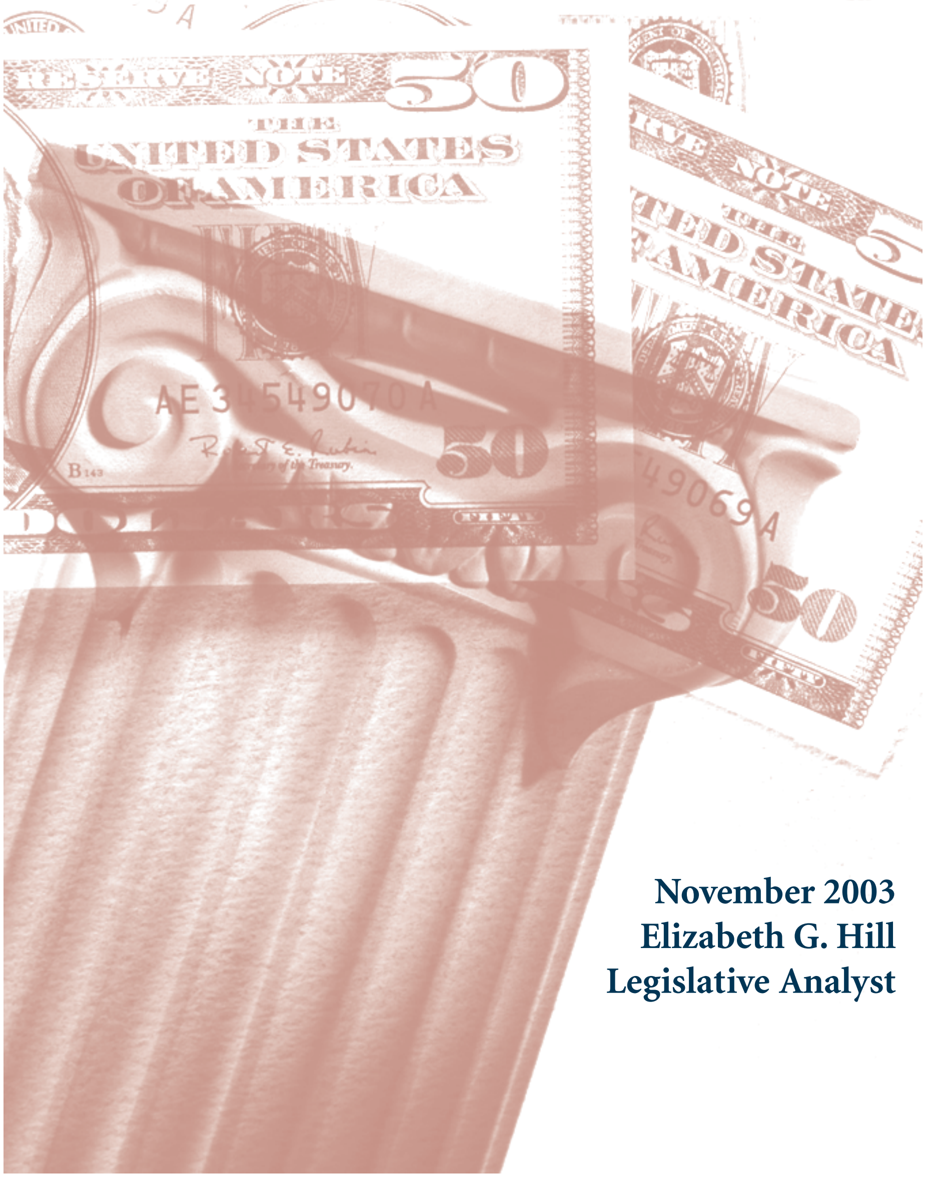
CALIFORNIA'S

Fiscal Outlook

LAO Projections 2003-04 Through 2008-09



November 2003
Elizabeth G. Hill
Legislative Analyst

Foreword

This report provides our projections of General Fund revenues and expenditures for 2003-04 through 2008-09. 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 ninth 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.

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Chapter 1

The Budget Outlook

SUMMARY

Major Budget Problem Still Confronts State

As was the case last year, California's policymakers will face a substantial challenge in crafting next year's General Fund budget. According to our updated projections, the state is facing a year-end shortfall of $10.2 billion in 2004-05 assuming the vehicle license fee (VLF) rate increase remains in effect, and substantially more if the rate is rolled back and the state resumes backfill payments to localities. Over the longer term, absent corrective actions, the state faces annual current-law operating deficits (that is, excesses of expenditures over revenues) that remain over $9 billion through the end of the forecast period—and $14 billion if the VLF rate is rolled back.

Actions Now Can Eliminate The Structural Problem

The persistent nature of the out-year operating shortfalls—even in the face of an improving economy—indicates that the state will not be able to "grow its way out" of its budget problems on the natural. The "good news," though, is that the projected operating shortfalls do start to narrow over time. This means that once the basic gap between annual expenditures and revenues is closed by ongoing solutions, we would expect future revenue growth to be sufficient to cover program costs over the forecast period.

In the paragraphs below, we (1) briefly review the 2003-04 budget signed by the Governor in August, (2) discuss the subsequent budget-related developments that have occurred, and (3) present our updated budget projections for 2003-04 through 2008-09.

REVIEW OF THE 2003-04 BUDGET PLAN

In confronting the 2003-04 budget, policymakers faced an enormous fiscal shortfall that the administration estimated was as high as $38 billion. This shortfall was the product of three years' worth of major imbalances between revenues and expenditures, which first opened up when revenues plunged during the 2001 economic downturn and stock market decline.

As Figure 1 shows, the majority of the 2003-04 budget solutions were clearly one-time in nature, consisting of borrowing, deferrals, funding shifts, and revenue accelerations. The budget plan did include ongoing savings from various program reductions and a VLF rate increase (the latter triggered by the "insufficient funds" provision in current law).

Ongoing Operating Shortfalls Not Fully Addressed. Assuming that all of the budgetary savings and borrowing actions included in the 2003-04 budget plan would be realized, that plan estimated that the huge 2003-04 shortfall would be closed and the state would end the year with a reserve of about $2.2 billion. However, since so much of the adopted 2003-04 budget solution involved borrowing, deferrals, and other one-time actions, it also was acknowledged that the disappearance of such solutions the next year would leave a large "budget hole" and thus a major operating shortfall of roughly $10 billion would automatically reemerge in 2004-05. The added debt-service costs associated with repayment of the deficit financing and pension bonds that the budget plan authorized also contributed to the projected shortfall in 2004-05. Taking into account the carryover $2.2 billion reserve projected for the end of 2003-04, the year-end 2004-05 budget shortfall was expected to be about $8 billion, absent further corrective actions.

Figure 1

Main Elements of 2003-04 Budget Plan[a]

✓ Borrowing and Deferrals ($18.3 billion)
- Deficit financing, pension obligation bonds.
- Local mandates, education, and transportation deferrals.
- Special funds loans.

✓ Program Savings ($9.2 billion)
- Education.
- Medical services and reimbursement rates.
- Social services cost-of-living adjustments.

✓ New/Accelerated Revenues ($4.5 billion)
- Tribal gaming.
- Tobacco securitization.

✓ VLF Rate Increase ($3.4 billion)

✓ Shifts to Other Funds ($4.1 billion)
- Federal funds.
- Fees.

a Dollar estimates as of time budget was enacted.

WHAT'S HAPPENED SINCE THE BUDGET'S ENACTMENT?

As Figure 2 shows, there have been both positive and negative developments on the budget front since the summer that we have taken into account in updating our fiscal projections.

Economy and Tax Revenues Are Up . . .

On the positive side, recent economic developments and cash receipts trends have been more favorable than expected. These positive developments, which are discussed in Chapter 2, include (1) a sharp improvement in business investment spending documented in the third quarter's gross domestic product report, which should benefit California firms; (2) healthy business earnings reports; and (3) higher state tax collections from withholding and quarterly estimated income tax payments during the first four months of 2003-04. As a result of these and other developments, we have revised upward our projections of major tax revenues by modestly over $2 billion in both 2003-04 and 2004-05.

. . . But So Are Budget-Related Expenses

On the negative side, however, the added revenues from these positive developments have been more than offset by added costs in the state budget. These include the effects on pension-related costs of an adverse court ruling involving the planned pension obligation bond sale, various costs related to the Southern California fires, higher Proposition 98 spending (triggered by the gains in revenues), and budget deficiencies in corrections, Medi-Cal, and state operations. In addition to these costs, we expect tribal gaming revenues to be considerably less than previously assumed.

Bottom Line—State Still Faces Formidable Challenge

Taking into account both the positive economic and revenue developments and the more-than-offsetting cost increases, the budget outlook is modestly worse than previously thought for 2003-04 and 2004-05 although modestly better over the longer term. Despite these recent developments, however, the key point for policymakers is the same as before—namely, the state faces a major mismatch between revenues and expenditures, and this will ultimately need to be addressed through spending reductions and/or revenue enhancements if the state is to regain fiscal balance.

Figure 2

Developments Since the 2003-04 Budget's Enactment

Underlying Revenue Outlook Improving . . .

- Economy and stock market up.
- Recent tax collections higher-than-expected.

. . . But New Tax Revenues Consumed by Other Budget Related-Factors

- One-half of added revenues goes to Proposition 98.
- Pension obligation bonds invalidated by Superior Court.
- Tribal gaming revenues overestimated.
- Major deficiencies in Department of Corrections and Medi-Cal.
- Costs for Southern California fires.
- Shortfall in other budget savings.

Figure 3

LAO Projections of General Fund Condition

2002-03 Through 2004-05[a]
(In Millions)

		Forecast	
	2002-03	2003-04	2004-05
Prior-year fund balance	-$1,983	$1,513	$2,003
Revenues and transfers	70,852	74,165	74,968
Deficit financing bond	10,675	—	—
Total resources available	$79,544	$75,678	$76,971
Expenditures	$78,031	$73,675	$85,727
Ending fund balance	$1,513	$2,003	-$8,756
Encumbrances	$1,402	$1,402	$1,402
Reserve	**$111**	**$601**	**-$10,158**

[a] Detail may not total due to rounding.

SPECIFIC GENERAL FUND BUDGET ESTIMATES

Figure 3 presents our updated estimates of the General Fund's condition for 2002-03 through 2004-05. These estimates take into account our revised projections of current-law revenues and expenditures discussed in Chapter 3 and Chapter 4, respectively. The basis for our estimates, including their underlying methodology and assumptions, is summarized in the accompanying box (see page 7). The estimates shown in Figure 3 assume that the VLF rate increase (effective October 1, 2003) remains in effect in both 2003-04 and 2004-05, as provided for in current law. Our projections indicate the following.

Revised 2003-04 Outlook

Based on our updated projections, 2003-04 General Fund revenues will total $74.2 billion, expenditures will be $73.7 billion, and the year will end with a positive reserve balance of $601 million. This compares to the $2.2 billion reserve that was anticipated when the 2003-04 budget was enacted. If the VLF rate were rolled back and refunds were provided to motorists that have paid the higher rate since it went back into effect, current-year

Vehicle License Fee (VLF)

Background

The state law enacting a VLF rate reduction beginning in 1999 included three accompanying provisions which are of significance to the current fiscal outlook: (1) it required that the state backfill local governments for their revenue losses resulting from the lowered rates, (2) it required that the VLF rate be increased whenever there were insufficient moneys in the General Fund to pay for the backfill, and (3) it stated that, from 2000-01 through 2003-04, California Work Opportunity and Responsibility to Kids (CalWORKs) cost-of-living adjustments (COLAs) would be granted only in fiscal years in which VLF tax relief is granted.

Several VLF-related actions were taken in conjunction with the 2003-04 budget which are having an impact on General Fund expenditures. In June 2003, the Director of Finance made the determination that there were insufficient moneys in the General Fund for the backfill, thereby terminating backfill payments and triggering a rate increase (from 0.65 percent to 2 percent) for VLF payments due on or after October 1, 2003. Backfill payments to local governments (with a few minor exceptions) ceased after June 20, 2003, saving the General Fund about $4 billion in 2003-04. The revenue loss to local governments during the time period between when the backfill ceased and additional revenues from the rate increase started flowing is being treated as a loan. The loan is scheduled to be repaid by mid-2006.

The 2003-04 budget included language which sets the VLF backfill at $1,000 for 2003-04, regardless of the tax rate's level. Presumably, this language would hold the backfill to $1,000, absent legislative action, even if the tax rate were rolled back this year. Also, because tax relief was eliminated, the CalWORKs COLA for 2003-04 was suspended.

Our VLF Expenditure Forecast

Given the large operating shortfalls that we are projecting through 2008-09, we are assuming that the "insufficient moneys" provision holds through the forecast period, and the higher VLF rate therefore remains in effect as provided for in current law. Thus, our estimates include no VLF backfill payments other than a loan repayment in 2006-07. We also include no 2003-04 COLA for CalWORKs recipients, again reflective of current law.

What Happens if New Administration Rolls Back the VLF Rate? The Governor-elect has stated his intent to roll back the VLF tax rate once he takes office. The fiscal impact of this rollback, particularly *in 2003-04,* would depend on exactly how such a reduction were implemented. Figure 4 shows the potential effects in 2003-04 under three alternative scenarios regarding the timing of the rollback and which governmental level—the state or localities—bears the revenues losses from the rollback. In *Scenario A*, the rate is rolled back effective February 1, 2004, but legislation is not passed which restores the backfill to local governexpenditures would be $3.2 billion higher than the baseline, and the year would end with a deficit of $2.6 billion, absent corrective actions. Please see nearby box for a discussion of the VLF situation and its potential fiscal impacts.

2004-05 Outlook

For 2004-05, revenues are projected to be $75 billion, or $10.7 billion less than the projected expenditure total of $85.7 billion. As a result of the reemergence of the mismatch between revenues and expenditures, the budget faces a year-end def-

Vehicle License Fee (VLF) *continued*

ments. Under this scenario, local governments would shoulder the full cost of the rate reduction in 2003-04—$1.8 billion. In *Scenario B*, the rate reduction is also effective February 1, 2004 but legislation is passed restoring the backfill. Under this scenario, the State General Fund would bear the costs of the tax reduction. In *Scenario C*, the rate reduction would apply retroactively to everyone that paid the higher rate in 2003-04, through a rebate mechanism. Assuming that the backfill is also restored, the 2003-04 cost to the General Fund would be about $3.2 billion.

In all three scenarios, the out-year costs of a VLF rollback would be identical, as current law would again require backfill payments to local governments beginning on July 1, 2004. These backfill payments would be about $4.2 billion in 2004-05, increasing modestly in subsequent years.

Impact on CalWORKs Costs. The rollback of the VLF rate would have no impact on General Fund expenditures on CalWORKs in 2003-04. The additional costs would be covered from federal reserve funds. However, there would be costs of roughly $223 million in 2004-05 and about $130 million in subsequent years, as the federal reserves are depleted and the added CalWORKs costs are borne by the General Fund.

Figure 4

Potential Impacts of VLF Rate Rollback in 2003-04[a]

(In Billions)

	Vehicle Owner Savings	Governmental Cost: State General Fund	Governmental Cost: Local[b]
Scenario A—Rate reduction effective February 1, 2004 but no backfill in 2003-04.	$1.8	—	$1.8
Scenario B—Rate reduction effective February 1, 2004 and backfill restored through legislation.	1.8	$1.8	—
Scenario C—Rate reduction made retroactive to October 1, 2003 and backfill restored through legislation.	3.2	3.2	—

a Fiscal effects in subsequent years are identical for all scenarios at $4.2 billion in 2004-05, $4.4 billion in 2005-06, $4.6 billion in 2006-07, $4.8 billion in 2007-08, and $5 billion in 2008-09.

b The cost shown is in addition to the $960 million reduction in backfill payments already being experienced by local governments.

icit of $10.2 billion, absent corrective actions. If the VLF rate increase were rolled back and the backfill resumed beginning this year (2003-04), the cumulative impact on the 2004-05 reserve would be a $7.4 billion deterioration—the $3.2 billion noted above for the current year and another $4.2 billion in 2004-05. (This assumes no other offsetting savings were achieved.) In addition, California Work Opportunity and Responsibility to Kids (CalWORKs) cost-of-living adjustment (COLA) costs would increase by $223 million. Thus, the rollback would increase the projected cumulative year-end shortfall for 2004-05 to $17.8 billion.

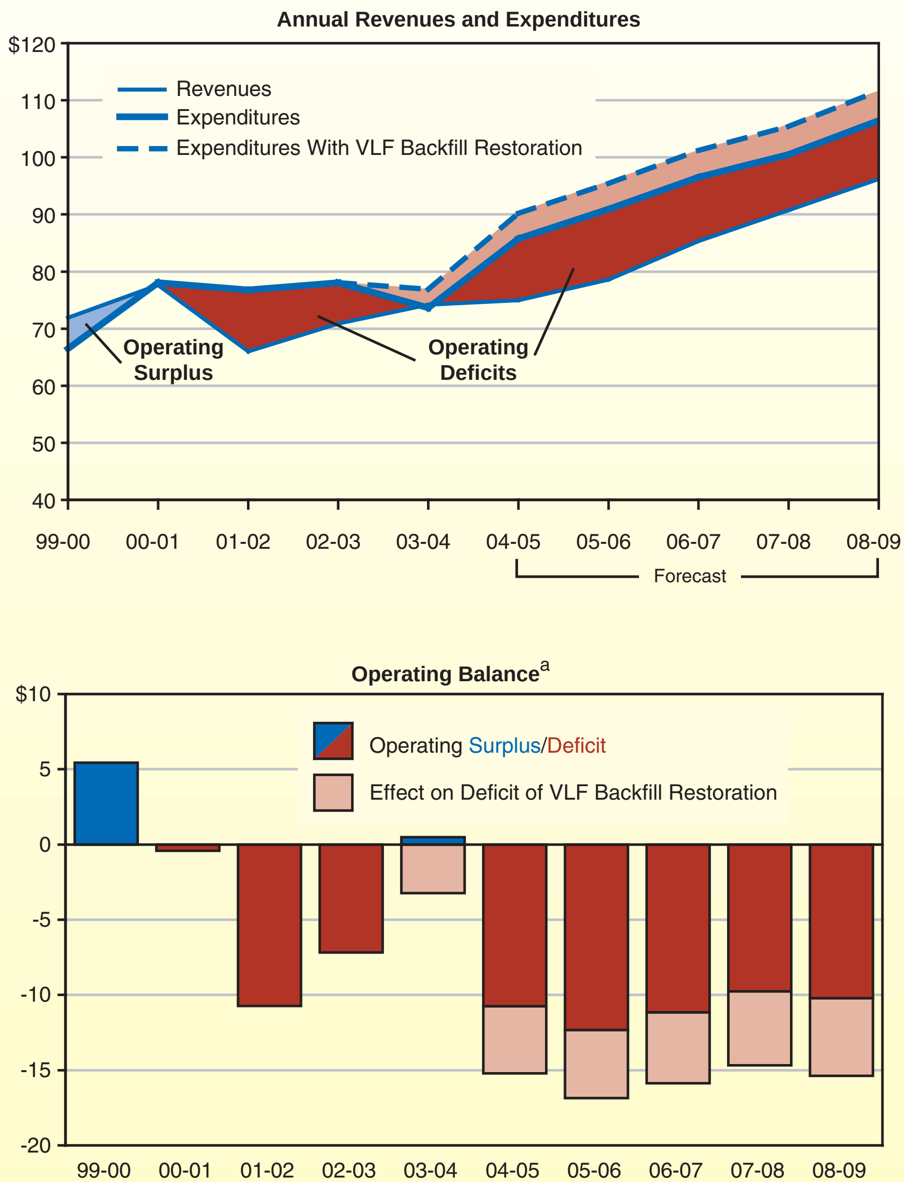
Longer-Term Forecast—Shortfalls Persist

Figure 5 presents our revenue and expenditure forecasts through 2008-09, both with and without a rollback in the VLF rate. It indicates that, for example, assuming no rollback, the operating deficit grows to a peak of $12.3 billion in 2005-06. This primarily reflects the large scheduled repayment of a transportation loan and the resumption of local mandate reimbursements in that year. In the following three years, the gap narrows somewhat, as ongoing revenue growth modestly outpaces ongoing growth in program expenditures. As of 2008-09, however, the gap would still remain in the range of $10 billion assuming the VLF increase remains in place, and $15 billion if it is rolled back (the difference due to the amount of the backfill).

Figure 5

Current-Law Operating Deficits to Persist

General Fund (In Billions)



[a]Revenues minus expenditures.

APPROACHING THE BUDGET PROBLEM

This is the third consecutive year that we have projected in our fiscal forecast a persistent current-law budget shortfall extending throughout the forecast period. This indicates that the state has not yet met the fundamental challenge of getting expenditures and revenues in line. In the preceding two reports, we also identified a group of budget-balancing principles, strategies, and tools that we again offer, as summarized in Figure 6 (see next page). Although the specific numbers in this year's report differ from those provided previously, we believe that these items still merit the Legislature's attention. This is because the state's basic budget problem is still essentially the same—namely, current-law expenditures exceed current-law revenues.

Among other things, we recommend that the Legislature:

- ***Take Current-Year Actions.*** Undertaking mid-year actions that produce budgetary benefits will not only improve the General Fund's projected balance at the end of 2003-04 that carries forward into 2004-05, it would also reduce the out-year problem as well. In addition, because implementation of some budget solutions takes time, acting early will help the state maximize the budget-year benefits that can be realized from them.

Basis for Our Estimates

As noted in past reports, our revenue and expenditure forecasts are based primarily on the requirements of current law, including constitutional and statutory funding requirements (such as the Proposition 98 funding guarantee). Our estimates also reflect projected changes in caseloads, federal reimbursements, and other factors affecting program costs.

For the current forecast, we have also taken into account language included in the 2003-04 budget plan stating the Legislature's intent that the administration *not* include certain funding adjustments in developing the 2004-05 budget. These include funding for: (1) University of California (UC) and California State University (CSU) salary increases and enrollment growth; (2) discretionary price adjustments to state, UC, and CSU operations; (3) local mandate reimbursements; (4) direct appropriations for capital outlay in excess of $50 million; and (5) Proposition 98 spending above the minimum guarantee.

Our basic estimates included in Figure 3 assume that the VLF rate increase, triggered by the insufficient funds provision of current law, remains in place through the forecast. Because the Governor-elect has stated his intent to roll back the increase, we discuss the incremental impact of that change separately. Our out-year estimates also include scheduled loan repayments to special funds as well as payments to cover accumulated local government mandate claims.

Projections, Not Predictions. Our estimates 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.

- ***Put Everything on the Table.*** In order to get the budget back into balance on an ongoing basis, we believe it makes sense to consider all types of actions—including spending reductions, fund shifts, revenue augmentations, and improved tax collections and compliance activities. The Legislature may of course find that some of these alternatives deserve more attention than do others, and the potential benefits in some areas may already have been largely exhausted due to actions already taken. However, potential savings and budgetary benefits can still be achieved in most program areas, and we recommend that the Legislature consider the largest possible "menu" in addressing the budget problem.

- ***Be Cautious About Additional Borrowing.*** Although the 2003-04 budget relied extensively on borrowing as a solution to close the fiscal shortfall, we believe that additional use of this tool should be limited given the future costs it imposes and its failure to address the budget's underlying problem (see accompanying box).

- ***Take Significant Ongoing Actions.*** The Legislature has extensively relied on one-time solutions in crafting both its 2002-03 and 2003-04 budget packages. Prudent use of

Figure 6

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.
- ✓ Be cautious about additional borrowing.

Individual Tools

- ✓ Spending-related options.
  - •Eliminate or modify programs.
  - •Suspend/reduce COLAs.
  - •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.

one-time solutions could also help address the current problem. However, to the extent that one-time solutions are used to temporarily deal with ongoing problems, they generally end up creating a "budget hole" that needs to be filled with yet an-

Borrowing and the Budget Shortfall

How Much Budget-Related Borrowing Have We Done?

As indicated earlier, the 2003-04 budget relied on a variety of different types of borrowing-related actions to help close the budget gap. Among others, these included the use of deficit financing and pension bonds, direct loans from special funds, deferrals of spending obligations such as for transportation and local mandates, tobacco bonds to accelerate the state's receipt of future revenues, and refinancing of existing general obligation bond principal repayments. Altogether, we estimate that there was close to $20 billion of these and other different types of borrowing incorporated in the adopted 2003-04 budget plan. This budget-related borrowing is in addition to the more traditional types of borrowing that use general obligation and lease-revenue bonds to finance the state's outlays for infrastructure and other capital needs, as well as the internal and external borrowing needed for cash-flow purposes.

The Impact of Budget-Related Borrowing on the General Fund's Condition

Budget-related borrowing of course helps the General Fund's condition in the years when it is undertaken. However, it generally is a one-time savings, and thus creates a "budgetary hole" to fill the next year. In addition, the effect of borrowing eventually becomes a drag on the budget, because debt service expenses for *past* spending will interfere with providing *current* public services.

A significant portion of the General Fund operating shortfalls that we project for 2004-05 and beyond is associated with such debt repayments. For example, in 2005-06, debt service on the deficit financing bond and the scheduled payment of the transportation loan totals about $3.9 billion, or one-third of the projected operating shortfall for that year.

Is More Budgetary Borrowing the Way Out?

There is no "hard and fast rule" to identify what amount of borrowing is "right" for the Legislature to use in addressing budget shortfalls. As a general policy, however, we believe that budget-related borrowing—particularly from private markets—should be relied on only as a last resort. Actions to bring spending and revenues into line should be the top priority.

This is not to say that there are no instances where some borrowing makes sense. Examples might be when the size of a deficit is simply too large to handle all at once, or when a budget shortfall will likely be quickly eliminated by a strongly rebounding economy. We do not believe that either of these situations currently exists. Engaging in budget-related borrowing to avoid spending cuts and tax increases, or to finance additional spending and tax cuts—is a slippery slope.

Given the large amount of budget-related borrowing already authorized, we caution against the state engaging in new borrowing—particularly from private markets—to cover the projected 2004-05 operating shortfall.

other action the next year. Given the persistent current-law operating shortfalls we foresee over the forecast period, the current budget problem for the most part represents an *ongoing* imbalance between revenues and spending. As such, it is important that the Legislature also adopt major *ongoing* solutions—spending reductions and/or revenue augmentations.

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 both the large projected 2004-05 shortfall and the ongoing operating imbalances projected for future years.

Chapter 2

Economic and Demographic Projections

Economic and demographic developments are typically two of the most important determinants of California's fiscal condition through their impacts on both tax revenues and state expenditures. This chapter presents our economic and demographic projections for 2003 through 2009, which will affect California's fiscal condition during fiscal years 2003-04 through 2008-09.

THE ECONOMIC OUTLOOK

Overview of the Economic Forecast

We believe that California, like the nation, has "turned the corner" economically and is now embarking on a period of faster and more-balanced expansion as 2003 comes to a close. This acceleration is due to (1) a long-awaited improvement in business investment in computers, software, and other high-tech goods produced and designed in this state; and (2) ongoing strength in home construction and consumer spending. A key assumption in our outlook is that this faster economic expansion will finally result in an improvement in the jobs outlook, which has lagged thus far during the current rebound.

Our forecast assumes that the massive October fires in Southern California, while having tragic personal and economic consequences for those directly affected, will not have a major net adverse impact on the overall state economy. We anticipate that the loss in wealth and income in the regions affected will be roughly balanced by a surge in rebuilding financed by federal funds and private insurance payments. Figure 1 (see next page) summarizes the details of our economic forecast. In subsequent sections, we discuss in more detail major factors underlying our projections.

Recent National Economic Developments

Although the recession officially concluded in late 2001, the ensuing recovery was weak and unbalanced through 2002 and into early 2003. Low interest rates and federal tax reductions kept consumer spending and housing activity on an upward track. However, business spending and hiring remained soft during this period, reflecting chronic overcapacity in many key industries, weak foreign demand, and a loss of confidence by corporate executives who make investment decisions.

The improvement in business spending finally materialized in the third quarter of this year (see Figure 2). This increase, coupled with sharp gains

Figure 1

The LAO's Economic Forecast 2003 Through 2009

Percentage Change (Unless Otherwise Indicated)

	2003	2004	2005	2006	2007	2008	2009
United States							
Real gross domestic product	3.0%	4.2%	3.7%	3.7%	3.5%	2.9%	2.8%
Personal income	3.2	5.3	5.7	5.9	5.8	5.3	5.3
Wage and salary jobs	-0.3	1.1	2.4	1.8	1.5	1.1	1.2
Consumer Price Index	2.4	2.0	2.4	2.5	2.6	2.6	2.7
Unemployment rate (%)	6.1	6.1	5.9	5.8	5.7	5.6	5.6
Housing starts (000)	1,775	1,680	1,640	1,620	1,640	1,620	1,590
California							
Personal income	4.2%	5.9%	6.3%	6.2%	6.0%	5.9%	5.9%
Wage and salary jobs	-0.4	1.3	2.6	2.2	1.9	1.7	1.6
Taxable sales	2.4	5.9	6.3	6.2	5.9	5.7	5.7
Consumer Price Index	2.8	2.3	2.7	2.7	2.8	2.8	2.9
Unemployment rate (%)	6.6	6.1	5.6	5.5	5.6	5.5	5.5
New housing permits (000)	188	179	180	178	175	173	170

in consumer spending and strong housing construction, boosted real gross domestic product (GDP) by a 7.2 percent annual rate in the July-through-September period. Of particular importance to California was the jump experienced in spending on computers and software, as the business sector began to upgrade systems that had not been replaced since 1999.

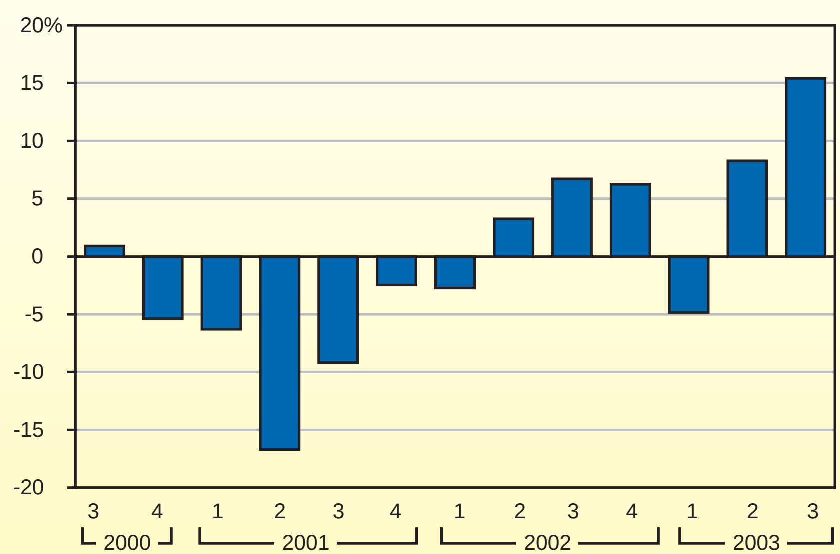
Recent California Developments

Gross domestic product data on consumption and business investment are not available at the state level, so it is not possible to directly determine how the recent national improvement in GDP growth has affected our state. However, various industry and tax-related data suggest that California's economy clearly is participating in the national recovery. For example:

Figure 2

U.S. Business Equipment and Software Investment Accelerating

Percent Change From Prior Quarter, Annual Rate



- ***Company Reports.*** Business revenues and profits reported by California companies on their financial reports are up sharply in 2003. According to a recent survey of 167 public companies in Silicon Valley, for example, combined sales rose 12 percent between the third quarter of 2002 and the third quarter of 2003, while combined net income jumped from a $4.4 billion loss to a $1.7 billion profit during the same period.

- ***Tax Receipts.*** As discussed later in Chapter 3, personal income tax withholding, taxable sales, and corporate tax payments are up significantly in 2003 from last year, suggesting significant improvements in both spending and income.

- ***Foreign Trade.*** After falling sharply in 2001 and 2002, exports of goods produced in California stabilized in the second quarter of 2003, and more current monthly data from the state's major ports suggest that shipments abroad are starting to turn upward.

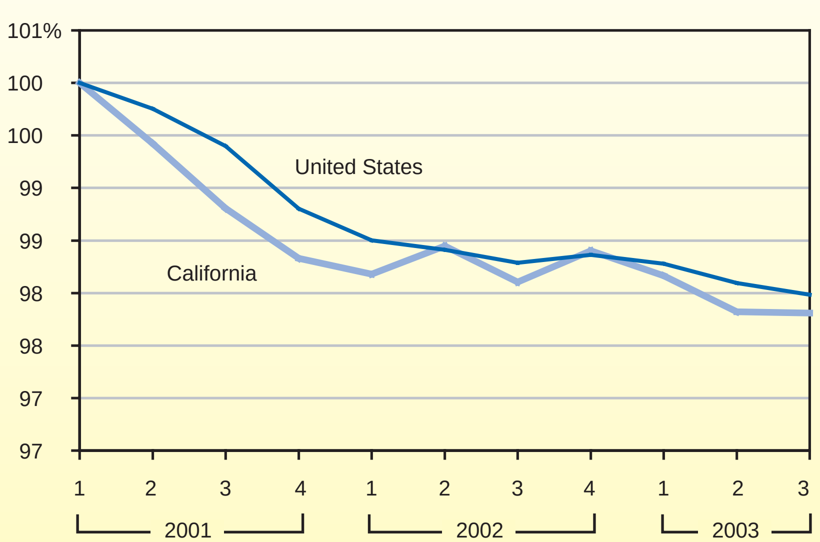
- ***Housing.*** Demand for housing remains surprisingly strong in California despite record home price levels and some recent increases in interest rates. According to the California Association of Realtors, the median home price in the state has jumped by 20 percent from the prior year and is now over $400,000. Housing supply is also expanding, as permits for new construction are on track to reach 188,000 units in 2003—the strongest level since 1989.

While these gains are encouraging, an important uncertainty concerning the durability of the current expansion—both at the national and state levels—is whether the recent improvements in spending and output will translate into more jobs in the months ahead. The jobs outlook is particularly clouded by the differing trends in employment data that the two main information sources are exhibiting, with the "household survey" showing growth but the "payroll survey" showing continued declines (see box on page 15). We examine California's job picture in more detail below, comparing its current performance to that of past recession/recovery periods and to the nation as a whole.

Figure 3

Employment Losses in California Similar To Rest of Nation

Wage and Salary Jobs, Percent of Pre-Recession Peak



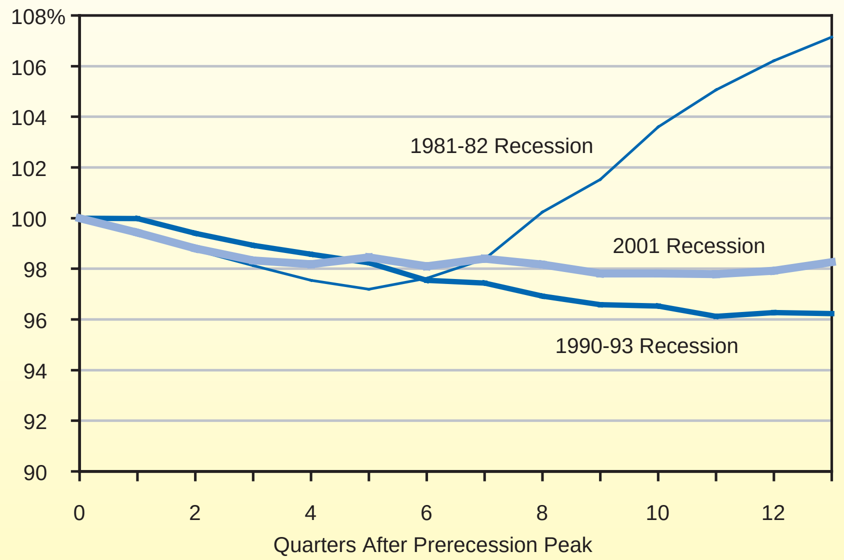
Job Losses From 2001 Recession—Mild but Prolonged

California Relative to the Nation. The job losses experienced in California since early 2001 (when the most recent recession began) are not out of line with the rest of the nation. As shown in Figure 3, the cumulative job loss over the past 30 months is about 2.2 percent in California, compared to 2 percent for the nation as a whole. Within California, the percentage reduction in the San Francisco Bay Area has been considerably greater than for the nation, but losses in Southern California and the Central Valley regions of the state have been proportionally less.

Figure 4

State Still Awaiting Full Recovery

Wage and Salary Jobs, Percent of Prerecession Peak



Current Performance Compared to Past Recessions. As indicated in Figure 4, the cumulative job losses associated with the 2001 recession and its aftermath are roughly on a par with those of the early 1980s' recession, but considerably less severe than the early 1990s' downturn. In terms of duration, however, job declines in the current period have been prolonged compared to the 1980s' experience. For example, the cumulative 2 percent *decline* in jobs during the 30 months following the start of the 2001 recession compares unfavorably to the 4 percent net *gain* in jobs that had occurred 30 months after the beginning of the 1981 recession. In this regard, the current downturn is more similar to the 1990s' recession.

Thus, while many indicators are pointing toward improved sales, production, and income in the state, the lack of job growth thus far remains a key concern regarding the durability of the expansion.

The Economic Outlook

National Outlook

Our updated forecast assumes that U.S. economic growth will pick up somewhat and expand at a very healthy pace through 2004, before settling into a somewhat more moderate though sustainable pace in subsequent years. During the next year, the economy is expected to benefit from continued improvements in business investment and foreign trade, as well as ongoing expansion in consumer spending. Overall, we forecast that growth in U.S. GDP will accelerate from 3 percent in 2003 to 4.2 percent in 2004, before moderating some in subsequent years. The unemployment rate is projected to slowly decline from the current level of around 6.1 percent down to 5.6 percent by 2008.

What About Large Budget Deficits? Clearly, the large U.S. budget deficits that federal officials project for the future imply that the borrowing needs of the federal government will be substantial in the years ahead. At present, U.S. government borrowing is being easily accommodated in the credit markets, due to the large amount of liquidity in the financial system and the fact that businesses have large amounts of cash on hand to finance new investments. However, the large federal budget deficits will likely put upward pressure on interest

So—What's the True Picture Regarding Employment Strength?

There are two surveys used to measure employment performance at the national and state levels. The first is the *household survey*, which is drawn each month from interviews with members of a selected sample of households. The resulting data are then used to develop detailed estimates of the employment and unemployment characteristics of individuals in the labor force. The second source is the *payroll survey*, which is based on information collected from employers that file withholding and unemployment insurance reports. These latter data are used primarily for estimates of aggregate employment totals and job performance within various industry categories, and indeed are what we are referring to in our discussion of current employment trends.

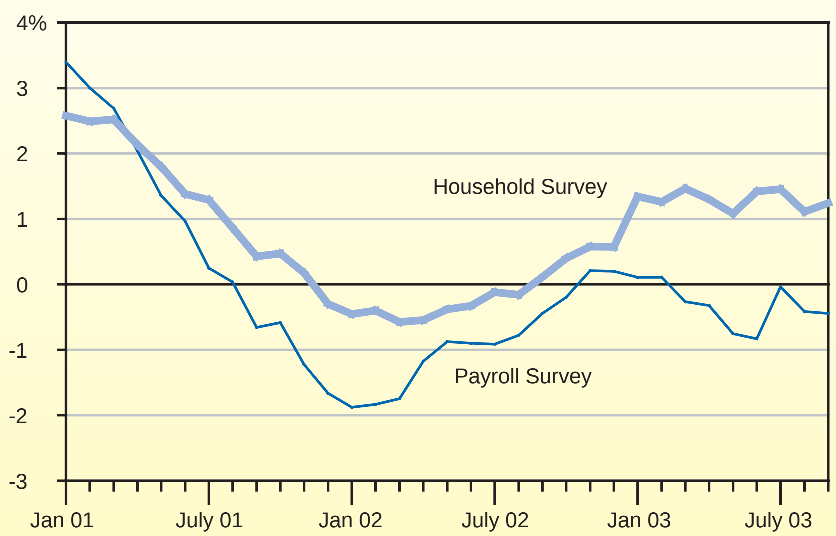
Historically, the above two employment series have usually moved in concert with one another over economic cycles, although the household series has shown more month-to-month variation due to its smaller sample size. As shown in Figure 5, however, the two series have significantly diverged from one another in 2003, with the payroll survey showing year-to-year *declines* averaging about 0.5 percent, and the household survey showing year-to-year *increases* averaging about 1.2 percent. A similar discrepancy is evident at the national level.

The payroll survey is traditionally considered to be a more reliable indicator of employment trends due to its more extensive coverage and greater detail. However, at the present time, the household survey seems to be more consistent with the more upbeat data on spending and production in the economy. One of the possible explanations for the current difference between the two surveys' results may be an increase in the use of contract workers by employers that are reluctant to add to their permanent workforce. These contract workers would show up in the household survey as employed but may be excluded from the industry survey, which is based on actual company payrolls. While the contract jobs are more likely to be part time and have less pay and fringe benefits than traditional jobs, the growth in this sector provides some positive evidence that businesses are taking the first step toward renewed hiring.

Figure 5

State's Current Employment Picture Somewhat Unclear

Year-Over-Year Percent Change in California Employment, by Month



rates once private demand for borrowing picks up. This will push interest rates slowly upward over the forecast period, and these higher rates will eventually work to moderate economic performance in such areas as business investment, consumer spending, and housing activity.

California Outlook

We forecast that California's economy will grow in line with the national economy over the next several years, reflecting the positive effects of improving business investment and foreign trade on our manufacturing and high-tech service industries. After falling for most of 2003, we expect that wage and salary employment will stabilize late in the year and grow modestly in 2004 and thereafter. On an average annual basis, we forecast that jobs will fall by 0.4 percent in 2003 before expanding by 1.3 percent in 2004 and 2.6 percent in 2005.

Reflecting the improvement in jobs, wages, and business earnings, we project that personal income will accelerate from 4.2 percent this year to 5.9 percent in 2004 and 6.3 percent in 2005. Finally, we forecast that taxable sales will accelerate from 2.4 percent this year to 5.9 percent in 2004 and 6.3 percent in 2005. These projected strong taxable sales gains are in part reflective of the expected improvement in the roughly one-third of taxable sales that are related to business spending.

We expect that housing construction will remain near current levels through the forecast period. While this is well above the rates achieved over the past decade, our projected pace of residential building construction remains below what many economists consider the amount needed to fully accommodate the state's ever-expanding population. The shortfall between the available supply and demand for housing, which is partly related to the limited availability of developable land in key areas of the state, will continue to put upward pressure on home prices in future years.

Risks to the Forecast

We see two primary risks to the near-term economic outlook. These involve:

Lack of Job Growth. While our forecast assumes that the recent growth in business spending and output will translate into added jobs in the U.S. and California economies, we have yet to see firm evidence that this is occurring. On the one hand, the fact that businesses have been able to increase output and sales without adding to the workforce suggests that productivity gains in the economy are even better than anticipated. This, by itself, has positive implications for the long-term achievable growth in output, income, and wealth in the nation and state. However, persistent softness on the job front poses a significant near-term risk, in that the lack of job creation may undermine consumer confidence and spending, and in turn undercut the economic expansion. The lack of job growth is an especially significant risk in California, where concerns about business costs could translate into more out-of-state outsourcing and less expansion in the state than would normally be expected during a growth period.

Potential Home Price Bubble. A second key risk to California's outlook involves the pattern of extraordinary increases in home prices. Following four years of uninterrupted increases, the median home price statewide is now over $400,000, with many major metropolitan areas being above $500,000. The key question this raises is whether the state faces a home price "bubble" that will deflate or even burst in the near future. Many economists and real estate analysts currently believe that the price jumps being experienced are not due primarily to speculative excesses. Rather, they attribute them as largely reflective of limited housing supply in many regional markets and ongoing growth in the state's population. However, there is no doubt that the recent price increases make the housing market more vulnerable to adverse economic developments than otherwise, such as a significant upturn in interest rates. To the extent that the increased household wealth associated with home price increases has been a positive factor underlying consumer spending during the past two years, a sharp reversal in home prices could have a significant negative effect in the future.

THE DEMOGRAPHIC OUTLOOK

California's population currently totals slightly over 36 million. During the six-year forecast period covered in this report, the state's population is projected to grow annually by about 1.3 percent, or close to half a million persons yearly. (This is roughly equivalent to a city the size of Long Beach.) Thus, California will add roughly 2.9 million people over the forecast interval and reach almost 39 million by 2009.

The population growth rate we are projecting is somewhat slower than that experienced in the latter part of the 1990s, when growth was averaging about 1.6 percent. This reflects both the dampening effects of the slower economy of recent years on in-migration, plus 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 California for out-of-state destinations). On average, these two components have tended to contribute about equally over time to the state's population growth. However, their relative shares can vary significantly from one year to the next depending largely on the strength of the net in-migration component—by far the most volatile element.

Natural Increase. We project that the natural-increase component will average about 275,000 new Californians annually over the forecast period. This amount is slightly less than in the late 1990s and early 2000s, when it averaged about 295,000. This softening reflects 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 during the latter half of the forecast period. This is 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 nearly 215,000 annually over the next six years. This is weaker than during the latter half of the 1990s and early 2000s when annual net in-migration averaged about 260,000. It also is considerably less than the projected natural-increase component. As shown in Figure 6 (see next page), this reflects a projected drop in *domestic* net in-migration that we believe will follow California's period of economic softness. 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 Significantly By Age Group

Figure 7 (see next page) shows our population growth projections by broad age categories, including both numerical and percentage growth.

Ranks of Baby Boomers to Dramatically Swell. The 45-to-64 age group (largely the "baby boomers") continues to be by far the fastest growing segment of the population. Over 1.7 million new people are expected to move into this age category over the next six years. At the other extreme, slow growth is anticipated for preschoolers and the K-12 school-age population. This reflects several factors. One is the movement of children of the "baby boom" generation beyond the upper-end of the 5-to-17 age group. Other factors include the slower rate of net in-migration, and the decline in birth rates in recent years that has reduced the number of children moving into the preschool and school-age categories.

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.

Other Variations

In addition to age, projected population growth will also differ markedly along other dimensions. For example:

Figure 6

Net In-Migration to Slow

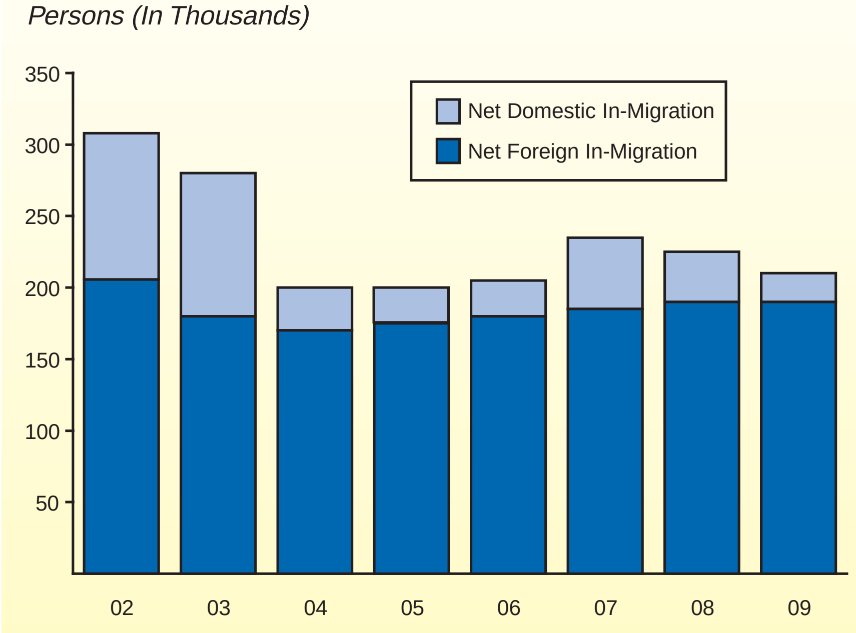
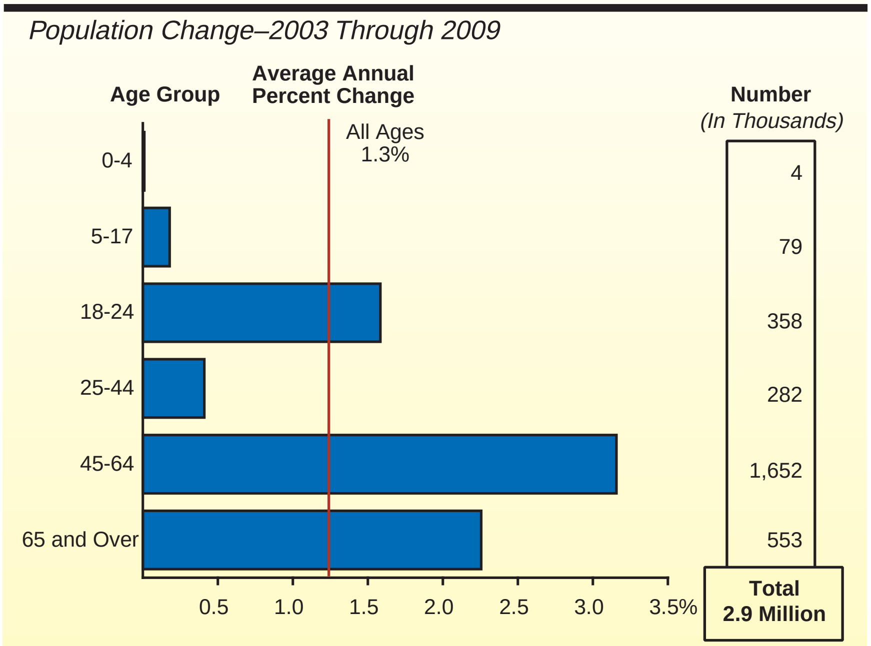


Figure 7

California's Population Growth, by Age Group

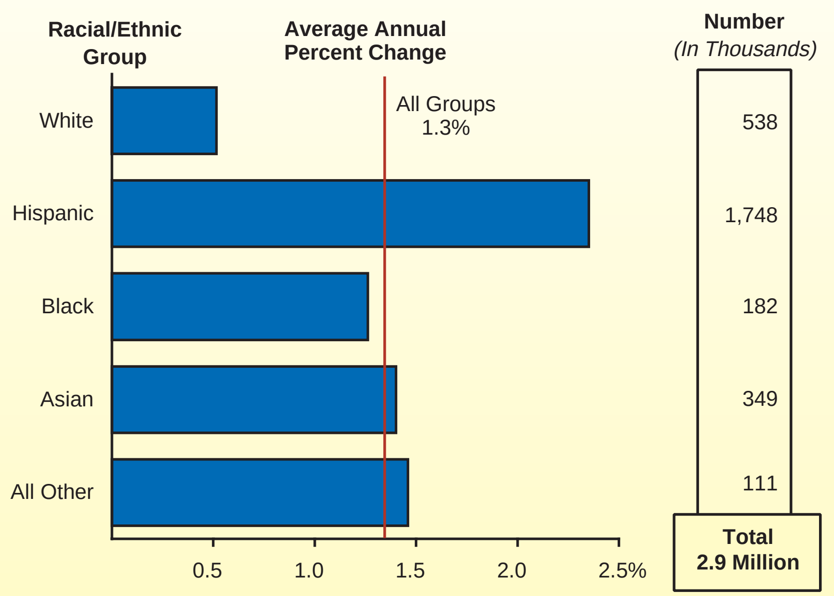


- ***Geographic Variation.*** Rates of growth will be above-average for the state's Central Valley, Inland Empire, and foothills areas. This will occur as the availability of land allows population to "fill in" and attracts intrastate migrants from the more congested coastal areas where growth will be constrained. Such high-growth regions will face new challenges in providing the public services and infrastructure to accommodate growth.

Figure 8

California's Population Growth, by Race/Ethnicity

Population Change–2003 Through 2009



- ***Racial/Ethnic Variation.*** Figure 8 indicates that the amounts and rates of population growth will also differ significantly for different racial and ethnic groups.

Chapter 3

Revenue Projections

The revenues that finance California's state General Fund budget come from a wide variety of sources, including taxes, fees, licenses, interest earnings, loans, and transfers. Over 90 percent of the total, however, 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 this chapter, we summarize our updated revenue projections and provide detail behind our key revenue-related assumptions.

THE LAO'S REVENUE FORECAST

The News Is Positive

In welcome contrast to our updates for the past two years when the key revenue-related development involved downward revisions, we are forecasting a significant improvement in the state's revenue picture compared to what was anticipated when the 2003-04 budget was adopted. Figure 1 presents our updated revenue projections.

2003-04 Revenues. We project that revenues will total $74.2 billion in 2003-04, a 4.7 percent increase from 2002-03. Our current estimate is up $813 million from the 2003-04 budget forecast, reflecting the following partially offsetting factors:

- On the positive side, underlying revenues from the state's major taxes are up by about $2.2 billion, primarily due to higher personal income tax receipts.

- On the negative side, however, the state is facing shortfalls related to problems with two key budgetary solutions contained in the 2003-04 budget plan. The first is a $630 million fall-off related to the lower-than-assumed amount of tribal gaming revenues that we currently anticipate from new or renegotiated contracts. The second is a $996 million shortfall related to the assumed transfer of special funds' contributions to the Public Employees' Retirement System. These transfers are associated with the planned sale of a $1.9 billion pension obligation bond, which has been invalidated by a Superior Court decision. (The $0.9 billion balance of the total bond sale would have showed up for budgetary scoring purposes not as revenues, but as a reduced expenditure for the General Fund's portion of the state's annual 2003-04 PERS contribution. Thus, the failure to sell the bond will raise expenditures by this amount.)

2004-05 Revenues. We forecast that General Fund revenues will be $75 billion in 2004-05, an increase of 1.1 percent from the current year. Our updated estimate is $1.5 billion above the 2003-04 budget forecast. This reflects a $2.3 billion increase in projected collections from the state's major taxes, partly offset by a downward revision (from $680 million to $200 million) in the amount of receipts from new or renegotiated tribal gaming compacts, along with some other downward adjustments.

Although the revenue growth rate for the budget year is only modest, the "underlying" growth rate is considerably higher—over 6 percent—and thus more consistent with the economy's projected moderate expansion. This discrepancy between total versus underlying revenue growth reflects the $3 billion in one-time funds included in the 2003-04 budget's revenue base. This is related to the second tobacco bond ($2.2 billion) and loans from special funds ($835 million). In addition, CT receipts will be pulled down in 2004-05 due to the conclusion of the two-year suspension of net operating loss (NOL) deductions that has been in effect for income years 2002 and 2003 (discussed further below).

Key Developments Affecting Our Revised Outlook

The increase in our revenue forecast relative to the 2003-04 budget estimate reflects both the improving state economy and the stronger-than-expected cash performance during the past several months. Regarding the latter factor, total tax receipts during the first four months of 2003-04 are up by roughly $500 million, reflecting significantly higher PIT monies and more-modest gains in SUT and CT collections.

Both Withholding and Profits Taxes Are Up

Of special significance is the strength in key payments that are tied to current economic activity. As shown in Figure 2, PIT withholding payments have steadily improved over the course of 2003, and were up a healthy 8 percent from the prior year in the third quarter. This reflected growth in wages, bonuses, and a revival in stock-option income. Similarly, CT payments jumped beginning in the fourth quarter of 2002 and have remained strong throughout 2003. While some of this strength in the CT relates to the suspension of NOL deductions noted above, a significant portion also appears to simply reflect stronger underlying business profits.

These higher tax payments suggest that, although the economic expansion has thus far failed to produce significant job growth, the increases in sales and output in the economy are producing meaningful growth in both personal and corporate income in California.

Figure 1

The LAO's General Fund Revenue Forecast

(Dollars in Millions)

Revenue Source	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Personal income tax	$32,442	$35,580	$38,270	$40,920	$43,840	$46,860	$50,090
Sales and use tax	22,330	23,540	24,850	26,410	28,030	29,680	31,370
Corporation tax	6,700	7,265	7,400	8,120	8,710	9,230	9,760
Other revenues and transfers	9,380	7,780	4,448	3,146	4,750	4,974	4,830
Total Revenues and Transfers	**$70,852**	**$74,165**	**$74,968**	**$78,596**	**$85,330**	**$90,744**	**$96,050**
Percentage change	-2.0%	4.7%	1.1%	4.8%	8.6%	6.3%	5.8%

Special Factors in the Outlook

The revenue totals shown in Figure 1 reflect not only basic economic developments, but also numerous revenue-related policy actions taken in conjunction with the 2002-03 and 2003-04 budgets. Key examples include:

- ***Revenue Increases Passed With the 2002-03 Budget.*** These included the two-year suspension of NOL deductions (along with an increase in the percentage of losses that can be carried forward and deducted in *future* years, which will reduce revenues), increased withholding on stock options and certain real estate sales, and the one-year suspension of the teachers' tax credit.

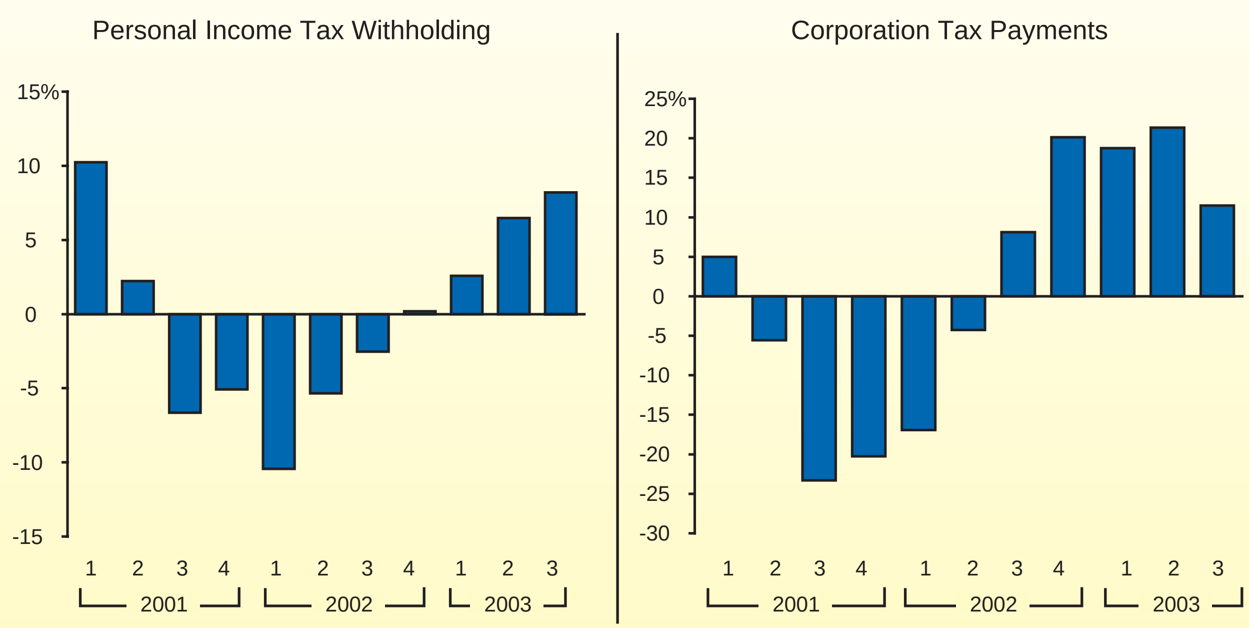
- ***Tobacco Securitization.*** The 2002-03 revenue total includes $2.5 billion from the sale of one tobacco securitization bond, while the 2003-04 total includes an additional $2.2 billion from the sale of a second tobacco bond. Under legislation originally passed in 2002, the state sold to investors its rights to a future stream of tobacco settlement receipts in exchange for an up-front cash payment. This was achieved through the sale of two revenue bonds secured by tobacco settlement payments for as many years as it takes to pay the bonds off. The 2002-03 budget assumed that the total amount of proceeds (originally estimated at $4.5 billion) would be raised through two bond sales in 2002-03. However, the second bond sale was delayed and ultimately occurred in 2003-04.

- ***Special Funds Loans and Transfers.*** The 2002-03 budget totals include $2.6 billion in mostly one-time loans and transfers from special funds. The single largest component is a $1.1 billion loan from the Traffic Congestion Relief Fund (TCRF), which is now scheduled to be repaid prior to the

Figure 2

Key California Tax Payments Rebounding

Year-Over-Year Percent Change, by Quarter



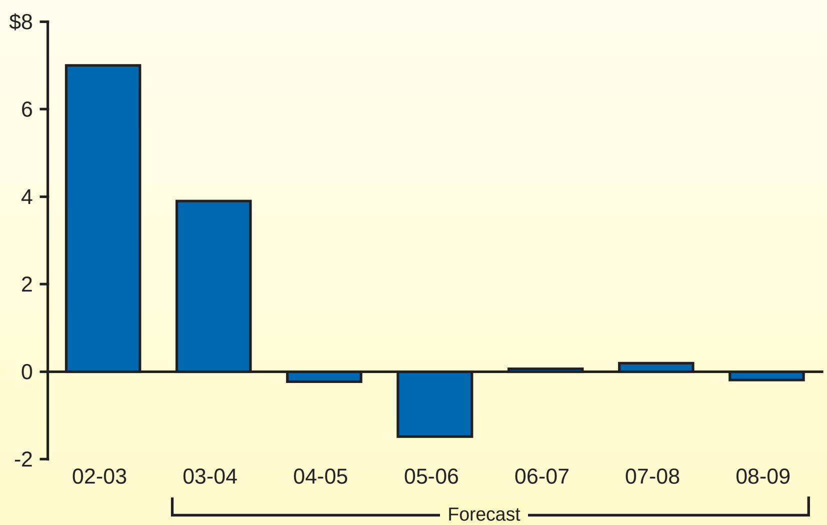
end of 2005-06. In addition, the 2003-04 budget included an additional $835 million in mostly one-time loans and transfers, from such sources as the California Teleconnect Fund and the Beverage Recycling Fund. We have included in our long-term General Fund projections the repayment of loans with specific statutory repayment dates, as well as payments for a portion of those loans not having specific statutory repayment dates.

As shown in Figure 3, the above one-time or limited-term factors can have major impacts on the General Fund revenue totals for individual years. For example, they increased the revenue totals by $7 billion in 2002-03 and nearly $4 billion in 2003-04, but will reduce revenues by varying amounts in subsequent years. The significant revenue decline shown for 2005-06 relates to the scheduled repayment of the TCRF loan.

Figure 3

Net Impact on Revenues of Special Factors[a]

(In Billions)



[a]Reflects actions taken in 2002-03 and 2003-04 that affect revenue totals in years shown.

INDIVIDUAL REVENUE SOURCES

Personal Income Tax

We currently forecast that PIT receipts will increase from $32.4 billion in 2002-03, to $35.6 billion in 2003-04, and $38.3 billion in 2004-05. Over the longer term, we project that receipts from this source will grow at an average annual rate of about 7 percent between 2004-05 and 2008-09, reaching $50.1 billion by the end of the forecast period. Compared to the 2003-04 budget forecast, our current estimate is up $2 billion in 2003-04 and $2.2 billion in 2004-05.

Key Forecast Factors

Our upward PIT revision from the 2003-04 budget forecast is primarily related to the recent strength in cash payments and evidence of an improving economy and stock market.

Cash Receipts Up. Cash receipts from the PIT during the first four months of 2003-04 are running about 4 percent ahead of the budget estimates, reflecting strength from a variety of payment sources, including withholding and quarterly estimated payments. It appears that the stronger economy is having a positive effect on wages, bonuses, business income, and stock market-related receipts.

With regard to the latter factor, Figure 4 provides some perspective on the impact of capital gains and stock options on General Fund revenues in recent history and through the forecast period. It shows that revenues from these sources accounted for as much as $17 billion in PIT receipts at the peak of the market in 2000-01, but then plunged to $6 billion in 2001-02 and to less than $5 billion in 2002-03.

Capital Gains and Stock Options—Strengthening but Still Down. The figure also shows that for the 2003-04 budget forecast made last May, we assumed that revenues from these sources would increase moderately beginning in 2003-04, but remain well below their previous peak through the five-year forecast period. Reflecting the recent positive stock market and revenue-related developments, we have raised our associated revenue estimates by roughly $1.2 billion per year in our updated forecast. Even with this improvement, however, our projected amount of revenues from these sources still remains less than half of the 2000-01 peak through the forecast period.

Sales and Use Taxes

We estimate that SUT receipts will total $23.5 billion in 2003-04, a 5.2 percent increase from the prior year. We project that these receipts will grow further to $24.9 billion in 2004-05, an increase of 5.6 percent from the current year. Our updated estimates for 2003-04 and 2004-05 are similar to those in the 2003-04 budget, reflecting slightly stronger estimates of "real" sales growth, but slightly less growth in commodity prices than we had assumed previously. Over the longer term, we forecast that SUT receipts will increase at an average annual rate of about 6 percent per year between 2004-05 and 2008-09, reaching $31.4 billion by the end of the forecast period.

Key Forecast Factors

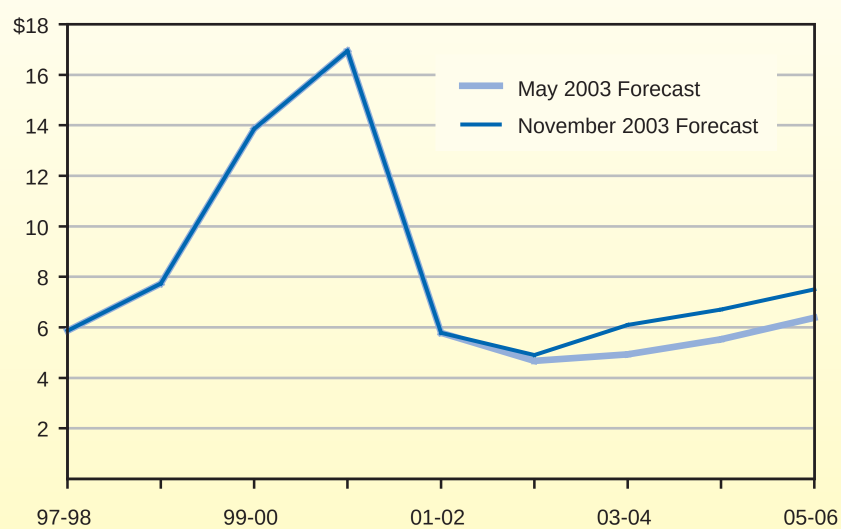
The main determinant of SUT receipts is taxable sales, about two-thirds of which is related to retail spending by consumers, and about one-third of which is related to business-to-business transactions. The past weakness in business spending on both new facilities and equipment has had a major adverse impact on taxable sales during the previous two years. In 2002, for example, taxable spending fell by 0.9 percent, reflecting a sizable drop in business-related transactions partially offset by a small gain in retail spending.

Taxable Sales Growth to Pick Up. Our forecast for 2003 assumes that an improvement in business spending will occur in the second half of the year, and that this half-year effect will boost overall sales by a modest 2.8 percent for the year as a whole. Thereafter, the continuation of this healthier business spending on a full-year basis should produce the 5.9 percent increase that we forecast for calendar year 2004, and similar gains in subsequent years.

Figure 4

Revenues From Capital Gains and Stock Options Outlook Improves Modestly

(In Billions)



One-Time Gain From Suspended Transfer. Our sales tax estimate for the current year also reflects a one-time gain of $87 million related to the one-time suspension of the annual transfer of certain sales tax revenues from gasoline sales out of the General Fund and into a special transportation fund.

Corporation Taxes

We estimate that CT receipts will increase from $6.7 billion in 2002-03, to $7.3 billion in 2003-04, and $7.4 billion in 2004-05. Over the longer term, we forecast that collections from the CT will increase at an average annual rate of slightly over 7 percent between 2004-05 and 2008-09, reaching $9.8 billion by the final year of the forecast period. These updated estimates are up from the 2003-04 budget forecast by $230 million in 2003-04 and $245 million in 2004-05.

Key Forecast Factors

The main factor underlying CT receipts is the California taxable corporate profits of firms doing business in California. We currently estimate that these profits will jump 16 percent in 2003 and 12.5 percent in 2004. This reflects the combined effect of large increases in sales and output and declining unit labor costs—the latter due to significant productivity gains across all major industry sectors. We project that profit growth in subsequent years will settle into a more moderate and sustainable pace, increasing at about 6 percent per year.

NOL Deductions to Return. The CT receipts are also being affected by two special factors. The first is legislation passed in conjunction with the 2002-03 budget that suspended NOL carryforward allowances for 2002 and 2003. These allowances are reinstated in 2004, with the percentage of losses that can be deducted against future earnings increasing from 65 percent to 100 percent effective beginning in 2005. This provision raised revenues by $600 million in 2003-04, but will reduce collections by $325 million in 2004-05 and slightly higher amounts annually thereafter.

MIC to Disappear. The second special factor is the expiration of the manufacturers' investment credit (MIC) beginning in 2004. The statute creating the MIC in 1994 included a provision stating that the MIC would expire following any year after 2000 in which the cumulative growth in manufacturing employment (excluding aerospace) from 1994 was less than 100,000 jobs. Manufacturing jobs fell below the specified threshold level in 2003, triggering the expiration of the MIC effective January 1, 2004. The elimination of this credit will boost CT revenues by $40 million in 2003-04, $195 million in 2004-05, and up to $450 million annually by the end of the forecast period.

Other Revenues and Transfers

This category encompasses all remaining General Fund revenue sources. It includes taxes on insurance, alcoholic beverages, estates, and cigarettes. It also includes collections from the above-cited tobacco bond sales, interest on investments, asset sales, and various other transfers and loans from special funds.

Collections to Vary. As shown in Figure 1, the amount of collections from these other revenue sources combined is expected to fall from $9.4 billion in 2002-03 to $7.8 billion this year, and continue sliding to a low point of $3.1 billion in 2005-06. Thereafter, combined collections from these sources are expected to rebound to nearly $5 billion in the latter years of the forecast period.

Budget-Balancing Actions a Key Factor. The totals in this category for the forecast period are dominated by the effects of budget-balancing actions taken by the Governor and Legislature during the past two years, as identified earlier in the "Special Factors in the Outlook" section of this chapter. Apart from these factors, ongoing underlying revenues are expected to grow at a modest pace reflecting the net effect of increases in insurance taxes, declines in cigarette and alcoholic beverage taxes, the continued phase-out of the estate tax, and other factors.

Chapter 4

Expenditure Projections

In this chapter, we discuss our General Fund expenditure estimates for 2002-03 and 2003-04, and our projections for 2004-05 through 2008-09, both in total and by key program area. We first look at general budgetary trends during the forecast period, and then discuss in more detail our expenditure projections for individual major program areas.

GENERAL FUND BUDGET TRENDS

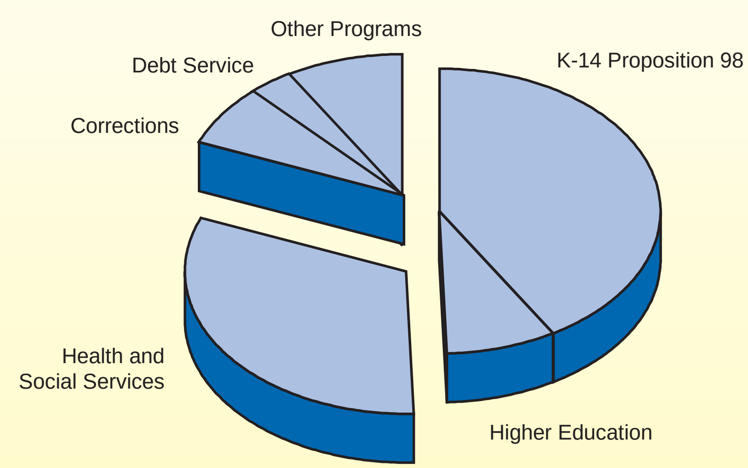
Distribution of General Fund Spending

Figure 1 shows how General Fund spending is distributed among major program areas in 2003-04. It indicates that education programs account for nearly one-half of total spending, with 41 percent attributable to K-14 education and another 8 percent for the University of California (UC) and California State University (CSU). Nearly one-third of the total is for health and social services, and about 7 percent is for corrections. The remainder is for debt service, various local subventions, pension payments, and other purposes.

Figure 1

Education, Health, and Social Services Account for Most Spending

General Fund 2003-04[a]



[a]Data shown assume no VLF backfill payments to localities.

Spending Trends Over the Forecast Period

Figure 2 (see next page) shows our forecast for major General Fund spending categories. The impacts of a vehicle license fee (VLF) rate rollback are included at the bottom of the figure. We forecast that General Fund expenditures will jump from $73.7 billion in 2003-04 to $85.7 billion in 2004-05, an increase of 16.4 percent. This large jump is related to two main factors: (1) the expiration of one-time expenditure savings included in the 2003-04 budget, and (2) large increases in expenditures for the repayment of the deficit financing bond assumed to be issued in 2004-05.

Expiration of One-Time Savings. Major examples in this first category are:

- Use of $1.8 billion in new one-time federal funds in 2003-04 to offset state costs in Medi-Cal, social services, and a variety of other areas in the budget.
- A savings of $960 million in debt service payments related to the deferral of principal payments on certain general obligation bond debt.
- A $930 million savings related to a shift in accounting for Medi-Cal payments from an accrual basis to a cash basis.
- The deferral of $856 million in transportation payments.

Figure 2

Projected General Fund Spending for Major Programs

(Dollars in Millions)

	Estimated		Forecast					Average Annual Growth From
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2004-05
Education programs								
K-14—Proposition 98	$29,189	$30,513	$34,135	$35,978	$37,672	$39,250	$40,781	4.5%
CSU	2,646	2,430	2,500	2,596	2,711	2,843	2,998	4.6
UC	3,059	2,761	2,846	2,955	3,086	3,236	3,413	4.6
Health and Social Services								
Medi-Cal benefits	$9,967	$10,018	$11,784	$12,345	$13,156	$13,892	$14,503	5.3%
CalWORKs	2,077	2,082	2,402	2,573	2,636	2,701	2,801	3.9
SSI/SSP	3,031	3,380	3,550	3,771	3,975	4,229	4,546	6.4
IHSS	1,122	1,269	1,425	1,607	1,831	2,076	2,343	13.2
DDS	1,866	2,102	2,398	2,568	2,800	3,064	3,361	8.8
Other major programs	4,832	4,556	5,499	5,836	5,923	6,139	6,404	3.9
Department of Corrections[a]	$4,948	$5,084	$5,188	$5,458	$5,789	$5,953	$6,112	4.2%
VLF subventions	$3,786	—	—	—	$834	—	—	—
Debt service	$2,233	$2,484	$3,788	$4,087	$4,480	$4,855	$5,253	8.5%
Other programs/costs	$9,276	$6,996	$10,016	$10,771	$10,957	$11,549	$12,947	6.6%
Totals—no VLF backfill	**$78,031**	**$73,675**	**$85,727**	**$90,941**	**$96,496**	**$100,514**	**$106,275**	**5.5%**
Effect of resumed VLF backfill:								
VLF subventions	—	$3,237[b]	$4,224	$4,394	$4,581	$4,787	$5,024	4.4%
CalWORKs VLF interaction	—	—	223	127	129	130	133	-12.1
Totals—with VLF backfill	**$78,031**	**$76,912**	**$90,175**	**$95,462**	**$101,206**	**$105,431**	**$111,433**	**5.4%**

[a] Reflects employee compensation costs starting with forecast period (2004-05).

[b] Assumes VLF rate reduction made retroactive to October 1, 2003. The 2003-04 amount would be $1.8 billion if rate reduction were effective on February 1, 2004.

Deficit Financing Bond Repayment. The spending totals for 2004-05 and beyond include roughly $2.4 billion in increased annual General Fund payments for Proposition 98. These payments are part of a multistage shift of sales and property taxes (the so-called "triple flip"), and are tied to repayment of the deficit financing bond (see box on page 32).

The right-hand column of Figure 2 shows the average annual growth rates from 2004-05 through 2008-09 that we are projecting. Overall spending is projected to grow by an average of about 5.5 percent per year, reflecting divergent trends among major state program areas. With regard to specific individual program areas, the figure shows that:

- ***K-12 Proposition 98 (General Fund)*** spending is projected to increase at an average annual rate of 4.5 percent, reflecting slowing growth in enrollment and ongoing increases in local property taxes' share of the overall Proposition 98 guarantee.

- ***UC and CSU*** are each expected to increase by an average of 4.6 percent per year, reflecting growth in student enrollments and inflation.

- ***Medi-Cal*** benefits are projected to grow at an average annual rate of 5.3 percent. This reflects: (1) continued increases in costs for medical services and prescriptions, especially for the aged and disabled population, and (2) moderate growth in caseload commensurate with population growth over the forecast period.

- ***California Work Opportunity and Responsibility to Kids (CalWORKs)*** spending is projected to see average General Fund growth of 3.9 percent annually through the forecast period due to the exhaustion of federal carry-over reserves in 2004-05 and the costs of fully funding the program (including statutory cost-of-living adjustments [COLAs]).

- ***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 modest 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 13.2 percent, reflecting increases in caseload and service hours, as well as increases in annual wages for IHSS workers, as provided for by current law.

- ***Developmental Services (DDS)*** is projected to grow at an average annual rate of 8.8 percent over the forecast period. This reflects ongoing large increases in both caseloads and costs-per-client served by the DDS Regional Centers.

- ***Department of Corrections*** spending is forecast to grow at an average annual rate of 4.2 percent. This reflects the combination of slightly declining inmate populations but significant cost increases related to the Unit 6 bargaining agreement.

- ***Debt Service*** expenses for general obligation and lease revenue bond debt is projected to increase at an average annual rate of 8.5 percent over the forecast period. The increase assumes the sale of about $6 billion of General Fund-supported debt annually for traditional capital outlay purposes.

- ***Other Programs/Costs*** are expected to experience spending growth of an average annual rate of 6.6 percent. A key factor behind this above-average growth rate is the scheduled payment (with interest) of $856 million in funds for transportation, which were deferred in 2003-04. Absent this factor, underlying projected growth in this category is 4.3 percent per year, reflecting such factors as inflation, caseload changes, and retirement costs.

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 California Community Colleges (CCC). Proposition 98 is funded from the state General Fund and local property taxes and accounts for almost 80 percent of total support for K-14 education. 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 6.2 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 1.1 million full-time equivalent students at 108 colleges operated by 72 locally governed districts.

The Spending Forecast

Figure 3 displays our projections of the Proposition 98 minimum guarantee—as well as its General Fund and local property tax funding components—throughout the forecast period. We would also note that our budget totals reflect an updated figure for 2002-03 Proposition 98 spending which is $100 million higher than assumed at the passage of the 2003-04 budget package.

Forecast for the Current Year. The *2003-04 Budget Act* appropriates $45.7 billion in Proposition 98 spending. We now forecast a minimum guarantee of $46.6 billion for 2003-04, around $875 million higher than the current appropriation level. The increase in the minimum guarantee is mainly due to our estimate of $2.2 billion in higher General Fund tax revenues in 2003-04, but is also affected by changes in school attendance and population estimates. Because the 2003-04 appropriation level has not changed, we forecast that the Proposition 98 minimum guarantee is now underappropriated by $875 million. Based on the legislative intent language in Chapter 228, Statutes of 2003 (AB 1756, Budget Committee) to spend at the minimum guarantee in 2003-04 and 2004-05, our fiscal forecast assumes that the Legislature appropriates an additional $875 million in 2003-04.

Figure 3

The LAO Proposition 98 Forecast

2003-04 Through 2008-09
(In Billions)

	2003-04						
	Budget Act	Revised	2004-05[a]	2005-06	2006-07	2007-08	2008-09
Proposition 98							
General Fund	$30.0	$30.5	$34.1	$36.0	$37.7	$39.2	$40.8
Local property tax	15.7	16.1	14.9	16.0	17.3	18.5	19.7
Totals	$45.7	$46.6	$49.0	$52.0	$54.9	$57.8	$60.5

[a] Funding components reflect a $2.45 billion reduction in property tax revenues—and commensurate increase in General Fund support—due to the triple flip budget solution, which has an ongoing effect throughout the forecast period.

We forecast that local property tax revenues will be $345 million higher than assumed in the *2003-04 Budget Act*. Thus, the state would be required to provide an additional $530 million from the General Fund to meet the minimum guarantee. This additional funding would reduce the outstanding "maintenance factor" to just under $2.5 billion (see discussion in box on page 32).

Forecast for the Budget Year. For 2004-05, we estimate the Proposition 98 minimum guarantee will total $49 billion. This is $2.4 billion (5.1 percent) more than in 2003-04. During 2004-05, K-14 local property tax revenue will decrease by a net of $1.2 billion because of (1) a $2.45 billion transfer of K-14 local property taxes to cities and counties to backfill foregone sales tax revenue as part of the triple flip (also discussed in box on page 32) and (2) $1.2 billion in increased local property tax revenues because of increased assessed property values. Thus, General Fund costs of meeting the Proposition 98 minimum guarantee will grow by $3.6 billion between the current 2003-04 level and 2004-05 (an 11.9 percent increase).

Out-Years' Forecast. For the remainder of the forecast period, we estimate that growth in total Proposition 98 spending will average $2.9 billion annually (5.4 percent). Strong property tax growth averaging $1.2 billion annually (7.4 percent) helps reduce the impact on the General Fund. General Fund support for Proposition 98 will grow around $1.7 billion annually (4.5 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. Figure 4 summarizes our assumptions for these factors and the K-12 COLA rate.

For our forecast:

- We assume a slowing rate of growth in K-12 ADA. As Figure 5 (see page 34) shows, we forecast that by the end of the period, ADA will actually *decline* between 2007-08 and 2008-09.
- We forecast California per capita personal income to grow at 2.8 percent in 2004-05, and then average 4.6 percent for the remainder of the forecast period.
- Our forecast also reflects relatively strong annual growth in per capita General Fund revenues averaging 5.1 percent, and in lo-

Figure 4

The LAO Proposition 98 Forecast Factors

	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Proposition 98 "Test"	2	2	2	2	2	2
Annual Percentage Change						
K-12 average daily attendance	1.1%	1.0%	0.9%	0.5%	0.3%	-0.1%
Per capita personal income	2.3	2.8	4.1	5.0	4.6	4.5
Per capita General Fund	5.5	4.5	5.5	5.2	4.9	4.9
State population	1.5	1.3	1.3	1.3	1.4	1.3
Local property taxes	8.8	7.6[a]	7.9	7.7	7.2	6.7
K-12 COLA	1.9	2.2	2.5	2.8	2.8	2.8

[a] Growth rate in 2004-05 reflects the underlying growth in school district and community college property tax revenues. This rate does not account for changes in revenues resulting from the triple flip.

cal property taxes around 7.4 percent (excluding the triple flip adjustments).

- The K-12 statutory COLA rate increases slightly from 1.9 percent in 2003-04 to 2.2 percent in 2004-05. We forecast that the COLA rate will grow to 2.8 percent by 2006-07, and remain at that level for the remainder of the forecast period.

Proposition 98 Cost Pressures

The state's actions to address the 2002-03 and 2003-04 budget problems in K-14 education relied heavily on (1) one-time solutions, (2) borrowing from the future by deferring appropriations to future years to support current costs, and (3) a large limited-term reduction in general purpose funding for K-12. The growth in Proposition 98 funding over the forecast period would allow the state to (1) address the fiscal obligations created by the recent budget solutions, (2) provide growth and COLA, and (3) allocate roughly an additional $1 billion in growth annually throughout the forecast period for program expansions or restorations. In this section, we provide information on the statutory cost pressures for K-14 education over the forecast period. Specifically, these fiscal obligations include:

Key Education Terms

What Is the Maintenance Factor?

Over the long-run, the Proposition 98 minimum guarantee is determined by the growth in K-12 attendance and growth in per capita personal income (referred to as long-term Test 2 level). The Constitution allows the Legislature to appropriate less for K-14 education than this long-term Test 2 level under two circumstances: (1) the Legislature suspends the requirements of Proposition 98, or (2) per-capita General Fund revenues grow slower than per-capita personal income (known as a Test 3 level).

In either of these circumstances, the Constitution requires the state to restore in future years the difference between the actual level of spending and the long-term Test 2 level of spending. This difference is known as the maintenance factor. Generally, maintenance factor is restored during Test 2 years (when the growth of General Fund revenues exceeds growth in personal income). For instance, in 2001-02 when General Fund revenues fell by more than 17 percent (a Test 3 year), the Legislature appropriated $3.9 billion less than would have been required if Test 2 were operative. This created a $3.9 billion maintenance factor that must be restored in the future.

In 2002-03, the state was required to provide approximately $500 million to begin restoring the maintenance factor. Based on our current forecast, the state will be required to restore additional maintenance factor of $875 million in 2003-04 and around $600 million in 2004-05. Currently, for each $1 increase in General Fund revenues, there is around a $.50 increase in the minimum guarantee as more maintenance factor is required to be restored.

What Is the Deficit Factor?

Because school district revenue limit funding is continuously appropriated, the Legislature must amend statute if it wants to provide less than the full statutory COLA or enrollment funding, or wants to make additional reductions to revenue limit funding. Technically, the Legislature and

- ***K-12 Principal Apportionment Deferral and CCC Deferrals.*** Chapter 227, Statutes of 2003 (AB 1754, Budget Committee), states legislative intent to pay off the K-12 principal apportionment deferral when maintenance factor funding is provided. To pay off the K-12 deferral and a $200 million CCC deferral, the Legislature would need to appropriate $1.3 billion in one-time funds, and $200 million in ongoing funds (building the $200 million CCC deferral back into the Proposition 98 base). Under our forecast, we project that the state would repay enough maintenance factor to fully pay off these deferrals by 2004-05.

- ***K-12 "Deficit Factor."*** The state, in Chapter 227, created a $894 million deficit factor in 2003-04 (see discussion in nearby box), consisting of $350 million due to a 1.2 percent reduction to general purpose revenue limit funding, and $544 million due to a foregone COLA (1.9 percent). Chapter 227 states legislative intent to use Proposition 98 growth funding in 2004-05 first to restore this deficit.

- ***K-14 Growth and COLA.*** We forecast growth and COLA costs for K-12, CCC, and child care of $1.6 billion in 2004-05. These costs would increase to $1.7 billion

Key Education Terms *continued*

Governor "deficit" (that is, reduce) the revenue limit funding by some factor or percentage. In the early 1990s the revenue limit deficit factor grew to 11 percent after several consecutive years of not providing school districts with a full statutory COLA. In 2000-01, the state provided an addition $1.8 billion in revenue limit funding to eliminate the deficit factor. In 2003-04, the state created a new deficit factor of 3.1 percent or $894 million—consisting of a base reduction of 1.2 percent and a foregone COLA (1.9 percent). This deficit factor would be fully restored in 2005-06 absent additional legislative action.

The Triple Flip

A key feature of the 2003-04 budget package was the method devised to finance the deficit financing bonds. The state enacted a three-step approach—commonly referred to as the triple flip—that provides a dedicated funding source for the deficit bonds:

- Beginning in 2004-05, the budget package temporarily redirects a share of the local sales tax (one-half of 1 percent) to the state to use to repay the deficit reduction bonds.

- The budget package completely offsets those local sales tax losses (almost $2.4 billion in 2004-05) by redirecting to cities and counties a commensurate amount of property taxes from the Educational Revenue Augmentation Fund (ERAF).

- Increased state education apportionments, in turn, will replace K-14 district revenue losses associated with the redirection of ERAF monies.

The retirement of the bonds is dependent on revenues received by the state, but is expected to occur over roughly five years. The swap of sales taxes for property taxes ends after the deficit financing bonds are repaid.

in 2005-06, and then begin to decline as the attendance rate for K-12 falls over the forecast period. For CCC, we assume enrollment growth would reflect growth in the 18 to 24 year old population, and that the K-12 statutory COLA rate also would apply.

- ***Public Employees' Retirement System (PERS) Costs.*** According to recent data from PERS, we forecast a 12.2 percent PERS contribution rate for 2004-05, costing just over $100 million to cover the higher K-12 costs as required by statute.

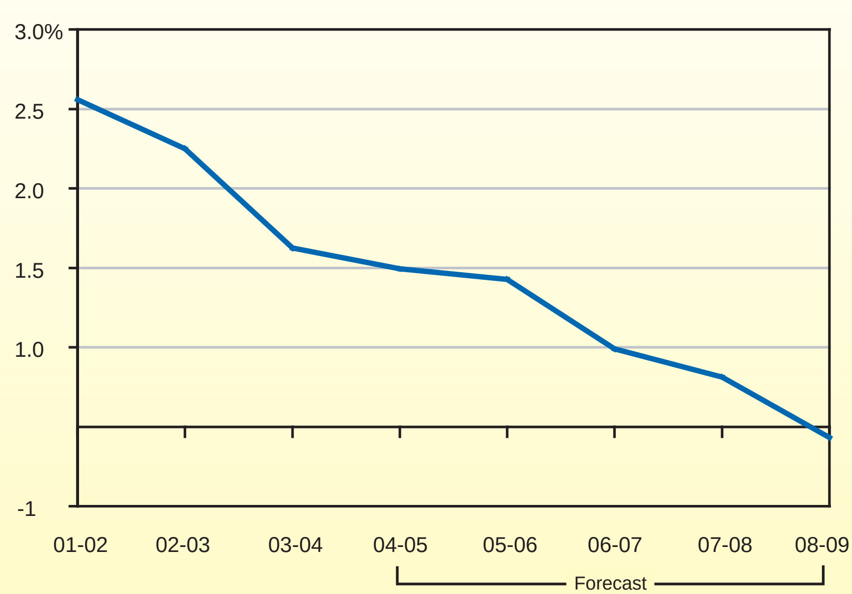
- ***Mandates.*** By the end of 2003-04, we estimate that outstanding K-14 reimbursable mandate claims will have reached $1.1 billion on a one-time basis to pay prior-year claims and around $300 million for ongoing expenses. Chapter 228 states legislative intent to defer mandate funding for schools again in 2004-05. In order to fund the ongoing costs of mandates and pay off outstanding obligations over the remaining four years of the forecast period, the Legislature would have to provide around $600 million annually between 2005-06 and 2008-09.

Because of the strong growth in Proposition 98 over the forecast period, the Legislature could fund all of the cost pressures described above, and still allocate roughly $1 billion annually throughout the forecast period for program restorations or expansions. The Legislature's choices in allocating this additional funding will affect the "split" of Proposition 98 resources between K-12 schools and CCC. The CCC's share of Proposition 98 resources has ranged between 9 percent and 11 percent. The Proposition 98 levels in our forecast suggest that the Legislature will have considerable discretion in how to allocate K-14 funding beyond growth, COLA, and other obligations.

Proposition 49. Approved by voters in 2002, Proposition 49 requires that the state appropriate additional funding for after school programs beginning in 2004-05 if certain conditions are met. Specifically, the state must appropriate up to an additional $430 million for after school programs if total state spending reaches a specified threshold. Based on our revenue forecast, the state would not be required under Proposition 49 to augment after school programs over the forecast period.

Figure 5

Projected K-12 Attendance Changes



HIGHER EDUCATION

In addition to community colleges, the state's public higher education system includes UC and CSU. The UC consists of eight general campuses, one health sciences campus, numerous special research facilities, and a soon-to-open 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 under specified circumstances.

The Spending Forecast. We estimate that General Fund spending for UC and CSU (excluding funding for capital outlay and debt service) will increase from $5.2 billion in 2003-04 to $5.3 billion in 2004-05. This is an increase of $154 million, or 3 percent. It primarily reflects the restoration of one-time reductions that were made in the 2003-04 budget. By 2008-09, we estimate that that spending for UC and CSU will increase to $6.4 billion, reflecting average annual increases of almost 5 percent starting in 2005-06.

Key Forecast Factors. Consistent with the Legislature's expressed intent, our forecast assumes no funding for enrollment growth, new salary increases, or discretionary price adjustments in 2004-05. We assume that the segments will begin receiving additional funds for COLAs and enrollment growth starting in 2005-06. Over the forecast period, inflation is projected to average about 2.8 percent annually.

With regard to enrollment growth, our forecasts are based primarily on population growth among 18 to 24 year olds. This population is currently growing at a relatively low rate, although we project that this rate will increase to about 2.6 percent by the end of the forecast period. While we assume that there will be no funding for enrollment growth in 2004-05, we have assumed that the demand created by population growth in 2004-05 would be accommodated in subsequent fiscal years.

Our estimates assume that college participation rates will remain relatively constant throughout the forecast period. This is for three reasons. First, we note that college participation rates are already at historic highs. Second, recent and anticipated fee increases could dampen the potential for further increases in participation rates. Finally, recent reductions in funding for UC and CSU outreach programs could further reduce the likelihood that participation rates would increase significantly during the forecast period.

Cal Grant Costs Likely to Increase Substantially. We estimate that spending for financial aid programs administered by the Student Aid Commission will increase from $683 million in 2003-04 to approximately $1.1 billion in 2008-09. The bulk of the expected increase is attributable to the Cal Grant Entitlement programs. Effective beginning in 2001-02, these programs guarantee financial aid to recent high school graduates and community college transfer students under 24 years of age. Because these programs are still relatively new, future growth in their participation rates remains uncertain. However, our projections assume that student participation in the entitlement programs will continue to grow somewhat faster than student enrollment.

HEALTH

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, county administration of eligibility, and other costs) will reach $10.7 billion in the current year, about a $170 million increase over the amount appropriated in the *2003-04 Budget Act*. We project that, barring other actions by the Legislature and Governor, General Fund support would grow to $12.6 billion in 2004-05, a 17 percent increase from current-year expenditures. This is largely due to the one-time effect of the accounting shift of the program from an accrual to cash basis as well as the phase-out of a temporary increase in the federal share of support for the Medicaid Program. By the end of the forecast period in 2008-09, we estimate that General Fund spending for Medi-Cal will reach $15.5 billion, an average annual increase of 7.8 percent over the projection period.

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

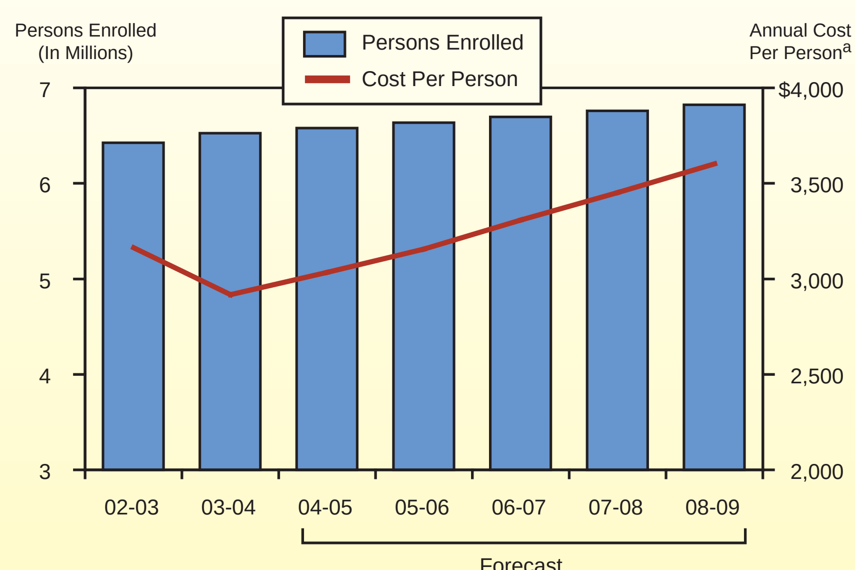
- ***Health Care Costs.*** The most significant factor in our forecast is the assumption that the cost of most health care services provided to aged, blind, and disabled Medi-Cal enrollees will increase at an annual rate of between 5 percent and 7 percent from 2004-05 through 2008-09 because of increased utilization and costs. In contrast, our projection assumes that the cost of health care services for most families and children would grow more slowly (up to 2.8 percent during the same period). As shown in Figure 6, the average cost per person enrolled in the program is projected to grow from $2,900 to $3,600 during the forecast period. Our health care cost assumptions are subject to considerable uncertainty and small changes in the actual rate of growth in medical costs could have significant fiscal effects.

- ***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. This caseload growth was due primarily to changes in program eligibility rules, but 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 population.

- ***Reductions in the Federal Matching Rate.*** The federal share of cost for support of Medicaid is based on each state's per capita income relative to the nation for the most recent three calendar years for which data

Figure 6

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



[a]General Fund and federal funds.

are available. However, during 2002-03 and 2003-04, the state is expected to receive about $890 million in additional federal funds due to a temporary increase in the federal share of support for the program. Our projection assumes that when this one-time increase ends as scheduled in June 2004, the federal matching rate for Medi-Cal will be reduced.

- ***Further Savings in 2004-05.*** Our forecast assumes that the state will achieve an increased level of savings in 2004-05 from the full-year implementation of various cost reduction strategies begun in 2003-04. These strategies include the antifraud effort expansion, and various drug and medical supply cost-containment proposals. Our estimate also assumes that savings of $134 million will result in 2004-05 from the rate freeze for long-term care facilities and acute hospital inpatient services that were adopted as part of the 2003-04 budget plan.

- ***Implementation of Health Coverage Legislation.*** Our forecast takes into account the enactment of Chapter 673, Statutes of 2003 (SB 2, Burton). Among other changes, starting in 2005-06, Chapter 673 would establish (1) a mandate for certain employers to provide health insurance coverage to their employees and (2) a program in which the state would assist low-income employees enrolled in Medi-Cal to pay premiums to obtain employer-based coverage for most of their health care needs.

Healthy Families Program

The Healthy Families Program (HFP) 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 Spending Forecast. We estimate that overall General Fund spending for HFP will be $290 million in 2003-04. We further estimate that overall General Fund spending for the program will increase about 5.5 percent in 2004-05 to about $306 million, and that by 2008-09 the program will have an annual General Fund cost of about $450 million.

Key Forecast Factors. Compared to prior years, the 2004-05 forecast reflects a slower growth rate in program spending, which is due in part to recent statutory direction to freeze the rates paid to HFP health plans at the current level through 2004-05. The forecast assumes that rate increases for the cost of medical coverage resume commencing in 2005-06.

Our forecast also reflects the enactment of Chapter 673, beginning in 2005-06. Our projection takes into account the likelihood that the premium assistance provisions of Chapter 673 will add a significant number of children to HFP enrollment.

The forecast assumes that a proposed expansion of enrollment to some parents of children eligible for HFP does not occur during the forecast period. However, the caseload of children continues to grow as the program reaches a larger proportion of the total eligible population.

Developmental Services

The Lanterman Developmental Disabilities Services Act of 1969 provides a variety of services and supports to individuals with developmental disabilities, including mental retardation, cerebral palsy, epilepsy, autism, or other similar disabling conditions. The DDS, which oversees the programs, 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 2003-04 will total $2.1 billion, about the same amount of funding appropriated in the *2003-04 Budget Act*. Of that total, excluding headquarters, about $1.7 billion would be spent by RCs for community services and about $369 million would be spent for operating the DCs.

We further estimate that General Fund spending for developmental services will grow by about 14 percent in 2004-05 to approximately $2.4 billion. Part of that growth is due to a transfer of habilitation services from the Department of Rehabilitation to DDS.

Between now and 2008-09, we estimate that General Fund spending for the developmental services program will grow by $1.3 billion and reach a total of almost $3.4 billion. This expenditure growth is due almost entirely to the RCs. We estimate there will be a one-time increase in spending in 2004-05 as a result of the closure of Agnews DC followed by an ongoing reduction in DC operating costs. Spending for DCs is projected to remain relatively flat over the rest of 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

The CalWORKs 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 for the CalWORKs program is estimated to be $2.1 billion in 2003-04, which is unchanged from the prior year. We project spending to increase by 15 percent to $2.4 billion in 2004-05 and by 7 percent to a total of $2.6 billion in 2005-06. For the remainder of the forecast, we project that spending will increase by an average of 2.9 percent each year. The primary reason for the substantial spending increases in 2004-05 and 2005-06 is due to a reduction in available carry-in federal Temporary Assistance for Needy Families (TANF) funds. For 2003-04, California had $533 million in unexpended TANF funds from prior years. We estimate the available carry-in TANF funds for 2004-05 will be $268 million less than were available in 2003-04, with further reductions in available funds in the out-years. Given this substantial reduction in available carry-in funds, California would have to spend above the federal maintenance-of-effort requirement beginning in 2004-05 in order to fund the program.

Key Forecast Factors. Beyond the estimated reduction in unexpended federal TANF funds, our spending projection is based on several factors, the most important being our caseload projections (discussed below). Other important assumptions include federal funding of the TANF block grant at $3.7 billion and providing the state statutory COLA which is based on the increase in the California Necessities Index.

Caseload Trends and Projections. From 1994-95 through 2002-03, the CalWORKs caseload declined by 48 percent. This decline in caseload is attributable to a number of factors including the strong economy of the late 1990s, annual reductions in the teen birth rate, and CalWORKs program changes which emphasized welfare-to-work services. However, since October 2002, the caseload has remained essentially flat at about 480,000 cases. Accordingly, for this fiscal forecast report, we have assumed that the total caseload will remain essentially flat.

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 SSI/SSP is estimated to be about $3.4 billion in 2003-04, an increase of about 12 percent compared to the prior year. For 2004-05, we project a 5 percent increase, raising total expenditures to $3.6 billion. From 2004-05 through the end of the forecast period, spending for SSP will increase by an annual average rate of 6.4 percent, eventually reaching a total of $4.5 billion.

Key Forecast Factors. The two primary cost drivers for SSI/SSP are caseload growth of about 2.1 percent and the cost of providing the statutory COLA each January beginning in 2005. (The *2003-04 Budget Act* suspended the January 2004 COLA.) For 2004-05, a six-month COLA accounts for $89 million in increased costs and caseload growth accounts for an additional $71 million. Estimated costs for 2005-06 include annualization of the 2004-05 COLA ($89 million), the January 2006 COLA ($46 million), and caseload growth of $76 million. During the out-years of the forecast, COLA costs average around $117 million per year and caseload growth averages around $84 million per year. Finally, we note that beginning in 2006-07, the cost of providing state-only SSI/SSP benefits to noncitizens who immigrated to the United States after August 1996 substantially increases because counting their sponsor's income as an offset to the grant amount ends after ten years.

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 just over 2 percent per year. We expect the growth rate to continue throughout the forecast period.

IHSS

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

The Spending Forecast. General Fund spending for IHSS is expected to be $1.3 billion in 2003-04, an increase of 13 percent over the prior year. For 2004-05, we project that costs will increase again by 12 percent to a total of $1.4 billion. For the remainder of the forecast, we expect costs to increase an average of 13 percent each year, resulting in total expenditures of $2.3 billion in 2008-09.

Key Forecast Factors. Our forecast assumes that costs will increase 9.5 percent each year due to caseload growth and increases in the hours of service provided to recipients. The other significant cost driver for IHSS is provider wages. Our projection assumes that counties will increase provider wages gradually throughout the forecast period, though by less than the maximum level authorized by current law. We project that by 2008-09, provider wage increases will result in additional annual General Fund costs of $295 million.

JUDICIARY AND CRIMINAL JUSTICE

The major state judiciary and criminal justice programs include support for three departments in the executive branch—the California Department of Corrections (CDC), Department of the Youth Authority, and the Department of Justice—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 32 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 $240 million from 2002-03 to 2004-05, reaching about $5.2 billion at the end of that period. Expenditures for CDC are forecast at about $6.1 billion by 2008-09. (Our estimates for the forecast period, beginning in 2004-05 include adjustments for employee compensation increases, but do 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. During the forecast period the CDC budget would grow at an average annual rate of 4.2 percent 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 $65 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 amount is $69 million less than budgeted in 2003-04.

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 $900 million during the forecast period. 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. In addition, inmate health care costs are expected to increase by $40 million during the forecast period due to the implementation of court orders instructing the department to improve the delivery of health care services to inmates.

Prison population is not a significant driver of General Fund cost increases during the forecast period. As seen in Figure 7, the population is projected to decrease by 11,300 inmates between 2002-03 and 2005-06, and is expected to stabilize at this level increasing by only 590 inmates (or less than 1 percent) over the remainder of the projection period. The population decrease is largely due to policy changes adopted by the Legislature and administration aimed at reducing the inmate population and parolee recidivism.

OTHER PROGRAMS

Employee Compensation

While departments' budgets include base costs for the compensation of state employees, the budget typically includes a lump sum for any additional compensation items that take effect in the budget year. Given the overall budget situation, the 2003-04 budget assumes a *reduction* of $585 million in General Fund costs for state employee compensation costs (through Control Section 4.10). This amount is the combination of (1) the avoidance of employee compensation costs that were not budgeted ($404 million) and (2) the reduction of expenses below departments' budget appropriations ($181 million).

To achieve these savings, the administration has pursued a number of strategies to reduce state employee compensation costs. The Legislature has approved new or renegotiated contracts with 14 of 21 state bargaining units. These agreements (as described in Figure 8) include current-year net savings and out-year costs. In addition, the administration eliminated thousands of vacant positions throughout state government. Departments also identified other savings—such as reducing overtime and temporary employees. Finally, about 300 employees have been laid off so far, with more than an additional thousand layoffs expected by the end of 2004-05.

Figure 7

Inmate Population Projected to Decrease Then Stabilize

Fiscal Year Ending June 30 (In Thousands)

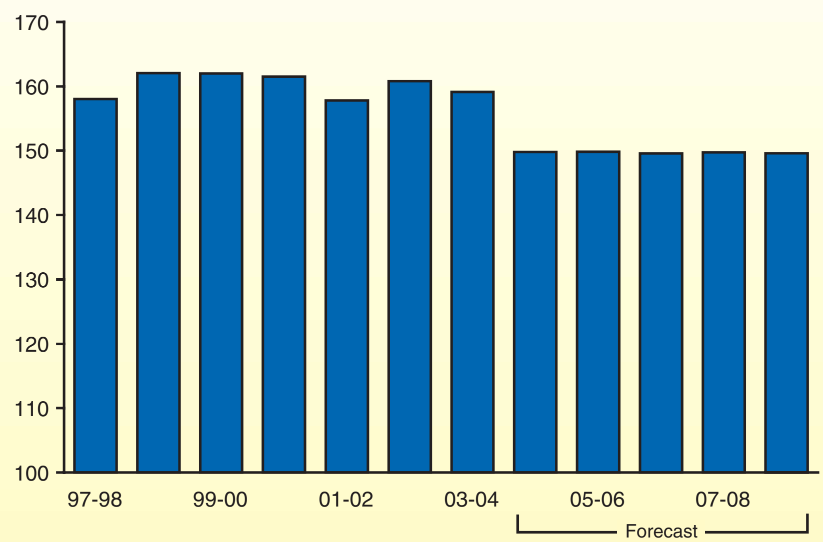


Figure 8

Major Provisions of Recently Approved State Employee Contracts

- ✔ The Legislature has approved administration-negotiated agreements for 14 of the state's 21 bargaining units to defer scheduled July 1, 2003 salary increases, in exchange for additional benefits. (The largest group which has not come to a new agreement is bargaining Unit 6, which represents corrections employees.)
- ✔ In particular, the administration agreed to (1) pay 80 percent of health insurance costs effective January 1, 2004, (2) allow employees to accrue one additional vacation day per month (approximately equivalent to the deferred 5 percent salary increase for most employees), and (3) in some cases, continue the suspension of employees' retirement contributions to maintain take-home pay at current levels.
- ✔ The Department of Personnel Administration estimates that these provisions will generate net savings of $185 million ($67 million General Fund) in 2003-04.

The Spending Forecast. While the administration has made proposals to achieve employee compensation savings, it has not yet accounted for some increased employee costs that will likely be unavoidable (such as for corrections and other 24-hour care agencies). In addition, the timing of layoffs will prevent some departments from achieving full-year savings. Consequently, we expect net current-year savings to fall short of the expected $585 million by about $200 million. This shortfall will create pressure on departmental budgets. We project that the shortfall will result in a combination of departments absorbing additional costs and seeking authorizations for deficiency spending.

Separate from the net savings associated with Control Section 4.10 discussed above, the state will incur additional employee compensation costs over the forecast period (as discussed below). We estimate that General Fund costs will increase by more than $1.5 billion by 2008-09.

Key Forecast Factors. While the renegotiated employee contracts will result in reduced state costs in 2003-04, they will increase costs over the forecast period. For instance, the deferred July 1, 2003 salary increase and state payment of 80 percent of health benefits negotiated with 14 bargaining units (and also adopted by the administration for employees excluded from collective bargaining) will increase General Fund expenditures by more than $200 million in 2004-05. These costs will grow to almost $500 million by 2008-09 due mainly to rising health insurance premiums.

For the other bargaining units without renegotiated provisions (including correctional officers), we have included the ongoing costs of the salary increases that began this year. These costs total about $350 million in 2004-05 and grow to almost $800 million by 2006-07. In those years beyond scheduled pay raises, we assumed compensation costs for all bargaining units will increase at the same rate as inflation.

Retirement

In typical years, the budget includes funding for state costs related to retirement in three areas: (1) contributions to the PERS, (2) contributions to the State Teachers' Retirement System (STRS), and (3) the state portion of retirees' health and dental insurance premiums. In place of the state's annual retirement contributions to PERS, the 2003-04 budget authorizes the issuance of $1.9 billion in pension obligation bonds. A recent Superior Court decision ruled that the state cannot sell these bonds without voter approval. (This decision is being appealed by the state.)

The Spending Forecast. Given the court's decision, we have assumed that the state will pay its retirement obligations to PERS in the typical fashion. This worsens the state's General Fund condition by $1.9 billion in 2003-04 compared to the budget plan. In future years, we estimate the state's overall retirement-related costs will increase gradually.

Key Forecast Factors. We project that state retirement contributions to PERS will continue their upward trend for 2004-05, given the continued underperformance of PERS investments. (The investment return for 2002-03 was 3.7 percent, compared to the 8.25 percent assumed annual return.) Beginning in 2005-06, we assume that state contributions will begin to decline. With respect to the STRS, we assume the state contribution—a statutory percentage of teacher payroll—will grow at the same rate as Proposition 98 expenditures. Finally, consistent with recent experience, we assume double-digit annual growth in General Fund expenditures for the state portion of retirees' health and dental insurance premiums—primarily reflecting rising health costs. We estimate that premium costs of $760 million in 2004-05 will grow to $1.3 billion by 2008-09.

Statewide Savings

The *2003-04 Budget Act* included $80 million in General Fund savings from:

- ***Workers' Compensation.*** Reduced state employee workers' compensation costs ($30 million) due to anticipated reforms.

- ***Renegotiation of Contracts.*** Reduced state contract costs ($50 million). The budget and related legislation give the Department of General Services (DGS) new powers to achieve these savings.

For workers' compensation, the state's program does not operate in the same fashion as the private sector. For instance, the state already had in place many of the cost control measures (such as for generic drugs) recently enacted. In regards to contract savings, DGS thus far has only been able to identify minimal opportunities for contract savings. We, therefore, project that only a fraction of these statewide savings will be achieved in the current year.

Noneducation Mandates

By the end of 2003-04, we estimate that outstanding noneducation reimbursable mandate claims will have reached nearly $800 million. Chapter 228 states legislative intent to defer these outstanding claims as well as new and ongoing claims in 2004-05, for a combined deferral of about $1 billion. In order to fund the ongoing costs of mandates and pay off outstanding obligations over the remaining four years of the forecast period, we estimate that the state would have to provide around $550 million annually between 2005-06 and 2008-09.