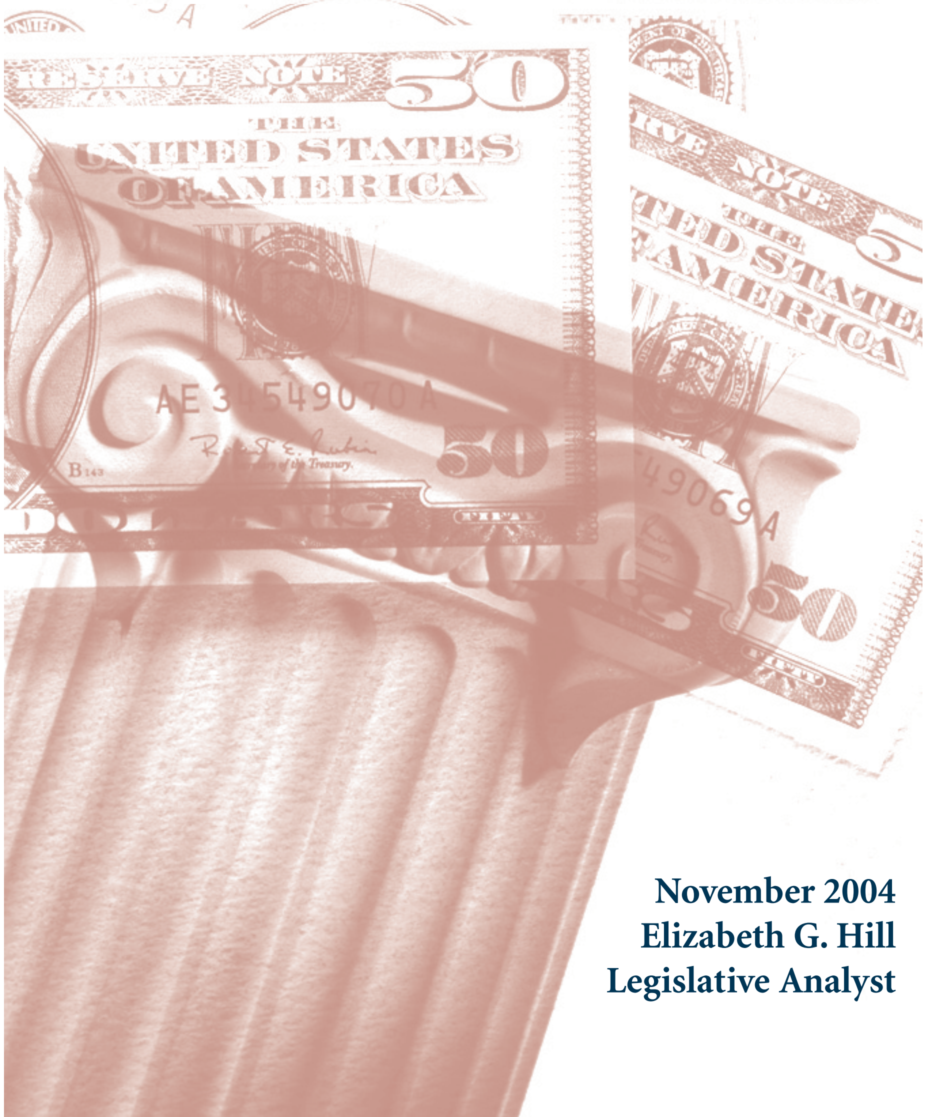
C A L I F O R N I A ' S

Fiscal Outlook

LAO Projections 2004-05 Through 2009-10



November 2004
Elizabeth G. Hill
Legislative Analyst

Foreword

This report provides our projections of General Fund revenues and expenditures for 2004-05 through 2009-10. 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 tenth 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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Elizabeth G. Hill

Deputy Legislative Analysts
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Mac Taylor

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Adult corrections .... Brian Brown
Juvenile/local criminal justice .... Melissa Tanner
Courts .... Vacant

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Chapter 1

The Budget Outlook

SUMMARY

Major Budget Challenges Loom

In approaching the 2005-06 budget, California's policymakers face a deceptively difficult challenge. On the one hand, the strengthening revenue picture, coupled with the availability of the remaining $3.5 billion in authorized deficit-financing bonds that have not yet been used, would enable the Legislature to balance the 2005-06 budget by making a relatively modest amount of hard choices to reduce spending and/or augment revenues.

This would only be a temporary fix, however, as the 2005-06 outlook masks a much more negative underlying budget picture. This is because the 2005-06 budget will be helped by a carry-over balance and various limited-term solutions enacted in the 2004-05 budget which will not be available in subsequent years. As a result, these solutions cannot be counted on to address the state's large and persistent ongoing structural budget shortfall. We project that this shortfall will reach nearly $10 billion in 2006-07 under current-law spending and revenue policies, absent corrective actions.

The size and persistence of this shortfall, even in the face of an expanding economy and strengthening revenues, underscores a critical point that we have made in the past—namely, it is unlikely that California will be able to simply "grow its way out" of this shortfall.

Ongoing Solutions Need Adoption

Given the above, we believe it is critical that the Legislature act now to address the large underlying structural budget imbalance. Every ongoing budget solution that is adopted this year will reduce the amount of actions that will be needed later. Conversely, postponing action will only make the state's fiscal matters worse in the future. Therefore, we recommend that the state adopt real and ongoing solutions to close the budget gap in 2005-06 and that it *not* sell the remaining $3.5 billion in deficit-financing bonds at this time. Such an approach will have the dual benefits of both (1) reducing the structural deficit in later years through adopting ongoing solutions, and (2) preserving the bonding authority for possible use in 2006-07 or thereafter, when the current-law structural shortfall gets much larger and harder to deal with.

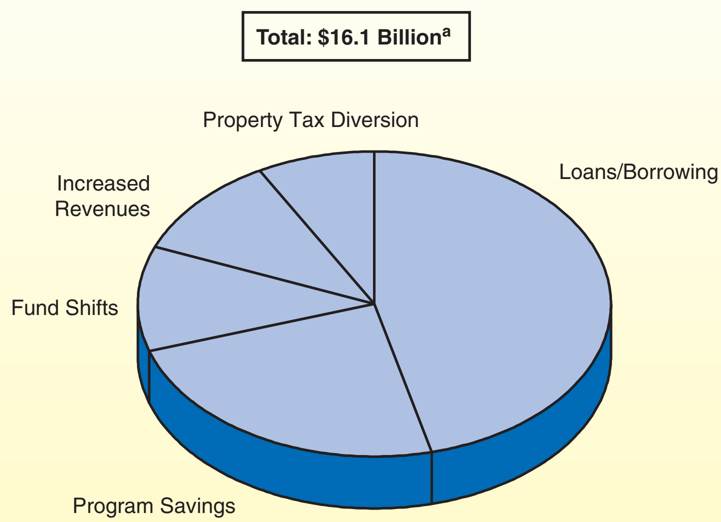
UPDATE ON THE 2004-05 BUDGET

Review of the 2004-05 Budget Plan

The 2004-05 budget adopted last summer addressed a roughly $15 billion budget shortfall. As shown in Figure 1, that budget plan contained a variety of budget-balancing actions, including substantial borrowing, a two-year diversion of property taxes, targeted revenue increases, funding shifts

Figure 1

Allocation of 2004-05 Budget Solutions



[a]Includes $15.3 billion to address budget shortfall and $768 million for reserve.

(including higher education student fee increases), and significant program savings in education and other areas of the budget.

Proposition 98 Suspension. The budget package included a suspension of Proposition 98 and language in Chapter 213, Statutes of 2004, that 2004-05 education spending be set at $2 billion less than the minimum guarantee. (This language, in effect, signals the Legislature's intent to provide more/less funding if the guarantee increases/decreases during the year—for example, due to changes in revenues or attendance.) The difference between this Chapter 213 "target" level and the actual amount appropriated by the budget—$302 million—is shown as a Proposition 98 reserve in the 2004-05 budget.

General Fund Condition. Under the budget plan, the 2004-05 fiscal year was estimated to conclude with a reserve balance of $768 million, of which $302 million was earmarked for Proposition 98 and the remaining $466 million was to be available for non-Proposition 98 purposes. Because of the budget's reliance on one-time or limited-term solutions, it was clear when the budget was adopted that the state would continue to face substantial budget shortfalls in the future, absent further corrective actions.

Recent Budgetary Developments

Since the 2004-05 budget was enacted, there have been various developments affecting the revenue and expenditure sides of the budget. Key changes in our fiscal estimates relative to the budget act are shown in Figure 2.

Revenues Up Sharply. We estimate that the major taxes will exceed the budget estimate by $2.4 billion over 2003-04 and 2004-05 combined, due to a sharp increase in the corporation tax and more moderate gains in both the personal income tax and the sales and use tax. Partly offsetting the increase in tax revenues is a $364 million decline in nontax revenues, due to lower-than-expected receipts from tribal gaming revenues and the sale of surplus property. The net increase in General Fund revenues is $2.1 billion.

Costs Are Also Up. Offsetting a significant portion of the revenue increase are higher state costs totaling about $860 million. The increases are occurring in a variety of areas, including corrections, Medi-Cal, trial court funding, and spending on state operations. In some instances, the higher costs are occurring because the amount of savings resulting from various budgetary solutions is falling short of earlier estimates.

Revised Reserve. Taking into account the higher revenues and higher costs, we estimate that the year-end reserve increases by about $1.2 billion, to just under $2 billion.

Proposition 98 Interaction. The increase in projected 2004-05 tax revenues increases the minimum Proposition 98 K-14 funding guarantee by about $1 billion compared to the budget plan. Consequently, if the Legislature funds Proposition 98 at the Chapter 213 target level (that is, $2 billion below the guarantee), it would require a $1 billion increase in school appropriations. In Figure 2, we have reflected this higher obligation as an increase in the Proposition 98 reserve from $302 million to $1.357 billion. This leaves $614 million of the total reserve available for non-Proposition 98 purposes, only a marginal increase from the $466 million estimated at the time the budget was enacted. Thus, the large increase we project in tax revenues is almost completely offset by increased spending due to the Proposition 98 interaction and higher costs in other program areas.

Figure 2

Effect of Recent Developments on 2004-05 Budget

(In Millions)

2004-05 Budget Year-End Reserve		
Proposition 98 reserve	$302	
Non-Proposition 98 reserve	466	
Total		**$768**
Higher Revenues (2003-04 Plus 2004-05)		
2003-04 major taxes	$430	
2004-05 major taxes	1,997	
2004-05 nontax revenues	-364	
Subtotal (increase to reserve)		$2,063
Higher Costs/Reduced Savings		
Punitive damage award redirection	$390	
Unallocated savings	316	
Corrections	201	
Medi-Cal	96	
Trial courts	90	
Proposition 98: lower ADA and higher property taxes	-445	
Other	212	
Subtotal (decrease to reserve)		$860
Revised Reserve:		**$1,971**
Proposition 98 Reserve		(1,357)
Non-Proposition 98 Reserve		(614)

2005-06 OUTLOOK

Figure 3 (see next page) shows the General Fund condition through 2005-06, using the assumptions outlined in the accompanying box. We estimate that revenues will climb to $82.2 billion and expenditures will total $89.5 billion in 2005-06, resulting in a $7.3 billion operating shortfall (that is, the difference between annual revenues and annual expenditures). After taking into account the $614 million non-Proposition 98 reserve available from 2004-05, the 2005-06 year-end deficit would be $6.7 billion.

Year-End Condition if Proposition 98 Not Increased. If appropriations for Proposition 98 were not increased in the current year, spending in the current year and budget year each would be reduced by $1.4 billion. This would reduce the 2005-06 year-end shortfall from the $6.7 billion shown in Figure 3 down to $3.9 billion.

Figure 3

LAO Projection of General Fund Condition

2003-04 Through 2005-06
(In Millions)

	2003-04	2004-05	2005-06
Prior-year balance	$4,178	$3,542	$1,543[a]
Revenues and transfers	75,000	78,884	82,247
Deficit-financing bond	2,012	—	—
Total Resources Available	**$81,190**	**$82,426**	**$83,790**
Expenditures	77,649	79,526	89,540[a]
Ending fund balance	$3,542	$2,899	-$5,751
Encumbrances	929	929	929
Reserve	**$2,613**	**$1,971**	**-$6,680**
Proposition 98	—	(1,357)	—
Non-Proposition 98	—	(614)	—

[a] Assumes that 2004-05 Proposition 98 reserve is appropriated.

LONGER-TERM FORECAST—LARGE SHORTFALLS CONTINUE

Our longer-term revenue and expenditure forecasts through 2009-10 are detailed in Chapters 3 and 4, respectively. Figure 4 (see page 6) shows the effects of these projections on the state's operating deficit—annual revenues minus expenditures—under two scenarios:

- *Assuming Proposition 98 Spending Is Increased to Chapter 213 Target.* Under this scenario, the budget's operating shortfall jumps sharply in 2006-07 to nearly $10 billion, and remains at slightly below $9 billion until the final year of the forecast period, when the gap narrows to below $6 billion.

- *Assuming No Change to Current Proposition 98 Appropriation Level.* Under this scenario, the minimum guarantee would be lower throughout the forecast period. As a result, the projected operating shortfalls, while still substantial, would be reduced—peaking at about $8.3 billion in 2006-07 before falling to just over $4 billion by the end of the forecast period.

Reasons Behind the Structural Shortfalls

The state has been plagued with a large structural budget shortfall since 2001-02, when revenues plunged following the recession and the steep decline in the stock market. The annual gap between projected revenues and expenditures has been massive, reaching as much as one-quarter of annual General Fund spending. While the state has addressed the annual shortfalls in each of the past three budgets, many of the solutions have involved borrowing, spending deferrals, accounting shifts, and other one-time actions. As the benefits of these one-time solutions fell away in subsequent years, the large underlying structural shortfall reemerged.

The one-time and limited-term savings included in the 2004-05 budget are highlighted in Figure 5 (see page 6). They include savings from deficit-financing bonds, pension obligation bonds, Proposition 42 transportation loans, postponement of local mandate payments, and diversion of local property taxes.

These actions, along with substantial borrowing undertaken in previous budgets, are resulting in significant current and future General Fund costs. As indicated in the accompanying box, annual General Fund costs related to budget borrowing will peak at nearly $4 billion annually in 2006-07 through 2008-09, before trailing off somewhat in subsequent years.

APPROACHING THE BUDGET PROBLEM

As discussed above, our projections indicate that, absent corrective actions, the state will not resolve its structural imbalance. As a result, it is important that the Legislature take meaningful actions in 2005-06 to address this shortfall. In this regard, we believe that there are four basic "building-blocks" that should be considered in crafting a strategy for dealing with the budget shortfall in 2005-06:

Basis for Our Estimates

Our revenue and expenditure forecasts are based primarily on the requirements of current law, including constitutional and statutory funding requirements. Our estimates also reflect projected changes in caseloads, federal reimbursements, and other factors affecting program costs. Of special significance in the current forecast are our assumptions in the following three areas.

Governor's Higher Education Compact. In the current forecast, we have not assumed the Governor's "compact" with higher education, as the Legislature has taken no statutory action to implement such an agreement. Rather, our estimates for higher education are based on projected enrollment and inflation-related increases. Fully funding the compact would require added annual expenditures beyond those we are projecting, reaching over $500 million by the final year of our forecast period.

Future Proposition 58 Transfers to the Budget Stabilization Account. Proposition 58, approved by the voters in March 2004, created a Budget Stabilization Account (BSA) to cushion the state against budget-related shortfalls. The measure provided for annual transfers of General Fund revenues to the BSA, equaling 1 percent of General Fund revenues in 2006-07 (about $875 million), 2 percent in 2007-08 (about $1.9 billion), and 3 percent in 2008-09 (about $2.9 billion) and thereafter until the balance in the fund reaches $8 billion. The measure, however, allows the transfers to be suspended or reduced through a Governor's executive order. Given the major budget shortfalls we are already projecting in the out years, we have not included the added expenditures that would be needed to fund the annual transfers to the BSA in our estimates.

Interaction of Proposition 98 With Revenue Increases. Our baseline estimates include the impacts of the current-year increase in revenues—and other factors—on the Proposition 98 spending levels. This is consistent with language in Chapter 213, which was enacted with this year's budget. However, given the increased General Fund shortfalls and increased pressures on non-Proposition 98 programs that would result from this use of revenues, we also show the outlook assuming no change in 2004-05 Proposition 98 appropriations.

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.

- ***Avoid Using the Remaining $3.5 Billion in Deficit Bonds in 2005-06.*** The state is already benefiting from carry-over reserve funds and other one-time savings in 2005-06 that will not be available in subsequent years. By preserving these bond proceeds, the state can "even out" difficult budget actions and avoid much harsher adjustments that would otherwise be needed in 2006-07.

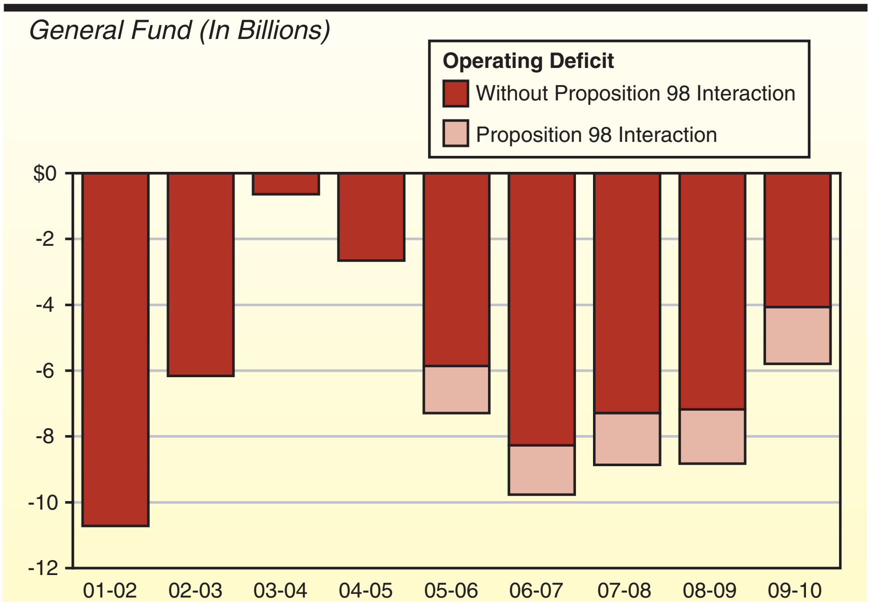
- ***Avoid Making Additional Deferred Spending or Revenue Commitments.*** As noted above, a significant portion of California's projected out-year structural imbalance is related to loans and spending deferrals included in recent budgets. The state should avoid adding to these types of commitments.

- ***Consider Maintaining 2004-05 Proposition 98 Appropriations at the Existing Level.*** Achieving the Chapter 213 spending target would result in $1.4 billion in additional current-year funds being directed to Proposition 98. Given the fiscal pressures confronting the General Fund, we believe the Legislature should seriously consider maintaining Proposition 98 spending at the current level. This would generate ongoing savings of roughly $1.4 billion per year, without any reductions in education services assumed in the 2004-05 budget package. In addition, under this scenario, there would still be sufficient growth in the guarantee over the forecast period to provide full growth and cost-of-living adjustments, retire existing obligations to schools, and expand educational programs.

- ***Adopt Other Ongoing Budget Solutions.*** As we have indicated in the past, we continue

Figure 4

Current-Law Operating Deficits to Persist[a]



[a]Annual revenues minus expenditures, excluding use of deficit-financing bonds.

Figure 5

One-Time or Limited-Term Solutions in 2004-05 Budget

- Deficit-financing bond proceeds ($2 billion)
- Proposition 42 transportation loan ($1.3 billion)
- Diversion of local property taxes ($1.3 billion annually for two years)
- Pension obligation bond proceeds ($929 million)
- Postponement of local mandate payments (about $200 million)
- Suspension of teachers' tax credit (about $200 million annually for two years)

to believe that all budget options should be on the table, both those involving expenditures and revenues. Potential solutions include suspension or reduction of cost-of-living adjustments throughout the budget, reduction of General Fund support for

BORROWING AND THE BUDGET SHORTFALL

As noted elsewhere in this report, we believe that the Legislature should minimize the use of budget-related borrowing in its solutions to the projected 2005-06 budget shortfall. The state has already accumulated $26 billion of outstanding budget-related debt, consisting of $18 billion in bonds, $4 billion in loans from local governments and schools, and about $4 billion in loans from transportation and resources special funds. This budget-related borrowing is in addition to the $40 billion in traditional borrowing used to finance new infrastructure.

Borrowing Is a Temporary Fix . . .

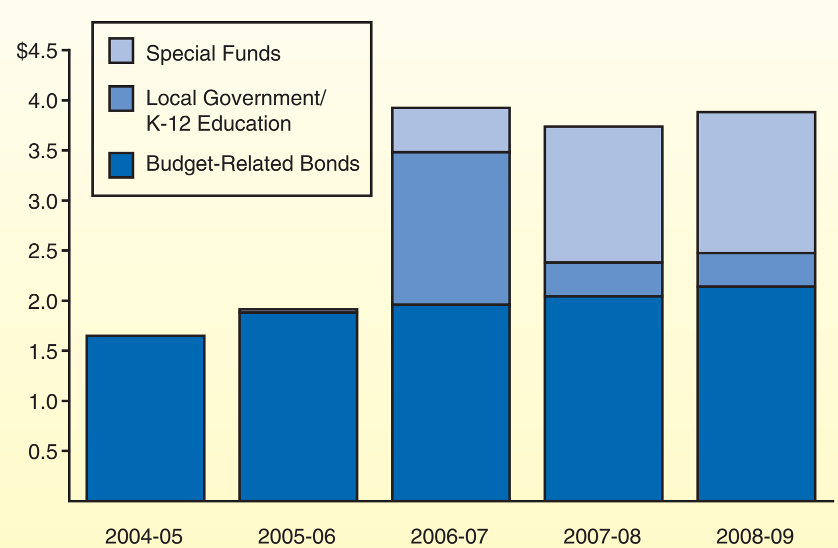
While budget-related borrowing enables the state to maintain funding for programs and avoid deeper cuts or revenue augmentations in the year in which it is undertaken, it is a temporary solution, which does nothing to address the ongoing mismatch between revenues and expenditures.

. . . That Diverts Resources From Future Budgets

Just as importantly, the borrowing eventually becomes a drag on future budgets, as revenues are diverted from current programs to pay for past borrowing. As shown in the figure, the budgetary borrowing already undertaken will result in annual General Fund costs of nearly $4 billion for the 2006-07 through 2008-09 fiscal period. While the costs will drop off in subsequent fiscal years, they will remain above $2 billion annually until the Proposition 57 deficit bonds are repaid (anywhere from 2013 to 2018). Over the next several years, these budget-related borrowing costs will account for over 40 percent of the annual operating shortfalls that we are projecting. Additional debt will only add to the size of these future diversions, and will hamper meaningful progress toward resolving the state's ongoing structural shortfall.

Annual General Fund Costs Related to Budgetary Borrowing

(In Billions)



transportation, the elimination of selected mandates, and the elimination of selected tax expenditures.

While it is tempting to use deficit-financing bonds to avoid the more painful budget choices in 2005-06, making real changes in the budget year would enable the state to make meaningful progress toward eliminating the structural problem that has plagued the state since 2001-02.

Chapter 2

Economic and Demographic Projections

Economic and demographic developments are important determinants of California's fiscal condition, mainly because of their impacts on state revenues and expenditures in such areas as education, health, social services, and transportation. This chapter presents our economic and demographic projections for 2004 through 2010, which will affect California's fiscal condition during fiscal years 2004-05 through 2009-10.

Looking ahead, we expect economic growth to slow modestly in 2005 due to the constraining impacts on the economy of high household debt levels, the rise in energy costs, and mild increases in interest rates. In subsequent years, our outlook calls for moderate expansion at both the national and state levels. Figure 1 summarizes the details of our economic forecasts for the nation and state. In the subsequent sections, we discuss in more detail major factors underlying our forecasts.

THE ECONOMIC OUTLOOK

Overview of the Economic Forecast

Despite sharply rising fuel prices and somewhat uneven job gains, both the national and state economies have experienced solid economic growth over the past year. The gains have been fueled by strong performances in interest-sensitive sectors such as housing, as well as healthy gains in business capital investment and continued strength in consumer spending.

Figure 1

The LAO's Economic Forecast

Percentage Change (Unless Otherwise Indicated)

	2004	2005	2006	2007	2008	2009	2010
United States							
Real gross domestic product	4.3%	3.4%	3.5%	3.3%	3.1%	3.2%	3.2%
Personal income	5.3	5.0	5.4	5.6	5.8	6.0	6.2
Wage and salary jobs	1.0	1.6	1.2	1.1	1.0	1.0	1.0
Consumer Price Index	2.7	2.7	1.7	2.0	2.2	2.3	2.4
Unemployment rate (%)	5.5	5.4	5.6	5.6	5.6	5.6	5.5
Housing starts (000)	1,933	1,771	1,664	1,627	1,615	1,598	1,617
California							
Personal income	5.9%	5.5%	5.8%	6.1%	6.3%	6.3%	6.2%
Wage and salary jobs	0.9	1.4	1.5	1.8	1.9	1.8	1.7
Taxable sales	6.5	5.6	5.6	6.0	6.5	5.8	5.7
Consumer Price Index	2.8	3.1	2.0	2.2	2.4	2.4	2.6
Unemployment rate (%)	6.1	5.6	5.4	5.4	5.5	5.5	5.5
Housing starts (000)	207	195	183	176	187	179	178

U.S. Economy

Solid Growth Continues

The national economy has experienced broad-based economic growth over the past year. Although the third quarter's real (that is, inflation-adjusted) gross domestic product (GDP) growth—initially reported at a 3.7 percent annual rate—was modestly below expectations, the shortfall was mainly related to less-than-expected accumulation of business inventories, as opposed to a softening in consumer or business demand.

Monthly information for October and early November suggests that solid economic growth is continuing in the final quarter of 2004. After several months of sluggish gains, job growth rebounded sharply in October. Although some of the increase was due to post-hurricane rebuilding activity in the southeastern U.S., the October expansion was widespread, affecting most major industry sectors. Recent reports on retail sales, company profits, new orders for manufactured goods, and consumer confidence, also point toward healthy fourth-quarter economic growth. Finally, the stock market, after lagging for much of 2004, jumped in early November, reflecting optimism about future business sales and profits.

Key Areas of Concern

Although the near-term outlook is clearly positive, the U.S. economy faces at least two key challenges as of late 2004. These are high oil-related prices—which are boosting the costs of gasoline and heating oil—and the uneven job gains in 2004.

Oil Prices. As indicated in the accompanying box, world oil prices have jumped dramatically in 2004, having reached an all-time high of $55 per barrel in mid-October before sliding back to slightly below $50 as of early November. The oil price jump has had a major adverse impact on prices paid by American consumers for gasoline, diesel fuel, heating oil, and other oil-based commodities. It is also negatively affecting consumer confidence, and will likely have a modest negative impact on spending over the next year.

Jobs. Although the U.S. job report for October was bullish, the employment gains over the past year have been uneven, with businesses relying on added hours and productivity gains from their existing workforce rather than hiring additional employees. This strategy has worked so far, yielding major gains in business earnings, as well as higher wages for some workers. However, the lack of broad-based job growth remains a risk to the durability of the expansion, in that, if continued, it may undercut consumer confidence and spending throughout the economy.

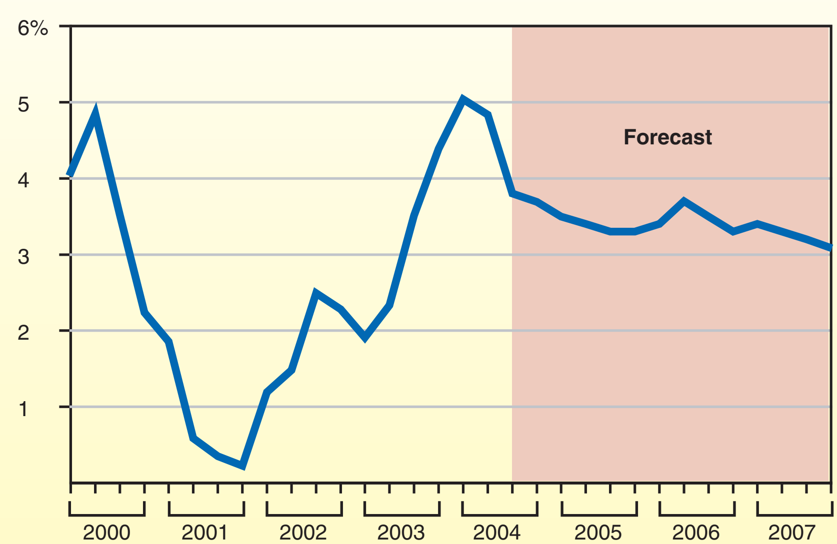
The Outlook—Tapering but Still-Solid Growth

Our forecast assumes that the U.S. economy will expand at a solid though moderating pace in 2005. As indicated in Figure 2, we forecast that year-over-

Figure 2

U.S. Economic Growth To Taper

Real Gross Domestic Product
Year-to-Year Percent Change, by Quarter



Impact of High Oil Prices

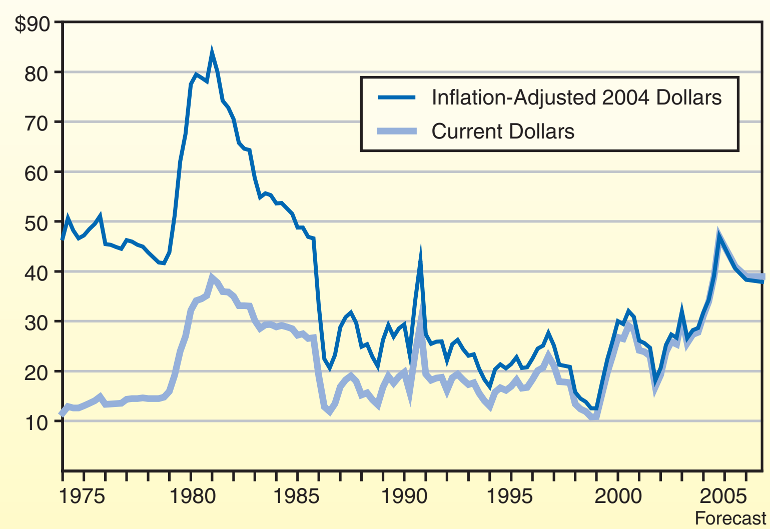
After several years of relative stability, oil prices have soared in 2004, reflecting the impacts of sharply rising worldwide demand, the lack of new production capacity, and numerous supply disruptions in the Gulf of Mexico and abroad. As shown in the accompanying figure, the per-barrel price of crude oil rose from $19 in early 2002 to $30 in early 2004, before soaring nearly to $50 in the final quarter of the year. The increase in crude oil prices has in turn boosted retail prices of gasoline—where the average per gallon price in late October surpassed $2 nationwide, and $2.40 in California—as well as heating oil and a variety of other oil-based products.

The increases that have already occurred will have modest adverse effects on inflation and real economic growth over the next year. Indeed, the modest economic slowdown we are projecting in 2005 is partly related to the effects of higher energy costs on household confidence and discretionary incomes. We do not, however, expect the negative economic impacts to be anywhere near as dramatic as in the 1970s and early 1980s, when sharply rising oil prices sent the U.S. economy into two recessions. The main reason is that, while oil prices are at an all-time high, they are nowhere near the levels reached in 1980 in inflation-adjusted terms. As shown in the figure, in constant 2004 dollars, oil prices peaked at more than $80 per barrel in 1981.

In addition, the consumption of oil-based products as a percentage of economic output and income is less today than a quarter century ago, meaning that the proportional impact of any given crude oil price increase is less today than in the past. A related factor is that the oil price increases do not appear to be having the same type of adverse "ripple" effects on other prices throughout the economy as they did in the 1970s and early 1980s. Businesses have thus far managed to "hold the line" on retail prices, due to offsetting savings related to, for example, worker productivity increases. Absent more broad-based increases in economy-wide inflation, it thus is unlikely that the oil price increases will have the dramatic negative impacts on interest rates and other elements of the economy that they did in the 1970s.

Inflation-Adjusted Oil Prices High But Below Historical Peak

Average Per-Barrel Price of Imported Crude Petroleum



year increases in inflation-adjusted GDP will subside from the current 4 percent pace to around 3 percent by mid 2005, before accelerating modestly in 2006. This outlook assumes continued healthy increases in business investment, but slowing growth in consumer spending.

Our national outlook assumes that:

- ***Consumer spending*** will slow from 3.6 percent growth in 2004 to 3 percent in 2005, before accelerating mildly to a trend pace of 3.2 percent in 2006 and beyond. The main factors behind the 2005 slowing are: (1) household debt levels, which remain at historically high levels; (2) rising interest rates, which will adversely impact monthly payments on variable rate loans and raise financing costs for big-ticket purchases such as cars; and (3) high energy costs, which will cut into household budgets.

- ***Business investment*** will slow from 10.6 percent in 2004 to a still-healthy 8.5 percent in 2005, and an average rate of 6 percent during the subsequent five years. The main source of growth in this sector will be spending on high-tech and productivity-enhancing equipment and software. However, we also expect investment in new facilities to grow in 2005, as businesses seek to modernize and expand their operations.

- ***Wage and salary employment*** will accelerate from 1 percent growth in 2004 to 1.6 percent in 2005, followed by annual increases averaging 1 percent in the 2006-through-2010 period. This outlook reflects the expectation of continued increases in sales, output, and corporate earnings, as well as the results of recent surveys suggesting that businesses intend to step-up hiring in 2005.

- ***Inflation*** will rise modestly over the next several months, boosted by high costs for energy, lumber, steel, and other raw materials, before subsiding in the second half of 2005. On an annual average basis, we forecast that the U.S. Consumer Price Index (CPI) will increase by 2.7 percent per year in both 2004 and 2005. Over the longer term, slightly slower inflation is expected, with the CPI averaging a projected 2.1 percent between 2006 and 2010.

- ***Oil prices*** will continue to fall from their recent peaks, and will settle in a range of $35-to-$40 per barrel—still well above recent historical norms. Although recent reports suggest that the crude oil inventories are rebounding from very low levels, we expect that strong worldwide demand, limited near-term increases in worldwide production capacity, and continued threats of supply disruptions will keep prices from falling dramatically in the foreseeable future.

- ***Interest rates*** also will rise, reflecting the impacts of Federal Reserve policies to boost short-term yields from recent historically low levels, and the prospects of large future federal budget deficits. The average yield on one-year Treasury Bills is projected to increase from 1.5 percent in 2004 to 2.5 percent in 2005, and to continue trending upward to over 4 percent by the end of the forecast period.

- ***Housing starts*** will subside from near-record levels of 1.9 million in 2004, to just below 1.8 million in 2005, and average about 1.6 million per year over the 2006-through-2010 forecast period. Our predicted slowdown is largely related to higher interest rates.

California's Economy

The California economy has experienced generally healthy growth since mid-2003. The state has faced challenges in many areas—most recently being the major increase in gasoline costs. However, most measures of statewide economic activity—such as taxable sales, personal income, permits for new construction, and company profit reports—suggest that the state's economy is clearly on an upward track as 2004 draws to a close.

Factors boosting economic growth over the past year have included:

- The strong national rebound in business investment, particularly in high-tech goods, computers, networks, and software systems produced and supported by California firms;

- The state's booming housing market, which has boosted income in the state's construction, finance, and various retail trade industries; and

- A sharp increase in international exports, which has boosted activities in the manufacturing and agriculture sectors.

The Outlook-—Continued Growth

Similar to the national pattern, we expect that California's economic growth will continue in 2005, although at a more moderate pace than in 2004. As indicated earlier in Figure 1, personal income is forecast to slow from 5.9 percent in 2004 to 5.5 percent in 2005, but then average over 6 percent for the balance of the forecast period. On the positive side, the national outlook for continued strong business investment will boost many industries in this state. On the negative side, however, we expect that high energy costs and rising interest rates will take a significant toll on consumer spending and housing activity in the state.

Sector-by-Sector Prognosis

Employment Picture Mixed—Some Improvement Expected. Over the past year, the employment picture has been uneven. According to the monthly survey of employers, payroll jobs (which economists follow closely in gauging the strength of the job markets) have increased by just 110,000 between September 2003 and September 2004, a growth rate of just 0.8 percent. This is less than one-third the number of payroll jobs that would normally be expected at this stage of an expansion.

As we have indicated in previous forecasts, the separate survey of households (which is mainly used to calculate the unemployment rate) shows significantly more job growth. Using this alternative measure, the total number of jobs in California has increased by over 300,000 in the past year, a more respectable 2 percent growth. The discrepancy between the two job measures may reflect an increase in the number of individuals working as independent contractors. Such workers would be counted in the household survey but not necessarily included in the survey of employers. While the higher job growth totals in the household survey is encouraging, its exact implications for the economy are uncertain. This is because little is known from the household survey about the nature of the nonpayroll jobs—for example, whether they are full or part time, or their pay and benefit levels. In any event, the reluctance of employers to expand their permanent work force remains a concern in the outlook.

Looking ahead, we forecast that job growth will improve modestly, from 0.9 percent in 2004 to 1.4 percent in 2005 (an increase of 210,000 jobs), as businesses step up hiring to meet continued growth in output and sales. Over the 2006-through-2010 period, job growth is forecast to average 1.7 percent per year (about 240,000 jobs annually), a rate that is roughly consistent with projected adult population growth and thus labor force expansion.

Personal Income Growth Has Been More Positive. While California's job performance has been disappointing, the recent rebound in personal income has been more positive. As shown in Figure 3 (see next page), after falling sharply in the 2001 recession, real personal income growth jumped sharply to almost 4 percent in early 2004, due to healthy increases in wages and business earnings.

Although we project a modest slowdown in personal income during 2005, growth should remain in the solid 3 percent to 4 percent range through the forecast period.

International Exports Finally Improving. Exports are an important element of California's economy. In 2003, international sales of California-produced goods totaled about $95 billion, directly accounting for about 7 percent of California's gross state product. Over one-half of California's exports related to high-tech goods, such as computers, electronics, and aerospace products. Other key export categories include paper, chemicals, and pharmaceuticals.

As shown in Figure 4, after lagging since 2001, international exports jumped to a quarterly level of over $27 billion (over 20 percent growth) in the first half of 2004. Key factors behind the growth are the declining value of the U.S. dollar (which makes U.S. goods more competitive in foreign markets), major growth in the economies of China and other developing nations on the Pacific Rim, and a long-awaited acceleration in Japan's economy. We expect export growth to continue in 2005 and 2006, although at a slower pace than in 2004.

Figure 3

California Income Rebounding by More Than Jobs

Year-to-Year Percent Change, by Quarter

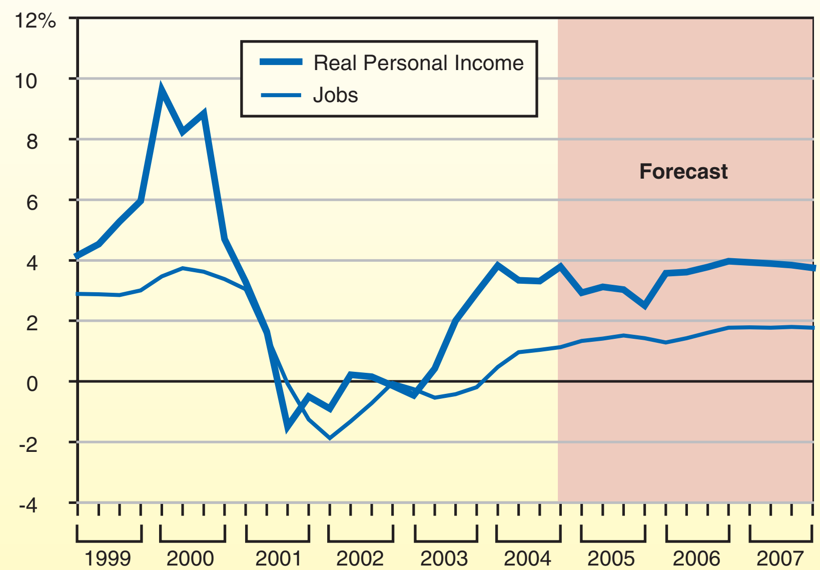
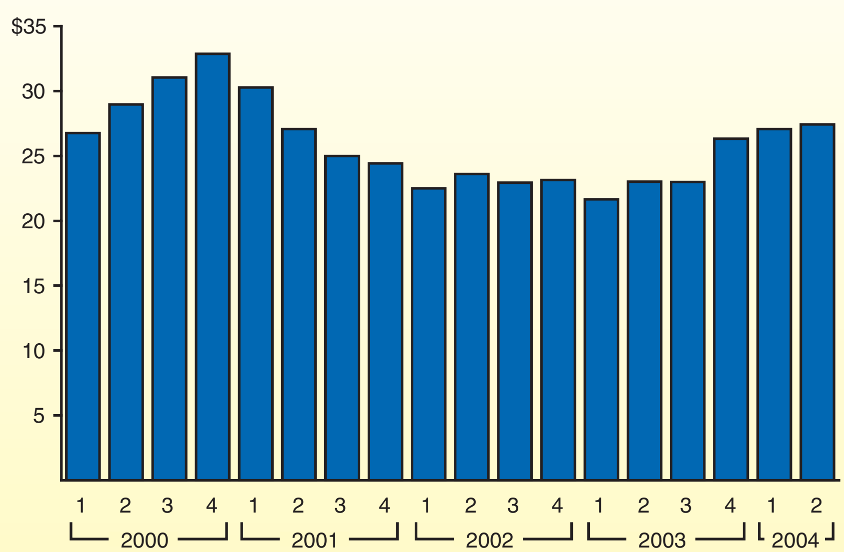


Figure 4

California Exports Recovering in 2004

International Exports of Products Made in California, by Quarter (In Billions)

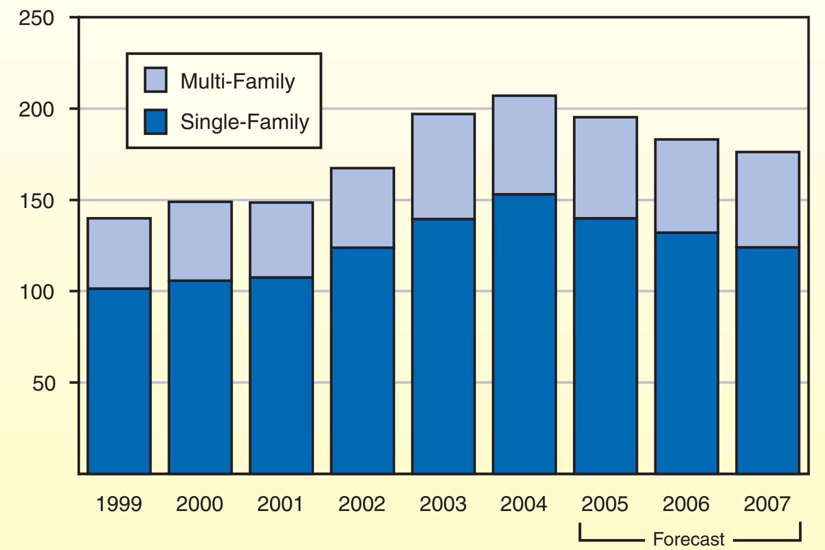


A Key Factor In California's Outlook—Housing. California's housing market has been booming, as evidenced by record sales levels, dramatic price increases, and strong levels of new construction. As of September 2004, the median price of a detached single-family home in California was $465,000, up over 20 percent from the prior year. Home construction will likely exceed 200,000 units in 2004, the strongest level in 15 years.

Figure 5

Home Construction Outlook–Strong But Slowing

Residential Building Permits, In Thousands



Our forecast assumes that prices will level off and that sales and new construction will retreat modestly from 2004 levels. As shown in Figure 5, we assume that permits for new construction will fall slightly below 200,000 in 2005, and slide a bit further to around the 180,000-to-190,000 range for the remainder of the forecast period. Our forecast assumes that interest rates will increase only modestly, and that underlying population and income growth result in continued strong demand for new housing. This forecast is vulnerable, though, to a larger-than-expected climb in interest rates. Given that many recent home buyers are already financially stretched by large mortgages, rising rates on variable interest rate loans could further squeeze their household budgets. For prospective buyers, such higher rates would further reduce the affordability of new homes, resulting in fewer sales and downward pressure on home prices. These developments could depress construction activity, and potentially reduce levels of spending and income in other areas of the economy.

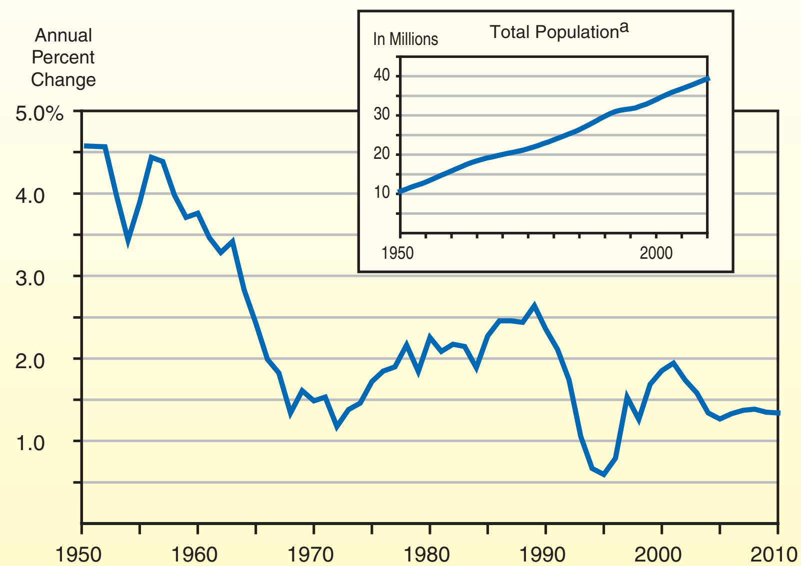
THE DEMOGRAPHIC OUTLOOK

California's population currently totals over 36 million persons. During the six-year forecast period covered in this report, Figure 6 (see next page) shows that the state's population growth is projected to average about 1.3 percent annually. In terms of numbers of people, this annual growth translates into about half-a-million people and is roughly equivalent to adding a new city the size of Long Beach to California each year. As a result, California will add roughly 3 million people over the forecast interval and reach over 39 million by 2010.

The population growth rate we are projecting is somewhat slower than that experienced in the late 1990s and early 2000s, 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.

Figure 6

State's Population to Grow at Modest Pace



[a]LAO projections for 2004 and beyond.

Our forecast incorporates the well-documented trend of declining birth rates that has been occurring for essentially all ethnic groups in recent years in California. Despite these declining birth rates, however, the number of new births in our forecast actually trends up a bit through 2010. This is due to significant growth in the female population of child-bearing age groups in the faster-growing segments of California's population, including Hispanic and Asian women. As a result, even after accounting for growth in the number of deaths occurring annually in California, we project that the natural increase component will grow slightly during the latter half of the forecast period.

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 in the past 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 close to 300,000 new Californians annually over the forecast period. This net natural gain reflects an annual average of around 550,000 births partially offset by about 250,000 deaths.

Net In-Migration. We project that combined domestic and foreign net in-migration will average roughly 206,000 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 300,000 natural-increase component noted above.

- Most of the net in-migration we are projecting reflects *foreign* net in-migration from other nations. This component has been relatively stable over the past decade and has proved to be less sensitive to the economy than domestic population flows between states. We forecast that net foreign in-migration will be fairly constant through 2010, averaging about 195,000 annually.

- Regarding *domestic* net in-migration, preliminary data suggest that this was slightly negative in 2004 (that is, more people left California for other states than flowed in from them). In large part, this is attributable to California's recent recession and continued sluggish job market. Given our outlook for moderate expansion of California's economy and continued concerns about job growth, we do not foresee a return to net positive interstate population in-flows for a couple of years. Starting in 2007, we project modest net domestic in-flows of 20,000 annually.

Growth to Vary Significantly By Age Group

Figure 7 shows our population growth projections by broad age categories, including both numerical and percentage growth.

Baby Boomers Swelling 45-64 Age Group. The 45-to-64 age group (largely the "baby boomers") continues to be by far the fastest growing segment of the population. Nearly 1.6 million additional people are expected in this age category over the next six years.

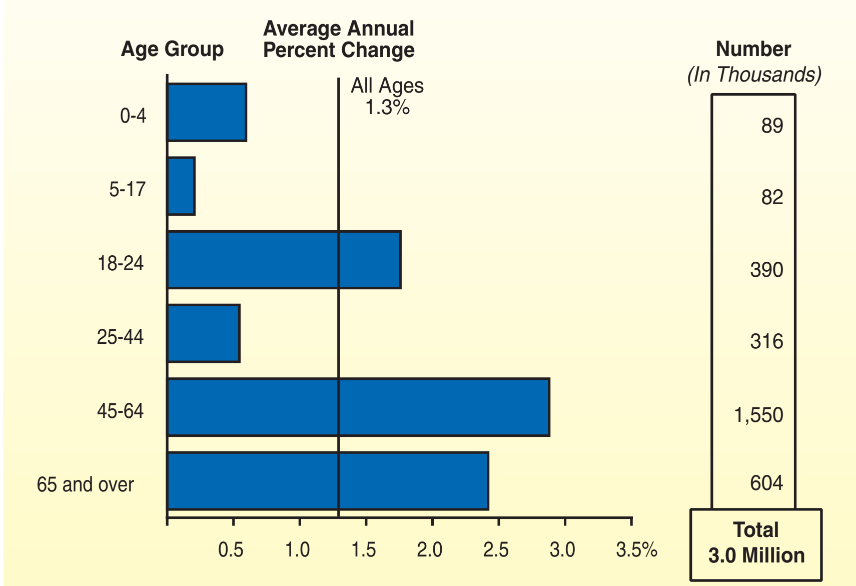
Slow Growth for Children. At the other extreme, slow growth is anticipated for preschoolers and the K-12 school-age population. This reflects several factors. One is the movement of children of the "baby boom" generation beyond the upper-end of the 5-to-17 age group, which partially explains the above-average growth in the 18-24 age category. 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.

Figure 7

California's Population Growth, by Age Group

Population Change–2004 Through 2010



Chapter 3

Revenue Projections

The revenues that finance California's state General Fund budget come from numerous sources, including taxes, fees, licenses, interest earnings, loans, and transfers. However, over 90 percent of the total is attributable to the state's "big three" taxes—the personal income tax (PIT), the sales and use tax (SUT), and the corporation tax (CT). In this chapter, we summarize our updated General Fund revenue projections and provide detail behind our key revenue-related assumptions.

CURRENT REVENUE TRENDS

Before presenting our revenue forecast, it is first useful to review where things currently stand in terms of recent revenue-related trends that serve as the "springboard" to our revenue projections.

Revenues Continue to Strengthen

Total cash receipts from major taxes during the first four months of this fiscal year have exceeded the 2004-05 budget projection by over $900 million, largely reflecting much-stronger-than-expected CT receipts. Despite the mild slowdown in overall economic activity that we are projecting for 2005, we believe that the stronger revenue trend will hold through the remainder of this fiscal year, and that total revenues through June 30, 2005, will exceed the budget estimate by slightly over $2 billion. About $430 million of this increase is attributable to final returns for 2003 tax liabilities, and thus will be accrued back to 2003-04. The balance will be reflected as higher revenues in the current year.

Business-Related Receipts Booming

Figure 1 (see next page) shows that estimated tax payments under the CT were up from the prior year by 28 percent in the third quarter of calendar-year 2004. These higher payments were primarily attributable to large increases by firms in the petroleum, finance, and high-tech manufacturing industries. The figure also indicates that PIT-related estimated tax payments were up by over 15 percent in the third quarter from the same time in the prior year. We believe that this increase was likewise due to strong business payments—in this case, those related to earnings of the subset of businesses that file under the PIT (such as S-corporations, partnerships, and sole proprietorships).

Other Sources—Somewhat Subdued But Still Healthy

Revenue collections from other sources have been growing at a more subdued, but still healthy, rate in 2004. For example, Figure 2 (see next page) shows that after a strong performance in late 2003 and early 2004, the growth in PIT-related withholding payments—which are attributable to employee wages, salaries, stock options, and bonuses—moderated to about 6 percent as of the third quarter of 2004. These recent increases are generally consistent with solid wage gains but relatively subdued employment gains over the past year. We believe that some of the recent slowdown is related to a slackening of stock option-related activity since the stock market peaked in early 2004.

THE LAO REVENUE FORECAST

Figure 3 presents our updated revenue projections for the period 2003-04 through 2009-10.

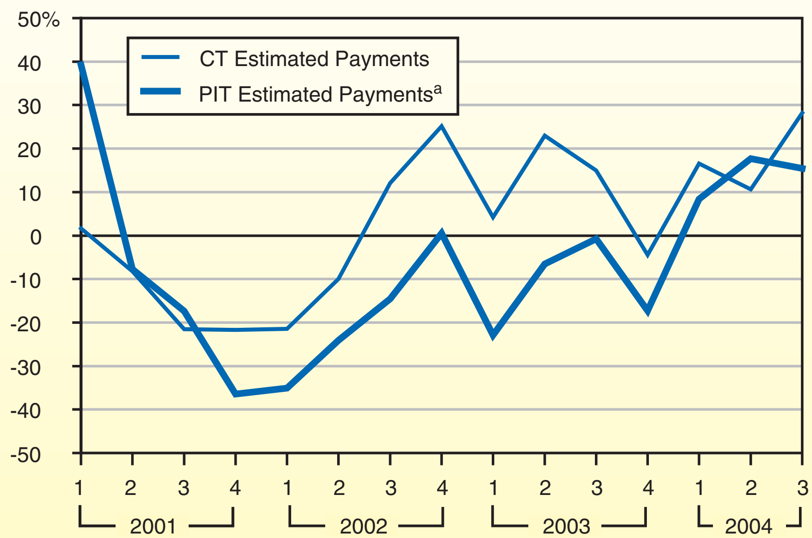
2003-04 Revenues. We estimate that revenues and transfers totaled $75 billion in 2003-04. This is up $430 million from the 2004-05 budget estimate. The increase is mainly due to higher-than-expected payments related to CT and PIT final returns for 2003. Even though many of these returns are filed in 2004-05, under California's modified accrual system of revenue accounting their associated payments are accrued back to 2003-04.

2004-05 Revenues. We project that revenues and transfers will total $78.9 billion in 2004-05. This is up slightly over $1.6 billion from the 2004-05 budget estimate. The major taxes are up by $2 billion, mainly reflecting the stronger-

Figure 1

Business-Related Tax Payments Booming

Year-Over-Year Percent Change, by Quarter



[a]While these payments cover both business- and nonbusiness-related activities, we believe that much of the recent strength in these payments is due to business profits.

Figure 2

PIT Withholding Payments Moderating

Year-Over-Year Percent Change, by Quarter

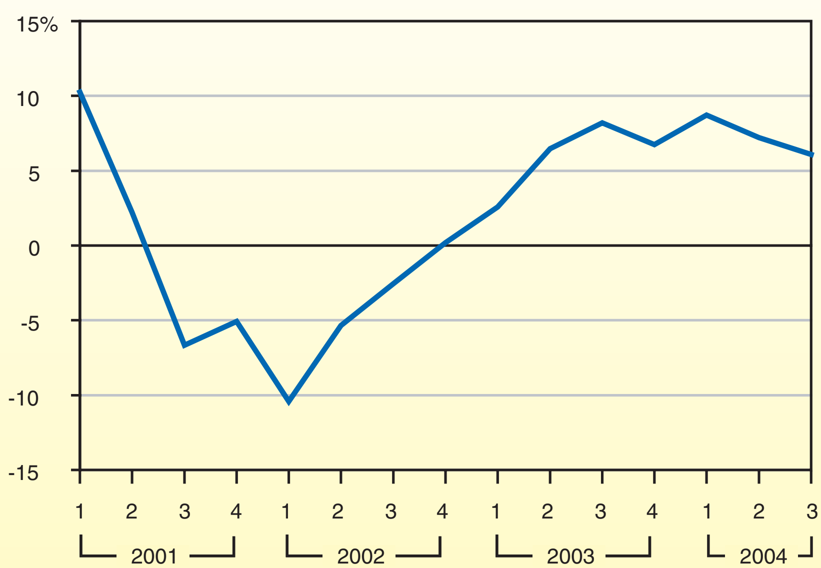


Figure 3

The LAO's General Fund Revenue Forecast

(Dollars in Millions)

Revenue Source	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Personal Income Tax	$36,200	$39,640	$42,210	$44,810	$47,960	$51,400	$55,050
Sales and Use Tax	23,720	25,340	26,630	28,150	29,870	31,570	33,400
Corporation Tax	7,480	8,730	9,170	9,730	10,270	10,860	11,510
Other Revenues and Transfers	7,600	5,174	4,237	4,659	4,996	4,459	5,043
Total Revenues and Transfers	**$75,000**	**$78,884**	**$82,247**	**$87,349**	**$93,096**	**$98,289**	**$105,003**
(Percentage Change)	—	5.2%	4.3%	6.2%	6.6%	5.6%	6.8%

than-expected tax payments from business earnings discussed above. Specifically, we estimate that CT taxes will be up by about $1.2 billion in the current year and that PIT revenues will exceed the budget estimate by about $670 million. We also expect that sales taxes will exceed the budget estimate by just under $200 million.

The increase in major tax receipts will be partly offset by lower receipts from nontax sources. Specifically, we estimate that tribal gaming revenues will total about $100 million in 2004-05 instead of the $300 million anticipated in the budget. We also expect that General Fund proceeds from asset sales will be $50 million, which is $164 million less than assumed in the budget. Our estimates continue to assume $560 million in General Fund revenues from the sale of $950 million in pension obligation bonds, which are subject to legal validation. (The remaining portion of the bond proceeds shows up on the expenditure side of the budget.)

2005-06 Revenues. We forecast that total revenues and transfers will be $82.2 billion in 2005-06, a 4.3 percent increase from the current year. This relatively modest growth rate reflects the projected economic slowdown in 2005 as well as a decline in nontax revenues. As indicated in Figure 3, we estimate that revenues from the major nontax sources will fall from $5.2 billion this year to $4.2 billion next year. This decline is related to the drop-off in one-time revenues from pension obligation bonds, as well as an assumed loan repayment to a transportation special fund. Absent these special factors, "underlying" revenues are expected to increase by a moderately stronger rate of 5.8 percent.

2006-07 Through 2009-10. We project that total revenues will increase at an average annual rate of 6.3 percent, or slightly faster than the 6.1 percent average growth in personal income, during the period. For this interval, we are projecting that PIT revenues will grow moderately faster than the overall economy, reflecting the interaction of rising real incomes with California's progressive PIT rate structure. In contrast, we are projecting receipts from the remaining income sources to grow slightly slower than personal income during this period.

Special Factors in the Outlook

The revenue totals shown in Figure 3 are affected by both the state's economy and numerous policy-related actions taken in conjunction with recent budgets. While the magnitude of these special factors in 2004-05 is considerably less than in the 2001-02 through 2003-04 period, they nevertheless will have a significant impact on both the revenue totals and the year-to-year changes in receipts for 2004-05 and beyond. Key examples of these special factors include:

- *Recent Tax Law Changes*. Our forecast includes the impacts of 2004-05 budget actions resulting in a two-year suspension of the teachers' tax credit and a two-year change in the application of the use tax to certain high-value items, such as yachts.

- ***Pension Bonds.*** As noted above, the revenue forecast for 2004-05 includes about $560 million related to the assumed sale of the pension obligation bond.

- ***Tribal Gaming Revenues.*** We assume there will be revenues from recently negotiated tribal gaming compacts totaling about $100 million in 2004-05, increasing to $300 million yearly in 2007-08 and subsequent years. Our updated estimate for the current year is down $200 million from the 2004-05 budget estimate. We also assume that $846 million in proceeds from a bond sale backed by future tribal gaming revenues will be used to repay the majority of a loan to the General Fund from a transportation special fund otherwise due in 2005-06. Our previous long-term estimates had assumed that this loan repayment would come solely from other General Fund revenue sources.

- ***Other One-Time Receipts.*** The 2003-04 totals included other one-time receipts exceeding $3 billion. Over $2.2 billion of that total was related to the sale of a tobacco securitization bond. The revenue totals for 2004-05 include a much more modest one-time gain of about $200 million, mostly related to unclaimed property and one-time loans from special funds.

As shown in Figure 4, special factors combined to raise General Fund revenues and transfers by about $4 billion in 2003-04 and by another $1.8 billion in 2004-05. In future years, the figure also shows that the impact of special factors will reduce annual revenues modestly, mainly because of the loan repayments that are due at various points in time.

DETAIL ON INDIVIDUAL REVENUE SOURCES

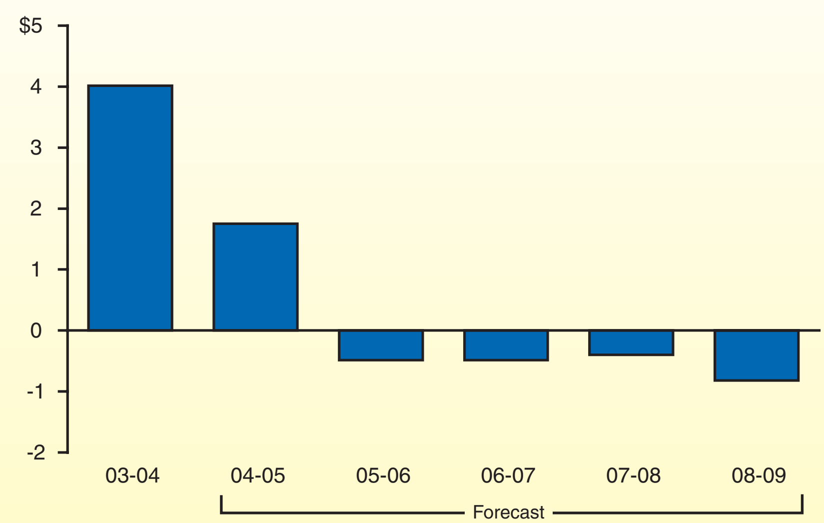
Personal Income Tax

We forecast PIT receipts will increase from $36.2 billion in 2003-04 to $39.6 billion in 2004-05. These estimates are up from the levels assumed in the *2004-05 Budget Act* by about $200 million and $670 million, respectively. We project that PIT revenues will grow moderately to $42.2 billion in 2005-06, and at an average annual rate of 6.9 percent during the balance of the forecast period.

Figure 4

Net Impact on Revenues of Special Factors[a]

(In Billions)



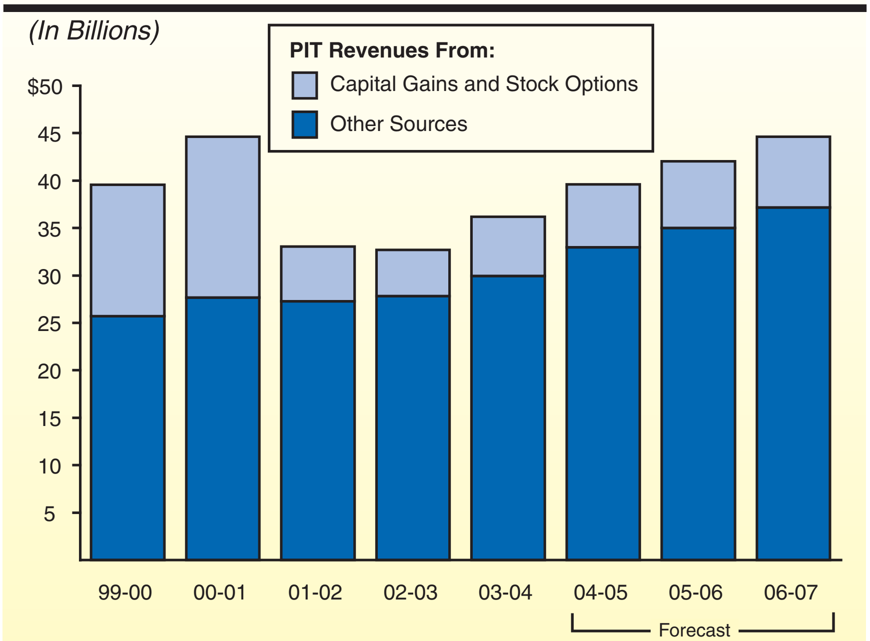
[a]Reflects actions taken in 2002-03 through 2004-05 that affect revenues in years shown.

Key Forecast Factors. Our upward PIT revision from the *2004-05 Budget Act* forecast is the net result of three main factors:

- First, net payments (that is, final payments minus refunds) related to 2003 liabilities have been about $200 million above expectations during the July-through-October period of 2004. This implies that 2003 tax liabilities—which serve as a starting point for our future years' projections—are likewise up by about $200 million.
- Second, the large increase in quarterly estimated payments suggests that businesses filing under the PIT are experiencing stronger-than-expected earnings increases in 2004.
- Third, and partly offsetting the first two factors, is that we expect somewhat slower economic growth in 2005. This will depress growth in PIT-related payments during the second half of 2004-05 which are related to wages and investment earnings.

Figure 5

PIT Collections on Rebound



Capital Gains and Stock Options—Moderate Growth Assumed. Figure 5 depicts the important role that stock options and capital gains have played in the PIT revenue totals during recent years. It shows that the dramatic decline in revenues from these two sources—from nearly $17 billion in 2000-01 to below $5 billion by 2002-03—was the principal cause of the over-25 percent decline in total PIT collections during this period. It appears that revenues from these sources partially rebounded to $6.2 billion in 2003-04, but still remain at just over one-third of their 2000-01 peak. Looking ahead, we expect that revenues from these sources will grow by about 8 percent (to $6.7 billion) in 2004-05, and by roughly 6 percent to 7 percent in subsequent years, reflecting assumed moderate future gains in stock market valuations.

Sales and Use Taxes

We estimate that SUT receipts will total $25.3 billion in 2004-05, a 6.8 percent increase from the prior year. Our updated forecast is up by $194 million from the *2004-05 Budget Act*. We project that SUT receipts will grow further to $26.6 billion in 2005-06, and at an average annual rate of 5.8 percent during the balance of the forecast period.

Key Forecast Factors. The main determinant of SUT receipts is taxable sales. About two-thirds of these sales are related to retail spending by consumers and the remainder is related to building materials that go into new construction and to business-to-business transactions.

Taxable sales grew by slightly more than 6 percent during the first half of calendar-year 2004, which was nearly double the pace for all of 2003.

The main factors responsible for the acceleration are: (1) increases in both the prices and sales quantities of lumber and building materials, (2) the sharp rise in gasoline prices, (3) strong increases in equipment spending by businesses, and (4) continued moderate growth in retail spending by consumers. For 2004 as a whole, we project that taxable sales will be up by 6.4 percent from the prior year.

Looking ahead, we anticipate that sales growth will slow to 5.6 percent in 2005, reflecting the negative impacts of higher interest rates and gasoline prices on both consumer confidence and household spending on sales of nongasoline goods. In subsequent years, we project that taxable sales will increase at an average annual rate of 5.9 percent through the end of the forecast period. This reflects moderate gains in consumer spending and continued healthy growth in business investment.

Corporation Taxes

We estimate that CT receipts will increase from roughly $7.5 billion in 2003-04 ($200 million more than assumed in the *2004-05 Budget Act*) to $8.7 billion in 2004-05 (up by $1.2 billion from the *2004-05 Budget Act* estimate). We forecast that CT tax receipts will grow to $9.2 billion in 2005-06, and will increase at an average annual rate of 5.8 percent during the remaining four years of the forecast.

Key Forecast Factors. Two categories of factors are of special importance in our updated forecast of CT receipts:

- ***Corporate Profits.*** The single most important factor underlying CT receipts is California taxable corporate profits. After jumping 12 percent in 2003, strong estimated CT payments suggest that business earnings are up another 22 percent in 2004 (see Figure 6). These large increases reflect major increases in oil company earnings, as well as solid growth in business sales and high productivity gains in a variety of other sectors of the economy. For 2005 through the forecast period, we project that profits will grow between 5 percent and 6 percent per year, reflecting moderate increases in business sales and continued healthy increases in productivity.

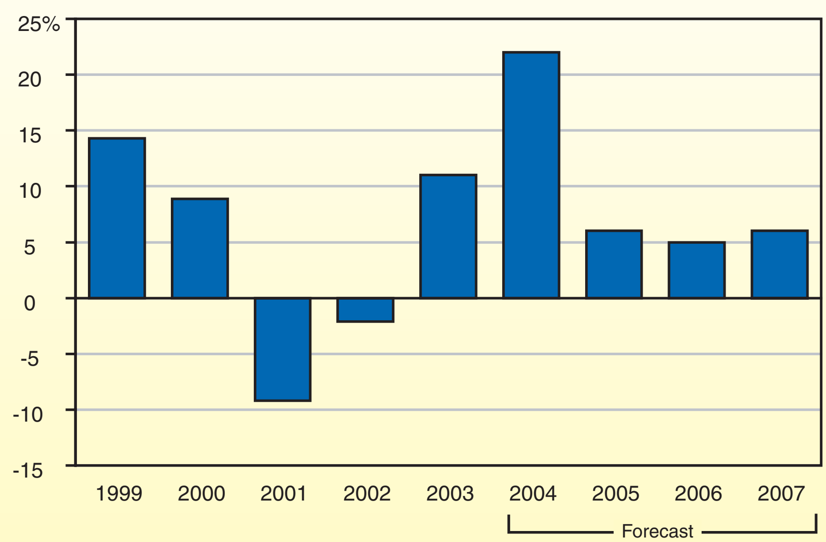
- ***NOLs and the MIC.*** Corporation tax receipts are also being affected over the forecast period by two, largely offsetting, special factors—the first relating to net operating loss (NOL) deductions and the second relating to the state's now-terminated manufacturers' investment tax credit (MIC).

Regarding NOL deductions, legislation passed in conjunction with the *2002-03 Budget Act* sus-

Figure 6

After Booming in 2004, California Profit Growth to Moderate

Annual Percent Change in California Taxable Corporate Profits



pended NOL deductions for both 2002 and 2003. This legislation, however, also reinstated the deductions in 2004, with the percentage of losses that can be deducted against future earnings permanently increasing from 65 percent to 100 percent effective beginning in 2005. These provisions raised revenues by $600 million in 2003-04. We estimate that the reinstatement and expansion of NOLs will reduce collections by about $300 million in 2004-05 and by modestly higher amounts in subsequent years. We would note, however, that there is considerable uncertainty surrounding this estimate. This is because the exact timing and amount of losses from 2002 and 2003 that will be used to offset future tax liabilities is not known.

Regarding the MIC, the statute creating this credit in 1994 contained a provision stating that the credit would sunset following any year after 2000 in which the cumulative growth in manufacturing jobs (excluding aerospace) from 1994 was less than 100,000. Manufacturing jobs fell below this threshold in 2003, triggering the expiration of the MIC effective January 1, 2004. The elimination of this credit boosted CT revenues by $40 million in 2003-04, $195 million in 2004-05, and by additional annual amounts increasing to over $400 million by the end of the forecast period.

Other Revenues, Transfers, and Loans

This category encompasses all remaining General Fund revenue sources. It includes taxes on insurance, alcoholic beverages, estates, and cigarettes. It also includes various fees, interest on investments, asset sales, pension bond proceeds, as well as loans and transfers from special funds. Absent special factors, we would expect revenues from these categories to currently total roughly $4.5 billion. However, this category has been much larger in recent years, due to various one-time solutions adopted to address the budget shortfall.

As shown previously in Figure 3, combined receipts in this category totaled $7.6 billion in 2003-04, of which $2.2 billion was related to the proceeds of a tobacco securitization bond sale. The total drops off to $5.2 billion in 2004-05, reflecting a smaller, though still significant, amount of one-time revenues from pension bonds. Projected revenues from the nonmajor tax sources falls further to $4.2 billion in 2005-06, and then fluctuates between roughly $4.5 billion and $5 billion over the balance of the forecast period. The annual totals shown reflect steady-though-modest increases in tax and fee revenues, and incorporate various scheduled loan repayments from the General Fund to special funds over time.

Chapter 4

Expenditure Projections

In this chapter, we discuss our General Fund expenditure estimates for 2003-04 and 2004-05, as well as our projections for 2005-06 through 2009-10. We first look at general budgetary trends and then discuss in more detail our expenditure projections for individual major program areas.

GENERAL FUND BUDGET TRENDS

2005-06 Outlook

Figure 1 (see next page) shows our forecast for major General Fund spending categories. We forecast that General Fund expenditures will grow from $79.5 billion in 2004-05 to $89.5 billion in 2005-06, an increase of 12.6 percent. Roughly one-half of this large increase is an anomaly related to one-time savings in 2004-05 that temporarily depress General Fund expenditures in that year. These savings include the use of deficit-financing bond proceeds to support General Fund programs, the assumed use of pension obligation bond proceeds to cover a portion of the state's retirement contributions, the deferral of mandate payments to localities, a deferral of Proposition 42 transportation payments, and a delay in cost-of-living adjustments (COLAs) for CalWORKs and SSI/SSP recipients.

Expenditure Growth During Balance of Forecast Period

Moderate Total Growth Projected. The right-hand column of Figure 1 shows our projected average annual growth in expenditures for major programs from 2005-06 through 2009-10. We forecast that total spending will increase by an average rate of 5.5 percent over the period, or slightly less than statewide personal income growth. This average growth rate, however, masks divergent trends among the different individual program areas that make up the total. Annual spending totals during the final four years of the forecast period are affected by deferred payments to local governments and transportation special funds making year-to-year comparisons difficult.

Highlights for Individual Program Areas. With regard to some of the major individual program areas in the budget, the figure shows that:

- ***K-14 Proposition 98 (General Fund)*** spending is projected to increase at an average annual rate of 4.8 percent. The General Fund spending totals for 2006-07 and beyond are increased by $1.3 billion annually due to the expiration of the two-year diversion of local property taxes from local governments to school districts. Excluding the effects of this diversion, General Fund spending for schools is forecast to increase at an average annual rate of just 4 percent per year. This relatively modest rate reflects slowing K-12 school enrollments and healthy growth in local property taxes (which offsets, dollar-for-dollar, the General Fund's spending requirements for K-12 education).

- ***UC and CSU*** are forecast to grow at an average annual rate of 4.2 percent (combined), reflecting full funding of projected enrollment and inflation. General Fund costs, however, grow somewhat more slowly, due to new revenue from the gradual phase-in of an excess unit surcharge on students.

- ***Financial aid*** spending is projected to grow by 5.7 percent annually, reflecting growth in the Cal Grant entitlement program.

- ***Medi-Cal*** benefits are projected to grow at an average annual rate of 5.5 percent. This reflects continued increases in costs for medical services and prescriptions, especially for the aged and disabled population. Our esti-

Figure 1

Projected General Fund Spending for Major Programs

(Dollars in Millions)

	Estimated		Forecast					Average Annual Growth From
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2005-06
Education programs								
K-14—Proposition 98	$30,277	$33,693[a]	$36,300	$38,767	$40,252	$42,216	$43,831	4.8%
CSU	2,630	2,448	2,456	2,529	2,611	2,700	2,810	3.4
UC	2,868	2,721	2,667	2,766	2,874	2,987	3,093	3.8
Financial aid	672	637	839	892	952	1,007	1,047	5.7
Health and Social Services								
Medi-Cal benefits	$9,254	$11,214	$12,169	$12,858	$13,637	$14,416	$15,056	5.5%
CalWORKs	2,053	2,187	2,220	2,402	2,550	2,763	2,984	7.7
SSI/SSP	3,157	3,474	3,740	4,032	4,296	4,559	4,847	6.7
IHSS	1,117	1,181	1,330	1,483	1,649	1,829	2,025	11.1
DDS	1,964	2,220	2,426	2,669	2,881	3,158	3,468	9.3
Other major programs	5,005	5,107	5,670	5,871	5,873	6,107	6,346	2.9
Department of Corrections[b]	$4,594	$5,557	$5,797	$6,074	$6,252	$6,414	$6,588	3.2%
VLF-related payments	$2,839	—	—	$1,187[c]	—	—	—	—
Prop 42-related payments	$289	—	$1,280	$1,351	$2,774	$2,459	$1,476	3.6%
Local mandate reimbursements	—	—	$254	$588	$602	$616	$630	25.5%
Retirement-related payments	$1,083	$1,901	$2,360	$2,574	$2,869	$3,157	$3,424	9.8%
Debt service	$2,307	$3,538	$3,949	$4,411	$5,083	$5,657	$5,797	10.1%
Deficit bond proceeds[d]	$2,012	-$2,012	—	—	—	—	—	—
Other programs/costs	$5,527	$5,660	$6,084	$6,661	$6,803	$7,071	$7,373	4.9%
Totals	**$77,649**	**$79,526**	**$89,540**	**$97,114**	**$101,958**	**$107,115**	**$110,793**	**5.5%**

a 2004-05 total reflects appropriations to date. Reserve funds for Proposition 98 total 1.4 billion. Projections for subsequent years, however, assume that reserve funds are appropriated.

b Reflects employee compensation costs.

c VLF "gap" loan repayment to local governments.

d Of the amount authorized by the voters in Proposition 57, about $3.5 billion remains available.

mates also take into account some out-year savings related to federal enactment of Medicare reforms affecting prescription drugs.

- *CalWORKs* spending is projected to increase by an average of 7.7 percent annually over the forecast period. This significant increase reflects the combined effect of COLAs, modest increases in caseloads, and the exhaustion of carry-over federal funds in 2006-07 to support program spending. Our estimates also assume reauthorization of the federal TANF block grant.

- *SSI/SSP* spending is projected to increase at an average annual rate of 6.7 percent, reflecting statutory COLAs and moderate growth in caseloads during the forecast period.

- *In-Home Supportive Services* spending is projected to increase at an average annual rate of 11.1 percent. This rapid growth reflects both increases in caseloads and service hours, as well as wage increases for IHSS workers.

- *Department of Developmental Services* (DDS) is projected to increase at an average annual rate of 9.3 percent over the period, reflecting continued increases in caseloads and the cost-per-client served by the state's 21 Regional Centers.

- *Department of Corrections* spending is forecast to increase at an average annual rate of 3.2 percent over the forecast period. The modest growth rate during this period takes into account the final year of pay increases related to the Unit 6 bargaining agreement approved in 2001, rising health care costs, as well as slow growth in prison inmate populations.

- *Debt-service* expenses for general obligation and lease-revenue bonds are projected to increase at an average annual rate of 10.1 percent, primarily reflecting annual sales of somewhat over $7 billion in General Fund-supported debt for capital outlay purposes.

In the sections that follow, we provide a more detailed discussion of the expenditure outlook for these and other individual major program areas.

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 is funded from the state General Fund and local property taxes, and accounts for about three-fourths of total support for K-14 education. The remainder is from a variety of sources including federal funds, lottery revenue, community college fee revenues, and other local revenues. Generally, the Proposition 98 guarantee is increased annually by the growth in K-12 pupil attendance and the growth in the economy.

California's public K-12 education system consists of more than 1,000 locally governed school districts and county offices of education serving about 6.3 million K-12 students. In addition, these entities serve infants and preschool students receiving child care and individuals in adult education programs. The California Community Colleges (CCC) provide instruction to about 1.2 million full-time equivalent students at 109 colleges operated by 72 locally governed districts.

The Spending Forecast

Figure 2 (see next page) 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. The forecast shows steady increases in funding for K-14 education—between $2.5 billion and $3.2 billion in annual growth. Much of the cost of meeting the minimum guarantee is supported by increased local property tax revenues, which we forecast will grow by $1.2 billion to $1.3 billion annually.

Forecast for the Prior Year. An increase in 2003-04 General Fund revenues (see Chapter 3) results in a $210 million increase in the Proposition 98 minimum guarantee for that year. The state will eventually have to provide the additional $210 million to "settle up" the Proposition 98 guarantee for 2003-04. However, as part of the budget package for 2004-05, Chapter 216, Statutes of 2004 (SB 1108, Budget Committee), delayed all settle-up obligation payments for fiscal years 1995-96 through 2003-04. The delay effectively transforms these obligations into a loan from Proposition 98 to the General Fund. Chapter 216 establishes a repayment plan for this loan, providing $150 million annually beginning in 2006-07 until the loan is repaid. The estimated increase of $210 million we forecast is on top of $1 billion the state already owes to Proposition 98 for these prior years.

We estimate that local property tax revenues for 2003-04 increased by $135 million. These additional funds will reduce the General Fund costs of Proposition 98 for 2003-04 by a similar amount.

Forecast for the Current Year. Chapter 213, Statutes of 2004 (SB 1101, Budget Committee), suspended the Proposition 98 minimum guarantee for 2004-05, providing for spending that is $2 billion less than would otherwise be required. We project the 2004-05 suspension will result in annual savings, growing from $2 billion in 2004-05 to $2.5 billion by the end of the forecast period. When the budget was adopted, the state assumed that the Proposition 98 minimum guarantee would have been $49.3 billion. Given the suspension, the 2004-05 budget package included $47.3 billion in Proposition 98 funding (recognizing a $302 million Proposition 98 reserve).

If the state is to meet the target of providing $2 billion less than the Proposition 98 guarantee, we estimate it would now need to appropriate an additional $1.4 billion in 2004-05. Figure 3 summarizes the components of this increase. First, the Legislature would need to appropriate the $302 million in the Proposition 98 reserve. Second, we now forecast that the Proposition 98 minimum guarantee has increased by $986 million since the budget was

Figure 2

The LAO Proposition 98 Forecast

(In Billions)

	2004-05						
	Budget Act	**Revised**	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**
Proposition 98							
General Fund	$34.3[a]	$35.1[b]	$36.3	$38.8	$40.3	$42.2	$43.8
Local property tax	13.0	13.2	14.6	14.6[c]	15.7	17.0	18.2
Totals	**$47.3[a]**	**$48.3[b]**	**$50.9**	**$53.3**	**$56.0**	**$59.2**	**$62.0**
Growth	—	—	$2.6	$2.5	$2.7	$3.2	$2.8

a Assumes appropriation of a $302 million Proposition 98 reserve.

b Assumes appropriation of a $1,357 million Proposition 98 reserve.

c The state will transfer $1.3 billion of local property tax revenues from schools to local governments in 2006-07. This transfer roughly offsets the growth of local property taxes for schools in this year.

adopted. The increase in the minimum guarantee is the net effect of two main factors—additional General Fund revenues and lower K-12 attendance. We estimate that 2004-05 General Fund tax revenues are $2 billion higher than assumed in the 2004-05 budget package, and that attendance growth is about a quarter percent lower than assumed in the budget. Finally, we estimate that forecasted 2004-05 Proposition 98 spending will fall by around $70 million because lower K-12 attendance growth will reduce the continuous appropriation for school districts' and county office of educations' revenue limits. Since less Proposition 98 resources will be spent on revenue limits, the state would need to reallocate the $70 million for a different K-14 use. For purposes of this forecast, we assume the Legislature provides the additional $1.4 billion in funding in 2004-05, building the base upon which future Proposition 98 funding increases are added. However, in the nearby box, we discuss options that the Legislature has to address current-year Proposition 98 funding given the state's overall fiscal condition.

Figure 3

Additional K-14 Spending Needed To Meet Proposition 98 Target[a]

(In Millions)

2004-05 Budget Act Proposition 98 reserve	$302
Increase in guarantee	986
Revenue limit adjustment	70
Total	**$1,357**

[a] Assuming the state provides $2 billion less than the minimum guarantee, per Chapter 213, Statutes of 2004.

Forecast for the Budget Year. For 2005-06, we estimate the Proposition 98 minimum guarantee will total $50.9 billion. This is $2.6 billion (5.4 percent) more than we forecast for 2004-05, and $3.9 billion (8.3 percent) more than provided in the *2004-05 Budget Act*. For 2005-06, we forecast that K-14 local property tax revenue will increase by $1.35 billion. Thus, General Fund costs of meeting the Proposition 98 minimum guarantee will grow by $1.25 billion (3.4 percent) from the revised 2004-05 estimate. The slow growth in General Fund costs is a combination of fast growth in local property tax revenues and slow K-12 attendance growth.

Out-Years' Forecast. For the remainder of the forecast period, we estimate that annual growth in total Proposition 98 spending will average $2.8 billion (5.1 percent). Strong property tax growth averaging $1.2 billion annually (8.2 percent) helps reduce the impact on the state budget, resulting in General Fund support for Proposition 98 growing around $1.6 billion annually (4 percent).

Proposition 49 Trigger. 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 $428 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 until 2008-09. When the trigger is reached, Proposition 49 requires that the additional $428 million be appropriated *above* the Proposition 98 minimum guarantee. The additional costs of funding Proposition 49 are factored into the Proposition 98 growth estimates in Figure 2 starting in 2008-09.

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.

Figure 4

The LAO Proposition 98 Forecast Factors

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Proposition 98 "Test"	2	2	2	2	2	2
Annual Percent Change						
K-12 average daily attendance	0.7%	0.7%	0.4%	0.1%	—	—
Per capita personal income	3.3	4.6	4.3	4.6	4.8%	4.9%
Per capita General Fund	7.2	4.4	4.4	5.0	5.0	5.0
State population	1.3	1.3	1.4	1.4	1.4	1.4
Local property taxes	9.4[a]	11.0	9.6[a]	8.2	7.8	7.0
K-12 COLA	2.4	3.4	3.0	2.6	2.8	2.9

[a] Growth rates in 2004-05 and 2006-07 reflect the underlying growth in school districts and community colleges property tax revenues.

Legislature's Current-Year Proposition 98 Options

Chapter 213 suspended the Proposition 98 guarantee for 2004-05. It also included language that the state would provide $2 billion less than required by the Proposition 98 minimum guarantee. Chapter 213, in effect, signals the intent of the Legislature to appropriate additional funding if the Proposition 98 guarantee increases (as we are forecasting). Because the statute does not provide specific appropriation authority to meet this requirement, the Legislature would have to take positive action in the future to do so. Absent such action, the minimum guarantee would "default" to the current level of appropriations. Because of the language in Chapter 213, we developed our Proposition 98 forecast assuming that the Legislature would appropriate an additional $1.4 billion in the current year. This amount increases the Proposition 98 base, resulting in comparable increases in each out-year of the forecast.

Given the state's projected large, ongoing budget problems (see Chapter 1) and the suspension of the guarantee which has already occurred, we would encourage the Legislature to reconsider the funding goal laid out in Chapter 213 and instead leave 2004-05 Proposition 98 funding at its current level of appropriations. (This could be accomplished either by specifically amending Chapter 213 or by simply not making additional Proposition 98 appropriations in the current year.) This option would save $2.8 billion in 2004-05 and 2005-06 combined, yet would not reduce the current level of educational services. In 2005-06, the increase in the Proposition 98 guarantee would fully fund the base program as adjusted for growth and cost-of-living adjustments (COLAs) and still support limited additional spending. In the out-years of the forecast, Proposition 98 would provide enough to pay for growth and COLAs, eliminate the education credit card debts (discussed later in this section), and begin to expand K-14 programs. While we recognize there are a range of options which the Legislature could consider regarding Proposition 98 in the current year, we believe this option would not only provide for reasonable growth in school spending, but would reduce the pressure to suspend Proposition 98 again in the near future.

For our forecast:

- We assume a slowing rate of growth in K-12 ADA. As Figure 5 shows, we forecast that by the end of the period, ADA will remain relatively flat for the last three years of the forecast.

- We forecast California per capita personal income growth will average 4.6 percent annually beginning in the budget year.

- After strong General Fund revenue growth in the current year (7.2 percent per capita), our forecast reflects moderate annual growth in per capita General Fund revenues averaging 4.8 percent. We forecast 11 percent growth in local property taxes in 2005-06 and strong growth averaging 8.2 percent for the remainder of the forecast period.

- The K-12 statutory COLA increases to 3.4 percent in 2005-06 then averages around 2.8 percent for the remainder of the forecast. We estimate that the K-12 COLA will cost around $1.4 billion in 2005-06.

Proposition 98 Cost Pressures

The state has four main cost pressures to continue currently required K-14 services over the forecast period: (1) growth in K-12 and community college attendance, (2) COLAs, (3) funding ongoing programs for which one-time funds were used in 2004-05, and (4) funding Proposition 49 after school programs. Figure 6 shows the annual growth in Proposition 98 resources over the forecast period, and the amount needed to fund these increases in base program costs.

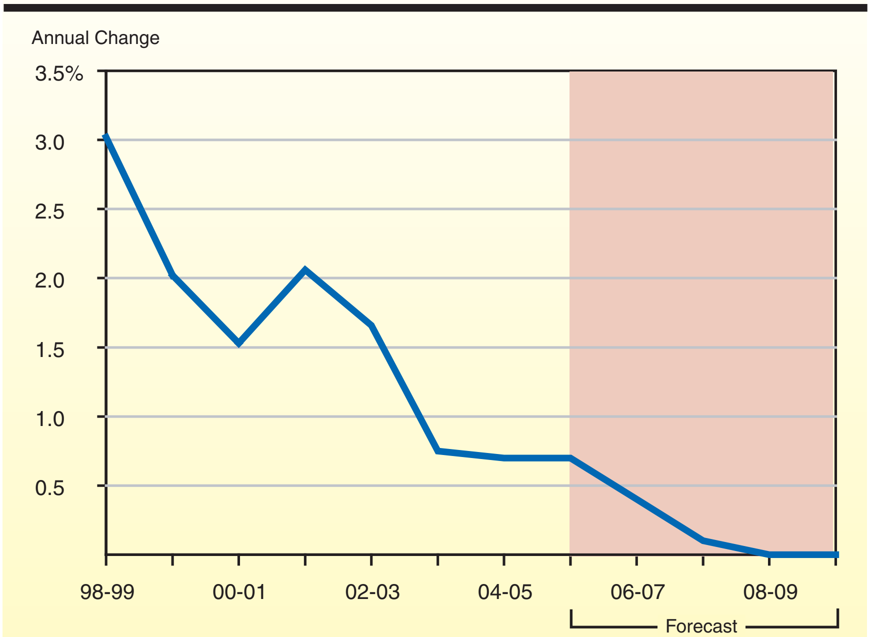
- ***K-14 Growth and COLA.*** We forecast growth and COLA costs for K-12 and CCC of $2.2 billion in 2005-06. These costs would decrease to $1.8 billion in 2006-07, and continue to decline as the attendance rate for K-12 falls over the forecast period.

- ***Restore Ongoing Funding for Ongoing Programs.*** In balancing the 2004-05 budget, the state used $279 million in one-time funds to support on-going programs. These programs include child care ($119 million), Targeted Instructional Improvement Grants ($99 million), school safety ($48 million) and deferred maintenance ($13 million). In 2005-06, the Legislature will likely need to use ongoing funding to continue these programs at current levels.

- ***Proposition 49 Would Trigger in 2008-09.*** As noted earlier, we forecast that Proposition 49

Figure 5

Projected K-12 Attendance Changes



would "trigger" in 2008-09, requiring an additional $428 million for after school programs. In future years, this program would be supported by K-12 base funding.

Proposition 98 Will Provide Significant Resources Beyond the Base Program. As Figure 6 also shows, Proposition 98 will provide significant new resources beyond those needed to maintain the base program. However, the state created large K-14 fiscal obligations for future years while addressing state budget problems in 2002-03 and 2003-04. Specifically, the state 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 2004-05 budget provided some funding beyond base program growth and COLAs , but did not begin to address the overall size of these obligations to K-14 education. We have termed these obligations the "K-14 education credit card." Figure 7 shows that the state will face a credit card balance of almost $3.5 billion in K-14 costs in 2005-06, absent corrective actions.

These credit card costs include program funding deferrals, mandate deferrals, and K-12 revenue limit "deficit factor." This latter obligation was created when the state temporarily reduced revenue limit payments to K-12 districts by $643 million in 2003-04. By 2006-07, current law requires the state to provide the additional $643 million in revenue limit funding.

Proposition 98 Growth Will Allow for Program Expansion After Meeting Current Obligations. If the Legislature meets the Proposition 98 target in Chapter 213, providing an additional $1.4 billion in 2004-05, the growth in Proposition 98 funding over the forecast period would allow the state to maintain the base program and completely eliminate the education credit card by 2006-07. This scenario would leave significant resources for program expansion. Alternatively, if the Legislature maintains the current Proposition 98 funding level, the state could still maintain the base program, eliminate the credit card, and expand programs over the forecast period. However, the level of program expansion would be somewhat less.

HIGHER EDUCATION

In addition to community colleges, the state's public higher education system includes UC and CSU. The UC consists of nine general campuses (including a new campus at Merced, which is scheduled

Figure 6

Proposition 98 Funds Available After Maintaining Base Program[a]

(In Millions)

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Resources						
Increases in Proposition 98 funding	$1,357	$2,593	$2,450	$2,674	$3,186	$2,809
Base Program Needs						
Growth and COLA	—	$2,186	$1,842	$1,693	$1,487	$1,511
Backfill for one-time spending	—	279	—	—	—	—
Proposition 49	—	—	—	—	428	—[b]
Funds available for other purposes[c]	**$1,357**	**$129**	**$608**	**$981**	**$1,271**	**$1,299**

[a] Assuming the state provides $2 billion less than the minimum guarantee, per Chapter 213, Statutes of 2004.

[b] Proposition 49 funded as part of base program beginning this year.

[c] Such as program expansions or reductions in existing K-14 obligations.

to open in fall 2005), one health sciences campus, and numerous special research facilities. The UC awards bachelor's, master's, and doctoral degrees, as well as various professional degrees. Of the segments, UC has almost exclusive 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 joint doctoral degrees with UC under specified circumstances. Overall, state policy for higher education is laid out in its Master Plan for Higher Education, which was originally adopted in 1960.

The Spending Forecast. Our forecast assumes cost increases which fully fund the projected impacts of inflation and enrollment growth. As a result, the segments' budgets grow by an average annual rate of about 4.2 percent over the forecast period. General Fund costs, however, grow somewhat more slowly, due to new revenue from the gradual phase-in of an excess unit surcharge on students (adopted as part of the 2004-05 budget). Including the offsetting effect of that revenue, we project that General Fund spending will increase from $5 billion in 2004-05 to $5.9 billion in 2009-10, for an average annual increase of 3.8 percent over the period.

Key Forecast Factors. Our forecast is largely based on three key factors.

Figure 7

K-14 Education Credit Card Balance

(Year-End Balance in Millions)

	2004-05
One-Time	
Revenue limit and categorical deferrals	$1,083
Community college deferrals	200
Cumulative mandate deferrals	1,524
Ongoing	
Revenue limit deficit factor	$643
Total	**$3,450**

- ***Inflation.*** We assume that base funding will increase annually to compensate for inflation. Neither the Master Plan nor statute provides any explicit guidance about inflationary adjustments. Over the forecast period, we project inflation to be a little less than 3 percent annually.

- ***Enrollment.*** Forecasting enrollment growth is more difficult. Enrollment growth depends primarily on population growth and participation rates. The latter responds to a range of factors, including state policies in areas such as outreach and financial aid, and actions by the segments in areas such as admissions policies and class scheduling. California's college participation rates, currently among the highest in the nation, have been relatively flat over recent years. Given this, we have assumed they will remain constant throughout the forecast period. Thus, our enrollment projections are driven by projected population growth. We calculated the ethnic, gender, and age makeup of each segment's student population, and projected separate growth rates for each group based on statewide demographic data. When all student groups' projected growth is aggregated together, we project that demographic-driven enrollment at the two segments will grow annually between 1 percent and 2 percent during the forecast period.

- ***Fees.*** We assume that enrollment fees will increase annually at the rate of inflation, thus maintaining their current purchasing power. We have also assumed that the excess course unit fee initiated in the current year will continue to be phased in over the forecast period.

Governor's Compacts. Earlier this year the Governor developed "compacts" with UC and CSU in which he commits to seek certain funding increases for the segments in his future budget proposals. Because these compacts are neither in statute nor formally endorsed by the Legislature, we have not reflected them in our projections for spending at UC and CSU. The nearby box explains the compacts in more detail.

Cal Grant Costs Likely to Increase Substantially. We estimate that General Fund spending for financial aid programs administered by the Student Aid Commission will increase from $637 million in 2004-05 to approximately $1 billion in 2009-10. The bulk of the expected increase is attributable to growth in the Cal Grant entitlement program, as well as our assumption that all Cal Grant funding will be covered by General Fund revenue starting in 2005-06. (In 2004-05, $147 million of Cal Grant funding is being covered by surplus revenue available from the Student Loan Operating Fund.) Since 2001-02, the Cal Grant entitlement program has guaranteed financial aid to recent high school graduates and community college transfer students under 24

GOVERNOR'S HIGHER EDUCATION COMPACTS

In May of this year, the Governor and the heads of UC and CSU agreed to pursue specific annual funding goals for the university systems over the next six years. These goals were expressed in "compacts," whereby the Governor committed to include the specified funding levels in his annual budget requests, and the segments agreed to provide annual reports on a variety of activities and outcomes. There is no clear link, however, between the compacts' funding targets and the Master Plan. In addition, the Legislature was not party to these compacts, and thus we believe it should be guided by its own priorities for the segments in its annual deliberations on the state budget.

The compacts seek base increases for the segments of 3 percent in 2005-06 and 2006-07, 4 percent in 2007-08, and 5 percent for 2008-09 through 2010-11. Cumulatively, these rates would result in a base funding increase of 21.6 percent during our forecast period. This is almost one and a half times our estimate of inflation during the period.

The compacts also assume annual enrollment growth of 2.5 percent for both segments. Over our forecast period, this would result in cumulative growth of 13.1 percent. This is considerably higher than our estimate of 8 percent, which is based on demographic changes. The compacts also seek additional, unspecified state funding to cover increases in debt service, retirement contributions, and annuitant health benefits. Our projections assume such increased costs would be covered through base inflation adjustments.

Finally, the compacts call for annual student fee increases of 8 percent in 2005-06 and 2006-07. In subsequent years, the compacts assume fees will increase based on the change in per capita personal income. The compacts assume that revenue from these fee increases will not offset state General Fund support, but rather will add to the total funding available to the segments. In contrast, our forecast assumes that fees will increase annually at the rate of inflation, thus ensuring that both fees and the General Fund continue to fund their existing shares of total costs.

Overall, we estimate that the funding goals of the compacts would cost the state about $1.3 billion more than our forecast of state spending for UC and CSU during the period. Similarly, student fee levels under the compacts would be almost 20 percent higher by the end of the forecast period than under our assumptions.

years of age. Because it is still relatively new, future participation rates remain uncertain. Over the forecast period, our projections assume that student participation 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 $12 billion in the current year, about a $100 million increase over the amount appropriated in the *2004-05 Budget Act*. The increase is mainly due to our estimate of increased rates paid to nursing homes and increased Medicare premium costs for persons enrolled in both Medi-Cal and the federal Medicare program. These increases are partially offset by lower-than-anticipated caseloads for certain beneficiary categories.

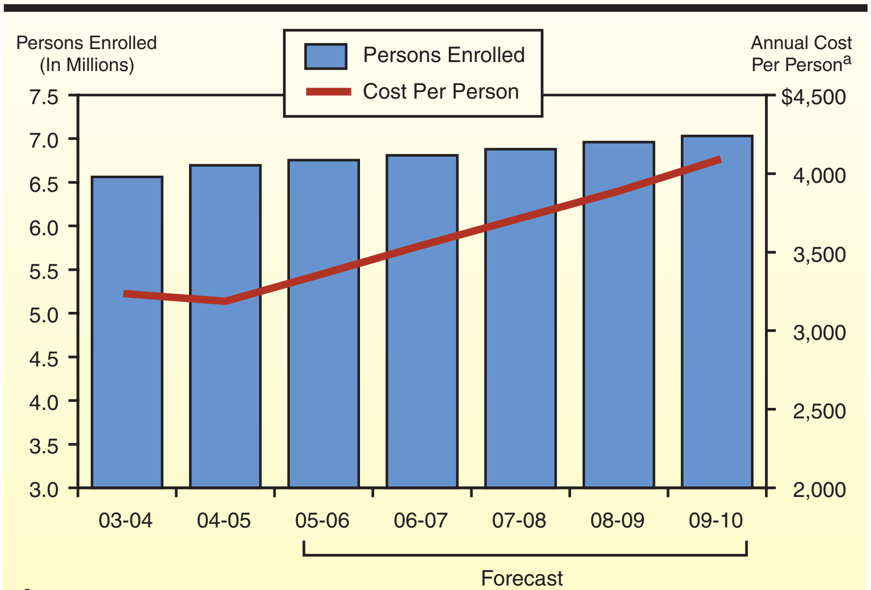
We project that General Fund support would grow to $13 billion in 2005-06, an 8 percent increase from current-year expenditures. This is largely due to the General Fund backfill of two major one-time technical funding changes that reduced program costs in 2004-05. The full-year effect of prior cost-reduction actions is assumed to partly offset these additional costs. By the end of the forecast period in 2009-10, we estimate that General Fund spending for Medi-Cal will reach $16 billion, an average annual increase of 4.2 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 2005-06 through 2009-10 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 2.9 percent during the same period). As shown in Figure 8, the average cost per per-

Figure 8

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



[a]General Fund and federal funds.

son enrolled in the program is projected to grow from $3,400 to $4,100 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 8, the overall Medi-Cal caseload appears to be stabilizing. This period of relative stability follows several years of strong caseload growth among low-income families and children who do not receive cash assistance. Our forecast assumes some continued caseload growth commensurate with increases in the state population.

- ***Impact of One-Time Cost Reductions.*** One-time savings of $288 million General Fund were achieved in 2004-05 by delaying checkwrites by two weeks for reimbursements to health care providers. This will result in increased costs in 2005-06 equivalent to the amount of the one-time savings achieved the prior year.

- ***Further Savings in 2005-06.*** Our forecast assumes that the state will achieve an increased level of savings in 2005-06 from the implementation of various cost reduction strategies begun in 2003-04 and 2004-05. These include the expansion of antifraud efforts and various drug and medical supply cost-containment proposals. Because our forecast is based on current law, it does not include any projected savings from Medi-Cal changes which may be proposed by the administration.

- ***Medicare Modernization Act.*** Our forecast takes into account the enactment in 2003 of the Federal Medicare Prescription Drug, Improvement, and Modernization Act that creates a new prescription drug benefit for Medicare beneficiaries. After certain provisions take effect in January 2006, the state will experience savings on the cost of drugs now provided for Medi-Cal beneficiaries who are also enrolled in Medicare. However, the state will be required to offset part of the federal cost of providing the new Medicare drug benefit for these beneficiaries through payments to the federal government. Both of these aspects of the measure are reflected in our projection for the Medi-Cal Program.

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 (FPL). To participate in HFP, families pay a relatively low monthly premium and are offered coverage similar to that available to state employees. Beginning this year, the federal government has also authorized the use of federal funds to cover children up to age two in families with incomes below 300 percent of FPL who have transferred to HFP from the state's Access for Infants and Mothers program.

The Spending Forecast. We estimate that overall General Fund spending for HFP local assistance will be $325 million in 2004-05. We further estimate that overall General Fund spending for the program will increase to about $360 million by 2005-06 and that by 2009-10 the program will have an annual General Fund cost of about $490 million. The average annual growth in expenditures over the forecast period is projected to be about 9 percent.

Key Forecast Factors. Compared to prior years, the 2005-06 forecast reflects a greater growth rate in program spending, which is due in part to projected increases in medical costs. Our projection also takes into account a policy change adopted as part of the 2004-05 budget plan that partially offsets the growth in program spending. Specifically, beginning in 2005-06, the premiums for children paid by families with incomes between 201 percent and 250 percent of FPL will generally increase from the present level of $9 per child to $15. Our projection takes into account both revenues resulting from the premium increase and the effect of the increase on program caseloads.

Developmental Services

The state 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 2004-05 will total $2.2 billion, the same amount of funding appropriated in the *2004-05 Budget Act*. Of that total, about $1.8 billion will be spent by RCs for community services and about $368 million, excluding Proposition 98 funds, will be spent for operating the DCs.

We further estimate that General Fund spending for developmental services will grow by about 9 percent in 2005-06 to approximately $2.4 billion.

Between now and 2009-10, we estimate that General Fund spending for the developmental services program will grow by $1.3 billion and reach a total of almost $3.5 billion. This expenditure growth is due almost entirely to the RCs. We estimate there will be various one-time administrative and programmatic costs in 2006-07 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.

CalWORKs is primarily funded by state General Fund and federal funds that the state receives as part of its Temporary Assistance for Needy Families (TANF) block grant. In order to receive these federal funds, the state must meet a maintenance of effort (MOE) requirement, which is largely satisfied through state and county spending on CalWORKs.

The Spending Forecast. General Fund spending for the CalWORKs program is estimated to be $2.2 billion in 2004-05, a $134 million increase from the prior year. We project spending to increase by $33 million in 2005-06 and an additional $181 million in 2006-07. For the remainder of the forecast, we project that spending will increase by an average of about 7.5 percent each year, reaching a total of nearly $3 billion in 2009-10.

Key Forecast Factors. Our forecast includes $222 million in 2005-06 for retroactive payment of the October 2003 COLA for 2002-03 and 2003-04, because a district court has ruled that the October COLA is required by current law. We note that the administration has appealed this decision and a ruling on this matter is expected in summer 2005. The cost of retroactive COLA payments will be more than offset by anticipated carryover of funds from the prior year.

The substantial increase in General Fund expenditures in 2006-07 is due to the reduction in available TANF carry-in from the prior year. The increase in program costs in the out years is primarily due to COLAs and small increases in grant costs consistent with projected demographic changes.

Given the projected program spending and the reduction in available carry-in funds, California would have to spend significantly above the General Fund federal MOE requirement beginning in 2006-07 in order to fund the program at current services levels without reducing grants.

Beyond the estimated reduction in unexpended federal TANF funds, our spending projection is largely based on our caseload projections. Other key assumptions include receipt of $3.7 billion in federal TANF block grant funding and the state providing the statutory COLA (based on the increase in the California Necessities Index) each year.

Caseload Trends and Projections. From 1994-95 through 2003-04, 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. Since October 2002, the caseload has remained relatively flat on a quarterly basis, with a quarterly average of about 480,000 cases. The most recent caseload figures (through July 2004) have shown a slight increase in caseload beginning in March 2004. However, given the long period of relatively flat caseload, our projection assumes that caseload in the out years would remain stable, growing only by the projected increase in 18 to 44 year olds (on average, about 1 percent annually).

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 $3.5 billion in 2004-05, an increase of 10 percent compared to the prior year. For 2005-06, we project a 7.6 percent increase, raising total expenditures to $3.7 billion. From 2005-06 through 2009-10, spending for SSI/SSP will increase by an annual average rate of 6.7 percent, eventually reaching a total of over $4.8 billion.

Key Forecast Factors. The two primary cost drivers for SSI/SSP are caseload growth of about 2.7 percent and the cost of providing the statutory COLA. The 2004-05 budget delayed the January 2005 state COLA until April 2005, but did "pass through" the January federal COLA. For 2005-06, annualization of the April COLA costs $74 million and the January 2006 COLA amounts to an additional $103 million. In 2006-07, total state COLA costs are estimated to be $177 million. Beyond 2006-07, annual COLA costs are expected to moderate to about $120 million per year, primarily attributable to anticipated reductions in the rate of inflation. 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. This is because sponsor's income will no longer be counted as an offset to the grant amount.

***Caseload Trends and Projection*s.** 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. From 1998 through 2003, the caseload grew at a steady rate of just over 2 percent per year. However, in the past year, caseload growth has begun to edge up past 2.5 percent. Given this recent modest up-tick in caseload growth and anticipated growth in the aged population, we project caseload growth to approach 3 percent by the end of 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 $1.2 billion in 2004-05, an increase of 5.8 percent over the prior year and an increase of 2 percent above the current-year appropriation. For 2005-06, we project that costs will increase by about 13 percent to a total of $1.3 billion. For the remainder of the forecast, we expect costs to increase an average of 11 percent each year, resulting in General Fund expenditures of $2 billion in 2008-09.

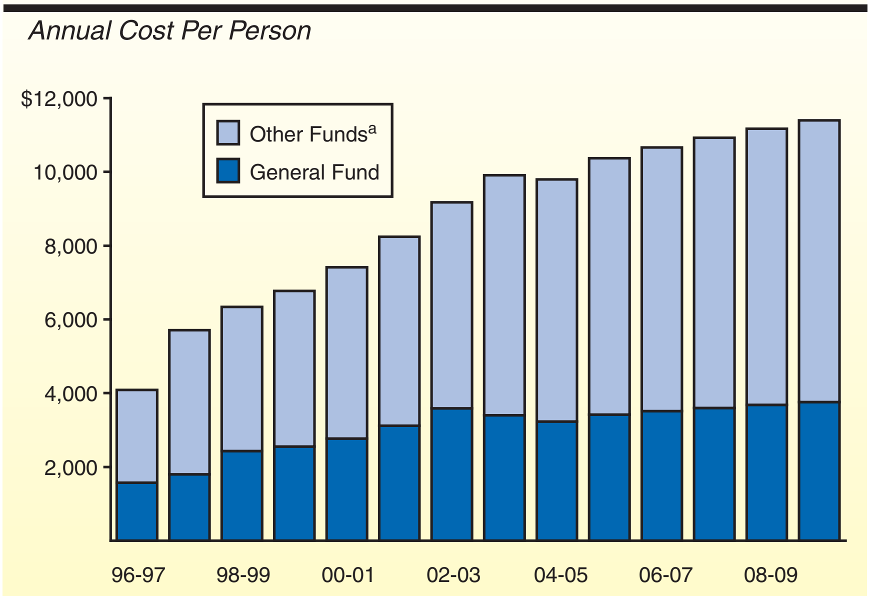
Key Forecast Factors. In August 2004, the U.S. Department of Health and Human Services approved California's proposed Section 1115 Medicaid waiver to provide federal financial participation for approximately 75,000 state-only IHSS recipients. This waiver results in General Fund savings of $216 million during 2004-05 and is authorized through 2008-09. For 2004-05, our forecast includes approximately $16 million to cover state costs associated with a wage increase for IHSS workers recently granted by Los Angeles County and about $6 million for certain state-only IHSS recipients who are not covered by the waiver.

In the budget year and beyond, the primary cost drivers for IHSS are caseload growth of about 8.5 percent per year and increases in provider wages. For this forecast, we have assumed annual increases in state costs of $40 million per year as counties gradually increase wages paid to IHSS providers.

Figure 9 presents recent trends and our projections of IHSS costs per person. From 1996-97 through 2003-04, the cost per case more than doubled, primarily due to increases in provider wages and the hours of services provided to recipients. We anticipate modest increases in the cost per case during the projection period, with about half of these increases supported through federal funds.

Figure 9

IHSS Costs Still Growing, Though More Slowly



[a] Federal and county funds.

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 appellate courts. The two largest expenditure programs—CDC and Trial Court Funding—are 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. The CDC expenditures for 2004-05 are estimated to be about $200 million more than appropriated in the budget primarily due to delays in implementing policies aimed at reducing the inmate population as well as parolee recidivism. These policy changes include, for example, the expansion of work credits to certain reception center inmates, and the use of intermediate sanctions for some parole violators who would otherwise be returned to prison.

Spending is projected to increase by 4.3 percent to $5.8 billion in 2005-06, and by 4.8 percent to $6.1 billion in 2006-07. For the remainder of the forecast period, General Fund spending is projected to increase by an average of 2.7 percent each year, reaching $6.6 billion in 2009-10. This is a substantially slower growth rate than in the past when increases exceeded 10 percent. This slower growth rate reflects a continuing trend of slower population growth that began in the late 1990s, as well as recent policy reforms targeting the inmate and parole populations. (Our estimates for the forecast period 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.)

During the forecast period, the department's General Fund costs are assumed to be partially offset by $78 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.

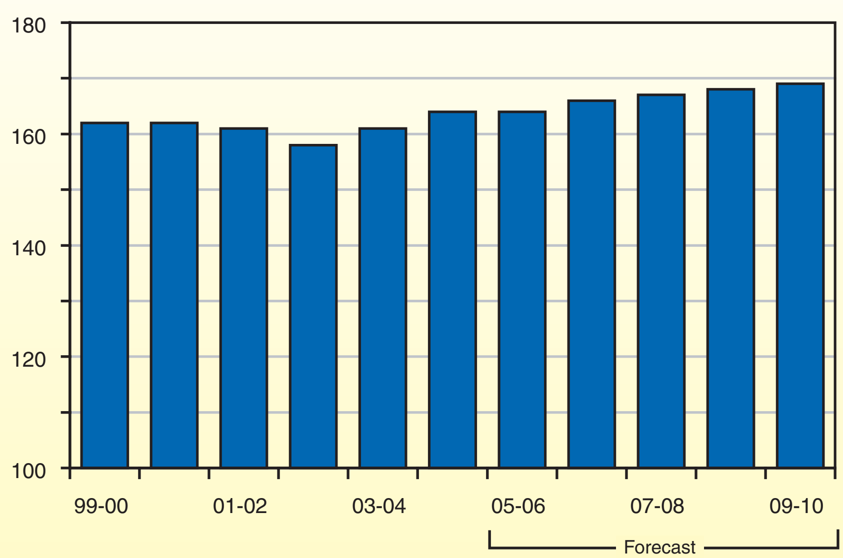
Key Forecast Factors. The projected increases in General Fund support for CDC are driven by a combination of factors, including salary increases; inflation on operating expenses and equipment; and growth in the prison population. During the forecast period, salaries are projected to increase by nearly $600 million, which represents about 56 percent of the total growth in General Fund spending for the department between 2004-05 and 2009-10. Price adjustments for operating expenses and growth in inmate health care costs are projected to account for about 28 percent of the total increase. The remainder (16 percent) consists of several factors, including population growth; the implementation of health care improvements pursuant to court orders; and costs for collection of DNA samples pursuant to Proposition 69.

As Figure 10 shows, the prison population is projected to increase by approximately 5,200 inmates during the forecast period. This relatively slow growth (less than 1 percent annually) reflects a recent trend of increasing court commitments, par-

Figure 10

Inmate Population Projected to Slowly Increase

Fiscal Year Ending June 30 (In Thousands)



tially offset by inmate population decreases that are expected to result from recent policy changes aimed at reducing the inmate population and parolee recidivism.

Trial Court Funding

The Trial Court Funding program provides funds for support of the state's trial courts. California has 58 trial courts, one in each county. Chapter 850, Statutes of 1997 (AB 233, Escutia and Pringle), shifted fiscal responsibility for the trial courts from the counties to the state.

The Spending Forecast. Trial court expenditures for 2004-05 are estimated to exceed the budget appropriation by about $90 million in order to fully fund court employee negotiated salary and benefit increases. General Fund spending is projected to increase by 13 percent to $1.5 billion in 2005-06, in part due to the restoration of one-time funding reductions. For the remainder of the period, General Fund spending is projected to increase by an average of about 8 percent each year, reaching $2 billion in 2009-10. This is a faster growth rate than in the past five years during which General Fund spending increased an average of 4.5 percent each year.

Key Forecast Factors. Current law requires that most of the trial court budget be adjusted by the annual change in the state appropriations limit. This requirement accounts for approximately 90 percent of the projected growth in funding for the trial courts. Our projection also reflects a partial offset due to increased revenues from court fees and surcharges over the period.

OTHER

Local Government Finance

The 2004-05 budget package enacted significant changes to state-local finance, including (1) a shift of $1.3 billion of city, county, special district, and redevelopment property taxes to K-14 school districts in 2004-05 and in 2005-06 for the fiscal benefit of the state and (2) a swap of $4.1 billion of city and county vehicle license fee "backfill" payments from the state for an equal amount of increased property taxes from K-14 school districts. These major changes to state-local finance enacted in the 2004-05 budget package are consistent with Proposition 1A, the local government revenue measure approved by the statewide electorate in November. As a result, we reflect these changes in the property tax revenue numbers in our Proposition 98 forecast.

Noneducation Mandates

Over the last three years, the state has required cities, counties, and special districts to implement several dozen state mandates, but deferred funding to reimburse local governments for these mandates to an unknown future date. In May 2004, the State Controller reported the state owed over $1 billion to cities, counties, and special districts for mandated programs. The 2004-05 budget package and Proposition 1A enacted major changes regarding state payment of noneducation mandate costs. Specifically, Chapter 211, Statutes of 2004 (SB 1096, Committee on Budget), codified the state's commitment to pay all outstanding city, county, and special district mandate costs over a period of not more than five years, beginning in 2006-07. In addition, Proposition 1A amended the Constitution to limit the state's options regarding payment of local government's annual costs to implement noneducation mandates. Under Proposition 1A, the Legislature must take one of the following actions regarding every local government mandate: (1) fully fund the annual cost of the mandate in the budget, (2) include language in the budget *suspending* local government obligations to carry out the mandate in the fiscal year, or (3) repeal the mandate. The only exception to this requirement is for noneducation state mandates relating to employee rights.

The Spending Forecast. Given the new statutory and constitutional provisions, we have assumed that the state will pay the annual cost for all noneducation mandates (with the exception of those the Legislature has suspended annually in the past) beginning in 2005-06—about $250 million. We also assume that the state will pay its outstanding mandate liabilities in five equal installments beginning in 2006-07—about $300 million annually.

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. Most collective bargaining units renegotiated existing contracts in 2003-04 to postpone scheduled salary increases until 2004-05. As a result, the *2004-05 Budget Act* includes $405 million from the General Fund to pay for these costs in the current year. For bargaining units that did not renegotiate existing contracts, the budget did not appropriate funds to pay for new spending provisions included in those contracts. Instead, departments were required to accommodate these increased employee costs within existing appropriations.

The Spending Forecast. For employee compensation costs not already in departmental budgets, we estimate that costs will increase from $405 million in 2004-05 to almost $1.5 billion in 2009-10. This reflects the costs associated with existing collective bargaining agreements and projected compensation increases over the forecast period.

Key Forecast Factors. Most General Fund-supported employees received a 5 percent salary increase this year, with the state also paying 80 percent of health insurance premiums. The major exception is correctional officers (Unit 6) and their supervisors and managers. Under the terms of a renegotiated agreement approved earlier this year, this group will receive:

- Two pay raises in the current year—5 percent effective July 1, 2004 and another 5 percent effective January 1, 2005.
- Two pay raises in the budget year—currently estimated at 5.1 percent effective July 1, 2005 and 0.9 percent effective June 30, 2006.
- One pay raise in 2006-07—currently estimated at 4.9 percent effective July 1, 2006.

We anticipate that as contracts expire, the state will incur additional employee compensation costs over the forecast period due to new collective bargaining agreements. In those years beyond scheduled pay raises, we assume 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 Public Employees' Retirement System (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 a portion of the state's annual retirement contribution to PERS, the 2004-05 budget authorizes the issuance of a $0.9 billion pension obligation bond. In addition, state retirement law was amended this year with the intent of generating savings to offset the debt service cost of the bonds. Under the plan, the state will not make retirement contributions for new employees for two years. After the two-year period, these employees will then choose whether to (1) transfer the funds in their account to PERS or (2) cash out their account. If an employee chooses to transfer the proceeds to PERS, that employee will receive retirement service credit for the two years. The state will bear any additional financial liability (beyond the transferred funds) for the retirement costs associated with the two years of service. This increased liability will be paid through increases in future employer contribution rates.

The Spending Forecast. In 2003-04 and 2004-05, the state has reduced retirement-related expenses by a total of $1.4 billion using one-time budget solutions—through the pension bond and a reduction in a scheduled payment to STRS. Beginning in 2005-06, the state will once again face its full retirement obligations. From 2005-06 to 2009-10, we project retirement-related costs will rise steadily—by about $1 billion over the five-year period.

Key Forecast Factors. Last year, a Superior Court ruled that the state could not sell a pension obligation bond without voter approval. For the purposes of our forecast, we have assumed that the administration successfully issues the pension obligation bond authorized in 2004-05. Another adverse court decision, however, would worsen the state's General Fund condition by $0.9 billion in 2004-05.

In future years, we project that state retirement contributions to PERS will continue their upward trend for the forecast period. This is because of (1) recent years' poor investment returns that must still be fully recognized in contribution rates (despite good returns in 2003-04) and (2) the anticipated rate impact of the retirement changes for new employees. With respect to STRS, we assume the state contribution—a statutory percentage of teacher payroll—will grow at the same rate as Proposition 98 expenditures. Finally, we assume General Fund expenditures for the state portion of retirees' health and dental insurance premiums will grow with medical inflation and enrollment. We estimate these premium costs of $796 million in 2004-05 will grow to $1.3 billion by 2009-10.

Statewide Savings

Punitive Damages. The *2004-05 Budget Act* assumes that General Fund spending in 2004-05 will be offset by $450 million in punitive damage award revenues transferred to the state. However, based on our analysis of prior punitive damage awards, our forecast assumes a significantly lower General Fund offset of $60 million in both 2004-05 and 2005-06. The punitive damages provisions expire in July 2006.

Other. The *2004-05 Budget Act* included $396 million in General Fund savings from:

- ***Unallocated Reductions.*** Reduced state expenditures from departmental reductions in both state operations and local assistance ($150 million) and from the reorganization of state departments ($150 million).

- ***Procurement Savings.*** Reduced state costs from improved state purchasing and contracting practices ($96 million).

To date, no specific savings have been identified by the administration. Consequently, any reductions in the current year would likely not produce full-year savings. Over the remaining forecast period, we project that savings will increase somewhat but still significantly fall short of the targeted amounts.