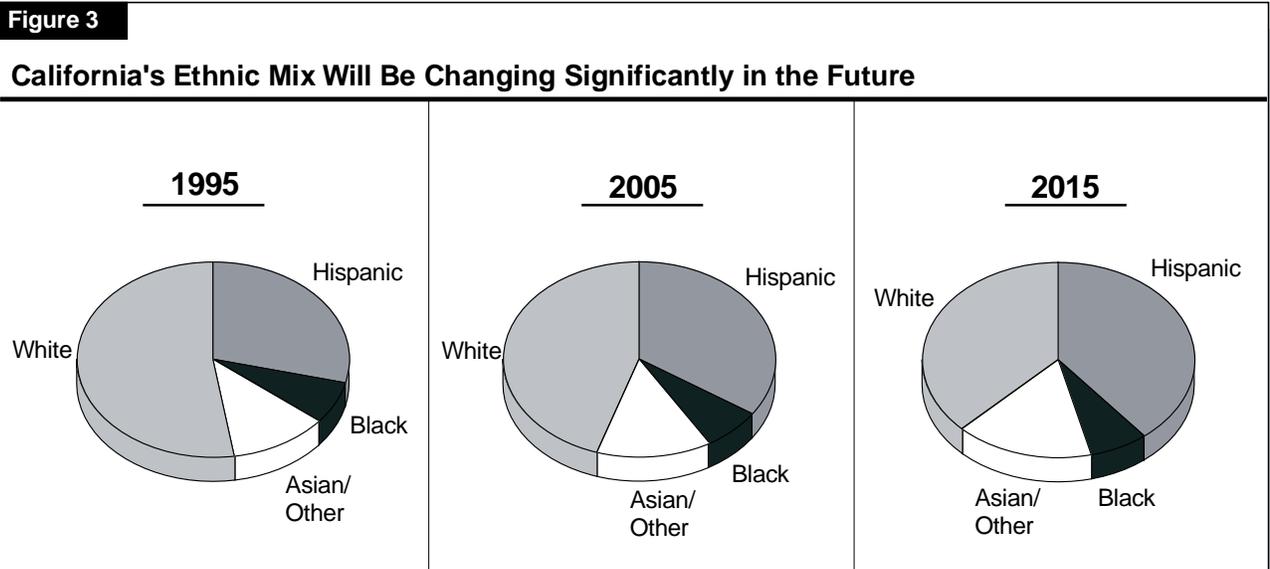


omy has recently been in the midst of many major structural changes due to such factors as reduced defense spending, business reorganizations that accompanied and followed the past recession, widespread cost-cutting and implementation of new technologies in the financial sector, and increased international competition faced by California firms. These factors make it especially hard to know what California's economic growth path will be in the future, and thus what revenue growth will be.

years is a very difficult task, projecting its longer-run performance is even more difficult. This is especially true today, because the state's econ-

We believe that over the longer-term it is reasonable to assume the economy would on average experience moderate real growth and modest inflation. In this event, revenue growth would probably average in the general range of 5 percent to 6 percent annually (or about the same pace as state personal income), although growth in any given year could vary signifi-



cantly. However, stronger or weaker economic growth and/or inflation could easily make average revenue growth be a percent or more different in either direction. As Figure 4 shows, General Fund revenues in 2006-07 would be about \$80 billion under a moderate growth scenario. This amount, however, could be \$10 billion higher or lower under realistic alternative scenarios.

STATE PROGRAMS

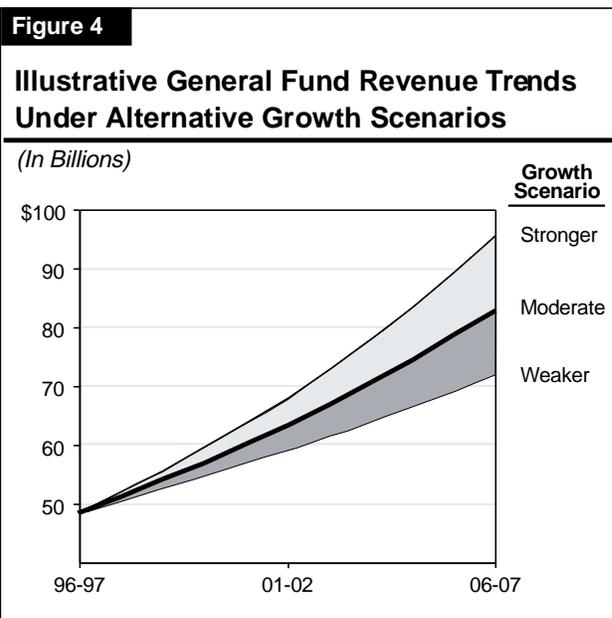
As discussed below, particularly significant long-term fiscal considerations are associated with several program areas within the state budget.

Welfare

The federal welfare reform act includes several provisions that could lead to significant changes in state law regarding various public assistance programs. These include the elimination of federal requirements for the Aid to Families with Dependent Children (AFDC) program, work participation requirements for needy families under the new Temporary Assistance for Needy Families (TANF) program, and restrictions on legal noncitizens' eligibility for Supplemental Security Income/State Supplementary Program (SSI/SSP). Perhaps most important from a long-term perspective, the act prohibits the allocation of federal TANF block grant funds to persons on aid for more than five years. While this restriction applies only to federal funds, the

Legislature could adopt a time limit for state funds as well. Considering that about one-third of AFDC recipients currently have been on aid for more than five years, it is apparent that such a limit would have significant fiscal consequences for the state.

As an indication of the potential fiscal effects of a five-year limit, we estimate that if all recipients currently on aid for more than five years were eliminated from the caseload, the state would save \$1.7 billion and the counties about \$95 million annually from reduced grant expenditures (with no federal savings because the state is operating under a block grant). Because of the maintenance-of-effort provision in the TANF program, however, the state would have to redirect more than half of such savings into programs serving needy families with children.



Furthermore, much of the state savings would be offset by costs to the counties due to increases in their General Assistance caseloads.

The state could also incur substantial savings from the provisions excluding noncitizens from SSI/SSP eligibility. Based on the assumptions that we used for our short-term forecast, we estimate that long-term savings would eventually level out at approximately \$127 million annually. As is the case for the five-year limit on the TANF program, these savings would be offset by costs—potentially of a greater amount—to the counties' General Assistance program.

In summary, welfare reform could have a significant fiscal impact on the state and the counties. This will depend, however, on the specific actions taken by the Legislature and the Governor in response to the federal act.

Proposition 98

One of the significant factors affecting the adequacy of General Fund support for all state programs is the extent to which funding is directed to Proposition 98 under the formula contained in the state Constitution. In other words, funds spent on K-14 education are not available for other state programs. Proposition 98 spending depends on the growth in personal income, General Fund and local property tax revenues, total state population, and K-12 student attendance.

Over the forecast period, we estimate that Proposition 98 will absorb a large proportion (over 60 percent) of *new* General Fund revenues each year. As a result, we forecast that the Proposition 98 (General Fund) share of revenues will increase from 38 percent in 1995-96 to 43 percent in 1998-99.

Beyond the forecast period, it is much more difficult to predict Proposition 98's share of the General Fund budget. Under the moderate economic growth scenario noted above, however, we think it is likely that Proposition 98's share of the budget will stabilize. Should the economy grow at a faster rate, the school's share of the budget would increase again.

Higher Education

Our projections of cost increases at the University of California (UC) and the California State University (CSU) assume a 1 percent annual rate of enrollment growth through 1998-99. Some higher-education analysts have projected higher growth rates. The California Postsecondary Education Commission (CPEC), for example, projects annual enrollment growth at UC and CSU of about 1.6 percent during this time period.

Estimates of increased enrollments beyond 1998-99 are based in large part on projected increases in the young-adult population. As Figure 5 shows, for example, we project that the number of 18 year olds in California will increase by 78,000, or 19 percent, from 1996-97 to 2001-02, and by 186,000, or 45 percent, by the year 2015.

These relatively large increases have been labeled by some as “Tidal Wave II” (the children of the “baby boomers”).

How these population numbers translate into increased higher education costs, however, is problematic. Apart from the uncertainties of projecting population growth generally, projecting growth in UC and CSU populations is complicated further by significant variability and uncertainty about the numbers of:

- High-school students who will graduate.
- High-school graduates who will apply to college.
- College applicants who will be accepted and will ultimately attend a UC or CSU campus.

Each of these factors is influenced by general economic conditions, the educational goals and achievement of students, and the cost of various public and private educational opportunities.

Corrections

Figure 6 shows that the Department of Corrections (CDC) anticipates that the state’s prison population, which is now about 144,000, will reach 250,000 inmates by June 2006. Although this is not as great an increase as previously projected by the CDC, this level of caseload increase represents a major operational and fiscal challenge to the state.

Figure 5

California's Projected 18-Year-Old Population

(In Thousands)

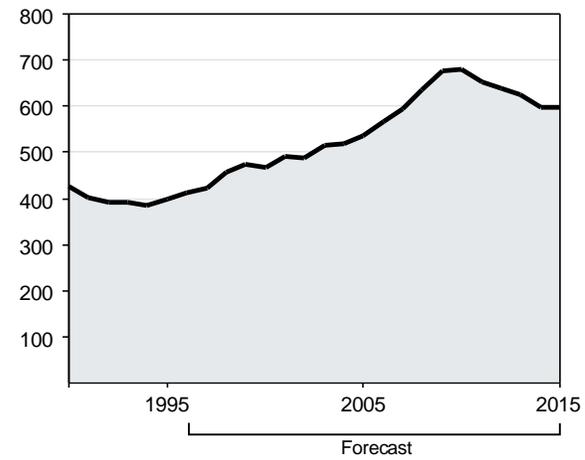
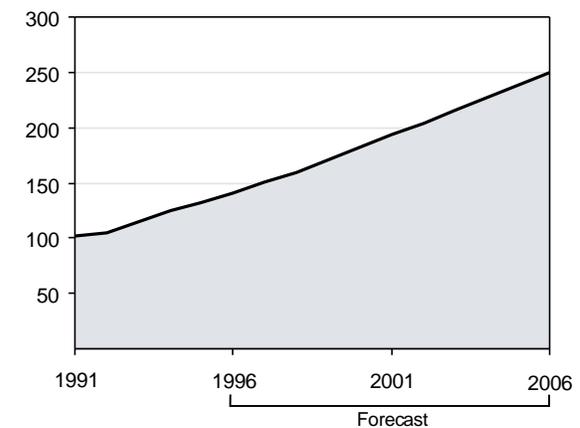


Figure 6

State Prisons Face Continued Inmate Population Growth

Inmates as of June 30 (In Thousands)



We estimate that if the significant growth in the inmate population persists, the CDC support budget would reach about \$6.2 billion by 2005-06, or roughly double the present funding level, after adjusting for anticipated federal funds. The CDC budget would grow at an average annual rate of about 7.5 percent, compared with an annual 5.5 percent growth in revenues that would occur for the state General Fund under a moderate economic growth outlook during that same ten-year period. If the state accommodated this increased population by overcrowding existing prisons and building additional prison space, the state would incur one-time capital outlay costs of more than \$3 billion to build as many as ten additional prisons. However, the cost of CDC operations and capital outlay could be lower if the Legislature or the courts took actions which either slowed inmate population growth or provided alternative forms of punishment for some offenders.

State Infrastructure

In our spending projections, we forecast that expenditures on debt service (for both general obligation and lease-purchase bonds) would grow steadily—reaching 5.2 percent of General Fund revenues by 1998-99. (After 1998-99, this ratio would begin to decline as existing debt is paid off.) These debt service payments primarily pay for *existing* facilities. The state, however, will face significant demands for *new* capital outlay expenditures in the coming years.

Figure 7 shows the capital outlay needs projected just for the next five years. It indicates that state agencies and K-12 education have identified needs totaling \$39 billion over that period. Most of the identified projects fall in the areas of transportation, education, and corrections.

In recent years, the vast majority of capital outlay has been financed with state bonds. The major exception is transportation, which is financed primarily from state special funds and federal funds for transportation capital outlay. Presumably, future capital outlay projects would be similarly financed.

Figure 7

Projected Five-Year Capital Outlay Needs For the State and K-12 Education 1996-97 Through 2000-01

(Dollars in Millions)

	Five-Year Total
Executive	\$50
State and consumer services	1,325
Transportation	14,346
Resources	840
Health and welfare	420
Youth and adult corrections	4,604
K-12 education	10,500
Higher education	6,610
General government	228
Total	\$38,923