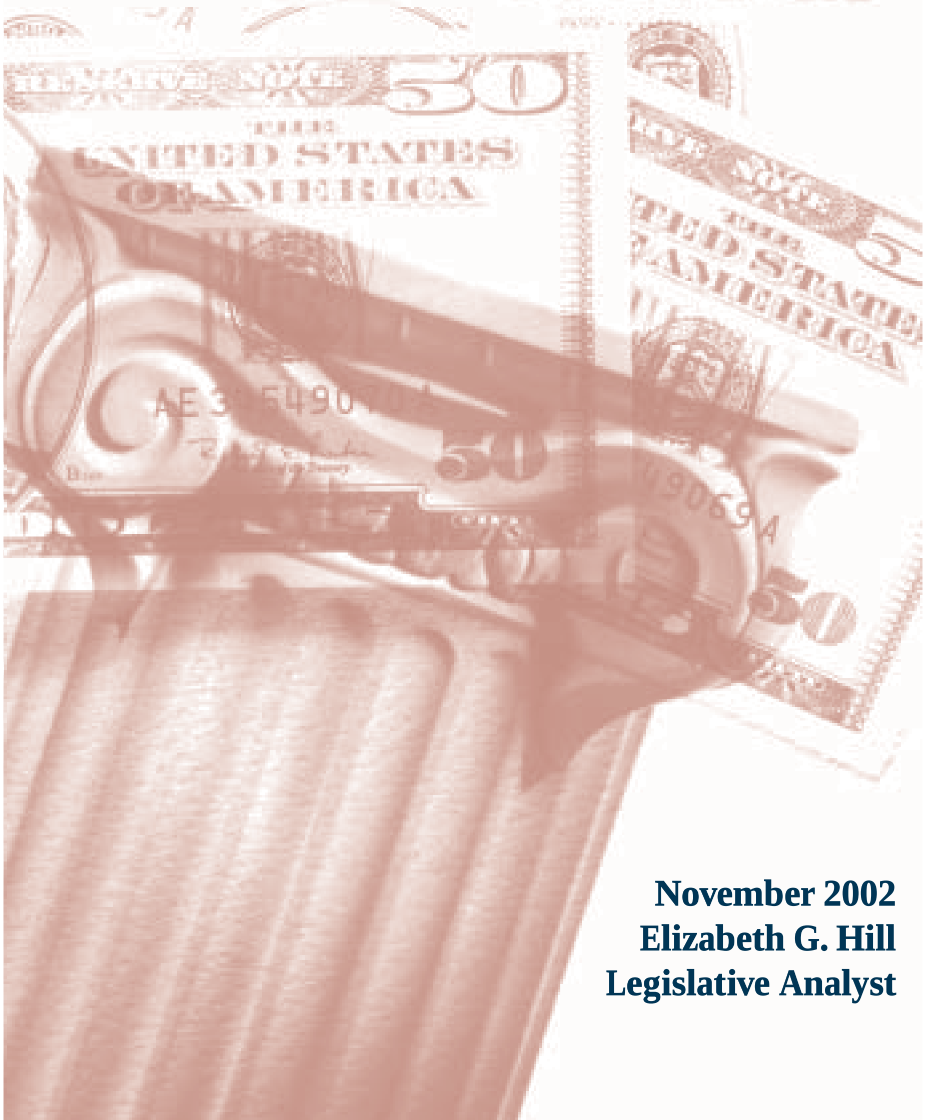
C A L I F O R N I A ' S

Fiscal Outlook

LAO Projections 2002-03 Through 2007-08



November 2002
Elizabeth G. Hill
Legislative Analyst

Foreword

This report provides our projections of General Fund revenues and expenditures for 2002-03 through 2007-08 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 report, in its eighth year of publication, reflects the historical mission of the Legislative Analyst's 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

Deputy Legislative Analysts
Hadley Johnson, Jr.
Mac Taylor

Capital Outlay
Director .... Mac Taylor
Corrections facilities/seismic issues .... Chris Guyer
Higher education facilities .... Paul Guyer
State offices/resources infrastructure .... Steve Lehman

Criminal Justice
Director .... Greg Jolivette
Adult corrections .... Lisa Ann Mangat
Courts .... Yvette Rincon
Juvenile/local criminal justice .... Jeff Cummins

Economics, Taxation, and Fiscal Forecasting
Director .... Jon David Vasché
Taxes .... Mark Ibele
Fiscal and economic data/demographics .... Robert Ingenito
Economics/forecasting .... Brad Williams

Higher Education
Director .... Steve Boilard
Community colleges .... Steve Boilard
UC/adult education .... Sona Nagar
CSU/child care .... Anthony Simbol

K-12 Education
Director .... Rob Manwaring
Education finance/special education .... Jennifer Borenstein
Accountability/assessments .... Victoria Carreon
Compensatory education/health-related programs .... Maryza Gutierrez
Teacher training/charter schools/financial aid .... Jennifer Kuhn

Health Services
Director .... Daniel C. Carson
Medi-Cal—families/children .... Farra Bracht
Medi-Cal—elderly/disabled .... Tiffany Reyes Reddy
Public health/Healthy Families .... Lisa Folberg
Mental health .... Daniel C. Carson

Social Services
Director .... Todd Bland
CalWORKs .... Kasia O'Neill Murray
Child welfare, child support .... Mary Adèr
Aged, blind, and disabled/employment programs .... Todd Bland

Local Government
Director .... Mac Taylor
Local government issues .... Marianne O'Malley

Resources and Environmental Protection
Director .... Mark Newton
Energy/water .... Keely Martin Bosler
Air quality/land acquisition/solid and hazardous waste .... Catherine Freeman
Wildlife/parks/forestry .... Jenny Giambattista

State Administration
Director .... Michael Cohen
Information technology .... Anna Brannen
Business issues/state employment .... Todd Clark
State budgeting/consumer issues/gambling .... Vacant

Transportation
Director .... Dana Curry
Transportation financing/highways .... Joel Riphagen
Public transportation/traffic enforcement .... Vacant

Table of Contents

Chapter 1

The Budget Outlook

SUMMARY

California policymakers will be facing an enormous challenge in crafting the 2003-04 General Fund budget. For the second year in a row, the state faces a budget problem in excess of $20 billion. Specifically, our updated forecast indicates the following:

- *Current Year.* California will end the 2002-03 fiscal year with a General Fund deficit of $6.1 billion, compared to the $1 billion positive reserve balance assumed when the *2002-03 Budget Act* was adopted.

- *Budget Year.* The 2003-04 budget faces a cumulative year-end deficit of $21.1 billion, absent corrective actions. However, if California's economic performance continues to lag and fails to experience the accelerating growth that we are expecting in the latter half of 2003, the shortfall could easily be several billion dollars higher.

- *Beyond the Budget Year.* Over the longer term, the state will face annual operating deficits (that is, excesses of expenditures over revenues) of between roughly $12 billion and $16 billion per year, again absent corrective actions. These shortfalls average about 14 percent of the state's annual General Fund budgets over the period.

WHAT IS BEHIND HUGE BUDGET PROBLEM?

Given that the General Fund budget enacted for 2002-03 only a few months ago was balanced with a $1 billion reserve, a natural question to ask is: *How could such an enormous problem for 2003-04 develop so fast?* As discussed below, two main factors are responsible:

- First, the budget enacted for 2002-03, while at the time balanced, did not address the large underlying mismatch between current-law expenditures and revenues.

- Second, due largely to soft economic performance, fiscal conditions—especially the outlook for revenues—have deteriorated substantially.

Underlying Operating Shortfall Not Addressed In 2002-03 Budget

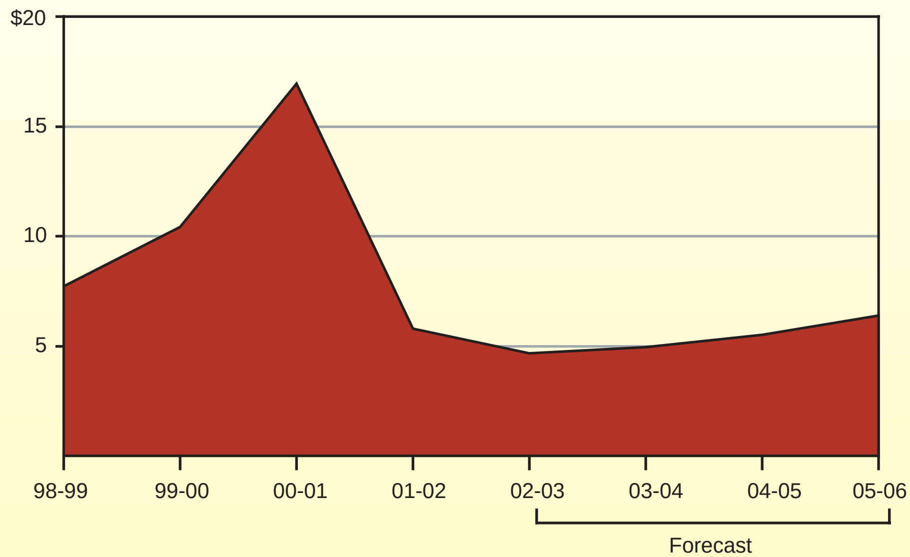
About one-half of the projected 2003-04 budget problem relates to an underlying operating shortfall in California's General Fund budget that would have existed even without the recent deterioration in the economic and revenue outlook.

Stock Market Collapse a Key Factor. As we have indicated in previous reports, the state has faced a large and ongoing imbalance between revenues and expenditures since the stock market bubble burst and tax revenues fell by over $10 billion in 2001-02. The dramatic impact of the stock market decline is depicted in Figure 1, which shows the amount of personal income taxes attributable to stock options and capital gains. It indicates that these tax revenues peaked at $17 billion in 2000-01, but fell abruptly following the stock market decline—to under $6 billion in 2001-02. This unprecedented 66 percent decline is the key factor behind the $10-plus billion annual mismatch between revenues and expenditures that began in 2001-02.

Figure 1

Revenues From Capital Gains and Stock Options Down Sharply

(In Billions)



One-Time Solutions Provided Only Temporary Relief. In dealing with the cumulative $23.6 billion budget shortfall facing the state in 2002-03, the Governor and Legislature relied primarily on *one-time* actions to close the gap. While these actions addressed the cumulative shortfall in the 2002-03 budget itself, they did not eliminate the underlying current-law gap between revenues and expenditures. Thus, the expenditure-revenue mismatch was destined to reappear. Consequently, even if *all* of the assumptions embedded in the 2002-03 budget had held up, the state would have still faced an operating shortfall of over $10 billion in 2003-04.

Further Deterioration in Revenue and Expenditures

The other roughly half of the projected $21 billion cumulative shortfall in 2003-04 largely relates to the recent deterioration in the revenue outlook resulting from near-stagnant economic conditions in past months. This factor has caused us to reduce our General Fund revenue forecasts relative to our earlier projections by $777 million in 2001-02, $4.1 billion in 2002-03, and $6.5 billion for 2003-04—or a total of $11.4 billion for the three years combined.

Our updated estimate of the 2003-04 shortfall also includes the impacts of revised assumptions about new federal funds, retirement incentives, Medi-Cal fraud detection, and state operations reductions—as well as savings related to lower Proposition 98 spending in 2003-04. On balance, these expenditure revisions have worsened the budget's bottom-line condition, although not to the same extent as have revenues.

KEY FORECAST ASSUMPTIONS

Economic Outlook

Recent Trends Have Been Weak. Although the national and state economic downturns appear to have bottomed out in late 2001, the economic expansion has been extremely sluggish in 2002. At the national level, consumer spending has increased over the past year, but business spending and net exports have been soft. These trends have also been evident in California, where growth has been extremely limited in recent months.

Modest Growth Expected. Our updated forecast assumes that the national and state economies will continue to expand at subdued rates until mid-2003, when improvements in business spending and export sales start to boost overall economic growth. Specifically, we forecast that U.S. gross domestic product will increase by about 2.5 percent this year and 2.6 percent in 2003, before accelerating to annual growth rates in the 3 percent to 4 percent range in subsequent years. In California, we forecast that, following a marginal gain of 1.2 percent in 2002, personal income growth will accelerate to 4 percent in 2003, slightly over 6 percent in 2004, and to between 6 percent and 7 percent in subsequent years.

Downside Risks Exist. Our forecast is subject to a significant downside risk that further delays in business hiring and spending, coupled with sagging consumer confidence and spending, will depress U.S. and California economic growth below our current forecast. Another risk involves the resolution of the current labor-management dispute involving workers at West Coast ports. A protracted economic slowdown could reduce state General Fund revenues by several billions of dollars below our baseline forecast in the current and budget years combined.

Revenue Outlook

We currently forecast that revenues will grow from $73.1 billion in 2001-02 to $75 billion in 2002-03, before declining to $70.2 billion in 2003-04. These totals are affected by a variety of special factors, which are discussed in Chapter 3. Absent these factors, *underlying* revenues fell by about 16 percent in 2001-02, and are expected to decline another 1 percent in 2002-03 before growing about 5.6 percent in 2003-04. Over the longer term, revenue growth is forecast to average roughly 7 percent per year.

Revenue Revisions. As indicated above, our revenue forecast is down from the *2002-03 Budget Act* estimates by $777 million in 2001-02 and by $4.1 billion in 2002-03. In addition, our estimates for 2003-04 and beyond are below our previous estimates by about $6 billion annually. These substantial downward revisions are primarily associated with the personal income tax. Collections from this source are being adversely affected by (1) the continued reductions of jobs and income in high-paying manufacturing and software industries, and (2) continued declines in stock market values, which will result in reduced levels of taxable income from stock options and capital gains. To a lesser degree, sluggish economic growth is also depressing collections from the sales tax and corporation tax.

PROJECTED GENERAL FUND CONDITION

Figure 2 (see next page) presents our updated General Fund condition projections for 2001-02 through 2003-04. These estimates take into account our revised projections of current-law revenues and expenditures, discussed in Chapter 3 and Chapter 4, respectively.

Revised Outlook for 2002-03

Deficit to Exceed $6 Billion. The 2002-03 budget enacted in September assumed that the current fiscal year would end with a positive reserve of $1 billion. However, we estimate that the large combined $4.9 billion reduction in 2001-02 and 2002-03 revenues, coupled with $1.8 billion in added expenditures and a $410 million deterioration in the 2001-02 carry-in balance, will use up the reserve and push the state into a deficit of $6.1 billion in the current year. As discussed above, the decline in revenues reflects the deterioration in the near-term economic outlook. The increase in expenditures is due to our revised estimates related to new federal funds, the state retirement incentive program, state operations reductions, and Medi-Cal fraud detection.

Figure 2

LAO Projections of General Fund Condition

2001-02 Through 2003-04
(In Millions)

		Forecast	
	2001-02	**2002-03**	**2003-04**
Prior-year fund balance	$2,627	-$1,192	-$4,635
Revenues and transfers	73,121	75,010	70,199
Total resources available	$75,748	$73,818	$65,564
Expenditures	76,940	78,453	85,216
Ending Fund Balance	-$1,192	-$4,635	-$19,652
Encumbrances	1,473	1,473	1,473
Reserve	**-$2,665**	**-$6,108**	**-$21,125**

Outlook for 2003-04 And Beyond

Basis for Our Estimates

Current Law Assumed. Our revenue and expenditure forecasts for 2003-04 and beyond are based primarily on the requirements 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 adjustments (COLAs), federal reimbursements, and other factors affecting program costs. We have also adjusted the budget for one-time costs and savings in the current year.

Projections, Not Predictions. It is important to note that our fiscal projections are *not* predictions of what the Legislature and Governor will adopt as policies and funding levels in future budgets. Rather, our estimates are intended to be a reasonable "baseline" projection of what would happen if current-law policies were allowed to operate in the future. In this regard, we believe that our forecast provides a meaningful starting point for legislative deliberations involving the state's budget.

Treatment of Loan Repayments and Mandates. In preparing our estimates for 2003-04 and beyond, we needed to make assumptions about repayments of loans to the General Fund from special funds, as well as state payments to localities associated with mandates which were deferred in 2002-03. With regard to loan repayments, our estimates include the timely repayment of all loans which had specific repayment dates scheduled in the budget. We also assume that about one-half of the remaining loans are repaid evenly over the forecast period. With regard to state-imposed local mandates (excluding education), we assume that prior-year claims will be paid off over the forecast period.

2003-04 Outlook— Huge Problem Looming

Key Elements. As shown in Figure 2, we estimate that revenues will fall from $75 billion in 2002-03 to $70.2 billion in 2003-04. The decline reflects the large amount of one-time revenues, loans, and transfers that total $9.5 billion in 2002-03, but which are largely absent in 2003-04. At the same time, expenditures are projected to increase from $78.5 billion in the current year to $85.2 billion in 2003-04. The increase reflects a variety of factors, including new General Fund costs associated with health programs previously funded from the tobacco settlement special fund, the annualized costs of COLAs provided for the Supplemental Security Income/State Supplementary Program in June 2003, $1.2 billion in added funding for transportation spending (as mandated by Proposition 42), and additional costs for employer retirement contributions. General Fund Proposition 98 funding is projected to grow by only 2.4 percent in 2003-04, due to (1) a relatively small increase in the minimum funding guarantee and (2) a rapid increase in local property taxes, which reduces the General Fund share of total Proposition 98 funding.

$21 Billion Imbalance Projected. The combination of the expenditure increases and revenue reduction in 2003-04 will result in an operating deficit of nearly $15 billion in the budget year. Thus, when combined with the $6.1 billion deficit carry-in from 2002-03, the 2003-04 budget faces a cumulative shortfall of roughly $21 billion, absent corrective actions.

Longer Term Outlook—Continued Shortfalls

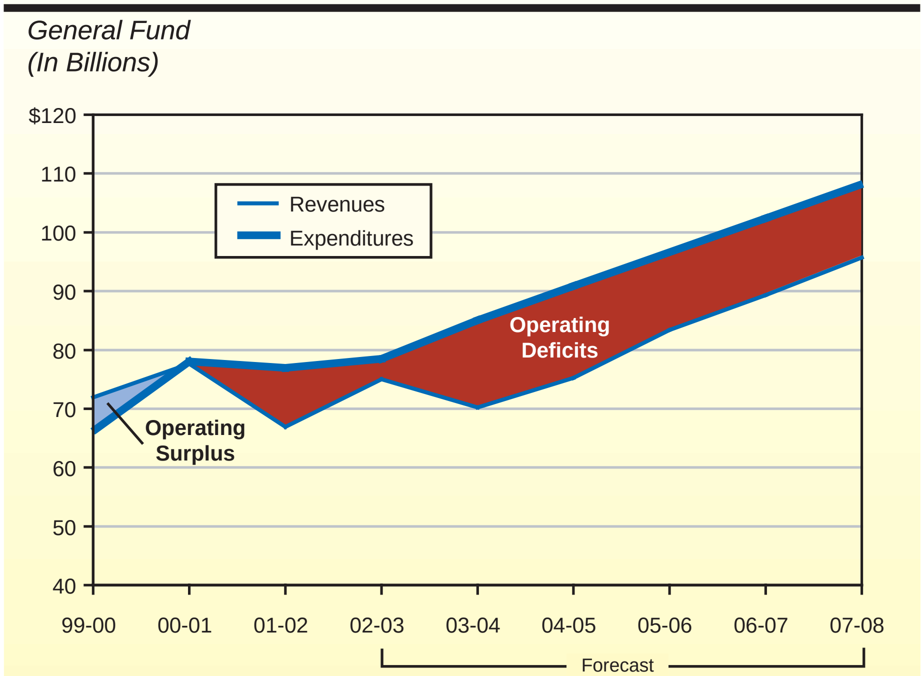
Figure 3 presents our revenue and expenditure forecasts through 2007-08. It indicates that current-law operating deficits are expected to persist over the entire period, absent corrective actions.

On the positive side, we do expect revenues to grow somewhat more rapidly than expenditures over these years, as evidenced in Figure 3 by the revenue line closing in a bit on the expenditure line over time. Our projected faster growth for revenues than for expenditures reflects our assumption that revenue growth will accelerate in 2004-05 as the economic expansion gains momentum. It also reflects relatively slow growth in General Fund Proposition 98 spending, due primarily to slowing growth in K-12 school enrollments. As a result of the above factors, our projected operating deficits do decline slightly over time.

Despite these favorable trends, however, projected revenues remain well below expenditures at all times over the forecast period. Specifically, as the figure indicates, we expect that annual operating deficits peak at $15.6 billion in 2004-05 before slowly declining to $12.3 billion by 2007-08. The persistence of these large mismatches between current-law revenues and expenditures indicates that the state has a large structural budgetary imbalance that it cannot simply "grow" its way out of on the natural. As a result, substantial budget-balancing actions will be needed.

Figure 3

Current Law Operating Deficits to Persist



APPROACHING THE PROBLEM

This Year Will Be Much Harder Than the Last

Last year, when the state faced a cumulative $23.6 billion budget problem, we identified for the Legislature a variety of principles, strategies, and tools for dealing with the shortfall (see, for example, our report entitled *Addressing the State's Fiscal Problem*, December 2002). The current budget shortfall is much more formidable and challenging than last year's. This is due both to the magnitude of the problem and because a number of the one-time solutions heavily relied on last year cannot be used again—such as the $4.5 billion raised from tobacco securitization, the $1.1 billion near-term savings from restructuring repayments of state general obligation bonds, and certain loans and tax accelerations. *Given this, there is really no easy way out of the current predicament, and this makes it all the more important that the Legislature take advantage of the alternative budget-balancing approaches and options available to it.*

Key Principles, Strategies, and Tools

Figure 4 summarizes in broad terms the various key budget-balancing principles, strategies, and tools that we have previously identified and that we believe merit the Legislature's attention again this year.

Figure 4

Basic Budget-Balancing Principles, Strategies, and Tools

Key Principles

- ✓ Wide range of budget solutions should be considered.
- ✓ Out-year repercussions should be assessed.
- ✓ Budget solutions should "make sense."
- ✓ Current-year solutions should play a key role.

Basic Strategies

- ✓ Determine the relative roles of spending and revenue options.
- ✓ Identify the appropriate contributions of different program areas.
- ✓ Establish the desired mix of one-time versus ongoing solutions.
- ✓ Assess whether a multiyear solution is appropriate and feasible.

Individual Tools

- ✓ Spending-related options.
  - Eliminate or modify programs.
  - Suspend/reduce COLAs.
  - Defer spending.
  - Shift funding from the General Fund.
  - Implement improvements and efficiencies.
  - Revert or disencumber funds.
- ✓ Revenue-related options.
  - Eliminate or modify tax expenditures.
  - Broaden basic tax bases.
  - Raise tax rates.
  - Transfer special fund balances.
  - Improve tax compliance and collections.
  - Revise accrual procedures and sell assets.

Of particular importance are:

- *Take Current-Year Actions.* In last year's budget process, the Governor and Legislature acted mid-year to make significant reductions in 2002-03 spending. We recommend that the Legislature again consider mid-year adjustments. This would not only reduce the projected year-end 2002-03 deficit, but could reduce the out-year problem as well.

- *Put Everything on the Table.* In order to bring the budget back in balance, it will be necessary to consider all types of solutions—spending reductions and deferrals, fund shifts, revenue increases, and improved tax compliance and collection. Or, put differently, we believe that nothing should be taken off the table when considering options. This doesn't mean that all program areas are of the same import. The Legislature, for instance, has made it clear that K-12 education is a high priority. However, there are potential efficiencies and savings that can be achieved in any area, and the Legislature will need the largest possible "menu" from which to choose in addressing the problem.

- *Continue to Use One-Time Solutions, But Significant Ongoing Actions Needed.* The Legislature relied extensively on one-time solutions in crafting its 2002-03 budget package. We believe one-time solutions should also play an important role in coming budget deliberations. Of the $21 billion problem that we have identified, roughly $6 billion is from the projected year-end 2002-03 deficit. This part of the problem could be appropriately addressed entirely with one-time solutions. The remaining $15 billion portion of the budget problem for the most part represents an ongoing imbalance between revenues and spending. Thus, it is important that the Legislature adopt major ongoing solutions—spending reductions and revenue increases—to address this portion of the gap.

In the coming months, our office will be assisting the Legislature in developing possible budget-balancing expenditure and revenue strategies and options to help address the large projected 2003-04 shortfall.

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 revenues and state expenditures. This chapter presents our economic and demographic projections for 2002 through 2008, which will affect California's fiscal condition during fiscal years 2002-03 through 2007-08.

THE ECONOMIC OUTLOOK

Overview of the Economic Forecast

California's economy has been hard hit by the slump in spending on high-tech goods and services, plunging exports, and the stock market's decline. These factors have combined to produce soft personal income growth in the state, and they continue to dampen economic performance as of late 2002. Looking ahead, we forecast that the economy will continue to "muddle along" until the second half of 2003, when a long-delayed improvement in business investment spending is anticipated to begin to boost California's overall job and income growth. From then on, moderate income and job gains are expected through the remainder of the forecast period.

Although our forecast reflects what we believe is the most likely future path for the economy, our forecast—like any—is subject to risks and uncertainties. In this regard, we believe that the main risk to our forecast is on the downside—namely, our economic projections are subject to the possibility that further declines in consumer confidence and spending could occur that, in turn, could result in prolonged economic weakness during the next year. In this event, both the economy and the state's fiscal condition would under-perform our expectations.

Figure 1 (see next page) summarizes the details of our economic forecast, while the current state of the economy and the major components of our economic forecast are discussed below.

Recent National Economic Developments

Consumer Spending Keeping U.S. Economy on Upward Track . . .

After falling in 2001, the U.S. economy has experienced a modest rebound over the past year. For example, U.S. real gross domestic product (GDP) grew by 3 percent between the third quarter of 2001 and the third quarter of 2002. This output increase has occurred despite virtually no growth in employment and only modest gains in personal income, and thus is attributable primarily to increased productivity.

Figure 1

The LAO's Economic Forecast 2002 Through 2008

Percentage Change (Unless Otherwise Indicated)

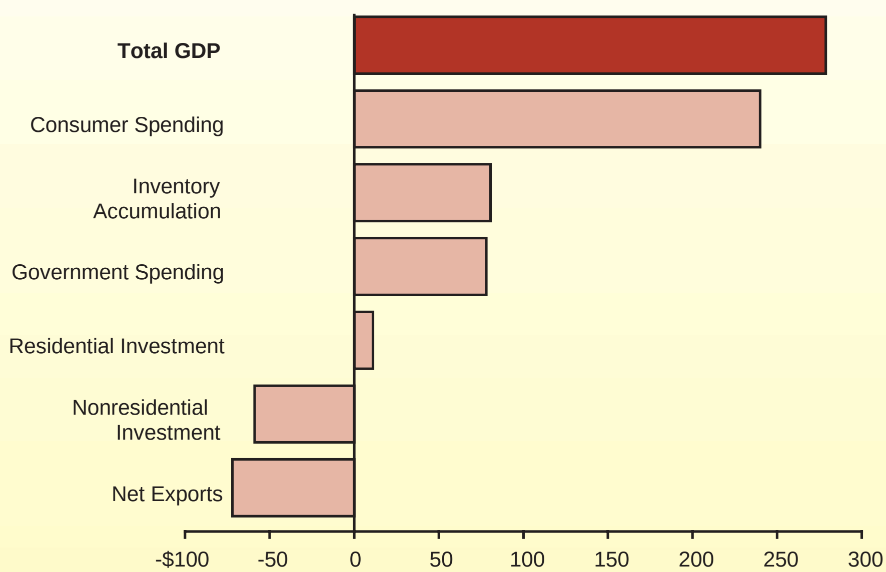
	2002	2003	2004	2005	2006	2007	2008
United States							
Real gross domestic product	2.5%	2.6%	3.8%	3.6%	2.9%	3.0%	3.0%
Personal income	3.2	4.5	5.9	6.1	5.7	5.4	5.4
Wage and salary jobs	-0.8	1.2	2.5	1.7	1.1	1.2	1.1
Consumer Price Index	1.7	2.9	2.9	2.9	2.6	2.4	2.3
Unemployment rate (%)	5.8	5.9	5.3	5.0	5.1	5.1	4.8
Housing starts (000)	1,637	1,572	1,711	1,704	1,669	1,698	1,730
California							
Personal income	1.2%	4.0%	6.1%	6.7%	7.0%	6.5%	6.4%
Wage and salary jobs	-0.8	0.5	2.4	2.6	2.7	2.3	2.1
Taxable sales	-1.4	3.9	6.2	6.9	6.9	6.3	6.2
Consumer Price Index	2.7	2.5	2.9	3.0	3.1	2.7	2.7
Unemployment rate (%)	6.2	6.1	5.6	5.3	5.1	5.0	5.1
New housing permits (000)	155	153	157	164	165	168	165

As shown in Figure 2, most of the recent growth in U.S. output has been related to consumer spending, which has remained surprisingly strong in view of the lack of job and income growth over the past year. A key force behind this continued spending growth has been low interest rates, which have boosted sales of automobiles and other interest-sensitive durable goods. Declining mortgage rates have also produced a boom in both new home sales and financings, as well as the refinancing of existing mortgages. The new home activity has

Figure 2

Consumer Spending Main Source of Recent U.S. Economic Growth

Change in Real GDP, Third Quarter 2001 to Third Quarter 2002 (Billions of Dollars)



directly added to output, and the refinancings have enabled individuals to reduce their home payments and/or "cash out" some of their previously built-up home equity—in both cases providing additional funds for spending.

. . . But Continued U.S. Growth Will Depend on Businesses

A very important question for the U.S. outlook is how much longer can consumer spending carry the economic expansion—especially in view of the recent lack of employment and personal income growth in the economy. In this regard, a key to future economic growth would appear to be increased business spending on capital equipment and labor.

Normally, continued growth in consumer spending would be matched by new investment and hiring by businesses. However, this has not been the case during the past year. For example, nonresidential investment, which includes spending by businesses on new plants and equipment, fell by over 4 percent between the third quarter of 2001 and the third quarter of 2002 (see Figure 2). The decline in business investment, coupled with cautious attitudes by employers generally, has contributed to a 190,000 drop in private sector jobs since the beginning of the year.

The lack of business spending on plants and equipment reflects the large amount of idle capacity that currently exists in the economy, which has partly resulted from past over-investment by many businesses in telecommunications and other high-tech areas. It also reflects pressures that businesses are facing from their shareholders and directors to control costs and improve their "bottom line" profit statements. These factors have translated into delays or cancellations of equipment and software upgrades, and sharp cutbacks in hiring.

The lack of job growth, coupled with declining stock market values and other uncertainties, is starting to take a toll on consumers. The Conference Board's consumer confidence survey plunged to a nine-year low in October, and preliminary reports suggest that retail sales softened in October. A slowdown in consumer spending would have major implications for the overall economic expansion, since consumer spending accounts for over two-thirds of economic output.

Given these factors, a key to the outlook is an improvement in business spending and hiring. Such an improvement would provide a welcome boost to income and jobs, which would in turn sustain gains in consumer spending and overall economic growth in the future.

California Developments

Employment and Income Both Have Been Weak

There are no current state-level gross domestic product data available to precisely measure output changes in California. However, the information that is available from such diverse sources as employment, personal income, withholding, taxable sales, new vehicle registrations, and building permit activity suggests that, like the nation, California's economy bottomed-out in late 2001, and has been on a weak growth path during the first ten months of 2002. The recovery has not been of sufficient magnitude to create new jobs and, in fact, California's private sector has experienced job losses during the past year. With regard to personal income, California has suffered a steeper slowdown than the rest of the nation, due to (1) a large amount of job losses in the state's high paying manufacturing sector, and (2) continued declines in stock-option income. Reflecting these factors, we estimate that the state's personal income will increase by just 1.2 percent in 2002, compared to 3.2 percent for the nation as a whole.

California's Manufacturing-Related Jobs Have Plunged

As indicated in Figure 3 (see next page), total California manufacturing employment has fallen by over 230,000 jobs (12 percent) since its peak in late 2000. Although not as dramatic as in the early 1990s, when the state faced major restructuring of its defense industry, the manufacturing job downturn has nevertheless been one of the steepest two-year declines in the state's history.

Business Services Employment Also Has Suffered

A similarly large employment reduction has occurred in the state's business services job sector (which includes temporary hires by manufacturers as well as computer and software design jobs). After growing at an average rate of 8.4 percent per year between 1995 and 2000, this sector has lost 11 percent of its job base during the past two years. The losses of manufacturing and computer-related business services jobs are significant, since these are among the highest paying jobs in the state.

Forces Behind California Job Losses—Weak Business Spending and Exports

As with the nation generally, a key force behind the job losses in California's manufacturing and business services sectors has been the weakness in national business investment spending. The decline is important to California since so much of its high-tech goods and services are sold to businesses.

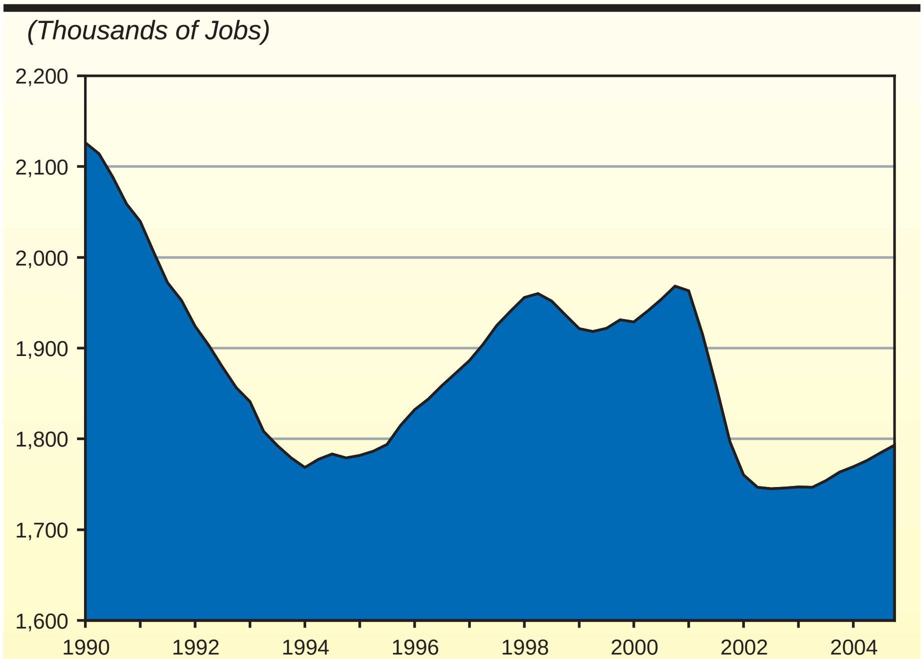
In addition to the decline in U.S. investment spending, manufacturers in this state are also coping with a plunge in foreign demand for their products. Total California-produced exports fell by 11 percent in 2001 and will decline by another 14 percent this year, due to soft economic conditions abroad. As shown in Figure 4, the export decline between the first half of 2001 and the first half of 2002 has been concentrated in computers, electronics, aerospace, and transportation products. The drop in exports is important since a significant share of California-produced high-tech goods are sold in other countries.

Main Positive Force in State—Low Interest Rates

Outside of the manufacturing and business services sectors, the California economy has recently managed to grow at a modest pace. The main positive forces have been low interest rates and continued California population growth. Like the rest of the nation, California's spending on automobiles has remained strong in 2002, buoyed by zero-interest financing promotions. Likewise, strong home sales and mortgage refinancings associated with low interest rates, along with continued growth in residential construction

Figure 3

California Manufacturing Hit Hard By Economic Slowdown



activity, are boosting employment in California's construction and finance-related industries. Nonbusiness services employment is also expanding modestly, reflecting gains in such diverse industries as health care, personal services, and auto repair.

Increases in interest-sensitive and population-driven industries have managed to keep California's economy on a slight upward track thus far in 2002. However, it is unlikely that they can continue to offset the negative effects of falling business spending and exports for much longer. Without improvement in these latter two areas, it is unlikely that California can sustain a meaningful expansion.

The Economic Outlook—Slow Improvement Beginning In Mid-2003

Our forecast assumes that both the national and state economies increase at a very subdued rate through the first half of 2003. At that point, we assume that business spending will finally begin to improve, providing a much-needed boost to overall economic growth. We expect business spending to eventually improve because, although the manufacturing sector currently has a considerable amount of unused capacity, businesses will eventually need to upgrade equipment and software to take advantage of new innovations in communications, web technology, and other areas.

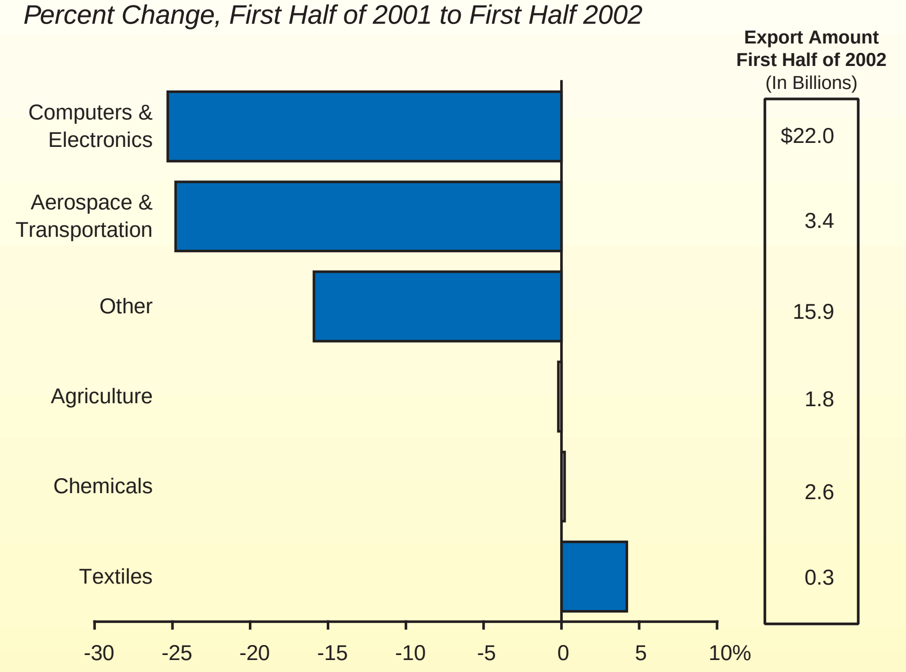
National Outlook

As indicated previously in Figure 1, we forecast that U.S. GDP will increase by 2.5 percent and 2.6 percent in 2002 and 2003, respectively, before accelerating to 3.8 percent in 2004 and an average of about 3.3 percent over the balance of the forecast period. Over the longer term, growth in U.S. economic output will be aided by healthy gains in worker productivity, which we expect to rise by slightly over 2 percent per year.

Figure 4

High-Tech Exports Plunge in 2002

Percent Change, First Half of 2001 to First Half 2002



The forecast assumes similarly modest accelerations in jobs and income. Inflation is expected to remain relatively low over the forecast period, with the Consumer Price Index forecast to increase by an average of less than 3 percent over the next six years.

California Outlook

As with the nation, we expect California's economy to grow at a very sluggish pace until the second half of 2003, with employment and income improving slowly in 2003 before accelerating in 2004 and 2005. The improvement is tied to an assumed rebound in manufacturing employment, which we expect to benefit from an eventual rebound in business spending and exports.

We specifically project that personal income will increase by 4 percent in 2003 and 6.1 percent in 2004, and that wage and salary employment will grow by 0.5 percent and 2.4 percent during the same two years. Continued population growth and low interest rates will result in growth in residential construction activity during the forecast period. Nonresidential construction is expected to decline through mid-2003, then slowly grow thereafter.

Risks to the Forecast

Our near-term forecasts for both the nation and California are below the consensus of estimates made by other economists in October 2002, particularly with regard to California personal income growth. However, given recent negative reports on employment, consumer confidence, and manufacturing activity, we believe that even our forecast is subject to considerable downside risk. The combination of a steeper slowdown in consumer spending, and further cutbacks in business investment and hiring, could further weaken near-term growth—or even produce a "double dip" recession early next year. Such a development would result in further job declines and another year of near-zero growth in personal income in 2003. It would also have substantial adverse effects on state tax revenues, and thus on the projected outlook for the General Fund's condition. Another risk involves the current labor management dispute at the West Coast ports. While our forecast assumes that current federally mediated negotiations will produce a successful resolution, a prolonged lockout or strike would disrupt commerce in California and elsewhere in the nation.

THE DEMOGRAPHIC OUTLOOK

As of 2002, California's population totaled slightly over 35 million. During the six-year forecast period, the state's population is projected to grow annually by about 1.5 percent, or well over half a million persons yearly. Thus, California will add roughly 3.3 million people over the forecast interval and reach over 38 million by 2008.

The population growth rate we are projecting is somewhat slower than that experienced in the latter part of the 1990s. This reflects both the dampening effects of the slower economy on in-migration, and a continuing downward trend 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 those leaving for other destinations). On average, these two components tend to contribute about equally to the state's population growth, although their relative shares can vary significantly from one year to the next depending largely on the strength of net in-migration.

Natural Increase. We project that the natural-increase component will average about 285,000 new Californians annually over the forecast period. This amount is slightly less than in the late 1990s, due to the ongoing decline in birth rates being experienced by all ethnic groups. Despite these declining birth rates, however, the natural-increase component still will grow 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 265,000 annually over the next six years. This is weaker than during the latter half of the 1990s and somewhat less than the natural-increase component. As indicated by Figure 5, this reflects a projected drop in *domestic* net in-migration that we believe will accompany California's less-than-robust economic performance. In contrast, *foreign* net in-migration—which has been relatively stable over the past decade and has proved to be less sensitive to the economy—is projected to remain relatively flat.

Growth to Vary by Age Group

Figure 6 shows our population growth projections by broad age categories, including both numerical and percentage growth.

Ranks of Baby Boomers to Swell. The 45-to-64 age group (largely the "baby boomers") continues to be the fastest growing segment of the population. Over 1.6 million new people are expected to move into this age category over the next six years. At the other extreme,

Figure 5

Net In-Migration to Slow

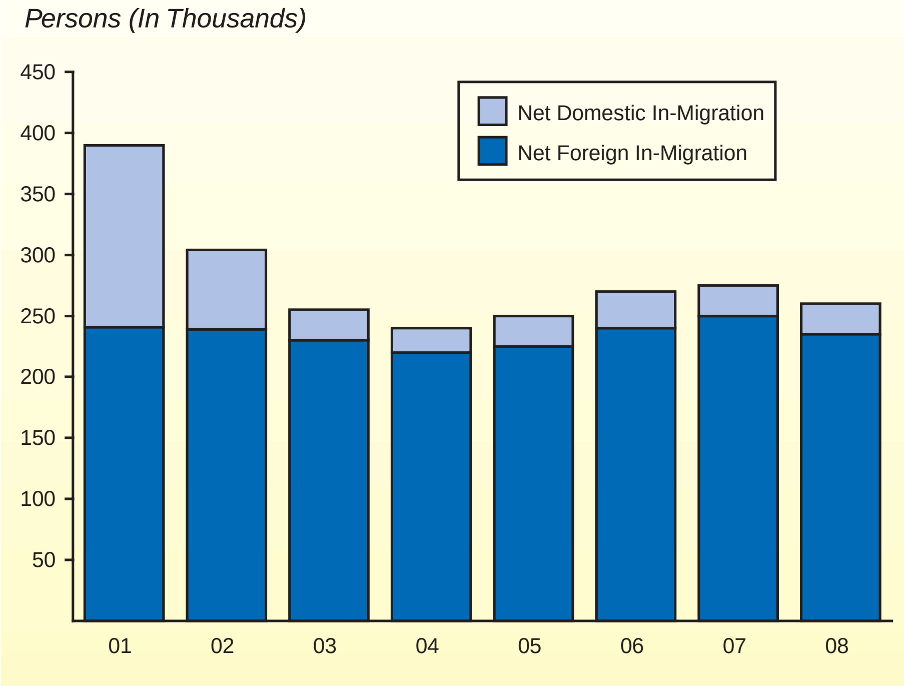
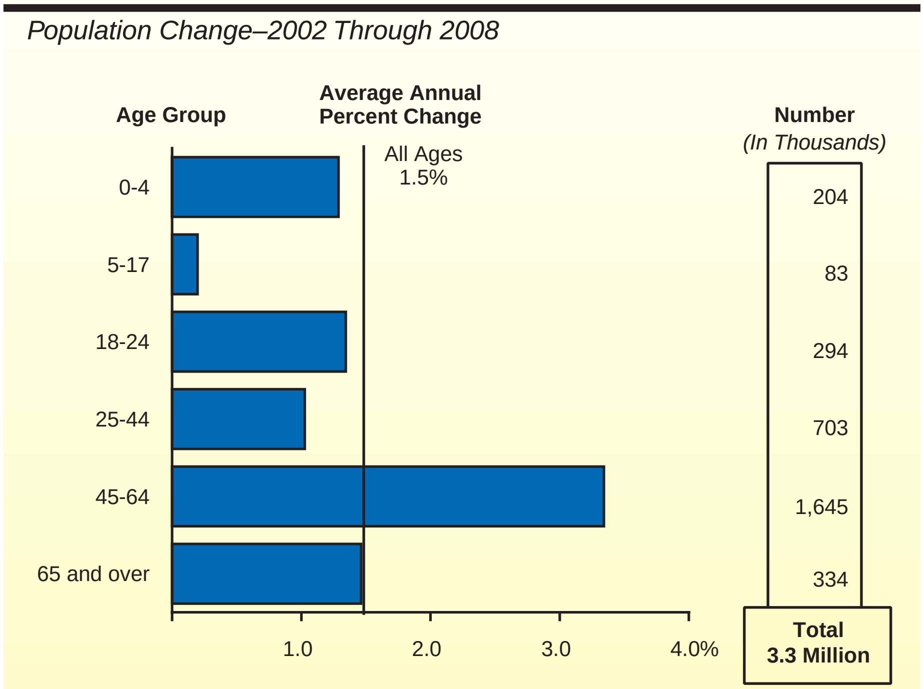


Figure 6

California's Population Growth, by Age Group



although continued in-migration will result in moderate growth for preschoolers, relatively slow growth is anticipated for the K-12 school-age population. This reflects the movement of children of the baby boom generation beyond the 5-to-17 age group. The decline in birth rates in recent years has also resulted in fewer children moving into the school-age category.

These various age-group demographic projections can have significant implications for the state's revenue and expenditure outlook. For example, strong growth of the 45-64 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.

Chapter 3

Revenue Projections

The revenues that finance California's state General Fund budget come from a wide variety of different sources, including taxes, fees, licenses, interest earnings on investments, loans, and transfers. The great majority of General Fund revenues, though, is attributable to the state's three major taxes—the personal income tax (PIT), the sales and use tax (SUT), and the corporation tax (CT). In addition, however, actions taken in conjunction with the adoption of the 2002-03 budget have also resulted in a variety of significant one-time revenue increases in the current year related to loans and the securitization of tobacco receipts. In this section, we summarize our revenue projections and provide detail behind our key revenue-related forecast assumptions.

THE LAO'S REVENUE FORECAST

Major Downward Revisions To Outlook

The revenue outlook continues to deteriorate. Our updated revenue forecast, presented in Figure 1 (see next page), is as follows:

- *Prior-Year Revenues.* We estimate that revenues in 2001-02 totaled $73.1 billion, about $777 million below what was assumed in the *2002-03 Budget Act*. This shortfall is primarily due to lower-than-expected combined receipts from the PIT and SUT in May and June, as well as higher-than-expected CT refunds this fall (which we accrued back to 2001-02). The $12.8 billion shown in the figure for "other revenues and transfers" in 2001-02 includes $6.2 billion related to the repayment of the General Fund loan for electricity power purchases.

- *Current-Year Revenues.* Revenues are projected to total $75 billion in the current year, a 2.6 percent increase from 2001-02. The current-year amount includes about $9.5 billion in special factors included in the 2002-03 budget package. These include tobacco securitization, tax increases, and one-time loans and transfers. Absent these and related changes affecting revenues in the prior and current years, "underlying" revenues are *down* about 1 percent from 2001-02. Compared to the 2002-03 budget forecast, our revenue projection for the current year is down by about $4.1 billion, reflecting a particularly large PIT revision.

- *Budget-Year Revenues.* We forecast that General Fund revenues will be $70.2 billion in 2003-04, a 6.4 percent decline from the current year. This decline reflects the

Figure 1

The LAO's General Fund Revenue Forecast

(Dollars in Millions)

Revenue Source	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Personal income tax	$33,370	$34,510	$36,380	$40,190	$44,520	$48,450	$52,490
Sales and use tax	21,340	22,420	23,530	25,200	26,900	28,670	30,460
Corporation tax	5,620	6,760	6,700	6,540	7,010	7,530	7,930
Other revenues and transfers	12,791	11,320	3,589	3,298	3,980	4,646	4,812
Total revenues and transfers	**$73,121**	**$75,010**	**$70,199**	**$75,228**	**$82,410**	**$89,296**	**$95,692**
Percentage change		2.6%	-6.4%	7.2%	9.5%	8.4%	7.2%

large amount of one-time revenues included in the current-year totals but missing for 2003-04. Absent these factors, underlying receipts would be up a modest 5.6 percent in 2003-04. Our updated forecast is down by about $6.5 billion from the long-term projections for the budget year that we made in summer 2002.

- *Longer-Term Revenues.* We forecast that improving economic conditions will result in accelerating General Fund revenue growth in 2004-05 and thereafter. Specifically, we forecast that revenues will increase by 7.2 percent in 2004-05 and 9.5 percent in 2005-06, before settling down into a more moderate pattern of growth rates during the final two years of the forecast.

Main Factors Behind the Downward Revenue Revisions

The major downward revisions to revenues in the current and budget years are primarily related to the continued softness in California's economy. This softness is taking a greater toll on personal income, taxable sales, and taxable profits than we had previously estimated would be the case. In addition, the continued deterioration in the stock market since last spring implies that personal income taxes from stock options and capital gains will be even less than assumed in spring 2002.

The impacts of continued softness in economic activity are evident in key California revenue indicators. As shown in Figure 2, although both personal income tax withholding and taxable sales have shown slight improvements since the beginning of 2002, both measures remain below last year's already-depressed levels.

Special Revenue-Related Factors

Our revenue forecast for 2002-03 and beyond includes the impacts of numerous actions taken in conjunction with the adoption of the 2002-03 budget. These include:

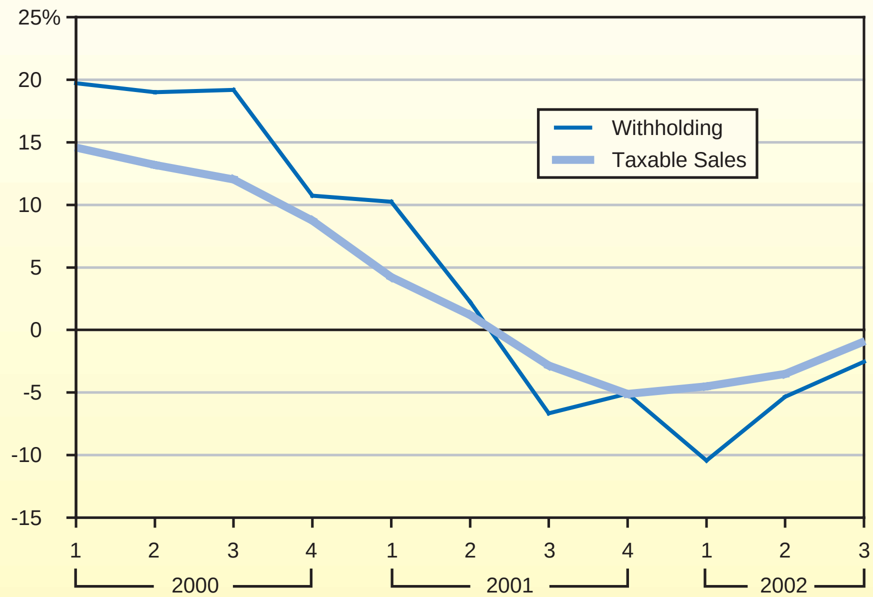
- *Revenue Increases.* The budget includes about $2.5 billion in new tax-related revenues during 2002-03. The main components are: (1) a two-year suspension of the business net operating loss (NOL) carryforward deduction (which is coupled with future increases in the amounts that can be carried forward from 65 percent to 100 percent beginning in 2004); (2) higher withholding on stock options and certain real estate sales; and (3) the suspension of the teachers' tax credit.

- *Tobacco Securitization.* About $4.5 billion in one-time revenue is anticipated in 2002-03 from the securitization of future tobacco settlement receipts. The state will raise these funds by selling its rights over the next 25 years or so to its tobacco settlement receipts, for $4.5 billion in up-front cash. This will be achieved through the sale of revenue bonds whose repayment is secured by the tobacco settlement payments the state receives beginning in 2002-03 until the bonds are paid off.

Figure 2

Key Revenue Indicators Remain Soft

Year-Over-Year Percent Change, by Quarter



- *Special Fund Loans and Transfers.* About $2.6 billion is involved in one-time loans and transfers from special funds. The single largest component involves a $1 billion loan from the Traffic Congestion Relief Fund, which is scheduled to be repaid over the subsequent three years. Our out-year revenue estimates include the repayment of this and other loans for which specific repayment dates have been established.

Combined Effect of Special Factors. Figure 3 (see next page) shows the net impact of the above special factors on General Fund revenues during the forecast period. Taken together, special factors will increase General Fund revenues and transfers by about $9.5 billion in 2002-03. In 2003-04, the net impact of these factors will be relatively small—$188 million—as the second-year impact of the NOL suspension is partly offset by scheduled loan repayments. In subsequent years (2004-05 through 2007-08), the net impact will be annual losses ranging from $250 million to $1.2 billion. These losses are due to loan repayments and higher NOL deductions.

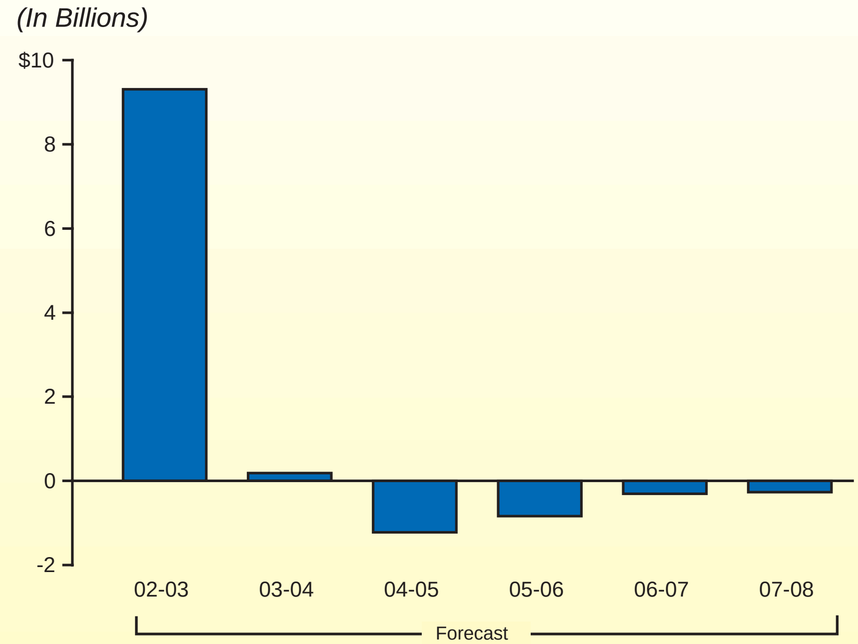
INDIVIDUAL REVENUE SOURCES

Personal Income Tax

After its historic 25 percent plunge (from $44.6 billion to $33.4 billion) between 2000-01 and 2001-02, we project that PIT receipts will increase modestly to $34.5 billion in 2002-03 and further to $36.4 billion in 2003-04. Over the longer term, we forecast that PIT receipts will increase at an average annual rate of 9.6 percent between 2003-04 and 2007-08, reaching $52.5 billion by the end of the forecast period.

Figure 3

Net Impact on Revenues of Special Factors[a]



[a] Actions taken in 2002-03 that affect revenue totals in the forecast period.

Key Forecast Factors

Much of the estimated PIT revenue gain between 2001-02 and 2002-03 is related to the $1 billion in PIT revenue increases adopted in conjunction with the 2002-03 budget. Absent these changes, the underlying growth in PIT receipts would be less than 1 percent. This small underlying increase is related to both continued economic sluggishness and the adverse impacts of further stock market declines on taxable income related to stock options and capital gains. We estimate that after plunging by nearly 66 percent in 2001, the income from gains and options will decline another 19 percent in 2002 before starting to rebound in 2003. In subsequent years, we project that the combination of an economic rebound and modest improvement in stock market-related income will boost PIT receipts.

Sales and Use Taxes

We estimate that SUT receipts will total $22.4 billion in 2002-03, a 5.3 percent increase from 2001-02. We forecast that these receipts will grow further to $23.5 billion in 2003-04. Over the longer term, we forecast that SUT receipts will increase at an average annual rate of 6.6 percent between 2003-04 and 2007-08, reaching $30.5 billion by the end of the forecast period. This growth in SUT receipts is projected to be slightly less than our projected growth for statewide personal income for the period, reflecting a slight decline in the portion of income that is spent on taxable commodities.

Key Forecast Factors

A key determinant of sales tax receipts is taxable sales. As indicted earlier in Figure 2, these sales fell sharply beginning in the second half of 2001, and have only partially recovered in the first three quarters of this year. On an average annual basis, taxable sales were down by 0.7 percent in 2001 (reflecting softness in the second half of year), and are expected to be down another 1.4 percent in 2002. As indicated in the shaded box, much of the recent softness appears to be due to weak business-related spending.

Looking ahead, we project that taxable sales will accelerate, increasing by 3.9 percent in 2003 and 6.2 percent in 2004. Over the longer term, our forecast assumes that taxable sales will increase slightly slower than personal income. These increases are somewhat subdued compared to what would normally be expected during a cyclical upturn. As indicated in Chapter 2 , consumer spending on automobiles and other durable goods has been strong during the recent economic downturn. Because of this, consumers at this point in time have less capacity to take on new debt and have less "pent up" demand than is normal for this stage of an economic cycle. This, in turn, will constrain taxable sales growth.

CORPORATION TAXES

We estimate that CT receipts will increase from $5.6 billion in 2001-02 to $6.8 billion in 2002-03, before falling to $6.7 billion in 2003-04 and $6.5 billion in 2004-05. In the subsequent three years, we project that revenues from this source will increase at an average annual rate of 6.6 percent, reaching $7.9 billion by the end of the forecast period.

Key Forecast Factors

Corporation tax receipts in 2002-03 and beyond will be affected both by changes in California taxable corporate profits and by law changes enacted along with the 2002-03 budget. Specifically:

Weak Business Spending Behind Drop In Taxable Sales

Although the plunge in PIT receipts has been the single most significant state revenue development during the past two years, California taxable sales have also fallen sharply during this period. This decline has adversely affected the state as well as local governments throughout California.

Although SUT receipts are most generally associated with *retail* spending, approximately one-third of taxable sales are actually attributable to *business-to-business* transactions. These include purchases of computers, telecommunications equipment, and building materials that go into the construction of new facilities. It is the softness in business spending that appears to be primarily responsible for the recent decline in taxable sales.

The impact of declining business spending on taxable sales during the 2001 economic downturn can be clearly seen in the detailed taxable sales data recently published by the Board of Equalization for the third quarter of 2001 (the most recent quarterly data available). It indicates that, during the 2000 to 2001 period, overall taxable sales fell by just under 3 percent. However, the relative performance of different components of taxable sales was very different. In particular:

- *Retail spending was basically flat*, reflecting moderate gains in sales of cars and building materials, and small declines in other retail categories. In contrast:

- *Business-to-business sales were down by nearly 8 percent*, reflecting reductions in spending for equipment and construction materials that go into nonresidential structures.

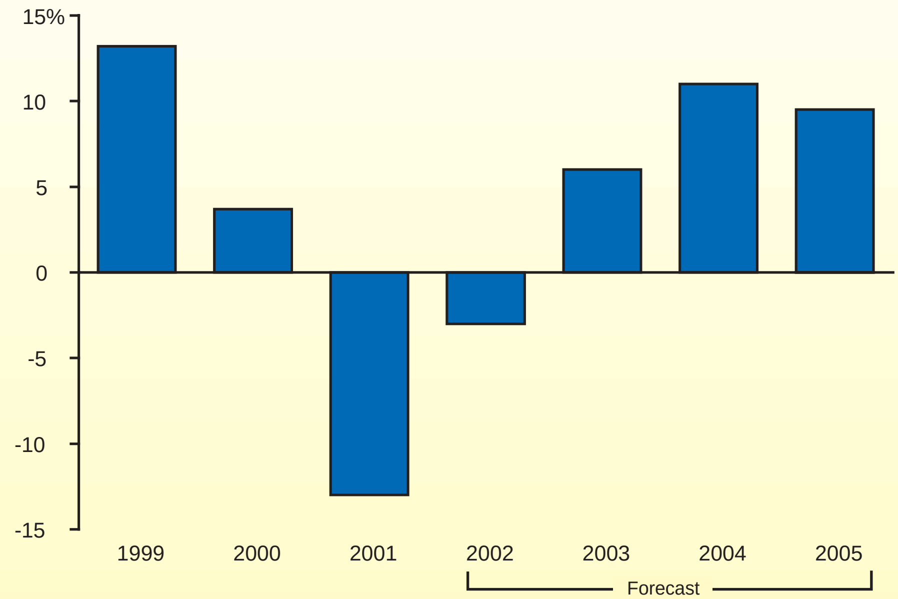
We believe that the trends evident in the 2001 taxable sales data—moderate consumer spending but declines in business-related sales—will persist until mid-2003, when business spending begins to improve.

- *Taxable Profits.* Figure 4 shows that, after growing by slightly over 3 percent in 2000, profits plunged by 13 percent in 2001. This reflected the dual impacts of falling sales and rising compensation costs on corporations' bottom-line profits. Despite major efforts by the business sector to control costs in 2002, we estimate that profits will continue to decline during the near term due to continued softness in manufacturing. We expect that profits will rebound beginning in 2003, reflecting the benefits realized from current cost-cutting measures and accelerating business sales anticipated for next year. Specifically, we forecast that California taxable profits will increase by 6 percent in 2003 and by roughly 10 percent in 2004 and 2005, before settling into annual rates of about 7 percent over the balance of the forecast period.

Figure 4

Profits To Slowly Recover

Percent Change in California Taxable Profits



- *Law Changes.* We estimate that the two-year suspension of NOLs, along with other tax-related law changes enacted in 2002-03, will boost CT receipts by $1.2 billion in the current year and about $540 million in 2003-04. In subsequent years, receipts will be reduced by between $250 million to $400 million annually, reflecting the increase in allowable NOL deductions from 65 percent to 100 percent of incurred losses beginning in 2004.

Other Revenues And Transfers

The remaining sources of income for the General Fund include various revenues other than from the PIT, SUT, and CT, as well as transfers to the General Fund from special funds. Included among the other revenues are taxes on insurance premiums, alcoholic beverages, and tobacco, as well as interest on pooled money investments. As shown earlier in Figure 1, we estimate that combined collections from all of these sources will fall from a peak of $12.8 billion in 2001-02, to $11.3 billion in 2002-03 and only $3.6 billion in 2003-04, before partly rebounding to $4.8 billion in 2007-08.

Key Forecast Factors

The total revenues from these other sources depends on a variety of factors, including the volume of insurance premiums written, alcoholic beverage and tobacco sales, interest rates, and the amount of General Fund resources available to be invested. Our projections for these variables reflect our underlying economic and demographic assumptions discussed in Chapter 2.

In addition, as noted above, numerous special factors also affect these revenue totals. These include the electricity loan repayment in 2001-02, the securitization of future tobacco settlement receipts, and one-time loans and their associated repayments.

With regard to ongoing revenues in this category, our estimates assume moderate increases in insurance taxes, stable receipts from alcoholic beverage taxes, and declining receipts from tobacco taxes. The estimates also take into account the phase-out of California's estate tax resulting from federal law changes enacted in 2001.

Risks and Uncertainties

As discussed in Chapter 2, the economic forecast on which our revenue projections are based has certain risks that are concentrated on the downside direction. Should the state's economic growth fail to achieve the modest increases we are assuming, annual General Fund revenues could easily fall several billion dollars below what we are projecting. The shortfall would be greater if economic growth stalled out and even a mild downturn were to develop.

Chapter 4

Expenditure Projections

In this chapter, we discuss our General Fund expenditure estimates for 2001-02 and 2002-03, and our projections for 2003-04 through 2007-08, both in total and by program area. We first look at general budget trends during the forecast period, and then discuss in more detail our expenditure projections for individual major programs.

GENERAL FUND BUDGET TRENDS

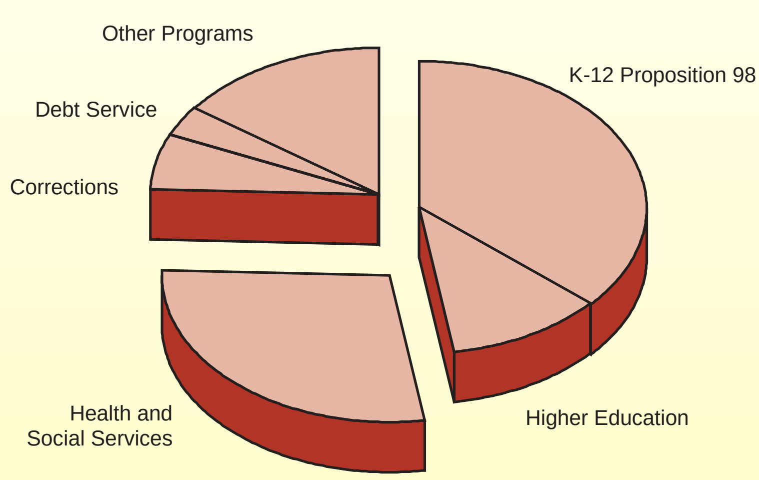
Distribution of General Fund Spending

Figure 1 shows how General Fund spending is distributed among major program areas in 2002-03. It shows that education programs dominate state spending, accounting for nearly one-half of the General Fund total. About 37 percent is attributable to K-12 education, and another 11 percent is for higher education (which includes the University of California [UC], California State University [CSU], and California Community Colleges [CCC]). Just over one-fourth of the total 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 backfill), and other purposes.

Figure 1

Education, Health, and Social Services Account for Most Spending

General Fund
2002-03



Spending Trends Over the Outlook Period

Over the forecast period, we project that General Fund expenditures will increase at an average annual rate of 6.6 percent. This overall growth rate reflects divergent trends among major state programs. As indicated in Figure 2:

- *K-12 Proposition 98 (General Fund)* spending is projected to increase at an average annual rate of 4.3 percent over the forecast period, reflecting slowing growth in school enrollments.

- *Higher Education* spending for community colleges (General Fund) will increase 5.4 percent per year over the forecast period, reflecting our estimate of Proposition 98 and community college enrollment. We also project that expenditures will increase at an average annual rate of 5 percent for CSU and 5.1 percent for UC. The increases for both of the latter segments reflect projected growth in student enrollment and inflation.

- *Medi-Cal* benefits are projected to grow at an average annual rate of 8.8 percent. This large increase reflects (1) continued rapid growth in costs for medical services and prescriptions and (2) added costs beginning in 2003-04 to cover recent program expansions that are currently being supported by the Tobacco Settlement Fund.

- *California Work Opportunity and Responsibility to Kids (CalWORKs)* spending is projected to remain nearly flat through the forecast period. Our projections assume that caseloads will continue to decline through 2005-06, enabling the state to fund both cost-of-living adjustments (COLAs) and employment services while at the same time holding total spending for the program near the federal maintenance-of-effort floor.

- *Supplemental Security Income/State Supplementary Program (SSI/SSP)* spending is projected to increase at an average annual rate of 6.4 percent. This reflects the impacts of caseload growth and statutory COLAs over the forecast period.

- *In-Home Supportive Services (IHSS)* spending is projected to increase at an average annual rate of 9 percent. Our estimates assume annual wage increases for certain IHSS workers, as provided for by current law, as well as continued growth in caseloads.

- *Other Major Health and Social Services Programs* are projected to grow at an average annual rate of 6.5 percent. Growth in this category is affected by continued rapid increases in caseload and costs in the Department of Developmental Services regional centers, as well as a funding shift for the Healthy Families Program and certain public health programs from the Tobacco Settlement Fund to the General Fund beginning in 2003-04.

- *Department of Corrections* spending is forecast to grow at an average annual rate of 4.5 percent. This reflects stable inmate populations, accompanied by cost increases for the Unit 6 bargaining agreement and health care costs for inmates.

- *Vehicle License Fee (VLF) Subventions.* Appropriations to backfill local revenue losses associated with the VLF tax reduction are projected to increase at an average annual rate of 5 percent. This reflects moderate increases in vehicle registrations and price levels over the forecast period.

- *Debt Service.* Principal and interest payments on general obligation and lease revenue debt are projected to increase at an annual rate of 16.8 percent. Our estimates reflect the Treasurer's restructuring of debt,

Figure 2

Projected General Fund Spending for Major Programs

(Dollars in Millions)

	Estimated		Forecast					Average Annual Growth Over the Forecast Period
	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	
Education programs								
K-12-Proposition 98	$26,806	$28,649	$29,398	$30,568	$32,309	$33,921	$35,316	4.3%
Community Colleges-Proposition 98	2,579	2,814	2,832	2,989	3,194	3,422	3,659	5.4
CSU	2,638	2,620	2,747	2,896	3,026	3,174	3,340	5.0
UC	3,232	3,133	3,303	3,482	3,638	3,817	4,016	5.1
Health and Social Services								
Medi-Cal benefits	$8,949	$9,782	$11,160	$12,075	$12,992	$13,863	$14,915	8.8
CalWORKs	2,021	2,041	2,143	2,078	2,078	2,078	2,078	0.4
SSI/SSP	2,807	3,060	3,420	3,566	3,750	3,960	4,182	6.4
IHSS	887	1,009	1,106	1,217	1,337	1,440	1,550	9.0
Other major programs	6,637	6,249	6,861	7,229	7,637	8,089	8,578	6.5
Department of Corrections	4,657	4,700	4,848	5,093	5,363	5,677	5,849	4.5
Vehicle license fee subventions	2,460	3,789	3,888	4,065	4,308	4,565	4,838	5.0
Debt service[a]	2,954	2,571	2,907	4,190	4,646	5,159	5,589	16.8
Other programs/costs	10,313	8,036	10,602	11,549	12,500	13,385	14,279	12.2
Totals	**$76,940**	**$78,453**	**$85,216**	**$90,996**	**$96,779**	**$102,551**	**$108,190**	**6.6%**

Detail may not total due to rounding.

[a] Includes both general obligation and lease-revenue bonds for all departments.

which will defer about $860 million in debt service payments in 2002-03. We assume that the state will sell a portion of the $25 billion of currently authorized general obligation bonds. We also assume that voters will approve the $22 billion in bonds already on the ballot in 2004, and that a relatively small portion of these bonds will be sold in the latter years of the forecast period.

- *Other Programs/Costs.* We project that these costs will increase at an average annual rate of 12.2 percent over the forecast period. Factors affecting this category include: (1) $1.2 billion in new spending for transportation beginning in 2003-04, as required by Proposition 42; (2) increasing costs for state employee health care and retirement programs; and (3) resumed payment of annual noneducation mandate costs and amortization of prior-year claims.

PROPOSITION 98— K-14 EDUCATION

State spending for K-14 education (K-12 schools and community colleges) is governed largely by

Proposition 98, passed by the voters in 1988. Proposition 98 sets the minimum amount the state must provide for California's public K-12 education system and the CCC. Almost 80 percent of total operations funding for K-14 education is from the state General Fund and local property taxes, pursuant to Proposition 98. The remainder is from a variety of sources including federal funds, lottery revenue, and other local revenues. California's public K-12 education system consists of more than 1,000 locally governed school districts and county offices of education serving about 6 million K-12 students. In addition, these entities serve infants and preschool students receiving child care, and individuals in adult education programs. The CCC provides instruction to about 1.7 million adults at 107 colleges operated by 72 locally governed districts.

The Spending Forecast. With the enactment of the *2002-03 Budget Act*, Proposition 98 appropriations exceeded the minimum guarantee by $6 million. We now estimate that declining General Fund revenues have lowered the 2002-03 minimum guarantee by $1.9 billion. Because the 2002-03 appropriation level has not changed, we forecast that the Proposition 98 minimum guarantee is now overappropriated by $1.9 billion.

For 2003-04, we estimate that Proposition 98 will require the Legislature to allocate approximately $2.2 billion, or 4.7 percent, more to Proposition 98 programs than in 2002-03. Since we estimate that over $1.4 billion of additional property tax revenue will be allocated to school and community college districts in 2003-04, the General Fund increase would be $770 million (a 2.4 percent increase). In addition to the $2.2 billion growth in the Proposition 98 guarantee, the Legislature will have available $400 million of funding in the Proposition 98 base that will be freed-up for other K-14 priorities in 2003-04. This funding is a result of spending deferrals that were made to help address the state's budget problem (see discussion in the nearby shaded box). For the forecast period, we estimate that growth in total Proposition 98 spending (General Fund and local property taxes) for K-14 education will average 5.4 percent annually (see Figure 3). This growth rate is lower than the rate currently projected for 2002-03 (7.6 percent), but higher than the growth rate in 2001-02 (0.7 percent).

Key Forecast Factors. General Fund expenditures for Proposition 98 depend on a variety of factors—including K-12 average daily attendance (ADA), per capita personal income, per capita General Fund revenues, and local property taxes. For our forecast:

- We assume a slowing rate of growth in K-12 ADA. We forecast the growth rate for 2003-04 at 1 percent, falling to 0.2 percent by 2007-08.

2002-03 Deferrals "Free-Up" Over $400 Million in 2003-04

As part of the solution to the 2002-03 budget problem, the Governor and Legislature deferred $1.1 billion of Proposition 98 spending from 2001-02 to 2002-03. Instead of receiving $1.1 billion in categorical funding in the late spring of 2002, schools received the funding in summer 2002. The deferral had no programmatic impact on school districts, although some districts may have experienced cash-flow and accounting difficulties as a result of the delay. A second component of the 2002-03 budget solution was to defer $681 million of Proposition 98 funding from 2002-03 to 2003-04. Since the deferrals are one-time costs and the level of deferral paid in 2002-03 ($1.1 billion) is larger than the deferral required to be paid in 2003-04 ($681 million), the Legislature will have over $400 million in resources available for other Proposition 98 priorities in 2003-04.

- We forecast California per capita personal income to grow at just over 2 percent in 2003-04. Given the uncertainty surrounding the economy and per capita personal income in the coming year, we note that the Proposition 98 guarantee would increase (decrease) by around $475 million for each additional 1 percent increase (decrease) in per capita personal income. Any change in per capita personal income would result in an equivalent change in General Fund needed for Proposition 98 (assuming the same growth in local property tax revenues).

- Our forecast also reflects moderate growth in General Fund revenues. However, we forecast local property tax growth averaging over 7.5 percent, reducing the General Fund portion of Proposition 98 growth.

Figure 3 summarizes our assumptions for these factors and identifies the annual changes in the guarantee that result.

Commitment to Over-Appropriate Proposition 98. In addition to the above factors, our forecast also accounts for statutory commitments to over-appropriate the minimum guarantee in 2003-04. Chapter 1167, Statutes of 2002 (AB 2781, Oropeza), requires the state to restore *any* "maintenance factor" in 2003-04 regardless of what the Proposition 98 minimum guarantee would require. (A maintenance factor is created in years where General Fund revenues grow more slowly than the economy. We estimate that the state will have a maintenance factor of $700 million in 2003-04.) Our forecast suggests that General Fund revenues will grow at roughly the same rate as the economy in 2003-04. As a result, Proposition 98 would not require any of the $700 million maintenance factor to be restored. Thus the statutory requirement to restore all of the maintenance factor would result in an over-appropriation of $700 million in 2003-04. In addition, Chapter 1167 requires the state to provide an additional $79 million over-appropriation related to the prior-year's deferrals. The over-appropriation of almost $780 million would become part of the Proposition 98 base—making the increase permanent.

Impact of Proposition 49. Our forecast also assumes that the recent passage of Proposition 49—the After School Education and Safety Program—will require the state to over-appropriate the minimum guarantee in 2004-05 by up

Figure 3

The LAO Proposition 98 Forecast

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Proposition 98 (In Billions)[a]						
K-12	$41.6	$43.6	$45.9	$48.6	$51.4	$54.0
Community Colleges	4.8	5.0	5.4	5.7	6.1	6.6
Totals	**$46.5[b]**	**$48.7[c]**	**$51.2[d]**	**$54.4**	**$57.5**	**$60.5**
Community Colleges share of guarantee	10.4%	10.4%	10.5%	10.5%	10.7%	10.8%
Proposition 98 "Test"	2	2	2	2	2	2
Annual Percentage Change						
State population	1.7%	1.5%	1.5%	1.5%	1.5%	1.5%
K-12 average daily attendance	1.4	1.0	0.8	0.8	0.4	0.2
Per capita personal income	-1.3	2.1	3.4	5.3	5.4	5.1
Total guarantee	7.6	4.7	5.2	6.1	5.8	5.3
General Fund	7.0	2.4	4.1	5.8	5.2	4.4
Local property taxes	8.7	9.6	7.4	6.8	7.0	7.0

[a] Includes local property tax revenues.
[b] Assumes restoration of $3.2 billion of "maintenance factor."
[c] Assumes restoration of $700 million of maintenance factor.
[d] Assumes over-appropriation of $428 million to fund Proposition 49.
Detail may not add to total due to rounding.

to $428 million under certain conditions. The initiative requires the state to over-appropriate Proposition 98 by the difference between $550 million and the 2003-04 appropriation for the program. If the 2002-03 appropriation level of $122 million is continued into 2003-04, then the state will be required to over-appropriate Proposition 98 by $428 million in 2004-05. The Legislature and Governor, however, could decide to increase funding for the before and after school program in 2003-04. Given the growth in the Proposition 98 minimum guarantee in 2003-04 and the net impact of deferrals, there will be over $1 billion available—beyond growth and COLA—for expansion of existing programs and/or funding for some new programs in 2003-04. Thus, the state could choose to fund part or all of the required Proposition 49 expansion within the 2003-04 minimum guarantee.

K-12 Funding Projections. Figure 4 displays our projected K-12 per-pupil spending levels (in both "current" and inflation-adjusted dollars). These estimates are derived from our Proposition 98 forecast and are adjusted for funding deferrals between years. (That is, we counted the spending toward the fiscal year in which school districts had programmatically committed the resources.) The estimates reflect real (that is, inflation adjusted) per-pupil increases averaging 1.7 percent annually over the forecast period. These additional resources—averaging over $750 million each year after 2002-03—would permit expansion of existing programs and/or funding for some new programs.

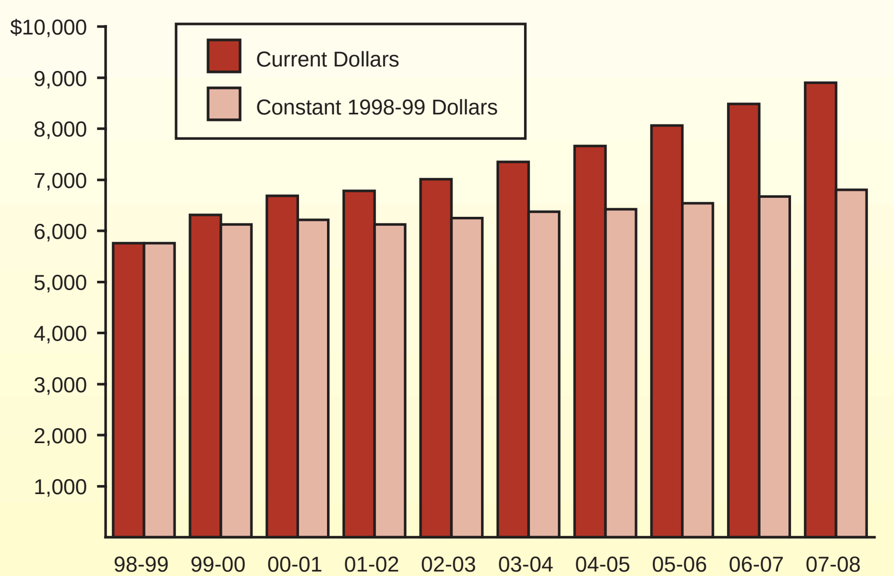
Community College Funding Projections. Based on our Proposition 98 projections, we estimate total CCC funding would increase by about 6.3 percent per year over the forecast period. To forecast the CCC's share of Proposition 98, we assumed that both CCC and K-12 would receive statutorily required growth and COLA each year. We assumed that growth in Proposition 98 funds in excess of growth and COLA would be distributed based on the historic K-12 and CCC split. The resulting forecast projects a gradual increase in CCC's share of Proposition 98 spending from 10.4 percent in 2002-03 to 10.8 percent in 2007-08. As shown in Figure 5, the increase in CCC's share of Proposition 98 funds is due to CCC's enrollment growth rate exceeding K-12's over the forecast period.

UC AND CSU

In addition to community colleges, the state's public higher education system includes the UC

Figure 4

Proposition 98 K-12 Funding per Student[a]



[a]For 2001-02 through 2003-04, we adjusted spending for deferrals–that is, we counted funds toward the fiscal year in which school districts programmatically committed the resources.

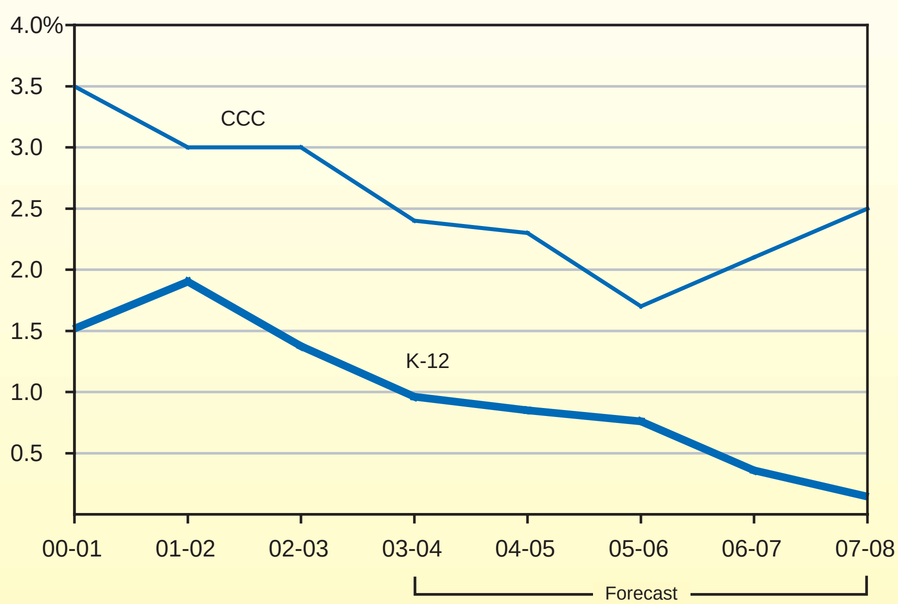
and the CSU. The UC consists of eight general campuses, one health science campus, numerous special research facilities, and a planned tenth campus in Merced. The UC awards bachelor's, master's, and doctoral degrees, as well as various professional degrees. The UC has primary jurisdiction over public university research. The CSU consists of 23 campuses and several off-campus centers. The CSU grants bachelor's and master's degrees and may award doctoral degrees jointly with UC or a private university.

The Spending Forecast. We estimate that spending for UC and CSU (excluding funding for capital outlay and debt service) will increase from $5.8 billion in 2002-03 to $6.1 billion in 2003-04, or by 4.9 percent. By 2007-08, we estimate that spending for UC and CSU will increase to $7.3 billion, reflecting annual increases of about 5 percent.

Key Forecast Factors. For 2003-04 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 roughly 3 percent annually. With regard to enrollment growth, the Master Plan calls for UC and CSU to draw from a fixed eligibility pool (12.5 percent and 33.3 percent, respectively) of high school graduates. The main component of enrollment growth, therefore, is growth in the number of high school graduates. This population is expected to grow at a modest rate of 1 percent to 2 percent annually over the forecast period. We expect the rate of college enrollment will be somewhat higher than this, however, for three reasons. First, the state continues to conduct outreach and similar activities to encourage increased college participation by targeted groups. Second, the recent expansion of financial aid programs, including the guaranteeing of Cal Grants to qualified high school graduates, is subsidizing the cost of college attendance for an increasing number of students. Third, the declining real cost of higher education fees (which have not been increased for eight years) provides an added fiscal incentive for college attendance.

Figure 5

Projected Enrollment Growth
CCC and K-12



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 still 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 annual total Cal Grant expenditures could exceed $1.5 billion by 2007-08.

HEALTH

Tobacco Settlement Fund

The 2001-02 budget plan established a new special fund, the Tobacco Settlement Fund, which is made up of revenues received by the state from the settlement of tobacco-related litigation. The law creating the fund initially required that, after 2001-02, all revenues from this source be deposited in the fund for the support of various specified health programs. However, under more recent legislation, this revenue stream was sold to investors (securitized) to provide funds to support overall state expenditures in 2002-03. Because tobacco settlement receipts will be used to retire this debt for the foreseeable future, little if any of these funds will be available in 2003-04 and subsequent years for the support of health programs.

The Spending Forecast. This forecast assumes that the cost of these programs—estimated to be $546 million in 2002-03—shifts to the state General Fund. The specific health programs affected by such funding shifts include Medi-Cal, public health programs such as the Child Health and Disability Prevention and prostate cancer treatment programs, and Healthy Families insurance coverage for children.

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 General Fund spending for Medi-Cal local assistance (including benefits, administration, and other costs) will be nearly $10.4 billion in the current year, about a $600 million increase over the amount appropriated in the *2002-03 Budget Act*. We project that, barring other actions by the Legislature and Governor, General Fund support for the program would grow to $11.8 billion in 2003-04, a 13.6 percent increase from current-year expenditures. By the end of the forecast period in 2007-08, we estimate that General Fund spending for Medi-Cal will reach $15.7 billion, an average annual increase of 8.5 percent over the projection period.

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

- *Health Care Costs.* The most significant factor in our forecast is our assumption that the cost of most health care services provided to Medi-Cal enrollees will increase at an annual rate of between 5 percent and 7 percent from 2003-04 through 2007-08, consistent with past trends. This increase in the cost of services provided to enrollees can be seen in Figure 6. Our projected health care costs are subject to considerable uncertainty and small changes in the rate of growth in medical costs could have significant fiscal effects.

- *Reductions in the Federal Matching Rate.* The federal Medicaid matching rate is based on a state's per capita income relative to the nation for the most recently available three calendar years. Because California's economy was especially strong in the late 1990s, the state's federal matching rate was reduced. The *2002-03 Budget Act* assumed that the state would receive an additional $400 million in federal assistance on a one-time basis to offset this adjustment in the federal matching rate but, at the time this projection was prepared, Congress had not taken any such action. Our forecast assumes this assistance will not be forthcoming in 2002-03.

- *Tobacco Fund Shift.* In 2002-03, the Medi-Cal budget is partly supported with money received from the settlement of tobacco litigation. Tobacco fund securitization will result in an ongoing shift to the General Fund of $235 million for the Medi-Cal Program alone. Our forecast reflects this anticipated funding shift.

- *Medi-Cal Enrollment Trends.* As shown in Figure 6, the overall Medi-Cal caseload appears to be stabilizing. This period of relative stability follows several years of particularly strong caseload growth among low-income families and children who do not receive cash assistance, which was due primarily to changes in program eligibility rules. The full effect of these changes now appears to have been largely realized. Our forecast assumes some continued caseload growth commensurate with increases in the state's population. It also assumes that the state's economic slowdown will result in a modest further increase in the Medi-Cal caseload in the near term.

- *Provider Rates.* Our forecast assumes restoration of more than $70 million from the General Fund in 2002-03 for Medi-Cal provider rates consistent with the Governor's intentions, which he stated while signing recent Medi-Cal-related legislation.

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 incomes 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.

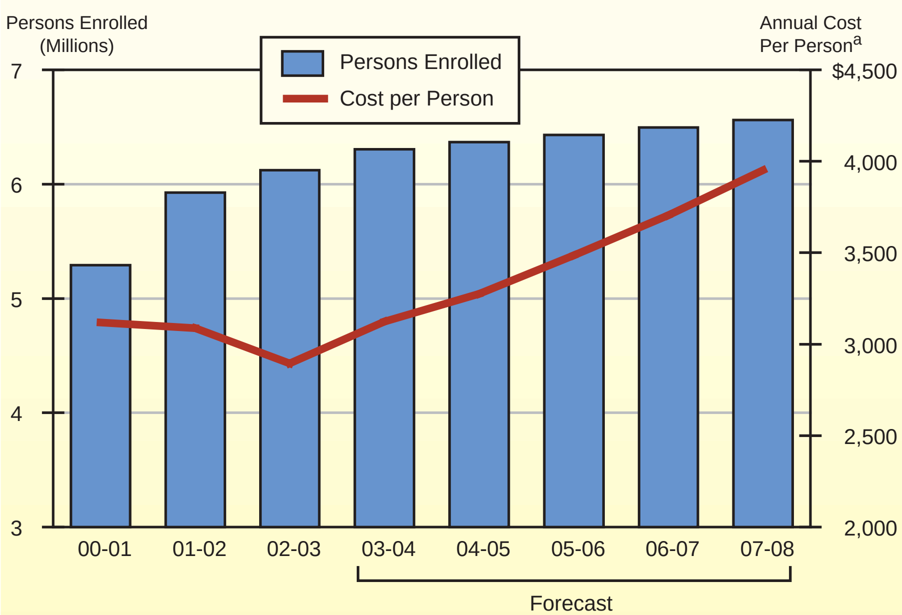
The state has received federal approval to expand Healthy Families coverage to eligible parents in families with incomes below 200 percent of the federal poverty level. However, the Governor vetoed funding that had been included in the 2002-03 budget to commence the expansion in October 2002 because of the state's ongoing fiscal problems.

The Spending Forecast. We estimate that overall state spending for the Healthy Families Program will exceed $260 million in 2002-03, about the same amount of funding as provided in the *2002-03 Budget Act*. About $21 million in support would be provided from the General Fund, with the balance in state funding during this period coming from the Tobacco Settlement Fund.

We further estimate that overall state spending for the program will increase about 14 percent in

Figure 6

Medi-Cal Cost Per Person Increasing– While Overall Caseload Stabilizing



[a]General Fund and federal funds.

2003-04 to about $300 million, and that by 2007-08 the program will have an annual cost of about $390 million. The forecast assumes that all $300 million in state support for the program commencing in 2003-04 comes from the General Fund.

Key Forecast Factors. The significant increase in General Fund resources for the program in 2003-04 is the result of the anticipated loss of program support from the Tobacco Settlement Fund. The forecast assumes that the expansion of the program to parents does not occur during the projection period. The growth in the program is based on the assumption that the caseload of children in Healthy Families continues to grow, although not as quickly as in previous years, as the program reaches a larger proportion of the eligible population. Specifically, we assume that the program, which had about 570,000 children enrolled as of July 2002, will reach an enrollment of almost 700,000 children by June 2008. The forecast assumes continued increases in the cost of medical coverage.

Developmental Services

The Lanterman Developmental Disabilities Services Act of 1969 entitles individuals with developmental disabilities to a variety of services, which are overseen by the DDS. Individuals with developmental disabilities have been diagnosed with mental retardation, cerebral palsy, epilepsy, autism, or other similar disabling conditions. The DDS operates five Developmental Centers (DCs) and two smaller facilities which provide 24-hour institutional care, and contracts with 21 Regional Centers (RCs) to coordinate and deliver community-based services.

The Spending Forecast. We estimate that General Fund spending for developmental services in 2002-03 will total $1.8 billion, the same amount of funding appropriated in the *2002-03 Budget Act*. Of that total, nearly $1.5 billion will be spent by RCs for community services and about $332 million will be spent for operating the DCs.

We further estimate that General Fund spending for developmental services will grow by about 9 percent in 2003-04 to nearly $2 billion. By 2007-08, we estimate that General Fund spending for this program will grow by $1 billion and reach $2.8 billion. This expenditure growth is due almost entirely to the RCs. We estimate that spending for DCs will remain relatively flat over the forecast period.

Key Forecast Factors. Our forecast of significant growth in RC spending reflects historical increases both in caseload and in the average cost of serving each RC client. Specifically, our forecast assumes that RC caseloads will continue to grow at an annual average rate of 5.4 percent and that costs will continue to grow at an annual average rate of 5.9 percent.

SOCIAL SERVICES

CalWORKs

In response to federal welfare reform legislation, the Legislature created the CalWORKs program in 1997. This 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 2002-03 for the CalWORKs program is estimated to be $2 billion, an increase of 1 percent over the prior year. In 2003-04, spending is projected to increase by 5 percent, to $2.1 billion. We project spending to decrease by 3 percent in 2004-05, and then remain stable through the remainder of the forecast period. The projected year-over-year spending changes result from (1) satisfying the remaining state match obligation for the federal Welfare-to-Work program in 2003-04 and (2) replacing lower maintenance-of-effort (MOE)-countable spending in other programs with additional General Fund spending within CalWORKs. Continued caseload decline projected through the forecast period enables the state to maintain spending at the federal MOE floor.

Key Forecast Factors. Our CalWORKs spending projection is based on several factors, the most important being our caseload projections (discussed below). In addition, we assume that California will meet the $2.7 billion MOE spending requirement by counting about $650 million being spent in other programs. Finally, we assume that the Temporary Assistance for Needy Families (TANF) block grant will be reauthorized at its current $3.7 billion annual level for California.

Unanticipated Caseload Declines Relieve CalWORKs Funding Pressures. Contrary to *2002-03 Budget Act* assumptions, the caseload decreased in 2001-02, and we project caseloads to decline further in the current year. (We discuss caseload trends below.) We project that these unanticipated caseload declines, as well as continued annual declines through 2005-06, will result in program savings and sufficient TANF carryover funds to enable the state to maintain General Fund spending at the MOE floor while providing the statutory COLA and inflation adjustments for employment services and child care throughout the forecast period.

Sensitivity to Caseload Projections. Our spending forecast is driven largely by our caseload projections, and relatively modest caseload movement in either direction could result in significant program costs or savings. If the caseload were to remain stable in 2003-04 and beyond, rather than decreasing as projected, we estimate that federal carryover savings would be exhausted in 2004-05. Fully funding the program in that year would require General Fund expenditures of approximately $300 million above the MOE floor. By 2007-08, fully funding the program would require spending over $1 billion above the MOE floor.

Caseload Trends and Projections. From 1994-95 through 2001-02, the CalWORKs caseload declined by 46 percent. As shown in Figure 7(see next page), we believe the decline will continue, due to economic and demographic trends (primarily lower birth rates). Specifically, we project a 2 percent decline in 2002-03 and a decline of 5 percent in 2003-04, followed by lower declines of 4 percent and 1 percent in 2004-05 and 2005-06, respectively. This is followed by caseload increases of about 1 percent in both 2006-07 and 2007-08. Our projections are based on a trend analysis of caseloads, birth rates, grant levels, and unemployment rates.

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.

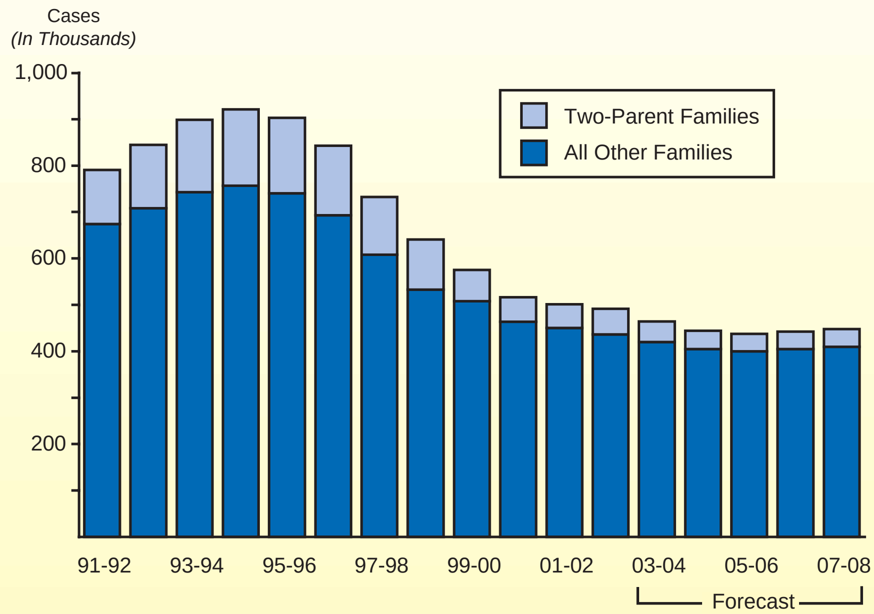
The Spending Forecast. General Fund spending for SSP is estimated to be about $3.1 billion in 2002-03, an increase of 9 percent over the prior year. For 2003-04, we project an increase of 12 percent, raising total expenditures to $3.4 billion. We project that from 2004-05 through the end of the forecast period, spending for SSP will increase by an annual average of 5.2 percent, eventually reaching a total of $4.2 billion.

Key Forecast Factors. The *2002-03 Budget Act* delayed the January 2003 COLA until June 2003. The current-year COLA cost of $24 million results in annual incremental costs of about $267 million (representing 11 new months of costs) in 2003-04. For the remainder of the forecast period, the two primary components of projected cost increases are (1) annual caseload growth of about 2.2 percent and (2) providing the statutory January COLA. In 2002-03, caseload growth and COLA result in additional costs of $93 million. In 2003-04 and subsequent years, annual caseload costs average about $70 million, and the cost of providing the COLA ranges from $70 million to $120 million, depending on the California Necessities Index and the amount of the federal SSI COLA, which is based on the Consumer Price Index.

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 due to federal policy changes which restricted eligibility. Since March 1998, the caseload has been growing at a steady rate of about 2.2 percent per year. We expect this growth rate to continue throughout the forecast period.

Figure 7

CalWORKs Caseload Decline Continues Through 2005-06



IHSS

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 about $1 billion in 2002-03, an increase of 14 percent over the prior year. For 2003-04 we project that costs will increase by 10 percent. This rate of spending growth will continue for the next two fiscal years and then fall to about 8 percent in the final two years of our forecast, resulting in total expenditures of $1.6 billion in 2007-08.

Key Forecast Factors. Our forecast assumes that costs will increase 7.5 percent each year due to caseload growth and increases in the hours of service provided to recipients. Recent legislation authorizing state participation in health benefits and wage increases for certain IHSS workers will increase annual costs by an additional $78 million over the forecast period.

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 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 $190 million from 2001-02 to 2003-04, reaching about $4.8 billion at the end of that period. Expenditures for CDC are forecast at about $5.8 billion by 2007-08. (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. The forecast assumes that the CDC budget would grow at an average annual rate of 4.5 percent through 2007-08, compared with substantially higher prior annual growth rates in the past that sometimes exceeded 10 percent.

During the forecast period, the department's General Fund costs are assumed to be partially offset by $143 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. This is roughly the same amount budgeted in 2001-02.

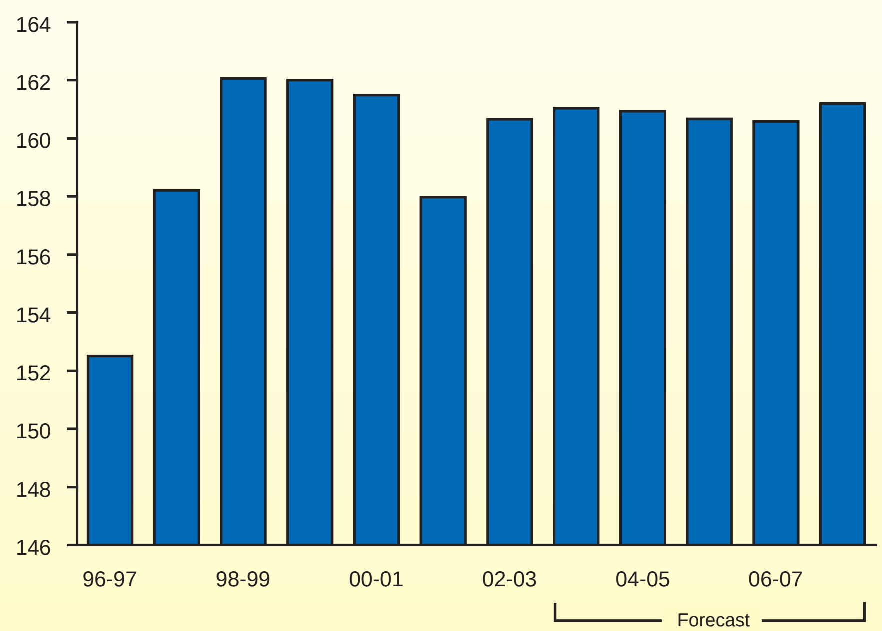
Key Forecast Factors. The projected increases in General Fund support for CDC are driven by a combination of factors, including correctional officer salary increases pursuant to the Unit 6 bargaining agreement; overtime, sick leave, and workers' compensation costs; and growth in the cost of inmate health care services. The Unit 6 agreement went into effect in January 2002 and is estimated to result in salary increases of over $600 million during the forecast period, with the first increase expected in 2002-03. Also, increases in the overall cost of providing health care to inmates have caused health care expenditures to increase at a higher rate than other prison support costs.

Prison population is not a significant driver of General Fund cost increases after 2002-03. As seen in Figure 8, although the population is projected to increase by 2,700 inmates by the end of 2002-03, it is expected to stabilize at this level increasing by only 540 inmates (or less than 1percent) over the remainder of the projection period. According to CDC, the 2002-03 population increase is largely due to a reduction in available local jail beds for CDC commitments.

Figure 8

Inmate Population Projected to Stabilize

(In Thousands)



OTHER PROGRAMS

Statewide Reductions

The 2002-03 budget package contained a number of provisions designed to generate statewide General Fund savings, including (1) unallocated reductions in departments' state operations budgets, (2) a golden handshake program for early retirement from state service, (3) elimination of vacant positions, and (4) the continuation of a hiring freeze. In total, these provisions were expected to generate over $1.1 billion in General Fund savings in 2002-03.

Based on several factors, we do not expect these provisions to generate the magnitude of expected savings in the current year. For instance, the golden handshake program will likely generate no savings due to optional participation by departments and the requirement that positions be held vacant only long enough to offset increased retirement costs. As a result, we project savings for these items to total slightly more than $300 million in 2002-03. We expect that this amount will increase in 2003-04 and thereafter, as additional vacancies are eliminated and spending reductions are more fully implemented.

Employee Compensation

In projecting expenditures for employee compensation costs, we have estimated the future costs for existing agreements between the state and its bargaining units. For instance, the negotiated pay increases for highway patrol and correctional officers will increase General Fund expenditures by $73 million in 2003-04—increasing to $677 million by 2006-07. For the other bargaining units without long-term agreements, we have included the costs for the general 5 percent salary increase due to begin at the start of 2003-04 ($188 million General Fund annually). For these units, we assumed compensation costs in future years will increase at the same rate as inflation. A 1 percent salary increase for state employees in these units increases General Fund costs by about $39 million.

Mandates

The California Constitution requires the state to reimburse local governments and K-14 school districts for the cost of complying with state mandates. In 2003-04, we estimate that the state will incur costs of about $1 billion to reimburse local governments and K-14 districts for new and ongoing mandates. We assume that funding for education mandates (approximately $500 million of the $1 billion) will be incorporated within the Proposition 98 guarantee—as has been the practice in previous years. We project that these annual mandate costs will grow by 5 percent a year, although recent experience suggests that these costs may grow at an even higher rate. In 2002-03, the state deferred payment on over $800 million of noneducation mandate claims. We assume the state will pay these deferred claims, with interest, between 2004-05 and 2007-08.

LAO
60 YEARS OF SERVICE

www.lao.ca.gov
All LAO publications are posted on our Web site at **www.lao.ca.gov.**
To be immediately notified when reports are released, visit the site and click on **subscribe.**

LAO Publications
To request publications call 916-445-4656.
The Legislative Analyst's Office is located at 925 L Street, Suite 1000, Sacramento, CA 95814