has three features favorable to impoverished children: (1) it does not begin taxation until just above the poverty line, unlike the federal system which withholds and taxes at below the line; (2) the state recently restored part of the renters' tax credit; and (3) in 2000 California enacted a child care tax credit. However, the previous renter's credit (meant to give the poor a counterpart to the large mortgage interest deduction of homeowners) was "refundable." Hence, it was not merely an offset to taxes, but could benefit the working poor who did not pay high personal income taxes. The reenacted renter's tax credit is "non-refundable," benefitting the poor with expenditures only one-third its previous level as a refundable credit, and having no benefit to those earning near or below the poverty line. The child care tax credit is refundable, and enjoys a small increase in 2002–03, but remains limited to less than 15% of existing child care costs. If a low-income working family cannot afford the remaining 85% cost they must privately provide, they are unable to obtain any benefit from the credit. Hence, very little of either of these two tax changes will reach the population of children most in need (see discussion in Chapters 2 and 6, respectively).

While these tax cuts were occurring, impoverished children—subject to food stamps and TANF as their basic safety net—have had assistance cut from close to the poverty line to 89% of the line in 1989 to 70% of the line currently. Between 2003–05, over one million California children face federal TANF cut-off, with possible state fill-in of the "child's share" reducing families to under 50% of the poverty line in TANF plus food stamp safety net assurance.

D. State/Local Structure: Devolution, Realignment, and Backfills

In addition to federal reductions passed through to counties, the state has started its own devolution of funding to counties and school districts with both state and federal funds. Traditionally state functions generally devolved to local discretion have included juvenile justice and most of the child protection systems (child abuse and dependency court). Starting in 1991–92, former Governor Wilson added to devolution three major areas, terming them "realigned" to local jurisdictions. The realignment scheme was divided into three block grants, one for mental health, one for health (some Medi-Cal functions), and one for social services. Counties were primarily given jurisdiction over these funds and expected to exercise local discretion in their administration.

In addition to these three funds and locally "realigned" services, local jurisdictions (cities and counties) needed additional state financing help. That help was needed both because of the cumulative effect of Proposition 13 property tax limitations (which do not allow revenue increase commensurate with population growth and public service demands). It was also driven by the increasing pattern of state legislative directives to local governments without a funding source ("unfunded mandates"). But most important, it was stimulated by the 1992–93 general fund shortage—not unlike the current dilemma facing the state budget. Among other things, Governor Wilson dealt with his deficit by requiring local governments to transfer approximately $3.75 billion in annual property tax revenue to the state for public education spending by school districts.[60] This transfer removed approximately one-third of this primary revenue source for counties and cities. In fact, the money did not add to education spending, but supplanted state general fund spending—in the same way the current administration is supplanting funds for general fund relief on an even larger scale.

In order to provide some funding for the newly-realigned functions and to make-up for the $3.75 billion removal of local revenue, two major revenue sources were dedicated for local jurisdiction use: a portion of sales tax revenue and the Vehicle License Fee (VLF). As to sales taxes, a 0.5% allocation of the state sales tax was reserved for local jurisdiction use. In addition, a local jurisdiction may assess up to 1.5% in additional funding—called local add-on rates.[61] Increases within these limits must be proposed by the Board of Supervisors and approved by a two-thirds vote of the local electorate. This realigned sales tax revenue amounted to $2.29 billion in 2000–01, $2.20 billion in 2001–02, and $2.3 billion for 2002–03.[62] All of this money was allocated to the three realigned funds arrayed below. Adjusted for population and inflation, this revenue to local jurisdictions has declined 7.2% over this period.[63]

The second source of revenue comes from the VLF imposed on every operating vehicle in the state. The fee is assessed in lieu of a personal property tax, and is based on 2% of the market value of the vehicle (the cost to the purchaser—adjusted by subsequent depreciation). As part of the 1991 realignment, the revenue from these fees was also dedicated to local governments—about one-fourth of it going to the three realigned accounts of Table 1-D below, and the other three-fourths designated for general county and city use and intended to compensate local jurisdictions for the $3.75 billion property tax revenue subtraction of 1991–93.

These three realigned funds are funded as follows from locally directed sales taxes and one-fourth of the VLF:

	2000–01	2001–02	2002–03
Mental Health	$1,064	$1,050	$1,112
Health	$1,415	$1,431	$1,517
Social Services	$1,043	$1,006	$1,015
Total:	**$3,523**	**$3,487**	**$3,644**

Dollars in millions.

TABLE 1-D. Realigned Funds

As with the federal block grants, the state to local devolution has also failed to adjust for population and inflation over time. As to the three realigned accounts in Table 1-D above, the small raw number increase of $3.52 billion to $3.64 billion over two years falls 4% below population growth and inflation over that period. In allocating these programs to the local level, state public officials provide a defined funding stream which may or may not match population/inflation or other factors relevant to need. However, the delegation of responsibility and financing allows state officials to avoid making visible, statewide decisions to increase—or to reduce spending.

The unrestricted VLF portion allocated to counties and cities has suffered a more prominent shortfall over time. Conservatively adjusted for statewide population and the Consumer Price Index (CPI), the 1991–92 $3.75 billion should now total $5.29 billion. It is currently static at approximately $4 billion.

As discussed below, the VLF has been offset or reduced during 1999 to 2002 from its statutory level of 2% of vehicle value—assuming adequate state revenues. Former Governor Davis' attempt to restore that funding in light of inadequate state revenues was characterized as a new "tax increase" by the media and by his recall opponents. The election of Governor Schwarzenegger led to the rescission of those increases and the loss of substantial sums for local and state government as of current 2003–04, and has exacerbated the substantial budget deficit for 2004–05. However, under the policies of both former Governor Davis and Governor Schwarzenegger, local governments should not lose the revenue from lower VLF collections because the state guarantees full recompense of all offset amounts to cities and counties. It is as if the state is "picking up the tab" for two-thirds of this fee and sending its portion to local jurisdiction beneficiaries. Local officials object that the current format allows the state to characterize what has long been a local financial entitlement—necessary in order to carry out state funding mandates— as provided through the beneficent grace of state officials.

Local governments (primarily counties and school districts) also receive numerous other defined funds from the state for defined purposes. Some of these grants have a block grant flavor in that they cover a broad subject area and give counties wide discretion in how funds are to be spent. This latitude exists in particular for education spending to school districts, and even more so for CalWORKs spending by county departments of social services. Even trial court funding, taken over by the state as a funding source, gives grants to counties and to a great degree allows local courts to allocate those funds.

Counties and school districts spending on these and other child-related programs administered locally may be substantially below these facial levels. For the devolved programs, California has been removing "state mandates," similar to the 1996 federal removal of "entitlement" status for AFDC (TANF). Hence, local governments may choose to cut substantially beyond the reductions in the overall fund. Such local "off-state-budget" cuts have not been monitored or examined systematically.

In addition, the state has essentially devolved major Medi-Cal administration to counties over the past five years. Counties are experimenting with their own varying plans, the most common the "two-plan" model (one plan controlled by local officials). In each case, there is substantial county discretion as to how each works, with rate, service, and consumer protection variations.

Consistent with this trend, starting with 1998–99, the state added to this mix grants to counties to implement welfare reform. California's county CalWORKs grants consist of a defined grant of sums pursuant to federal welfare reform. As discussed in Chapter 2, the counties are given substantial discretion as to how the money is to be allocated between forms of assistance, child care, training, job placement and public employment, *et al.* The state has allowed counties to keep 75% of the savings from welfare roll and assistance reductions. The state's grant of these "incentive payments" to counties has resulted in a $1.2 billion surplus of unspent funds at the county level—a fund that has been terminated, and has been partly expropriated by the state (see Chapter 2).

The devolution pattern described above now presents problems relevant to child investment, as follows:

1. Local Sales Tax Revenue Routed Away from Lower Income Jurisdictions

Locally-allocated sales tax revenues go to the jurisdiction from which they are collected. Hence, wealthier jurisdictions with upper-end commerce generate substantial revenues returned to the same neighborhoods generating the funds. While certain user fees are properly directed to the benefit of the payer, taxation rests on a different concept—that of police power collection and distribution based on need and merit, and conscious of the equality of opportunity obligations of the state. The return of money paid by the wealthy back to the wealthy—based on neighborhood/special district/city/county or school district location undermines those egalitarian principles (see discussion of *Serrano* case in Chapter 7 holding the distribution of property taxes for K–12 education based on neighborhood contribution to violate equal protection concepts).

2. Counties Child Service Reduction to "Free Ride"

State to local devolution, without state minimums, can also implicate equal protection principles. And it can reduce some important social services down to a "lowest common denominator." For example, counties may not invest heavily in job training or education for its TANF recipients, hoping they will leave for other jurisdictions. This "free ride" incentive may not lead to egregious abuses, but it is likely to discourage heavy investment in impoverished children where a local disparity *vis-a-vis* a nearby county may attract movement of such persons needing services. This concern is not merely theoretical. For example, the county by county survey of county spending of the CalWORKs block grant from the state reveals only 14% expended for job training, education, job search, *et al.*, and only 19% for child care provision (see Chapter 2). Devolution to local jurisdictions and the granting of broad discretion as to the "how" does not preclude state minimums as to outcomes. State grants to locals do not often include such minimums, and the alternative of incentive payments based on outcomes is rarely used intra-state. CalWORKs has been one grant which has included such an incentive based on at least one outcome measure, but its incentive payments were ended before the 2001–02 fiscal year.

This problem has been manifest in many state-to-local delegated functions. One example is special education, where a conscientious school district may find itself attracting more students in need to the advantage of less responsible districts who avoid investment (see Chapter 5).

Another example of free ride abuse is the practice of some counties who deny emancipating foster children public independent living assistance money unless they were emancipated by the local juvenile court. Some youth move between counties for legitimate reasons, such as employment, school opportunity, and pursuant to court order. Rather than following the child, these and other monies are denied by some counties with the expectation that other counties will provide funding—with those other counties similarly denying funds with the same expectation of pick-up by others.

3. State Capture of Local Funds

State budgets after 2001 have engaged in capture of local funds for general fund relief. During the preceding and current fiscal years, the state ended CalWORKs incentive payments to counties, and took over $600 million in unspent performance incentives from their use—only $169 million of which was allocated to maintain CalWORKs (state) funding.[64] The 2004–05 budget as revised in May would "borrow" $1.3 billion in the proposed 2004–05 fiscal year, and another $1.3 billion the following year (see discussion below).

4. Program Assignment without Funding or Alternative Local Revenue

Throughout this *California Children's Budget* are examples of program general fund termination, often with the instruction that funding is to be picked up by similar programs in pre-existing accounts (see, *e.g.*, the use of Proposition 98 funds for such purposes discussed in Chapters 5, 6, and 7, *passim*). Moreover, funds assigned to local jurisdictions are based on "backfilling" sums that would be received from the Governor's reduction of the VLF. But how does a VLF amount relate to local revenue needs? Local jurisdictions lack practical means to raise funds notwithstanding additional mandates from the state. The 2004–05 solution to this dilemma is not to provide possible revenue sources within the realistic control of counties, but to rather eliminate the state mandate for child-related (or other) services.

As noted above, assignable state sales taxes are limited in amount and require local two-thirds vote. The traditional revenue source for local government is the property tax. But under Proposition 13, real estate property taxes have declined in relation to population/inflation growth. Property taxes feeding local government and school financing amounted to five times state income tax collection in 1977; they are now at approximately the same amount.

The 1996 passage of Proposition 218 further limited local government resources and options by restricting "assessment districts," created to allow property owner financing of local improvements. Because proponents contended that some districts were financing general services, the measure required that, by July 1997, property owners pay through taxes only the share of "special benefit" conferred by the district. Property owners must directly approve any increase or enactment of assessments by a two-thirds vote—historically difficult to obtain. The unwinding of existing districts and revenue demands on existing local general fund resources may be significant in smaller and newer jurisdictions.[65]

5. State–Local Realignment and Public Official Accountability

A democracy works on the theory that public officials serve and are accountable to the citizenry. That accountability is enhanced where those who are responsible for making decisions have the authority to effectuate desired results. The mass delegation of responsibility to local officials without commensurate funding allows state officials to point locally for a failure of performance, while local officials point to the state for denying resources.

Critics of realignment contend that the result during economic flattening will be: (1) more local authority to decide what will be reduced, but by officials lacking the capacity to adjust revenue to need; (2) lower actual spending, as child-related programs compete with more powerful local interests; and (3) fragmentation of spending cuts into 58 county and 1,100 school district venues, where choices and revenue options are limited. Outcomes are attributed to local decisions, but state officials who have made the underlying budgetary decisions may escape accountability for the consequences.

The state is the sovereign, with generic power to tax and to specify criminal offenses and civil liability. Local jurisdictions lack the practical ability to generate resources in California's current constitutional setting. It is the state budget that defines the values and priorities of state officials—which no facial delegation to others should obscure.

IV. California Budgets and Children: 2002–03 to Proposed 2004–05

A. The 2002–03 Budget

The 2002–03 California budget was extraordinary, reflecting a general fund shortfall of $23.6 billion. Such a deficit is exacerbated by the fact that a state lacks the borrowing and deficit spending facility of the federal government—state budgets must balance. The Governor's May 2002 Revise outlined the following itemization of the Governor's 2002–03 proposal to meet the shortfall:[66]

	Amount (billions)
Program Reductions	$7.6
Tobacco Settlement Securitization	4.5
Loans	1.7
Fund Shifts	1.3
Temporary VLF Offset Reduction	1.3
Net Operating Loss Deferral (2 year)	1.2
Deferral of Education Disbursements	1.1
Debt Restructuring	1.1
Federal Funding Increases	1.1
Federal Tax Conformity/Compliance	.9

Other Accelerations and Transfers	.7
Fund Transfers	.6
Cigarette Tax Increase	.5
Total	$23.6

Table 1-G. Governor's May 2002 Revise Proposal to Close Budget Gap

Former Governor Davis' final proposal for 2002–03 eschewed new revenues—except for the cancellation of previously planned cuts to VLF discussed below and a small cigarette tax increase. Over 90% of the deficit was to be addressed by (1) spending cuts ($11.1 billion) and (2) forwarding costs to future years by a variety of means ($11.6 billion). This approach contrasts with the decision of former Governors Reagan and Wilson, each of whom faced similar unanticipated revenue shortfalls during their tenure, and each of whom agreed to revenue increases to make up at least 50% of the shortfall—balancing spending cuts and revenue enhancement responsibly. As discussed above, as economic conditions improved both administrations supported subsequent tax cuts. Those cuts often increase year to year substantially more than do spending amounts (contrary to common perception) because they often automatically increase with inflation and population.

In 2002, then Governor Davis instituted a hiring freeze at the state level. This policy required various departments to leave positions vacant where public employees retire or otherwise leave; another state policy requires the elimination of positions that are vacant for more than six months (law enforcement-related positions were exempt from the freeze). The freeze arbitrarily requires caseload increases based on the happenstance of staff depletion, with no relation to need. Similar policies were subsequently adopted at the local level as funding pressures have grown since 2003— and concentrating in agencies providing health and protection to children at the county level as discussed below.

State general fund preservation policy since 2002 has included the allocation of federal monies to supplant previous state general fund commitment. This diversion of funds may be accomplished where federal law does not explicitly require a maintenance of effort (MOE) spending level at previously established state amounts—as the federal Personal Responsibility Act required of states as a part of welfare reform. However, even where such MOE requirements were imposed, they rarely adjust for inflation and population, allowing the sequential diversion of intended additional federal monies. Those funds, intended for additive effect, replace general fund prior investment to relieve the state of revenue obligation and preserve California tax reductions and "tax expenditures" (special deductions/credits) enacted over the past eight years. In particular, alleged federal increases to education (No Child Left Behind Act) have suffered from such supplantation, as have numerous other accounts discussed in Chapters 2–9.

Not all of the reductions proposed by former Governor Davis were enacted in the 2002–03 budget, but adjusted spending was reduced by $2.6 billion from 2001–02, and a momentous $8.3 billion from 2000–01. Most of these cuts concentrate in child-related accounts, with $2.3 billion in education cuts imposed during the 2002 mid-year period immediately prior to the 2002–03 budget enactment. Higher education, now facing growing demand from the larger numbers of youth needing higher education opportunity, was cut— with community colleges reduced $141 million and the university and state college systems cut by $60 million each. Law enforcement has been largely exempt from reductions. During the 2002–04 period, counties (where social and health services are administered) began to suffer substantial financial pressure. The TANF surplus from welfare roll reductions dissipated, and federal incentive monies received were expropriated by the state for general fund reductions (see Chapters 2 and 8).

The 2002–03 budget as enacted effectuated deferrals through creative accounting measures. These included $1.2 billion in deferred education payments, deferral of payments to major public pension plans, including $412 million in 2002–03 and $440 million in 2003–04 to the State Teachers Retirement System. Former Governor Davis added to this deferral $371 million to CalPERS in 2002–03 and another $124 million in 2003–04, and transferred $97 million out of what he termed "idle cash" from nineteen funds. The general fund received $579 million borrowed from 15 special funds—which must be repaid under existing court precedent. Davis secured loans of $1.7 billion and "shifted" $1.3 billion temporarily. His budget carried a net operating loss deferral over two years of $1.2 billion. And he proposed spending most of the tobacco litigation (Master Settlement Agreement) monies over the next 22 years on "up front" bonds to reduce the general fund by $4.3 billion over 2002–04 (see discussion below).

B. The 2003–04 Budget

The failure of the 2002–03 budget to increase revenue (and instead enacting new tax deductions and credits), combined with its pushing forward of debt, led to the largest projected state budget deficit in U.S. history—a 2003–04 projected deficit of $38 billion. The state budget to purportedly fill that void was signed into law at the late date of August 2, 2003, over one month into the budget year. Given the budget crisis, it authorized the rescission of the planned VLF cuts, and restored those fees closer to 1998 levels—gaining $2.9 billion (see discussion below). It also allowed the manufacturer's $450 million tax credit to sunset, based on that tax expenditure's intent to stimulate manufacturing job creation (which critics of the credit argued did not occur).

Aside from the rescission of planned fee reductions and the ending of one tax credit, the budget produced no new revenue and relied for a second year on obligation deferrals/financing and on substantial spending cuts—again disproportionately affecting child-related accounts. Reductions totaled $9.4 billion, and included the following changes:

■ suspended the 2003–04 COLA for TANF recipients, 70% of whom are impoverished children;

■ reduced all Medi-Cal provider rates by 5%, and reduced dental and durable equipment payments;

■ cut child care after-school spending by $7 million and reduced compensation for providers (already among the lowest paid sectors of the economy) by $82 million, cut CalWORKs Stage 3 child care by $57 million, cut all general fund contribution to CalWORKs Stage 2 child care, cut child care assistance to all children over the age of 12, and eliminated quality improvement technical assistance spending entirely;

■ cut K–12 education $288 million below the 2002–03 budget, translating to $180 per pupil, and moving the state from $7,067 to $6,887 per pupil. Beyond this raw number cut, enrollment growth in categorical programs is unfunded; further, spending fails to adjust for cost-of-living increases both in categorical programs and in baseline ("revenue limit") spending (*e.g.*, financing teacher pay and underlying infrastructure); and

■ reduced higher education investment substantially—$293 million from the University of California and $204 million from the California State University system. This $497 million reduction is moderated by $363 million in additional revenue, but that enhancement comes entirely from increased tuition and fees assessed students. Similarly, community colleges are reduced by $81.8 million in basic appropriations, in addition to $86 million in apportionments and categorical programs. About one-half of that combined cut is also offset by increased student fees, rising from $11 to $18 per unit—a 64% hike. The net of approximately $200 million in raw number higher education cuts does not include population and inflation adjustment, a momentous factor given the bulge in population now graduating from California high schools. Even without that bulge, $334 million is required in 2003–04 to stay even with inflation and child population increase as a whole from 2002–03.[67] Both are "unallocated" reductions, requiring education officials to choose what to cut.

Of the $9.4 billion in reductions, child-related accounts suffered more than 75% of the total, with K–12 education absorbed 47.5%, higher education 17.1% and health 8.6%.[68]

In terms of unallocated reductions, compensation for state employees was cut 10%—much of which will be accomplished through continuation of the hiring freeze; as discussed above, this method of reduction irrationally determines available public workers based on the happenstance of current worker retirement, death, illness, or resignation, and has little to do with legitimate public need. Hence, those agencies with a small number of necessary employees and who suffer from such natural attrition will be unable to function as intended.

Reductions to local government were also significant. These cuts are felt in particular by counties that serve as the primary delivery vehicles for safety net (TANF), health, and child protection services. As discussed above, state mandates without commensurate funding forces local officials to make reductions separate and apart from state officials making state budgetary decisions. County and school district officials—who lack alternative revenue sources or practical authority to add funds—must make the reductions, separating the decisionmakers from the human consequences. Local governments had been deprived of property tax revenues historically reserved for their allocation in the early 1990s; this state taking was "backfilled" from several sources—most notably from assigned revenues from the VLF. However, the budget removes the VLF as so reserved for local government allocation and backfills the shortfall from the general fund.

Beyond spending reductions, the budget included $16.1 billion in continued and new "deferrals" of obligation, a problematical policy given the state constitutional prohibition on deficit financing:

■ $10.7 billion in "deficit retirement bonds" that have been supplanted in 2004 (see below);

■$1.9 billion in bonds to finance the state's contribution to the state pension fund (another method to push obligations forward to future years);

■$2 billion in bonds secured by the tobacco industry Master Settlement Agreement future payments, depriving future budgets of revenue promised over the next twenty years in order to pay interest and principal on bonds for 2003–04;

■$680 million in tribal gambling revenue (to be negotiated in the future);

■$290 million is transferred from special purpose transportation funds to the general fund;

■$813 million in Medi-Cal by changing accounting methods from accrual to cash (not a real savings);

■$3.2 billion in payment deferrals (*e.g.*, paying education salaries and bills due in June 2004 to July2004 to move a large sum into the next fiscal year); and

■$2.7 billion in "fund shifts," most from federal funds available to states to partly compensate them for the impacts of the 2001 and 2003 federal income tax reductions (however, the tax reductions are scheduled through 2011, while the federal funds terminate after 2004–05).

Many of these measures may be unconstitutional or otherwise unlawful, including the pension bond, the deficit bond, and takings from special funds. In addition to these reductions, the state exhausted the surplus "rollover" of monies from the reduction of welfare caseloads. That exhaustion left no cushion should the economy increase child poverty incidence, and in combination with lack of cost-of-living adjustments and population adjustment, casts doubt on state compliance with federal mandates for states to provide adequate child care and job training requirements for impoverished parents (see discussion in Chapter 2).

C. Governor Schwarzenegger's Mid-Year 2004 Reductions and Tax (Fee) Increases

Part of the 2003–04 budget includes mid-year authority for the Governor to cut any account he chooses by up to 5% to the extent necessary to offset any excess beyond budgeted spending from any source during the budget year. The California Governor already has "item veto" power over budgetary approval—unlike the President who is forced to veto or sign entire bills. That state item veto is exercised at point of final signature. However, the new authority extends beyond approval of the budget and is not subject to veto override by the Legislature. It allows the Governor to essentially implement the "Pay as You Go" proposal now in the Congress (see discussion above). Given overages by the Department of Corrections, as well as the unpredictable spending from health and other entitlements, such a power can be momentous. It allows mid-year reductions to be administratively ordered as selected by the Governor to the extent budget overages occur. As with the federal proposal, it does not include a comparable mid-course adjustment on the revenue side (*e.g.*, an increase in taxation or the reduction of tax deductions or credits where revenue is less than budgeted assumptions).

As with prior budgets and mid-year cuts, law enforcement has been largely spared reduction. Meanwhile, the Department of Corrections spending ran $454 million above approved appropriations levels during 2003. In addition to that overage, former Governor Davis granted another $90 million in extraordinary pay and benefit increases to the politically powerful prison guard lobby (a group contributing $1.1 million to his re-election campaign) after the enactment of the 2003–04 budget. Top pay increased from $55,000 to $73,000, and pension benefits increased dramatically, accounting for most of the overage.

1. VLF Reduction

The Vehicle License Fee is set by law at 2% of the value of a vehicle per annum. The VLF was imprudently "offset" from 1999 to 2002, in anticipation of continued high revenue from capital gains. That offset did not establish a permanent new tax level—it merely constituted a temporary reduction in light of the state's financial status. The offset from the 2% statutory level was reduced by 25% in January 1999, with a temporary one year add-on reduction to 35% for 2000, which was then extended to June 2001. The reduction was then increased to 67.5%, accomplishing a temporary rollback of the fee to one-third of normal levels. In his 2002 May Revise, former Governor Davis proposed to bring the adjustment back to 25% below the statutory 2% of vehicle-value level. However, the media quickly labeled this proposal to be a "tax increase." Further, when the former Governor subsequently proposed the rescission of the post-1999 VLF reductions—on the basis that the conditions allowing the designedly contingent offset were no longer present—he was accused of "tripling the car tax," allegations repeated frequently by the Schwarzenegger campaign.

The new Governor's first act upon his recall victory was the purported administrative rescission of the offset; hence, the current year budget lost $2.65 billion in budgeted revenue. On December 18, 2003, the Department of Finance approved an immediate $2.5 billion deficiency appropriation from the jeopardized general fund to backfill lost monies to cities and counties as required by Government Code section 10754.

2. Proposed "Caps" on Child Services and Other Proposed Cuts

In November 2003, the Governor proposed $1.9 billion in general fund cuts to take place immediately, with a like amount scheduled for the 2004–05 fiscal year (to be augmented by reductions in the January 2004 proposed budget for 2004–05). The approach taken by the new Governor's budget appointee Donna Arduin was to mechanically "cap" numerous child-related programs at their levels of January 1, 2004. This closure of services to additional children would be applied to Healthy Families (medical coverage for children of the working poor financed 2–1 by federal monies), the California Food Assistance Program (providing food stamps for immigrants), Regional Centers (serving disabled children), state mental hospitals, the Genetically Handicapped Persons Program, and the California Children's Services program (serving chronically ill kids). Caps would also apply to documented (legal) immigrants applying for Medi-Cal, Healthy Families, and CalWORKs.

Governor Schwarzenegger also proposed a 10% Medi-Cal reimbursement reduction—on top of the 5% reduction contained in the 2003–04 budget. Further, he proposed to cancel the cost-of-living adjustment for TANF benefit COLA cancellation, a 5% reduction in TANF grants, elimination of "non-core" regional center services to the disabled, elimination of the Transitional Food Stamp Program, re-imposition of asset and vehicle value ceilings that eliminate numerous children from public assistance coverage, and reduction in local government contributions by $475 million.

Most of these caps and reductions were not enacted on a mid-year basis, but were incorporated into the 2004–05 proposed budget now before the Legislature (see discussion below).

3. Implemented Mid-Year Budget Changes

On February 26, 2004, the Legislature enacted approximately half of the mid-year reduction amount requested by the Governor. The $990 million in cuts approved consisted of fund transfers and deferrals. The major Gubernatorial proposal listed above that won approval was the treatment of $475 million in "backfill payments" to counties and cities as a loan; this backfill is required by law where the state fails to collect VLF funds designedly allocated to local government (see discussion above). The proposed and enacted measure defers payment of this substantial amount until 2006–07. To comply with the statute, the taking is designated a "loan" to the state by local governments. The enacted measure includes a token $20.4 million needed to "compensate" counties where they can demonstrate special hardship if required to wait until 2006 for funding. As discussed below, local governments are already under great fiscal duress, and this additional shortfall is now precipitating the lay-off of thousands of county workers who provide services to children, particularly in areas of child support collection, child health, and child protection.

Beyond measures requiring legislative assent and as discussed above, the Governor now has authority to cut any account by up to 5% to make up anticipated budget overages (see 2003–04 budget change above). In December 2003, Governor Schwarzenegger announced sixteen such reductions—twelve of which (representing over 95% of proposed reductions) were to child- or youth-related accounts. The larger reductions included $50 million from Cal Grants for student higher education help; $41 million from CalWORKs directed at impoverished parents; $15.7 million from the University of California; $11.3 million from the California State University system; $12.5 million substantially terminating state college outreach to minorities and impoverished children, and $2 million from child support collection funding.

4. Fee Increases

The fee increases enacted during the 2003 legislative year and imposed prior to the 2004–05 budget focus on lower income and child-related enterprise. Percentage increases of from 30%–100% have been imposed on higher education tuition and school fees—with university and state college increases of 40% during 2003 (to $4,984 for university undergraduates and $5,219 for graduate students). Community college fees increased 39%—from $11 to $18 per unit. Beyond education, working poor parents had co-pays markedly increase for child care assistance (see Chapter 6). And child care providers and foster care families and agencies—although among the lowest paid service industries—suffered large percentage increases in license renewal fees (see discussion in Chapters 6, 7, and 8).

Healthy Families premiums charged to working poor parents to medically cover their children were also raised by a substantial amount. These premium raises were imposed notwithstanding the financing of two-thirds of such coverage from federal sources, the return of substantial sums to Washington due to large-scale coverage failure, and the fact that children may be covered at one-fifth the per person cost of older adults. It is also imposed above levels already charged, and which impede such coverage for many children of the working poor (see discussion in Chapter 4).

V. Governor Schwarzenegger's 2004–05 May Revise

A. General Fund Spending Trends

Governor Schwarzenegger campaigned on the theme of controlling excessive state spending. His post-election statements continued to advance the contentions that California is overtaxed, unfriendly to business, and has radically overspent its general fund resources—particularly since 1999; it imprudently squandered the bolus of capital gains personal income revenue on spending pork barrel it can no longer maintain; and with the economic "dot com" boom abated, the state must tame its irresponsible spending. However, as presented in Table 1-A, the Governor's own Budget Summary indicates that general fund revenue collection as a percentage of personal income was above 7% in the 1970s, dropping to around 6% in the early 1990s, and increasing back to just over 7.0% by 2000; since then, it has decreased each year to the current year's 6.5%—and the proposed budget cuts it to 6.0%. On the spending side, general fund expenditures since 1999 array as follows:

	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05 (proposed)
General Fund Spending	$66.5	$78.1	$76.8	$77.5	$77.6	$77.6
Adjusted	**$76.8**	**$86.5**	**$82.0**	**$80.1**	**$77.6**	**$75.1**

Adjusted to CPI and California child population (2003–04=1.00).

TABLE 1-H. General Fund Spending (in Billions)

As Table 1-H indicates, spending from 2000–01 was cut an adjusted 10.3% to current 2003–04. This decline to the current year represents the largest reduction in amount and in percentage in general fund spending from a previous year since at least 1960.[69] Only the reductions of 1993–94 are close to the reduction from 2000–01 to 2001–02, or the reduction from 2001–02 to 2002–03. There is no historical recorded precedent for the cumulative two-year decrease. The proposed 2004–05 budget would then impose another 3.2% reduction, bringing the four-year reduction to 13.2% in adjusted general fund spending—most of it to child-related accounts. The four-year total would represent the largest subtraction in child investment since the Great Depression of the 1930s.

B. Major Proposed Spending Changes, 2004–05

1. Caps on Children Served Notwithstanding Eligibility

The Governor repeated his mid-year proposal to cap the number of benefit recipients in his 2004 n05 budget proposal released in January 2004. As noted above, the list of capped programs was to include Healthy Families, Medi-Cal for immigrants (including prenatal care), California Children's Services (CSS) (the program providing medical treatment for chronically ill children), the Genetically Handicapped Persons Program, state mental hospitals, Regional Centers for the Disabled, and the California Food Assistance Program (providing Food Stamps for legal immigrants).

The "cap" approach suffers from a serious conceptual flaw, and its extensive proposal does not inspire confidence in the public officials advancing it. It mechanically allocates services normally provided on an entitlement or eligibility basis, favoring those already receiving services over those newly-eligible and who may well need assistance *in extremis*. The January budget proposal even applied the concept to important medical services for children. Fortunately, the 2004 May Revise withdrew the proposed imposition of caps across the program areas discussed above.

However, the 2004 May Revise retains substantial reductions across a wide spectrum of child investment, some of which will accomplish service and opportunity denial on more subtle bases than a numeric ceiling on recipients. Examined in detail in Chapters 2–9, the major changes by spending area are discussed briefly below.

2. Child Safety Net

The primary public safety net for children consists of two accounts: Temporary Aid to Needy Families (TANF, formerly AFDC) and Food Stamps. During the 1970s and 1980s, the maximum TANF grant plus average Food Stamps totaled more than the federal poverty line. By 1989, that total had declined to approximately the same amount as the line. Safety net protection was then reduced during the budget shortfall years in the early 1990s, falling to 77% of the poverty line during the Wilson Administration. Recognizing the hardship endured by impoverished children, the Legislature conditioned the Vehicle License Fee reductions after 1998 on the restoration of cost-of-living adjustments for TANF benefits. The proposed 2004–05 budget retracts those adjustments and imposes a 5% across-the-board cut in benefits. The resulting proposed level reduces total safety net protection for children to a record low of about 70% of the poverty line.

Some commentators have argued that California is a "high benefit" state compared to other states in TANF grants and medical/social benefits. The purpose of TANF grants is essentially to prevent homelessness by providing minimal rent and utility monies, and hopefully enough sustenance to meet the growing shortfall from Food Stamp reductions. The state-to-state comparisons in raw numbers fail to account for the state's extremely low level of housing subsidies for the poor (proposed for major additional cuts in 2004–05). Most relevant, such comparisons also fail to account for California's high rents and utilities. A fair comparative measure would take 80% of the median rent and utility charges as an adjuster for TANF benefits across states. Under such a comparison, California does not provide high benefits, but rather falls into the nation's bottom quartile. The state's poor are at extraordinary risk of homelessness unless substantial assistance beyond the assured safety net is available.

The proposed budget exacerbates the dangers for impoverished children by imposing new sanctions on families where CalWORKs requirements are not met or where the sixty-month lifetime budget is reached. Current state policy reduces grants for such persons by the "parent's share"—or from $669 per month as the maximum proposed for 2004–05 for the benchmark mother and two children to about $470 per month. The proposed budget then takes another 25% from the remaining amount (the "child's share"), reducing TANF maximum safety net grants to the benchmark family to $350. Adding in average Food Stamp benefits for all three will produce about $610 per month in total resources for food, rent, utilities, clothing, and all other necessities—thus providing these families with assistance at just 47% of the federal poverty line. The application of these sanctions to impoverished children has grown to large numbers in California, and the now proposed federal requirement of a forty-hour work week minimum, as well as the sixty-month maximum now facing thousands of families, could force more and more children and their families deeper into poverty.

Sociologists delineate families at under one-half of the federal poverty line as "extreme poverty," with serious ramifications for the long-term health and development of involved children. California is already indicating disturbing growth in child homelessness and undernutrition (see discussion in Chapter 3). And as noted above, income below 50% of the federal poverty line understates the impact on California children, given this state's unusually high housing, energy, and other costs.

The policy toward child safety net sustenance contrasts with the relatively generous Social Security (and universal medical) subsidies offered to the elderly—who enjoy a poverty rate of below 8%. Most of these safety net and medical benefits will be financed substantially beyond the contributions of their adult beneficiaries, by current children to be assessed their cost.

Related to a publicly-provided safety net is spending intended to limit child poverty, including lessons in reproductive responsibility, birth control so that children are intended by two adults planning for their arrival, parenting education, and child support collection. The Wilson Administration initiated some programs intended to address reproductive responsibility, but most have atrophied. Some new federal initiatives have been advanced, but most involve fragmentary grants to faith-based agencies and local projects supporting family responsibility on a token scale. New state initiatives or expansion of any ongoing child poverty preventive work are absent from the proposed budget.

Most important, child support collection is scheduled for major staff cuts. Reductions are underway across the state in county offices of the state's relatively new Department of Child Support Services. Ironically, money expended in such collection yields most of its revenue directly for the benefit of impoverished children, and over 40% of it repays public budgets for TANF costs. The record suggests that from $3–$5 is collected by public authorities for every new $1 invested in collection. The relative newness of the Department precludes trend comparison before 2002, but the budget was reduced $40 million in 2003–04. The 2004–05 budget increases the appropriation by $13 million in raw numbers, but the Department's account would require $47 million to stay even with inflation and population changes; thus, the Department is slated for a $34 million adjusted cut. For the first time over the last twenty years of records, it is likely that adjusted child support collection for 2004 and for 2005 will decline from the 2003 levels, and the raw amount (unadjusted for inflation/population) may even decline in 2005—after two decades of annual increases.

3. Child Nutrition

The Food Stamp Reauthorization, enacted through the Nutrition Title of the 2002 Farm Bill,[70] did not add new restrictions to Food Stamp receipt; included full federal Food Stamp funding for children of all lawful immigrants after October 1, 2003; indexed the standard deduction to inflation; provided a five-month transitional benefit for people leaving TANF coverage; and allowed a marginal increase in resource (savings) limits from $2,000 to $3,000 per household where one member is disabled. Food Stamps remain available to low-income families with dependents. Regrettably, they are not as available for youth emancipating from the foster care system; the system requires such "adult" recipients to work at least twenty hours per week to receive Food Stamps for more than three months every three years. Such a limitation may be applied notwithstanding job availability or work willingness and may work a particular hardship on foster youth who are often left at the age of 18 without homes or support (see Chapter 8).

Of even greater concern is the loss since 1997 of one million eligible California children from Food Stamp receipt. A substantial number of these children have not left TANF rolls for higher family income, and up to one-half of them live below 50% of the poverty line, without adequate safety net coverage or sufficient parental employment (see discussion in Chapter 3).

California does have a sophisticated nutrition program for pregnant women and infants (WIC), and an extensive system of subsidized school lunches. However, these programs provide meals to less than 20% of impoverished school-age children, and substantially miss children from age 1–5, a critical period of brain development.

During 2003–04, advocates for children and the poor lost most of the changes they sought for the protection of impoverished children, including: (1) an increase in Food Stamp levels to the "low-cost" food plan which more realistically calculates food costs (rather than the "thrifty food plan" of USDA); (2) indexing benefit levels to inflation; (3) mitigation of harsh time limits for unemployed workers by allowing at least six months of Food Stamps while looking for work and continuing benefits so long as work is sought and not unreasonably refused, particularly for youth under age 25, given the high youth unemployment rates; (4) allowance of some exceptions to the lifetime ban on safety net help for persons convicted of drug possession felonies where a clean start has been made (as enacted in 28 states); (5) increase of the minimum benefit by $25 and adjustment of the shelter allowance cap by the urban area median rent; (6) exclusion of reasonable retirement and educational savings from asset limitations; and (7) substantial federal funds to stimulate and finance state streamlining of for easier access to benefits. None of these measures is a part of the proposed 2004–05 California or 2005 federal budgets.

4. Child Health

The proposed 2004–05 state budget would make several momentous cuts to children's health programs. The January budget proposal repeated the mid-year plan to rollback Medi-Cal provider reimbursement rates by 10%, on top of the 5% previously authorized and now contested in the courts. The total 15% cut from previous levels were to be imposed across-the-board. One problem with such a formula is the current crisis in Medi-Cal underpayment. The state's Medicaid spending per resident is at $702, with the national average at $763. Of greater concern is the rate discrimination against pediatric specialties. Children now have to wait unprecedented lengths of time to see a pediatric orthopod or other specialists because the state's reimbursement schedule for many child-related treatment is below cost, and the supply of practitioners has accordingly declined. The rates for procedures for children are commonly one-half to one-third the amount paid by Medicare for identical services for the elderly. Child advocates contend that such discrimination violates federal law requiring compensation for comparable treatment between patient groups. Although the Governor's 2004 May Revise rescinds the 15% reduction proposal, it does not address the underlying disparity in pediatric specialty rates.

The Governor's January proposal to cap Medi-Cal enrollment for immigrants at the January 1, 2004 level, leaving 78,000 impoverished children otherwise eligible without coverage, and his proposed cap of Healthy Families was similarly withdrawn. The withdrawal of rate reduction and cap proposals saves almost $1 billion in federal funds and assures substantial continuation of current medical care coverage for children. However, the premium increases— including the imposition of higher premiums for parents between 200%–250% of the poverty line—will have some of the same effects as the cap proposal. It is difficult to persuade parents to spend $400–$1,000 in premiums on child coverage for children who are not ill at that point in time, and where discretionary income after payroll taxes, rent, child care, and food is minimal or non-existent.

The 2004–05 proposed budget both imposes new barriers to Healthy Families coverage and limits or stops outreach spending for new enrollment. The unstated premise of the Administration is to hold state spending down as much as possible, notwithstanding benefit-cost impact and the 2–1 federal match eschewed. The proposed budget would effectively preclude almost one million children who are eligible for coverage from receiving it. The state has already returned $1.1 billion in available matching funds for Healthy Families, and stands to return another $1.9 billion over the next three years—a sum that will amount to the largest giveback of appropriated federal funds for any state in the nation's history. The societal advantage to child coverage also includes its modest cost—one-fifth the per capita price of covering the elderly. All elderly receive basic coverage, and recently received $600 billion in additional federal pharmaceutical benefits.

Almost all children living in families with income above 250% of the poverty line have private coverage from parental employers. Those below 250% of the line are eligible for public coverage. A surprisingly small 3% of the state's children are not medically covered and are ineligible for coverage. Accordingly, child advocates urge the state to reverse its current system of several separate programs with paperwork, qualification, premiums, tracking, and filtering—all to keep this small proportion of children from receiving subsidized medical care. Such a small proportion of ineligible commends the reversal from the "you're out unless you are enrolled in" arrangement to a system where all children are presumed to be eligible for coverage. If a child then incurs more than $500 or some other threshold of expense over per year, parents may be required to certify their income, with billing on a sliding scale for those who must pay. Such a paradigm shift, already in force for the elderly at much greater cost, is likely accomplished at overall savings given the diminution in costly bureaucratic barriers, attraction of federal monies, and savings in long-term health benefits. The need for such a paradigm shift is underlined by the price now paid by working poor parents for medical care for a child; even the brief hospitalization of a child will likely mean the loss of accumulated family savings. The proposed 2004–05 budget does not implement such a vision, but maintains the wasteful filtering and inefficient bureaucracy currently in place.

The Schwarzenegger Administration also seeks a redesign of the Medi-Cal program, some elements of which will require federal consent. It intends to apply for a Section 1115 waiver for such changes in August 2004. Initial drafts suggest continuation of the theme of fee and premium increases for impoverished parents. Such increases are being planned for those below or near the poverty line in order to receive currently provided child services, particularly those related to mental health, orthopedic, vision, dental, and other services. Various medical needs would be designated as "optional" or upon payment. In addition, current working groups seek alignment of Medi-Cal eligibility with CalWORKs and SSI, a direction indicating additional barriers to coverage unrelated to child need.

5. Special Needs

The proposed 2004-05 budget includes substantial cuts for children with special needs. Although the Governor withdrew his January 2004 proposal to cap Regional Center and CCS caseloads, most special needs-related accounts will suffer adjusted reductions (see Chapter 5).

Beyond the state budget directly, infrastructure (county and school district level) cuts are now occurring and are disproportionately felt by special needs children. School districts suffering unprecedented staff lay-offs are not in a position to offer the same level of IDEA special education services. Counties throughout the state are currently cutting staff, with mental health staff and service reductions particularly severe.

6. Child Care

The proposed 2004–05 budget has preserved two areas of child care spending: preschool preparation (four-year-olds in particular) and after-school care. However, this preservation is from a relatively low base. For example, 53% of the state's 3- and 4-year-olds attend pre-school, with a national incidence of 64%. Only 41% of California's children participate in the successful federal Head Start program, compared to 58% nationwide.[71] After-school programs also reach a very small percentage of children and youth. Although they were championed by the Governor in his successful campaign for Proposition 49, the budget prerequisites for that measure's funding have not been met. Existing after-school programs have been preserved in the budget—perhaps partly due to the program's favored status with the Governor. Child care spending as a whole is hit hard in the proposed 2004–05 budget and thereafter, particularly for CalWORKs parents leaving TANF roles, and for the working poor who need some subsidy help to remain employment and avoid "latchkeying" children home alone.

The Little Hoover Commission contends that the current major child care subsidy system serves "7% of those eligible."[72] And it correctly identifies how limited supply is allocated: "[the] priority system for determining who receives child care subsidies [is] children receiving welfare assistance through CalWORKs and children at-risk in the protective services system....Low income working families receive subsidies as funds become available."[73] Waiting lists grew to 280,000 by 2002.[74] In addition, large numbers of parents no longer bother to seek waiting list status given its length and continuing lack of funding.

Recent cuts include the denial of subsidies for all 13-year-old children (coverage only to age 12), and elimination of what the Governor's Budget refers to as "grandfathered" child care—stopping assistance immediately to those who have temporary income just above the eligibility line. But of greatest concern is a $200 million reduction in child care help by (1) manipulating the compensation survey used to establish rates away from market factors; (2) categorically prohibiting hourly rates for full-time care; (3) limiting evening/weekend premium payments; (4) cutting the compensation ceiling to a lower percentile paid in the relevant regional market; and (5) changing the family fee schedule to require higher co-pays.[75] Although phrased in the jargon of child care compensation complexity, the reductions are serious.

On April 13, 2003, the California Department of Education (CDE) announced a categorical freeze on any new Stage 2 child care services to any additional CalWORKs participants or applicants. Reflecting an immediate financial shortfall, CDE issued formal notice that all CalWORKs contractors were to immediately cease enrollment of new families for Stage 2 child care because the "funds appropriated for Stage 2 are insufficient."[76] Importantly, this freeze is not to the more discretionary Stage 3 for working parents, but applies to the earlier stage during which parents are supposed to be given the training necessary for employment. Further, the cut was implemented before the 2003–04 enacted reductions— including the compensation reductions noted above.

Governor Schwarzenegger's proposed 2004-05 budget, as revised in May, will cut-off former TANF recipients who have found employment under CalWORKs at either the three- or four-year mark. That is, after two years in Stage 2, assured Stage 3 coverage will last for only two more years, bringing assured assistance (assuming income and otherwise qualified) to no more than four years—notwithstanding the federal promise of "adequate child care" for TANF recipients who secure employment. Those who are still receiving aid (as where employment income keeps them below the poverty line) will have a limit of one year in Stage 3. All of those in Stage 3 as of June 30, 2004 will be shifted to the non-time limited Alternative Payment (AP) program; however, the amount of money available to fund AP is severely limited and waiting lists are long.

The details of the 2004–05 budget continue prior reductions, and impose care denials across a wide spectrum. For example, assistance for 11- and 12-year-olds will be available only if after-school programs are demonstrably unavailable for those children (programs are generally unavailable on weekends, school holidays, and summer). The proposal estimates that 18,000 of these children will be cut-off from child care, and purportedly be shifted to after-school child care. However, the Governor's proposal estimates savings of $75.5 million; either that figure is inflated or the Administration anticipates substantial overall cut-offs.

The proposed budget also creates a three-tier income eligibility structure for general child care (*i.e.*, divides counties into low, medium, and high cost categories similar to TANF grants, and lowers the family income levels allowing qualification in rural counties—cutting off approximately 2,000 families from help in 2004–05[77] and more ominously presaging larger cut-offs in future years. It shifts income eligibility to the California Necessities Index, which will allow fewer families to qualify. It imposes new "family fees"—a co-pay requirement on subsidy recipients, to be payable directly to providers; in other words, the state will deduct this amount from the sum it pays the provider, and leave the provider to attempt collection from the parent. This fee sum starts at 1.4% of family income, and tops out at 10%. The amounts to be so assessed are substantial for working parents earning near the poverty line and will amount to $22 million in new co-payments affecting 77,250 children. It establishes a sliding scale for child care reimbursement, starting at only 40% of the regional market rate for such service (for non-licensed providers) and increasing to 85% for those "who can demonstrate the integration of early childhood development principles and are so accredited.[78] Rules will determine with greater precision how the lines will be drawn between five identified categories of providers arrayed along the 40%–85% of market price spectrum. However, those cut to unprecedented low levels of below 50% of market rates are asked to provide care for children at half the rate paid caregivers at market rates—in a market that provides compensation close to minimum wage.

The 2004–05 budget also assigns substantial funds from CalWORKs child care as Proposition 98 education funding to allow concomitant reductions in otherwise required Proposition 98 funding for education. One major addition is $2 million for a "comprehensive anti-fraud proposal." The Governor's Budget Summary states that "child care fraud may cost the State well over $100 million." This estimate is based on the stated assumption that "10% of the Alternative Payment program" involves fraudulent pay-out. Aside from its simplicity as a large, round number, the basis for such an estimate is uncited and unknown.[79] The Legislative Analyst estimates a net of 20,000 children directly losing child care assistance due to the proposed changes, with 77,250 children costing their parents new co-pay amounts notwithstanding their poverty line status.

7. K–12 Public Education

The proposed 2004–05 budget cuts education spending for both K–12 and higher education. In March 2004, Education Weekly rated the states for regionally (cost) adjusted K–12 spending per child. California placed 44th—between Louisiana and Mississippi. This rating used 2001 data, prior to the deep cuts of 2002, 2003, and as proposed. While some other states also suffered reductions, most have not followed California's "no new revenue" insistence. Child advocates believe that with the enactment of the proposed budget the state is likely to be 50th in the nation in regionally adjusted education spending per child. The state's decline in public education investment from among the top of the nation (from the 1950s through the 1970s) to last place has received little public discussion. It has occurred notwithstanding the electorate's strong enactment of Proposition 98 in1988 to assure minimum general fund commitment to public education.

The Governor proposes to spend a combined $966 million below the Proposition 98 minimum guarantee for 2002–03 and 2003–04. These underages continue the trend in California budgeting to regard the Proposition 98 guarantee not as a minimum for public education, but as a ceiling that may be undercut in a future year by any amount it has been exceeded previously. As to this $996 million shortfall, the state would appropriate additional resources at some future time in order to "settle up" to the amount constitutionally required—delaying repayment until 2006–07.[80]

For 2004–05, Governor Schwarzenegger estimated that Proposition 98 would require an increase in K–14 funding of $3 billion. Instead, he proposed that the level of Proposition 98 appropriations be "rebased" at a level approximately $2 billion less than otherwise would be required for 2004–05.[81] The Governor would then restore this base from "future years," as with other budgetary policies. The Legislative Analyst opines that revenues would have to grow to about $103 billion, or 8% annually, in order to simply restore this taking by 2008–09.[82] The Governor's 2004 May Revise increases Proposition 98 funding slightly from the January proposal above—but only by $275 million.

The 2004 May Revise seems to indicate that K–14 spending is increasing by $5.6 billion in 2004–05, but $4 billion of this total is merely a shift in property taxes to local government that the budget would then backfill from the general fund. This sum is not additional resources. General fund Proposition 98 funding per K–12 pupil is $7,011 in 2003–04 and is set at $7,007 in 2004–05, not adjusted for inflation—accomplishing an approximate 2% real spending reduction.

Beyond the generic Proposition 98 funding for teacher salaries and basic education costs are a series of categorical programs. The current 2003–04 budget provided approximately $49 billion for these Department of Education programs. Instead of across-the-board reductions as proposed by then-Governor Davis in January 2003, the 2003–04 budget contained $1.13 billion in targeted reductions that reduce or eliminate funding for "lower priority categorical programs," such as equalization, instructional materials, deferred maintenance, summer school, and peer instruction and review. Also, the 2003–04 budget reduced subsidized child care expenditures by $384 million by implementing several "reforms," such as limiting services to children under thirteen years of age, decreasing the state preschool caseload and the CalWORKs Stage 3 caseload, reducing provider regional market rates, and reducing the after-school program.

The 2004–05 proposed budget makes further cuts to the 70 categorical programs that include class size reduction, special education, teacher training, child nutrition, and others. Some of these programs are designed to take advantage of federal subsidies (*e.g.*, school nutrition programs); others are experiments with educational reforms, and others address particular statewide needs. Governor Schwarzenegger is proposing to eliminate 22 categorical programs and transfer the funding to revenue limits; the level of funding for those 22 programs is currently at approximately $2 billion. Education advocates were grateful that the 2004 May Revise added $36 million to reflect population/inflation change for this spending. The categorical programs proposed for elimination include Advanced Placement Programs; Home to School Transportation; the Instructional Materials Block Grant; Dropout Prevention; English Learners Student Assistance; the Targeted Instruction Improvement Block Grant; and 10th Grade Counseling.

8. Higher Education Investment

The Governor's proposed budget for 2004–05 provides $32.3 billion from all sources for higher education. The proposed 2004–05 general fund contribution to higher education is 2.3% less than the final 2003–04 figure. Overall spending is kept relatively constant due to some federal funds increase, and an overall 18.2% increase in student fees. The Governor's proposed budget does not include funding for enrollment growth or cost-of-living adjustments at public universities—and alarmingly proposes to reduce freshman enrollment growth at UC and CSU by 10%.

Overall, Governor Schwarzenegger's proposed budget for 2004–05 includes several major reductions in higher education investment. Combined, these changes would result in over a half billion dollar disinvestment in our young adults, and would add to the state's ongoing failure to ensure appropriate student access to higher education. The major components of the Governor's higher education reductions include the reduction of general fund support for outreach programs at UC and CSU; reduction of freshman enrollment growth at UC and CSU by 10% ($45.9 million); increasing UC and CSU fees by 10–40% ($209.9 million); increasing community college fees by 44% ($73.4 million); reducing Cal Grant income ceilings ($11.2 million); and reducing maximum Cal Grant awards for students at private colleges ($32.7 million). Cal Grants to children in need of assistance for higher education would not be increased by a cost-of-living adjustment, but would be adjusted for the tuition increases under the May Revise.

The Governor is also proposing a long-term fee policy applicable to the UC and CSU systems, linking undergraduate fees to the change in per-capita personal income, reflecting ability of families to pay. But he is proposing an increase of 14% for 2004–05 and a floor of at least an 8% increase for each of the following two years, with increases pegged to the personal income percentage increase thereafter. Only

20%–33% of the additional fees will be reserved for student financial assistance; the remainder is intended to relieve the general fund of financial obligation. While child advocates do not begrudge some increase in tuition for graduate schools in engineering, business, law, or medicine—where students will shortly have repayment opportunity—the broad-based increases proposed extend to basic higher education, combined with cuts in Cal Grant resources for grants and/or loans, and with substantially increasing housing and other costs for students.

Using nomenclature similar to that adopted by former Governor Davis, Governor Schwarzenegger announced in his 2004 May Revise that he had entered into a Higher Education Compact with UC and CSU. The Compact would begin in 2005–06 and last through 2010–11. It purports to guarantee annual fixed increases in base state general fund support, starting in 2005–06 and continuing through 2010–11, to be used for activities including core instruction, academic and institutional support, faculty and staff salary and benefit increases, inflation, and facility maintenance.[83] Allegedly assured annual budget increases will be 3% in 2005–06 and 2006–07, increasing to 4% in 2007–08, and 5% in 2008–09 through 2010–11. The additional 1% increase provided beginning in 2008–09 will be specifically for core academic support needs, including instructional equipment, instructional technology, libraries, and ongoing maintenance. These increases will not match inflation/population growth, requiring real spending reductions in the system over the next seven years—when the population bulge of 18-year-olds and societal need for a much higher rate of higher education degrees will coalesce. The compact includes the promise of enrollment growth funding to sustain 2.5% annual capacity increase, but it is unclear if this funding is expected to come from the general fund assurance levels above. It is unclear how enrollment growth can be accommodated under the compact and its planned constrictions. Importantly, in April 2004 both UC and CSU systems announced substantial reductions in admitted students for the 2004–05 school year. These represent not merely a failure to grow with population, but the denial of admission to qualified students who would have been admitted last year, and their referral to community colleges for delayed entry. It is unlikely that the 2.5% enrollment growth target—if actually funded—will accomplish the increase in higher education incidence that future employment for youth will require.

The California Community College (CCC) system currently serves 1.104 million students, and is projected to have an enrollment of 1.137 million in 2004–05. Total revenue for 2004–05 represents a 4.4% adjusted increase from current year revenue. Actual proposed spending for 2004–05 is $6.623 billion, up 6.6% from the 2003–04 funding level. As noted above, the 2003–04 Budget Act increased tuition for California's community colleges (CCC) from $11 per credit to $18. The proposed 2004–05 budget increases the amount to $26 per unit, a combined increase of 136% for community college students over just two years. Although the fees remain under the national average, child advocates are concerned that the Schwarzenegger Administration is contemplating further increases, perhaps eliminating one of the most prized legacies of California investment in children—its highly affordable "second chance" access to advanced education.

Governor Schwarzenegger estimates that community colleges will experience a 3% enrollment growth in 2004–05. Any such "growth" would be primarily due to the state's failure to adequately fund the necessary number of slots at UC and CSU schools and their referral down to community colleges, as noted above. Community college advocates predict that the Governor's budget would require the state's community colleges to turn away 39,600 students—primarily in order to make room for the students who will be redirected from the UC and CSU systems.[84] This capacity contraction does not account for the special population bulge now graduating from high schools. Even before the profound cuts ordered, community colleges have been in a growing capacity "crisis" since at least 2001, with the numbers of courses increasingly limited and additional semesters or multi-school registration needed to meet degree or certificate requirements.

The Governor's 2004 May Revise lists the addition of general fund contribution to community colleges by $620.4 million in Proposition 98 funds. However, almost all of this sum is not new money, but represents part of the shift of property taxes from K–14 to locals to help make up for the cut in VLF monies normally going to local governments. The general fund addition simply backfills the reductions—moving it from one fund to another without substantial change in amount.[85] The Revise does increase the cost-of-living adjustment for certain categorical programs from 1.84% to 2.41%.

Child advocates observe that politicians across the spectrum now publicly espouse "retraining" and enhanced higher education to ameliorate the unemployment caused by the export of manufacturing jobs overseas. All agree that the labor market niche of the U.S. centers on technology and higher education. Ironically, while those promises are now commonplace, the 2004–05 state budget not only fails to expand higher education opportunity to more students, but markedly contracts the percentage of 18-year-olds able to obtain advanced education for marketable employment.

Exacerbating the capacity contraction and beyond tuition/fee increases, the 2004–05 proposed budget will put education out of the reach of many students through grant/loan denial or limitation. The Governor is proposing to reduce Cal Grant income ceilings—the maximum allowable income for Cal Grant recipients—by 10%. For example, the current income ceiling for a family of four is $67,600; under the Governor's proposal, the maximum income would be cut to $60,840. Thus, fewer students would qualify for Cal Grants under the Governor's proposal, saving the state $11.2 million. At the same time, the budget reduces the maximum Cal Grant award for students at private colleges and universities from $9,708 per year to $5,482 per year—an amount equal to the annual undergraduate fee at UC schools, if the Governor's proposed 10% fee hike takes effect in 2004–05.

The Governor's May Revise provides $34 million to cover the 14% undergraduate fee increases to be imposed by both UC and the CSU systems in 2004–05, and withdraws his proposal to "decouple" Cal Grant awards from UC and CSU tuition level increases—allowing at least comparable increases going forward. However, the Governor's May Revise also cut another $5 million to reflect a reduced number of competitive awards the Student Aid Commission may grant (from 22,500 to 16,875). And the Revise also calls for a one-time general fund reduction of $134 million, to be backfilled with "surplus funds" from the Commission's Student Loan Operating Fund. Thus, the May Revision makes a net general fund reduction of $73.3 million from the Commission's funding levels contained in the January budget proposal.

The authority to match tuition increases in Cal Grant awards is an important recognition of the pressures on students. However, the budget contraction promises serious limitations on Cal Grant help beyond tuition, and a likely substantial reduction in the number of students able to receive awards—just when the population of students needing help is rising, and both tuition and room and board (and private rental) increases will price higher education out of reach for those students not able to receive adequate grant help.

9. Child Protection

The Governor's 2004–05 Budget Summary notes the increase in foster care payment expenses since 1998, accurately attributing the increase to three factors: "(a) COLAs, (b) rate increases for group homes, (c) increased placements in higher-cost FFAs and Group Homes."[86] The summary announces the Governor's intent to "promote the care of more children in a family home environment and to shorten the period of time children spend in foster care, particularly in more restrictive placements such as group homes. These proposals are expected to save approximately $20 million (in general fund monies) in 2004–05 and increasing amounts in subsequent years."[87] The Administration proposes to convene a "stakeholders group" to develop reforms. But child advocates without ties to foster care providers have advocated a series of measures that would accomplish these stated ends by increasing family foster care rates to at least equal the out-of-pocket costs of caring for the children involved (at least a 22% increase); assigning an office within the Department of Social Services with the specific task of improving family foster care supply and quality; creating a budget for such an office to enable it to stimulate a range of measures from mass media recruitment to community college courses; and raising the quality of family foster care by providing for advanced certification and rewarding those who achieve it with a premium compensation rate. These measures were part of a legislative proposal killed in the Assembly Appropriations Committee's Suspense File in 2001 (see discussion of AB 1330 (Steinberg) in Chapter 8). The enactment of such reforms would entail some initial investment over the immediate several years, but would yield increasing economic returns as more children are cared for by families at $900 per month (even with the stated increase) and fewer at $5,000 per month in group homes, and as more children would be adopted by those families. Hence, progress here, as in other areas, requires some investment in children now in order to yield financial savings and child improvement over the longer term. Such a perspective has not been a part of the state's deliberations, and is not reflected in the 2004–05 budget proposal.

The disconnect between proper diagnosis and concrete proposals contradicting or unrelated to those intentions is also reflected in the major 2004–05 proposal of the Legislative Analyst (to cut back on adoption assistance coverage and payments). Child advocates contend that this puzzling proposal suffers the same short-term vision and misunderstanding of the economics of foster care as does the budget proposal of the Administration. Child advocates argue that existing "adoption assistance" payments only partially offset the expenses of adopted children. Denying or cutting those adoption payments reduces the supply of those able to afford adoption, and relegates more children to continued foster care to their disadvantage. Not only is the permanence of enhanced adoptions beneficial to children, but those relatively low assistance payments stand in contrast to the group home costs (7 to 10 times foster or adoption assistance levels), where foster children are often placed or relocate.

The Governor's 2004–05 proposed budget's major child welfare addition is $39.2 million for "system improvement" efforts partly triggered by three critical reports of system performance—including one from the federal Department of Health and Human Services. Only $4.5 million of the total sum is from the general fund; $18 million is from federal TANF funds (reducing those needed job training and child care monies accordingly) and the remaining $16.7 million is from other sources (including special funds and county funds, which can ill afford additional obligations given fiscal pressures extant). The Legislative Analyst has opined that the work so far "offers high-level concepts" that would require statutory change to implement, recommending that these monies not be expended for focus group machinations. Child advocates argue that answers are not available in committee meetings but through the enactment of legislation previously barred from passage because it imposes modest costs to enhance the supply and quality of family foster care providers (the source of 80% of foster child adoptions), and to commit to prevention—which "system examination" work has not addressed.

As a result of numerous failures in the state's child welfare services computer system, the federal jurisdiction withdrew substantial funding for the system—in an amount that leads the current budget to understate general fund costs to the state by $43 million.[88] But the price is greater than that. First, because the system does not comply federally, the state owes the federal jurisdiction the $50 million it received over three years for its development. The federal jurisdiction requested that one-time payment in June 2003, but none of it is included in the 2004–05 proposed budget

Child advocates agree that adoption is a primary goal for children whose parents have had their rights terminated. In addition to the danger presented by the LAO suggestion of adoption assistance cuts are proposed reductions in the Governor's 2004–05 budget for "Adoption Facilitation." This account reached its zenith in 2001–02 and has been reduced since, with another 4% adjusted cut proposed. The pattern reflects the laudable effort to reduce paperwork and increase adoptions in the late 1990s, leading to increases in 1999–2001. Those increases have now leveled and face likely decline given investment fall-off and prospects. They did produce $4.4 million in federal adoption incentive payments provided to California from the Congress in 2002 based on previous success and intended to be expended for adoption stimulation. All of it was diverted into general fund relief in 2002–03.

10. Juvenile Justice

The state's role in juvenile justice includes the enactment of statutes specifying crimes, punishments, and procedures; the funding (from 1998) of local courts; California Department of Youth Authority incarceration of young persons referred from the counties; parole of those released from CYA; restitution to crime victims (including a substantial population of injured children) through the State Board of Control; prevention programs run by the Office of Criminal Justice Planning (OCJP); and a new sum included in the CalWORKs block grant to counties with juvenile justice purposes. Two CYA accounts (Institutions and Camps and Parole Services) and the state's crime victim fund are the three largest accounts. The average cost of housing each juvenile committed to CYA in the current 2003–04 year is approximately $60,000 per year in direct expenses, excluding capital costs.[89]

The February 2004 population of all institutions and camps was 4,351; CYA was also supervising 4,165 parolees as of February 2004.[90] The Governor's budget proposes total expenditures of $378.1 million for CYA in 2004–05, about 13% below estimated current-year expenditures. Under the Governor's proposal, the general fund portion of CYA funding would drop 12% below general fund expenditures in 2003–04. The proposed decrease in general fund spending for 2004–05 is the result of proposed closures of youth correctional facilities, as well as the continued decline in the juvenile institution and parole populations. The Governor also proposes to reduce the age of CYA's jurisdiction for wards and parolees from 25 to 22 years of age, in order to allow CYA to "re-engineer its system to focus its rehabilitative resources on a much more specialized population of youthful offenders."[91]

Several reports issued in late 2003 and early 2004—and commissioned by Attorney General Bill Lockyer—were highly critical of CYA in the areas of health care services; mental health care and substance abuse; education programs; sex offender treatment programs; and general conditions. The Attorney General requested these reports as part of a pending class action filed in January 2002 by the Prison Law Office and three other non-profit entities.[92] The substantial cuts in funding cast doubt on effective redress.

In 1989–90, the state spent $124 million in current population adjusted dollars for "prevention and community corrections." This account addressed delinquency through prevention grants and projects, such as upgrading local facilities, etc. In 1991–92, the account was "significantly reduced in order to meet budget reduction requirements."[93] It was then made into an Office of Prevention and Victim Services within Parole Services and Community Corrections at a fraction of previous spending. The current 2003–04 and the proposed 2004–05 budgets impose further overall reductions in prevention spending—in the face of a major Little Hoover Commission Report recommending increased resources and major state governmental reorganization to apply them. Those reductions include the virtual elimination of the Office of Prevention and Victim Services, currently funded at just $6.5 million—a cut of 92% from the 1989–90 unadjusted funding level. Governor Schwarzenegger is proposing to cut this program's funding further to $3.7 million in 2004–05.

The Juvenile Justice Crime Prevention Act Grant Program (JJCPA) addresses a continuum of responses to at-risk youth and juvenile offenders—including prevention, intervention, supervision, treatment and incarceration—and responds to specific problems associated with these populations in each county. The main source of federal funds for JJCPA programs is the federal TANF block grant, which has historically provided approximately $200 million for probation services. Under current law, however, the TANF block grant for juvenile probation programs sunsets in October 2004. Governor Schwarzenegger has proposed to allow the block grant funding to sunset at that time, resulting in a reduction of $134 million in 2004–05 for juvenile probation programs. In other words, of TANF's $200 million allocation for probation services in 2004–05, $67 million would be appropriated for that purpose from July–October 2004, but starting in November, the remaining $134 million would be retained by the CalWORKs program.

TANF block grant funds are primarily used by county probation departments to provide services to youth detained in juvenile halls, camps, and ranches—elements that LAO describes as "core services."[94] Thus, the loss of these funds would appear to have a significant impact on the ability of counties to operate juvenile probation facilities; such an action could result in a lower level of public safety and increased general fund costs resulting from more CYA commitments.[95]

As opposed to the core services funded by the TANF block grant, JJCPA grants (for which the Governor's budget proposes $100 million for 2004–05) primarily support program "add-ons" or enhancements that may still be in the early stages of development.[96] Although—as discussed above—such grant programs have initially shown promise in steering at-risk youth in the right direction, LAO has recommended that the Legislature consider eliminating or suspending the JJCPA grant programs, instead of allowing the TANF block grant funds to expire.[97]

The Office of Criminal Justice Planning (OCJP) was the staff arm of the now-defunct California Council on Criminal Justice. Within the OCJP account, juvenile justice programs included two major subaccounts: victim services and public safety. Of the 19 programs funded from this account, 10 focused on youth: including delinquency prevention, drug abuse prevention in schools,[98] gang violence, homeless youth, sexual assault prosecutions, sexual abuse prevention and training, youth emergency telephone referral, and gang risk intervention. Another group of specific programs previously in OCJP's victim services account included seven individual programs which were child- or family-related and including in particular domestic violence, family violence, homeless youth, youth emergency, and two child sexual abuse programs. The Bush Administration's 2005 budget proposes a 41% decrease in funding for juvenile justice programs (a total of $127.4 million in cuts).[99] These cuts include a $3.2 million reduction in funding for the Office of Juvenile Justice and Delinquency Programs and the elimination of the Juvenile Accountability Block Grant program

11. Local Infrastructure

Apart from direct state budget accounts discussed above, administration of many child-related programs depends upon county and school district offices. The counties are political subdivisions of the state and local staff which directly provide social workers and administration for CalWORKs, Medi-Cal, Healthy Families, and other medical programs for children; mental health and special needs services; child care; child protection (including local child protective offices); and juvenile justice (local camps and probation). The 2002–03 threatened cuts of 20% across-the-board for local administration were not implemented, but during 2003–04 local governments began to lose hundreds of millions in expected revenues from the state due to a dispute over the proper "depreciation schedules" to use in calculating the VLF revenues due local jurisdictions. That is, the state "backfill" of these VLF monies lost from the Schwarzenegger reduction is not fully being sent to local governments until final court ruling—likely in late 2004. A statutory change to resolve the problem was sabotaged by its sponsor, Republican leader Kevin McCarthy, because it was labeled a "tax increase."

Los Angeles County started to lose $30 million per month as of March and April 2004. Other counties will lose proportional sums. Under a 1982 statutory command, general assistance and certain other programs—primarily for adults—remain a local mandatory obligation. Thus, local cuts must be made to "discretionary programs," consisting in large measure of police/fire funding and spending for children. The former have substantial local political power due to organized labor representation and the popular appeal of law enforcement and fire protection (particularly after the serious fires in Southern California during 2003). Disproportionate and severe cuts in parks, libraries, and programs serving children are occurring and are predicted.

Typical of the decisions being faced in April 2004 is the $53 million in cuts considered by Contra Costa County. The County is pondering cuts of from 10%–20% of its budget, with a 4% increase required to maintain current levels of service. The initial list includes the closing of the George Miller Centers that served developmentally disabled children, closing the born free programs that help pregnant women with drug/alcohol abuse problems, and thirty other reductions, generally focusing on children and the impoverished. On April 20, 2004, San Diego County announced the elimination of 983 positions and the layoff of another 394 workers to close an anticipated reduction of $151 million. Although the cuts are the largest in county history, no sheriff deputy lay-offs were included. The County conceded that many of those receiving notices are in child support collections, probation, and social service programs (serving impoverished and protecting abused children).[100]

The May Revise will require $1.3 billion local government reduction in the proposed and the following year—characterized as a "loan" of the VLF monies from the locals to the state. Hence, the Governor keeps his promise to restore local government their losses from the VLF cuts, but only after two years of forbearance, with the shortfall repaid by the state after 2005–06. The May Revise does limit the county portion of this "loan" to $350 million per year. However, their impact, in addition to the current hiring freeze and reductions being implemented across the state in the current 2003–04 year is likely to approximate the total workforce reduction anticipated in 2002–03. The evidence suggests that two years of such additional cuts will translate into the lay-off of about 4,909 local workers—a disproportionate number relied upon by children in need. A final count of cuts taking place in the current year and planned for 2004–06 has not been completed, but estimates indicate the following position reductions are predictable: adoptions—126; child welfare services (child abuse protection)—420; foster care for abused children—221; Food Stamps—976; TANF/CalWORKs safety net (70% children beneficiaries)—863; Medi-Cal—1,846.[101]

The Governor's "agreement" with local governments will give up the $1.3 billion in local property taxes they would normally receive for general fund for use by schools (see discussion of education fund shifts above). Cities and counties will swap $4.1 billion in VLF losses that are supposed to be backfilled from the general fund, for assured receipt of property taxes after 2005–06. In return for this serious diminution in local resources, the Governor will agree to support a constitutional amendment that will repeal any state mandate that is not funded after one year. As with the general "deferral" of obligation pattern of the Administration, the Governor would then repay this $2.6 billion in two years of shortfall (the "loan") with a large sum in fiscal 2006–07 and smaller payments over the succeeding four years.

The current shortfall will be further exacerbated by two 2004 May Revise additions to local burden. First, the counties must pick up 20% rather than the current 10% in Medicaid expenses for the Early Periodic Screening Diagnosis and Treatment (EPSDT) required for impoverished children; total obligation to be added is a significant $44 million. The Revise similarly assesses counties $17 million for child welfare system augmentation that had been previously waived.

Across the state, child advocates are now reporting dismissal and attrition of basic infrastructure serving children—ranging from clinic closures in Los Angeles County to CalWORKs staff cuts in the Bay Area, to the layoff of paralegal and clerical assistance for counsel representing abused children in San Diego. The reductions are significant, and carry with them costs that are rarely reported to the public or to those public officials approving them. They are delegated out into 58 counties and 1,000 school districts that lack practical financial resources, and are compelled to reduce services to children. The state hiring freeze precludes state assistance to fill developing vacuums. Resulting from this evolution are backlogs and delay in coverage and services, and service denial where workload precludes coverage.

C. Child Investment Omissions in the 2004–05 Budget

Beyond reductions discussed above, the 2004–05 Budget proposal avoids important child investment obligations and opportunities. The major omissions include a failure to:

- Give impoverished parents a chance to reach beyond the poverty line and toward self-sufficiency, including (a) a seamless quality child care system that includes coverage of the working poor, and (b) an earned income tax credit state augmentation (see Chapters 2 and 6).

- Provide a realistic and efficient plan to provide child health coverage (true presumptive eligibility), despite federal funds available at a 2–1 match to provide it, as well as efficiencies flowing from the reduction of red tape barriers (see Chapter 4).

- Create a private responsibiity agenda, including public service announcements on reproductive responsibility, available parenting education to teach basics about children—particularly for males (see Chapter 2).

- Reduce class sizes, especially in grades 4–8, to move California up from its current rank of 49th in the nation in class size, and improve teacher supply and quality as was attempted in the substantially aborted teacher improvement program of former Governor Davis (see Chapter 7).

- Expand higher education capacity substantially, from the UC to community colleges, and further enhance student aid to allow a generation realistic job opporunity in the labor market of the 21st century (see Chapter 7).

- Assure adequate supply and quality of family foster care providers, realistic adoption opportunities, and resources so state-parented children who become 18 have a realistic chance at higher education—something that a responsible parent would provide (see Chapter 8).

D. Propositions 57 and 58—Budget Changes and Obligation Deferral

In March 2004, the electorate approved Propositions 57 and 58, proposed by the Governor as a double-joined method of deficit amelioration. Proposition 57 authorizes up to $15 billion in bonds to finance the state budget deficit. It is to be repaid over as much at 19 years from the proceeds of a one-half cent sales tax apportionment at an annual cost of $1.2 billion in 2004–05, to increase incrementally thereafter. In May 2004, the state sold $7.9 billion in bonds at a fixed rate of from 2.5%–5.25% (depending upon term). Another sale of $4 billion on a variable rate basis is planned for mid-June. The total cost of this $11.9 billion for immediate deficit financing will include its repayment, plus over $0.5 billion per year in immediate years, declining gradually as bonds expire. The accumulation of these and other bonds issued by the state also have an effect on general fund revenues, since interest paid is not subject to federal or state income tax. That tax status allows the state to pay 4.2% interest when market rates are at 6.5%, but that difference represents a partial offset to income taxes otherwise receivable to the general fund. Hence, long-term bond financing of state deficits imposes costs on future taxpayers (including present children and youth entering the work force over the next two decades), adds interest to that deferral, and subtracts some general fund revenues as an incentive to attract financing.

The Governor's 2004–05 budget proposes to use $9.2 billion of the bond proceeds to pay off the accumulated deficit as of June 30, 2003—currently financed through short-term borrowing and several deficit vehicles currently under challenge in the courts. The Governor then proposes to use the remaining $3.1 billion to pay the state's share of employee retirement costs unpaid in 2003–04 ($1.9 billion), repay the $188 million in loans from special funds to the general fund, cover the $325 milion in the expansion of net operating loss deductions, make $100 million in state debt service payments, pay $209 million in state employee compensation costs, and add $300 million to the state's reserve.

In other words, the Governor's initiative would replace the legally questionable $10.7 billion bond authorized by the Legislature in 2003–04, and cure at least some of the likely unconstitutional special fund, pension borrowing, and related machinations to produce a balanced budget on paper. The Governor's plan includes the retention of $2–$3 billion of the remaining sum authorized for gradual relief of the deficit for fiscal 2005–06—hoping that this sum will be sufficient to bridge the "structural deficit" as the economy grows and spending is trimmed over the next two and one-half years.

Proposition 58 amends the state Constitution to authorize the Proposition 57 bonds. It also sets up a process for mid-year spending cuts. To wit, where general fund revenues decline or expenditures increase substantially, the Governor may declare a fiscal emergency and call the Legislature into special session. The term "substantially" is not defined and effectively delegates the trigger to the Governor. The Legislature must act on the Governor's proposal or an alternative within 45 days, and it may not recess or act on any other bill until it does so. The measure also prohibits the Legislature from enacting and the Governor from signing any budget that spends more from the general fund than revenues received, although such calculations are always made on an estimate basis. The state would be explicitly prohibited from future general deficit relief bonds such as those enacted in 2003–04 or the bond authorized by Proposition 57. Short-term borrowing would still be permitted, as would any bond with a legal obligation of repayment (including education, prison construction, and other special purpose bonds). Finally, the measure requires the transfer to a special reserve of 1% of estimated general fund revenues for 2006–07, 2% for 2007–08, and 3% in 2008–09 and thereafter—until the total reserve reaches 5% of estimate general fund revenues or $8 billion, whichever is greater. Up to 50% of this sum allocated for reserve commitment could be used to retire the $15 billion Proposition 57 bonds ahead of schedule.

E. Other Obligations Pushed Forward

Although Propositions 57 and 58 rectify some of the most egregious "push forward" accounting tactics of 2002–04 (such as borrowing against public pensions and special funds), numerous other deferral tactics remain in place beyond. It also appears to include paying the June bills in July, and most of the other accounting devices discussed above that are not clearly unconstitutional expropriation of funds for other purposes. The total sum placed upon future generations goes substantially beyond the $15 billion in authorized bond plus accrued interest due over the next two decades of pay-off. The "carrying costs" for such large-scale obligation deferral total a significant burden for future taxpayers and also carry considerable risk. In addition to interest pay-out and lost general fund revenue because of the deductibility of interest from state personal income tax, such large bond issues have an impact on the marketability of other bond financing by the state, including the education and corrections capital accounts that depend largely upon such bond financing.

Other obligations pushed forward include making up the entire VLF shortfall to local government after 2006–07 in the May Revise, including a $2 billion bolus of repayment in 2006–07 for a "loan" from locals to the state of $1.3 billion a year in 2004–05 and 2005–06, respectively (see local infrastructure discussion above).

F. Tobacco Master Settlement Agreement: Diversion of Future Funds

The Tobacco Settlement Fund collected monies paid by the tobacco industry pursuant to the Master Settlement Agreement of 1998, settling most public/state claims against the tobacco industry. The settlement requires the payment of sums for the benefit of those injured by the nicotine addiction deceit and manipulation and related unfair business practices of the tobacco industry. The five California suits settled alleged violation of Business and Professions Code section 17200 (the Unfair Competition Act).

The restitution sums payable to California amount to approximately $21 billion payable over twenty five years from 1999. The state receives 50% of the sum ($10.5 billion) and local jurisdictions the other 50%. The state received $515 million in 1999–2000, $386 million in 2000–01, and $475 million for 2001–02. The state created the Tobacco Settlement Fund (TSF) in 2001 and committed itself to spend the money for health-related purposes, as restitution principles require. The Centers for Disease Control has issued guidelines on proper spending purposes, including de-addiction services and anti-smoking education, particularly for youth.

However, instead of directing these funds at restitution or health, 75% of it has now been committed over the entire life of the obligation to pay interest and principle on bonds to lessen the general fund debt; $4.5 billion in bond sales were scheduled ($2.3 billion were sold by October 2003 for the current fiscal year). All future revenue over the next 20 years is sacrificed for immediate relief, and incur debt service obligations of $116 million in 2002–03, increasing to $356 million in current 2003–04, and maintaining that approximate annual level in proposed 2004–05, with small incremental decreases as bonds mature. The total cost with interest over the 22 years will be $7.9 billion, at 5% interest. The cost does not include lost revenues to the general fund because interest paid on the bonds is deductible from state (and federal) income tax. Complicating reliance on these monies further is the forty-year term of the bonds (well beyond the period of tobacco obligation) and the warning from the tobacco firms that lawsuits and other difficulties may provoke bankruptcy filings that could inhibit future interest payments. The current arrangement provides some immediate general fund relief at substantial risk and cost to children and youth as future taxpayers—through 2042. And it diverts virtually all of the "restitution" that equity doctrine commands go first and foremost to the "general public" injured by the unfair acts complained of (*e.g.*, to medical treatment of smokers, de-addiction services, and youth smoking prevention). Virtually none of it will be so expended.

G. New Fee Levels

The 2004–05 budget includes momentous increases in fees amounting to $240 million. Fees are not considered "taxes" and hence may be increased by majority vote. The "fee" characterization also apparently undermines the "tax and spend" label appended by the media to the political detriment of public officials proposing it. The fee increases enacted during the 2003 legislative year and imposed prior to the 2004–05 budget focus on lower-income and child-related enterprise.

As discussed above, the 2003–04 budget and following mid-year correction from Governor Schwarzenegger has increased fees and tuition for education from 30%–100%, community college fees were increased by cross a spectrum of accounts—focusing primarily on child-related payors. Medical coverage co-pays were increased. Child care and foster care providers face substantial percentage increases in license renewal fees.

The Governor's 2004–05 budget adds another bolus of such increases, with more promised in future years. Community college fees, increased from $11 to $18 per unit already, would now go to $26, a 136% increase over two years. Healthy Families program (working poor) parents face higher premiums to cover their children. Medicaid recipients would face new premiums to receive the same benefits under a Medicaid waiver proposal now pending. And the child care and foster care providers—among the lowest paid sectors of the economy—would have yet additional increases imposed in 2004–05 and thereafter until they offset entirely all regulatory and related costs. That is, they are effectively stripped of general fund contribution for child protection inspections and other functions, already at levels below required monitoring of dog kennels (see discussion in Chapters 6 and 8).

The philosophical underpinning behind these increases is that they are not "taxes" involving a state-imposed burden, but are merely payment to the state for benefits received. Hence, they are properly increased so that the beneficiaries of state programs "pay their own way." That assumption raises a little discussed issue: What is the proper state investment to provide a floor of protection and opportunity for our children? Should such a floor involve cross subsidies beyond what groups of children or their providers may be able to provide privately?

Economists point to the concept of "external benefit" as a market flaw appropriate for state adjustment. Such a benefit occurs where the real beneficiaries are difficult to bill. Hence, a lighthouse may be publicly created without assessment of each ship that does not run aground because of its beacon. The external benefit to society-at-large, including business, from a population that is healthy and undisabled from medical coverage and proper safety in their placements, one that is educated and qualified for available jobs, may warrant assessment of such costs beyond the children involved or their direct providers. The notion that each child warrants investment beyond what their parents or providers may be able to afford has been a historically accepted ethic by both political parties. The 2004–05 budget departs from that "joint and several" investment assumption.

H. Taxes

Basic taxes have been reduced $9 billion since 1996. Almost half of that reduction consists of the VLF reductions ordered by Governor Schwarzenegger. As discussed above, the Governor's VLF decision was not to halt a tax increase, but to preserve a conditional tax cut. That tax cut was framed as an "offset" or reduction of the 2% of automobile value VLF long in place—on the assumption that revenues would increase to make it affordable without serious child disinvestment. That assumption was wrong as of 2002, and the reduction (or "offset" from the statutory 2% fee) was properly rescinded by then-Governor Davis.

Beyond tax reductions is the issue of tax "expenditures," which the 2004–05 budget does not abate. These are tax deductions and credits that diminish tax obligation and lower general fund collection. Their growth is a major factor in the decline in public child general fund investment as a percentage of personal income since 1978. As discussed below, each such tax break continues unless affirmatively ended and requires a two-thirds vote to terminate. Such deductions and credits tend to increase automatically with population and inflation, unlike state spending for children—which is increasingly cut year to year by keeping the amount constant in raw number amount as population and inflation rise. The 1,300 registered lobbyists in Sacramento understandably seek these tax advantages for their clients, and their total now exceeds $30 billion annually—offsetting corporate, sales, and especially personal income taxes for the higher brackets.

Tax expenditures added since 1996 have varied from $46 million to $397 million each year. Each then tends to increase annually thereafter. Of the 40 such new expenditures approved between 1996–2003, only the $190 million refundable child care credit of 2000 clearly benefits children directly.[102]

Beyond legal tax expenditures is the issue of tax avoidance. In 2003, the state authorized a special "amnesty program," allowing Californians who evaded taxes through unlawful tax shelters to pay monies due without penalty or other sanction. The forbearance was expected to yield some $90 million in additional funds. As of April 2004, it yielded over $1 billion. The one-time infusion was welcome, but its extent raises a poignant question: the state has trumpeted major anti-fraud programs for welfare cheaters, Medi-Cal overcharges, and ineligible Food Stamp receipt. The evidence indicates that the amounts here at issue may be relatively insubstantial (see discussion in Chapters 2 and 3). In contrast, the $1 billion in revenue came from 1,000 taxpayers, 296 of them corporations—with substantial representation from the oil and retail sectors.[103]

I. Public Policy and 2004–05 Budget-Related Non-Governmental Costs

Framing basic public investment decisions in children are the costs of necessities. The federal poverty line and cost of living adjustments (where made) assume an overall rate of inflation. But some costs over the past four years and as projected through at least 2005, and particularly in some states, may outstrip those measures of need. Their disproportionate inflation may jeopardize basic safety net and services without commensurate increase in child protection and investment. California has been subject to extraordinary expenses for impoverished parents over the last five years and as projected, while children have suffered safety net diminution. This contextual setting for the 2004–05 budget includes the following:

■ **Housing prices and rents** are at record levels, with median prices passing $350,000. As of April 2004, median prices in Southern California reached $386,000, including new construction, resales, and condominium sales; the median for singe family residences reached $425,000. The prices are higher in coastal counties, where the state's population is concentrated. For example, median single family homes in San Diego have reached $485,000 and are even higher in Orange County and in most of the Bay Area. The increase in housing of all types from April 2003 to 2004 was 25.7% in Southern California.[104]

Consistent with real estate inflation, rents are increasing, with median rents passing $650 per month in urban counties. On the positive side, interest rates have remained low. However, any increase in mortgage interest, as is now predicted, will drastically effect the carrying costs of prevalent variable rate mortgages on rental properties, providing additional inflationary pressure. Some cities have implemented rent control, but such limitations inflate rents to youth seeking independent housing. Longstanding renters have their rates artificially frozen below market—stimulating compensatory higher rents from new renters (*e.g.*, youth and future renters). California has four statewide public policies that further exacerbate this private market setting: (1) the state has among the lowest percentages in the nation of Section 8 or other housing subsidies for impoverished parents; (2) California has created a discriminatory property tax system that freezes assessments upon which the 1% maximum rate may be applied at just above 1977 values (hence, older adults with tenure in their homes will pay one-fifth to one-tenth the property tax on homes of the same current value for the same services as will youth and newer purchasers); (3) mortgage interest is deductible with little practical limitation (and, as discussed above, includes even second and vacation homes); rent tax credits to provide some limited equity to renters have been cut back and are now only credited to offset tax liability (non-refundable); and (4) state and local policies, as well as land availability, limit real estate development and supply.

■ **Utility rates** and costs have increased substantially beyond general inflation rates over the last four years. Although the energy deregulation statute of 1996 facially required a rate freeze, and a 20% roll-back at final deregulation implementation, families instead saw rate increases to SDG&E of 30% in 2000, followed by an additional 17% increase, followed by an additional 9% on January 4, 2001, followed by a 12% increase in September 2001, and with another increase in 2002, and still another pending. PG&E and SCE obtained rate hikes averaging 55% above previous levels during 2001—a rate increase involving almost $5 billion in annual additional revenue. Additional increases have since been requested, with PG&E seeking such monies through bankruptcy proceedings. Projecting forward, the state has long term contracts locked in for energy purchases at almost double actual market rates. Of prospective concern, natural gas prices are reaching record levels as of 2004—with gas-fired generators the largest single source of electrical power in the state.[105] The Schwarzenegger Administration disfavors a return to fair rate of return regulation and will alter deregulation to allow utilities to own and operate their own power plants, and large energy users to bargain with energy producers for low priced power. The result of these forces is likely to mean continued and possibly increased energy inflation.

■ Related to utility inflation is the state's disproportionate increase in **gasoline prices**. The lack of mass transit development in the state makes the automobile critical for many working parents to secure and retain employment. In May 2004, gasoline prices reached $2.30 a gallon in most of the state, with the state's altered gasoline formulae to inhibit smog and alleged anticompetitive oil company practices creating an extraordinary disparity 15%–25% in costs above most of the nation—including users with relatively low volume and greater distances from wellhead or refinery supply points.

■ The high costs extant have led working poor parents to assume record levels of **personal debt**. Credit card and related interest now charged commercially is commonly above 20%, sometimes above 30%—two to three times the Constitution-set usury level, and ten times the prime rate. Profit margins between the cost of money obtained by financial institutions and credit charges are at unprecedented levels. California has exempted this debt from usury and invalidated its pre-1990s 18% maximum annual credit card interest ceiling at the behest of the banking and financial industry. The consequence of necessity inflation and high interest charged working poor parents properly informs public policy in formulating child safety net protection. Many parents, and consequently their children, are in financial peril. As discussed in Chapters 2 and 3, indications of child homelessness and hunger are increasingly significant.

■ The **TANF grant** is the safety net intended to provide minimum rent and utility sustenance for child protection. Commentators often cite the state's relatively high TANF grants nationally to indicate room for reduction. But the state's housing costs over the past two decades have brought its grants—properly cost adjusted—close to the nation's middle over the 1970s and 1980s. During the 1990s, and particularly over the last five years and as projected forward, those disproportionate costs are growing. Such continuing rent and utility cost increases commend a substantial increase in TANF grants to maintain comparable safety net protection, prevent homelessness, and inhibit undernutrition. Instead, the TANF grant for the benchmark family of three has been reduced from $1,022 in 1989 to $704 in standard inflation-adjusted dollars to the 2003–04 fiscal year. Instead of rectifying that trend for child protection, the proposed 2004–05 budget then would lower the grant to an adjusted $645 ($611 for the less generous Region 2 counties). Further, sanctions imposed on any family after sixty-months of lifetime aid, or where CalWORKs terms dictate, would reduce monthly grants to under $350 per month.

■ **Child health costs** have increased, while compensation has been limited, creating serious supply shortages, waiting lists, and treatment denials (noted above and discussed in Chapter 4). Pharmaceutical costs have increased well beyond inflation levels. Drug firms have secured federal legislation limiting alternative sources of supply and state-sponsored consumer bargaining power as part of Medicare funding expansion. One manifestation of high profit margins has been unprecedented prescription drug promotion via mass media. Another has been the expensive stimulation of reflexive drug therapies for liberally diagnosed ADD or ADHD, with record numbers of children now prescribed Ritalin and other amphetamines—while one million children lack medical coverage, despite federal 2–1 matched funds to cover most of them (as discussed above).

■ As of May 2004, **milk** prices have reached record levels—of particular importance to young children, and to the reach of the WIC program discussed in Chapter 3. California's dairy industry has arranged a unique formulation for milk gratuitously different than the other 49 states, and with the purpose and effect of inhibiting lower priced competition. In addition to record high national prices, California suffers from its own disproportionately high add-on costs, as with gasoline. Although framed in terms of public health or state concern, such policies turn a state with extraordinary resources and size (to accommodate strong economies of scale) into a high-cost setting. Ironically, more unfettered competition produces extremely low prices for the state's fast food industry that aggressively promotes an array of unhealthy products to children. California, as with the nation as a whole, now faces a child obesity problem of serious dimension, and with future health cost implications. No constitutional limitation exists to reverse public policies: Maintain vigorous competition and low prices for milk and vegetables, and tax unhealthy foods to pay for some of the external costs from their ingestion, as well as preventive nutritional education. Although some legislation pertaining to vending machines and school lunches is discussed in Chapter 3, state policies in prospect provide little new direction beneficial to child health, consistent with the child health disinvestment orientation of the 2004–05 budget.

J. Remaining (Structural) State Deficit

1. The Real Deficit: $11 billion

The Governor's combination of cuts and deferrals do not address the "structural deficit." According to the LAO, the measures leave a $7 billion gap between revenues and normal state operating costs—even with optimistic economic projections. However, the actual deficit is properly measured against a defensible spending level. As discussed below in the presentation of the "2004–05 Children's Budget," that amount should include short term revenue to make-up the accrued and planned deferrals of payment to future taxpayers. And it should include a long term adjustment of target revenue consistent with historical levels of child investment. That continuing deficit amounts to $11 billion and is not addressed by the Governor's 2004–05 budget as proposed in January or as revised in May.

2. Revenue Subtractions (Deficit Dangers) Excluded from Budget Assumptions

a. MSA Tobacco Bond Obligations

As discussed above, the state has assumed an obligation of $7.9 billion in bond obligations (including interest) over the next forty years—in order to provide $4.5 billion in general fund relief for the current and proposed year. The obligation is secured by revenue from promised tobacco settlement monies (the Master Settlement Agreement). But the bond obligation extends twenty years beyond the promised tobacco payments, and it is backed by the full faith and credit of the state (in order to secure reasonable interest). During 2003, major tobacco firms (including Philip Morris) announced that the affirmation of recent large damage awards in civil smoking lawsuits could precipitate industry bankruptcies and default on the tobacco MSA payment obligation. Such a default would require payment from the state's general fund of close to $500 million in 2004–05, with repeated assessments annually thereafter at gradually reduced levels, until the $7.9 billion total sum pledged for current general fund relief is paid.

b. Corporate Tax Collection Case: *Farmer Brothers v. FTB*

In February 2004, the U.S. Supreme Court denied review of *Farmer Brothers v. FTB*, letting stand a decision that will cost the state from $500 million to $1.5 billion in required corporate tax refunds, and a continuing reduction of $180 million per year in ongoing otherwise anticipated revenue.[106] The decision holds that California's "dividends received reduction" (under Revenue & Taxation Code section 24402) was unconstitutional since it afforded taxpayers a deduction for dividends received from corporations subject to tax in California, while not allowing it for corporation not subject to California taxation. Hence, allowing such an offset discriminated against non-taxpaying companies operating in the state and impermissibly "burdened" interstate commerce.

c. Proposition 13 Tax Case: *Orange County v. Bezaire*

Proposition 13 limits property taxes to 1% of assessed valuation. But it also freezes property tax assessments at 1977 levels, with a cap of 2% per annum on valuation increases. Hence, a typical homeowner purchasing for $40,000 in 1977 is likely to be paying 1% of $60,000 currently—on a house with an actual market value of $400,000 (see discussion below of youth discrimination implications of these assessment limitations). In an attempt to moderate the discrepancy between actual market value and the limited Proposition 13 value, counties have sometimes increased by more than the allowable 2%, if they did not increase valuations (or if values did not rise) during the previous year. This "catching up" with lost revenues, called "recapturing," has been used statewide since 1977. During 2001, Orange County Superior Court Judge John M. Watson ruled the practice unconstitutional. If the ruling is upheld, the cost is estimated at $10 billion, $5.3 billion from state government contribution to schools. Although the 4th District Court of Appeal reversed judge Watson on March 26,2004,[107] review by the Supreme Court has been sought.

d. Federal Inheritance Tax Impact

The phased elimination of federal inheritance tax discussed above has a momentous indirect impact on state revenue as well. Although California eliminated estate taxes in 1982, the state had received substantial income from an allocated portion of the federal tax, reaching $935 million in 2001. That total declined to $135 million in 2003–04 and will decline further in 2004–05, and terminate entirely by 2010. One source estimates California's share of general fund budgetary cost will total $5.3 billion from 2003–07.[108]

e. Reinstitution of Manufacturer's Tax Credit

In 2003, the California Manufacturer's Tax Credit was sunsetted—earning status as one of the few state tax breaks to actually terminate. It was not reinstituted because its raison d'etre was the preservation of manufacturing and related jobs in California, and the $450 million expended in foregone revenues did not yield any clear gain in such employment—which has fallen during the course of the credit's availability. Child advocates argue that any measure (regardless of benefits to children or long-term public cost savings) that may require immediate spending in excess of $100,000 has been categorically foreclosed from enactment in the state's 2003 and 2004 legislative sessions. Such measures face legislative Appropriations Committee's Suspense File termination without public vote. In contrast, the reinstitution of the $450 million Manufacturer's Tax Credit is before the Legislature in four separate bills and—unlike a spending bill—does not face Suspense File preclusion.

f. Overages in the Corrections Account

The Governor's proposed 2004–05 budget assumes reductions in prison spending that are problematic. During 2003–04, the Department of Corrections ran $500 million over budget. Allegedly, the Department added 1,000 jobs to the payroll without prior legislative authorization in recent years.[109] The Department was supposed to cut more than 500 positions during the current year. It did not do so, and the Governor's budget excuses that failure by agreeing to a net reduction of less than 100 positions.

State adult inmate population went from 19,000 in 1977 to more than 160,000 by year 2000, at which point California's incarceration rate rose to among the highest in the nation, a nation with a rate higher than any other developed country. The prison population growth has leveled somewhat over the past four years. However, mechanical application of lifetime three strikes sentencing rules and relegation of more youth to adult sentences may stimulate further additions to the population. Each inmate incurs over $40,000 in direct and allocated capital annual cost. Even with reductions, the politically powerful prison guard association has won salary additions even during budget shortfall years, and during that same period of crisis managed to procure improvements to the most generous pension system in the public domain. These factors, in addition to the prospect of court orders compelling prison services and their constitutionally required possibility, make serious overages in this account a predictable problem for 2004–05 and thereafter.

g. Impact of Bonds on General Fund Diminution and Debt Financing Capacity

The new $15 billion bond issue authorized by Proposition 58 occurs in the midst of other major state borrowing, including new education bonds and a schedule of corrections bonds, as well as the tobacco MSA bond that also had to be secured by the state's full faith and credit. Underlying these are the extensive bonds floated for energy crisis amelioration discussed below. Even before the recent spate of new bonds, the bond rating of the state was reduced by Standard & Poors on April 24, 2001 by two rating steps, from AA to A+) and is now among the lowest rated of any state. Such lower ratings than require more interest to attract bond financing, further encumbering the state perhaps as to *all* of its revenue bonds. Finally, that increased interest is tax deductible to the bond purchaser, removing that income from personal income tax liability and general fund collection.

h. Energy Policies

In 1996, the California Legislature enacted AB 1890 (Brulte) (Chapter 854, Statutes of 1996). Effective March 1, 1998, the statute authorized creation of an "Independent System Operator" (ISO), which assumed control of the power grid that transmits electricity statewide between the respective utilities controlling local delivery; further, a second agency, the Power Exchange (PX), functions like a stock exchange, enabling sellers and buyers to bargain for the best price for electricity.[110] However, the deregulation experiment was conceptually flawed and led to alleged rigging of prices by energy producers. Wholesale prices that were $33 a megawatt hour in 1999 climbed to an average of $346 on the spot market in 2000, with prices spiking up to $1,900 in 2001. The price increases led to charges above normally competitive levels of more than $40 billion from June 2000 to June 2002.

The state responded by bidding for long-term contracts at specified prices to undercut the wildly excessive "market" price, and used the state's Department of Water Resources to purchase about half the power demanded. The state purchased power at highly inflated prices, using more than $5 billion of 2000–01 surplus funds and issued revenue bonds of $13.4 billion to finance further purchases and to repay the general fund. An additional $5 billion in bond funds were produced to create additional generator capacity and stimulate conservation. Excessive prices moderated in 2002, and the but the debacle is severe enough to have long-term budgetary consequences.

The current debacle has the following unavoidable and continuing costs:

■ The radical increases in consumer rates—above 50% over the last three years, and still increasing—have substantial effects on energy concentrating businesses, from pizza parlors to retail stores requiring extensive air conditioning in inland desert areas; small businesses near the edge of survival were pushed into bankruptcy, a continuing burden in lost revenues, unemployment compensation, and other costs.

■ The extensive bond issues are being repaid with interest from utility customers and not the general fund, but additional bond issues push up interest rates on state bond indebtedness generally. The bond rating of the state April 24, 2001 was reduced by Standard & Poor's on April 24, 2001 by two rating steps (from AA to A+), which then requires more interest to attract bond financing in general.

■ Payors purchasing these bonds forego state income taxes on bond interest received.

■ The state's long-term contracts have locked in prices at well above market levels. These high costs continue to be borne, with additional rate increases in progress, by schools and state agencies, particularly air conditioning and lighting costs. Nor are such costs trivial; former Governor Davis calculated energy increases to schools in 2001 as requiring an augmentation of $500 million.

The concern about energy pricing impact is underlined by the Governor's apparent support for a deregulation approach that many consumer advocates contend is not easily applicable to energy—an industry underlying other enterprise and arguably lacking many of the prerequisites to effective competition (*e.g.*, difficulty in lessening demand with price increases, the assessment of charges at levels determined well after its use, its infrastructure features underlying other enterprise, the involvement of utilities in generation and their constitutional right to a fair rate of return regardless of inefficiency, a history of price manipulation by power suppliers, *et al.*).

VI. The 2004–05 Children's Budget

The state of California should meet its 2003–04 and 2004–05 deficits through new revenues over three years, with those funding sources automatically sunsetting in 2007–08. An enhancement of $4 billion per year over three years would (1) allow the cancellation of the $15 billion bond designed to burden a future generation with the current deficit plus interest on that debt, and (2) terminate the various accounting gimmicks and unconstitutional borrowing that has characterized state budget policy since 2001–02.

Separate and apart from this episodic shortfall is the long-term "structural deficit." The current approach is to cut spending and defer obligation to future years. While some spending reductions may be appropriate, their imposition by mechanical formulae, or based on service cuts and fee hikes for the politically powerless, is not optimum public policy. Rather, the extent of the structural deficit should be calculated based on a rational and fair decision of underlying, minimum obligation to publicly invest in our children. Then reductions within such a limit should proceed based on empirical evidence of failure versus success in accomplishing legislatively intended goals. The proposed budget promises neither of these essential prerequisites.

In calculating the appropriate long-term general fund collection target, historic allocations for children should be a floor. High child poverty and a growing need for higher education for future jobs commend such prior contribution as an ethically compelled minimum. California expended 7.4% of personal income on general fund spending in 1978–79. Comparisons before 1977 are distorted by the Proposition 13 and *Serrano* case radical alterations in state finance. Because correctional spending was a much smaller proportion of the general fund in 1978, the percentage would have to be at 7.85% for the state to replicate the same investment commitment of adults to children one generation ago. The general fund produced by such a ratio is $99 billion, $21.4 billion more than the 2004–05 budget proposes, as revised in May. The average commitment over the last 27 years has amounted to 6.57%, or 6.96% after adjusting for the corrections increase to keep child investment constant.[111] Setting a target at 7% of personal income for general fund spending, with $9 billion committed to corrections and the brunt of the remainder invested in children, would preserve a relatively steady investment proportion based on historical levels—albeit substantially below the 1978–79 level. Arguably, that proportion should increase beyond 7% where standards of living rise to allow a higher percentage for such a commitment. But such a floor would yield $88.65 billion—$11 billion more than the proposed 2004–05 budget as revised in May will assess and spend.

The $88.65 billion level should be the target for revenue in the normal course, adjusted annually by personal income change. That income is projected to increase 5.6% in 2005–06, suggesting a $93.6 billion in general fund revenue that year. These are sums that do not represent real enhanced spending from historical levels, nor is it a level reflecting a sudden episodic bulge in personal income tax revenue as occurred in 2000–01 (from capital gains and options). Such a 27-year average produces monies sufficient to cancel the $3 billion in serious budget reductions still part of the 2004–05 budget after the moderation of the May revise. Those restorations would include $350 million back to counties, giving them a proper backfill as long promised by the state. And it would fund back the $2 billion in education cuts regrettably remain a part of the current proposed 2004–05 budget. The remaining $8 billion should be expended on minimal safety net provision consistent with historical levels, medical coverage for all of California's children, child care help for the qualified working poor, and implementation of the Governor's after-school care initiative. That additional $8 billion should attract at least $3 billion in federal funding otherwise lost (much of it from Healthy Families funding at a 2–1 match) and allowing children to benefit from $11 billion in additional investment—countering the incremental annual cuts in favor of tax relief that have quietly accumulated over the last 25 years.

As discussed below, the additional revenues should co-extensively accompany structural reform in the state's tax system. That restructuring should resolve the gross inequities between generations from property tax assessment disparities, and allow proper majoritarian democratic influence over state spending/taxation decisions. Finally, major elements of the conservative agenda are appropriately included in the spending and structural reforms: major investment in private responsibility, and the required allocation of from 1%–3% of all substantial spending programs for independent outcome measurement—substituting for the absent marketplace for natural selection improvement and accountability, and informing legislative decisions on spending cancellation, increase, and refinement.

A. Revenue Sources for Child Investment

Revenue for the 2004–05 Children's Budget totals $15 billion more than is currently budgeted; of that sum, $4 billion will sunset after three years 2006–07 and intended to remedy the bond and creative accounting deferral of funds to future taxpayers, $3 billion would reverse anticipated reductions, and $8 billion would be committed to new child investment. Potential sources of revenue for both the $4 billion temporary purpose and the $11 billion continuing obligation are many. California is a relatively wealthy state within a relatively wealthy nation. The 2004–05 personal income estimate is a record $1.262 trillion—a 5.4% increase, to be followed by a projected 5.6% growth in 2005–06. As discussed above, the state has high sales tax rates, but is disproportionately low in other categories, including property taxes and taxation of alcohol. The state has enacted an extensive system of tax exceptions and forbearance for special interests. While the Children's Budget is not a tax document, the notion that the state cannot afford more monies for children—even to historic levels—makes a list of available resources appropriate. The fear that such assessment will hamper state economic growth or cause outflow of business from the state is belied by the historical impact of tax increases and by the anticipated impact of the measures, discussed below. The oft-repeated argument that California suffers from over-taxation is disputed by many economists based on policies in other states and developed nations. But the assumption below is not that revenues be increased against an external comparison, but that they be committed consistent with the revenue production of previous generations as a percentage of personal income.

1. State Capture of One-Third of 2001 & 2003 Federal Income Tax Cuts: $9 billion

As discussed above, the federal personal income tax reductions of 2001 and 2003 average over $27 billion per year in savings for Californians over the next ten years, unless some are sunsetted—which is politically unlikely. A state income tax surcharge equal to one-third of those federal reductions will produce an average of $9 billion per year. Such a surcharge would allow California adults to retain two-thirds of the reductions, while investing one-third of those savings in children at the state level.

2. Raise the State Personal Income Tax Highest Bracket to 14%: $4.15 billion

California's wealthiest residents have prospered at record levels. Nevertheless, their total state and local tax contribution is less, as a percentage of income, than for the bottom quintile of taxpayers, as discussed above and in Chapter 2. The high tax bracket was at 11%, but was rolled back during the 1980s. A 14% assessment is not confiscatory. The 2001 and 2003 federal tax savings provided income cuts substantially more than such an assessment will produce. Its imposition will still leave upper level taxpayers with the largest real spending gains over the last decade of any income group. Such an assessment would make the local/state tax balance less regressive and more equitable.

3. Temporarily Suspend New Tax Expenditures Granted Since 1997: $6 billion.

As discussed above, California has enacted numerous tax deductions/credits over the last six years. They cost the general fund $6.1 billion as of current 2003–04.[112] The state should retain only the refundable child care tax credit (currently costing $200 million), reconfigured to provide more assistance to the working poor and a bit less to those families earning over $50,000 per year (see discussion in Chapter 6). The Teacher Retention tax credit enacted in 2001–02, and then suspended due to the budget crisis, should be independently examined for its beneficial impact—an examination appropriate for all existing tax expenditures, discussed below.

4. Examine All Tax Expenditures, Remove Unjustified Loopholes: $3.5 billion.

Quite apart from the recently enacted tax expenditures are another $18 billion in older and long unexamined tax deductions, credits, and exceptions to state personal income taxes, and another $8–$10 billion in corporate, use, and sales tax exceptions and exemptions. Some are immediately appropriate for termination (recently-enacted personal income deductions noted above, and sales and corporate exceptions discussed below). But beyond these are a phalanx of hundreds of special exceptions and expenditures that have grown over years of legislative lobbying. As the structural reform recommendation below discusses, all state tax expenditures should be subject to some of the same checks applied to state spending. The state Constitution should be amended to provide that no such expenditure shall last more than three years unless specifically extended by the Legislature by a two-thirds vote. That is the same supermajority required for spending decisions, and such special exceptions constitute forbearance made up by other taxpayers—effectively functioning as a spending decision.

A critical review of the current tax expenditure budget should find at least 15% of existing subsidies appropriate for termination or further limitation. Even the sacrosanct mortgage interest deduction, originally intended to stimulate home ownership and home improvements, now finances the transfer of non-deductible credit card debt onto second and third mortgages to obtain the tax deduction benefit—unrelated to the deduction's original purpose. Even more egregious is the extension of the mortgage deduction—intended to assist the middle class obtain the dream of home ownership—into the deduction of interest on second home purchases, such as the vacation lodge at Tahoe.

Many of the largest personal income and use tax breaks warrant re-examination and either termination or tightening. Tax reform advocates cite the following examples, among many others:

■ $1.5 billion is lost due to the cancellation of capital gains by death. That benefit allows inheritors, already benefitting from the removal of inheritance taxation, to obtain a property and both the giver and the recipient avoid the taxation on its appreciation otherwise due upon transfer or sale.

■ All investment income from life insurance and annuity contracts are tax exempt, a subsidy amounting to $900 million annually.

■ Senior citizens are given a categorical "exemption" from taxation, enriching them by $98 million annually. The elderly as a group have an poverty rate of under 8%, with child poverty above 20% in the state. The elderly are uniquely assured a safety net, universal health coverage, and substantial pension subsidies. The last includes including $3.2 billion in pension tax expenditures annually (second only to the home mortgage deduction in amount). Is it fair that this group should receive an additional tax subsidy based entirely on age?

■ The "Yacht" Loophole costs an estimated $55 million and allows purchasers of vehicles, aircraft, and boats to purchase them out-of-state 90 days before delivery in California and avoid all state vehicle/use taxation. Such a policy discriminates against state merchants who pay such taxes. AB 694 (Levine) would apply such taxes to a newly-purchased vehicle, plane, or yacht that is kept in the state within one year of its purchase.

5. Tax Corporate Profits: $800 million

California corporations pay from $5.5–$7 billion annually in state corporate taxes. As the economy continues to grow, corporate tax revenue is reduced by the cumulative effect of corporate tax deductions and credits as discussed above. The rescission or suspension of sufficient corporate tax expenditures, and/or a small rate increase of from the current 8.8% to 9.9%, would generate close to $1 billion. Such a corporate contribution is warranted given the long-term advantage to local businesses from a population of healthy and educated youth.

6. Limit Corporate Tax Avoidance: $2 billion

In California, corporate tax revenues decreased an inflation-adjusted 10% between 1989 and 2002—notwithstanding higher corporate profits. The state tax rate has fallen to around 5% of reported profit. One reason for declining collection is the growth of "business tax shelters," now allowing reductions amounting to $1.34 billion annually in California.[113] Corporations hold patents and other intellectual property in offshore tax havens so that profits earned on them will escape taxation. They similarly base their operations in low-corporate tax states, such as Delaware and Florida, to minimize tax liability. Beyond selection of states requiring the lowest public contribution, domestic California corporations are allowed to establish their corporate headquarters in such tax havens as Bermuda and the Cayman Islands. These "paper" relocations are not bona fide, but are accomplished in name-only for a small emolument to a foreign nation. Such artificial offshore affiliates should have their income treated as U.S. sourced for purposes of taxation. Montana has enacted such legislation, naming the commonly used tax dodge locations and designating them as "water's edge" status amenable to domestic taxation. California would join Montana in closing this "expatriate loophole" with the enactment of AB 2584 (Chu), pending in 2004.

Other corporate tax loopholes appropriate for examination include the following:

■ Capture $400 million by reinstituting the worldwide unitary method of apportionment for multinational corporations, inhibiting their current avoidance of taxation.

■ Confine Subchapter S corporate tax pass through status to companies that bring less than $20 million in annual revenue. The purpose behind the Subchapter S exception was to allow small businesses that operate as sole proprietorships or closely-held family operations to operate with a pass through of income or loss to their stockholders. The manipulation of this intent to cover large corporations by tax counsel should be terminated, producing a significant $500 million in state tax revenue.

■ Adopt income apportionment rules for telecommunication companies developed by the Franchise Tax Board to prevent their escape of corporate taxation, with a possible yield of $200 million annually.

■ Eliminate bank sheltering of income through Regulated Investment Company loophole status to produce $45 million.

■ Legislatively invalidate the *Ceridian* decision, allowing deductions for dividends paid to insurance company subsidiaries, and adding $165 million for 2004–05 and $45 million annually thereafter.

7. Tax Alcohol: $2 billion

California has one of the nation's lowest alcohol tax rates. That dispensation is largely based on the historical strength of the industry's political influence. Beer and wine are taxed at $0.20 per gallon in California; the tax amounts to $.04 for a bottle of wine, less than 1%. The taxes on alcohol could be increased by a factor of ten with very little impact on sales. A $2 charge per gallon translates to $0.40 for a bottle of wine. Hard liquor taxes are somewhat higher but could be doubled with little inconvenience for consumers and some public benefit from slightly reduced consumption. These changes would likely generate an additional $2 billion over the current relatively paltry revenue of $290 million from alcohol.

8. Energy Excess Profit Tax Revenues/Refunds: $1 billion

California could impose an "excess profits" tax to operate on a sliding scale as energy prices exceed 10% of 1999–2000 market levels, adjusted by the CPI, or by the wholesale price of natural gas. The tax should be levied at 80% of any revenue collected beyond a charge more than 30% above that level—with full allowance for unavoidable, pass-through costs to generators. Such a check on excessive prices provides a state substitute for absent federal check. Ironically, utility refunds have been procedurally defeated because of the application by the courts of what is termed the "filed rate doctrine." Intended to defer to a regulatory (utility) regulator setting "fair rate of return" rates, it here defers to a regulatory regime that refuses to impose a cap on prices at more than ten times cost. Accordingly, the state properly protects itself through such a tax. It essentially imposes an externally specified limit on the spot market, indirectly accomplishing a meaningful wholesale cap separate and apart from reliance on the Federal Energy Regulatory Commission (FERC). A portion of those revenues may be directed at resource development, conservation, or minimizing external costs from energy production and use.

The case for such a check is underlined where producers and utilities have a well-established history of price manipulation and wildly excessive charges, and where the state is now poised to reinstitute deregulation, as favored by the Schwarzenegger Administration. Such a tax, which could be arranged to yield approximately $ 1billion in revenue, is not imposed directly on the energy producers, but on the utilities or any other purveyor of energy operating within the state and who are subject to California and PUC jurisdiction. But it is automatically passed on and effectively imposes a ceiling above which the California wholesale buyer is inhibited from exceeding.

In addition, the state should press aggressively for a full refund from FERC, or through litigation, of the excessive charges imposed by energy generators and dealers—including the $7–$9 billion expended by the state through Department of Water Resources purchases.

9. Retail Sales Taxation Scope: $300 million to $2 billion

California has taxed retail sales since 1933 and currently imposes a high rate of from 7.25%–8.25% in Los Angeles and most Bay Area counties, to 8.5% in San Francisco. However, the scope of the taxation is limited. The state loses over $200 million annually due to Internet sales taxation escape. That effective avoidance of retail sales tax by California vendors provides a cross-subsidy disfavoring local merchants who sell to local residents. The amounts foregone are estimated at under $300 million, but the growth of the internet makes this omission a substantial source of tax collection loss in future years.

Beyond Internet tax avoidance, specific interests have won exemption from sales taxation. Medicine and food purchased for home consumption were exempted as “necessities,” but related special interests then managed to carve out exceptions for livestock slaughtered for food, medicine to keep livestock healthy, seeds to produce food, fertilizer to grow seeds, chicken litter for fertilizer, and most recently, dry ice and carbon dioxide to ship perishable food.

Sales taxation does not cover services. Even a partial extension coverage to professional services could generate substantial new revenues. Proponents of such taxation argue that purveyors of services use local services in the same way as do sellers of merchandise and are properly assessed based on revenue received. Such scope expansion might allow the relatively high sales tax rate to enjoy a reduction with revenue neutrality.

10. VLF Restoration: $1 to $3 billion

As discussed above, the VLF has been based historically on a 2% annual assessment of the value of a California registered vehicle, payable at point of renewal. After 1998, the state’s budget surplus led to a decision to offset or reduce that rate, assuming budgetary surplus to allow it. Those reductions eventually were calculated to reduce the fee to 25% of its previous level. The condition precedent for those reductions ceased to exist in 2001–02, and it was appropriately rescinded. However, Governor Schwarzenegger campaigned on the theme of voiding what he and other misleadingly characterized as a “tax increase”—and upon election returned to an “offset” level one-quarter of the authorized fee rate. The end result has been a $3–$4 billion reduction in revenues at a point of deficit crisis, as discussed above. One option for funding would be the rescission of post 1998 VLF “offsets” and the restoration of previous fees producing up to $3 billion more in annual revenue. In the alternative, a partial restoration could produce a lesser amount. It is unclear why a conditional fee reduction establishes a permanent new rate level and any moderation of that reduction becomes a politically unacceptable “tax increase.” Such a dogmatic aversion to a fee adjustment is particularly inconsistent for an Administration raising $240 million in new fees imposed on child-related and impoverished populations.

11. Property Taxation Restructuring: $10 billion

The argument for generic property tax reform is discussed as a structural budget issue below. In summary, the current Proposition 13 limitation on property tax assessment at 1% of assessed valuation may be maintained without the current distortion between generations. Beyond the Proposition’s limitation on property tax rate was a provision to freeze property assessments at 1977 levels plus a small annual increase. The extraordinary real estate inflation of five to ten times 1977 levels was not anticipated by the electorate, and now leaves youth and future children with a property tax obligation five to ten times the levels of older home (and business property) purchasers. It is unclear why a young person purchasing a home should pay ten times the taxes as an older adult owning an identically valued property to fund the same governmental services. Assessing real property consistent with its actual value follows wherever an *ad valorem* tax is based on the value of an asset. Rectifying the increasingly untenable distortion by imposing annual tax assessments based on actual property values would produce substantial new revenue. The reduction of the current cross-generation discrimination can also be accomplished in a revenue neutral manner by reducing the 1% of assessed valuation limit to 0.7% or 0.5%, as appropriate.

12. Business Property Tax Reform: $2 billion

The property tax valuation freeze at 1977 levels also applies to commercial property. But businesses are able to sell stock in their corporations rather than sell real property interests to trigger a reassessment. Since residential properties sales trigger those reassessments at point of sale, homeowners as a whole are assuming a much greater tax burden over time. Commercial interests avoid taxation commensurate with either land value increase and inflation gain. As a result, for example, commercial property taxes in Los Angeles County have declined from 47% of local tax generation to 33%, while single family home property taxes have grown from 40% to 55%.

Because of the effective freeze below market, even where sales occur, much business real estate remains at 10%–50% above 1977 levels, while its actual value is three to ten times those levels. Hence, new business owners suffer greater taxation obligations than their established, older competitors. As time has passed, those disparities have increased to grotesque levels, with new competitors saddled with five times the property tax bill of older business properties. Such dichotomies discriminate against newer (younger) entrepreneurs. As with rent control distortion, older businesses essentially market their discriminatory advantage when they transfer business property through stock sale. SB 17 and SB 3x (Escutia) would preserve the essential policy of Proposition 13 as advertised—the imposition of an absolute limit on property taxation of 1% of the assessed valuation of the property. But it provides for periodic assessments so that limit is applied equitably between properties.

13. Implement an Oil Severance Tax: $300 million

California is the only state that does not assess a severance tax on oil extracted from the ground in its territory. The justification for such an assessment is manyfold, including the public investments facilitating pumping and transmission, to the state-asset nature of the resource lying beneath the surface and across surface property lines. Such an assessment may also be justified by the nature of oil as a non-renewable resource properly discouraged over alternatives, and perhaps allowing cross-subsidy of renewable options to preserve otherwise lost resources for future generations. California has significant oil reservoirs tapped by major oil firms, including significant on-going drilling in Los Angeles County.

14. Rebate Monies Due from Pharmaceutical Firms: $1.5 billion

According to a federal audit completed in December 2003, pharmaceutical companies owe California $1.3 billion in rebates. The report from the Office of Inspector General of the U.S. Department of Health and Human Services contends that prescription drugs must be sold to state plans at a reduced rate. During 2004, Medi-Cal is expected to spend $5 billion in drugs and collect $1.5 billion in rebates based on payments made beyond legally permitted charges. The current deficiency is blamed partly on delay and lack of administrative resources to collect it, and extends to overpayments back to 1991. The pharmaceutical industry disputes the $1.3 billion figure, but concedes that $818 million is owed the state.[114] The shortfall in collection is close to the proposed health cuts of Governor Schwarzenegger's the 2004–05 budget.

15. Gambling Revenues: $1 billion

California collects $180 million per year from private gambling: horse tracks, card rooms, and Native American Tribes. About $150 million of the total comes from the Tribes which manage 51,400 slot machines within 54 casinos in California—spurred by the electorate's approval of Proposition 1-A in March 2000.[115] In contrast to California, Connecticut and New York charge Tribes a 25% tax on gambling profits—an amount that would total over $1 billion in California. A proposed November 2004 initiative (the Gaming Revenue Act of 2004) would assess such a 25% tax. The initiative, substantially supported by tracks and card rooms, would earmark collections as follows: $1.2 million to non-gaming Tribes; $3 million to gambling addiction resources; and the remained divided 50% to county offices of education for foster youth and 50% to local governments for law enforcement and firefighters. Aside from political popularity, it is unclear why the funds are so inflexibly allocated. Meanwhile, negotiations are underway between Tribes and the Governor for a deal to abandon that initiative in favor of an agreement whereby Tribes would receive additional slot machines and gambling latitude for greater state revenue contribution (but well below 25%).

However, the state's reliance on gambling revenue, both from taxation of casinos and the state's own lottery, raises two significant ethical issues: (1) what is the impact of gambling promotion and reliance on the families and children of those who gamble, particularly low-income parents and a predictable population of gambling addicts; and (2) what should the state represent in terms of contribution versus reward—that wealth comes to those who work and offer benefits, or based on chance? Of particular concern is the Governor's public position that local governments are free to contract with Native American Tribes for "territory swaps" or other artifices allowing casinos to proliferate throughout the state. That proliferation will certainly occur given local government revenue needs, unless the state draws proper limitations as the sovereign. The Governor's "neutral" position is not neutral at all, but represents a radical departure in state policy—one that will have long-term negative effects on the children of gamblers, almost all of whom will financially lose.

Child advocates argue that to the extent gambling is allowed, it should appropriately contribute its fair share as a business enterprise for public benefit.

16. Tobacco Tax Increases: **$500 million**

An excise tax tobacco increase of $0.23 would produce $300 million in projected additional income. An increase to $0.40 (as proposed by former Governor Davis) would generate $700 million annually.

17. Sale of State Assets: $500 million to $2 billion

The state possesses significant assets, particularly real property in high-value urban locations. Where the state is faced with a choice between child disinvestment or pushing obligations forward, the asset sale and leaseback of some of these properties may be warranted as an alternative. Such a sale would now bring a premium given interest rates and real property inflation. Further, have leasehold status carries some flexibility advantages for the state. High capital investment costs may not be needed for expansion that may be temporary or not fit into existing property configurations. Finally, such sale will return these properties to the local property tax base, since buyers will privately own the asset and be assessed property taxes at sale (market) level. This revenue enhancement will continue year to year to the benfit of the general fund monies coming from property taxes, as well as local jurisdictions drawing primarily from this revenue source.

18. Punitive Damage Allocation to the General Fund: $250 million

The Governor's 2004 May Revise would tap a new revenue source: allocating 75% of all future civil trial punitive damage assessments to the general fund, projecting a $450 million annual revenue gain. Called "split-recovery statutes," the concept of allocating a portion of punitive damages to the general fund has been enacted in eight states and has substantial support among scholars and child advocates. However, the Governor's May Revise proposal reaches the $450 million estimate by including an extraordinary judgment against General Motors for $4.2 billion that was then reduced to $1.2 billion on remand (and then settled). Indeed, the recent Supreme Court decision indicating that punitive damages above nine times actual damages may be constitutionally infirm further undermines such reliance.[116] Removing that anomalous case yields a more likely sum of $250 million. Even that sum may not be reached because of another flaw: the allocation to the general fund only applies to judgments post-trial, not to settlements where the litigants can characterize monies paid more flexibly, excluding punitive damage characterization. The Governor's measure would give both parties strong incentive to do so—the defendant to avoid punitive damage assessment condemnation, and the plaintiff to avoid having to pay 75% of the funds to the state.

The Governor's proposal would yield more money if it were imposed on a sliding scale: 25% of the first $1 million, then 50% up to $10 million, and 75% over that amount. Such variation may produce more funds for the state and retains the strong incentive to collect such funds for deterrent benefit.

19. Federal Penalty Cancellations: $500 million

On May 17, 2004, the Schwarzenegger Administration announced agreement with the federal jurisdiction to soften or delay some of the federal penalties assessed against California and discussed in Chapters 2, 3, 5 and 8. The changes include restoration of $57 million in penalties for the failures in the Child Welfare System Case Management computer system. The changes will save a total of $230 million, and defer another $220 million in child support computer penalties until the end of 2005. Although another example of obligation deferral, the delay may provide opportunity to secure waiver of some of the penalty of the state complies in the interim.

20. Obtainable Matching Federal Monies: $3 billion

The federal tax cuts of 2001 and 2003 included a promised allocation of $20 billion nationally to states over two years (with California's share $1.2 billion per annum). This sum is intended to assuage the negative effect of federal fiscal reductions and tax consequences upon the states. But that allocation terminates after 2004. As discussed above, other federal assistance is increasingly guided by a "block grant" format that may not adjust to population and inflation, accomplishing state constriction. However, some federal funds remain available on an entitlement basis (e.g., AFDC - foster care) and other funds have not reached block grant ceilings and require only a state match to obtain.

The Governor's 2004 May Revise restoration of some health-related monies for children will restore some of these available federal matching funds that would have been lost, including as much as $900 million in Medicaid funds. And the Governor has rescinded his ill-advised "caps" on children eligible for basic services, as discussed above; that change will restore substantial additional federal monies otherwise lost. The Governor has also announced his intention to seek another $350 million in federal allocations, arguing that the state receives only 77% of the monies it pays in federal taxes. As discussed in Chapter 8, the state is particularly underpaid in its child welfare services allocation. Finally, the Governor is seeking additional revenue for homeland security costs, and for the management of unlawful immigrants, which is partly the product of federal policies outside of state control.

Notwithstanding these efforts, the Governor's 2004–05 budget, as revised in May, maintains substantial new qualification barriers and reductions as summarized by budget subject area above. Most of these cuts sacrifice federal matching funds. Food Stamp impediments save only $46 million in state funds but deprive impoverished persons—mostly children—of $202 million in federal funds. And the majority of cuts summarized above will sacrifice otherwise available federal funds in an amount several times the total saved or deferred. In terms of lost opportunities, the amount of such monies left on the federal table for distribution to other states is profound and is illustrated most starkly by the failure to collect federal State Child Health Insurance Program money at a 2–1 match for California's Healthy Families implementation, as discussed above. That failure is the product of impediments to entry of income-qualified families with children—from premium barriers, outreach disinvestment, and other barriers to qualification. The total sum of available federal money for 2004–05 not to be obtained under the proposed budget is conservatively estimated at between $2.5–$3 billion after the 2004 May Revise.

B. Structural Recommendations

Beyond the political struggle to balance child investment obligation against tax burdens are the procedural rules underlying budget and tax decisions. In theory, democratic institutions reflect the will of the majority. Child advocates argue that the values of the body politic as a whole includes strong support for child investment. To what extent do political rules impede majoritarian decisions? Are those rules justified by an articulable public policy? Are the rules balanced so that a required supermajority is similarly required for parallel decisions (such as direct spending and spending through selective tax forbearance)? By the same token, are rules in place to meet conservative concerns about lack of accountability in public agency performance? Are structural changes advisable to more equitably balance decisions to invest in children against the imposition of new revenues? Are changes commended to meet legitimate concerns about state overspending and bureaucracy growth—changes that may be more refined than a reflexive "do not feed the 'beast' (government)"?

1. Bi-Lateral Supermajority

California is one of three states (with Arkansas and Rhode Island) that requires a two-thirds vote to enact a budget (California Constitution Article IV, §12d). California also requires a two-thirds vote to increase taxation, and to terminate a tax break (deduction or credit), since such action is technically a tax increase. Hence, child investment faces a successful bar to spending, or taxation, or the removal of tax expenditures (which rarely benefit children) by a minority of one-third of the Legislature. A more balanced approach would follow the precedent of most states and allow budgetary adoption by majority vote. Such a decision represents the basic appropriations power of the Legislature properly guided by majoritarian decision. It does not raise issues of minority protection requiring a special margin of approval. To require a two-thirds legislative vote to enact a new tax is not as rare, but that restriction—intended to limit the fiscal power of the state—does not require its extension to the rescission of special tax forbearance (called "tax expenditures" by economists). The current imbalance requires a two-thirds vote to invest in children on the spending side, another two-thirds vote to impose taxes to finance that spending, and an affirmative two-thirds vote to end tax spending, while decisions to create new tax exceptions ("expenditures") require only majority vote.

2. "Pay as You Go" on the Tax Side

Related to the supermajority lack of balance is the one-sided application of the "Pay As You Go" concept both federally and in California. As discussed above, that concept requires any new spending to be counterbalanced by spending reductions in some other account. The Schwarzenegger-sponsored Proposition 58 implements a partial Pay As You Go element in delegating to the Governor circumscribed authority to reduce spending by mid-year cuts to accounts he selects—where other accounts project above budgetary levels. The concept is to preserve the initial expenditure target.

A balanced approach would similarly require an increase in public revenues wherever the Legislature proposes to decrease tax obligations to selected taxpayers (usually through special interest deductions and credits). If the rationale of Pay As You Go on the spending side is to preserve the budgeted amount, why should it not apply on the revenue side for the same reason? Why must spending be "made up" by subtraction somewhere else, but tax expenditures that decrease revenue with the same budgetary imbalance result have no such countervailing check?

3. Rotating Sunsets for Tax Expenditures

All state spending must be specifically enacted annually as part of the budget process. In contrast, tax expenditures (deductions or credits for particular taxpayers) are enacted initially by majority vote, and then continue indefinitely in the normal course unless specifically terminated. Most such expenditures have a legislative purpose (*e.g.*, to stimulate home ownership, research and development, solar power development or some other applicable legislative intent). Some of these deductions and credits warrant continuation or increase, while others fail to provide promised benefits. As with any budgetary decision, they should properly be reviewed on a regular basis. The difference between a default rule of no more than one year applicable to spending, and permanent status for tax forbearance represents an imbalance in policy against child investment and favoring tax dispensation. For the merits of both types of decisions to be reviewed, tax expenditures require some mechanism for their review. While annual sunsets and required re-enactment may require too substantial an increase in legislative review (and lead to pro forma approvals), a system of rotating sunsets, to provide for automatic termination at three-, four-, or five-year periods unless specifically re-enacted would stimulate needed review. Those who receive public monies, or special tax forbearance, are both appropriate for accountability review by the Legislature overseeing budgetary policy. AB 990 (Ridley-Thomas), pending in 2004, provides for annual tax expenditure reports to the Legislature, and systematic review of such expenditures by the legislative budget committees and revenue and taxation committees.

4. Proposition 13 and Equal Protection

A decision to cap taxation is a policy decision available for electoral decision through constitutional proposition in California. The voters of California enacted Proposition 13 in 1976 to so limit property taxes to no more than 1% of the assessed valuation of real property. However, the initiative also improvidently froze all assessments at 1977 levels, with a limited 2% annual increase allowed thereafter.

A resale may establish a new assessment level, but businesses have avoided such reassessments by selling stock in corporations owning property—thus freezing assessments at particularly disproportionate levels. But even residential properties held by older adults are now paying taxes at rates that are one-fifth or one-tenth of their market value. A property tax is an *ad valorem* assessment (a tax on the market value of an asset). As discussed above, new residential purchasers—including in large measure youth and children who will buy in the future—will pay taxes on current market prices, suffering what is becoming increasingly gross discrimination *vis-a-vis* preexisting homeowners. It is unclear ethically why the young should bear five to ten times the tax burden of older persons based on a market value tax on properties of identical value and to provide the same governmental services. Such a categorical advantage based simply on tenure raises serious equal protection issues—notwithstanding the divided California Supreme Court decision approving of it. That approval, as with the electorate's approval of the concept, occurred without the benefit of hindsight about the degree of real estate inflation that has occurred, and which continues to create great tax disparities disfavoring the young.

Most economists agree that property subject to an *ad valorem* tax should be taxed at its market value at the point of taxation, not at some arbitrary historical point in time. Accordingly, all property should be assessed for tax purposes at its market value. Defenders of the current disparity argue that freezing assessments for older adults is necessary to allow the elderly to keep their homes—to prevent real estate inflation from driving up taxes and then compelling long-established homeowners to sell because they are unable to afford taxes. But real estate asset expansion carries with it a potent vehicle for borrowing at low interest, an option used by most of the older adults with large built-up equity. And if loss of a longstanding home were the *bona fide* motivation for freezing assessments, the tax could remain at a frozen level while the owner and spouse remain alive, and the assessing against the estate the accumulated difference between the frozen level and the actual tax due. Such a solution prevents persons from having to move out of their home, while avoiding discrimination against persons buying at a later point in time—a discrimination that has reached unacceptable levels.

Such an altered policy could preserve the 1% of real property market value tax limitation that is the heart of Proposition 13, and keep California as a relatively light property tax jurisdiction. Indeed, it would be preferable from the viewpoint of children to lower the ceiling to 0.7% or even a lower level that is revenue neutral *vis-a-vis* current collections. But accurate assessments are commended not for collection of additional revenue, but for reasons of equity—fairness between generations.

5. Required Spending Accountability

The 2004–05 Children's Budget recommends that any new program in excess of $1 million automatically sequester from 1%–3% into a special fund to finance independent review of each such spending (and tax expenditure) program for efficacy. Such studies should include surveys of similar programs and outcome measures in California and in other jurisdictions. Very few California public programs are subject to such independent evaluation. Indeed, Proposition 140 limiting legislative terms also placed limitations on the Legislature's budget. The cuts that have since occurred among legislative agencies and staff have lessened the Legislature's ability to staff a monitoring/evaluation function. The Little Hoover Commission, Bureau of State Audits, Legislative Analyst's Office, Senate Office of Research, outside think tanks and academic institutions, and occasional committee hearings explore a small number of programs and problem areas annually. The review is episodic, fragmented, and uncoordinated—and most often non-existent.

Such governmental programs usually have no private competition and lack the check provided by normal market forces. A bad program may continue indefinitely, especially where locally functioning and backed by a powerful legislator or a well-connected interest group. But such criteria are not decisions to continue, terminate, or expand made on the merits. The institutionalization of required review by those who must have no economic stake in the subject area reviewed will help to compensate for the lack of a market natural selection process. Ideas that work—in California and elsewhere—will have an empirical basis for generalization. Those that do not provide outcome benefits will face more likely termination. Moreover, such evaluations allow programs to be refined over time, to emphasize those aspects that work and to shift away from approaches that do not.

The State Auditor should be assigned the task of organizing and administering these measurement elements to assure coordination. A percentage of the study funds should be allocated to the Bureau of State Audits for that purpose. The Little Hoover Commission and Legislative Analyst would be in a position to compare results with reported outcomes in other states and jurisdictions of related ideas.

6. Prevention Investment

The Greek definition of a "professional" includes implicitly a person whose basic function is to eliminate the need for his/her services. A professional physician works to promote public health so fewer operations, hospitals, and doctors are needed. A professional attorney should work to prevent disputes. Similarly, state agencies providing services to children should ideally be working to eliminate the need for such services. However, budget forces at work in the normal course—while often praising prevention as a concept—rarely advocate for it in practice. As a result, investment in measures to lessen unwed births (among adult women as well as teens) have not been advanced by advocates nor become a part of a statewide strategy—notwithstanding its correlation with child poverty and needed child-related public services across a wide spectrum. Similarly, parenting education in schools and public education about reproductive responsibility—the right of a child to be intended by two adults and the benefits that flow from such a simple commitment—are not a part of public debate or expenditure.

The Legislature's own policy and research resources should be focused not on the media fascination du jour, but on underlying prevention strategies and funding. The Wilson Administration budgets at least raised some of these issues; the 2004–05 Schwarzenegger Administration budget avoids them.

7. Volatility Control

As discussed above, Proposition 58 adds several measures to avoid revenue volatility from creating sudden intractable deficits. These include the mid-year adjustment, and the reservation of a substantial reserve fund over time. However, an additional volatility control is advisable. Sources of revenue that are particularly volatile, such as capital gains and stock option revenue, should be income averaged over a running five-year period. Where a given year exceeds that average by some percentage, a substantial portion of that overage is properly banked for future expenditure. Hence, when such income jumped from $12.7 billion in 1999–00 to $17.7 billion in 2000–01, a large portion of the overage from historical levels should be placed in a "volatility control" fund. The state cannot engage in deficit financing as can the federal jurisdiction. Rather than dipping into deficit, as the Congress is now doing, a state must take a "surplus reservation" approach. Proposition 58 goes part way in providing some protection, but would not have as effectively addressed the 2000–01 overage as would a volatility protection surplus account.

C. A Comment on Revenue Line Drawing and Child Disinvestment

The "structural deficit" of $14 billion, as well as accrued deficits and unconstitutional borrowings, are addressed in the 2004–05 budget through two major mechanisms – obligation deferral and spending cuts. The failure to arrange for meaningful new revenues is contrary to longstanding precedents where smaller deficits have been presented. The approach further diminishes adult fiscal commitment to children.

The Administration has moderated some of the more egregious reductions from the January iteration of the 2004–05 proposal, and cites its remaining, significant reductions and deferral approach with two arguments: (1) the deficit is primarily the result of the state receiving capital gains/options income from an economic boom and imprudently setting new spending levels at those artificially high levels, and (2) future economic recovery will allow revenues to catch up with current public spending levels.

However, the closing of the real structural deficit does not occur with the return of revenues to the level of spending in 2000–01 or 2003–04. As this *California Children's Budget* calculates, population and inflation change the spending level required to hold child investment even. There are more children each year, and more taxpayers. Inflation is not high, but in combination with population, the proper adjustment is significant year to year and commonly requires 20% in additional spending over four to five years to simply maintain real spending levels. Normal increases in revenue growth are not likely to make up a $14 billion structural deficit.

Evidence supports the Governor's campaign thesis that the Legislature has engaged in some overspending—including in some child-related accounts. For example, most child advocates found dubious the decision of former Governor Davis to present every high school senior scoring in the upper 10% of statewide standardized testing with a $1,000 check from the general fund; the labeling of these checks as "Governor's Scholarships" bestowed upon newly-eligible voters added nothing to their merit.

Evidence also supports the more general conservative thesis that social service spending may be supported by a social service establishment reflexively and regardless of success, and that insufficient attention is paid to prevention to private responsibility. Indeed, a case can be made that, left to its own devices and without fiscal limitation, the standard "liberal" approach of grants, subsidies, and programs will produce one, then two, then three, then five, then fifteen, and eventually an infinite number of public employees assigned to each child. Conservatives argue that children are best served in a "vertical" structure where parents and family and teachers are deeply involved in a child's life, with little change in the identify of such persons, and a steady, sustained commitment from each. In contrast, conservatives argue that the social service establishment tends to organize horizontally, with children constituting "caseloads" of welfare, Food Stamps, health, special needs, child protection, and other social workers. Involved children tend to be names on pieces of paper flowing across desks manned by changing faces.

Conservatives cite Parkinson's Law that "income rises to meet expenditures." They apply the concept to public spending to argue that public employees seek lower caseloads and greater authority and resources with unclear boundaries, and then seek to tax at levels meeting those requests. And they argue that the social service establishment avoids the natural checks of a market. It tends to operate from the top down rather than from a consumer market up, and it lacks the natural selection or other outcome accountability markets tend to provide.

But the prescription advanced by the Governor does not follow from his diagnosis. That prescription is to confine underlying spending to levels produced by a decade of weakened revenue mechanisms. The standard for child investment is properly set as a percentage of personal income, or gross domestic product, or some other measure responsive to population, inflation and ability to pay factors—not raw numbers. Nor is the proper measure tax revenues in a setting of reduction and tax expenditure growth.

As discussed above, an allocation of adult personal income for child investment consistent with the past 27 years yields an existing $11 billion general fund shortfall on the collection side. A proper balance would restore that $11 billion base and require cuts down to that level—without egregious jeopardy to children in need, without deferral to future payers, and allowing full draw-down of federal funds. Regrettably, that has not been the choice made.

Minority leaders in both the state Senate and Assembly have seized upon an absolute bright line of "no new taxation." They purport to wholly exclude tax expenditures and fees from change. It is a line drawn with such fervor that the Senate Minority leader has threatened to personally campaign against any Republican who proposes or votes for any tax increase. The Assembly Minority leader regards a "tax increase" characterization similarly—as a categorical *malum prohibitum.* The spending cuts that are now occurring (and their real world implications for involved children) creates political risk and ethical liability for our policymakers, who are choosing to make those cuts in order to save wealthy taxpayers—already relieved of $37 billion per year in federal taxes—from making any increased contribution whatever.

A bright line position "on principle" properly yields where competing principles warrant refinement. As adults, our obligation to protect and invest in our children constitutes such a competing principle. Our responsibility to invest no less than our parents and grandparents invested in us as a percentage of our income constitutes a more defensible indicator of line-drawing for adult burden than does the happenstance of current revenue production. The legitimate conservative concern over the results of no clear limitation on spending has not been balanced by similar concern over the lack of limitation on tax reduction of special tax forbearance breaks. As with agencies seeking infinite spending expansion, the lobbies of Sacramento seek infinite tax reduction. In applying supermajorities to limit spending abuse, but not tax contribution avoidance, and drawing a strict ceiling on one without a floor to the other, the state moves into a downward spiral in long-term child investment.

Precedents for raising additional revenue center on prior Republican Governors. In the late 1960s, Governor Reagan faced a similar budget deficit inherited from his predecessor. He considered an across-the-board 10% spending cut, but upon practical consideration, approved of tax increases that amount to $5 billion in today's dollars. The increase did not spur an economic downturn, and minimized harm to important interests depending upon public monies. In 1991, Governor Wilson faced a similar deficit and similar posturing from his Party's legislative leaders; he insisted on serious spending cuts, but he also approved of new revenues yielding again about $5 billion in new revenue, making up about one-half of the shortfall. The economy did not suffer, and in fact expanded rapidly throughout the mid and late 1990s.

In 2004, California has a self-described child advocate Governor, who previously sponsored a substantial new spending program to provide after-school programs. He inherited a 2003–04 budget with $3 billion in excessive spending and $7 billion in failed revenue production—shortchanging our children from historical levels of California adult commitment. His response to meet the shortfall has been to (1) cut general fund spending by an adjusted $2.5 billion from the current year; (2) lower revenues $4 billion through VLF reduction retention, bringing the $7 billion in long-term revenue shortfall up to $11 billion; (3) push that remaining deficit of over $11 billion forward for future taxpayers; and (4) raise no new revenue, except for $240 million in increased fees—with the highest percentage applying to youth in higher education, child medical coverage costs and barriers, and license renewal fees on foster care and child care licensees.

A value-consistent short-term approach would be to (1) raise about one-half of the shortfall through new revenue (perhaps through the retraction of improvidently approved tax cuts), as did the Governor's two Republican predecessors; (2) refuse to push forward obligations on future taxpayers except to a very limited degree for averaging purposes; and (3) insist on spending reductions where benefit-cost impacts justify them.

In terms of longer-term policies, an approach consistent with the Republican critique would advance some of the systemic budgetary changes discussed above, in particular (1) preventive and private responsibility initiatives similar to those raised by the Wilson Administration; (2) insistence on social service (as well as education) performance accountability—with an assured portion of spending allocated for independent outcome measurement to substitute for the absent market and to guide spending termination/enhancement decisions; (3) agreement that tax expenditures are properly subject to review and periodic required approval as with other spending; (4) alteration of inequitable taxation (see discussion of Proposition 13 assessment inequities below); and (5) measures to dampen revenue volatility and assure an adequate surplus. Only the last element has been proposed by the Schwarzenegger Administration. Instead of refined policies actualizing core values that include child investment, equality of opportunity assurance, avoidance of obligation deferral to others, and accountability, the current Administration has replicated the absolutist posture of the two current Republican legislative leaders—a replication refused by both of the Republican governors whose strong leadership instructed, in strong, clear, and mandatory terms, the Party's legislative leaders to consider impacts on children and ordering acquiescence to new taxes in a balanced approach between reductions and revenues.

Nationally, a 2004 report by the National Association of State Budget Officers found general fund spending up 2.6% on average nationally. The increase is less than population/inflation gain and the average change annually from 1979 nationally has been an increase of 6.2%—which would cover inflation and population change, with marginal additional spending. However, California's change in spending commitment is lower both in adjusted amount and in raw numbers—and is more severe than other major states reported nationally. In addition to the disproportionate cut in general fund spending in California, the state is also out-of-step on the revenue side. The report found that the governors of 26 states are seeking $5.4 billion in additional revenue, mostly tax increases. Substantial additional increases are also in prospect from legislative addition. Few of the citizens or public officials of other states welcome additional taxes, but such revenues are properly justified based on compelling need. Evidence far short of California's deficit and disinvestment consequences has produced substantial new revenues throughout the nation—including states such as Kansas, Texas, and others dominated by the Republican Party.

Recent evidence suggests that the electorate's view is closer to the response nationally, and to traditional Republican policies—rather than current absolutist, arbitrary line-drawing. The sentiments of voters are counterintuitive to many public officials, but they support additional public taxation and the amelioration of cuts—particularly as to child-related accounts. The current position of state Republican leaders raises the ironic specter of political liability for standing inflexibly on the "principle" of categorical revenue rejection. The Public Policy Institute of California's surveys of voters have found surprising support for increased taxation, including income taxes and increased tobacco and alcohol taxation, among others. An extraordinary 82% oppose spending reductions for K–12 education, and a strong 71% oppose health and human services cuts. Interestingly, 67% would agree themselves to additional taxes to prevent education spending reductions.[117] It is possible that 2005 and 2006 will witness the defeat of a substantial number of political candidates because they refused to raise taxes, choosing instead to cut education and child-related programs. As with many matters of public policy, the decision to increase revenues or to moderate tax reductions turns on empirical impact and equities, and is not amenable to pre-determined dogma. The evidence suggests that the electorate understands such subtleties.

Summary of the *2004–05 Children's Budget* Recommendations

■ Generate new temporary revenue of $4 billion per year for three years, to sunset in 2007–08, to pay off deficits accrued through 2003–04, and with $3 billion allocated for 2004–05. Retire or cancel Proposition 57 and other bond indebtedness, rescind accounting devices and loans that defer obligations to future payers.

■ Establish a revenue base of 7% of personal income, consistent with the historical average over the past 27 years, to be publicly invested in children, producing $11 billion in new general fund revenue for 2004–05.

■ Utilize the $11 billion addition for leveraged investment in a **California Child Advancement Fund**, to promote child health, education, well-being, and opportunity consistent with prior investment and spending in other states. This expenditure would attract more than $3 billion in additional federal funds. The Child Advancement General Fund $11 billion should be allocated to the following:

- $3 billion would be used to reverse the child-related cuts of Governor Schwarzenegger's proposed 2004–05 budget, as revised in May. Such restoration should maintain inflation-adjusted spending for child accounts, rather than the reductions proposed. Maintenance of real spending levels would include TANF child safety net grants ($500 million), CalWORKs ($200 million), outreach and access to medical coverage ($20 million), child care compensation ($80 million), K–14 and higher education investment ($1.5 billion), juvenile probation and crime prevention ($150 million), and the "loan" required of counties to the state ($350 million). Child-related fee increases would be rescinded (*e.g.*, foster care and child care license renewals), as would tuition increases—except for tuition at graduate schools of engineering, medicine, law, and business ($200 million). This $3 billion in restoration should cause an increase of about $1 billion in federal monies, mostly in the medical coverage area.

- $8 billion would go toward new general fund investment expended as follows (and attracting $3 billion in additional federal funds through sums below that are asterisked), as follows:

    - $290 million to fund a Prevention Agenda, including on-going public education and public service messages supporting the right of a child to be intended by two adults, reproductive and paternal responsibility, parenting education, and the strengthening of marriage (Chapter 2)*

    - $450 million to assure a minimal safety net for impoverished children, including additions to local infrastructure; an 8% TANF grant increase to partially compensate for fifteen years of reductions; an economic downturn reserve fund to hold children harmless; and implementation of the housing voucher safeguard as intended to prevent child homeless status (Chapter 2)*

    - $80 million to redesign TANF for greater work incentive, and to give some credit to parents who work more than half-time (Chapter 2)

    - $200 million so TANF parents who are employed publicly receive wages (rather than a "workfare" allowance), thus allowing federal Earned Income Tax Credit and food stamp eligibility, and using federal funds to keep involved children above the poverty line (Chapter 2)*

    - $250 to implement broadly the Child Support Assurance concept pioneered in New York, to allow children owed support by absent parents to receive assured subsistence funding from the state, which then collects sums due (Chapter 2)

    - $950 million to create a state Earned Income Tax Credit (EITC) to supplement the federal EITC, to form a bridge over the poverty line and to self-sufficiency (Chapter 2)*

    - $57 million to ensure breakfast availability at all public schools and state-funded outreach for school meal inclusion and enhanced WIC coverage—all of which are primarily funded federally, allowing leveraged advantage for impoverished children (Chapter 3)*

    - $5 million for automatic retention of TANF families on Food Stamps for one year after transitioning from rolls, recognizing that virtually all such families remain income-eligible for such

- $50 million for the expansion of the Food Stamp electronic benefit card into a general "child assistance card," including updated eligibility information on magnetic strips for TANF, Food Stamps, medical coverage, special needs, and protective services, and allowing realistic and efficient access to help (Chapter 3)*

- $300 million to medically cover all children, providing screening and prevention statewide without regard to income. Where a child receives more than $500 in services in a year, bill parents earning over 300% of the poverty line *post hoc* on a sliding scale. Finance coverage from three sources: (1) $300 million new general fund money; (2) $300 million in general fund savings from the termination of over ten fragmented systems with expensive obstacles to exclude the 4% of California children now uncovered and ineligible for public coverage; and (3) $1.2 billion in available federal funds at a 2–1 match (Chapter 4)*

- In relation to the above proposal, combat "crowd out" (employers halting dependency coverage in light of available public coverage) by assessing a small fee on all employers with more than ten full-time employees who fail to provide dependency coverage for employees earning under 300% of the poverty line; use those monies to finance a tax credit of 30% of the cost for such dependency coverage for employers who do provide it (Chapter 4)

- $60 million to substantially increase funding for safety and injury prevention, with particular attention to lead poisoning dangers, vision/hearing screening, and dental disease prevention (Chapter 4)

- Fund from Proposition 10 sources systemic advocacy on behalf of the health of young children before the state's regulatory system and before the courts, where decisions affecting coverage are made and such children lack representation (Chapter 4)

- $32 million to better serve children with special needs by (1) preserving mental health within Medi-Cal and Healthy Families; (2) applying the "System of Care" concept for accountability (rather than eliminating it); (3) applying the managed care reforms to mental health services as recommended in Chapter 4; (4) providing attorney's fees for successful IDEA petitions; and (5) adjusting SSP benefits to the cost of living (Chapter 5)

- $450 million to create a single, seamless child care system on a sliding scale based on income and number/age of children. Alternatively, expand the state's new refundable child care tax credit to provide that sliding scale subsidy. Seek a federal match to total $900 million (Chapter 6)*

- $550 million to upgrade the quality of child care providers, including training and certification bonuses, retention subsidies, and "best practice" roll-out grants; attract a federal partial match to total $700 million (Chapter 6)*

- $120 million to confer refundable tax credits to child care providers close to the poverty line to facilitate compensation for these important caregivers at "self-sufficiency" levels above the poverty line (Chapter 6)

- $40 million to create a refundable tax credit available to child care centers and employers amounting to $500 for each caregiver they employ at a salary that is above 120% of minimum wage (Chapter 6)

- $180 million to allow a tax credit for child care centers amounting to $500 per year for each child (enrolled for a full year) living below 150% of the poverty line (Chapter 6)

- An amount to be determined to implement a five-year plan of bond investment and tax credit subsidy to provide $3 billion for the construction of quality child care centers in areas of undersupply, coordinated with the provider tax credits above and expanding upon AB 1542 (Chapter 6)

- $40 million to triple the state's regulatory oversight for child care in stages over a three-year period (Chapter 6)

- $1.5 billion to begin three-year phased class size reduction (especially in grades 4–12), bringing California to at least the national average by 2007–08 (Chapter 7)
- $300 million to target the lowest-performing schools with intensive intervention, not token grants (Chapter 7)*
- $30 million for parenting education programs (Chapter 7)
- $80 million for school districts, county offices of education, and district attorney to engage in aggressive truancy/drop out prevention (Chapter 7)
- $100 million and a bond sale for technology competence, to assure computer/distance learning facilities in public schools (Chapter 7)
- $25 million to test and mitigate lead drinking water levels in schools (Chapter 7)
- $400 million for community college and vocational school expansion (70% to be spent on increasing capacity) (Chapter 7)
- $1.2 billion for UC/CSU capacity expansion (Chapter 7)
- $31 million for Cal Grant increases for higher education opportunity (Chapter 7)
- $80 million to increase family foster care compensation rates by 15% and tie them to the Consumer Necessities Index thereafter; compensation should be additionally increased where providers are certified to care for special needs children through additional education (Chapter 8)*
- $16 million to enhance family foster care supply and quality through (1) the creation of an Office of Foster Care Supply and public campaigns to generate applicants; (2) removal of racial barriers to adoption; and (3) diminution of dependency court confidentiality (Chapter 8)
- $20 million for adoption assistance, which should be allocated without regard to parental income and maintained at family foster care rates, with increases for special needs children (Chapter 8)*
- $40 million for foster care children reaching 18 years of age, to assist them into employment and independence to age 23, including full tuition and room and board while a student in good standing at a vocational school or college (Chapter 8)*
- In conjunction with the four prior recommendations, substantially enhance child abuse prevention spending, including “Healthy Beginnings” and early intervention, education during pregnancy, and other initiatives (Chapter 8)
- $20 million for paternal involvement grants with federal match as a delinquency prevention strategy (in addition to Chapter 2 responsibility investment) (Chapter 9)*
- As to any existing program expending more than $2 million annually, or any new or pilot project of over $1 million, 1%–3% of the spending amount, for one to two years, should be automatically and inflexibly allocated to an independent evaluation of spending outcomes, with published reports analyzing comparative empirical results over time, and with other state and national programs (Chapter 1)

Total New General Fund Child Investment: $8.146 billion

Chapter 1

ENDNOTES

1. California Department of Finance, *Gross State Product, California* (Sacramento, CA; 2004) (available at www.dof.ca.gov; see also http://commerce.ca.gov/ttca).

2. California Employment Development Department, *California's Unemployment Rate Unchanged at 6.2%* (Sacramento, CA; March 2004) (available at http://www.calmis.cahwnet.gov).

3. Office of the Governor, *Governor's Budget Summary 2004–05* (Sacramento, CA; January 2004) at Figure Schedule 6. See also Office of the Governor, *May Revise 2004* (Sacramento, CA.; May 13, 2004) for recent personal income adjustments in economic status discussion at 1-15.

4. Office of the Governor, *Governor's Budget Summary 2004–05* (Sacramento, CA; January 2004) at Figure Econ-4.

5. Center on Budget and Policy Priorities, *Gaps Between High-Income and Other Americans Will Reach Record Level in 1999, Analysis Finds* (Washington, D.C.; Sept. 1999) at 1.

6. John Sladkus, Jean Ross, Kate Breslin, and Scott Harding, California Budget Project, *Working, But Poor, in California* (Sacramento, CA; September 1996) at 25.

7. California Legislative Analyst's Office, *California's Changing Income Distribution* (Sacramento, CA; Aug. 2000) at 2.

8. *Id.*

9. Deborah Reed, Melissa Glenn Haber, Laura Mameesh, Public Policy Institute of California, *The Distribution of Income in California* (San Francisco, CA; July 1996) at vi.

10. *Id.* at 24. Only Michigan had a higher rate of inequality gain from 1969 to 1989.

11. California Legislative Analyst's Office, *California's Changing Income Distribution* (Sacramento, CA; Aug. 2000) at 8.

12. Deborah Reed, *Income Inequality in the Golden State: Why the Gap Has Widened Between Rich and Poor,* Research Brief Issue #17, Public Policy Institute of California (February 1999) at 1–2.

13. See *infra* Appendix A (Table App.-C).

14. Children Now, *California County Data Book 2001* (Oakland, CA; 2001).

15. See *infra* discussion and citations in Chapter 2 (Figure 2-A).

16. U.S. Census Bureau, *Housing Vacancies and Homeownership Annual Statistics: 2001* (Washington, D.C.; 2002) at Table 13.

17. *Id.*

18. See Bureau of the Census, *Residential Population Estimates by Age, Sex, and Race for the Years 1970–1996* and *Population Projections of the United States by Age, Sex, Race, and Hispanic Origin: 1995–2050* (Washington, D.C.; 1999), cited in *Juvenile Offenders and Victims: 1999 National Report* (Washington, D.C.; 1999) at Chapter 1.

19. See Appendix A (Table App.-B).

20. This figure is applicable to the 48 contiguous states and the District of Columbia. Note that there are two separate federal measures of poverty. The "poverty thresholds" for various family sizes were the original format developed by Mollie Orshanksy of the Social Security Administration. These thresholds are used for statistical purposes, *e.g.* estimating the number of children in poverty each year.

    In contrast, the "poverty guidelines" are issued each year in the Federal Register by the U.S. Department of Health and Human Services (DHHS). They are a simplification of the more complex "thresholds" above for administrative purposes, including eligibility for income related programs. The guidelines below are in effect as of February 13, 2004 and are popularly referred to as the "federal poverty line." For the 48 contiguous states, they are:

Size of family unit	Poverty guideline
1	$9,310

2	12,490
3	15,670
4	18,850
5	22,030
6	25,210
7	28,390
8	31,570
additional members	add $3,180 each

Source: Federal Register, Vol. 69, No. 30 (Feb. 13, 2004) at 7336-7338; see also http://aspe.os.dhhs.gov/poverty/04poverty.shtml.

21. See *infra* Chapter 2 at Table 2-A.

22. See California Department of Education, Educational Demographics Unit, *English Learner Students and Enrollment in California Public Schools, 1993 through 2002* (Sacramento, CA; 2002). See also California Department of Education, Educational Demographics Unit, *Number of English Learners in California Public Schools, by Language and Grade, Ranked by Total, 2000-01* (Sacramento, CA; 2002) and *Statewide Enrollment in California Public Schools by Grade, 2000-01*(Sacramento, CA; 2002).

23. See U.S. Census Bureau Report released October 4, 2000, summarized by Melissa Healy and Robert Rosenblatt, *State Leads as Home to Immigrants*, L.A. TIMES, October 5, 2000, at 1.

24. Mary C. Daly, Deborah Reed, and Heather N. Royer, *Population Mobility and Income Inequality in California*, Public Policy Institute of California, California Counts Vol. 2, No. 4 (May 2001) at 1-2.

25. Office of the Governor, *Governor's Budget Summary 2000–01* (Sacramento, CA; January 2000) at 31 (tobacco settlement estimate of $388 million), at 121 (Proposition 99 projection at $394 million), at 143 (Proposition 10 revenues estimated at $719 million). Total revenues from the tobacco tax, only a portion of which is applied to children, plus the direct child welfare funds, total approximately 4% of the special fund total. Although some special fund revenues, particularly a designated portion of vehicle registration fees, are now realigned to the counties for what should include child-related purposes; this assignment is in lieu of general fund moneys taken from previous local and state sources, and has been set at an adjusted amount lower than funds previously contributed by the state.

26. See discussion of report in Ed Mendel, *Residents Tax Load Below U.S. Average*, SAN DIEGO UNION-TRIBUNE, April 8, 2004, at D-1.

27. See Office of the Governor, *Governor's Budget Summary 1998–99* (Sacramento, CA; January 1998) at Appendix 24 (Schedule 6). The employees per 1,000 population has increased from 8.0 in 1964-65 to 9.9 in 1977-78, to 9.1 currently and 9.0 as proposed in 2001-02 (see Office of the Governor, *Governor's Budget Summary 2001–02* (Sacramento, CA; January 2001) at Appendix 25 (hereinafter "*Governor's Budget Summary 2001–02*").

28. This calculation uses the most recent figures from the Governor's May 2004 Revise. It is obtained by taking the 1978–79 ratio of personal income to general fund expenditures (219.7 to 16.25) (see Office of the Governor, *2004–05 Budget Summary* (Sacramento, CA; Jan. 2004) at Appendix 25) and applying that ratio to the May Revise updated estimate of personal income for 2004–05 (1,262), yielding $93.343 billion. Subtracting the Governor's May Revise general fund total of $77.58 billion from that figure yields a shortfall of $15.76 billion.

29. See *supra* Table 1-C.

30. See compilation of data by county presented by Tom Zembar, American Federation of State, County and Municipal Employees, *California Cuts in Federal Aid Under the Congressional Budget Resolution* (July 29, 1996) in implementation of H.R. Cong. Res. 178. Note that the calculation here adjusts for inflation for accounts subject to appropriation caps (*e.g.*, Head Start), and for inflation and population for those accounts historically subject to entitlement status (*e.g.*, AFDC). We have subtracted the major non-child account (highway planning and spending reductions) from the study's totals for projected federal reductions; these subtractions amount to $67.8 million for 1997, $68.8 million for 2002, and total $427.4 million for the 1997–2002 five-year period.

31. See Andy Schneider, Center on Budget and Policy Priorities, *Overview of Medicaid Provisions in the Balanced Budget Act of 1997, P.L. 105-33* (Washington, D.C.; September 8, 1997) at 8–10.

32. See Office of the Governor, *Governor's Budget Summary 2002–03* (Sacramento, CA; January 2002) at 8 (hereinafter "*Governor's Budget Summary 2002–03*").

33. Joel Friedman, Richard Kogan, and Robert Greenstein, *Final Tax Bill Ultimately Costs as Much as Bush Plan*, Center for Budget and Policy Priorities (Washington, D.C.; May 29, 2001) at 1–3 (see www.cbpp.org).

34. *Id.*

35. *Id.*, at 4.

36. Center on Budget and Policy Priorities, *Overview Assessment of President Bush's Tax Proposal* (Washington, D.C.; February 15, 2001) at 1-2 (see www.bpp.org).

37. *Id.* A narrow exemption could be crafted to address such a concern (indeed, attorney-developed probate planning tactics, including incorporation and inter vivos trusts commonly loophole much current estate taxation).

38. Center on Budget and Policy Priorities, *Bush Tax Cut Tilts Toward Top* (Washington, D.C.; February 7, 2001) at 1 (see www.cbpp.org).

39. See Robert Greenstein, Richard Kogan, Joel Friedman, *New Tax Cut Uses Gimmicks to Mask Costs*, Center on Budget and Policy Priorities, June 1, 2003, at 1-3, hereinafter "Tax Cut Uses Gimmicks").

40. *Id.*, at 7.

41. *Id.*, at 2-3; see also cited study of the Urban Institute-Brookings Institution Tax Policy Center.

42. The United States will spend $396 billion for military purposes in fiscal 2003. The next largest military budget is Russia's at $60 billion. The 47 other major nations of the world combined spend $420.7 billion as of 2001. Christopher Hellman, *Last of the Big Time Spenders*, Center for Defense Information (2002) (see www.cdi.org/issues/wme/spendersFY03.html). Note that the $420.7 billion may be somewhat higher in the comparable year of 2003. However, the U.S. amount does not include $190 billion in indirect defense costs: military retirement pay, veterans' benefits, and interest attributable to past defense spending. See Center for Defense Information, *Military Almanac 2001–02* (2002) at 34 (see www.cdi.org).

43. Kaiser Family Foundation, *The President's Fiscal Year 2003 Budget: An Overview of Health Programs* (March 8, 2002) Chart 3 at 8, citing CBO estimates of January 2002.

44. See Comptroller General David Walker's comments in Marilyn Geewax, *Deficit Picture Grim, Federal Auditor Says*, SAN DIEGO UNION TRIBUNE, September 18, 2003, at A-1 and A-16.

45. See discussion by Chris Edwards, *Younger Americans, Watch Out*, LOS ANGELES DAILY JOURNAL, July 17, 2003, at 1.

46. For a discussion of the omitted liabilities and misleading federal reporting, see Harvard Law Professor Howell Jackson, *Social Security's Massive Liabilities*, SAN DIEGO UNION TRIBUNE, October 10. 2003, at B-9.

47. Office of the Governor, *Governor's Budget Summary 2002–03* (Sacramento, CA; Jan. 2002) at 113.

48. *Id.*

49. The remainder goes to counties (22%), cities (11%), and special districts (16%), and pays for such things as police, fire protection, courts, and other local services outside of the state budget.

50. *Serrano v. Priest* (1971) 5 Cal. 3d 584.

51. Legislative Analyst's Office, *The 2004–05 Budget: Perspectives and Issues* (Sacramento, CA; Feb. 2004) at 120.

52. Office of the Governor, *Governor's Budget Summary 1996–97* (Sacramento, CA; January 1996) at 72–73.

53. The tax rates for alcohol and tobacco have increased somewhat from historical levels, *e.g.,* the passage of Proposition 99 (The Tobacco Tax and Health Protection Act of 1988). However, declining cigarette consumption has reduced tobacco tax revenue since 1989.

54. For one listing of such expenditures, see California Department of Finance, *Tax Expenditure Report, 2000–01* (Sacramento, CA; February 2002) at 1–12.

55. *Governor's Budget Summary 2002–03, supra* note 47, at 101; for $5.9 billion figure, see Legislative Analyst's Office, *Overview of the 2002–03 Budget Bill* (Sacramento, CA; Feb. 2002) at 19.

56. See Table 1-C. Note that special fund sources have increased substantially more than has population and inflation, while general fund spending has increased about 1% over general population increase.

57. California Budget Project, *Who Pays Taxes in California?* (Sacramento, CA; April 15, 2002) at 1.

58. *Id. See also* Citizens for Tax Justice, *A Far Cry From Fair* (Sacramento, CA; 1991) (hereinafter "*A Far Cry From Fair*"). The quintile comparisons measure average total tax burden for a four-person family.

59. *Id.* The study found that since 1985, the poorest one-fifth of the population had its tax percentage of income increase by 19%, more than double that of any other quintile, while the tax percentage of the wealthiest one-fifth increased only 1%.

60. Property tax revenues contributed to education (school district accounts throughout the state budget) totaled $5.3 billion in 1991, $6.5 billion in 1992, and $8.2 billion in 1993.

61. Except note that the law makes three exceptions to the 1.5% permitted add-on: San Mateo may go to 2%, San Francisco to 1.75% and San Diego only to 1%.

62. *Governor's Budget Summary 2002–03, supra* note 47, REV -13 at 108.

63. This adjustment uses the conservative COLA and overall population, see Appendix at end of Budget, App.-A and App.-B, respectively.

64. See Office of the Governor, *Governor's Budget 2002–03* (Sacramento, CA; January 2002) at HHS 151.

65. See June Gin, *Legislative Analyst's Office and Local Government Reflect on Proposition 218's Impact,* CAPITOL WEEKLY (Jan. 6, 1997) at 1.

66. Office of the Governor, *May Revise 2002–03* (Sacramento, CA; May 2002) at 2.

67. The higher education budget in 2002–03 totaled $9.543 billion. The $334 million adjustment necessary to "stay even" in real spending per child is calculated by applying the 1.9% overall CPI inflation and 1.6% overall child population growth from 2002–03 to the current fiscal year to total higher education spending in 2002–03. See Appendix A, Table App.A and Appendix B, Table App. B.

68. See California Budget Project, *The 2003-04 Budget and Beyond*, Budget Watch (Sacramento, CA; Sept. 2003) Vol. 9, No. 3, Table at 3.

69. Office of the Governor, *Governor's Budget Summary 2004-05* (Sacramento, CA; Jan. 2004), Schedule 6 at Appendix 25.

70. For a full listing of the Food Stamp-related provisions of the Act, see www.cfpa.net/foodstamps/Rauth/Reauthcharts.pdf.

71. Children Now, *2002 Report Card on California's Children* (Oakland, CA; July 2002) at 1–3.

72. Little Hoover Commission, *Caring for our Children: Our Most Precious Investment*(Sacramento, CA; Sept. 1998).

73. *Id.*

74. California Budget Project, *Lasting Returns: Strengthening California's Child Care and Development System*, (Sacramento, CA.; May 2001) at 1–2 (see www.cbp.org).

75. Office of the Governor, *Budget Summary 2003-04* (Sacramento, CA; Jan. 2003) at 31.

76. See ACL 03-16 at http://www.dss.cahwnet.gov/getinfo/acl03/pdf/03-16.pdf.

77. See Office of Legislative Analyst, *Analysis of the 2004-05 Budget*, February 2004, at Figure 2 and "Child Care" discussion, hereafter "*LAO 2004-05*").

78. Office of the Governor, *Governor's Budget Summary 2004-05* (Sacramento, CA; Jan. 2004) at 58.

79. *Id.*, at 57.

80. *Id.*

81. Office of the Governor, *Governor's Budget Summary 2004–05* (Sacramento, CA; Jan. 2004) at 51. The Constitutional provisions added by Proposition 98 allow a temporary re-basing of the required appropriations, if a bill is enacted pursuant to a two-thirds vote of the Legislature.

82. Office of the Legislative Analyst, *Analysis of the 2004–05 Budget Bill* (Sacramento, CA; Feb. 2004) at E-18.

83. Office of the Governor, *Governor Schwarzenegger Announces Higher Education Budget Compromise* (Sacramento, CA; May 11, 2004).

84. Tanya Schevitz, *Protest Over Student Fees; Thousands March on Capitol for Community College Funding*, SAN FRANCISCO CHRONICLE, March 16, 2004.

85. Legislative Analyst's Office, *Overview of the 2004–05 May Revision* (Sacramento, CA; May 2004) at 11.

86. Office of the Governor, *Governor's Budget Summary 2004-05* (Sacramento, CA; Jan. 2004) at 132.

87. *Id.* at 132–33.

88. *Id.* at "Child Welfare, CWS/CMS."

89. California Youth Authority, *About the CYA: Summary Fact Sheet* (Sacramento, CA; 2004) (see http://www.cya.ca.gov/about/summarys.html).

90. California Youth Authority, *About the CYA: Summary Fact Sheet* (Sacramento, CA; 2004) (see http://www.cya.ca.gov/about/summarys.html)..

91. Office of the Governor, *Governor's Budget Summary, 2004–05* (Sacramento, CA; Jan. 2004) at 153.

92. *Stevens, et al. v. Harper*, U.S. District Court Case No. S-01-0675 DFL-PAN-P (E.D. CA).

93. Office of the Governor, *Governor's Budget 1992–93* (Sacramento, CA; 1992) at YAC-55.

94. Legislative Analyst's Office, *Analysis of the 2004–05 Budget Bill* (Sacramento, CA; Feb. 2004) at D-24.

95. *Id.* at D-25, D-27.

96. *Id.* at D-24.

97. *Id.*

98. Funding for programs to stop drug abuse in schools was allocated to the Department of Education beginning in fiscal year 1992–93. The importance of these programs is discussed in Kate Fogle and Marilyn Ericksen, California Child, Youth and Family Coalition, *A Response to Youth Crime Proposals* (1994).

99. Children's Defense Fund, *Fiscal Year 2005 Budget Analysis* (Washington, D.C.; Feb. 2004) at 7.

100. See Helen Gao, *County Issues Job Cut Warnings*, SAN DIEGO UNION TRIBUNE, April 20, 2004, at B - 1.

101. Frank Mecca, *Estimated Staff Reductions Related to May Revision Cuts* (Sacramento, CA; May 15, 2002) Table 1 at 1. The Mecca estimates were made anticipating reductions close to the amounts that the 2004-05 budget will implement.

102. See California Department of Finance, *Tax Expenditure Report 2002–03* (Sacramento, CA; 2003) at 8 and 9.

103. The new money was produced through the work of Assemblyman Dario Frommer and Senator Gil Cedillo, who sponsored legislation to impose tough tax shelter penalties stimulating the amnesty success. That work may yield some additional annual revenue from those relying on fraudulent shelters.

104. See DataQuick Information Systems compilation at DQNews.com, reported in Roger Showley, *Median Price of Housing In County Hits $439,000,* SAN DIEGO UNION TRIBUNE, May 20, 2004 at A-1 and A-10.

105. Although lower energy rates for "baseline" consumers purportedly allow relief, the threshold for kick-up to extraordinarily high rates is close to the consumption level of a typical refrigerator. For a detailed discussion of energy policy, see the CALIFORNIA REGULATORY LAW REPORTER, Vol. 17, No. 2, and Vol. 18, Nos. 1 and 2, at Public Utilities Commission.

106. *Farmer Bros. Co. v. Franchise Tax Bd.*, 108 Cal. App. 4th 976 (Cal. App. 2d Dist., 2003)

107. *County of Orange v. Renee M. Bezaire* 117 Cal. App. 4th 121 (2004).

108. See E. McNichol and J. Llibrera, *Why States Should Act Now to Preserve Their Estate and Inheritance Taxes*, Center on Budget and Policy Priorities, 1-30-2003.

109. See discussion in Clea Benson and Alexa Bluth, *Prison System Ignores Budget Cuts*, SACRAMENTO BEE, April 4, 2004.

110. For a description of PUC proceedings detailing the history of deregulation, see the *California Regulatory Law Reporter* (CRLR), a publication monitoring the PUC and other regulatory agencies, published by the Center for Public Interest Law, the parent organization to the Children's Advocacy Institute (see www.cpil.org). *See, e.g.,* 17:1 CRLR 170-175; 16:2 CRLR 140–44; 16:1 CRLR 158–62; 15:4 CRLR 234-37.

111. *Id*., note general fund expenditures per $100 in personal income, second from last column. The Corrections budget is currently set at 9% of the general fund, substantially above the 3% extant, an understandable increase given the state prison population increase from 19,000 to 170,000 as discussed briefly above and in Chapter 9.

112. Legislative Analyst's Office, *Overview of the 2002–03 Budget Bill* (Sacramento, CA; Feb. 2002) at 19. That total of $5.9 billion was then supplemented during 2002–03 with $150 million in additional IRA pension contribution deductions up to $5,000 per annum.

113. See David Johnston*, Business Tax Shelters a Drain on State Finances, Study Says*, NEW YORK TIMES, July 16, 2003.

114. For a discussion of the report, see CALIFORNIA HEALTHLINE, Sacramento Beat, February 5, 2004; see also Jim Hinch, *Pharmaceutical Firms Owe State $1.3 Billion, Federal Audit Finds*, ORANGE COUNTY REGISTER, January 31, 2004.

115. See discussion in Dan Morain, *Gambling Take Here is Fairly Modest*, LOS ANGELES TIMES, July 25, 2003.

116. See *State Farm Mutual Automobile Insurance v. Campbell* (2003) 538 U.S. 408.

117. Mark Baldassare, *PPIC Statewide Survey*, Public Policy Institute of California (June 2003) at 21–25.