C A L I F O R N I A ' S

Fiscal Outlook

LAO Projections 2001-02 Through 2006-07

November 2001
Elizabeth G. Hill
Legislative Analyst

Foreword

This report provides our projections of General Fund revenues and expenditures for 2001-02 through 2006-07 It includes our independent assessment of the outlook for California's economy, demographics, revenues, and expenditures.

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.

This year marks the 60th anniversary of the Legislative Analyst's Office which was the first of its kind in the nation. This report, in its seventh year of publication, reflects the historical mission of the office to assist the Legislature with its fiscal planning by assessing the revenues and expenditures of the state. 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. **319-8303**

Mac Taylor **319-8301**

Capital Outlay 319-8329

Director .... Mac Taylor

Higher education facilities .... Paul Guyer

Corrections facilities .... Chris Guyer

Natural resources infrastructure .... Steve Lehman

Criminal Justice and State Administration 319-8349

Director .... Greg Jolivette

Adult corrections .... Yvonne Choong

Courts .... Stephanie Marquez

Juvenile/local criminal justice .... Jeff Cummins

Information technology and state administration .... Anna Brannen

Economics, Taxation, and Fiscal Forecasting 319-8319

Director .... Jon David Vasché

Economics/forecasting .... Brad Williams

Budget overview/demographics/energy .... Keely Martin Bosler

Taxes .... Mark Ibele

Higher Education 319-8339

Director .... Steve Boilard

UC/financial aid .... Sona Nagar

Community Colleges .... Steve Boilard

CSU/Teacher training .... Jennifer Kuhn

K-12 Education 319-8339

Director .... Robert Turnage

Proposition 98 .... Robert Turnage

Compensatory education/childcare .... Anthony Simbol

School reform/accountability .... Robert Manwaring

Revenue limits/special education .... Jennifer Borenstein

Instructional materials/health-related programs .... Rebecca Ronquillo

Health Services 319-8349

Director .... Daniel C. Carson

Medi-Cal—families/children .... Farra Bracht

Medi-Cal—elderly/disabled .... Tiffany Reyes

Public health/Healthy Families .... Lisa Folberg

Mental health .... Daniel C. Carson

Social Services 319-8319

Director .... Todd Bland

CalWORKs .... Kasia O'Neill

Child welfare, child support .... Mary Adèr

Aged, blind, and disabled/employment programs .... Todd Bland

Local Government 319-8319

Director .... Mac Taylor

County and city fiscal affairs .... Marianne O'Malley

County and special district fiscal affairs .... Michael Cohen

Resources and Environmental Protection 319-8329

Director .... Mark Newton

Land acquisition/habitat protection .... Jason Weller

Air quality/solid and hazardous waste .... Catherine Freeman

Wildlife/parks/forestry .... Jenny Giambattista

Transportation, Business, And Labor 319-8329

Director .... Dana Curry

Gambling/consumer protection .... Bill Herms

Business regulation and development .... Todd Clark

Transportation financing/highways .... Joel Riphagen

Public Transportation/traffic enforcement .... Sam Delson

Table of Contents

Chapter 1

The Budget Outlook

SUMMARY

The current recession and declining stock market values are having devastating impacts on California's budget outlook, largely due to shortfalls in revenues. Figure 1 tells the story in a nutshell. It shows that after increasing 22 percent in 1999-00, revenues decelerated to 8 percent growth in 2000-01, and are projected to fall 12 percent in 2001-02—the deepest one-year decline in the post-World War II period. This abrupt revenue fall-off is pushing the state into a major deficit for the first time since the early 1990s. Specifically, we estimate that:

- California will end 2001-02 with a deficit of $4.5 billion, compared to the $2.6 billion reserve assumed in the *2001-02 Budget Act*.

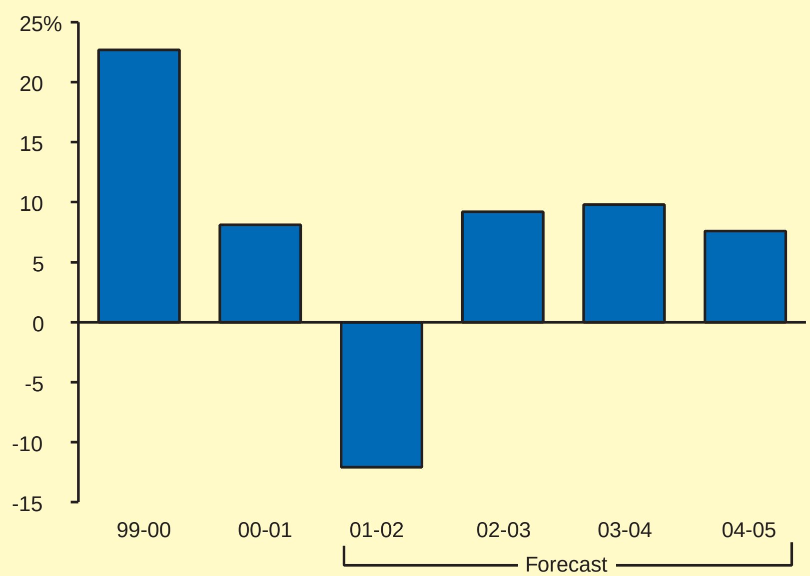
- The 2002-03 budget year faces a shortfall of $12.4 billion and potentially even more if the recovery we are assuming for next spring is delayed.

- Annual budget shortfalls will persist well beyond 2002-03 absent corrective actions. As a result, it will be necessary to adopt substantial ongoing expenditure cuts and/or revenue augmentations in order to bring the budget back into balance.

Figure 1

Revenues Plunge In 2001-02

Annual Percent Change in General Fund Revenues



KEY FORECAST ASSUMPTIONS

Economic Outlook

Economy Soft Prior to September 11

The U.S. and California economies were on the brink of recession even before the September 11 terrorist attacks, with economic measures such as employment, personal income, and taxable sales having been on a slowing trend since the beginning of 2001. Key factors behind California's slowdown were the national weakness in business investment—particularly in high-tech goods and services—as well as reduced wealth and income related to declining stock market values.

Weakness Intensified Following Attacks

As with the rest of the nation, California's economic downturn accelerated in the weeks following the September 11 attacks. The most severe adverse developments have been in travel-related industries, where, for example, hotel occupancy rates in November remain well below year-ago levels. However, softness is also being experienced in a wide variety of other industry sectors, including manufacturing, real estate, retail sales, and entertainment.

Outlook—Recession That Ends in Spring 2002

Our forecast assumes that the national and state economies are currently in a recession that will last until spring of 2002. The downturn is forecast to be relatively mild in terms of job losses, although the adverse impacts on personal income will be much more pronounced than on employment. This is due to the sharp reduction in stock options-related earnings estimated for 2001 and early 2002. Our forecast is similar to the consensus view that the national and state economies will emerge from the downturn next spring, and that economic growth will accelerate through 2003. We specifically project that California personal income growth will fall dramatically from 9.8 percent in 2000 to 1.7 percent in 2001, before rebounding to 4.2 percent in 2002.

Revenue Outlook

Sharp Falloff Due to Soft Economy and Stock Market Decline

Total revenues are projected to decline from $77.7 billion in 2000-01 to $68.3 billion in 2001-02, a drop of 12.1 percent. Our updated current-year revenue forecast is $6.8 billion below the *2001-02 Budget Act* forecast, reflecting the softening economy and a sharp drop in capital gains and stock options-related revenue. We then expect that the economic rebound will boost revenues by 9.2 percent in 2002-03. Despite this upturn, however, revenues will not regain their 2000-01 level until 2003-04. Over the longer term, we forecast that revenues will grow another 10 percent in 2003-04, then settle into annual increases of about 7.5 percent thereafter.

Delay in Economic Recovery Would Further Depress Revenues

Our forecast is for a relatively short-lived recession. However, there are a number of factors that could deepen and prolong the downturn. These include the ongoing effects of terrorism on spending by consumers, the uncertain timing of the recovery in business investment, and the depressing effects of the stock market's losses on wealth and spending. Given the considerable sensitivity of state revenues to changes in the strength of the economy, a delay in the economic recovery would further hurt the budget's outlook. As an illustration, we estimate that a six-month delay in the recovery—from spring 2002 to fall 2002—would reduce budget-year revenues by $3 billion to $4 billion below our forecast.

General Fund Condition

Figure 2 presents our updated estimates of the General Fund condition for 2000-01 through 2002-03. These estimates take into account our forecasts for state revenues and expenditures that are discussed in detail in Chapter 3 and Chapter 4, respectively. They include our estimated impacts of the Governor's recent executive orders that impose a hiring freeze and reduce procurement spending, as well as legislation enacted this summer. In addition, as discussed in the accompanying box, they assume that the $6-plus billion in General Fund loans used to purchase electricity this past year will eventually be repaid, and thus have no direct impact on the General Fund's condition.

Figure 2

LAO Projections of General Fund Condition

2000-01 Through 2002-03
(In Millions)

		Forecast	
	2000-01	2001-02	2002-03
Prior-year fund balance	$9,139	$6,684	-$3,718
Revenues and transfers	77,684	68,323	74,627
Total resources available	$86,823	$75,007	$70,909
Expenditures	$80,139	$78,725	$82,601
Ending fund balance	$6,684	-$3,718	-$11,692
Encumbrances	$701	$701	$701
Set-aside for litigation	7	100	—
Reserve	**$5,976**	**-$4,519**	**-$12,393**

Budget Outlook For 2001-02

The 2001-02 budget enacted in July assumed that the current fiscal year would end with a reserve of $2.6 billion. However, the $6.8 billion decline in revenues relative to

What About the Money Spent on Electricity?

We have not incorporated any effect from the $6-plus billion in General Fund loans used to purchase electricity on behalf of California's utilities in our estimate of the General Fund's condition. This is because existing law requires that these loans be repaid.

The *2001-02 Budget Act* assumes that this repayment will come from the proceeds of a long-term electricity revenue bond sale. This sale has been delayed several times pending an agreement concerning the revenue stream for paying off the bonds. At this point its timing still remains uncertain. Nevertheless, our forecast assumes that the General Fund will eventually be repaid, whether through electricity bond proceeds or some other means (such as payments by electricity ratepayers).

Although the loan-repayment delay does not itself reduce the General Fund's budgetary balance, it does have fiscal implications from a cash-management perspective. Namely, until the loan repayment occurs, the General Fund will have $6-plus billion less in cash than its budgetary balance.

To acquire this cash so that its day-to-day operations can continue, it will be necessary for the state to borrow an additional several billion dollars from investors to bridge the cash gap. This will pose a special challenge since the General Fund's projected large deficit will already require an unusually large amount of cash borrowing.

the *2001-02 Budget Act* estimate will eliminate the planned reserve and push the state into a deficit of $4.5 billion.

As noted in Figure 2 and illustrated in Figure 3, our forecast for revenues, at $68.3 billion, is more than $10 billion below the estimated expenditure total of $78.7 billion for the year. Aside from its impact on the current-year budget situation, this large operating deficit has serious negative implications for the budget outlook in 2002-03 and beyond. The fact that ongoing expenditures are running $10 billion above ongoing revenues means that—even with healthy revenue increases—large annual excesses of expenditures over revenues will likely persist in future years, absent corrective actions.

Outlook for 2002-03 and Beyond

Basis for Our Estimates. Our revenue and expenditure forecasts for 2002-03 and beyond are based primarily on the provisions of current law. For example, we have adjusted the current-year spending plan for constitutional and statutory funding requirements (such as the Proposition 98 minimum funding guarantee for K-14 education), as well as for projected changes in caseloads, cost-of-living indexes, price levels, federal reimbursement rates, and other factors affecting program costs. We have also adjusted the budget for any one-time spending in the current year.

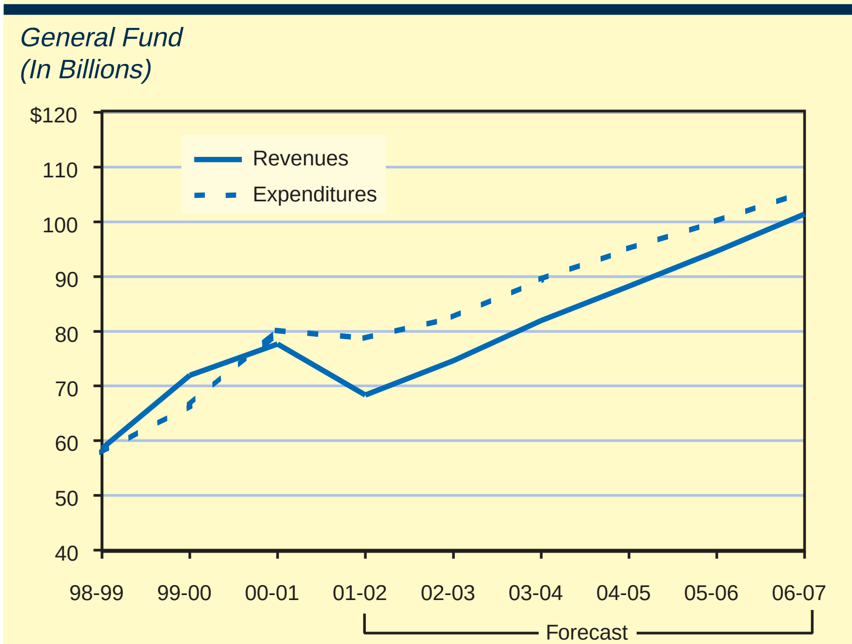
It is important to note that our fiscal estimates are not predictions of what the Legislature and Governor will adopt as policies and funding levels in future budgets. Nor are they our recommendations of what tax and spending policies should be. Rather, they are intended to be a reasonable "baseline" projection of what would happen if current-law policies were allowed to operate in the future. By using this approach, we believe that our forecast provides a meaningful starting point for legislative deliberations involving the state's budget.

The 2002-03 Outlook. As shown in Figure 2, we estimate that:

- Revenues will increase from $68.3 billion in the current year to $74.6 billion in 2002-03, an increase of 9.2 percent.
- Expenditures will grow from $78.7 billion in the current year to $82.6 billion in the budget year, an increase of 4.9 percent.
- Given the faster increase in revenues than in expenditures, we anticipate that the annual

Figure 3

Gap Between Revenues and Expenditures to Persist



operating deficit (that is, revenues minus expenditures) will shrink modestly from $10.4 billion in the current year to $8 billion in 2002-03.

- When combined with the current-year deficit of $4.5 billion, next year’s operating shortfall will push the year-end budget shortfall up to $12.4 billion.

Our expenditure estimate for 2002-03 assumes increases in health and social services programs averaging about 8.5 percent. This above-average increase is due to a variety of factors, including high medical inflation, statutory cost-of living adjustments, and provider rate increases. On the other hand, our forecast assumes that General Fund spending on Proposition 98 increases just 1.6 percent in the budget year, due to the restraining effects of the economic slowdown on the minimum guarantee calculation.

Longer-Term Outlook. Over the longer term, we project that General Fund revenues will grow somewhat faster than expenditures. Specifically, we forecast that revenues will increase at an average annual rate of 8 percent from 2003-04 through 2006-07, compared to annual expenditure increases averaging 6.3 percent. Based on these projections, the annual operating deficit will shrink from about $8 billion in 2002-03 to $4.1 billion by 2006-07 (see Figure 3).

A key factor restraining expenditure growth over the longer term is slowing enrollment in K-12 education, which limits growth in the Proposition 98 guarantee. In other areas, we project above-average increases in Medi-Cal expenditures, reflecting continued rising medical costs and utilization, moderate increases in combined spending on social services programs, and somewhat below-average increases in criminal justice and other state programs. Our out-year estimates include the resumption of $1 billion in General Fund outlays for transportation programs in 2003-04, consistent with legislation enacted in 2001.

Basic Strategies for Addressing the Deficit

As indicated above, the state faces a cumulative shortfall of $12.4 billion in next year’s budget. While the annual shortfalls between revenues and expenditures are projected to shrink some over time, they will remain quite large, absent corrective actions.

Given the persistence of large annual shortfalls into the future, any comprehensive solution to the budget problem would ideally include substantial *ongoing* adjustments to revenues and/or expenditures. Ongoing solutions (that is, revenue or expenditure adjustments enacted in one year that would automatically repeat themselves in future years) could include reductions or elimination of inflation adjustments for programs, permanent reductions in program service levels (such as by reducing caseloads or limiting benefits), or permanent increases in fees or tax rates. As one example, a 2 percent reduction in spending growth during *each* of the next two years (for example, the restriction of inflation adjustments or service reductions) would lower expenditures from our estimates by about $1.5 billion in 2002-03 and $3 billion in 2003-04 and thereafter.

To the extent that ongoing solutions are adopted that cover most of the projected operating shortfalls, the Legislature could use a variety of strategies to address the balance of next year’s shortfall—including one-time adjustments to revenues or expenditures. Examples of one-time adjustments include temporary service reductions, temporary fee increases, or deferrals in scheduled cost-of-living adjustments.

Given the magnitude of the adjustments that will be necessary to address next year’s budget problem, it will be important for the Legislature to consider a wide range of different spending and revenue-related strategies. As was the case in the early 1990s, when an equally large budgetary shortfall existed, the budget-balancing strategies fall into several broad categories. These are summarized in Figure 4.

In the coming months, our office will be assisting the Legislature with possible expenditure and revenue options for addressing the projected budget shortfall.

Figure 4

Strategies for Addressing the Budget Shortfall

✓ **Spending-Related**

- Reductions in the scope and level of state services, including elimination of low-priority programs.
- Consolidation of programs in order to avoid unnecessary duplication.
- Restructuring of programs to achieve greater effectiveness and efficiencies.
- Temporary reductions or suspensions in spending requirements.
- Funding shifts from the General Fund to fees.

✓ **Revenue-Related**

- Temporary tax rate increases.
- Broadening of tax bases.
- Elimination or modification of ineffective or inefficient tax expenditure programs.
- Actions that improve tax compliance, including increased auditing.
- Revenue accelerations, including quicker resolution of disputes with taxpayers.

Chapter 2

Economic and Demographic Projections

Economic and demographic developments in California have important effects on the state's fiscal condition through their impacts on both tax receipts and state expenditures. This chapter presents our economic and demographic projections for 2001 through 2007, which will affect California's fiscal condition during fiscal years 2001-02 through 2006-07.

THE ECONOMIC OUTLOOK

After nearly eight years of economic expansion, California—along with the rest of the nation—entered a recession in the second half of 2001. At this time, we are projecting that the downturn will be relatively modest in terms of employment losses—especially when compared to the prolonged downturn of the early 1990s. However, the recession will have a more pronounced adverse effect on personal income and state revenues than on employment, largely due to the impacts of recent stock market declines on stock options and capital gains.

There also is considerable uncertainty surrounding the current outlook. This relates to such factors as (1) the ongoing effects of the recent terrorist attacks, (2) the dramatic decline this year in stock market wealth, and (3) the uncertain timing of any improvement in U.S. investment spending, particularly on high-tech goods and services. These factors could, individually or collectively, deepen and prolong the recession.

Recent Developments

The National Economy

Before September 11. Even before September 11, the U.S. economy was teetering on the brink of recession. Business spending had been soft all year, and consumer spending also was moderating. While the consensus outlook in early September was that the U.S. economy would narrowly avoid a full-blown recession, most projections put the risk of a downturn at nearly 50 percent. Recent reports on the condition of the U.S. economy immediately before September 11 suggest the economy may have already been in decline.

After September 11. The terrorist attacks pushed the U.S. economy "over the edge" into recession by accelerating the slowdown noted above. Consumer and business spending collapsed in the weeks immediately following September 11, and while there are positive signs that consumer spending has subsequently experienced a partial rebound, most indicators of business confidence and spending remain extremely weak. New orders for manufacturing goods dropped 8.5 percent to a five-year low in September, as businesses cancelled or postponed commitments for aircraft, telecommunications equipment, computers, and other equipment. Layoffs were announced by firms throughout the economy, with particularly large job cuts instituted by companies in the airline, travel, and aircraft manufacturing sectors. Between September and October, the U.S. economy lost 415,000 jobs and the unemployment rate jumped from 4.9 percent to 5.4 percent.

In response to the economy's weakness, the Federal Reserve moved aggressively to lower interest rates, and the President and Congress are considering tax and spending measures aimed at stimulating future economic growth. The timing of any economic rebound, however, remains uncertain.

California's Economy

Before September 11. California's situation prior to September 11 was similar to the rest of the nation. While the state's economy held up well early in the year, private sector employment has been declining in recent months. Prior to September 11, however, the weakness was mainly concentrated in high-tech industries. For example:

- Figure 1 shows that significant job losses were experienced in the manufacturing and business services sectors since the start of the year, which were primarily related to cutbacks in computer and software industries.
- Figure 2 shows that unemployment nearly tripled in the tech-heavy Santa Clara County area during the past year.

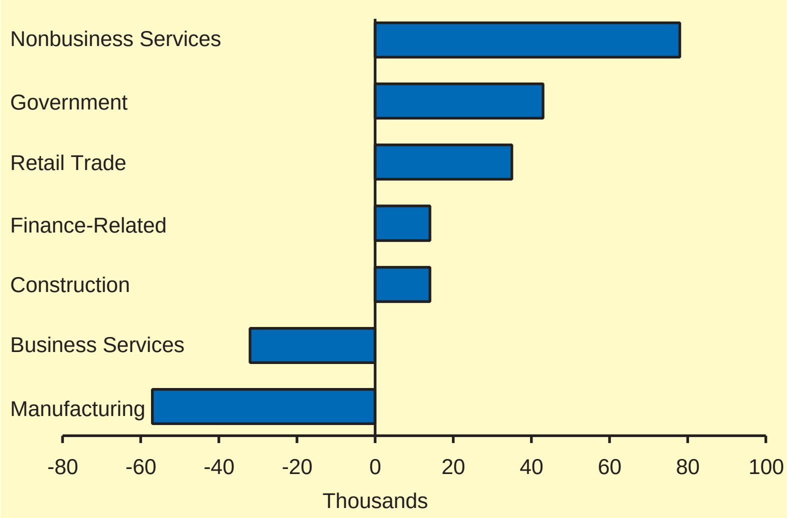
The adverse effects of the state's economic slowdown on sales and income in the pre-September period were more pronounced than for unemployment, with both taxable sales and personal income slipping from their large increases in 2000 to near-zero growth in the first half of 2001. A key factor behind the slowdown in both of these measures was the dramatic decline in stock options-related earnings, which has significantly reduced wealth, income, and spending in the state's economy.

After September 11. As with the nation, the economic slowdown in California appears to have broadened and deepened in the weeks following the September 11 attacks. A recent survey by the San Francisco Federal Reserve of economic conditions in the western states indicates that all sectors in the region slowed sharply immediately after September 11, with the most severe declines reported in the travel-related industries. While some survey

Figure 1

Pre-September 11 Job Losses Primarily in Manufacturing and Business Services

Changes in Seasonally Adjusted Jobs Between January and September 2001



respondents reported that business activity subsequently rebounded, many others indicated that sales remained soft. Other signs of continuing economic weakness include softness in withholding payments, industry reports of extremely low hotel occupancy rates, drops in help wanted advertising, and sharp increases in new claims for unemployment.

The National Outlook

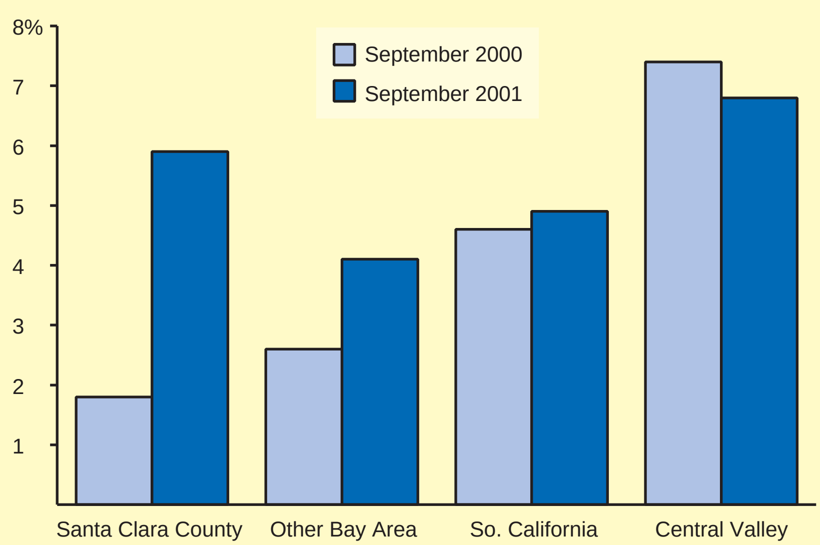
Near-Term Forecast (2001 Through 2003). Our forecast, which is consistent with the consensus of most public and private economists as of late October, is that the U.S. economy will remain in recession through early 2002, but that a rebound will emerge beginning next spring. The main assumptions behind this forecast are that (1) the chilling effects of the September 11 attacks on consumer and business activity will slowly subside, (2) the stimulative effects of federal monetary and fiscal policies will bolster income and spending next year, and (3) businesses will step up spending in 2002 in the information technology (IT) area. As shown in Figure 3 (see page 10), we project that growth in real gross domestic product (GDP) will accelerate from a marginal 0.8 percent next year (reflecting sluggish conditions in the first half and improvement in the second half) to 4 percent in 2003. The unemployment rate, which stood at 5.4 percent in October, is expected to peak at about 6.5 percent in mid-2002, before dropping back to 5.3 percent by the end of 2003. Inflation is expected to subside over the next two years, reflecting the economy's current large amount of unused productive capacity, lessening wage pressures, and stable oil prices.

Longer-Term Forecast (2004 Through 2007). Our longer-term forecast assumes that real GDP will increase at a trend rate of just under 3 percent per year through the end of the forecast period. This average annual growth rate is about three-quarters of what our longer-term outlook assumed last November, reflecting recent downward revisions to productivity gains in the late 1990s. These revisions have in turn caused many economists to reassess downward the prospects for growth in potential output in future years. We also assume that inflation will remain subdued, with the Consumer Price Index increasing at an average annual rate of 2.7 percent in the latter four years of our forecast.

Figure 2

Pre-September 11 Slowdown Concentrated in Bay Area

Unemployment Rates, by Region



California's Outlook

Near-Term Forecast (2001 Through 2003). We expect that the economic downturn in California will continue through early 2002, consistent with the national economy's performance. Factors contributing to the slide include ongoing weakness in high-tech spending, the adverse effects of the

September 11 attacks on the state's travel and tourism-related industries, and the negative impact of recent stock market declines on wealth, income, and spending in the state.

Although both employment and income will experience declines, Figure 4 shows that income will be the hardest hit:

- The downturn in *employment* is projected to be *relatively modest* by historical standards, with job losses totaling about 140,000 between mid-2001 and early 2002. This is about one-third the job losses experienced in the early 1990s' recession.

- In contrast, we expect the *income* declines to be *substantial* in this downturn. As shown in Figure 4, the year-over-year growth in real personal income is projected to fall from a peak of 8.8 percent in early 2000 to a minus 5.2 percent in late 2001. This sharp slowdown is partly due to the reductions in jobs and stock options in the high-paying IT-related sectors of the economy.

On a more positive note, we expect the job and income declines to be relatively brief, especially when compared to the early 1990s, when restructurings in the defense, banking, and telecommunications industries prolonged California's recession. We forecast that employment and income in California will rebound when the national upturn ensues during the spring of 2002. We project that personal income growth will accelerate from 1.7 percent in 2001, to 4.2 percent in 2002 as the recovery takes hold, and further to 7.8 percent in 2003.

Longer-Term Outlook (2004 to 2007). Our longer-term forecast assumes that after rebounding in 2002 and 2003, the California economy will expand at more moderate—but still healthy—rates in the subsequent three years. We expect that growth in jobs and income will outpace the nation during

Figure 3

The LAO's Economic Forecast 2001 Through 2007

Percent Change (Unless Otherwise Indicated)

	2001	2002	2003	2004	2005	2006	2007
United States							
Real gross domestic product	1.0%	0.8%	4.0%	3.1%	2.8%	2.8%	2.8%
Wage and salary jobs	0.5	0.1	1.5	1.6	1.6	1.4	1.4
Consumer Price Index	3.1	2.0	2.4	2.6	2.7	2.8	2.9
Unemployment rate (%)	4.7	5.9	5.4	5.1	5.0	5.0	5.0
Housing starts (000)	1,570	1,480	1,520	1,550	1,590	1,580	1,570
California							
Personal income	1.7%	4.2%	7.8%	6.8%	6.5%	6.4%	6.4%
Wage and salary jobs	1.8	0.4	2.4	2.8	2.5	2.4	2.3
Taxable sales	-2.0	3.9	7.9	6.8	6.3	6.4	6.2
Consumer Price Index	4.3	2.6	2.3	2.8	3.0	3.0	3.1
Unemployment rate (%)	5.4	6.7	6.0	5.6	5.3	5.1	5.1
New housing permits (000)	140	135	158	160	165	165	170

those years, reflecting California's favorable mix of fast-growing industries and above-average rate of population increases.

Risks to the Outlook

There always are a variety of uncertainties associated with making economic forecasts, including what future inflation will be, the likely course of interest rates, and how foreign economies will perform. However, the current forecast faces additional uncertainties that go well beyond those normally encountered. These are in three major areas:

- *Effects of Terrorism*. The main uncertainty here relates to the ongoing effects of the September 11 attacks. The forecast assumes that consumer and business spending will slowly recover to pre-September levels. While there are tentative signs that consumers are being enticed to spend more by price cuts and low-interest loans, businesses currently remain very cautious. Further business cutbacks in employment, production, and investment could undermine the chance for a recovery during the first half of 2002. In addition, further adverse effects could occur to the extent that additional terrorist-related disruptions take place, such as the current problems being experienced with mail delivery.

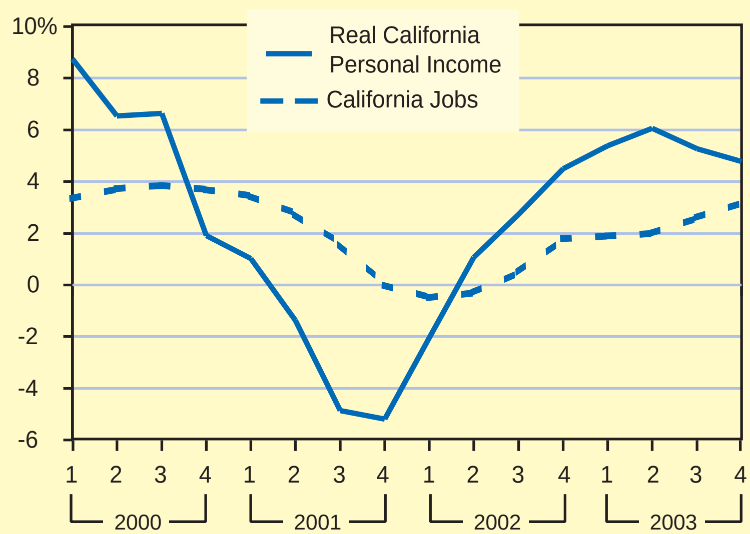
- *Timing of IT Spending Recovery.* A second and related risk involves the timing of an upturn in business investment spending involving IT-related goods and services. The forecast assumes that technologically driven investment in these areas will pick up next year. A delay in this recovery would have negative implications—especially for California, which accounts for about 20 percent of the nation's high-tech industry sector.

- *Stock Market's Effects*. Given the increased importance in recent years that the stock market has played in terms of generating wealth and income in California, the future performance of the market will be a key factor in the timing and strength of California's economic recovery. Our forecast assumes that stock market valuations will increase moderately beginning next year, in turn bolstering the wealth and incomes of Californians from their current levels. Given this, a stagnation or further decline in share values would have a restraining effect on the projected economic recovery.

Figure 4

Recession's Impacts–Mild Job Losses But Severe Income Declines

Year-Over-Year Percent Change, by Quarter



THE DEMOGRAPHIC OUTLOOK

The results of the 2000 Census indicate that California's population totaled around 34 million as the new millennium began. The state's population is projected to grow at an average rate of about 1.5 percent annually over the next six years. This growth is slightly slower than that experienced in the latter part of the 1990s, reflecting both the dampening effects of a slowing economy on net in-migration, as well as a continued decline in birth rates.

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). As indicated by Figure 5, the population growth associated with natural increase accounts for roughly one-half of California's projected annual growth over the forecast period, and is assumed to be fairly stable. Net in-migration accounts for the other half of the growth over the period, but varies with California's economic cycle.

Natural Increase. We project that the natural-increase component will contribute around 270,000 new Californians annually over the forecast period. This amount is slightly less than in the late 1990s due to the ongoing decline of birth rates being experienced by all ethnic groups. Despite declining birth rates, the natural-increase component grows slightly due to significant growth in the female population of child-bearing age groups in faster-growing segments of the population, including Hispanic and Asian women.

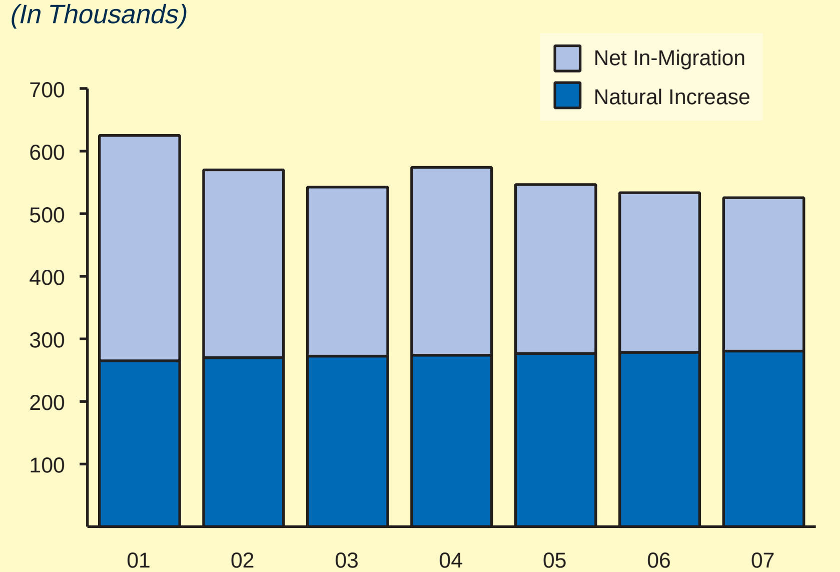
Net In-Migration. We project that net in-migration will average roughly 285,000 annually over the next six years, which is just slightly more than the natural-increase component. As indicated by Figure 5, the population growth associated with net in-migration is projected to decline in the near term due to the slowing of the California economy. However, a modest rebound is forecast in 2004 reflecting the state's projected economic recovery.

Nearly 85 percent of the net in-migration is associated with *foreign* in-migration. Foreign in-migration has remained relatively steady over the past decade and we expect similar levels in the near future, although some decline should result from the economic slowdown.

Figure 5

State's Population Growth to Vary With Economic Cycle

(In Thousands)



Regarding net *domestic* in-migration, this has historically fluctuated with California's economy. For example, California's early 1990s' recession resulted in negative net domestic in-migration, as more people were leaving the state than were moving in from other states. Similarly, we project that the current slowdown of the state's economy again will result in a decline in net domestic in-migration, especially in the very near term. However, domestic migration should rebound somewhat in response to the economy's recovery, before tapering off to its projected long-term level.

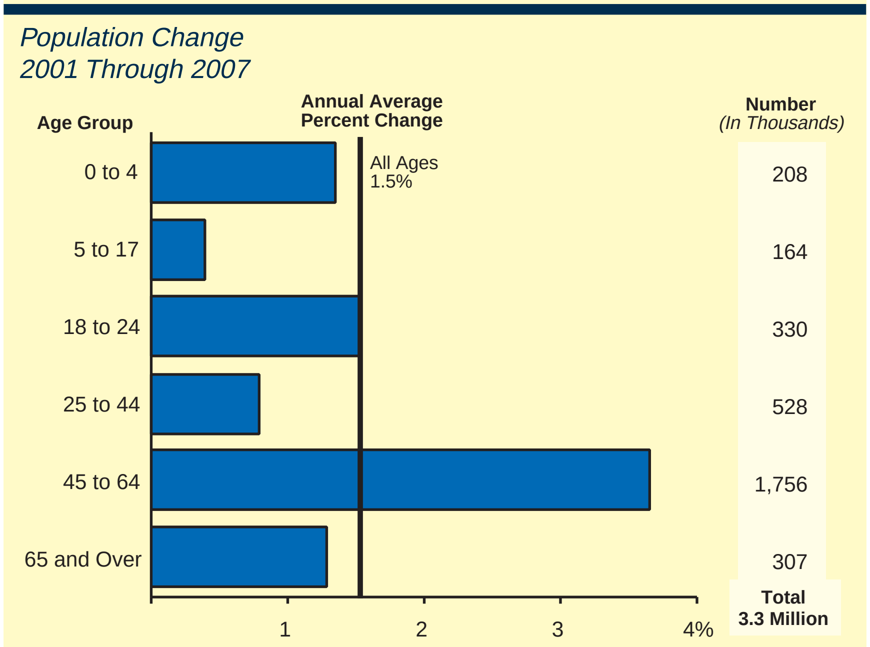
Growth to Vary by Age Group

Figure 6 shows our population growth projections by broad age categories, including both numerical and percentage growth. The 45-to-64 age group (baby boomers) continues to be the fastest growing segment of the population. Nearly 1.8 million new people are expected to move into this age category over the next six years.

These various age-group demographic projections can have significant implications for the state's revenue and expenditure outlook. For example, strong growth of the 45 to 64 age group generally benefits tax revenues since this is the age category that routinely earns the highest wages and salaries. Likewise, the growth in the young adult population affects college enrollments, while that for the 0-to-4 and 5-to-17 age groups drives K-12 enrollment growth over the forecast period.

Figure 6

California's Population Growth, by Age Group



Chapter 3

Revenue Projections

The revenues that finance California's state General Fund budget come from a number of different sources, including various taxes, fees, licenses, earnings on investments, loan repayments, and transfers from other funds. Of these, taxes are by far the most significant, typically accounting for over 90 percent of all revenues. This chapter summarizes our projections for General Fund revenues over the forecast period.

RECENT REVENUE DEVELOPMENTS

California's revenue outlook has deteriorated substantially since the 2001-02 budget was enacted last summer. The budget had already assumed that revenues in 2001-02 would fall by about 3.7 percent from last year's level, reflecting a slowdown in economic activity, and a decline in stock options and capital gains. Since the time of the budget's enactment, however, the economy and stock market have deteriorated more sharply than anticipated, and state revenue receipts have consequently fallen well short of earlier expectations.

Cash Shortfall Already Exceeds $1 Billion

Total cash receipts between May and September were down about $1 billion from the *2001-02 Budget Act* forecast, reflecting across-the-board softness in all major revenue sources. What is particularly disturbing is that most of the weakness so far has been related to economic activity *prior to* September 11, and thus, does not reflect the full effects of the slowdown in sales and income that occurred following the terrorist attacks.

A key indicator of the revenue slowdown is the slide in personal income tax (PIT) withholding. The month-to-month performance of revenues from this source is a very significant indicator of emerging fiscal trends, since the PIT is the state's largest revenue source and monthly PIT receipts reflect current trends in jobs, wages, and stock-option income. As shown in Figure 1 (see page 16), year-over-year growth in this key indicator was running above 20 percent during the peak of California's economic boom in early 2000, but had slid to a *minus* 6 percent as of the third quarter of this year. Other state tax receipts—including sales taxes as well as quarterly income tax prepayments from individuals and corporations—also have exhibited a similar adverse pattern—booming in 2000 but sharply weakening throughout 2001.

THE LAO'S REVISED FORECAST

Dramatic Deterioration Foreseen

Reflecting the recent extremely negative revenue developments and our projected downturn for the state's economy, our updated forecast foresees a dramatic revenue deterioration in the near term. Moreover, although revenues will begin recovering once the economic recovery starts, we do not expect revenues to climb back to their 2000-01 level until 2003-04. Our revenue forecast, presented in Figure 2, is as follows:

- *Prior Year.* Revenues in 2000-01 totaled $77.7 billion, about $318 million below the budget act forecast. This shortfall reflected revenue losses from each of the state's major taxes in May and June.

- *Current Year.* Revenues are projected to total $68.3 billion in 2001-02, a 12 percent decline from the prior year. This amount is $6.8 billion below the *2001-02 Budget Act* estimate, reflecting a dramatic $5.5 billion downward revision to the outlook for PIT receipts, as well as more-moderate declines from the sales and use tax (SUT) and bank and corporation tax (BCT).

- *Budget Year and Beyond.* We forecast that General Fund revenues will partially re-

Figure 1

Withholding Receipts Slowing Sharply

Year-Over-Year Percent Change, by Quarter

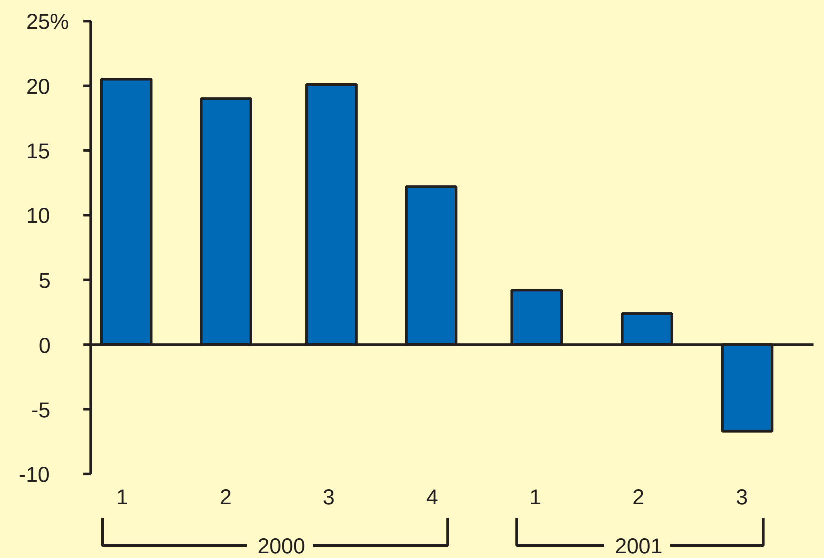


Figure 2

The LAO's General Fund Revenue Forecast

(Dollars in Millions)

Revenue Source	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Personal income tax	$44,776	$36,660	$41,740	$46,530	$50,890	$55,150	$59,480
Sales and use tax	21,292	21,180	23,120	24,980	26,600	28,300	30,100
Bank and corporation tax	6,443	5,220	5,900	6,690	7,160	7,640	8,140
Other revenues and transfers	5,173	5,263	3,867	3,767	3,565	3,536	3,710
Total revenues and transfers	**$77,684**	**$68,323**	**$74,627**	**$81,967**	**$88,215**	**$94,626**	**$101,430**
Percent change	8.0%	-12.1%	9.2%	9.8%	7.6%	7.3%	7.2%

bound from this year's very depressed level in 2002-03, with receipts increasing to $74.6 billion in the budget year. Over the longer term, we project that continued economic growth will boost receipts by roughly 10 percent in 2003-04, and by an average of roughly 7.5 percent in the subsequent three years.

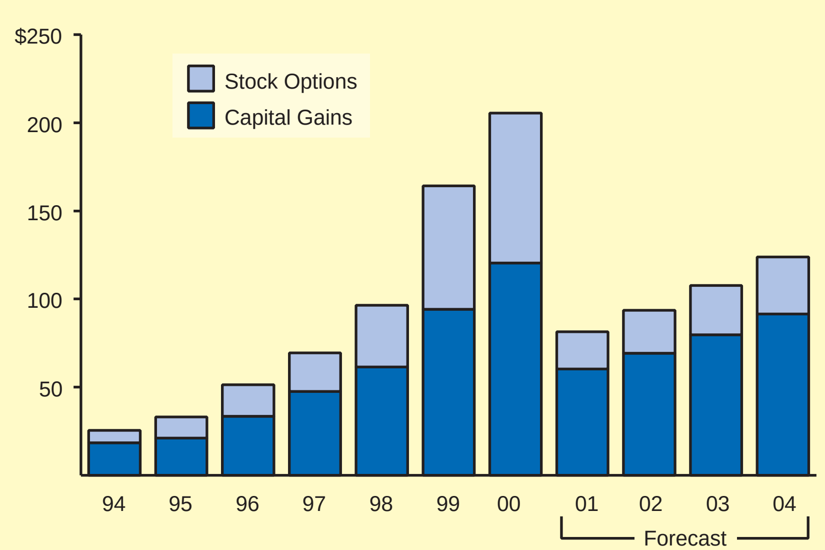
Revenue-Related Legislation

Our forecast reflects the fiscal effects of revenue-related measures that were enacted both in conjunction with the 2001-02 budget and during the summer. These measures included an agricultural and rural tax assistance tax package that exempted from the SUT purchases of farm and forestry equipment, diesel fuel used in farming and food processing, and certain purchases of liquefied petroleum gas. Taken together, these exemptions will reduce General Fund revenues by approximately $40 million annually beginning in 2001-02. Our estimates also incorporate the fiscal effects of legislation signed following adoption of the budget. These measures include SB 17xx, which provides a credit for the installation of solar systems for the production of electricity. The measure will reduce combined PIT and BCT revenues by $20 million in 2001-02 and $35 million in 2002-03. As discussed below, our forecast assumes that the one-quarter cent SUT trigger reduction will be in effect for 2001, but not thereafter.

Figure 3

Capital Gains and Stock Options Tumble in 2001

(In Billions)



INDIVIDUAL REVENUE SOURCES

Personal Income Taxes

After steadily increasing from $16.3 billion in 1994-95 to $44.8 billion in 2000-01, we estimate that PIT revenues will decline to $36.7 billion in 2001-02—a drop of over 18 percent. This current-year decline is, by far, the steepest in the past three decades. We expect that PIT revenues will partially rebound to $41.7 billion in 2002-03. Over the longer term, we project that PIT receipts will increase at an average annual rate of 9.3 percent from 2003-04 through 2006-07, reaching $59.5 billion by the end of the forecast period.

Key Forecast Factors

The single largest factor behind the drop in PIT receipts in the current year is the dramatic decline in capital gains and stock options. As shown in Figure 3, income related to these sources soared from $25 billion in 1994 to over $200 billion in 2000. At their peak, these sources accounted for over $17 billion in PIT revenues in 2000-01, which was over 22 percent of total General Fund revenues during that year.

Based on recent stock market and revenue trends, however, it appears that capital gains and stock options have plummeted in 2001. We are currently assuming that the decline will be about 60 percent this year, with revenues attributable to these sources dropping to about $7 billion in 2001-02.

Why the Sharp Decline? The sharp drop in stock options and capital gains is related to the general drop in stock market valuations over the past year, and in particular, the dramatic drop in share values of California's high-tech companies (which have accounted for the majority of stock-option income

Capital Gains and Stock Options

The dramatic decline in capital gains and stock options is the single most significant factor in the unprecedented drop in General Fund revenues estimated for 2001-02.

What Are Gains and Options?

Capital gains are a form of income recognized on PIT and BCT tax returns that arises from the sale of assets that have increased in value over time. We estimate that roughly two-thirds of total capital gains in California are related to company stocks, with the remainder related to transactions involving bonds, real estate, and other physical assets.

In contrast, *employee stock options* are legal contracts entitling an employee to purchase a fixed number of shares of the employer's stock at a predetermined price (usually the market price on the day the option is granted) for a specified period of time (usually ten years).

Example of How an Option Works

As a simple illustration of how a stock option works, assume that in a given year, an option is granted to an employee to purchase 1,000 shares of the company's stock at its then-market price of $10 per share. Assume further that after a three or four year "vesting period" (that is, a predetermined time period between when the option is granted and when the employee is first eligible to actually exercise the option and purchase the stock), the market price of the company's stock has increased to $30 per share. The tax treatment of this option will depend on whether it is a "nonqualified" or "qualified" option.

- For a *nonqualified* option, the employee must report as ordinary income subject to PIT taxation the "paper gain" on the stock at such time as the option is exercised and the stock is purchased, *even if* it is not subsequently resold and no actual capital gain has been realized. Thus, in our example, the employee would report upon exercising the option, a gain of $20,000 (1,000 shares times the increased stock price per share of $20).

- If, in contrast, it is a *qualified* option, the employee only has to report the gain realized when the stock *is resold*. In addition, if the stock is held for at least one year, a reduced federal preferential capital gains tax rate applies as opposed to the regular tax rate. Thus, qualified options can benefit both from having the taxes on their gains deferred and being taxed at a lower rate. (Qualified options are, however, subject to the federal Alternative Minimum Tax when they are exercised.)

in recent years). As shown in Figure 4, the stock prices of some of the largest of these companies currently are down by over 75 percent from their early 2000 peaks, and in many cases, options granted in recent years are "under water." This means that their current value is less than when they were granted, and thus, there is currently no income associated with them to tax.

Figure 4

Share Prices of Selected Major California Technology Companies

Company	Per-Share Stock Price		Percentage Decline
	March 2000	October 2001	
Cisco Systems	$77	$17	-78%
Intel Corporation	66	24	-64
Sun Microsystems	47	10	-79
Oracle Corporation	44	14	-68
Hewlett Packard Company	78	17	-78
Qualcomm Incorporated	149	49	-67

A second factor behind the decline is that a larger-than-normal proportion of stocks were sold in 2000, as investors and employees attempted to "lock in" gains that had accrued in previous years. This increased taxable income associated with capital gains and stock options in 2000, but also reduced dollar-for-dollar the amount of "stored up" gains potentially available for realization in 2001 and beyond.

Outlook for 2002 and Beyond

One of the key factors affecting the state's long-term revenue outlook is what the strength and timing of the recovery in stock market-related income will be. We forecast that stock prices will partially rebound beginning in 2002, leading to projected 15 percent increases in capital gains and options in both 2002 and 2003. Even with these increases, however, revenues from gains and options are expected to remain well below their 2000-01 peak through the forecast period.

Sales and Use Taxes

Following an increase of 11.5 percent in 1999-00, General Fund revenues from this source remained flat in 2000-01 and are expected to decline slightly in 2001-02. We project that revenues will rebound by 9.2 percent in 2002-03, increasing to $23.1 billion during the year. Over the longer term, we project that sales tax receipts will increase at an average annual rate of 6.8 percent from 2003-04 to 2006-07, reaching $30.1 billion by the final year of the forecast.

Key Forecast Factors

Both policy- and economics-related factors are involved in our SUT projections through 2006-07.

Policy-Related Factors. Three key factors are involved here:

- Collections in 2000-01 were reduced due to a diversion to a special transportation fund of $500 million in SUT receipts from gasoline sales.

- Revenues in both 2000-01 and 2001-02 are affected by the one-quarter cent "trigger" reduction in the SUT rate that occurred for calendar year 2001. This reduction lowered revenues by about $500 million in 2000-01 and $600 million in 2001-02.

- Finally, as noted earlier, SUT receipts in 2001-02 and beyond will be reduced by roughly $40 million annually due to passage of the rural tax relief package in conjunction with the 2001-02 budget.

Economic Factors. Both consumer and business spending have been soft since the beginning of 2001. This reflects several factors, including the general economic slowdown, sharp declines in business spending on capital goods, the loss of stock market-related wealth and income, and the adverse effects of higher rents and energy prices on household budgets.

Due to these factors, total taxable sales growth slowed from 10.9 percent in 2000, to a marginal 1.5 percent during the first half of 2001. Recent monthly data suggest that the softness continued in the third quarter of the year, partly due to the negative effects of the September 11 terrorists attacks on consumer and business spending.

Outlook for 2002 and Beyond

Looking ahead, we project that taxable sales will continue to slide in the fourth quarter, before stabilizing in early 2002, and then turning upward beginning next spring. On an average annual basis, we forecast that taxable sales will decline by 2 percent in 2001, before rebounding by 3.9 percent in 2002 and 7.9 percent in 2003. Over the longer term, we project that taxable sales will increase slightly more slowly than state personal income, averaging 6.5 percent annually over the final three years of the forecast period. Sales and use tax revenues will follow this general pattern.

Bank and Corporation Taxes

We estimate that BCT revenues will fall sharply from $6.4 billion in 2000-01 to $5.2 billion in 2001-02, before partly rebounding to $5.9 billion in 2002-03. Over the longer term, we project that revenues from this source will increase at an average annual rate of 8.4 percent from 2003-04 through 2006-07, reaching $8.1 billion by the end of the forecast period.

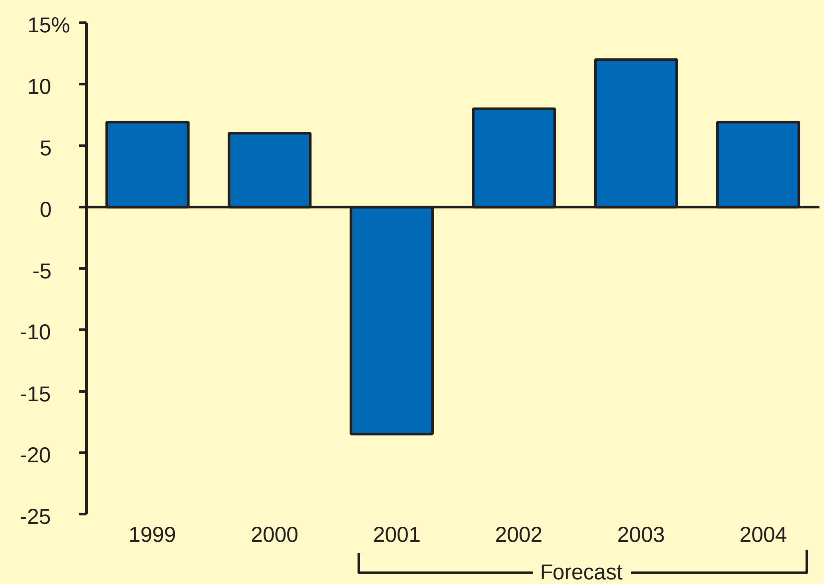
Key Forecast Factors

The current economic downturn is having a dramatic adverse impact on corporate profits. Based on BCT prepayments through September, we estimate that California taxable profits are down by over 18 percent in 2001 relative to the prior year (see Figure 5). Company earnings reports suggest that profits throughout the nation are being squeezed by idle capacity, sluggish sales in both in the U.S. and abroad, falling product prices, heavy debt loads, and high costs for employee health care. The slump in infor-

Figure 5

Profits Hammered by Economic Downturn

Percent Change in California Taxable Profits



mation technology (IT)-related spending is having a particularly negative effect on California's economy and profits. This is because, as noted previously, California accounts for roughly 20 percent of the nation's IT industry.

Looking beyond 2001, we expect that corporate profits will slowly recover beginning next year, accelerate in 2003, and continue to expand at a moderate pace through the balance of the forecast period.

Other Revenues and Transfers

We forecast that revenues and transfers from the General Fund's remaining sources of income will be about $5.3 billion in the current year, or roughly the same level as in 2000-01. We then expect receipts from these sources to fall to about $3.9 billion in 2002-03, and remain in the range of from $3.5 billion to $3.8 billion in the subsequent four years.

Key Forecast Factors

Current-year revenues in the "other" category are being affected by a variety of offsetting factors, including the diversion of tobacco settlement receipts to special funds, and an increase in one-time transfers—a minus $16 million in 2000-01 to over $1 billion this year. Similarly, the revenue decline between the current year and the budget year is related to the assumed reduction in one-time transfers to $100 million. Over the balance of the forecast period, we assume that revenues from most nonmajor tax sources will increase at a moderate rate. The one key exception involves the estate tax. Revenues from this source will decline from $1.1 billion in the current year to near zero by 2005-06, due to federal law changes enacted last spring that will result in the phase-out of California's estate tax over the next four years.

Chapter 4

Expenditure Projections

In this chapter, we discuss our General Fund expenditure projections for 2001-02 through 2006-07. We first look at general budget trends during the forecast period. We then discuss in more detail our expenditure projections for each of the major program areas.

GENERAL FUND BUDGET TRENDS

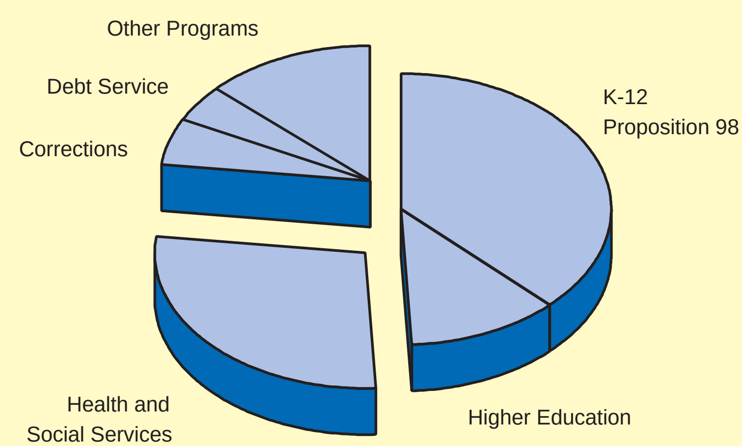
Distribution of General Fund Spending

Figure 1 shows how General Fund spending is distributed among major programs in 2001-02. Education programs dominate state spending, accounting for just less than half of General Fund spending. Of this total, 37 percent is for K-12 Proposition 98 funding and 11 percent is for higher education (including community colleges' Proposition 98 funding). Just over one-fourth of the budget is for health and social services and about 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.

Figure 1

Education, Health, and Social Services Account for Most Spending

General Fund by Program Area
2001-02



Spending Trends Over the Forecast Period

Total General Fund Spending. Figure 2 (see next page) presents our General Fund spending forecast by major program area through 2006-07. Total spending is estimated to decline from $80.1 billion in 2000-01 to $78.7 billion in 2001-02. This decline is the first year-over-year expenditure reduction since 1993-94. Over the entire period, General Fund expenditures are forecast to increase at an average annual rate of 4.7 percent, increasing to $105 billion by 2006-07.

Projections by Program Area. The overall 4.7 percent average annual increase in state spending reflects moderating growth in most program areas. As indicated in Figure 2:

- *K-12 Proposition 98.* General Fund spending is projected to increase at an average annual rate of 5.1 percent between 2000-01 and 2006-07. In the current year, General Fund spending grows 5.7 percent, reflecting full funding for inflation and enrollment growth as well as targeted increases for low-performing schools, expanded child care, a

Figure 2

Projected General Fund Spending for Major Programs[a]

(Dollars in Millions)

	Actual	Estimated	Projected					Average Annual Growth 2000-01 Through 2006-07
	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	
Education programs								
K-12—Proposition 98[b]	$27,221	$28,751	$29,531	$31,094	$33,185	$34,707	$36,647	5.1%
Community Colleges—Proposition 98	2,677	2,687	2,759	2,905	3,101	3,243	3,424	4.2
CSU	2,393	2,538	2,667	2,827	2,996	3,170	3,356	5.8
UC	3,090	3,258	3,349	3,538	3,733	3,929	4,149	5.0
Health and Social Services								
Medi-Cal benefits	$8,442	$8,963	$9,640	$10,522	$11,321	$12,112	$12,962	7.4%
CalWORKs	1,922	2,018	2,069	2,069	2,039	2,039	2,039	1.0
SSI/SSP	2,575	2,855	3,108	3,322	3,481	3,663	3,870	7.0
IHSS	724	915	1,059	1,226	1,418	1,583	1,773	16.1
Other major programs	5,224	6,297	6,819	7,469	8,123	8,532	9,219	9.9
Department of Corrections	$4,240	4,411	4,483	4,687	4,889	5,115	5,360	4.0%
Vehicle License Fee subventions	$3,894	2,315	3,753	4,015	4,317	4,532	4,759	3.4%
Debt service[c]	$2,822	3,333	3,417	3,623	3,756	3,851	3,804	5.1%
Other programs/costs	$14,916	10,384	9,947	12,164	12,709	13,629	14,132	-0.9%
Totals	**$80,139**	**$78,725**	**$82,601**	**$89,461**	**$95,069**	**$100,105**	**$105,494**	**4.7%**

a Detail may not total due to rounding.

b Projections for K-12 and community college Proposition 98 funding have been apportioned by the same percentages as actual funding in the *2001-02 Budget Act.*

c Includes both general obligation and lease-payment bonds for all departments.

settlement of the special education lawsuit, and before/after school programs. General Fund spending in 2002-03 is projected to grow less than 3 percent, due to the impact of the slowing economy on the overall guarantee. For the remainder of the forecast period, K-12 General Fund spending grows more slowly than the overall budget, reflecting slowing K-12 school enrollments.

- *Higher Education (Community Colleges/ California State University [CSU]/University of California [UC]).* Community College Proposition 98 General Fund spending increases at an average rate of 4.2 percent annually between 2000-01 and 2006-07, which should provide adequate funding to cover inflation and enrollment growth. California State University and UC spending are projected to increase annually over the forecast period by 5.8 percent and 5 percent, respectively. These increases are consistent with projected growth in enrollments and inflation during the period.

- *Medi-Cal Benefits.* These are projected to increase at an average annual rate of 7.4 percent. The main factors affecting growth in this program are an assumed 6 percent average annual increase in medical costs and a reduction in the federal matching rate for Medi-Cal benefits. Also contributing to the growth are expenditures associated with projected increases in caseloads of low-income families and children, due to simplified administrative procedures and expansion of eligibility rules adopted in recent years.

- *California Work Opportunity and Responsibility to Kids (CalWORKs).* Spending is projected to increase only 1 percent over the forecast period. This is due to the assumption that expenditures will stay at the minimum funding level required by the federal government through 2006-07. Caseloads are projected to increase in the current year and budget year due to the recession, but partially retreat in subsequent years.

- *Supplemental Security Income/State Supplementary Program (SSI/SSP).* Spending is projected to increase at an average annual rate of 7 percent. This reflects the impacts of caseload growth and statutory cost-of-living adjustments (COLAs) over the forecast period.

- *In-Home Supportive Services (IHSS).* Spending is projected to increase at an average annual rate of 16 percent over the forecast period. The increase is related to recent legislation authorizing wage increases for certain IHSS workers, as well as continued growth in caseloads and in the hours of service provided to recipients.

- *Other Major Health and Social Services Programs.* Spending for these programs, which include the Department of Developmental Services (DDS) and the Healthy Families Program, are projected to increase at an average annual rate of 9.9 percent over the forecast period. General Fund spending for the Healthy Families Program will initially decline because of funding shifts and then increase significantly because of caseload increases. The DDS forecast projects 10 percent annual growth from 2001-02 through 2006-07. This growth is due to increases in caseload and service utilization in the program.

- *Department of Corrections.* Spending is forecast to grow at an average annual rate of 4 percent. This growth reflects an initial decrease in inmate population followed by moderate growth in subsequent years. This reflects the effect of Proposition 36, which is expected to result in the redirection of a significant number of inmates into drug treatment programs instead of prisons.

- *Vehicle License Fee.* Subventions to backfill local revenue losses associated with the VLF tax reduction are projected to increase 3.4 percent over the forecast period. This growth is due to projected increases in vehicle sales and vehicle prices through 2006-07.

- *Debt Service.* These costs are projected to increase an average of 5.1 percent per year. Our estimates assume that the $10 billion in currently authorized but unissued general obligation debt is sold over the next three years.

- *Other Programs/Costs.* These costs are projected to remain virtually unchanged over the forecast period. This is mainly due to the large amount of one-time expenditures that were included in the 2000-01 budget for transportation and other programs. This category also includes contributions to public employees' and teachers' retirement systems, and state operations, which are projected to increase at a moderate rate over the forecast period.

PROPOSITION 98— K-14 EDUCATION

State spending for K-14 education (K-12 schools and community colleges) is determined largely by Proposition 98, passed by the voters in 1988. 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 6 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 1.6 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 average over 5 percent for the 2001-02 through 2006-07 period. This is lower than the 7.8 percent increase in 2000-01 and the projected increase of 5.9 percent for the current year. Proposition 98 spending in these two years reflects appropriations *above* the minimum guarantee ($415 million in 2000-01 and nearly $4 billion in the current year). Our forecast reflects our moderate revenue forecast and future spending at the minimum guarantee level. It also includes a slowing rate of growth in K-12 average daily attendance (ADA), a principal factor in setting the minimum guarantee level.

We estimate that Proposition 98 will require the Legislature to allocate approximately $1.5 billion, or 3.2 percent, more to Proposition 98 programs in 2002-03 than in 2001-02. Since we estimate that almost $1 billion of additional property tax revenue will be allocated to school and community college districts in 2002-03, the General Fund increase would be $500 million (a 1.6 percent increase).

Given the uncertainty surrounding the economy and per capita personal income in the coming year, however, the increase in the Proposition 98 guarantee in the budget year could easily range between $500 million and $2 billion. Assuming the same growth in local property tax revenues, the required appropriations from the General Fund in 2002-03 could range from a *decrease* of $500 million from the current-year General Fund appropriations to an *increase* of $1 billion.

"Freed-Up" Proposition 98 Funds. Within the amounts that we have forecast for Proposition 98 is a total of $600 million that will be available for reallocation to other K-14 education purposes on an ongoing basis beginning in 2002-03. This amount includes $350 million that is currently allocated to a loan repayment relating to the *CTA v. Gould* lawsuit. Another $250 million will become available due to the sunset of the Schiff-Bustamante Instructional Materials Program (Chapter 312, Statutes of 1998 [AB 2041, Bustamante]).

This $600 million of freed up funds represents an additional potential resource for meeting enrollment growth and COLA needs of existing K-14 education programs. We estimate that these enrollment growth and COLA needs will total about $1.5 billion in 2002-03. Our estimate of growth in the total Proposition 98 guarantee ($1.5 billion) would just meet these needs. However, if growth in the minimum guarantee level for 2002-03 falls in the low range of our estimates ($500 million) then even the availability of the $600 million of freed up funds would not permit the Legislature to fully meet enrollment growth and COLA needs within the Proposition 98 guarantee.

Key Forecast Factors. General Fund expenditures for Proposition 98 depend on the following factors: state population, K-12 ADA, per capita personal income, per capita General Fund revenues, and local property taxes. Figure 3 summarizes our assumptions for these factors and the annual changes in the guarantee which result.

Figure 3

The LAO Proposition 98 Forecast

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Proposition 98 (in billions)[a]						
K-12	$40.8	$42.2	$44.4	$47.3	$50.0	$52.6
Community Colleges	4.6	4.7	5.0	5.3	5.6	5.9
Totals	**$45.4**	**$46.9**	**$49.4**	**$52.6**	**$55.6**	**$58.5**
Proposition 98 "Test"	3	2[b]	2	2	2	2
Annual Percentage Change						
State population	1.8%	1.6%	1.6%	1.6%	1.5%	1.4%
K-12 average daily attendance	1.4	1.0	0.8	0.7	0.6	0.3
Per capita personal income	7.8	-1.0	4.5	5.8	5.0	5.0
Total guarantee	5.9	3.2[b]	5.3	6.5	5.6	5.3
General Fund	5.0	1.6	5.3	6.7	4.6	5.6
Local property taxes	8.1	7.1	5.4	6.1	6.1	6.4

a Includes local property tax revenues.

b Includes restoration of $1.5 billion of "maintenance factor."

K-12 Funding Projections. We project that K-12 Proposition 98 funding after 2002-03 will increase by an average of 5.7 percent per year over the forecast period. Figure 4 (see page 28) displays our projected K-12 per-pupil spending from 2001-02 through 2006-07 (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 averaging 1.6 percent each year from 2001-02 through 2006-07. These additional resources—averaging over $800 million each year after 2002-03—

would permit expansion of existing programs and/or funding for some new programs.

Slowing K-12 Enrollment Growth. K-12 ADA is projected to increase by just over 1 percent in 2002-03, bringing total K-12 ADA to over 5.8 million students. As Figure 5 shows, over the next seven years the rate of K-12 enrollment growth is expected to slow, then actually turn negative by 2008-09. This period of slow growth and eventual enrollment decline will ease somewhat the fiscal challenges the Legislature faces in meeting overall state needs.

Community College Funding Projections. Based on our Proposition 98 projections, we estimate total CCC funding would 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 only a small amount available for new programs or program augmentations.

UC AND CSU

In addition to community colleges, the state's public higher education system includes the UC and the CSU. The UC consists of eight general campuses, one health science campus, numerous special

Figure 4

Proposition 98 Funding Per K-12 Pupil

Current and Constant Dollars

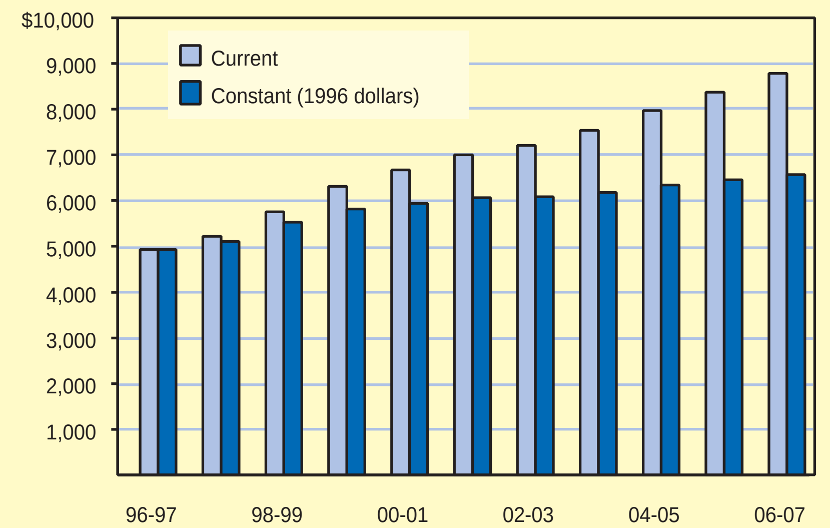
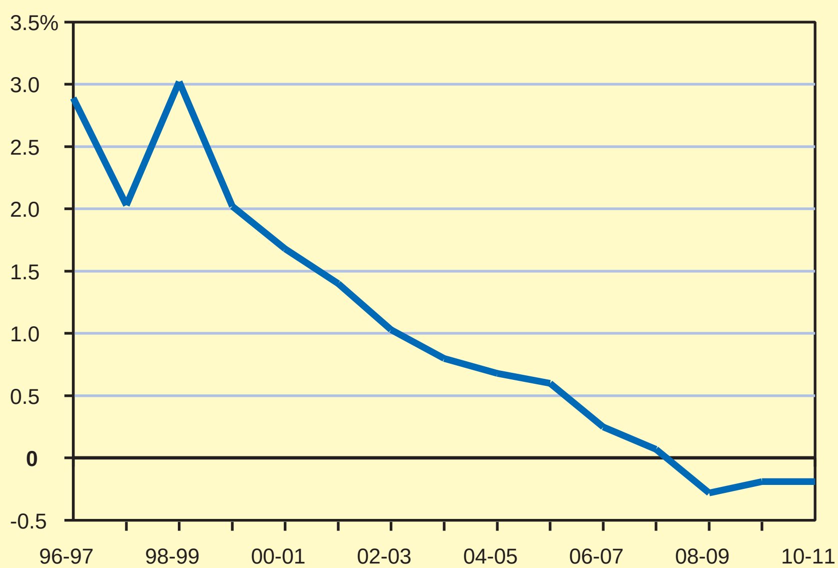


Figure 5

Growth in K-12 Enrollment Will Slow Significantly

1996-97 Through 2010-11



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 capital outlay and debt service) will increase from $5.8 billion in 2001-02 to $6 billion in 2002-03, or by 2.4 percent. By 2006-07, we estimate that spending for UC and CSU will increase to $7.5 billion, reflecting annual increases of about 5.4 percent.

Key Forecast Factors. For 2002-03 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 3.1 percent annually. With regard to enrollment growth, CSU's will vary between 2.6 percent and 3.1 percent over the period, with UC's growth being somewhat less each year.

In his "partnership" with CSU and UC, the Governor committed to annual General Fund base adjustments of 5 percent plus funding for enrollment growth. The Legislature has not endorsed such automatic funding increases. In fact, it is unclear what exactly the partnership means at this time, as the Governor proposed a 2 percent base increase (rather than 5 percent) in his May Revision of the 2001-02 budget. Our projections for the CSU and UC budgets are somewhat lower than would occur under the partnership.

Cal Grant Increases. Chapter 403, Statutes of 2000 (SB 1644, Ortiz), made Cal Grant awards an entitlement for every qualified graduating high school senior. There is much uncertainty as to the fiscal impact of the new entitlement program. This is because it is unclear how students and their families will respond to the changes in Cal Grant policies. Based on information from the Student Aid Commission, however, we project that Cal Grant expenditures could approach $1 billion by 2006-07.

HEALTH AND SOCIAL SERVICES

Medi-Cal

The Medi-Cal Program (the federal Medicaid program in California) provides health care services to recipients of CalWORKs or SSI/SSP grants, and 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 program costs on a roughly equal basis.

The Spending Forecast. We estimate that the General Fund spending for Medi-Cal benefits (excluding administrative costs) will be nearly $9 billion in 2001-02, essentially the same amount appropriated in the budget act. We project that by the end of the forecast period in 2006-07, General Fund spending for Medi-Cal benefits will reach $13 billion, an average annual increase of 8 percent over the projection period.

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

- *Medi-Cal Enrollment Trends.* As shown in Figure 6 (see next page), the caseload of low-income families and children who do not receive cash assistance will continue to grow in 2002-03 as eligibility expansion and simplification changes enacted in 2000-01 are fully implemented. After full implementation, we anticipate that this group will grow commensurate with increases in the state's population. Our forecast also assumes that the economic recession will result in a modest further increase in the families and children's caseloads.

- *Reductions in the Federal Matching Rate.* The federal Medicaid matching rate is based on a state's per-capita income relative to the nation, as determined by census data from the most recently available three calendar years. Because California's economy was especially strong from 1997 through 1999, the state's federal matching rate will likely be reduced by 1.4 percent in 2002, and result in an estimated loss in federal funding of $200 million in fiscal year 2002-03. General Fund spending will have to grow to offset this loss of federal money.

- *Health Care Costs.* Our forecast assumes that the average cost of health care services per Medi-Cal enrollee will decrease by about 5 percent in the current year. This is because families and children being added to the caseload have relatively lower health care costs than other persons eligible for Medi-Cal benefits, such as low-income elderly or disabled persons. Our forecast assumes that this decline in cost per eligible will end and that the cost of most health care services provided to Medi-Cal enrollees will increase at an annual rate of 6 percent from 2002-03 through 2006-07, consistent with past trends. Our projected health care costs are subject to considerable uncertainty and small changes in the rate of growth could have significant fiscal effects.

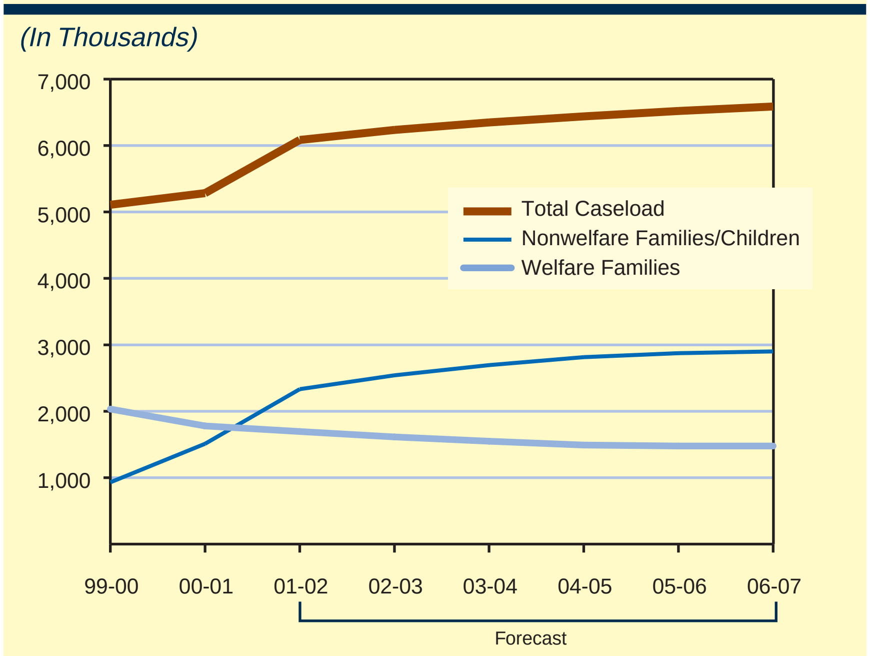
Healthy Families Program

The Healthy Families Program implements the federal State Children's Health Insurance Program, enacted in 1997. Funding generally is on a two-to-one federal/state matching basis. The program offers health insurance to eligible children in families with income below 250 percent of the federal poverty level. Families pay a relatively low monthly premium and are offered coverage similar to that available to state employees.

The Secretary for the California Health and Human Services Agency has submitted a waiver request to federal authorities to expand Healthy Families

Figure 6

Medi-Cal Caseload to Grow Sharply, Then Stabilize



coverage to eligible parents of children enrolled in the Medi-Cal and Healthy Families Programs. At the time these projections were prepared, California's waiver request was pending with federal authorities. The way the state pays for its share of the cost of the Healthy Families Program has changed recently. Previously all state costs were borne by the General Fund. This year, however, the costs of the proposed expansion of coverage to parents, as well as recent expansions of coverage to certain groups of children, have been shifted to a new special fund, the Tobacco Settlement Fund (TSF), which we discuss later in this section. The cost of coverage for most children continues to be funded from the General Fund.

The Spending Forecast. We estimate that overall state spending for the Healthy Families Program will exceed $200 million in 2001-02, about $37 million less than the amount of state funds appropriated for the program in the budget act. We further estimate that overall state spending for the program will increase 90 percent during 2002-03 to about $384 million, and that by 2006-07 the program will have an annual state cost of more than $650 million.

As we noted earlier, part of the state cost discussed above will be supported from the TSF and part from the General Fund. We estimate that General Fund support for Healthy Families will be $134 million in 2001-02, or $24 million less than appropriated in the *2000-01 Budget Act.* We estimate that General Fund spending for the program will increase 30 percent in 2002-03 to $174 million, and that by 2006-07 the program will have an annual General Fund cost of about $227 million.

Key Forecast Factors. General Fund spending is expected to decrease in 2001-02 compared to the previous fiscal year because some program costs that were previously supported by the General Fund were shifted to the TSF. Subsequent increases in General Fund spending are primarily the result of medical inflation and demographic factors. Our projection assumes that program enrollment will peak at 80 percent and 88 percent, respectively, for eligible children and adults in 2002-03.

Our projections assume that the enrollment of parents in the program, which has been delayed beyond the October 2001 date assumed in the budget, will actually commence in April 2002. Phasing-in of the parent caseload accounts for a significant part of the projected 90 percent increase in state expenditures for the Healthy Families Program in 2002-03. Future enrollment growth and demographic factors are expected to increase the cost of coverage for parents so that it accounts for almost half the cost of the Healthy Families Program by 2006-07.

Tobacco Settlement Fund

The 2001-02 budget plan established a new special fund, the TSF, which is made up of revenues received by the state from the settlement of tobacco-related litigation. State law specifies that about $402 million be deposited in the TSF in 2001-02 for various health care programs, with the remainder (approximately $73 million) deposited in the General Fund. In 2002-03 and subsequent years all settlement payments are to be deposited in the TSF for various appropriations for health programs.

Our projections indicate that as much as $56 million of the money allocated to the TSF for the 2001-02 fiscal year will probably go unspent, primarily because the planned expansion of the Healthy Families coverage for parents is occurring more slowly than anticipated. Assuming these unspent funds were carried over into the next fiscal year, it appears that a sufficient amount of money—about $500 million—would be available to support the programs now funded from the TSF in 2002-03.

However, our projections further indicate that the combined cost of these programs would begin to substantially exceed the amount of funding available from the TSF in 2003-04. By 2006-07, the cost of these programs could exceed the amount available from the TSF by more than $380 million, with these costs being borne by the General Fund.

CalWORKs

In response to federal welfare reform legislation, the Legislature created the CalWORKs program in 1997. This program, which replaced the Aid to Families with Dependent Children 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 2001-02 for the CalWORKs program is estimated to be $2 billion, an increase of 5 percent over the prior year. In 2002-03, spending is projected to increase by 2.5 percent, to $2.1 billion. Through the remainder of the forecast period, spending is projected to remain essentially stable, decreasing 1 percent by 2006-07.

Key Forecast Factors. Our CalWORKs spending projection is primarily based on assumptions about the federal maintenance-of-effort (MOE) requirement and the Temporary Assistance for Needy Families (TANF) block grant reauthorization. Our spending forecast assumes that the TANF block grant will be reauthorized at its current $3.7 billion annual level for California, resulting in essentially stable total program funding throughout the forecast period.

In order to receive the TANF block grant, California must meet a $2.7 billion annual MOE requirement, approximately $2 billion of which is satisfied with spending on the CalWORKs program. The remaining $700 million is spent on other MOE-eligible programs. Since CalWORKs was enacted, the Legislature has taken steps to maintain General Fund spending at the MOE floor. Our spending projection assumes this practice will continue.

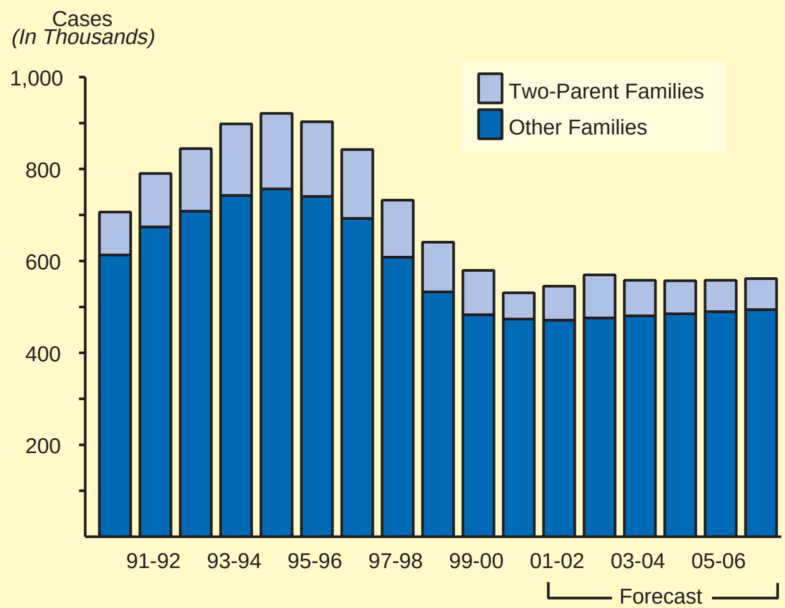
The combination of statutory COLAs and projected caseload increases (discussed below) will result in greater cost pressures in the CalWORKs program during the projection period. These pressures, will be partially offset by some savings due to adult recipients reaching their statutory five-year time limit on cash assistance. Given that grants are entitlements and that child care has essentially been treated as such, these cost pressures may result in potential underfunding of employment services compared to current levels. This shortfall would be compounded once the federal Welfare-to-Work funds, which have been a separate source of CalWORKs employment services funding, have been fully expended, most likely by the end of 2002-03.

Counties may use their performance incentive funds to address the potential employment services shortfall. As of July, counties had spent approximately 13 percent of the $1.1 billion in awarded incentives. Thus, depending on what service level counties elect to provide, as well as the extent to which they have already obligated their performance incentives, *in aggregate* counties could maintain the present level of employment services in the budget year and perhaps into later years. This may not be the case in certain counties that have already expended substantial sums of their incentive funds.

Caseload Trends and Projections. Following a rapid increase in the early 1990s, the caseload peaked at 921,000 in 1994-95, and then declined by 42 percent through 2000-01. The budget act forecast assumed an end to the decline in 2001-02, with modest caseload growth beginning midyear. We believe caseloads will be higher-than-budgeted due to the recent economic downturn, increasing by 3 percent in 2001-02, and by 4 percent in 2002-03. Following an economic recovery, we project a 2 percent caseload decline in 2003-04. We then project the caseload to remain essentially stable through 2006-07, as shown in Figure 7. Our projections are based on a trend analysis of caseloads, birth rates, grant levels, and unemployment rates, and our best judgment about the impact of a mild recession on single parent cases.

Figure 7

CalWORKs Caseload Decline Ends



SSI/SSP

The 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 the SSP is projected to be about $2.9 billion in 2001-02, an increase of 11 percent over the prior year. For 2002-03, we project an increase of 8.9 percent, raising total expenditures to $3.1 billion. We project that from 2003-04 through the end of the forecast period, spending for the SSP will increase by an average of 5.6 percent per year, eventually reaching a total of $3.9 billion.

Key Forecast Factors. The two main components of projected cost increases in SSI/SSP are (1) caseload growth and (2) providing the statutory COLA. As discussed below, the caseload is expected to increase at an average annual rate of about 2.2 percent during the forecast period. In 2002-03, spending is projected to increase by about $250 million. This increase is primarily due to the statutory COLA ($175million) and caseload growth ($63 million). From 2003-04 through 2006-07, these factors together will result in annual spending increases of about $200 million.

Caseload Trends and Projections. During the late 1980s and early 1990s the caseload grew rapidly, with most of the growth in the disabled component of the caseload. In the mid-to-late 1990s, the caseload leveled off and actually declined in 1997-98, in part because of federal policy changes which restricted eligibility. Since March 1998, the caseload has been growing. In the future, 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 caseload growth will be about 2.2 percent each year

In-Home Supportive Services

The IHSS program provides various services to eligible aged, blind, and disabled persons who are unable to remain safely in their own homes without such assistance.

The Spending Forecast. General Fund spending for IHSS is projected to be $915 million in 2001-02, an increase of 26 percent over the prior year. For 2002-03, we project that costs will increase by an additional 16 percent. This rate of spending growth is expected to continue for the next two fiscal years then fall to about 12 percent in the final two years of our forecast, resulting in total expenditures of $1.8 billion in 2006-07.

Key Forecast Factors. Our forecast assumes that costs will increase 7 percent each year due to caseload growth and increases in the hours of service provided to recipients. Further, recent legislation authorizing state participation in health benefits and wage increases for certain IHSS workers will increase costs by about an additional 7 percent each year through 2004-05.

JUDICIARY AND CRIMINAL JUSTICE

The major state judiciary and criminal justice programs include support for four departments 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. General Fund support for CDC is forecast to grow by about $157 million from 2000-01 to 2002-03, reaching about $4.4 billion at the end of that period. Expenditures for CDC are forecast at about $5.4 billion by 2006-07. (This includes adjustments for employee compensation increases, but does not include General Fund support for capital outlay and debt service, which are accounted for elsewhere in our projections.)

The projected growth in adult correctional expenditures continues a trend of steadily increasing CDC budgets that has existed since the early 1980s. However, in a change from past growth trends, the CDC budget now appears likely to grow significantly more slowly. Under our new projections, the CDC budget would grow at an average annual rate of about 4 percent through 2006-07, compared with substantially higher prior annual growth rates that sometimes exceeded 10 percent. Throughout the projection period, the CDC General Fund support budget is forecast to be about 5 percent of total General Fund expenditures.

The department's General Fund costs will be partially offset by $158 million in annual reimbursements from the federal government for a portion of the state's costs of housing undocumented immigrants convicted of felonies in California. We assume that Congress will continue to provide the federal fiscal year 2002 level in the future.

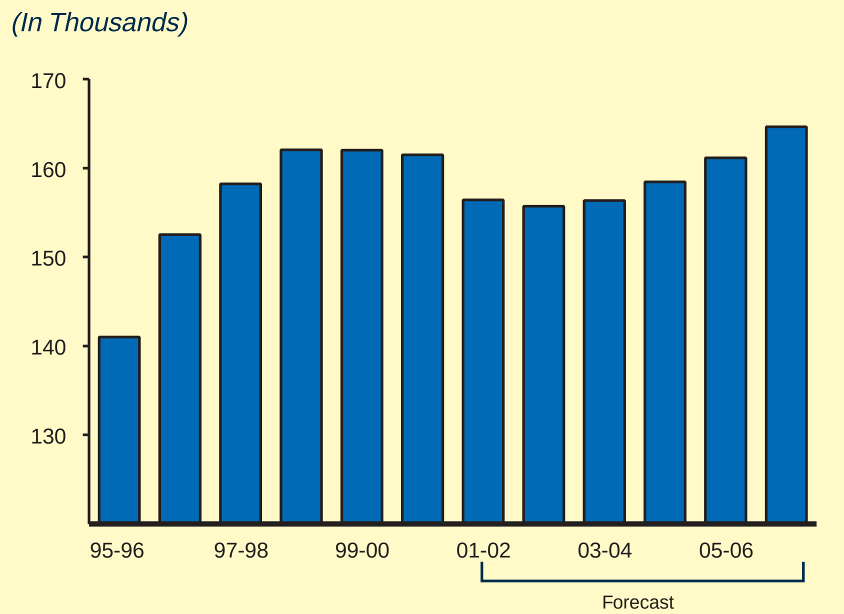
Key Forecast Factors. The projected increases in General Fund support for CDC reflect the continued growth in the prison inmate population that is expected during the forecast period. The inmate population is projected to exceed 164,000 by June 2007. That represents an increase of about 8,200 inmates, or about 1 percent, over the six-year projection period. As Figure 8 shows, the inmate population will decrease by 4,100 by the end of 2001-02, which is the largest population decrease since 1991-92. The inmate population will continue to stabilize at this lower level through 2002-03. Beginning in 2003-04, the population will increase at an average annual rate of about 2 percent, reaching a slightly higher level than the 2000-01 population by June 2007.

The projected 2001-02 population decrease is due primarily to Proposition 36—the Substance Abuse and Crime Prevention Act—which went into effect on July 1, 2001. This law requires that persons convicted of nonviolent drug possession offenses be placed on probation and receive drug treatment, rather than be incarcerated in state prison. Similarly, the measure will redirect parole violators who commit nonviolent drug possession offenses into treatment rather than returning them to prison. This initiative is expected to reduce the prison population by about 7,700 inmates by 2006-07.

The projected 2 percent annual increase in the population, beginning in 2003-04, is due primarily to existing inmates serving longer sentences and new inmates being sentenced under two voter-approved initiatives. Specifically, the "Three Strikes and You're Out" law, enacted in 1994 in Proposition 184, is expected to increase the population because of the significantly longer prison sentences imposed upon offenders with prior serious felony offenses. In addition, Proposition 21—the Gang Violence and Juvenile Crime Prevention Act—which was passed by the voters on March 7, 2000, is expected to increase the population by expanding the definition of serious or violent offenses, potentially resulting in more "strikes" and increasing penalties under the Three Strikes law. Currently, about 57,000 inmates have been sentenced under these laws. During the projection period, the increases attributable to the sentencing laws are projected to fully offset the decrease resulting from the implementation of Proposition 36.

Figure 8

Inmate Population Flattens Then Grows



The projected increase in the CDC General Fund support budget also reflects increases in prison health care expenditures. Increases in the overall cost of providing health care have caused health care expenditures to increase at a higher rate than other prison support costs. In addition, during the last decade, class action lawsuits brought by inmates against the state have resulted in settlement agreements mandating major prison health care reforms that have increased health care expenditures.

OTHER PROGRAMS

Vehicle License Fee Backfill

The VLF is an annual fee on the ownership of registered vehicles in California. It is levied in place of taxing vehicles as personal property, and the revenues are distributed to cities and counties. The Legislature reduced the fee—which was set at 2 percent of the depreciated value of a vehicle—by 25 percent in calendar year 1999, 35 percent in 2000, and 67.5 percent in 2001 and thereafter. Under the provisions of these 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. In the current year, local governments will receive about $3.5 billion from the General Fund backfill. Of this amount, $1.2 billion was appropriated in the prior year. For 2002-03, General Fund expenditures for the backfill will total $3.8 billion. We project that expenditures will grow to $4.8 billion by 2006-07, primarily due to increases in new car sales and car prices.