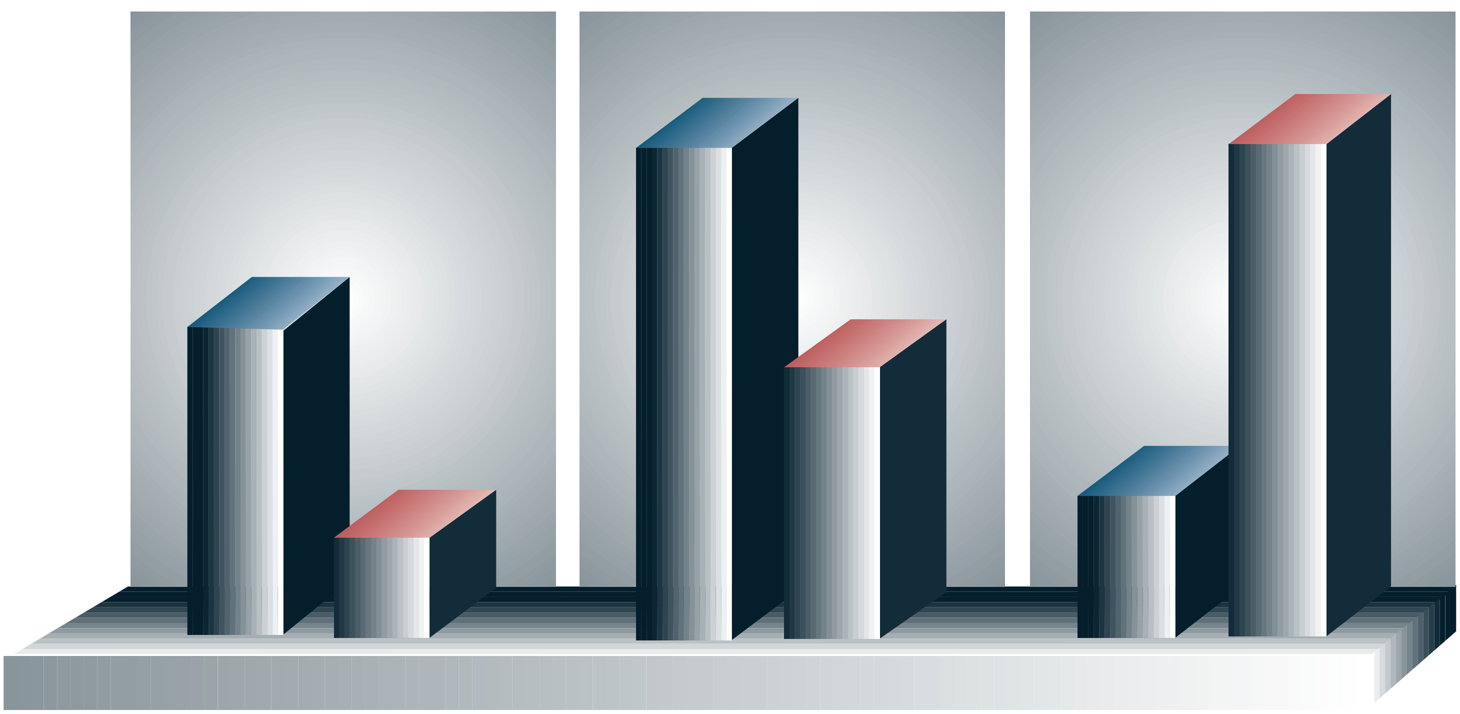
California's Fiscal Outlook

The LAO's Economic and Budget Projections



November 1998

Elizabeth G. Hill Legislative Analyst

Foreword

This report provides our projections of General Fund revenues and expenditures for 1998-99 through 2003-04. It includes our independent assessment of the outlook for the economy, demographics, revenues, and expenditures. It is designed to assist the Legislature with its fiscal planning.

Chapter 1 contains our principal findings and conclusions. Chapter 2 presents our economic and demographic projections, Chapter 3 our revenue forecasts, and Chapter 4 our expenditure projections.

Our fiscal projections reflect current-law spending requirements and tax provisions. They are not predictions of future policy decisions by the Legislature, nor are they our recommendations as to what spending and revenue levels should be. The report is part of an ongoing series and is updated periodically.

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Chapter 1

The Budget Outlook

In striking contrast to the past two years, when strong revenues provided funds for both tax relief and significant spending increases in education and other program areas, our projections indicate that 1999-00 will be a difficult year. In fact, significant budgetary adjustments will be needed to keep the General Fund budget in balance. Figure 1 summarizes our key findings, while Figure 2 (see page 2) presents our estimates of the state's General Fund condition.

As indicated in these two figures, we estimate that the current year will end with a reserve of $331 million, or $828 million less than the *1998-99 Budget Act* estimate of nearly $1.2 billion. With regard to the budget year, we estimate that expenditures will exceed revenues by nearly $1.4 billion, leading to a 1999-00 year-end deficit of over $1 billion absent corrective actions. Our longer-term forecast of revenues and expenditures indicates that the imbalance between revenues and expenditures will persist beyond the budget year, under current-law policies.

Figure 1

Key Findings of the LAO Outlook

Difficult Budgets Ahead

- Current-year reserve projected to be $331 million—down from the nearly $1.2 billion estimate contained in the *1998-99 Budget Act* (as adjusted for post-budget actions).
- Budget shortfall of $1 billion emerges in 1999-00, absent corrective actions.
- Under existing policies, budgetary shortfalls would persist into the future for several years.

What's Happened?

- ***Current Year***—$828 million deterioration, largely reflecting lower revenues and higher state costs.
- ***Budget Year***—Expenditures exceed revenues by $1.4 billion, partly due to new spending commitments and slower economic growth.
- ***Out Years***—Although revenues are likely to grow faster than spending, it would take several years to close the budget gap.

Implications

- A budgetary gap will need to be addressed in 1999-00.
- The solution will require some ongoing, as opposed to solely one-time, budgetary adjustments.

Figure 2

LAO Projections of General Fund Condition

1997-98 Through 1999-00
(In Millions)

		Forecast	
	1997-98	1998-99	1999-00
Prior-year fund balance	$907	$2,530	$776
Revenues and transfers	54,993	56,498	59,706
Total resources available	$55,900	$59,028	$60,482
Expenditures	$53,370	$58,252	$61,075
Ending fund balance	$2,530	$776	-$593
Other obligations	$445	$445	$445
Reserve	**$2,085**	**$331**	**-$1,038**

Our initial assessment of the budgetary outlook for 1999-00 is in stark contrast to the past two years, when the state had significant budget surpluses. The main reasons behind this change are a less optimistic revenue outlook, higher than anticipated current-year program costs, and significant expenditure increases that would occur under existing law in 1999-00.

KEY FEATURES OF THE LAO OUTLOOK

The Economy and Revenues

Economic Outlook. The 1998-99 budget adopted last summer was based on the administration's economic projections for 1998-99 and beyond, which assumed continued strong growth in the economy and healthy stock market-related increases in capital gains revenues. Current economic trends, while clearly more positive than a month or two ago, still suggest that Asia's economic problems and mixed performance in the U.S. stock market will lead to more restrained economic increases than the administration assumed last May—particularly in late 1998 and early 1999. Specifically, we project that California personal income growth will slow from 6.8 percent in 1998 to 5.2 percent in 1999, before partially rebounding to about 5.5 percent in 2000. These estimates compare to the administration's earlier projected increases of 7.2 percent, 5.7 percent, and 5.0 percent, respectively.

Revenue Outlook. We forecast that General Fund revenues will increase from $55 billion in 1997-98, to $56.5 billion in 1998-99, and $59.7 billion in 1999-00. Our updated projections take into account the effects of the slowdown in California's economy as well as the impacts of the tax relief packages enacted in both 1997 and 1998. Together, these packages will lower revenues by $1.4 billion in both the current and budget years.

Our updated revenue estimate for 1998-99 is nearly identical to our May 1998 estimate (as adjusted for the 1998 tax relief package that was adopted after our May estimate was prepared). However, it is down $485 million from the administration's *1998-99 Budget Act* forecast. For 1999-00, our current revenue forecast is $173 million below our May projection, and is down by $1.2 billion from the administration's estimate. Our lower revenue forecast relative to the administration's reflects our expectation of slower income growth in California. It also reflects the impact of the stock market's recent losses on such factors as bonuses, stock options, and investment earnings, all of which have contributed to the major revenue gains experienced in recent years.

Over the longer term (from 1999-00 through 2003-04), we project that total General Fund revenues and transfers will increase by about 5.7 percent per year, or roughly similar to statewide personal income growth.

Additional VLF Reductions Not Triggered. As discussed in Chapter 4, the Vehicle License Fee (VLF) tax reduction measure passed earlier this year provided for a 25 percent reduction in the VLF rate. This measure specified that additional VLF reductions could occur beginning in 2000-01, if revenues exceed the Department of Finance's May 1998 revenue forecast by at least $1.5 billion. Our long-term revenue forecast remains well below the trigger threshold through the forecast period. Thus, based on our projections, additional VLF reductions would *not* be triggered.

Updated 1998-99 Budget Outlook

The *1998-99 Budget Act,* as adjusted for post-budget legislation, assumed total revenues of $56.4 billion, expenditures of $57.8 billion, and a year-end reserve of $1.2 billion. Compared to the budget act, our estimate of current-year revenues is *down* $485 million and our estimate of current-year expenditures is *up* $493 million. Together, these two factors primarily are responsible for an $828 million reduction in the reserve, down to $331 million.

On the *revenue* side, most of the difference from the budget act relates to our lower estimate of personal income taxes, which in turn reflects our less optimistic assumptions about personal income growth and capital gains levels in 1998 and 1999.

On the *expenditure* side, $316 million of our higher costs are due to the Medi-Cal program, which is being affected by higher caseloads, a court injunction requiring continued payments for prenatal benefits to undocumented immigrants, and provider rate increases. Other factors raising current-year expenditures include reduced federal reimbursements for social services and corrections programs, likely increases in fire suppression costs, and increased local property tax administration reimbursements.

Budgetary Outlook For 1999-00

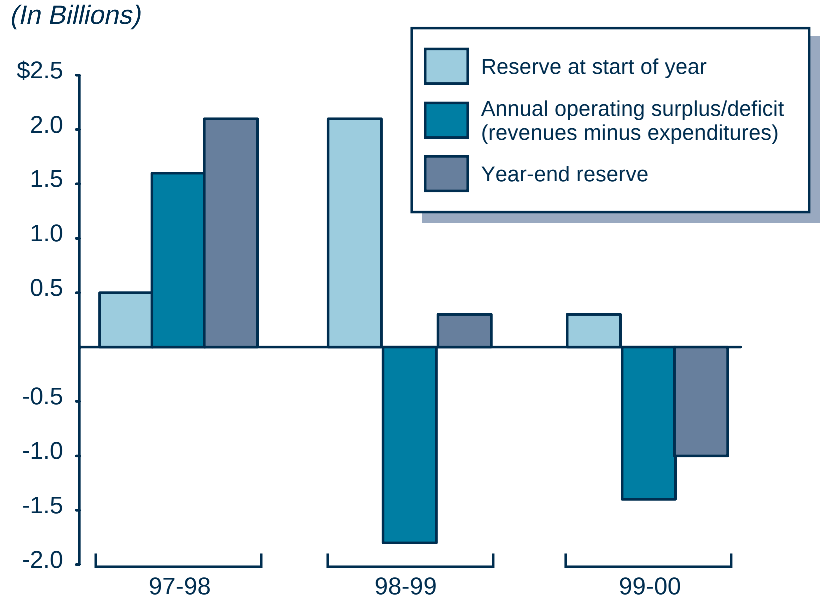
Basis for Our Estimates. Our revenue and expenditure forecasts for 1999-00 and beyond are based primarily on the requirements of *current law*. Specifically, we have adjusted the 1998-99 spending plan for constitutional and statutory funding requirements, as well as for projected changes in caseloads and inflation factors. For example, we have increased K-14 education funding in line with the Proposition 98 minimum funding guarantee. Spending for higher education is adjusted each year for projected changes in enrollments and inflation. Our estimates for California Work Opportunity and Responsibility to Kids (CalWORKs) and Supplemental Security Income/State Supplementary Program (SSI/SSP) incorporate cost-of-living adjustments (COLAs), as provided for in the *1998-99 Budget Act* and trailer bills. With regard to state employee compensation, we have included costs associated with the bargaining agreements reached with the four bargaining units to date. We also have included additional COLA adjustments for all state employees equal to inflation for 1999-00 and subsequent years.

Our fiscal estimates are *not* predictions of what the Legislature and Governor will adopt as policies and funding levels in coming budgets. Nor are they our recommendations of what tax and spending policies ought to be. Rather, our estimates are a baseline projection of what would happen if current policies were allowed to run their course. We believe that by using this approach, our forecasts provide a meaningful starting point for the Legislature's evaluation of the state's fiscal condition.

Our Forecast. As indicated in Figure 2, we project revenues to total $59.7 billion in 1999-00, or about $1.4 billion less than the $61.1 billion in expenditures that we forecast for the year. As a result of this imbalance, the remainder of the current-year's reserve would be "used up" and the 1999-00 fiscal year would close with a deficit of slightly over $1 billion.

Figure 3

Operating Deficits Lead to Projected Shortfall



How Did We Go From Surpluses to a Projected Deficit?

The key reason behind the deterioration in the state's projected fiscal condition is the emergence of a large and ongoing shortfall between revenues and expenditures, beginning in the current year. Figure 3 shows for 1997-98 through 1999-00 the relationship between the budget's carry-in reserve at the start of each year, its annual "operating balance" for each year (that is, revenues minus expenditures), and the year-end reserve for each year.

1997-98 Developments. Figure 3 shows that in 1997-98, the state began the year with an incoming reserve of $0.5 billion. In addition, revenues for the year exceeded expenditures by $1.6 billion (due to the much stronger-than-expected revenues received in April 1998). In other words, the state ran an "operating surplus" within the year. Added together, these two factors (the positive carry-in balance and the operating surplus) led to a year-end reserve of $2.1 billion, which was available at the beginning of 1998-99.

1998-99 Developments. In 1998-99, however, the state will spend *more* than it receives in revenues, resulting in an annual *operating deficit* of $1.8 billion during the year. This operating deficit will "draw down" the reserve from $2.1 billion at the start of the year to $331 million at the close of the year.

About $800 million of the state's $1.8 billion 1998-99 operating deficit was anticipated in the *1998-99 Budget Act*. This anticipated portion represented a planned drawing down of the reserve to support one-time expenditures for such purposes as resources, prison capacity expansion, and other forms of capital outlay. However, the remaining $1 billion of the $1.8 billion current-year operating deficit is due to *unanticipated* events—specifically, lower-than-anticipated revenues and higher-than-anticipated state costs.

1999-00 Developments. We forecast that the operating deficit will shrink modestly, from $1.8 billion in the current year to $1.4 billion in 1999-00. This occurs because the budget-year revenue growth ($3.2 billion) will be greater than expenditure growth ($2.8 billion).

Unlike in the current-year, however, the budget year cannot offset its operating deficit with a large carry-in reserve, since the 1999-00 carry-in reserve is only $331 million. Thus, the persistence of the still-large operating deficit causes the General Fund's year-end reserve to fall further in the budget year, to a deficit of about $1 billion.

The emergence of large operating deficits in both 1998-99 and 1999-00 is related to three factors.

- ***Revenue Shortfall.*** First, as indicated earlier, the 1998-99 budget was based on the administration's revenue forecast, which is above our current projections by about $0.5 billion for 1998-99 and $1.2 billion for 1999-00. If the administration's revenue forecast were to materialize, revenues would be nearly sufficient to cover the spending commitments made in 1998 for 1998-99 and 1999-00. Thus, the revenue shortfall is particularly significant in explaining the budget problem.

- ***Most Additional Current-Year Costs Are Ongoing.*** Second, a large portion of the $493 million in additional state costs we foresee for the current year are ongoing in nature, and thus will add to expenditure totals in 1999-00 and beyond.

- ***New Budget-Year Commitments.*** Third, while the current-year budget includes over $1.5 billion in one-time expenditures which will "drop off" in 1999-00, these reductions will be mostly offset by new commitments in the budget year. These added costs—which include funding for trial courts, CalWORKs, teachers' retirement, and local subventions for the VLF reduction—will raise spending totals in 1999-00 and beyond.

Long-Term Projections

The actual level of revenues, expenditures, and year-end reserves for future years will depend on a variety of factors, including actions taken by the Legislature and the administration to bring the 1999-00 budget into balance.

In theory, the 1999-00 budget could be brought into balance by reliance on either one-time or permanent adjustments to expenditures and/or revenues However, our long-term projections of revenues and expenditures under current law indicate that the current-law imbalance between annual revenues and expenditures would persist for several years. As a consequence, it will be important that actions taken to keep the 1999-00 budget in balance include various *permanent*—as opposed to solely one-time—budgetary actions.

This is underscored by the fact that our projections are based on continued economic expansion, and thus do not allow for disruptions to revenues that would accompany a pronounced economic slowdown or downturn. Ideally, one would be able to rely on a budgetary reserve to at least partially deal with this or other contingencies. However, because of the budget problem we foresee, no reserve would be available.

Chapter 2

Economics and Demographic Projections

California's economy and demographics are key factors in assessing the state's future fiscal picture. These factors significantly affect both state revenues and expenditures, due to their impacts on state tax receipts, as well as caseloads and other cost-related factors affecting state programs. This chapter presents our economic and demographic projections for 1998 through 2004, which will help to determine California's fiscal condition over the period 1998-99 through 2003-04.

THE ECONOMIC OUTLOOK

We forecast that the U.S. and California economies will slow somewhat in late 1998 and early 1999. This slowing will reflect the combined impacts of Asia's economic crisis and stock market volatility on exports, household wealth, and consumer and business confidence levels. Over the full forecast period, our projections assume moderate economic growth and slowly rising inflation. Figure 1 summarizes our U.S. and California economic outlooks.

Figure 1

The LAO's Economic Forecast 1998 Through 2004

Percent Change (Unless Otherwise Indicated)

	1998	1999	2000	2001	2002	2003	2004
United States							
Real Gross Domestic Product	3.5%	1.9%	2.4%	2.1%	2.4%	2.3%	2.3%
Wage and salary jobs	2.5	1.7	1.9	1.5	1.4	1.4	1.4
Consumer Price Index (CPI)	1.6	2.3	2.9	3.1	3.0	3.0	3.1
Unemployment rate (%)	4.5	4.8	4.7	5.0	5.3	5.6	5.6
Housing starts (000)	1,573	1,509	1,499	1,488	1,506	1,520	1,470
California							
Personal income	6.8%	5.2%	5.6%	5.4%	5.4%	5.5%	5.6%
Wage and salary jobs	2.9	2.2	2.5	2.4	2.3	2.1	2.0
Taxable sales	6.1	5.2	5.4	5.3	5.2	5.2	5.3
Consumer Price Index (CCPI)	2.2	2.3	2.8	3.1	3.0	3.0	3.1
Unemployment rate (%)	5.9	6.1	5.8	5.7	5.7	5.6	5.6
New housing permits (000)	130	144	164	177	180	190	200

Recent Developments

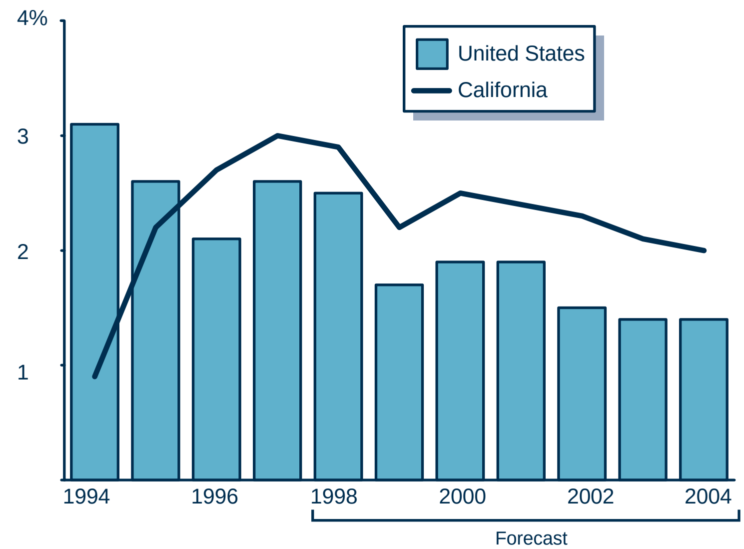
National Economy Still Expanding. The unfolding of Asia's economic and financial problems and turmoil in the U.S. stock market had prompted mid-year concerns that the U.S. economy was headed toward a serious slowdown—or perhaps even a recession—late in 1998. Recent evidence suggests, however, that the national economy remained on an upward track through the summer months. For example, real Gross Domestic Product (GDP) expanded at a stronger-than-expected 3.3 percent annual rate during the July-through-September period, led by healthy gains in consumer spending.

However, Slower Growth Lies Ahead. Despite the economy's continued expansion and growth in aggregate output, there are a number of key indicators pointing toward some economic softening in the months ahead. One of these indicators is a continued deterioration in the U.S. foreign trade balance, caused primarily by falling exports to Asia. Another is a slowdown in business investment, partly reflecting weakening sales and profits in key manufacturing sectors of the economy. In addition, recent surveys have indicated a marked decline in consumer confidence levels. These and related factors suggest that, while the U.S. economy continues to expand, the near-term outlook is for more subdued growth than in the recent past (see Figure 2). The same holds true for California.

Figure 2

Both U.S. and Caliifornia Economies to Slow

Year-Over-Year Percent Growth in Jobs
1994 Through 2004



California Feeling Impacts of Asia. The factors affecting the national economic picture are also having an impact on this state. For example, employment growth in key sectors is slowing in the second half of 1998, primarily reflecting the negative effects of the ongoing weakness in Asia on high-tech and related manufacturing businesses in California. As shown in Figure 3, sales of California-produced goods to South Korea, Japan, and other Asian destinations fell sharply between the first half of 1997 and the first half of 1998, leading to a small decline in overall exports during the period.

The slowdown in exports has had a particularly significant impact on California's computer and electronics manufacturing industries. These industries account for over 50 percent of California's shipments abroad, much of which goes to Asia. After several years of strong growth, these industries are experiencing major slowdowns in sales, corporate earnings, initial public offerings, employee bonuses, stock-option earnings, and jobs. As indicated in Figure 4, employment in the computer and electronic manufacturing industries has subsided in recent quarters, and fell during the summer.

Other Factors Are Keeping State's Economy On Upward Track. The slowdown in the state's high-tech manufacturing sectors has been mitigated by positive developments in certain other areas of California's economy. For example, services employment continues to expand at a healthy pace, reflecting strength in such sectors as software development, management consulting, and engineering. Also, building activity continues to climb in California, with permits for both residential and nonresidential construction increasing to their highest levels in eight years.

Figure 3

California's Exports to Asia Have Faltered

Percent Change in California Exports Between First Half of 1997 and First Half of 1998

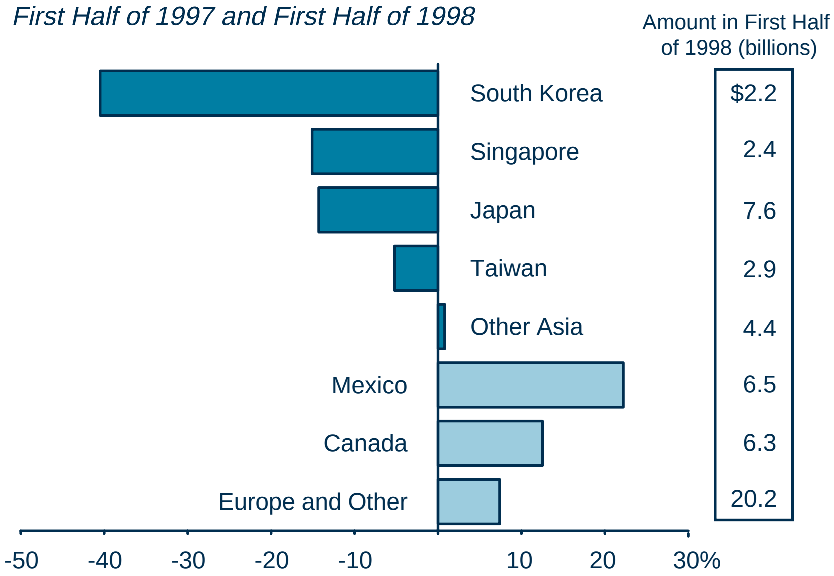
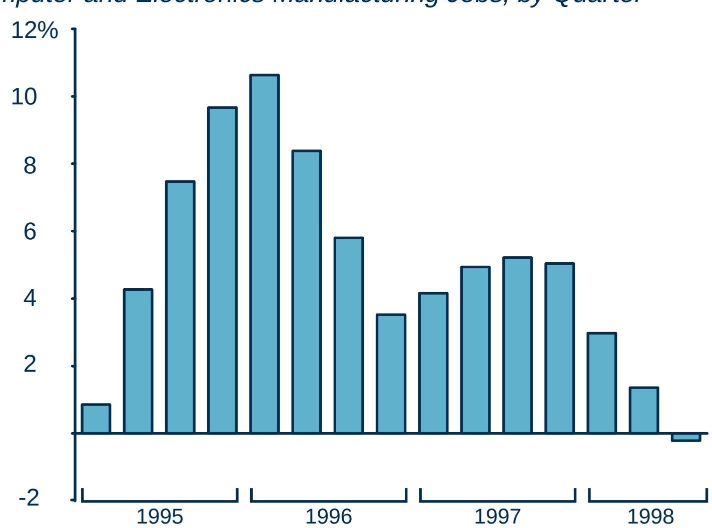


Figure 4

Asia's Problems Are Affecting California's High-Tech Industries

Year-Over-Year Percent Change in Computer and Electronics Manufacturing Jobs, by Quarter



Despite these positive factors, however, the overall pace of economic growth is slowing in the latter half of 1998.

The National Outlook

Near-Term Forecast (1998 Through 2000). We expect that the U.S. economy will slow but remain on a positive growth path through 2000. As indicated previously in Figure 1, real GDP is projected to grow by 1.9 percent next year and 2.4 percent in 2000, compared to 3.5 percent in 1998. Slower growth in spending by consumers and businesses is the main factor responsible for the overall slowdown. We expect inflation to rise modestly, as lower import and commodity prices only partly offset increases in labor costs. The U.S. CPI is projected to increase by 2.3 percent in 1999 and 2.9 percent in 2000, compared to 1.6 percent in the current year.

Longer-Term Forecast (2001 Through 2004). We project that the U.S. economy will experience moderate growth and slowly rising inflation over the longer-term forecast period. This projection reflects the fact that the U.S. economy is currently operating at near full capacity, characterized by low levels of unemployment and high factory operating levels. Given this, the longer-term outlook is tied to increases in the U.S. labor force (estimated to grow by slightly less than 1 percent per year) and the growth in productivity of the workforce (estimated to be about 1.4 percent per year). Our forecast implies moderate real output gains averaging about 2.4 percent per year. It also assumes that inflation will slowly accelerate, with the CPI increasing at annual rates of slightly over 3 percent by the end of the forecast period.

California's Outlook

Near-Term Forecast (1998 Through 2000). We project that employment and income growth will slow in California during late 1998 and early 1999—reflecting the impacts of a slowing national economy and Asia's economic problems on our high-tech industries. Specifically, we forecast that California personal income growth will slow from 6.8 percent in 1998 to 5.2 percent in 1999, and then recover a bit to 5.6 percent in 2000. After declining for several years, the state's unemployment rate is expected to stabilize in the range of 6 percent in late 1998 and 1999, before resuming a modest downward trend in 2000.

Longer-Term Forecast (2001 Through 2004) As with the nation, the long-term outlook for California is for moderate growth and slowly rising inflation. As indicated in Figure 1 and Figure 2 earlier, we expect that employment growth in the state will outpace the nation over the next several years. This will reflect such factors as above-average population increases, and a positive long-term outlook for California's mix of high-tech manufacturing and services industries.

Our economic forecast also assumes that residential construction activity, which has lagged in the 1990s, will continue to climb over the forecast period. This will occur as builders step up production to meet housing demands created by increases in population, jobs, and incomes. As shown in Figure 5, we project that permits in California for new residential construction will rise from 130,000 units in 1998 to 200,000 units by 2004.

THE DEMOGRAPHIC OUTLOOK

We project that California's population will increase from 33.5 million in 1998 to 37.1 million by 2004, an average annual increase of 1.7 percent. Our year-to-year demographic projections are shown in Figure 6, which depicts both total annual population and yearly percent changes. The projected pace of population growth is faster than that which occurred in the first half of the 1990s, but is slower than the 2.5 plus percent pace of the late 1980s.

Figure 5

Housing Sector Is Positive Factor In California's Outlook

California Residential Building Permits 1989 Through 2004

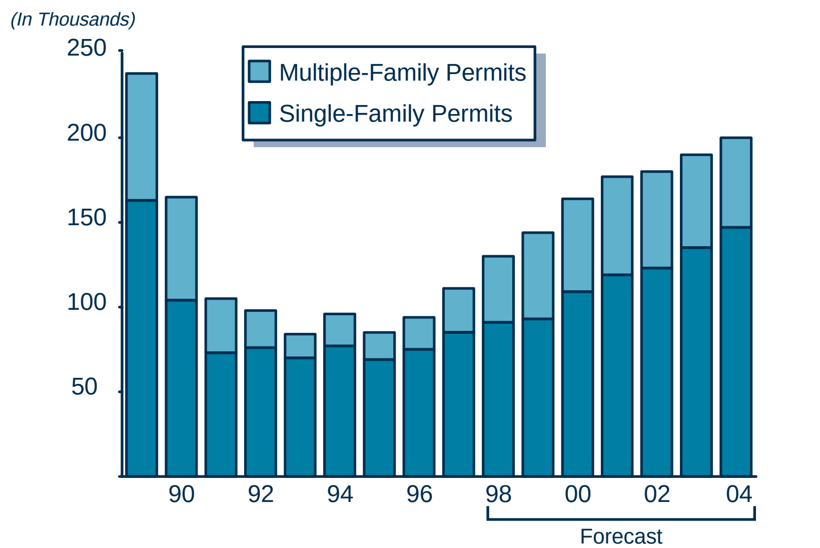


Figure 6

California's Population to Hit 35 Million at Millennium

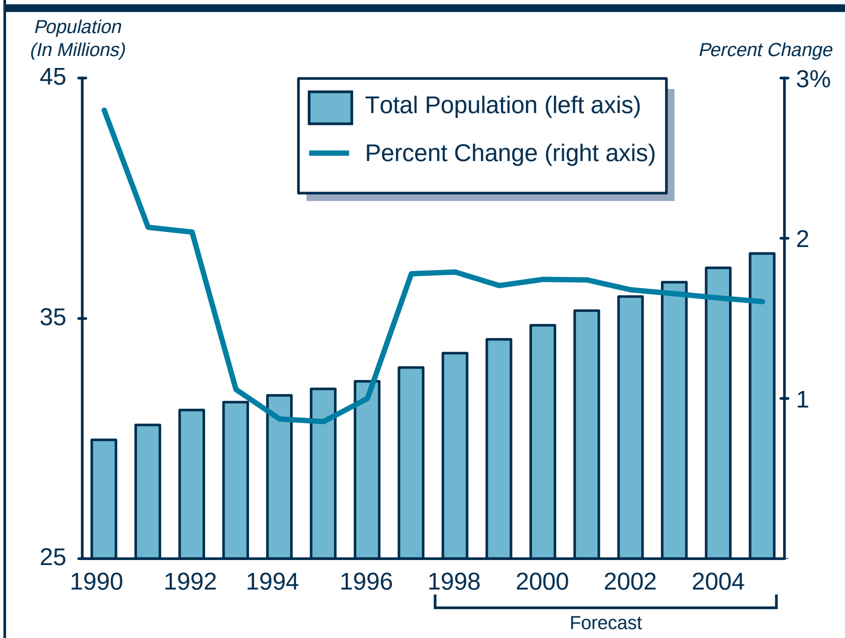
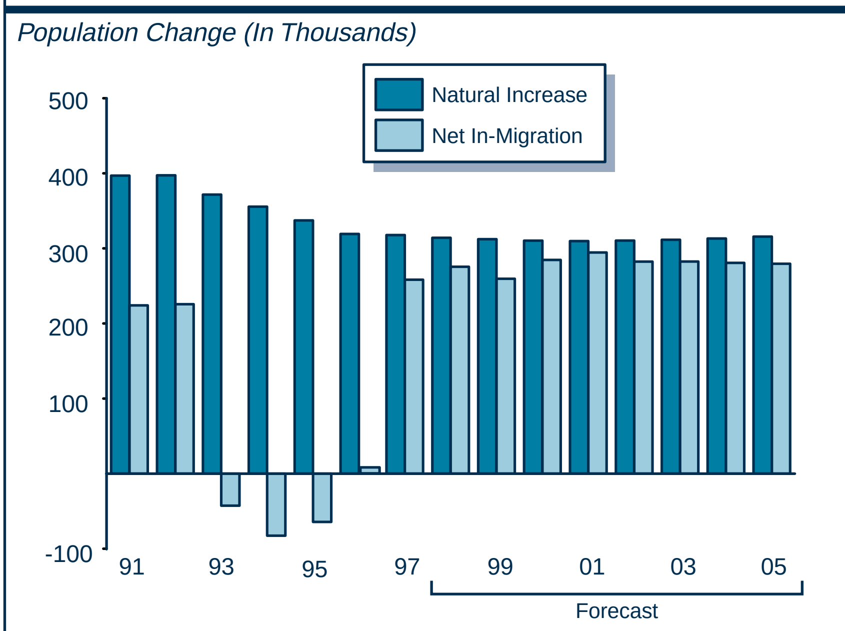


Figure 7

In-Migration to Account for Nearly Half of Population Growth



Population Growth Components. California's population growth can most effectively be discussed in terms of its two main components—*natural increase* (births minus deaths) and *net in-migration* (persons moving into California from other states and countries, minus people leaving the state for destinations outside of California). Figure 7 depicts the contributions of these two key demographic components to California's overall population growth from the start of the 1990s through the forecast period.

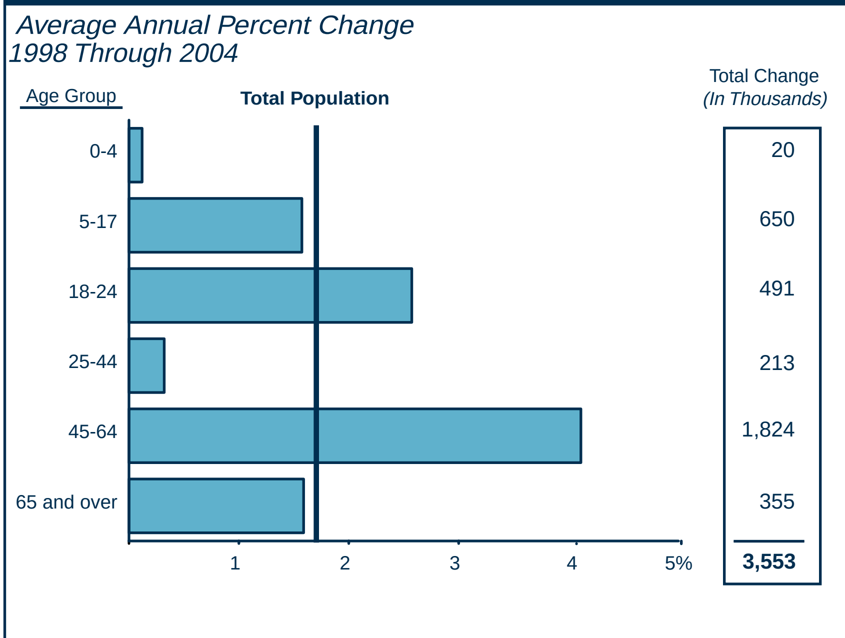
We project that the *natural increase* component will account for a bit over half of the state's population growth during the forecast period, averaging slightly over 310,000 per year. While this amount is similar to recent levels, it is significantly less than the nearly 400,000 occurring annually in the early 1990s. This reflects in large part the aging of the baby boomers beyond their years of highest fertility rates, as well as recent declines in birth rates within younger age groups.

Regarding the *net in-migration* component, we project that it will average about 280,000 per year during the forecast period, or slightly less than half of total population growth. Figure 7 shows that this is similar to the current in-migration level, but is significantly higher than for the first half of the 1990s, when net in-migration actually turned negative for three years.

The recent sharp swing in net in-migration from negative to positive primarily reflects *domestic* population flows—that is, the flows of workers and their families between California and other states. In the early part of the decade, California's deep recession resulted in a large *outflow* of people from California seeking better job prospects in other states, along with a diminished number of workers from other states coming to California to seek work here. The combined effect was to cause net domestic *out*-migration from California to occur. In more recent years, however, due to the resurgence of California's economy, net domestic in-migration has returned to more "normal" patterns, with fewer people leaving for jobs elsewhere and more workers from other states seeking opportunities here. As a result, net inflows of workers and families from the rest of the country are again occurring.

Figure 8

Population Growth to Vary Significantly by Age Group



Our forecast assumes a slight dip in the level of net in-migration in 1999, due to our projected slowing in California's economy. However, we expect that the state will continue to experience positive net in-migration from other states throughout the forecast period.

Growth to Vary by Age Group. Figure 8 shows our population growth projections over the forecast period by broad age categories, in both numerical and percentage terms. In *numerical* terms, the 45-to-64 age group (baby-boomers) easily dominates, followed by the 5-to-17 age group (their children). In *percentage* terms, the 45-64 age group again leads the way, followed by 18-to-24 year-olds.

These various age-group demographic projections have significant implications for the state expenditure outlook in many different program areas, including education, health, and social services. For example, population growth in the 5-to-17 and 18-to-24 age groups are the single most important determinants of K-12 and higher education enrollments.

Chapter 3

Revenue Projections

Our revenue forecast assumes slower growth in General Fund receipts in 1998-99 and 1999-00 than has been experienced in the past several years, when strong economic growth resulted in well-above-average revenue performance.

Our General Fund revenue outlook reflects three key factors: (1) the impact of recently enacted state tax reductions; (2) our projected slowing in California's economic growth; and (3) the recent turbulence in the stock market. Although the latter will have certain positive effects on revenues, it also is likely to have significant negative impacts on income tax receipts related to stock options, bonuses, and investment earnings over the next 12 to 18 months.

During the current and budget years, we expect General Fund revenue growth to be slightly slower than statewide personal income growth. Thereafter, however, we expect General Fund revenues to increase at about the same pace as personal income.

THE REVENUE FORECAST

Our revenue projections are summarized in Figure 1. It indicates the following:

- ***Current-Year Revenues.*** We estimate that General Fund revenues and transfers will total nearly $56.5 billion in 1998-99, a $1.5 billion (or 2.7 percent) increase from 1997-98. Our estimate reflects the impact of the tax reduction package enacted this

Figure 1

The LAO's General Fund Revenue Forecast

(Dollars in Millions)

		Forecast					
	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Personal Income Tax	$27,710	$28,410	$30,220	$32,220	$34,180	$36,310	$38,640
Sales and Use Tax	17,690	18,710	19,690	20,780	21,860	23,030	24,250
Bank and Corporation Tax	5,900	6,100	6,240	6,580	6,920	7,270	7,630
Other Revenues and Transfers	3,693	3,278	3,556	3,646	3,759	3,879	3,983
Total, Revenues and Transfers	**$54,993**	**$56,498**	**$59,706**	**$63,226**	**$66,719**	**$70,489**	**$74,503**
Percent Change	11.8%	2.7%	5.7%	5.9%	5.5%	5.6%	5.7%

year, which will reduce revenues by about $850 million in 1998-99. Our forecast for current-year revenues is similar to our May 1998 forecast (as adjusted for the budget's tax package), and is $485 million below the *1998-99 Budget Act* revenue forecast.

- ***Budget-Year Revenues***. We estimate that revenues will be $59.7 billion in 1999-00, a $3.2 billion (or 5.7 percent) increase from the current year. This forecast assumes that moderate increases will be realized in personal income tax (PIT) and sales tax receipts, along with sluggish gains in bank and corporation tax (BCT) revenues.

- ***The Four-Year Period Beyond the Budget Year.*** We estimate that revenues will increase to $63.2 billion in 2000-01, and continue to grow to $74.5 billion by 2003-04. As indicated in Chapter 1, these amounts are significantly below the thresholds that would trigger additional reductions in the vehicle license fee (VLF) in future years.

Over the period 1998-99 through 2003-04, we are projecting that revenues will increase at an average annual rate of 5.2 percent. Excluding the effects of the recently enacted tax reductions, the gain would be a slightly higher 5.5 percent. Our projected revenue growth over the entire period is similar to that for statewide personal income. What this means is that revenues are essentially growing "in sync" with economic growth generally.

Revenue Effects of the 1997 and 1998 Tax Packages

General Fund revenue growth in both the current and budget years, as well as beyond, will be significantly affected by tax reductions passed in 1997 and 1998. Figure 2 shows the fiscal effects of the 1997 tax relief package and the non-VLF tax provisions of the 1998 tax relief package. (The VLF provisions are discussed in Chapters 1 and 4). The figure indicates that the combined revenue reductions from these two packages amounts to $1.4 billion in 1998-99, rising to $1.7 billion by 2003-04. It also shows that the largest effect in the packages involves increases in the PIT dependent credit.

Figure 2

Estimated Revenue Reductions From 1997 and 1998 Tax Relief Packages

(Dollars in Millions)

	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
1997 Tax Relief Package						
Increased Dependent Credit	$295	$780	$800	$775	$805	$820
Other Changes	298	306	263	320	387	424
Total Impact of 1997 Changes	**$593**	**$1,086**	**$1,063**	**$1,095**	**$1,192**	**$1,244**
1998 Tax Relief Package (Non-VLF Provisions)						
Further Increase In Dependent Credit	$612	$22	$23	$24	$25	$26
Renters' Credit	133	141	144	147	150	153
Targeted Tax Reductions	106	157	172	236	246	256
Total Impact of 1998 Changes	**$851**	**$320**	**$339**	**$407**	**$421**	**$435**
Total Revenue Reductions	**$1,444**	**$1,406**	**$1,402**	**$1,502**	**$1,613**	**$1,679**

Dependent Credit Increases. The 1997 law change raised the dependent credit from $68 in 1997 to $120 in 1998, and further to $222 in 1999. As shown in Figure 2, the fiscal effect of these 1997 changes in the dependent credit was a $295 million revenue reduction in 1998-99, increasing to $780 million in 1999-00, with the revenue losses slowly expanding in subsequent years.

The 1998 tax relief package included a further increase in the dependent credit—from $120 to $253 in 1998 and from $222 to $227 in 1999. As seen in Figure 2, the substantial credit increase adopted in 1998 will reduce 1998-99 revenues by $612 million compared to what revenues would have been had the 1998 change not occurred. Thereafter, the 1998 law change will reduce revenues by somewhat over $20 million annually compared to the 1997 law base.

Other Provisions. The 1997 and 1998 tax packages also included a variety of other tax reductions. These included the restoration of an income-limited renters' tax credit, various federal income tax conformity provisions, reduced horse racing fees, and targeted tax relief for businesses. More complete discussions regarding the details of these tax packages are included in our post-budget *State Spending Plan* reports for the last two years.

MAJOR REVENUE SOURCES

As shown in Figure 1, the majority of General Fund revenues are from the PIT, sales and use tax, and BCT. Together, these three sources will account for about 94 percent of total revenues in 1998-99. In this section, we discuss the key factors affecting the revenue outlook for these taxes.

Personal Income Tax

The PIT is the state's single largest revenue source, accounting for slightly over one-half of total General Fund receipts in 1998-99. Taxpayers are subject to marginal tax rates ranging from 1 percent to 9.3 percent, depending on their levels of taxable income.

Liabilities Surged in 1996 and 1997. The PIT liabilities increased by around 15 percent in both the 1996 and 1997 income years—more than *double* the rate of statewide personal income growth for that period. A significant portion of these above-average increases can be directly or indirectly attributed to the dramatic gains in the stock market during those two years. These stock market gains boosted capital gains on investments, as well as earnings from stock options, bonuses, and initial public offerings. Federal tax law changes passed last year, which lowered the maximum federal income tax rate on capital gains realizations, also are likely to have boosted capital gains realizations in 1997. As indicated in Figure 3 (see page 16), net capital gains realizations reported on state income tax returns rose by over 55 percent in 1996, and we estimate they increased by an additional 50 percent last year.

Capital Gains to Taper Somewhat. We believe that capital gains will fall modestly in 1998 and 1999 from their 1997 peak, reflecting both a more mixed performance in the stock market and a diminished amount of gains related to realizations prompted by the recent federal tax-rate reductions (see Figure 3). The weaker stock market performance will also likely affect income from bonuses and stock options during 1998 and 1999.

Near-Term Revenue Forecast. The above factors will result in more moderate growth in PIT liabilities in the near term as compared to the past two years. After adjusting for the effects of tax law changes, we project that underlying PIT liabilities will increase by about 8 percent in 1998 and 6 percent in 1999, compared to over 15 percent in 1997.

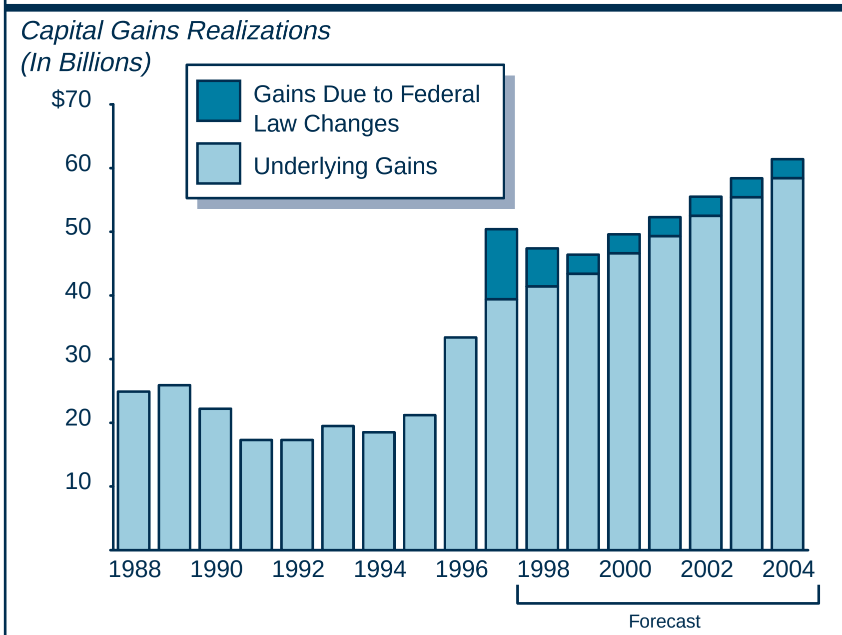
As a consequence of both slowing underlying liability growth and the tax law changes, we forecast that PIT collections will total $28.4 billion in 1998-99 (a 2.5 percent increase from 1997-98), and $30.2 billion in 1999-00 (a 6.4 percent gain).

Longer-Term Revenue Forecast. Over the longer term, we forecast that PIT liabilities will rebound in 2000, and grow somewhat faster than statewide personal income during the remainder of the forecast period. This will occur due to modest growth in average real income levels.

Thus, we project that PIT collections will increase to $32.2 billion in 2000-01, and rise further to $38.6 billion by the end of the forecast period (2003-04). Over the entire forecast period, we project that PIT receipts will increase at an average annual rate of 5.7 percent. Excluding the impact of recent tax-reduction legislation, the average annual increase is slightly over 6 percent.

Figure 3

Capital Gains to Dip Then Resume Growth



Sales and Use Tax

The sales and use tax is the second largest General Fund revenue source behind PIT, accounting for about one-third of total estimated revenues in 1998-99. The state sales and use tax rate is a combined 6 percent, which includes a 5 percent General Fund rate and a 1 percent rate allocated to special funds. Additional local rates ranging from 1.25 percent to 2.5 percent are imposed by cities, counties, and transportation districts, bringing the current combined state-local tax rate to between 7.25 percent and 8.5 percent.

Moderate Growth in Taxable Sales. The main factor determining the level of sales and use tax receipts is the strength in taxable sales—that is, sales of tangible goods such as clothing, furniture, automobiles, computers, and building materials. We project that taxable sales will increase slightly less than personal income over the next several years, expanding at an average annual rate of 5.4 percent from 1998 through 2004, compared to average annual personal income growth of 5.6 percent for the same period. The outlook reflects a continuation of a long-term trend in which consumption has shifted away from commodities (which are taxable) and toward services (which generally are not). Partly offsetting this trend are the effects of our forecast for continued growth in home construction, which will boost sales of building materials, home furnishings, and related items.

Near-Term Revenue Forecast. Based on our projections for taxable sales, Figure 1 shows that we estimate that General Fund sales tax receipts will rise to $18.7 billion in 1998-99 (a 5.8 percent increase from the prior year), and to $19.7 billion in 1999-00 (a 5.2 percent increase from the current year).

Longer-Term Revenue Forecast. We project that sales tax receipts will continue to expand, to $20.8 billion in 2000-01, and further to $24.3 billion by 2003-04. Over the entire forecast period, sales tax receipts are projected to increase at an average annual rate of 5.4 percent.

Bank and Corporation Tax

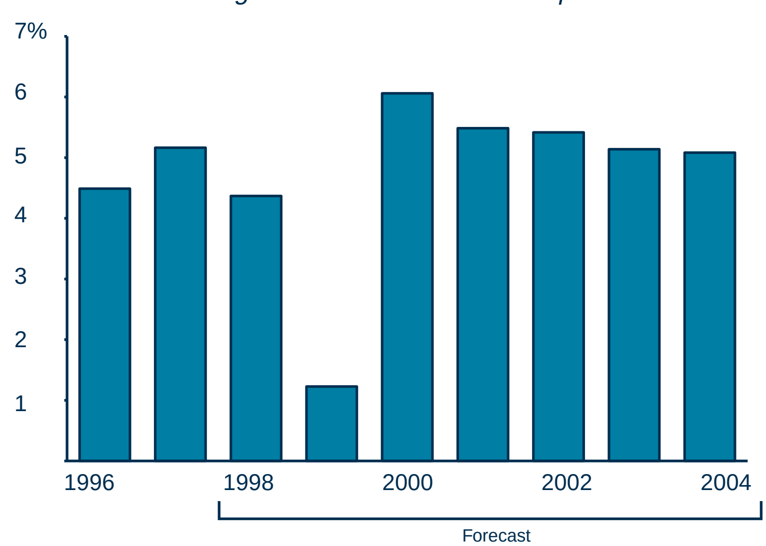
The BCT receipts are the General Fund's third largest revenue source, accounting for about 11 percent of total receipts in the current year. The general BCT tax rate is 8.84 percent, which is applied to corporate earnings. Banks and other financial institutions are subject to an add-on tax rate of 2 percent, which is in lieu of certain local taxes.

The key determinant of BCT receipts is California taxable profits. These profits grew strongly during the early stages of the current economic expansion in 1994 and 1995. However, profit growth expanded at a more modest pace, partly due to the effects of corporate restructurings in the state's banking and telecommunications industries. As indicated in Figure 4, we expect that California taxable profits will slow further in 1998, and particularly in 1999, as softening activity in the state's high-tech sectors takes its toll on the earnings of businesses in these industries. We project that profits will rebound in 2000, growing at a moderate pace thereafter.

Figure 4

Moderate Profit Growth Following Some Softness

Annual Percent Change in California Taxable Corporate Profits



Near-Term Revenue Forecast. We forecast that BCT receipts will increase from $5.9 billion in 1997-98, to $6.1 billion in 1998-99 and $6.2 billion in 1999-00 (increases of 3.4 percent and 2.3 percent, respectively). The fact that these gains are only modest is largely due to the subdued growth in projected earnings during this period.

Longer-Term Revenue Forecast. We project that BCT receipts will increase to $6.6 billion in 2000-01 and continue to grow thereafter, reaching $7.6 billion by 2003-04. Revenue growth over this longer-term horizon is affected by the targeted business-related tax reductions enacted in 1997 and 1998. These BCT reductions total $227 million in 2003-04.

Other Revenues and Transfers

We estimate that revenues and transfers from all other General Fund sources (including insurance premium taxes, estate taxes, tobacco and alcohol-related taxes, interest earnings, and a variety of fees) will decline from $3.7 billion in 1997-98 to $3.3 billion in the current year, before climbing to $3.6 billion in 1999-00. The drop in these revenues between the prior and current years reflects a reallocation of trial court revenues from the General Fund to a special trust fund, and a transfer of $120 million from the General Fund to various special funds in response to a recent court decision.

Over the longer term, we project that this "other revenue" category will grow from $3.6 billion in 2000-01 to $4 billion by 2003-04. Of the nonmajor taxes that are included in this revenue category, the fastest growing sources will be insurance and estate taxes.

Chapter 4

Expenditure Projections

In this chapter, we discuss our General Fund expenditure projections for 1998-99 through 2003-04, both in the aggregate and by individual program areas.

METHODOLOGY AND ASSUMPTIONS

Our projections are based on the following methodology and underlying assumptions:

- ***Current Law.*** As noted in Chapter 1, our projections assume the requirements of current law. They are based on the *1998-99 Budget Act* policies, adjusted for statutory and constitutional changes in future years. For example, our estimates for K-14 education assume the appropriation levels included in the *1998-99 Budget Act*, and are adjusted in future years in accordance with the Proposition 98 minimum funding guarantee. Our estimates also include the effects of legislation enacted in 1998 which will result in increased spending in future years. These include: (1) the full-year effects of cost-of-living adjustments (COLAs) provided for CalWORKs and SSI/SSP grants; (2) the full-year effect of the vehicle license fee (VLF) tax reduction; (3) added costs associated with enhanced teacher retirement benefits beginning in 1999; and (4) additional state costs associated with trial court financial restructuring.

- ***LAO Caseload/Enrollment Projections.*** The projections take into account caseload and enrollment forecasts for such programs as education, prisons, Medi-Cal, SSI/SSP, and CalWORKs.

- ***Other Adjustments.*** With regard to state employee compensation, our estimates include the effects of the compensation agreements already reached with four collective bargaining units. We have also assumed annual increases consistent with inflation (about 3 percent per year) for all state employees beginning in 1999-00. For other costs not specifically forecast, we have applied a modest adjustment to cover such factors as population increases.

PROJECTIONS OF TOTAL GENERAL FUND SPENDING

Figure 1 presents our General Fund spending projections by major program area. Total General Fund spending grows from $53.4 billion in 1997-98 to $58.3 billion in 1998-99 and $61.1 billion in 1999-00. Between 1997-98 and 2003-04, state expenditures under current law would increase by an average of about 5.5 percent per year. Our estimates do not include any offsets which may occur during the forecast period as a result of pending litigation brought by the Attorney General related to tobacco. The timing and amount of any payments are not known at this time.

Spending by Program Area

Figure 2 shows the current distribution of General Fund spending by major program area. It indicates that nearly 85 percent of total 1998-99 General Fund spending is devoted to education, health, social services, corrections, and debt service—with the education, health, and social services categories alone accounting for nearly three-fourths of the total. Given this, spending trends in these major program areas have significant implications for overall General Fund spending levels.

Figure 1

Projected General Fund Spending for Major Programs[a]

(Dollars in Millions)

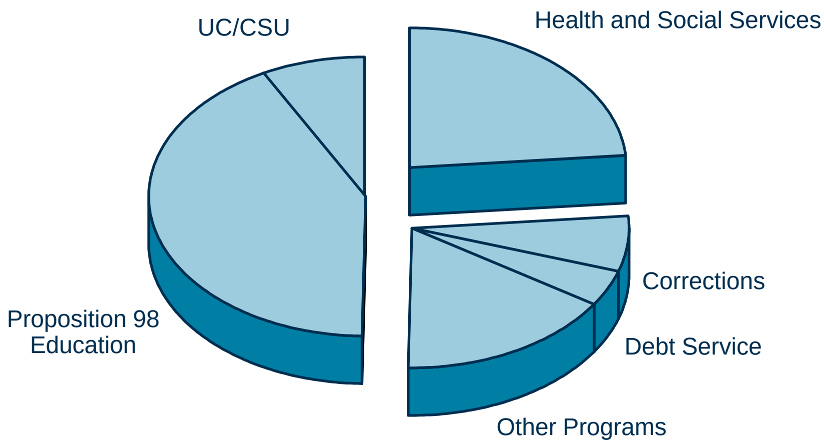
		Forecast						
	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	Average Annual Growth
Education programs								
Proposition 98/K-14 Education	$22,589	$24,517	$25,772	$26,982	$28,312	$29,636	$31,008	5.4%
Higher education—UC/CSU	3,941	4,532	4,628	4,850	5,092	5,346	5,614	6.1
Health and Welfare programs								
Medi-Cal benefits	6,427	6,736	6,837	7,219	7,635	8,125	8,668	5.1
CalWORKs	2,051	1,799	2,206	2,105	1,931	1,944	1,954	-0.8
SSI/SSP	2,017	2,217	2,413	2,505	2,583	2,670	2,814	5.7
Selected other programs	2,401	3,009	3,356	3,550	3,808	3,964	4,211	9.8
Department of Corrections	3,481	3,779	4,056	4,301	4,595	4,936	5,288	7.2
Debt service[b]	2,222	2,390	2,631	2,856	3,039	3,179	3,295	6.8
Other programs/costs	8,241	9,273	9,176	9,593	9,969	10,388	10,865	4.7
Totals	**$53,370**	**$58,252**	**$61,075**	**$63,961**	**$66,964**	**$70,188**	**$73,717**	**5.5%**

[a] Detail may not total due to rounding.
[b] Includes both general obligation and lease payment bonds.

Figure 2

Education, Health, and Social Services Account for Most Spending

General Fund by Program Area
1998-99



Projections by Program Area

The overall 5.5 percent average annual expenditure growth reflects divergent spending trends in the state's major programs. As indicated in Figure 1:

- ***Proposition 98*** spending is projected to increase at an average annual rate of 5.4 percent over the forecast period. This reflects a jump of 8.7 percent in the current year, and more moderate gains of 5 percent or below in future years. The moderate increases projected for future years are partly due to slowing projected growth in average daily attendance—from the over 2 percent annual increases in recent years, down to about 1 percent annual growth rates during the forecast period.
- ***Higher education (CSU/UC)*** spending increases by an average of 6.1 percent per year during the forecast period. This reflects a large spending increase in the current year, and future gains of about 5 percent—in line with inflation and enrollment projections.
- ***CalWORKs*** spending is projected to jump by 23 percent in 1999-00, due to a reduction in available federal funds and the full-year effects of COLAs provided in this year's budget. In subsequent years, CalWORKs spending is projected to decline, mostly reflecting continued caseload reductions in the program.
- ***SSI/SSP*** spending jumps in 1999-00, due to the full-year effects of grant restorations and COLAs provided in the 1998-99 budget. In future years, SSI/SSP increases at more moderate rates, due to projected slower growth in caseloads.
- ***Selected other health and social services programs*** (which include foster care, In-Home Supportive Services, developmental services, and the Healthy Families program) are projected to increase by an average of 9.8 percent per year during the forecast period. This increase is due to: (1) rapid caseload growth in several of these programs, (2) increased costs associated with new initiatives in the foster care and developmental services programs, and (3) rising spending due to the ramp up of the Healthy Families program.
- ***Department of Corrections*** spending is projected to grow at an average annual rate of over 7 percent, reflecting new ini-

tiatives enacted in 1998-99, along with continued growth in the inmate population and associated operating costs including employee compensation.

- ***Debt service*** is projected to increase an average of 6.8 percent per year during the forecast period, partly reflecting the recent increase in bond authorizations.

- ***Other programs/costs*** are projected to increase about 4.7 percent per year. Included in this category are contributions to the state employees' and teachers' retirement systems, subventions to local governments to offset the VLF reduction, and state operations.

HEALTH AND WELFARE

California Work Opportunity and Responsibility to Kids

In response to federal welfare reform legislation, the Legislature created the California Work Opportunity and Responsibility to Kids (CalWORKs) program in 1997. This program, which replaced the Aid to Families with Dependent Children (AFDC) program, provides cash grants and welfare-to-work services to families with children whose incomes are not adequate to meet their basic needs.

The Spending Forecast. General Fund spending in 1998-99 for the CalWORKs program is estimated to be $1.8 billion, a reduction of 12 percent from the prior year. We project that General Fund spending will increase by 23 percent in 1999-00 to a total of $2.2 billion. In comparison, General Fund expenditures for CalWORKs (AFDC) declined by 28 percent in 1997-98 and decreased by 12 percent in 1996-97.

Looking at the five-year horizon, we project that General Fund spending will decrease to $2.1 billion in 2000-01 and will then decrease to $1.9 billion in 2001-02 and remain at about that level in the following two years.

Key Forecast Factors. In recent years, a combination of caseload reductions, grant reductions, and the shift from a matching requirement to a block grant in federal Temporary Assistance for Needy Families (TANF) funds has led to substantially reduced General Fund spending for CalWORKs, despite increasing costs for welfare-to-work services and support services such as child care.

The primary reason that state spending is projected to increase in 1999-00 (despite a projected caseload decline of 8 percent) is a substantial *reduction* in available federal TANF funds, due to the effect of carry-over balances. During 1998-99, California is funding the CalWORKs program with $617 million in unexpended TANF funds carried over from the prior year, in addition to the annual $3.7 billion TANF block grant. For 1999-00, the balance of unexpended TANF funds is projected to be only $160 million, a reduction of $457 million, which must be backfilled from the General Fund. In addition to making up for the reduction in available federal funds, we project increased costs for: (1) welfare-to-work and support services ($281 million) due primarily to the full-year implementation of CalWORKs, (2) the full-year impact of grant increases that became effective in November 1998 ($106 million), and (3) a 2.2 percent statutory cost-of-living adjustment (COLA) in 1999-00 ($80 million). These costs will be partially offset by savings from: (1) caseload reductions (-$448 million), (2) the termination in the budget year of one-time costs in 1998-99 for a court case settlement (-$42 million), and (3) other policy changes (-$89 million).

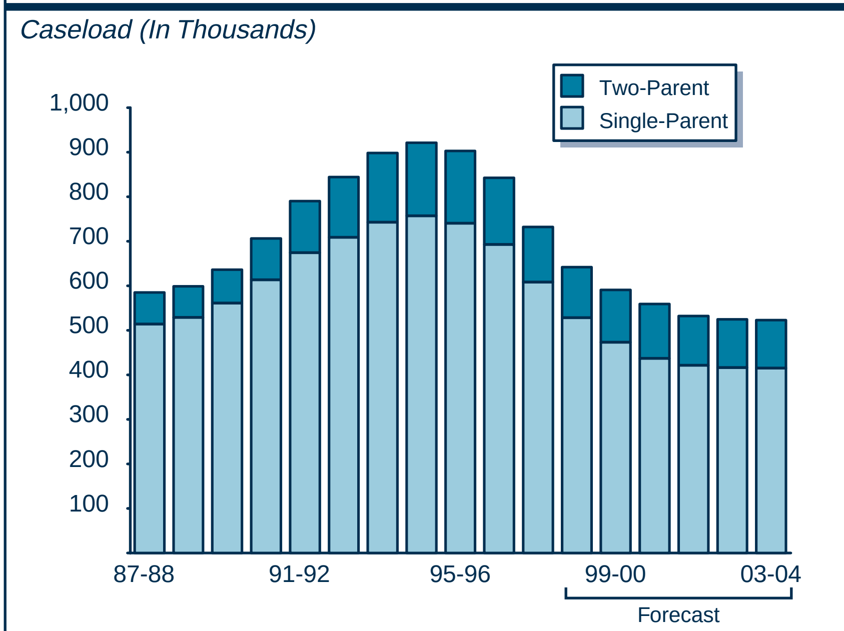
After 1999-00, we project that continued caseload reductions and the suspension of COLAs will result in lower General Fund spending. Budget trailer bill legislation for 1998-99 provides that CalWORKs COLAs will be suspended if revenues are insufficient to "trigger" an additional vehicle license fee (VLF) reduction, beginning in 2000-01. As discussed previously in this report, we believe that revenues will be insufficient to trigger such VLF reductions; thus, we project that COLAs for the CalWORKs program will be suspended each year after 1999-00. By 2001-02, we project that General Fund spending will be at the federal maintenance-of-effort (MOE) floor of approximately $1.9 billion and will remain at about that level through 2003-04.

Caseload Trends and Projections. Following a period of rapid increase in the early 1990s, the caseload peaked at 921,000 in 1994-95 and has since declined by 2 percent in 1995-96, 6.7 percent in 1996-97, and 12 percent in 1998-99. Our analysis indicates that about two-thirds of the recent decline in welfare caseloads can be explained by demographic trends, reductions in grant levels, and the current economic expansion. Other factors that may explain the balance of the caseload decline include (1) an "announcement effect" of federal and state welfare reform that affects behavior prior to policy implementation, and (2) a labor market effect whereby welfare recipients benefit more as the economy approaches full employment (where the supply of labor is more scarce) compared to the early stages of economic recovery.

Figure 3 shows our caseload projections for 1998-99 through 2003-04. The figure shows that the caseload will decline by 12 percent in 1998-99, 8 percent in 1999-00, about 5 percent in both 2000-01 and 2001-02, and about 1 percent in 2002-03 and 2003-04. The projections are based on (1) a trend analysis of caseloads, birth rates, grant levels, and unemployment rates; (2) an assumption that other factors contributing to the recent caseload decline (as described above) will continue; and (3) an estimate of the caseload impact of state welfare reform interventions—primarily additional welfare-to-work services and the implementation of a community service work requirement after two years on aid.

Figure 3

CalWORKs Caseloads Declining



AFDC-Foster Care

The AFDC-Foster Care program provides cash grants for children living with a foster care provider under a court order or a voluntary agreement between the child's parent and a county welfare or probation department.

The Spending Forecast. We estimate that General Fund expenditures in the Foster Care program will increase from $433 million in 1998-99 to $464 million in 1999-00, an increase of 7 percent.

We estimate that General Fund expenditures will continue to grow at an annual rate of about 7 percent through 2003-04, with the level of expenditures increasing from $498 million in 2000-01 to $535 million in 2001-02, $572 million in 2002-03, and $619 million in 2003-04.

Key Forecast Factors. The projected increases are due to caseload growth (about 5 percent annually) and statutory COLAs for group homes and foster family homes (about 2 percent annually). The caseload growth projection is based on the recent historical trend.

Child Support Enforcement

Federal law requires states to provide child support enforcement services to families receiving TANF (CalWORKs in California), and other families who request these services. Child support payments that are collected on behalf of CalWORKs families are used to offset the public costs of CalWORKs grants, except the first $50 of monthly payments which are distributed directly to the family.

Federal Automation Penalties. Federal law requires that states operate statewide automated child support data processing and information retrieval systems by October 1, 1997. Because California failed to implement a statewide computer system for child support by the federal deadline, it is subject to federal penalties in the form of reduced federal reimbursements for program administrative expenditures.

We estimate that California will be subject to federal automation penalties of $9 million in 1998-99, $22 million in 1999-00, $55 million in 2000-01, $85 million in 2001-02, and $11 million in 2002-03. This estimate assumes that (1) the new California Child Support Automation project will be completed according to the schedule of the Health and Welfare Agency Data Center and will meet federal automation requirements, and (2) the state will provide funding to compensate for federal automation penalties, with the exception that the counties will be responsible for 10 percent of penalties incurred after September 30, 2001. The latter assumption is consistent with the provisions of the budget trailer bill for social services, Chapter 329, Statutes of 1998 (AB 2779, Aroner).

Reduced Federal Incentive Payments. The federal government makes incentive payments to states which help offset the administrative costs of the Child Support Enforcement program. A new federal incentive payment formula will be phased-in over two years beginning in federal fiscal year 2000. The new formula will reduce California's incentive payments. In our projections, we assume that the reduction will be completely offset by additional General Fund expenditures. We estimate that the new federal incentive payment formula will result in General Fund costs of $14 million in 1999-00, $37 million in 2000-01, $64 million in 2001-02, $78 million in 2002-03, and $90 million in 2003-04.

Supplemental Security Income/ State Supplementary Program

The Supplemental Security Income/State Supplementary Program (SSI/SSP) provides cash assistance to eligible aged, blind, and disabled persons. The SSI component is federally funded and the SSP component is state funded.

The Spending Forecast. General Fund spending for SSP is projected to be $2.2 billion in 1998-99, an increase of 10 percent over the prior year. We project that General Fund spending in 1999-00 will increase 8.9 percent to a total of $2.4 billion. In comparison, spending increased by a modest 1.7 percent in 1997-98 and *decreased* by 1.7 percent in 1996-97. Looking at the five-year horizon, we project that spending for SSP will increase by between 3.1 percent and 5.4 percent each year, eventually reaching a total of $2.8 billion in 2003-04.

Key Forecast Factors. The spending increase in 1998-99 is due primarily to caseload growth and grant increases (the statutory COLA plus an additional 1 percent). We estimate that spending will exceed the budget act appropriation by $35 million. This increase is due to (1) a lower-than-expected increase in the Consumer Price Index (CPI) which, for technical reasons, increases the state cost of providing the grant COLA in January 1999, and (2) higher-than-anticipated caseload growth. These costs are partially offset by savings from federal legislation that continued eligibility for certain noncitizens who would otherwise have been transferred to the "state-only" program for SSI/SSP.

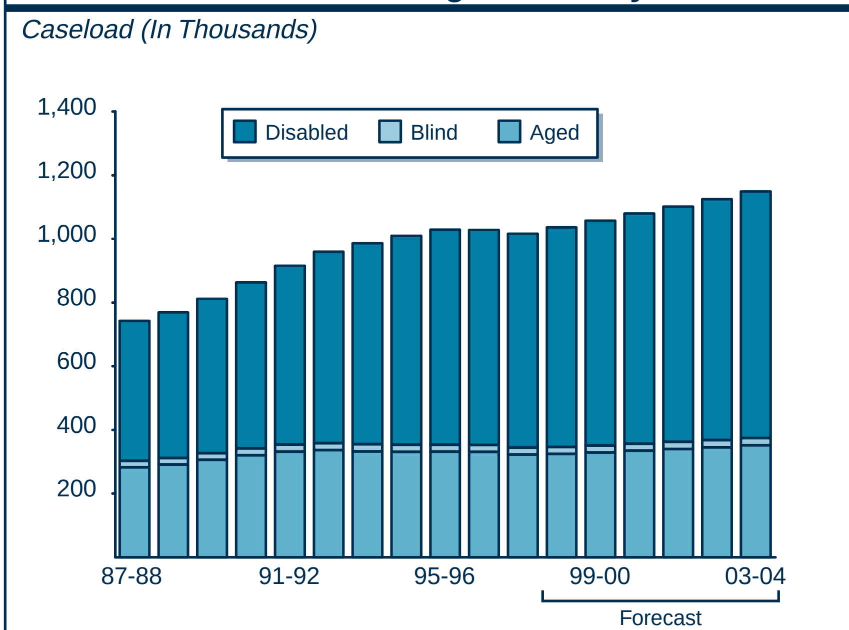
We project that spending will increase by about $200 million in 1999-00 because of (1) the full-year effect of current-year grant increases, which will become effective in January 1999, (2) caseload growth, (3) the application of the statutory COLA in January 2000, and (4) a modest increase in the administrative fee collected by the federal government. For 2000-01, we project spending will increase by about $100 million. This increase is due to caseload growth and a grant COLA, partially offset by savings from the scheduled termination in July 2000 of the state-only SSI/SSP for immigrants.

In 2001-02 and 2002-03, we project that spending will increase by 3.1 percent and 3.4 percent, respectively. In these years, the additional costs associated with grant COLAs and caseload growth are partially offset by savings from implementation of the regional 4.9 percent grant reduction in low-cost counties that is required by Chapter 307, Statutes of 1995 (AB 908, Brulte). This reduction has not been implemented because it would have brought the SSP grant below the federal MOE level. We estimate, however, that by January 2002 the SSP grant will be high enough to trigger the regional 4.9 percent reduction. Finally, we project that spending will increase by 5.4 percent in 2003-04.

Caseload Trends and Projections. From 1987-88 through 1995-96, the caseload increased by about 290,000 cases, with about 80 percent of this growth being in the disabled category (see Figure 4). This represented a relatively high rate of growth in the number of disabled cases, which

Figure 4

SSI/SSP Caseloads Growing Moderately



can be attributed to factors such as AIDS-related disabilities, federal expansion of eligibility, and outreach programs. More recently, the caseload has leveled off and in fact declined by 1.2 percent in 1997-98. The recent experience of essentially no growth in caseload is partially attributable to federal policy changes that (1) eliminated drug and alcohol addiction as qualifying disabilities, (2) made aged noncitizens in the U.S. prior to August 1996 (but not yet on SSI/SSP) ineligible for assistance, and (3) restricted eligibility for certain relatively less disabled children.

Since March 1998, the caseload has been growing. In the long run, we expect growth in the aged component of the caseload to mirror the growth of the overall population over age 65. For the disabled, we anticipate caseload growth will be similar to the average rate for the past year. In total, we project that the caseload will grow by just over 2 percent for each of the next five fiscal years.

Food Assistance Program For Immigrants

The Food Assistance Program for Immigrants provides state-only funded food stamp benefits to almost all of the noncitizens who became ineligible for federally funded food stamp benefits because of federal welfare reform legislation.

Because current state law terminates this program in July 2000, our spending forecast reflects annual savings of approximately $115 million beginning in 2000-01.

Child Welfare Services

The Child Welfare Services program provides immediate social worker response to allegations of child abuse and neglect, ongoing services to children who have been identified as victims or potential victims of abuse or neglect, and services to children in foster care who have been removed from their families because of abuse or neglect.

The Spending Forecast. We estimate that General Fund expenditures in the Child Welfare Services program will increase from $540 million in 1998-99 to $572 million in 1999-00, an increase of 6 percent.

We estimate that General Fund expenditures will continue to grow at an annual rate of about 6 percent through 2003-04, with the level of expenditures increasing from $607 million in 2000-01 to $644 million in 2001-02, $684 million in 2002-03, and $726 million in 2003-04.

Key Forecast Factors. The projected increases reflect recent trends in caseload growth (about 4 percent annually) and growth in the average cost of county social work staff (about 2 percent annually).

In-Home Supportive Services

The In-Home Supportive Services (IHSS) program provides various services to eligible aged, blind, and disabled persons who are unable to remain safely in their homes without such assistance.

The Spending Forecast. We estimate that General Fund expenditures in the IHSS program will increase from $486 million in 1998-99 to $527 million in 1999-00. This represents an increase of about 8 percent.

We estimate that General Fund expenditures will grow at an annual rate of about 5 percent from 1999-00 through 2003-04, with the level of expenditures increasing from $556 million in 2000-01 to $586 million in 2001-02, $618 million in 2002-03, and $651 million in 2003-04.

Key Forecast Factors. California's allocation of federal Title XX funds in federal fiscal year 1999 (beginning October 1998) was reduced by $56 million. As a result, available Title XX funds in 1998-99 will be $42 million (nine-month effect) less than the amount assumed in the *1998-99 Budget Act*. Our forecast assumes that (1) California's Title XX funding in 1999-00 and subsequent years will be $56 million less than the amount assumed in the *1998-99 Budget Act*, and (2) the reduction in Title XX funds will be offset by additional General Fund expenditures.

In addition, the forecast assumes that the program caseload will grow by 4 percent per year, and the average hours per case will grow by 1 percent per year. These assumptions are based on recent trends.

Department of Developmental Services—Community Services Program

The Department of Developmental Services (DDS) contracts with 21 nonprofit regional centers (RCs) to coordinate educational, vocational, and residential services for approximately 140,000 developmentally disabled clients each year. In addition to providing some services directly, such as diagnosis and case management, RCs purchase a variety of services from providers in the community.

The Spending Forecast. We estimate that General Fund expenditures in the Community Services Program will increase from $649 million in 1998-99 to $740 million in 1999-00, an increase of 14 percent. (These projections do not include the state's share of Medicaid reimbursements, which are reflected in the Medi-Cal budget.)

Beyond the budget year, we estimate General Fund expenditures of about $800 million in 2000-01, $875 million in 2001-02, $950 million in 2002-03, and $1 billion in 2003-04. This reflects an average annual growth rate of 8.6 percent.

Key Forecast Factors. The projected increases are primarily due to (1) estimated basic caseload growth of 5 percent annually (based on a continuation of recent trends) and (2) inflation in service costs. The rate of growth in spending is higher in 1999-00 due to the full-year impact of two initiatives begun in the current year to improve client health and safety.

In addition, we estimate that current-year General Fund expenditures will exceed the *1998-99 Budget Act* appropriation by about $35 million due to a federally imposed freeze of the state's Home and Community-Based Services waiver program, under which California receives federal funds for clients served in the community. In December 1997, the federal Health Care Financing Administration (HCFA) froze admissions to the waiver program after reporting numerous health and safety concerns for clients receiving services in the community. Since then, the number of clients covered by the waiver has dropped from 35,000 to approximately 31,000 as of October. Although HCFA has approved a new waiver program effective October 1, 1998, the admissions freeze will continue until DDS and the Department of Health Services demonstrate increased state-level oversight and monitoring of waiver services. As a result, DDS indicates that it will collect less federal funding than projected in the 1998-99 budget.

Medi-Cal

The Medi-Cal Program (the federal Medicaid Program in California) provides health care services to recipients of CalWORKs and SSI/SSP grants, and to other low-income persons who meet the program's eligibility criteria (primarily families with children and the elderly, blind, or disabled). The state and the federal governments share most of the costs of the program on a roughly equal basis.

The Spending Forecast. We estimate that General Fund spending for Medi-Cal benefits (excluding administrative costs) will be $6.74 billion in 1998-99, which is $309 million more than the amount appropriated in the budget act. The following four adjustments account for the bulk of the difference from the budget act appropriation:

- ***Add Back "Uncertainty Adjustment."*** The enacted budget assumed that spending would be $132 million (2 percent) below the midpoint of the Medi-Cal spending estimate of the Department of Health Services (DHS), due to uncertainties about caseloads and costs. However, caseloads are higher, rather than lower, than budget estimates (see below), and we are not aware of any other factors that would warrant a downward adjustment to the department's midpoint spending projection.

- ***Continuation of Prenatal Care for Undocumented Immigrants.*** The budget appropriation for Medi-Cal assumes savings from state regulations ending the availability of prenatal care for undocumented immigrants as of July 1, 1998. Implementation of those regulations has been delayed, however, pending the outcome of litigation. Accordingly, we have included $73.7 million in our 1998-99 spending estimate for the costs of continued prenatal care in the current year. These prenatal care costs are not included in our forecast for subsequent years. We note, in this respect, that SB 34 (Vasconcellos), which would have made this benefit permanent, was passed by the Legislature but vetoed by the Governor.

- ***Caseload Increase.*** Our estimate includes an additional $52.7 million for higher caseloads in the current year. Based on current caseload data and recent trends, we estimate that the average number of Medi-Cal eligibles will be about 82,000 (1.7 percent) more than the budget estimate. Much of this extra caseload reflects a temporary increase, due to providing continued eligibility to former CalWORKs recipients pending the development and implementation of new Medi-Cal eligibility criteria to comply with the requirements of welfare reform legislation.

- ***Rate Increases.*** Our estimate includes a total of $37 million for rate increases for Medi-Cal managed care plans, which DHS currently is developing, and for rate increases for children's hospitals that recently were approved by the California Medical Assistance Commission.

General Fund spending for Medi-Cal benefits increases by only 1.5 percent in 1999-00 in our forecast due to the partial offset of cost increases by continued declines in caseload and the assumed elimination of prenatal care costs for undocumented immigrants. By the end of the forecast period in 2003-04, we project that General Fund spending for Medi-Cal benefits will reach $8.7 billion, an average annual increase of 6.1 percent.

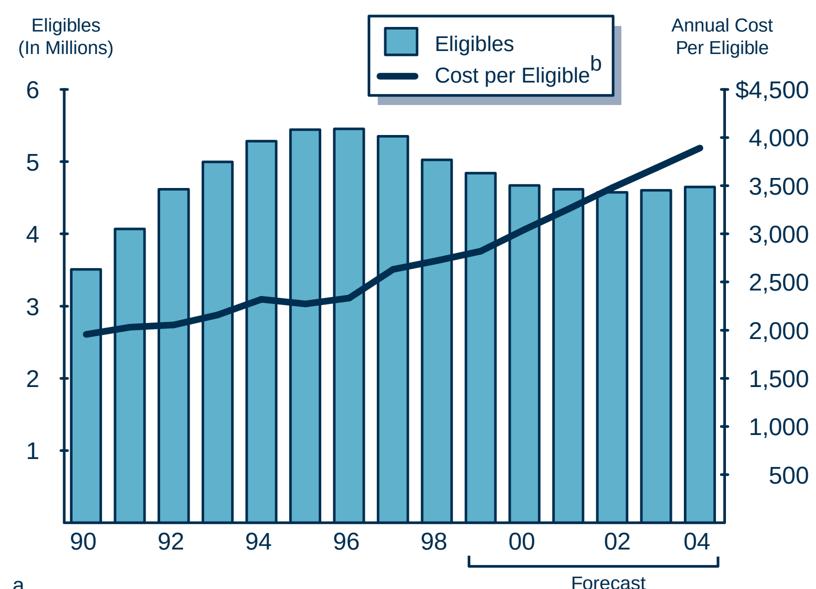
Key Forecast Factors. As shown in Figure 5, the total Medi-Cal caseload peaked in 1995-96 at almost 5.5 million, and has declined by about 10 percent since then—to 4.9 million—primarily due to the reduction in the CalWORKs caseload. As noted in our CalWORKs discussion, the decline in the CalWORKs caseload slows in our forecast, from 8 percent in 1999-00 to 0.3 percent in 2003-04. Meanwhile, over this period, other Medi-Cal caseloads grow modestly. The elderly and disabled caseload and the caseload of families and children who are in Medi-Cal, but not in CalWORKs, grow at annual rates of 2 percent and 1.3 percent, respectively, during the forecast period. These rates reflect our demographic projections that show the elderly population growing faster than the population of women in their primary childbearing years and of younger children over this period. The combination of the slowing decline in the CalWORKs caseload and ongoing modest growth for other Medi-Cal eligibility groups results in the total Medi-Cal caseload declining to about 4.6 million in 2001-02, and then growing slightly (about 1 percent annually) through 2003-04.

Although the caseload declines, spending increases over the forecast period, due to a general increase in the cost of health care (assumed to be 5 percent annually for most of the forecast period) and a more expensive "case mix." As the CalWORKs caseload declines, a larger proportion of the Medi-Cal caseload consists of the elderly or disabled, whose average medical costs are higher than those of children and families. The effect of this changing case mix adds about 3 percent to the increase in the cost-per-eligible in 1999-00 (when the decline in the CalWORKs caseload is large), but less than 1 percent in 2003-04 (as the CalWORKs caseload flattens).

Figure 5

Medi-Cal Caseload Stabilizes but Cost per Eligible Still Grows

1989-90 Though 2003-04[a]



[a] Fiscal years ending in year shown.

[b] Includes federal funds and funding for related programs that flow through Medi-Cal.

Uncertainties and Risks. Below we discuss several uncertainties and risks associated with our forecast, each of which could result in a higher level of spending.

- ***Prenatal Care.*** Continuation of prenatal care for undocumented immigrants after 1998-99 would add between $300 million and $400 million to *cumulative* General Fund spending through 2003-04.

- ***Participation of Children and Families in Medi-Cal.*** Many low-income families (particularly the children) can qualify for Medi-Cal without being on welfare (which provides Medi-Cal coverage automatically). For this reason, there was some expectation that recent large reductions in the CalWORKs portion of the Medi-Cal caseload would be partially offset by increases in the number of families and children enrolled in other Medi-Cal categories, as families moved from welfare to work (in presumably low-paying jobs). This has not occurred so far—the Medi-Cal caseload of families and children outside of welfare has remained almost flat. For this reason, there has been a decline in the overall participation rate of children and families in Medi-Cal (that is, the enrollment in Medi-Cal as a percentage of the total population of children and women of childbearing age). Although our forecast assumes a small slowing of this current trend, Medi-Cal participation by children and families declines further during the forecast period.

We note that the 1997-98 and the 1998-99 budgets provided DHS with significant additional funds for enrollment outreach targeted at children and families. To the extent that these expanded outreach activities are successful in the future, enrollment and costs would increase. If the participation rate remains at its current level rather than declines, General Fund spending could increase—potentially by a cumulative total of several hundred million dollars over the forecast period.

- ***Hospital Outpatient Rates.*** As a result of litigation (*Orthopaedic Hospital v. Belshe*), DHS is contracting for a study to provide a basis for setting new outpatient rates for hospitals. Medi-Cal outpatient rates are essentially the same regardless of whether the services are provided in a hospital or another setting. The hospital industry contends that outpatient services are more costly to provide in a hospital, and that hospital outpatient rates should be adjusted accordingly. The rate study (due by the summer of 1999) will provide a specific basis for Medi-Cal hospital outpatient rates in order to comply with the court decision in the case. Depending on the outcome of the study, the potential for increased General Fund costs could be up to tens of millions of dollars annually.

Healthy Families Program

The Healthy Families program provides medical, dental, and vision coverage for children in families with incomes below 200 percent of the federal poverty level, but above Medi-Cal limits. The program resulted from federal and state legislation enacted in 1997, and coverage of children began in July 1998. The Managed Risk Medical Insurance Board (MRMIB) administers the program with the cooperation of the DHS, which oversees some of the administrative and outreach functions as well as some modest Medi-Cal expansions that are part of the overall program. (The DHS costs for the program are included in our Medi-Cal estimate.) The federal government provides funding for the Healthy Families program on approximately a two-to-one matching basis.

The Spending Forecast. We estimate that General Fund spending for the Healthy Families program will be $22.9 million in 1998-99, or $15.3 million less than the budget act appropriation of $38.2 million. This reduction is due to enrollment in the Healthy Families program that is substantially behind budget estimates. As of October 31, 1998, enrollment totaled 33,000—less than half of the budget estimate for that date.

At current monthly enrollment rates, total enrollment on July 1, 1999 will be only about 60 percent of the budget estimate. Based on these trends, we estimate that General Fund spending will reach $144 million in 2003-04.

Key Forecast Factors. The shortfall in enrollment is partly due to an apparent overestimate of the potentially eligible population. Based on revised data released in October 1998 by the University of California Los Angeles Center for Health Policy Research, MRMIB has reduced its estimate of the total number of potentially eligible uninsured children by 27 percent—from 551,000 to 400,000.

The complexity of the Healthy Families application and concerns of immigrant families about using the program appear to have contributed to the lower-than-anticipated rate of enrollment. Some increase in the rate of enrollment could result from a current effort by MRMIB and DHS to simplify and shorten the existing 28-page enrollment application, and to seek clarification from the federal government regarding the effect of enrollment in Healthy Families on the immigration status of immigrant children or parents.

We note that the General Fund share of administrative and outreach costs of the Healthy Families program could increase by up to several million dollars annually if enrollment remains low. This is because a large portion of those costs are fixed, but federal funding of such costs is limited to one-ninth of benefit costs.

K-14 EDUCATION

This section reviews our estimates of state Proposition 98 costs for K-14 education (K-12 schools and community colleges).

Proposition 98 sets the minimum amount that the state must provide for California's public K-12 education system and the California Community Colleges. About 85 percent of total funding for these school programs is from the state General Fund and local property taxes. Public K-12 education in California is provided to about 5.6 million students—ranging from infants to adults—through about 1,060 locally governed school districts and county offices of education. The California Community Colleges provide instruction to about 1.4 million adults at 107 colleges operated by 71 locally governed districts.

The Spending Forecast. We estimate that annual growth in total Proposition 98 spending (General Fund and local property taxes) for K-14 education will be about 5 percent for the forecast period (1999-00 through 2003-04). This is lower than the 9.2 percent increase in 1997-98 and the projected increase of 7.2 percent for the current year. Proposition 98 spending in these two years reflects appropriations *above* the minimum guarantee. For 1998-99, the appropriation above the guarantee (at the time the budget was enacted) was almost $600 million, which raises the Proposition 98 base for all future years. (Based on our current revenue estimates, this appropriation above the minimum has grown to an estimated $1.1 billion.) Our forecast also reflects (1) the reduction in taxes approved by the Legislature during the 1998 session, (2) our moderate revenue forecast, and (3) future spending at the minimum Proposition 98 guarantee level.

Key Forecast Factors. General Fund expenditures for Proposition 98 depend on the following factors: state population, K-12 average daily attendance (ADA), per-capita personal income, per-capita General Fund revenues, and local property taxes. Figure 6 summarizes our assumptions for these factors and the guarantee which results. Our economic forecast assumes state tax revenues will grow by about 5.5 percent annually over the forecast period. We also assume that growth in

Figure 6

LAO Proposition 98 Forecast

Annual Percent Change

	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
State population	1.7%	1.8%	1.7%	1.7%	1.7%	1.7%
K-12 average daily attendance (ADA)	1.8	1.4	1.1	0.9	0.9	0.9
Per-capita personal income	4.2	3.6	3.6	4.1	3.9	3.9
Local property taxes	4.4	5.1	5.2	5.4	5.3	5.4
Proposition 98 guarantee[a]	7.2	5.1	4.9	5.1	4.9	4.9

[a] General Fund and local property taxes.

local property tax revenues will continue to recover from the relatively low rates of the past few years. As indicated in the figure, these inputs increase the total guarantee (General Fund and local property tax) by around 5 percent for the forecast period.

K-12 Funding Projections. Figure 7 displays our projected K-12 per-pupil spending from 1993-94 through 2003-04 (in both "current" and inflation-adjusted dollars). These estimates, which are derived from our Proposition 98 forecast, reflect real (that is, inflation adjusted) per-pupil increases of about 1 percent each year between 1999-00 and 2003-04. These additional resources—amounting to over $300 million each year—would permit modest expansion of existing programs and/or funding for some new programs.

Community College Funding Projections. Based on our Proposition 98 projections, we estimate total community college funding will increase by about 5 percent a year over the forecast period. (This assumes no change in the proportion of Proposition 98 funds going to community colleges.) After adjusting for inflation, this would provide about a 2 percent increase annually for additional enrollment and/or program improvements.

HIGHER EDUCATION

In addition to community colleges, the state's public higher education system includes the University of California (UC) and the California State University (CSU). The UC consists of eight general campuses, one health science campus, and numerous special research facilities. The UC awards bachelor's, master's, and doctoral degrees, as well as various professional degrees. The UC has primary jurisdiction over research. The CSU consists of 22 campuses and several off-campus centers. The CSU grants bachelor's and master's degrees and may award doctoral degrees jointly with UC or a private university.

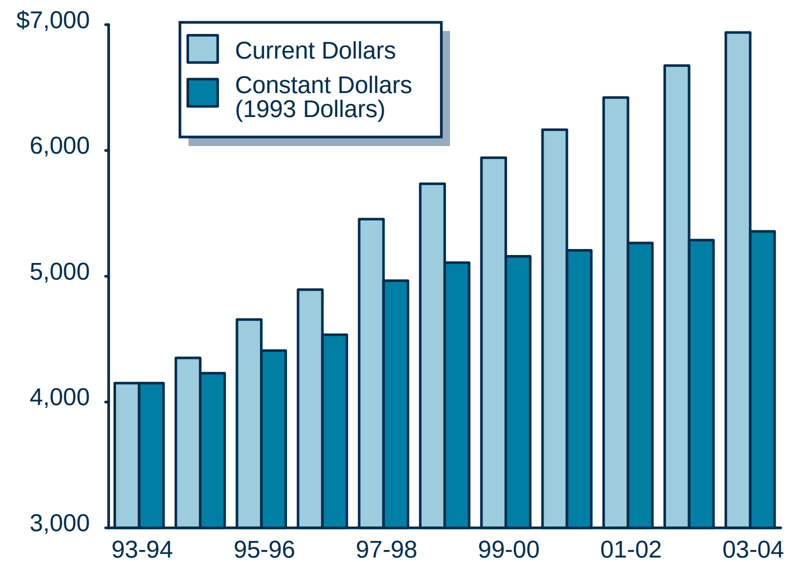
The Spending Forecast. We estimate that spending for UC and CSU (excluding funding for debt service) will increase from $4.5 billion in 1998-99 to $4.6 billion in 1999-00, or by 2.1 percent. After adjusting for one-time appropriations in the 1998-99 budget for UC and CSU ($147 million), however, the increase for 1999-00 would be 5.5 percent. For 2000-01, we estimate that spending for UC and CSU (excluding funding for debt service) will increase to $4.8 billion, or by 4.8 percent compared to 1999-00.

Key Cost Factors. For 1999-00 and subsequent fiscal years, we assume that UC and CSU will re-

Figure 7

Proposition 98 Funding per Student

Current and Constant Dollars



ceive "base" budget increases equivalent to the growth in inflation and enrollments. Over the forecast period, inflation is projected to average about 3 percent annually and enrollment for the two segments combined is forecast to grow an average of about 2 percent a year.

General Fund Replacement of Foregone Fee Revenues. Chapter 853, Statutes of 1997 (AB 1318, Ducheny), reduced UC and CSU systemwide fees for resident undergraduates by 5 percent for 1998-99 and "freezes" those fees at the reduced level for 1999-00. Chapter 734, Statutes of 1998 (SB 1896, Peace), reduced resident graduate student fees to the undergraduate level. Our projection for 1999-00 includes an additional $33 million to "buy out" a 4.5 percent fee increase that UC and CSU would have recommended absent these legislative restrictions on fee increases. This assumption is consistent with similar actions taken by the Legislature and Governor in the last three annual budget acts.

JUDICIARY AND CRIMINAL JUSTICE

The major state judiciary and criminal justice programs include support for four agencies in the executive branch—the Departments of Corrections, the Youth Authority, Justice, and the Office of Criminal Justice Planning—as well as expenditures for local trial courts and state appellate courts. The largest expenditure programs—the Department of Corrections and the Trial Court Funding Program—are discussed in more detail below.

Department of Corrections

The California Department of Corrections (CDC) is responsible for the incarceration, training, education, and care of adult felons and nonfelon narcotics addicts at 33 state prisons. The CDC also supervises and provides services to parolees released to the community.

The Spending Forecast. The department's General Fund support budget is forecast to grow between 1997-98 and 1999-00 by almost $575 million, exceeding $4 billion at the end of that period. We further project that annual CDC support expenditures will reach almost $5.3 billion by the 2003-04 fiscal year. (This includes adjustments for employee compensation increases but does not include General Fund support for capital outlay or lease-payment bonds, which are accounted for elsewhere in our projections.)

The department's General Fund costs will be partially offset by reimbursements from the federal government for the state's costs of housing undocumented immigrants convicted of felonies in California. We expect federal support to drop from $195 million in 1997-98 to $161 million by 2003-04. Although our estimate assumes that Congress will continue to provide the same total level of funding to reimburse states as it has in the past two years ($585 million nationwide), we assume that California's share of the total will decline somewhat as other states and local governments become more sophisticated at tracking their costs for incarcerating undocumented felons and making claims to the federal government.

The projected growth in adult correctional expenditures continues a trend of steadily larger CDC budgets that has existed since the early 1980s.

Key Forecast Factors. The significant increases projected in General Fund support for the CDC reflect continued major growth in the prison inmate population expected during the forecast period. Our estimates through 2003-04 are based primarily on the CDC's projections of the inmate population. We believe the CDC projections are reasonable, but have adjusted the figures to take into account budget and other statutory correctional program changes that were enacted after the projections were completed. We anticipate that the CDC prison population will exceed 200,000 by June 2004, representing an increase of as many as 44,000 inmates or about 28 percent over the six-year projection period. (Our projections are shown graphically in Figure 8.)

The increase in prison population is largely the result of tougher sentencing measures approved by the Legislature, Governor, and the voters, including the "Three Strikes and You're Out" law enacted in 1994. Also, demographic shifts, in particular the growth in the state's 18-to-24 age group, can increase the prison population. On the other hand, the state of the economy and the availability of jobs to persons who might otherwise commit crimes can work to reduce the growth in the inmate population. Local law enforcement practices and the deterrent effects of tougher sentencing policies also could have an effect on the numbers of persons arrested and convicted of crimes.

This continued inmate growth represents a major operational and fiscal challenge to the state. Should it persist, the CDC support budget would grow at an average annual rate of 7.9 percent in the short term (through 1999-00) and 7.2 percent in the long term (through 2003-04).

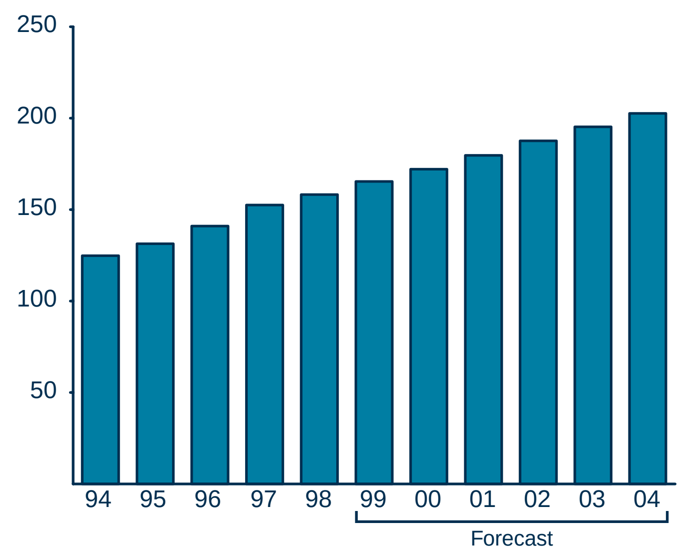
Moreover, if these trends hold, the state prison system will exhaust all available space for housing inmates—including 7,200 beds the department considers to be "high security risk" (such as triple bunks in prison gymnasiums and dormitories) and not viable long-term housing—by late 2001. By June 30, 2004, the state would have to accommodate 27,000 inmates for whom space is not now available. That is the equivalent of five to six state-run prisons carrying a one-time construction cost of $1.6 billion. However, the cost of CDC operations and capital outlay could be lower if the Legislature and Governor or the courts took further actions which either slowed inmate population growth or provided alternative forms of punishment for some offenders.

Meanwhile, the number of parolees under the supervision of CDC parole agents is also expected to increase, reflecting the overall growth in the state's population of criminal offenders. Once again, we have adjusted CDC parole population

Figure 8

State Prisons Face Continued Inmate Population Growth

Inmates as of June 30 (In Thousands)



projections to take into account 1998 correctional program changes that are likely to keep more parolees out of prison and under continued supervision by parole agents. Accordingly, we project that the parolee population will grow by more than 30,000, or almost 30 percent, over the six-year period ending June 30, 2004.

Trial Court Funding

Under the Trial Court Funding Program, the state pays for the bulk of costs of operating the trial courts throughout the state. Legislation enacted in 1997 (Chapter 850, Statutes of 1997 [AB 233, Escutia and Pringle]) restructured the program and significantly increased the state's fiscal obligation for support of the courts, beginning in 1998-99. Specifically, the measure reduced and capped each county's financial obligation, and increased the state's obligation by providing that the state will be responsible for supporting all future cost increases for the trial courts. Two other recent measures—Chapter 406, Statutes of 1998 (AB 1590, Thomson) and Chapter 1017 (AB 2788, Thomson)—further increased the state's financial responsibility for support of the trial courts and reduced the counties' responsibility.

The Spending Forecast. Total General Fund expenditures for support of the courts will increase from $399 million in 1997-98 to almost $1.3 billion in 2003-04—more than a three-fold increase.

Key Forecast Features. The increases in the first two years of the projection period—1998-99 and 1999-00—will be the most significant because of the implementation of the various pieces of legislation outlined above. Costs will increase $260 million in 1998-99 (a 65 percent increase) and $218 million in 1999-00 (a 33 percent increase) as the state's financial responsibility increases and the counties' financial responsibility decreases. We assume that the costs will increase throughout the projection period consistent with historical increases in trial court costs and projected increases in court-related workload. Our estimates assume that the largest periods of growth will occur during the early years of the projection period and taper off somewhat in the later years as the state gains greater control over the operations and costs of the trial courts. We would note that any major new state trial court programs enacted in the future would have to be paid for entirely by the state.

OTHER PROGRAMS

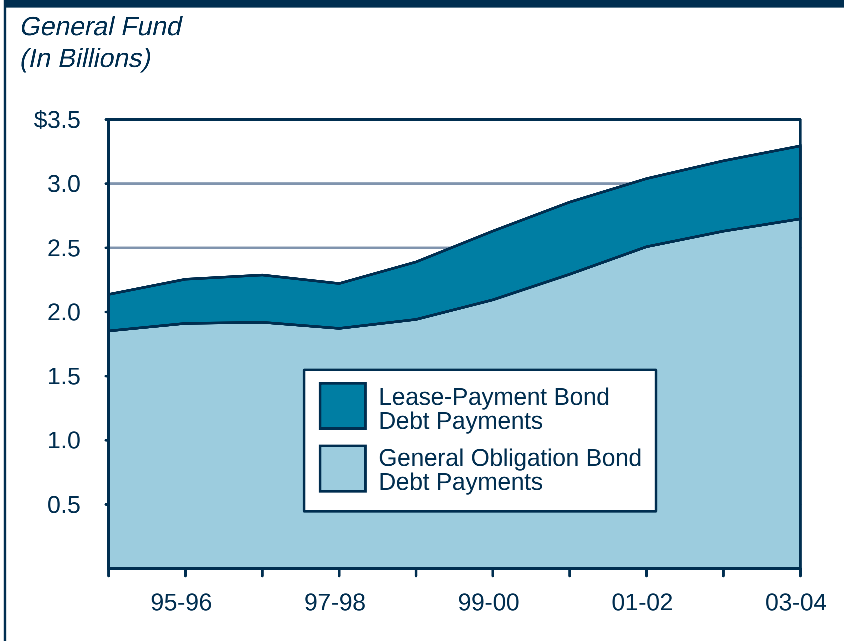
Debt Service

Debt Payments. As shown in Figure 9, we estimate that General Fund debt costs (for general obligation and lease-payment bonds) will increase from $2.4 billion in the current year to about $3.3 billion in 2003-04. This is an average annual increase of 6.7 percent. Our forecast assumes that almost $16 billion in currently authorized bonds will be sold over the forecast period, including almost all of the $9.2 billion in education bonds approved by the voters at this month's election. We also assume that additional bonds will be approved in 2000 and 2002 of which $2 billion would be sold by 2003-04. As a percent of total debt, lease-payment bond debt peaks at 20 percent in 1999-00 and declines to 17 percent in 2003-04 based on currently authorized bonds.

Debt Ratio. The state's debt ratio (debt payments as a percent of General Fund revenues) increased from 2.5 percent in 1990-91 to a high of 5.1 percent in 1994-95. In recent years, General Fund revenues have increased at a faster rate than the increase in debt payments. Thus, the debt ratio declined to 4.2 percent in 1997-98. We estimate that with sales of currently authorized

Figure 9

Bond Debt Payments Will Increase Steadily



bonds, the debt ratio will increase to 4.7 percent in 2001-02 and decline thereafter. Voter approval of additional general obligation bonds or legislative authorization of new lease-payment bonds would, of course, increase the debt ratio.

Vehicle License Fee

As part of the 1998 tax reduction package, the vehicle license fee (VLF) was reduced by 25 percent. Cities and counties will continue to receive the same amount of revenues as under prior law, with reduced VLF amounts replaced by General Fund spending. This tax reduction takes effect January 1, 1999. As a result, the General Fund backfill in 1998-99 will only be for half of the fiscal year, at an estimated cost of $533 million. The first full-year backfill will occur in 1999-00 at an estimated cost of about $1 billion.

Beginning in 2000-01, additional reductions in the VLF would be triggered if certain revenue levels are reached. As we describe in Chapter 1, our projected revenues are well below the trigger levels. In the event of an additional VLF reduction, however, the General Fund backfill would increase to cover local governments' further losses.