Foreword

This report provides our projections of General Fund revenues and expenditures for 1999-00 through 2004-05. 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.

Legislative Analyst's Office

Legislative Analyst

Elizabeth G. Hill **445-4656**

Deputy Legislative Analysts

Hadley Johnson, Jr. **445-5456**

Mac Taylor **445-6511**

Business, Labor, and Capital Outlay 322-8402

Director .... Gerald Beavers
Consumer protection/gambling .... Megan M. Atkinson
Business regulation/development and
employee relations/compensation .... Todd Clark
Capital outlay, state indebtedness/labor .... Chris Guyer
Capital outlay/state property management ...... Paul Guyer

Criminal Justice and State Administration 445-4660

Director .... Craig Cornett
Adult corrections .... Daniel C. Carson
Courts .... Eraina Ortega
Juvenile/
local criminal justice .... Yvonne Choong/Tracy Kenny
Information technology and
state administration .... Anna Brannen

Economics, Taxation, and Fiscal Forecasting 324-4942

Director .... Jon David Vasché
Senior Economist .... Brad Williams
Taxation .... Mark Ibele
Budget overview .... Robert Ingenito

Health and Welfare 445-6061

Director .... Chuck Lieberman
Welfare/cash grants .... Todd Bland
Social services .... Mary Adèr
Medi-Cal .... Dan Rabovsky
Public Health .... Karin Bloomer
Developmental services/
mental health .... Kasia O'Neill

Higher Education 445-8641

Coordinator and UC .... Buzz Breedlove
Community Colleges .... Stuart Marshall
CSU .... Jennifer Kuhn

K-12 Education 445-8641

Coordinator .... Robert Turnage
Proposition 98 .... Erik Skinner
Compensatory education/childcare .... Mary Jones
School reform/accountability .... Robert Manwaring

Local Government 445-6511

Director .... Mac Taylor
County and city fiscal affairs .... Marianne O'Malley
County and special district fiscal affairs .... Michael Cohen

Transportation and Resources 445-5921

Director .... Dana Curry
Transportation financing/highways .... Rebecca Long
Transportation financing/
public transportation .... Jason Weller
Traffic enforcement/
resources conservation .... Steve Boillard
Resources Agency departments .... Jennifer Giambattista
Environmental Protection
Agency departments .... Mark C. Newton

Table of Contents

Chapter 1

The Budget Outlook

California's fiscal fortunes have again significantly exceeded expectations, due largely to its robust economic performance and the accompanying increases in General Fund revenues. We project that continued revenue growth will trigger all of the vehicle license fee (VLF) reductions previously agreed to, enable full funding of all current-law programs, and produce significant budgetary reserves in the next several years.

As indicated in Figures 1 and 2, we now project that 1999-00 will end with a reserve of nearly $2.6 billion, up substantially from the $881 million forecast just five months ago when the budget was adopted. In 2000-01, the reserve would grow further to slightly over $3 billion. In the subsequent four years, revenues and expenditures would increase at about the same average rate, and a good-sized re-

Figure 1

Key Findings of the LAO Outlook

✔ **Economy and Revenues Again Exceed Expectations**

- U.S. and California economies are growing strongly.
- Current-year state revenue trends are well above estimates.
- Revenue forecast is revised sharply upward.

✔ **Balanced Budgets With Significant Reserves Projected Over Long Term**

- Current year to end with reserve of $2.6 billion, $1.7 billion more than budget estimate.
- Under current law, reserve increases to $3 billion in 2000-01.
- Budgets tighten some thereafter, due to major vehicle license fee trigger reductions.
- Yet, large reserve remains intact.

✔ **Implications**

- 2000-01 fiscal environment is most positive in years.
- Even so, it's important to consider multiyear effects of any new commitments.
- Maintaining an adequate reserve should be a priority.

Figure 2

LAO Projections of General Fund Condition

1998-99 Through 2000-01
(In Millions)

		Forecast	
	1998-99	**1999-00**	**2000-01**
Prior-year fund balance	$3,064	$3,099	$3,071
Revenues and transfers	58,614	64,849	67,906
Total resources available	$61,678	$67,948	$70,977
Expenditures	$58,579	$64,877	$67,479
Ending fund balance	$3,099	$3,071	$3,498
Other obligations	$480	$480	$480
Reserve	**$2,619**	**$2,591**	**$3,018**

serve would be maintained throughout the forecast period, assuming current policies.

KEY FEATURES OF THE LAO OUTLOOK

The Economy

The single largest factor behind the improved budgetary outlook is the strong performance of the U.S. and California economies, which have continued to outperform expectations by a significant margin. Based on our current estimates, U.S. real gross domestic product will expand by just under 4 percent for the third year in a row in 1999, due to particularly strong increases in consumer spending and business investment. These national trends are clearly evident in California, where such measures as personal income, employment, and retail sales are up sharply this year.

Our forecast assumes that economic growth will slow some over the next two years, but still continue at a solid pace. For example, we project that California personal income growth will slow from 6.7 percent in 1999, to 6.1 percent in 2000. In subsequent years we project that personal income will continue to expand at annual rates of between 5 percent and 6 percent. Our economic forecast for the full projection period is somewhat stronger than our previous long-term projections, reflecting an upward assessment regarding the rate at which the economy is able to grow over the long term.

Revenues

We forecast that General Fund revenues will increase from $58.6 billion in 1998-99 to $64.8 billion in 1999-00, and further to $67.9 billion in 2000-01. Relative to the *1999-00 Budget Act* forecast, our estimate for 1998-99 is up $684 million, reflecting strong receipts during the early months of this fiscal year which will be accrued back to the prior year. Our forecast for 1999-00 is up by nearly $1.9 billion, due to both the improved economic outlook, and stronger-than-expected monthly receipts from key sources such as personal income tax withholding and sales tax payments.

Over the longer term, revenues are forecast to expand roughly in line with statewide personal income, increasing at an annual rate of about 5.6 percent, and reaching $84.4 billion by 2004-05.

The General Fund Condition in 1999-00

The 1999-00 budget assumed that the fiscal year would end with a reserve of $881 million. In contrast, our updated estimates result in a 1999-00 year-end reserve of over $2.6 billion. The $1.7 billion improvement is the net result of a $2.6 billion increase in revenues ($687 million in 1998-99 and $1.9 billion in 1999-00, as discussed above), partly offset by $0.8 billion in higher costs. The added costs are primarily related to higher-than-expected Medi-Cal expenditures, due primarily to lower-than-anticipated receipt of new federal reimbursements.

Budgetary Outlook for 2000-01 And Beyond

Basis for Our Estimates. Our revenue and expenditure forecasts for 2000-01 and beyond are based primarily on the *requirements of current law*. Specifically, we have adjusted the 1999-00 spending plan for constitutional and statutory funding requirements, as well as for projected changes in caseloads, federal reimbursement rates, and other factors affecting program costs. For example:

- Our expenditure forecast for K-14 education is determined by the changes in the Proposition 98 minimum funding guarantee.
- Spending for higher education is based on projected enrollments and inflation.
- Our projections for health and social services take into account caseloads, program service requirements, and statutory cost-of-living adjustments (COLAs) required by current law.
- Costs for employee compensation for 2000-01 take into account the collective bargaining agreements approved by the Legislature this summer. For the out-years, we have assumed future annual employee compensation increases equal to projected inflation (slightly less than 3 percent per year).

Finally, our estimates include the impact of future VLF reductions that would be "triggered" under our revenue projections. However, they do not include the impact of court cases pending against the state.

Our fiscal estimates are not predictions of what the Legislature and Governor will adopt as policies and funding levels in future 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-law policies were allowed to run their course. We recognize that the Legislature may choose to make other policy choices as it has in recent years. For example, it may choose to over-appropriate the Proposition 98 minimum funding guarantee. We believe that by using this approach, however, our forecasts provide a meaningful starting point for the Legislatures's evaluation of the state's fiscal condition.

Forecast for 2000-01— Large Reserve

As indicated in Figure 2, we estimate that revenues will rise 4.7 percent to $67.9 billion, and expenditures will increase 4 percent to $67.5 billion during the year. The $427 million operating surplus during the year will raise the 2000-01 year-end reserve to just over $3 billion.

As with revenues (discussed above), the modest growth rate projected for expenditures partly reflects the existence of large one-time outlays in the current year. In terms of major ongoing programs, we project that education spending will increase by about 5 percent next year, that Medi-Cal and Supplemental Security Income/State Supplementary Programs (SSI/SSP) will increase by about 7 percent, and that California Work Opportunity and Responsibility to Kids (CalWORKs) spending will decline by nearly 10 percent.

Long-Term Projections—Balanced Budgets

Over the long term, our projections indicate that revenues and expenditures will roughly balance for the 2001-02 through 2004-05 period as a whole. As a result, the $3 billion reserve we project for 2000-01 would remain largely intact at the end of the five-year forecast horizon.

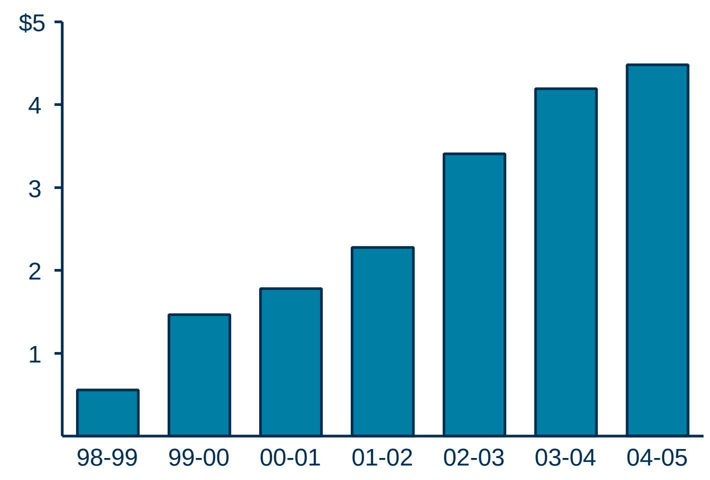
During this period, the year-to-year surplus would fluctuate somewhat due to such factors as the phasing-in of the VLF tax cuts. Revenue growth would be somewhat *greater* than spending growth related to *existing* state programs. One reason for this is that General Fund Proposition 98 spending is forecast to grow by about 4.5 percent per year, due largely to slow growth in school enrollments.

However, as noted above, the state will also be facing new obligations which are related to VLF rate reductions (that would be automatically triggered if revenues meet our projections). As indicated in Figure 3, we estimate that state subventions to backfill local revenue losses resulting from the VLF rate reductions will climb from $1.5 billion in the current year, up to $4.5 billion by 2004-05.

Figure 3

Projected Vehicle License Fee Backfill Expenditures[a]

(In Billions)



[a] Reflects cummulative Vehicle License Fee reductions of 25 percent effective January 1, 1999; 35 percent effective January 1, 2000; 46.5 percent effective January 1, 2002; and 67.5 percent effective January 1, 2003 (the higher of two trigger reductions effective on that date).

IMPLICATIONS OF OUR ESTIMATES

Recent economic and revenue developments have helped create an extremely positive budgetary environment for California. Based on our current projections, the state will be able to provide nearly $3 billion in additional VLF tax relief over the next five years, maintain all existing budget commitments, and still have enough resources to finance some new obligations and maintain a reserve.

As the Legislature approaches its 2000-01 budget deliberations in this favorable fiscal climate, it will have the opportunity to both review its *existing* spending and tax policies to ensure that they reflect current priorities, *and* decide whether to take on *new* commitments (either spending or tax relief) in light of the large projected 2000-01 surplus.

If new commitments are desired, however, it will be very important to take into account their long-term fiscal consequences. Given that revenues and expenditures are projected to be about equal to one another during the 2001-02 through 2004-05 period, significant new ongoing budgetary commitments, if not offset by savings elsewhere, would result in reductions in the reserve during this period. As one example, new ongoing budgetary commitments of just $300 million annually beginning in 2000-01 would reduce the $3 billion reserve we project for 2000-01 down to $1.3 billion by the end of 2004-05.

Although the size of reserve is ultimately a legislative policy decision, we believe that, *at a minimum*, $1.5 billion (or roughly 2 percent of the budget) should be targeted for this purpose. Preferably, the amount would be even higher. The maintenance of a healthy reserve through the next several years is important for at least two reasons: (1) the future performance of the economy is uncertain and (2) the existence of lawsuits and claims that could potentially have significant negative fiscal impacts on the state.

With regard to the economy, a significant economic downturn sometime during the next five years would result in revenues falling well below our projections. We note that the effects of a significant revenue drop-off would be partly mitigated by the fact that some or all the VLF trigger reductions we are projecting might not take place, depending on the circumstances. For example, if revenues were to grow at the subdued pace of 2 percent annually for several years, as much as one-third of the resulting $20-plus billion revenue loss over the period would be offset by reduced expenditures to backfill VLF reductions. In addition, the Proposition 98 minimum funding guarantee and expenditures for certain other state programs would also fall. Even allowing for these adjustments, however, a significant economic slowdown would put immediate pressure on the budget.

With regard to legal challenges, the most immediate potential liability involves an appellate ruling that the state illegally collected smog impact fees from motorists that registered out-of-state cars in California. The Governor has recently declared his intent to make reimbursements of these fees with interest, although the timing and ultimate size of any such reimbursements will depend on legislative action. Other legal issues include (1) pending school district claims before the Commission on State Mandates regarding special education programs, and (2) a recent superior court ruling that the state's previous shift of property taxes from local governments to schools was illegal.

Thus, while the current fiscal climate is very positive, it will be important for the Legislature to be cognizant of the out-year implications of potential fiscal threats and new commitments on either the revenue or expenditure side of the budget to ensure that a balanced budget will be maintained in the future.

Chapter 2

Economic and Demographic Projections

Economic and demographic developments in California have important effects on the state's fiscal condition. These factors affect both revenues—through their impacts on tax receipts—and expenditures—through their impacts on caseloads, cost-of-living adjustments, and other factors affecting state programs. This chapter presents our economic and demographic projections for 1999 through 2005, which will affect California's fiscal condition during fiscal years 1999-00 through 2004-05.

THE ECONOMIC OUTLOOK

Our economic forecast assumes that both the nation and California will experience continued solid, though moderating, economic growth during the forecast period. Our U.S. and California economic outlooks are summarized in Figure 1 (see page 8). These new projections are more optimistic than our previous forecast (prepared in May 1999), reflecting a variety of positive developments at both the state and national levels.

Recent Developments

Economic growth continues to surpass expectations in 1999, as the U.S. and California economies appear to have both overcome problems associated with Asia's economic crisis, and avoided the resurgence of significant inflationary pressures. At the national level, the ongoing expansion has been led by unexpectedly strong consumer spending, particularly on automobiles and other durable goods. These trends also are evident in California, where taxable sales jumped by more than 9 percent in the first half of 1999—by far the largest increase in the 1990s (see Figure 2, page 8).

Many economists and industry analysts attribute the recent strength in consumer spending partly to the "wealth effect" associated with the major increases in stock market prices that have occurred in the 1990s. Other contributing factors include high levels of consumer confidence, favorable employment conditions for workers, and rising wages during the year.

California's Employment Performance. During the past 12 months, California wage and salary employment has increased by about 3.5 percent. Figure 3 (see page 9) breaks down this job performance among key industries. It shows that the Asian economic crisis had negative impacts on California's manufacturing sector, where jobs fell by 2.8 percent between the third quarter of 1998 and the third quarter of 1999. Job losses were particularly evident in the computer, electronics, and aerospace sectors. Offsetting this decline, however,

Figure 1

The LAO's Economic Forecast 1999 Through 2005

Percent Change (Unless Otherwise Indicated)

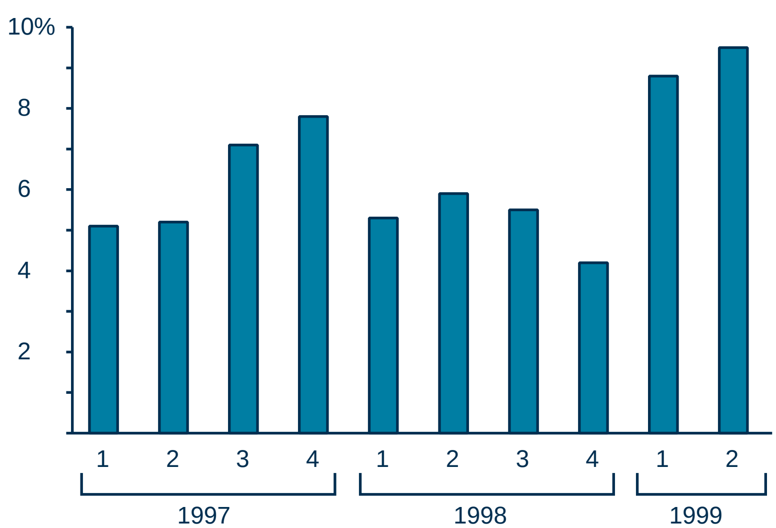
	1999	2000	2001	2002	2003	2004	2005
United States							
Real gross domestic product[a]	3.9%	2.8%	2.6%	2.2%	2.6%	2.4%	2.6%
Wage and salary jobs	2.2	2.7	1.1	1.1	1.2	1.2	1.1
Consumer Price Index (CPI)	2.4	2.8	2.0	2.4	2.5	2.5	2.6
Unemployment rate (%)	4.2	4.2	4.3	4.6	4.7	4.9	5.1
Housing starts (000)	1,675	1,568	1,545	1,499	1,504	1,515	1,510
California							
Personal income	6.7%	6.1%	5.5%	5.2%	5.4%	5.7%	5.6%
Wage and salary jobs	3.5	3.1	2.5	2.2	2.3	2.4	2.4
Taxable sales	8.1	5.5	5.2	5.0	5.3	5.5	5.5
Consumer Price Index (CCPI)	2.9	3.1	2.5	2.7	2.8	2.8	2.9
Unemployment rate (%)	5.3	4.7	4.8	5.1	5.2	5.2	5.3
New housing permits (000)	139	153	165	170	175	180	190

[a] Data do not reflect late-1999 revisions to the National Income and Product Accounts.

Figure 2

Recent Growth in California Taxable Sales

Year-Over-Year Percentage Change, by Quarter



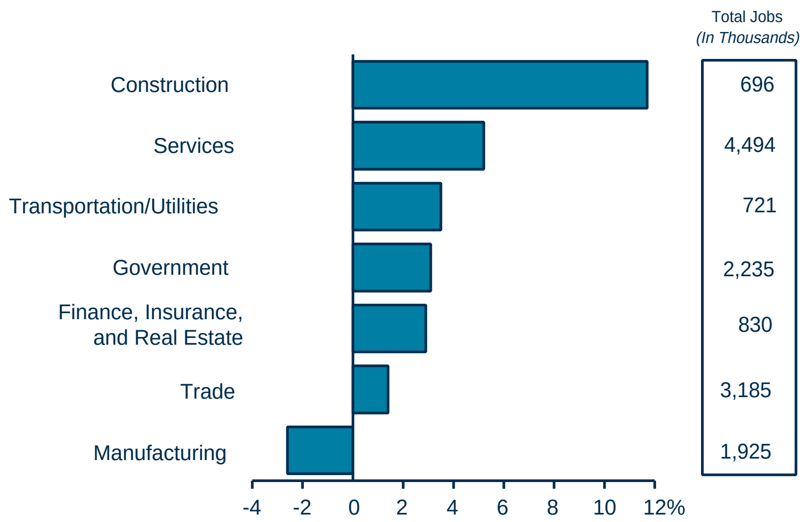
were widespread gains in nonmanufacturing industries such as construction, services, finance, and transportation. These latter industries benefited from high levels of consumer and business confidence and spending in the state. The software side of the computer industry experienced particularly healthy growth during the year. The business services sector, for example, is up about 7 percent from the prior year, reflecting major gains in software development, computer systems design, and Internet-related business.

In other California developments, home sales and new construction continued to rebound in

Figure 3

All Industries Except Manufacturing Growing in 1999

Percent Change in Jobs
Third Quarter 1998 Through Third Quarter 1999



the first three quarters of 1999. Likewise, withholding receipts, which provide a good indication of current trends in wages and stock-option income, were up 14 percent in the July-through-September period.

Is Inflation Lurking? Despite the fact that the U.S. economy has been operating at near-full capacity for several years, inflation has remained subdued, held in check by high rates of productivity growth and low commodity prices. In recent months, though, increasing wholesale prices and compensation costs suggest that inflationary pressures are beginning to build. These factors have already prompted the Federal Reserve (FED) to raise interest rates in an attempt to slow the economy to a more noninflationary pace. Assumptions about the success of these efforts are very important elements in the near-term economic outlook.

U.S. Outlook

Near-Term Outlook (1999 Through 2001). Our forecast assumes that the FED will be successful in its efforts to slow the economy to avoid inflation. As shown in Figure 1, we project that real gross domestic product (GDP) growth will slow from 3.9 percent in the current year to 2.8 percent in 2000, and further to 2.6 percent in 2001. The figure also shows that while projected inflation does accelerate modestly in 2000, it subsequently comes back down as economic growth subsides.

Longer-Term Forecast (2002 Through 2005). After dipping to 2.2 percent in 2002, we forecast that economic growth will slightly rebound to roughly 2.5 percent annually through the remainder of the forecast period. The outlook for these latter years is tied to assumptions about growth in the work force (estimated to be about 1 percent per year) and worker productivity (roughly 1.5 percent to 2 percent annually). Our forecast assumes that inflation, as measured by the Consumer Price Index, remains in the range of 2.5 percent to 3 percent per year during the 2002 through 2005 period.

California's Outlook

Near-Term Forecast (1999 Through 2001). We expect that economic growth in California will follow the same general pattern as for the nation, with income, employment, and spending expanding by solid, but moderating, rates through 2001. As shown in Figure 4 (see page 10), we expect that economic growth in California will exceed the national average significantly during this period.

A key reason for this is that California is in an earlier stage of its business cycle, having emerged from the recession about two years later than the rest of the nation. Because of this, many industries and geographic regions within the state have a bit more "room" to grow before reaching labor supply constraints. Another factor is that, while home construction is expected to slow nationally, strong demand should keep home building on an upward track in California through the forecast period (see Figure 5). Finally, California's computer and electronics manufacturers will likely benefit from improving economic conditions in Asia, and the expected continuation of generally strong business investment in high-tech labor-saving equipment.

Longer-Term Outlook (2002 Through 2005). Our longer-term forecast assumes that California's economy continues to grow at a moderate pace through 2005. Our current projections assume that economic growth in the state will continue to exceed that for the nation as a whole, reflecting faster population growth and the state's favorable mix of high-tech industries.

Where Could the Forecast Go Wrong?

Our U.S. and California forecasts have both upside potential and downside risks.

Figure 4

California Economic Growth to Outpace the Nation

Year-Over-Year Percent Growth in Personal Income 1995 Through 2005

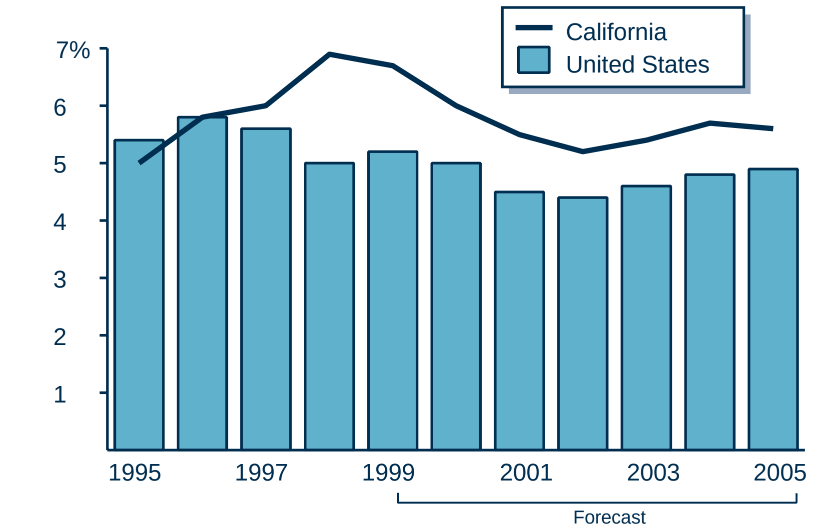
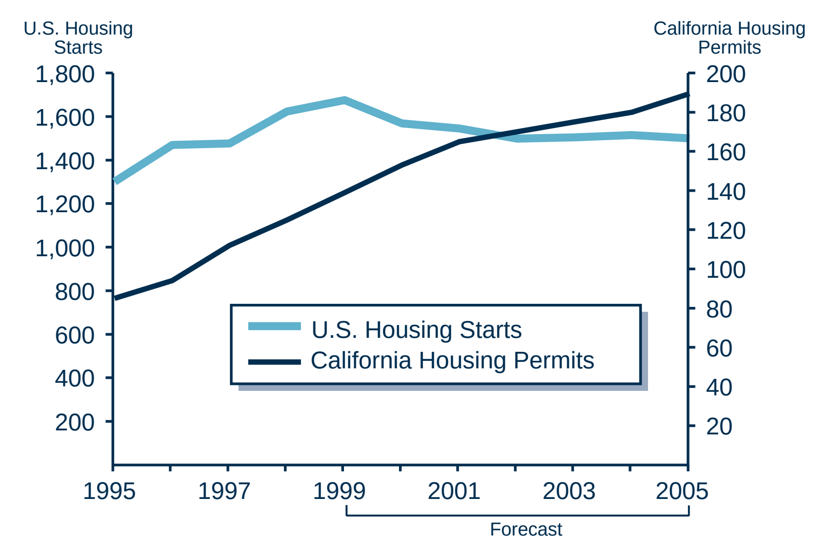


Figure 5

Contrasting Trends in U.S. and California Homebuilding

(Thousands of Units)



On the upside, although our current projections assume slightly higher productivity growth over the long term than our previous forecast, there are some economists who believe that large investments in new technologies will *substantially* raise productivity on an ongoing basis. This would imply that instead of a 2.5 percent to 3 percent "speed limit" for long-term economic growth, the U.S. economy could grow by more than 3 percent annually without incurring significant inflation.

On the downside, the national economy is currently in its ninth year of expansion, and is just three months shy of surpassing the 1960s' expansion—the longest on record. Given the advanced age of the expansion and the recent emergence of some inflationary pressures, many economists believe that the economy is vulnerable to unforeseen shocks, and could experience a downturn sometime in the next several years.

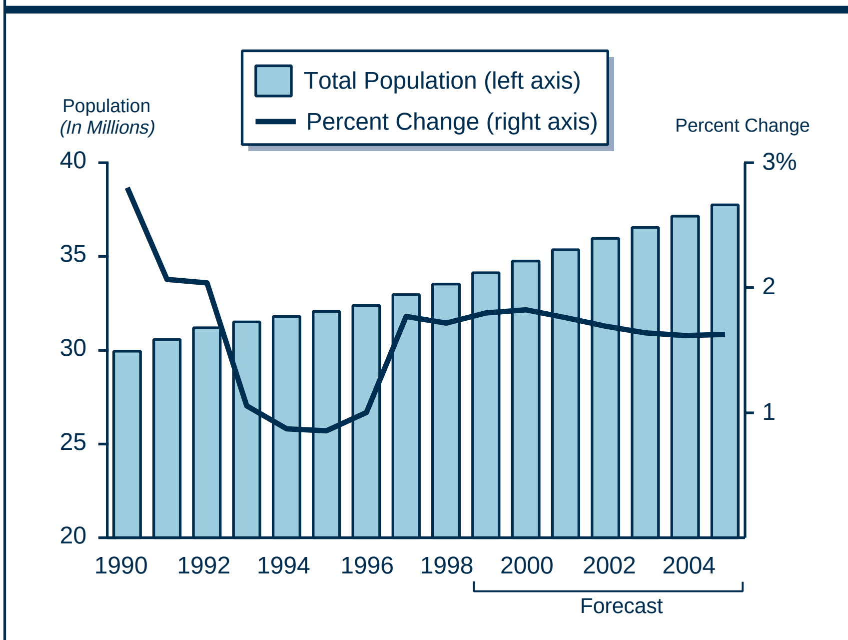
THE DEMOGRAPHIC OUTLOOK

California's population, estimated to be 34.1 million in 1999, is projected to grow at an average annual rate of 1.7 percent during the next six years. Thus, it will reach 37.7 million by the year 2005. In numerical terms, this increase represents about 3.6 million new residents—a population slightly smaller than the City of Los Angeles. California's population growth rate will be roughly double the national rate in each of the next six years.

Our year-to-year demographic projections are shown in Figure 6, which depicts both our projected total annual population and yearly percent changes. The projected pace of population growth is faster than what occurred in the first half of the 1990s, but is slower than the 2.3 percent pace of the 1980s.

Figure 6

California's Population to Exceed 37 Million by 2005



Population Growth Components. California's population growth can be broken down into two major components—*natural increase* (the excess of births over deaths) and *net in-migration* (persons moving into California from other states and countries, minus people leaving the state for other destinations).

Natural Increase. The natural-increase component is projected to account for slightly over half of the state's total population growth, averaging about 309,000 persons per year. This amount is similar to recent levels and slightly above that of the 1980s, but significantly less than for the early 1990s, when natural increase averaged nearly 400,000. The decline largely reflects the aging of the baby boomers past their years of peak fertility, as well as declines in birth rates within younger age groups—especially the 15-to-19 age range.

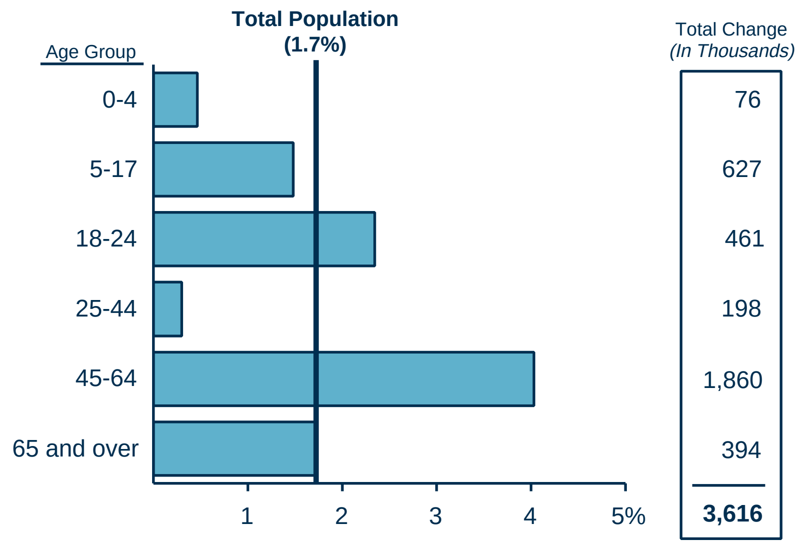
Net In-Migration. We project that net in-migration will average about 290,000 per year during the forecast period, or slightly less than half of the projected total population increase. Current and projected net in-migration is significantly higher than for the recessionary years of the early 1990s, when it actually turned negative for three consecutive years.

Growth to Vary by Age Group. Figure 7 shows our population growth projections over the forecast period by broad age categories, both in 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. In percentage terms, the 45-to-64 age group again leads the way, followed by 18-to-24 year olds.

Figure 7

Population Growth to Vary Significantly by Age Group

Average Annual Percent Change
1999 Through 2005



These various age-group demographic projections have significant implications for the state's expenditure outlook in many different program areas, including education, health, and social services. For instance, 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, respectively.

Chapter 3

Revenue Projections

The state's revenue outlook has improved substantially over the past several months, due to the combination of (1) higher 1998-99 year-end accruals, (2) a stronger near-term California economic outlook, and (3) higher current cash-receipt trends. Our revenue forecast is discussed below and summarized in Figure 1.

THE REVENUE FORECAST

Prior-Year (1998-99) Revenues. In the prior year, revenues are estimated to be $58.6 billion, which is $687 million more than assumed in the *1999-00 Budget Act.* The higher total is primarily related to lower-than-expected personal income tax (PIT) refunds and higher-than-expected sales and withholding tax receipts during the first three months of this fiscal year—which were attributable to tax liabilities occurring in 1998-99 and, thus, were accrued back to the prior year.

Current-Year (1999-00) Revenues. We forecast that General Fund revenues will reach $64.8 billion in the current year, a 10.6 percent increase from 1998-99. Relative to the budget estimate, our projections for the current year are up by nearly $1.9 billion, reflecting both stronger near-term economic growth and recent positive trends in receipts from sales and personal income taxes.

Figure 1

The LAO's General Fund Revenue Forecast

(Dollars in Millions)

	Preliminary	Forecast					
Revenue Source	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**
Personal Income Tax	$30,881	$34,200	$36,250	$38,450	$40,550	$43,200	$45,900
Sales and Use Taxes	18,980	20,300	21,400	22,500	23,640	24,920	26,270
Bank and Corporation Taxes	5,725	5,950	6,200	6,520	6,780	7,180	7,550
Other Revenues and Transfers	3,028	4,399	4,056	4,290	4,448	4,519	4,688
Total Revenues and Transfers	**$58,614**	**$64,849**	**$67,906**	**$71,760**	**$75,418**	**$79,819**	**$84,408**
Percent Change	6.6%	10.6%	4.7%	5.7%	5.1%	5.8%	5.7%

Budget-Year (2000-01) Revenues and Beyond. In the budget year, we estimate that total General Fund receipts will reach $67.9 billion, a 4.7 percent increase from the estimated current-year total. Adjusting for receipts from asset sales and other one-time sources in the current year, revenues from ongoing sources are projected to increase by about 5.5 percent, or slightly less than our projected increase in statewide personal income for that same period. Over the longer term, we forecast that General Fund revenues will increase at a moderate rate of about 5.6 percent annually, reaching $84.4 billion by 2004-05.

1999 Tax Legislation

Our revenue estimates include the impact of various tax-related measures enacted in 1999. The main provisions include (1) an increase in the deduction allowed for the cost of health insurance premiums paid by the self-employed, (2) the elimination of the sunset provision for the partial income tax exclusion of capital gains on small business stock, (3) the elimination of the minimum corporate franchise tax for new corporations for the first two years of operations, and (4) an increase in the income tax credit for research and development expenditures. The combined fiscal effects of these measures is a revenue reduction of about $60 million in 1999-00, expanding to around $200 million by 2003-04 and beyond.

The 1999-00 Budget Act also provided for a one-time additional Vehicle License Fee (VLF) reduction in calendar year 2000, which will result in a roughly $250 million increase in state subventions to backfill the local revenue losses resulting from the VLF reduction. Issues related to the VLF are discussed further in Chapter 4.

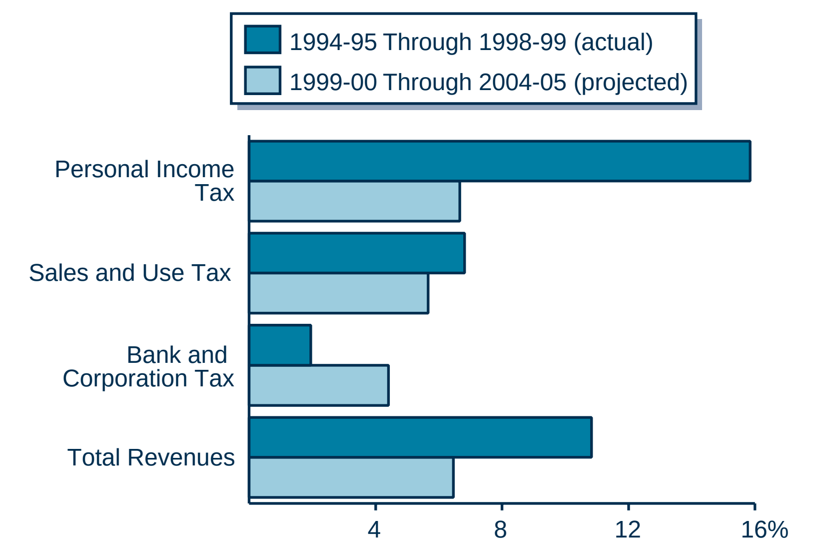
INDIVIDUAL REVENUE SOURCES

By far, the single largest factor affecting the recent and projected future performance of General Fund revenues has been developments involving the PIT. This is illustrated in Figure 2, which compares revenue growth from each of the state's major taxes during two periods—during the first four years of the current expansion covering the 1994-95 through 1998-99 period, and during the forecast period from 1999-00 through 2004-05. It shows that growth in total revenues is expected to moderate during the forecast period, and that most of this slowdown is due to the PIT.

Figure 2

General Fund Revenues, By Source[a]

Average Annual Percent Change



[a] Excludes effect of revenue-related legislation passed in the 1990s.

Personal Income Taxes—Boosted by Rapid Growth at High End of Income Distribution

The dramatic increase in PIT receipts during recent years can be partly attributed to California's overall economic expansion, which has resulted in steady increases in aggregate employment and personal income. However, a second important factor has been particularly rapid increases in incomes reported by taxpayers at the top end of the income distribution. Specifically, from 1994 through 1998, adjusted gross incomes reported by taxpayers filing joint returns in the top 20 percent of the distribution (corresponding to those with earnings of more than $95,000 in 1998) jumped by 62 percent, while incomes reported by taxpayers in the bottom 80 percent of the distribution increased by a more moderate 21 percent.

The increases in earnings at the high end of the distribution have had a major effect on PIT liabilities. This is because under California's progressive tax rate structure (where marginal tax rates increase from 1 percent to 9.3 percent), the earnings reported by high-income taxpayers are subject to tax rates which are several times higher than the tax rates applying to lower- and middle-income taxpayers.

This rapid increase in high-income earnings can be attributed to three main factors:

- First, capital gains realizations (which have historically accrued disproportionately to high-income taxpayers) have increased dramatically, driven by increases in the stock market. As shown in Figure 3, these gains have tripled in recent years, jumping from just over $20 billion in 1994 to over $60 billion in 1998.

- Second, a related factor has been the recent growth in the value of stock options granted to management and highly skilled workers, particularly in high-tech companies that have experienced major increases in stock market values.

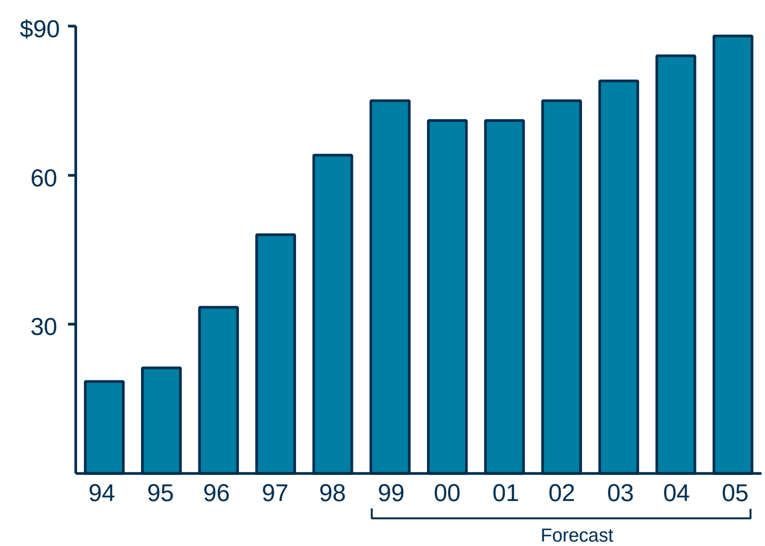
- Third, wages and bonuses of highly compensated employees in various high- tech industries have grown particularly rapidly, reflecting strong competition among firms to attract and retain highly skilled workers.

Looking ahead, after another strong year in 1999, we expect that personal income will continue to grow moderately. We also anticipate that above-average

Figure 3

Capital Gains to Pause After Strong 1999

Capital Gains Reported on California Tax Returns (In Billions)



income gains will continue to occur for high-income taxpayers, but at less rapid rates than in the recent past. Tight labor markets and intense competition for workers will continue to put upward pressure on wages, particularly for highly skilled workers.

A partly offsetting factor is our forecast for more modest increases in capital gains over the next six years, which reflects our assumption that future stock market gains will be less robust than in the recent past. We specifically forecast that after increasing by 18 percent in 1999, capital gains will slip 5 percent in 2000, remain flat in 2001, then increase by about 5.5 percent annually during the balance of the forecast period.

The PIT Revenue Forecast. Based on the assumptions discussed above, we project that PIT receipts will total $34.2 billion in 1999-00, a nearly 11 percent increase from the prior year. Our current estimate is $1.3 billion above the *1999-00 Budget Act* estimate. In 2000-01, we project an increase to $36.3 billion. In subsequent years, we forecast that PIT receipts will increase at an average annual rate of 6 percent, reaching $45.9 billion by 2004-05.

Sales Taxes—Strong in 1999-00, Moderate Thereafter

Collections from the sales tax are currently benefitting from the observed surge in consumer expenditures on durable goods, including automobiles. We estimate that taxable sales in calendar year 1999 will be up by over 8 percent from 1998, the largest increase since 1989.

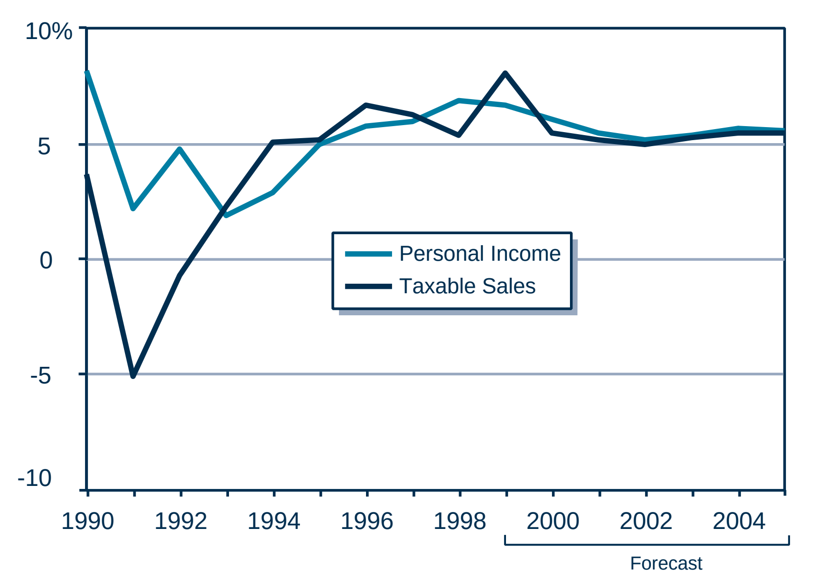
We forecast taxable sales growth to slow to 5.5 percent in 2000, and remain in the general range of 5 percent to 5.5 percent through the balance of the forecast period. The slowdown next year is due largely to two factors: (1) our assumption that gas prices will not experience the same spike in the spring of 2000 as they did this year when various refinery fires resulted in tight supplies; and (2) consumer spending on automobiles, although still strong, will fall slightly from this year's record levels. Over the longer term, we forecast that taxable sales will roughly mirror income growth, increasing by only slightly less than statewide personal income (see Figure 4).

Sales Tax Revenue Forecast. Based on our projections of taxable sales, we forecast that sales tax receipts will be $20.3 billion in 1999-00, a 7 percent increase from the prior year. Our estimate is up $340 million from the *1999-00 Budget Act* forecast.

Figure 4

Taxable Sales to Mirror Personal Income Growth

Annual Percent Change



In subsequent years, we project that revenues will grow by between 5 percent and 5.5 percent annually, reaching $26.3 billion by 2004-05.

Bank and Corporation Taxes—Slow but Steady Growth

Bank and corporation tax (BCT) receipts have increased at a sluggish pace in recent years, despite economic reports of strong company profits. Part of the recent softness has been related to restructurings involving such industries as aerospace, telecommunications, and utilities. Also, the recent slowdown in the state's high technology manufacturing sector had a negative impact on company earnings in 1999.

Looking ahead, we project that California taxable profits will rebound in 2000, reflecting resumed growth in high-tech manufacturing. It should then continue to expand by about 5 percent to 6 percent annually over the balance of the forecast period.

The BCT Revenue Forecast. We forecast that BCT receipts will be slightly less than $6 billion in the current year, a 3.9 percent increase from 1998-99. This estimate is $194 million above the *1999-00 Budget Act* forecast. We project that tax receipts will then rise by 4.2 percent to $6.2 billion in 2000-01. Collections in that year will be affected by both moderate underlying profit growth, as well as the fiscal impact of recent tax legislation passed in conjunction with the 1999-00 budget. Over the longer term, we forecast that revenues from this source will increase by about 5 percent per year, reaching $7.6 billion by 2004-05.

Other Receipts—A Dip in 2000-01, Then Modest Increases

We forecast that revenues from all other sources—including insurance premiums taxes, estate taxes, tobacco and alcohol-related taxes, interest earnings, and a variety of other sources—will jump from $3 billion in 1998-99 to $4.4 billion in 1999-00. This increase is partly related to $562 million in tobacco settlement funds and $180 million in one-time asset sales assumed to be received in the current year. Our forecast for 2000-01 assumes that revenues from these sources will fall to $4.1 billion (reflecting less one-time receipts during the year), and then grow steadily to $4.7 billion by 2004-05.

Chapter 4

Expenditure Projections

In this chapter, we discuss our General Fund expenditure projections for 1999-00 through 2004-05. We first look at general budget trends during the forecast period, and then discuss expenditure projections for each of the major program areas in more detail.

GENERAL FUND BUDGET TRENDS

Distribution of General Fund Spending

Figure 1 (see page 20) shows how General Fund spending is distributed among major programs in 1999-00. Slightly less than half of the total is devoted to education spending, of which 41 percent is for Proposition 98 education (K-14) and about 7 percent is for University of California (UC) and California State University (CSU). Slightly less than one-fourth of the budget is for health and social services, and 6 percent is for corrections. The remainder is for state operations, debt service, various local subventions (including the vehicle license fee [VLF] backfill), and other purposes.

Spending Trends Over the Forecast Period

Total General Fund Spending. Figure 2 (see page 21) presents our General Fund spending forecast by major program area through 2004-05. Total spending is projected to increase from $58.6 billion in 1998-99 to $64.9 billion in 1999-00, then to $67.5 billion in 2000-01. Over the full forecast period, General Fund expenditures are projected to increase at an average annual rate of about 6.1 percent per year, rising to $83.7 billion by 2004-05. This increase includes the impact of increased local subventions associated with VLF reductions. Spending for all programs excluding the VLF subventions grows at a more moderate average rate of 5.3 percent.

Projections by Program Area. The overall 6.1 percent increase in state spending reflects divergent trends among the General Fund's major programs. As indicated in Figure 2:

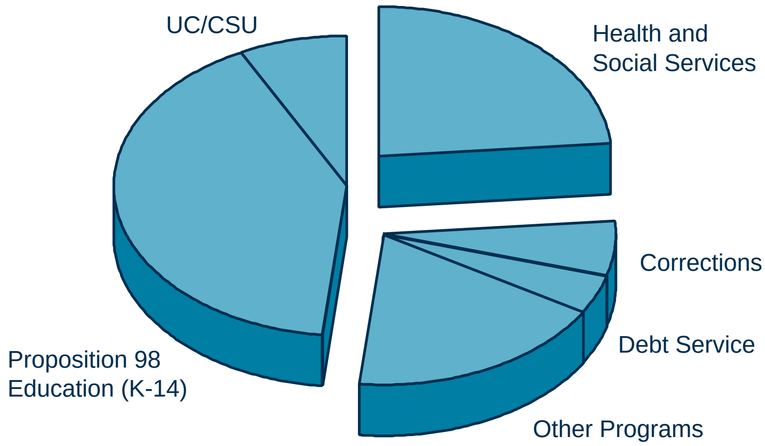
- *General Fund Proposition 98* spending is projected to increase at an average annual rate of 4.8 percent between 1998-99 and 2004-05. The relatively low growth rate of the minimum guarantee is the single most significant factor keeping overall spending growth moderate during the forecast period. The overall increase includes a 6.1 percent jump in the current year, reflecting the

Governor's and Legislature's decision to over-appropriate the minimum funding guarantee, and more moderate gains in the 4 percent to 5 percent range in future years. The moderate future increases are primarily due to declining growth in K-12 school enrollments, which are expected to slow from over 2 percent annual increases in recent years, down to just over 0.5 percent per year by 2004-05.

Figure 1

Education, Health, and Social Services Account for Most Spending

General Fund by Program Area
1999-00



- *CSU/UC* spending is projected to increase at an average annual rate of 5.7 percent during the forecast period. This forecast reflects projected increases in enrollment and inflation during the period.

- *Medi-Cal benefits* are projected to increase at an average annual rate of 6.1 percent during the forecast period. The main factor behind the increase is rising health care costs, which we estimate will increase by about 5 percent per year.

- *CalWORKs* spending is projected to decline in 2000-01, then turn upward and grow at fluctuating rates during the subsequent four years. A key factor holding down state spending during the next two years is the availability of "carryover" balances of unexpended federal and county funds, which are assumed to offset state spending in 2000-01 and, to a lesser degree, in 2001-02.

- *SSI/SSP* spending is projected to increase at an average annual rate of 6.6 percent. The annual growth rate reflects the impact of caseloads and cost-of-living adjustments (COLAs) over the forecast period.

- *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 at an average rate of 8.4 percent. General Fund cost estimates for these programs include the impacts of a projected loss of a portion of the federal funds for the child support enforcement program (due to automation penalties and a reduction in federal incentive payments), the continued phase-in of the Healthy Families Program, as well as caseload and inflation.

Figure 2

Projected General Fund Spending for Major Programs[a]

(Dollars in Millions)

	Actual	Estimated	Projected					Average Annual Growth 1998-99 Through 2004-05
	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	
Education programs								
Proposition 98/K14 education	$24,773	$26,459	$27,758	$29,053	$30,225	$31,539	$32,837	4.8%
UC and CSU	4,505	4,815	5,080	5,393	5,698	5,996	6,289	5.7
Health and Welfare programs								
Medi-Cal benefits	$7,026	7,484	8,035	8,622	9,089	9,531	10,001	6.1%
CalWORKs	2,025	1,997	1,807	1,964	2,214	2,276	2,489	3.5
SSI/SSP	2,244	2,472	2,648	2,792	2,948	3,117	3,289	6.6
Selected other programs	2,967	3,310	3,603	3,973	4,288	4,615	4,824	8.4
Department of Corrections	$3,721	3,958	4,117	4,333	4,530	4,759	4,973	5.0%
Vehicle license fee subventions	$557	1,467	1,780	2,276	3,406	4,193	4,483	41.6%
Debt service[b]	$2,355	2,566	2,774	2,897	2,967	3,015	3,160	5.0%
Other programs/costs	$8,406	10,349	9,878	10,444	10,655	11,024	11,388	5.2%
Totals	**$58,579**	**$64,877**	**$67,479**	**$71,748**	**$76,060**	**$80,064**	**$83,733**	**6.1%**

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

- *California Department of Corrections (CDC)* spending is forecast to grow at an average annual rate of about 5 percent. This moderate growth rate reflects a downward assessment of future inmate population increases. Current estimates by the CDC anticipate annual growth in inmate populations of about 2.1 percent per year through 2004-05. This is about half the annual growth rate we projected one year ago.

- *Debt service* is projected to increase an average of 5 percent per year, reflecting the assumption that about $2 billion in new bonds will be sold annually throughout the forecast period.

- *Other programs/costs* are projected to increase about 5.2 percent per year. Included in this category are contributions to the state employees' and teachers' retirement systems, state operations, and expenditures associated with recent and future employee compensation COLAs.

The state's subvention to local governments to backfill VLF tax relief is projected to increase from $557 million in 1998-99 to $4.5 billion by 2004-05. Our estimates assume that all of the potential future VLF tax reductions previously agreed to will be triggered, lowering the VLF tax rate from 2 percent in 1998 down to 0.65 percent by 2003 and thereafter.

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. In recent years, General Fund spending for CalWORKs has declined, despite increasing costs for welfare-to-work services and support services such as child care. This overall decline in expenditures is due to a combination of caseload reductions and the shift from a federal matching requirement to a block grant in federal Temporary Assistance for Needy Families (TANF) funds. Since 1995-96, General Fund spending on the AFDC/CalWORKs program has decreased by $700 million.

General Fund spending in 1999-00 for the CalWORKs program is estimated to be $2 billion, a reduction of 1.4 percent from the prior year. For 2000-01, we project a 10 percent decrease in General Fund spending. Beginning in 2001-02, we project that General Fund spending will increase each year (by about 8 percent annually), eventually reaching a total of $2.5 billion in 2004-05.

Key Forecast Factors. In 1998-99, unexpectedly slow implementation of the CalWORKs program resulted in a $654 million savings in employment services which were carried over into the budget year. These "county carry-over funds" were counted as a funding source in the *1999-00 Budget Act*. A review of actual expenditures for 1998-99, however, indicates that the county carry-over will be about $300 million greater than anticipated. Thus, we assume those funds ($300 million) will be carried over to 2000-01. In combination with these county carry-over balances, available federal TANF funds, caseload reductions, and a reduction in the TANF maintenance-of-effort requirement (because California is in compliance with federal work participation requirements) will permit California to reduce General Fund spending to $1.8 billion in 2000-01.

By 2001-02, available TANF and county carry-over balances will decline somewhat, resulting in an increase in expenditures to $2 billion in that year. For 2002-03, we project that all carry-over balances will have been exhausted and spending will increase to $2.2 billion. For the remainder of the forecast period, General Fund expenditures will continue to increase, primarily due to costs associated with projected small *increases* in the caseload and providing the statutory COLA, offset by some savings from statutory time limits on aid that result in grant reductions.

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 declined by 30 percent since that time. The caseload reduction was 13 percent in 1997-98 and 12 percent in 1998-99. A caseload reduction of 9 percent is expected for 1999-00, based on partial-year data. We project that the caseload reduction will slow to 7 percent in 2000-01 and 5 percent in 2001-02. We further project the caseload will be flat in 2002-03 and then grow by 1.6 percent in 2003-04 and 2.5 percent 2004-05. These projections are based on (1) a trend analysis of caseloads, birth rates, grant levels, and unemployment rates; and (2) an estimate of the caseload impact of state welfare reform interventions—primarily additional welfare-to-work services and the implementation of the community service work requirement after two years on aid.

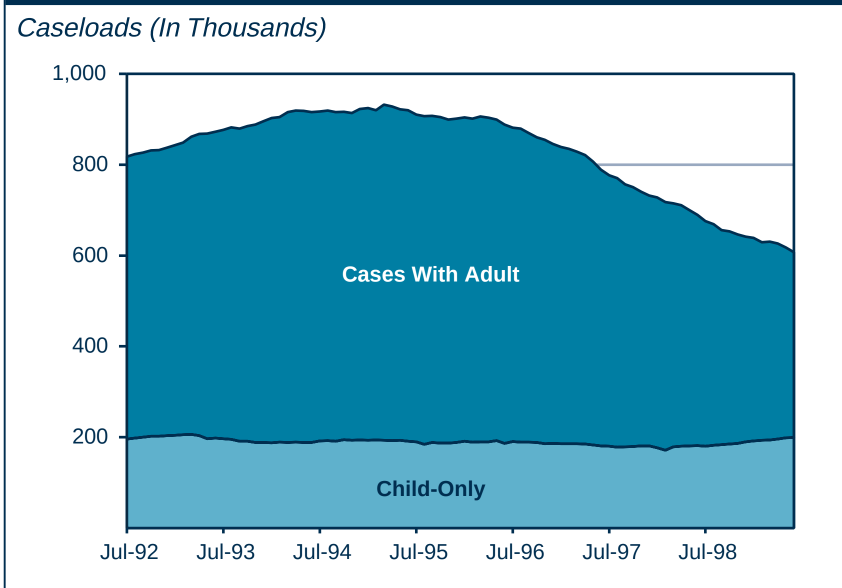
Child-Only Cases On the Rise. While the overall CalWORKs caseload has been declining during the past few years, one segment of that caseload—child-only cases—has been increasing. Examples of child-only cases include situations where the parents are undocumented immigrants or the children are being cared for by a nonneedy relative. In 1995, about 21 percent of the AFDC caseload was comprised of child-only cases. As of June 1999, the percentage of child-only cases had increased to approximately 33 percent. Figure 3 shows that cases with adults have been declining rapidly, while the child-only caseload stayed constant during the early-to-mid 1990s before beginning to increase over the past 18 months.

This trend toward more child-only cases is likely to continue assuming the expanded CalWORKs participation mandate will result in an increased level of sanctions. (The sanction for failure to participate in work or related activities is removal of the adult from the grant calculation, thus creating a child-only case.) The increase in child-only cases has resulted in budgetary savings for two reasons. First, child-only cases have relatively lower grant costs because there are fewer aided individuals in the case. Second, because there is no adult in the case, there is no need to provide welfare-to-work services such as education, training, and child care.

The TANF Block Grant Reauthorization Creates Uncertainty. The TANF block grant is authorized by Congress through federal fiscal year (FFY) 2002. Our forecast presented above assumes that the TANF block grant will be reauthorized at its current $3.7 billion level for California. We note, however, that since the enactment of federal welfare reform in 1996, the number of TANF recipients nationwide has declined by approximately 40 percent, and as a result there have been some proposals at the federal level for reductions in the block grant.

Figure 3

Child-Only Cases Expanding as Share of Total CalWORKs Cases



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 about $2.5 billion in 1999-00, an increase of 10 percent over the prior year. For 2000-01 we project an increase of 7.1 percent, raising total expenditures to $2.6 billion. We project that from 2001-02 through the end of the forecast period, spending for SSP will increase by approximately 5.5 percent per year, eventually reaching a total of $3.3 billion in 2004-05.

Key Forecast Factors. The $228 million spending increase in 1999-00 primarily results from (1) the full-year cost of the Cash Assistance Program for Immigrants (CAPI),which provides state-only funded benefits to certain noncitizens who are not federally eligible; (2) the statutory COLA; and (3) caseload growth. In 2000-01, spending is projected to increase by $176 million. This increase is primarily due to caseload growth ($56 million) and the statutory COLA ($114 million). From 2001-02 through 2004-05, we project spending to increase by an average of $160 million per year, mostly because of caseload growth and the statutory COLA.

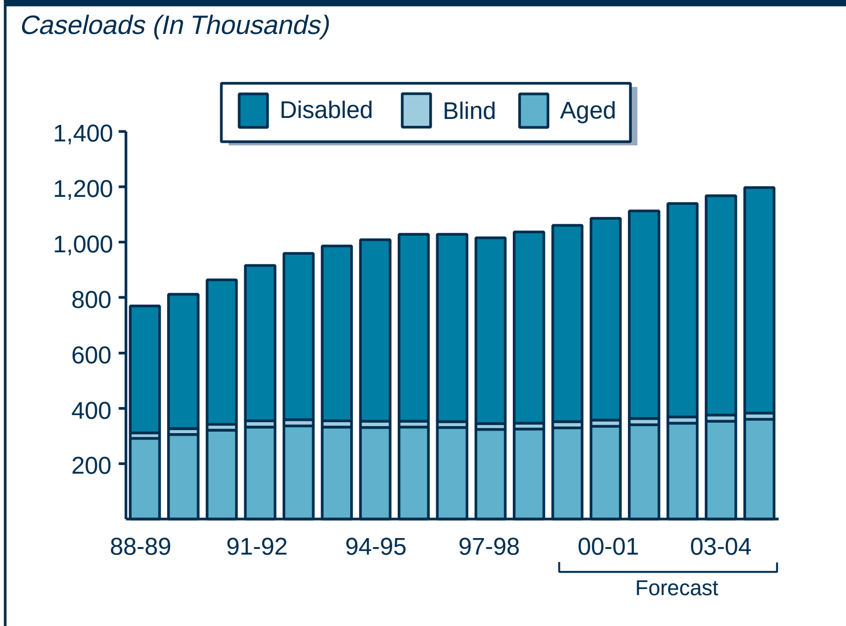
Historical Context. We project that General Fund spending on SSI/SSP will moderate from its current annual average growth rate of about 10 percent to an average of just under 6 percent from 2000-01 through the end of the forecast period. This growth rate is in contrast to trends in the earlier part of this decade. From 1992-93 through 1996-97, annual spending either *decreased* (by nearly 10 percent in some years) or increased by no more than 1 percent. This period of decreasing and/or slow growth in spending resulted from a combination of grant reductions, COLA suspensions, and federal eligibility changes. In 1997-98, spending grew by about 2 percent. For the final two fiscal years of the decade, spending increased by 10 percent annually, mostly due to reinstating the statutory COLA, a 1 percent grant increase above the COLA in 1998-99, and the creation of the CAPI.

Caseload Trends and Projections. During the late 1980s and early 1990s the caseload grew rapidly, with most of the growth being in the disabled component of the caseload (see Figure 4). In the mid-to-late 1990s, the caseload leveled off and declined by 1.2 percent in 1997-98. This period of essentially no growth is partially attributable to federal policy changes that (1) eliminated drug and alcohol addiction as qualifying disabilities, (2) made certain legal noncitizens 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 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 past year. In total, we project that the caseload will grow by about 2.5 percent during each of the next five fiscal years (2000-01 through 2004-05).

Figure 4

SSI/SSP Caseloads Growing Moderately



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 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 almost $7.5 billion in 1999-00, which is $348 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:

- *No Adjustment to Federal Medicaid Matching Rate.* The enacted budget assumed that the federal government would increase the federal matching rate for California's Medi-Cal Program, resulting in a $210 million General Fund savings. The increased matching rate would have corrected an underestimate of the state's population used in the federal Medicaid funding formula. At this time, however, the federal government has not revised the matching rate, nor to our knowledge, is any such action pending. Accordingly, we have not included these savings in our forecast.

- *Delay in Obtaining Federal Family Planning Waiver.* Our forecast includes $61.1 million of additional costs due to a delay in obtaining federal approval of a Medicaid waiver providing 90 percent federal funding for the current state-only family planning program (serving women above the normal Medi-Cal income limits). The budget assumed full-year federal funding under the waiver in 1999-00 for a General Fund savings of $146.7 million. However, the federal government had not approved the waiver as of early November 1999. Our forecast assumes that the waiver will be approved effective December 1, 1999, and thus, be in effect for seven months of the fiscal year.

- *Caseload Increase.* Our estimate includes an additional $26 million net cost for higher-than-budgeted caseloads in the current year. We estimate that the average number of Medi-Cal eligibles will be 82,000 (1.6 percent) above the budget estimate. This extra caseload reflects delays in redetermining Medi-Cal eligibility for former CalWORKs recipients. These recipients were continued on Medi-Cal since early 1998 while the Department of Health Services (DHS) and the counties developed and implemented new Medi-Cal eligibility criteria to comply with welfare reform legislation. We estimate that, as of September 1999, the backlog of these cases totaled about 370,000 Medi-Cal eligibles. Based on information from the department and some counties, our forecast assumes that the counties will complete these redeterminations by June 2000 and that 65 percent of the persons in the backlog will be found eligible to remain on Medi-Cal. The cost of the added caseload ($48.2 million) is partially offset by a reduction in the average cost per eligible due to a shift in the caseload mix, resulting in a net cost of $26 million.

- *Managed Care Rate Increases.* Our estimate includes a total of $54.4 million for unbudgeted rate increases for Medi-Cal managed care plans, which DHS has already granted or is currently developing. After making these adjustments, General Fund spending for Medi-Cal benefits increases by 6.5 percent in 1999-00, compared to the prior year.

We project that by the end of the forecast period in 2004-05, General Fund spending for Medi-Cal benefits will reach $10 billion, an average annual increase of 6 percent.

Key Forecast Factors. Three factors play a major role in our forecast:

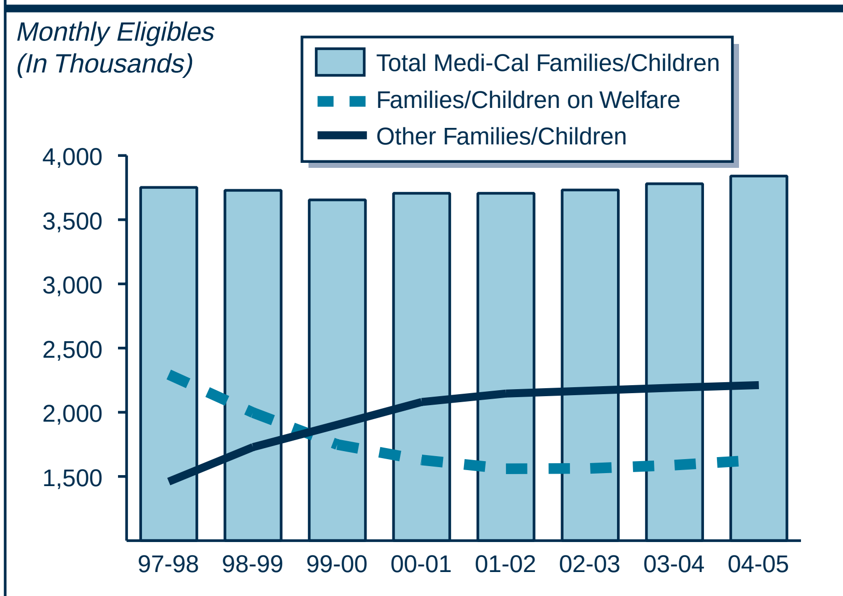
- *Enrollment of Families and Children in Medi-Cal.* The current number of welfare (CalWORKs and AFDC) families and children enrolled in Medi-Cal has been declining over the last few years. Most of this decline to date has been offset by increased enrollment of nonwelfare families and children, generally in low-income working families. As a result, the current year will be the first time that most families and children enrolled in Medi-Cal will not be welfare recipients. Figure 5 illustrates the shift in Medi-Cal enrollment. Our forecast projects that this trend will continue, so that almost all of the decline in the welfare caseload will be offset by an increase in the number of Medi-Cal families and children who are not on welfare.

  These estimates, however, are subject to significant uncertainty for two reasons. First, recent caseload trends are somewhat obscured by the backlog of unprocessed cases of former CalWORKs recipients. These recipients have been retained in the Medi-Cal program pending redetermination of their Medi-Cal eligibility. We have assumed that 65 percent of these recipients will be found eligible for Medi-Cal. To the extent that actual eligibility rates differ from this assumption, our projections would be affected accordingly.

  Second, recent legislation to expand and simplify Medi-Cal eligibility also makes our forecast subject to uncertainty. Chapters 146 and 148, Statutes of 1999 (the 1999-00 budget trailer legislation for health programs) require simplification of the eligibility process and extend Medi-Cal family eligibility to parents in working families with incomes up to 100 percent of the poverty level, effective March 2000. (Children in these families are currently eligible.) Our forecast includes an increase of 76,600 average monthly eligibles in

Figure 5

Most Medi-Cal Families and Children Will Not Be on Welfare



the current year and about 235,000 in subsequent years due to this expansion.

- *Health Care Costs.* In the current year, our forecast assumes that the average cost of health care services per Medi-Cal enrollee will increase by more than 10 percent, consistent with DHS' estimates for the 1999-00 budget. Other purchasers of health care, such as the California Public Employees' Retirement System also are experiencing a jump in health care costs after a recent period of slower growth. Our forecast assumes that the current spike in health care cost will be temporary, and that the cost of health care services provided to Medi-Cal eligibles will increase at an annual rate of 5 percent between 2000-01 and 2004-05. In addition, we have included a modest increase in hospital outpatient rates to recognize the potential for an increase in those rates resulting from a court decision (*Orthopaedic Hospital v. Belshe*).

  These health care cost projections are subject to uncertainty, and small changes in the rate of growth of health care costs could have significant fiscal effects. For example, increasing the annual future growth rate of Medi-Cal costs from 5 percent (as assumed in our forecast) to 6 percent would increase General Fund spending by a cumulative total of $1.3 billion over the forecast period.

- *Census Adjustment to Federal Matching Rate.* The results of the 2000 Census should correct the underestimate of the state's population used in the federal Medicaid funding formula. We estimate that this adjustment will increase the state's federal matching rate beginning in 2002-03. On a cumulative basis through the forecast period, changes in the matching rate result in net General Fund savings of about $550 million.

K-14 EDUCATION

This section reviews our estimates of state Proposition 98 expenditures 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 (CCC). About 80 percent of operations funding for these school programs is from the state General Fund and local property taxes, pursuant to Proposition 98. Public K-12 education is provided to about 5.8 million students—ranging from infants to adults—through over 1,000 locally governed school districts and county offices of education. The CCC provide instruction to about 1.5 million adults at 107 colleges operated by 72 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 slightly less than 5 percent for the forecast period (1999-00 through 2004-05). This is lower than the 8.3 percent increase in 1998-99 and the projected increase of 6.5 percent for the current year. Proposition 98 spending in these two years reflects appropriations *above* the minimum guarantee. For these two years, the cumulative appropriation above the guarantee is about $440 million, which raises the Proposition 98 base for all future years. Our forecast reflects our moderate revenue forecast and future spending at the minimum guarantee level.

Key Forecast Factors. General Fund expenditures for Proposition 98 depend on the following factors: state population, K-12 average daily attendance, per capita personal income, per capita General Fund revenues, and local property taxes. Figure 6 (see page 28) summarizes our assumptions for these factors and the guarantee which results. Our economic

Figure 6

LAO Proposition 98 Forecast

Annual Percent Change

	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
State population	1.8%	1.8%	1.7%	1.7%	1.6%	1.6%
K-12 average daily attendance	1.5	1.2	0.9	0.7	0.5	0.6
Per-capita personal income	4.5	4.5	4.1	3.8	3.8	4.0
Local property taxes	5.9	6.7	6.0	5.6	5.6	5.6
Proposition 98 minimum guarantee[a]	6.5	5.4	5.1	4.5	4.8	4.6

[a] General Fund and local property taxes.

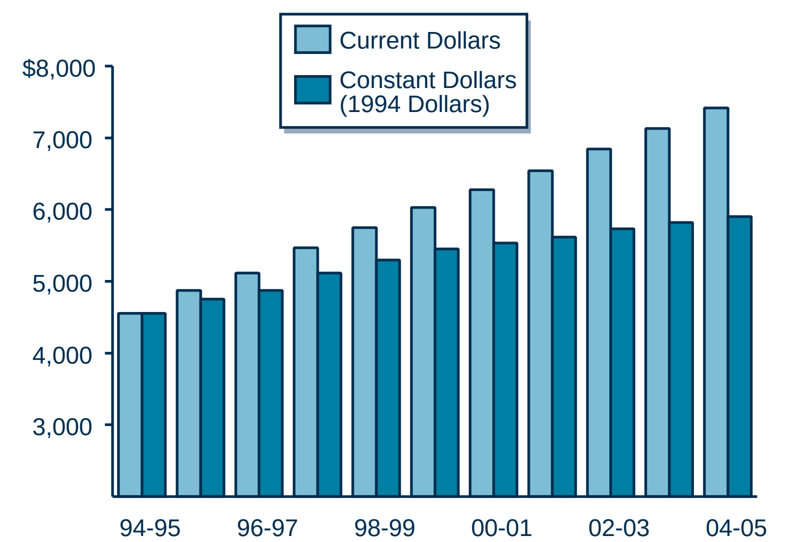
forecast assumes state tax revenues will grow by about 5.5 percent annually over the forecast period.

K-12 Funding Projections. Figure 7 displays our projected K-12 per-pupil spending from 1994-95 through 2004-05 (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 1.6 percent each year between 1999-00 and 2004-05. These additional resources—amounting to over $500 million each year—would permit modest expansion of existing programs and/or funding for some new programs.

Figure 7

Proposition 98 Funding Per Student

Current and Constant Dollars



Community College Funding Projections. Based on our Proposition 98 projections, we estimate total CCC funding will increase by about 5 percent per year over the forecast period. (This assumes no change in the proportion of Proposition 98 funds going to the CCC.) These increases would cover inflation and projected enrollment growth, with little or nothing available for new programs or program augmentations.

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, numerous special research facilities, and a planned tenth campus in Merced. 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, several off-campus centers, and a planned campus at Camarillo. 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 $4.8 billion in 1999-00 to $5.1 billion in 2000-01, or by 5.5 percent. For 2001-02, we estimate that spending for UC and CSU (excluding funding for debt service) will increase to $5.4 billion, or by 6.2 percent compared to 2000-01.

Key Cost Factors. For 2000-01 and subsequent fiscal years, we assume that UC and CSU will receive "base" budget increases equivalent to the growth in inflation and enrollments. Over the forecast period, inflation is projected to average about 2.5 percent annually and enrollment for the two segments combined is forecast to grow an average of about 3 percent per year. We assume student fees at UC and CSU will increase by about 2.5 percent per year to keep pace with inflation.

JUDICIARY AND CRIMINAL JUSTICE

The major state judiciary and criminal justice programs include support for four agencies in the executive branch—the California Department of Corrections (CDC), Department of the Youth Authority, the Department of Justice, and the Office of Criminal Justice Planning—as well as expenditures for local trial courts and state appellate courts. The largest expenditure program—the CDC—is discussed in more detail below.

California Department Of Corrections

The 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 1998-99 and 2000-01 by about $396 million, reaching about $4.1 billion at the end of that period. We further project that annual CDC support expenditures will reach almost $5 billion by the 2004-05 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 $173 million in 1998-99 to $161 million by 2004-05. 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. However, in a change from our past projections, the CDC budget now appears likely to grow significantly more slowly than in the past. Under our new projections, the CDC support budget would grow at an average annual rate of about 5 percent through 2004-05. Throughout the projection period, the CDC General Fund support budget is forecast to be about 6 percent of total General Fund expenditures, the lowest share it has been of the General Fund since 1992-93.

Key Forecast Factors. The continued projected increases in General Fund support for CDC reflect the continued growth in the prison inmate population that is expected during the forecast period. Our estimates through 2004-05 are based on the CDC's projections that the inmate population will exceed 183,000 by June 2005. That represents an increase of as many as 21,000 inmates, or about 13 percent, over the six-year projection period. (The population projections are shown graphically in Figure 8.)

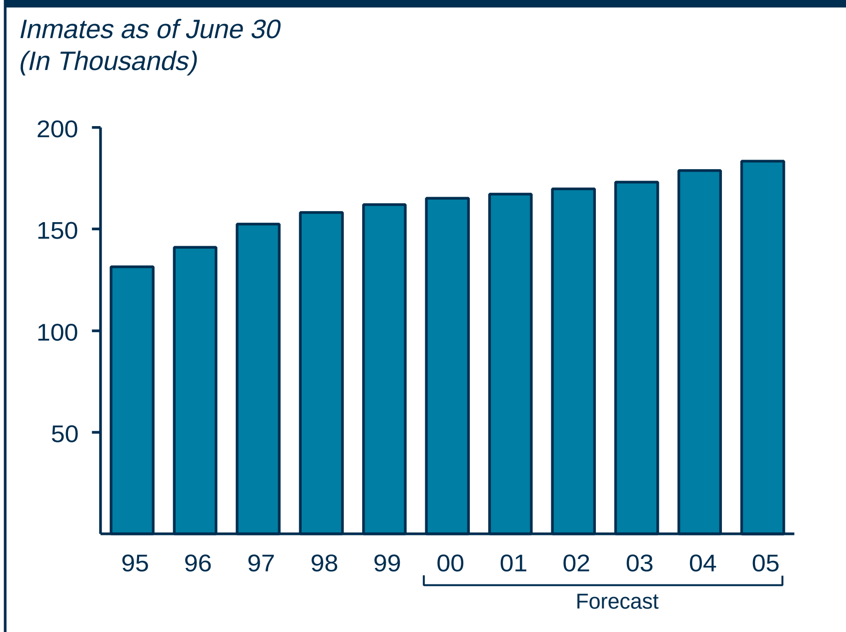
Notably, the inmate population is still trending upward even though the number of offenders being sentenced to prison each year by the courts has dropped somewhat. The continued growth in inmate population is primarily the result of tougher sentencing measures approved by the Legislature, Governor, and the voters, including the "Three Strikes and You're Out" law enacted in 1994. Under the Three Strikes law, many offenders being sent to state prison are receiving longer prison sentences than they would have received in the past for the same crimes.

The projected rate of growth in the inmate population is lower than CDC had foreseen in the past. Just one year ago, CDC expected the inmate population to climb to about 216,000 inmates by June 2005, or by about 33,000 more inmates than it currently projects will be held in state prison as of that same date.

Because the state will have to accommodate 33,000 fewer prisoners by June 2005, the CDC budget will grow less rapidly than would otherwise have been the case. Our projections assume, however, that the savings resulting from a slowdown in the growth of the inmate caseload will be partly offset by significant increases in personnel and other CDC operating costs.

Figure 8

State Prisons Face Moderate Inmate Growth



The slower pace of growth in the inmate population also has significant ramifications for CDC operations. In recent years, faced with continued growth in the inmate population and the overcrowding of its existing prison facilities, the Legislature and Governor approved construction and acquisition of additional space for state prison inmates and initiated new programs intended to prevent inmates released on parole from returning to state custody for new crimes. The markedly slower pace of inmate population growth means that it is now likely that the existing space in the prison system, combined with the steps taken recently to address the long-term prison capacity needs of CDC, will be sufficient to meet the state's prison capacity needs at least until the end of the 2005-06 fiscal year.

A prolonged drop in crime rates, particularly crimes against persons which are likely to result in felony prosecution and a state prison commitment, appears to be contributing to the slower growth in the prison population. A number of factors may be behind the drop in crime, including:

- Holding a large number of offenders in state prison for longer periods of time.
- Demographic shifts, particularly a lull several years ago in the growth in the state's 18-to-24 age group.
- The strength of the California economy and the availability of jobs to persons who might otherwise commit crimes.
- Local law enforcement practices affecting the numbers of persons arrested and convicted of crime.

OTHER PROGRAMS

Vehicle License Fee Backfill

The vehicle license fee (VLF) is an annual fee on the ownership of a registered vehicle in California, levied in place of taxing vehicles as personal property. The revenues are distributed to cities and counties. As part of the 1998 budget agreement, the VLF was permanently cut by 25 percent, with the potential of additional reductions beginning in calendar year 2001 if specific revenue levels (or "triggers") are reached. (These potential reductions range from 35 percent to 67.5 percent.) In order for any of the additional reductions to become permanent, the corresponding revenue triggers need to be reached in two consecutive years.

As part of this year's budget agreement, the cumulative reduction was increased to 35 percent for *calendar year 2000 only*, without affecting the previously agreed to triggers.

For all VLF reductions, cities and counties continue to receive the same amount of revenues as under prior law, with the reduced VLF amounts replaced by General Fund spending. The General Fund will spend nearly $1.5 billion in 1999-00 to backfill revenues to local governments.

Under our current revenue projections, the first trigger will be "pulled," resulting in the continuation of the cumulative 35 percent reduction through calendar year 2001. We are also projecting that each of the maximum attainable reduction levels will be reached through 2003-04. As a result, under our forecast, the VLF cumulative reduction would be 67.5 percent beginning in 2003-04, with a backfill cost of more than $4 billion in that year. Figure 9 (see page 32) shows the estimated VLF backfill expenditures under our forecast, as well as the corresponding VLF reduction percentages.

Debt Services

Debt Payments. As shown in Figure 10, we estimate that General Fund debt costs (for general obligation and lease-payment bonds) will increase from $2.4 billion in 1998-99 to about $3.2 billion in 2004-05. This is an average annual increase of 5 percent. Our forecast assumes that almost $15 billion (an average of around $2 billion each year) in bonds will be sold over the forecast period. As a percent of total debt, lease-payment bond debt remains at about 20 percent throughout the forecast period based on currently authorized lease-payment 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 percent in 1998-99. We estimate that with the sale of bonds assumed in our forecast, the debt ratio will increase to 4.1 percent in 2000-01 and decline gradually thereafter. Sales of a larger amount of bonds resulting from voter approval of more general obligation bonds than we have assumed or legislative authorization of new lease-payment bonds would, of course, increase the debt ratio.

Figure 9

Vehicle License Fee (VLF) Backfill Projected Reductions and Costs

(Dollars in Billions)

Calendar Year	1999	2000	2001	2002	2003
VLF Reduction	25.0%	35.0%[a]	35.0%	46.5%	67.5%[b]
Fiscal Year	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**
VLF Backfill	$1.5	$1.8	$2.3	$3.4	$4.2

[a] Reflects a temporary additional increase.
[b] Both the 55 percent and 67.5 percent reductions would trigger in this year.

Figure 10

Bond Debt Payments Will Increase Steadily

General Fund
(In Billions)