Foreword

This report provides our projections of the General Fund condition for 1997-98 through 1999-00. It includes our independent assessment of the outlook for the economy, demographics, revenues, and expenditures. It is designed to assist the Legislature with its fiscal planning.

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. Chapter 5 discusses long-term considerations relating to the state's fiscal outlook. Among others, these include economic, demographic, and revenue developments, as well as caseloads and other factors affecting state spending levels.

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. The report is part of an ongoing series and is updated periodically.

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Chapter 1

The Budget Outlook

During the 1997 session, the Governor and Legislature reached agreements on a number of issues that will have significant implications for state revenues and spending in the future. These include welfare reform, a significant reduction in personal income taxes, a financial restructuring of the trial court system, the expansion of health care coverage for low-income children, and employee pay increases.

Given the significant fiscal effects associated with these agreements, an important question is whether California's General Fund will be able to fully accommodate these commitments in future years, without policymakers having to find savings in other areas of the state budget.

The "Bottom Line"— Positive Budgetary Outlook

Our current forecast suggests that the General Fund *will* be able to accommodate these commitments, *plus* cover the other requirements of current law through 1999-00. Our key findings are summarized in Figure 1, and our estimate of the General Fund condition is displayed in Figure 2 (see next page).

Figure 1

Key Features of LAO Outlook

✔ **Overall Budget Outlook Is Positive**

- Despite a major tax cut and significant new spending commitments, the General Fund budget will remain in balance through 1999-00.
- Key reasons include continued healthy economic and underlying revenue growth, and declining Medi-Cal and CalWORKs caseloads.

✔ **Current Year to End With Reserve of Nearly $770 Million**

- Reserve up $657 million from *1997-98 Budget Act* estimate, due primarily to higher state revenues and to lower costs in the Medi-Cal program.

✔ **1998-99 and 1999-00 Budgets Remain Balanced**

- Revenues sufficient to fully fund requirements of current law—even with tax reduction and recently enacted program increases.
- One-time PERS payment in 1997-98 creates "room" for tax cut, trial court funding increase, employee pay raise, and increases to other programs.
- Reserve shrinks in 1999-00, but state still ends with a positive balance.

✔ **Major New Proposals Will Involve Fiscal Trade-Offs**

- Given a declining reserve over time, significant new proposals would come at the expense of current-law requirements.

As indicated in the two figures, we estimate that the current year will end with a reserve of $769 million, or $657 million more than the *1997-98 Budget Act* estimate. We further estimate that the budget will remain in balance in the future, with the reserve rising slightly to $836 million in 1998-99, before declining to $304 million in 1999-00.

Figure 2

LAO Projections of General Fund Condition 1996-97 Through 1999-00

(In Millions)

	1996-97	1997-98	1998-99	1999-00
Prior-year fund balance	$444	$896	$1,220	$1,287
Revenues and transfers	49,325	53,038	55,769	58,356
Total resources available	$49,769	$53,934	$56,989	$59,643
Expenditures	$48,873	$52,714	$55,702	$58,887
Ending fund balance	$896	$1,220	$1,287	$755
Other obligations	$451	$451	$451	$451
Reserve	**$445**	**$769**	**$836**	**$304**

There are three main reasons for this favorable outlook:

- ***Healthy California Economy***. The favorable economic outlook has resulted in healthy underlying revenue increases. As the result of the stronger-than-expected economy and recent federal law changes affecting capital gains taxation, we estimate that revenues will exceed the *1997-98 Budget Act* amount by over $500 million. During the next two years, revenues are forecast to increase by about 5 percent—despite the phase-in of the recently enacted tax reduction.

- ***Falling Caseloads in Health and Welfare.*** We expect caseloads in Medi-Cal and CalWORKs to continue declining over the next two years, holding down growth in overall General Fund spending during this period.

- ***One-Time PERS Payment***. Program spending in the current-year budget was reduced in order to accommodate the one-time $1.2 billion payment to the state's Public Employees' Retirement System (PERS). Since the PERS payment was a one-time obligation, funds that were devoted to this payment will be available in 1998-99 and 1999-00 for other purposes, including the spending and tax-related measures passed this year.

KEY FEATURES OF THE LAO OUTLOOK

The Economy and Revenues

Economy Stronger Than Previously Expected. When enacted, the *1997-98 Budget Act* reflected the consensus view that economic growth in California would slow in line with the national economy during 1998. However, recent positive developments relating to activity involving home construction, aerospace, and other industry sectors suggest that California's economic expansion will continue at near its current pace through next year. We forecast that wage and salary employment will increase by 3.1 percent next year—up significantly from the budget's estimate of 2.3 percent—before moderating to 2.6 percent in 1999 and 2.3 percent in 2000.

Revenue Outlook—Moderate Growth. As noted in Chapter 3, our revenue forecast for 1997-98 assumes that this year's weakness in quarterly estimated tax payments is largely transitory, and that the stronger near-term economy will result in higher revenue collections over the balance of 1997-98. Specifically, we forecast that revenues during 1997-98 will total $53 billion, or $507 million above the *1997-98 Budget Act* estimate. Our forecast takes into account the projected impacts of federal reductions in the maximum tax rate on capital gains, which are expected to translate into $450 million in additional state personal income tax receipts in 1997-98.

For the budget year and year following, we project that California's ongoing economic expansion will result in revenue increases of 5.1 percent in 1998-99 and 4.6 percent in 1999-00.

Our revenue projections reflect the impact of California's recently enacted tax reduction package, which will lower revenues by an estimated $189 million in 1997-98, increasing to over $1 billion when fully phased in during 1999-00.

Budget Outlook for 1997-98

The *1997-98 Budget Act*, enacted in August, assumed total revenues in 1997-98 of $52.5 billion, expenditures of $52.8 billion, and a year-end reserve of $112 million. As indicated above, we now estimate that the current year will close with a reserve of $769 million, $657 million higher than the budget estimate. Key factors responsible for the improved projected year-end balance include:

- ***Higher Revenues.*** As noted above, we estimate that current-year revenues will exceed the budget estimate by $507 million, even after taking account of passage of the state's 1997 tax reduction package. We also note that there have been a number of accrual changes affecting 1996-97 and prior years, which have been largely offsetting.

- ***Medi-Cal Spending Reductions***. Based on significantly lower caseloads and lower costs per eligible beneficiary, we estimate that Medi-Cal expenditures fell below the budget estimate for 1996-97 by $100 million, and that they will fall below the 1997-98 estimate by an additional $281 million, for a two-year savings of $381 million. This lower Medi-Cal spending trend also has a positive impact on our budget estimates for future years.

Partially offsetting these factors are:

- ***Increased K-14 Education Funding.*** Our higher revenue estimates translate into a $63 million increase in the Proposition 98 minimum funding guarantee in 1996-97 and a $220 million increase in 1997-98.

- ***Other Costs***. Based on final Congressional actions, our current estimates reflect lower federal reimbursements for undocumented felons. We also assume additional expenses for fire suppression in 1997-98.

Budget Outlook for 1998-99 and 1999-00

Basis for Our Estimates. Our revenue and expenditure forecasts for 1998-99 and 1999-00 are based on the *requirements of current law*. Specifically, we have adjusted the 1997-98 spending plan for constitutional and statutory requirements, as well as for projected changes in prices and caseloads. In this regard, we have increased K-14 education funding in accordance with the Proposition 98 minimum funding guarantee. (The projected increase in the guarantee will cover the ongoing costs of the recent class size reduction initiatives, enrollment growth and inflation, and allow for modest new spending proposals.)

In the remainder of the budget, we have made specific adjustments to reflect recent agreements reached in the areas of welfare reform, trial court funding, and the Healthy Families Program. Continuation of the higher education "compact" is assumed through 1998-99. And, as noted above, our revenue estimates include the impact of the state's 1997 tax reduction package passed in September.

Our current-law estimates also include the fiscal impacts of the restoration of the renters' credit in 1998, the restoration of certain welfare grant levels and cost-of-living adjustments during the budget year, and a 3 percent cost-of-living adjustment (COLA) for state employee compensation in both 1998-99 and 1999-00. Finally, our spending estimates for 1998-99 assume the payment of the interest portion of the court-ordered PERS payment (estimated to be approximately $300 million).

It is important to note that our fiscal estimates are *not* predictions of what the Legislature and Governor will adopt as policies and funding levels in coming budgets. Nor are they our recommendations of what tax and spending policies ought to be. Rather, our estimates are a "baseline" projection of what would happen if current policies were allowed to run their course. We believe that by using this approach, our projections provide a meaningful starting point for the Legislature's evaluation of the state's fiscal condition, and its assessment of any necessary or desired future changes to California's spending and taxing levels.

Budget Remains in Balance. We estimate that revenue growth during the next two years, in conjunction with available reserves, will be sufficient to cover current-law expenditure increases. As a result, the state's General Fund budget would remain in balance.

The Situation in 1998-99. As indicated in Figure 2, revenues and expenditures in 1998-99 are expected to total $55.8 billion and $55.7 billion, respectively, and the year is projected to close with a reserve of $836 million. As indicated above the budget is affected by numerous factors in 1998-99, including the tax reduction (which will lower revenues by $591 million), the restoration of the renters' credit ($530 million cost), trial court restructuring ($450 million cost), the Healthy Families Program ($88 million cost), and an assumed 3 percent employee pay increase ($150 million cost). However, these factors are largely offset by: reasonably healthy revenue growth; the "room" created by expenditure reductions made in the current year to accommodate the one-time $1.2 billion PERS payment; and declining caseloads in the state's Medi-Cal and CalWORKs (formerly Aid To Families With Dependent Children) programs.

1999-00 Budget Gets Tighter. As shown in Figure 2, current-law expenditures grow about 1 percent faster than revenues in 1999-00, leading to a decline in the size of the year-end budgetary reserve. Revenue growth continues to be affected by the phase-in of the 1997 tax reduction package. The phase-in of welfare-reform-related job and child care services, as well as COLAs and certain grant restorations, cause CalWORKs spending to jump by nearly 16 percent during the year. The net result of these revenue and expenditure changes is that the budget experiences an operating deficit in the year of about $530 million, which explains why the year-end reserve shrinks.

It should be noted that expenditures for CalWORKs are projected to peak in 1999-00 and decline from 2000-01 through 2004-05. Partly for this reason, the operating deficit in 1999-00 is not necessarily indicative of an emerging structural problem.

What If Economy Underperforms?

It is important to keep in mind that our estimates assume continued moderate economic and revenue growth over the next three years. If the state were to experience a downturn, or even a material slowdown, revenues would fall significantly below our projections while expenditure demands would increase. (The latter is especially true in the health and welfare areas, where falling caseloads in recent years have significantly contributed to the General Fund's improvement.) The modest reserve projected for 1999-00 would cover only a small share of the shortfall that would develop in such an instance. Under these circumstances, significant corrective actions would be needed to keep the General Fund "out of the red."

IMPLICATIONS OF OUR PROJECTIONS

Our projections imply a positive outlook for the state's General Fund during the next two years. Assuming continued economic and revenue growth, the Governor and Legislature will be able to fully fund the commitments made earlier this year, *plus* all of the other requirements of current law, and still maintain a modest reserve through the end of the decade.

Given the modest reserve, major new proposals would require making trade-offs within the current-law budget. We believe it is important to focus on issues having significant implications for the state's long-term fiscal health. Among these are investment in new capital facilities, maintenance of the existing public infrastructure, restructuring of the state-local fiscal relationship, and maintenance of an adequate budgetary reserve fund.

Chapter 2

Economic and Demographic Projections

The economic and demographic outlooks play important roles in determining the state's fiscal condition, through their effects on revenues as well as on caseloads and various other factors affecting the costs of state programs. This chapter presents our economic and demographic projections for 1997 through 2000, which will influence the state's fiscal condition in 1997-98, 1998-99, and 1999-00.

THE ECONOMIC OUTLOOK

We forecast that California's economic expansion will continue near its current healthy pace through 1998, before moderating in 1999 and 2000. We expect virtually all major industries and geographic regions to participate in California's expansion during this period. Figure 1 summarizes our U.S. and California economic outlooks.

Figure 1

LAO Economic Forecast

Percent Change (Unless Otherwise Indicated)

	1997	1998	1999	2000
United States				
Real GDP	3.7	2.3	2.2	2.5
Wage and salary jobs	2.2	2.0	1.4	1.2
Consumer Price Index	2.4	2.3	2.8	3.1
Unemployment rate (%)	5.0	4.9	5.2	5.3
Housing starts (millions)	1.45	1.42	1.41	1.38
California				
Personal income	6.7	6.4	5.8	5.6
Wage and salary jobs	3.4	3.1	2.6	2.3
Consumer Price Index	2.2	2.5	2.7	3.1
Population	1.4	1.7	1.8	1.8
Unemployment rate (%)	6.4	5.7	5.5	5.4
Housing permits (thousands)	107	132	144	148

Recent Developments

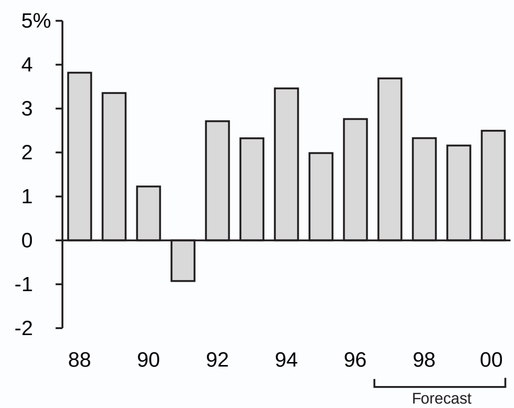
Economic Gains Surpass Expectations. Both the U.S. and California economies grew faster than expected during the past year. California added approximately 400,000 jobs between the fourth quarter of 1996 and the fourth quarter of 1997, reflecting major gains in high-technology manufacturing and service industries, as well as improvements in two industries that had lagged so far in the current expansion—aerospace and finance. A key positive development for late 1997 has been the improvement in the state's real estate markets. Home sales, prices, and new construction are now increasing in most regions of the state.

Unemployment and Inflation Rates Are Down. As a result of ongoing economic growth, both the national and California unemployment rates continued to fall in 1997. As of September 1997, the California rate stood at 6.3 percent, down from 7.1 percent 12 months earlier. The U.S. rate is now down to 4.7 percent, which is near its lowest level in three decades. Despite the tightness in national labor markets and other signs that the U.S. economy is operating at near full capacity, wage and price pressures have not yet emerged. In fact, most measures of inflation fell in 1997 relative to 1996. For example, the U.S. Consumer Price Index (CPI) rose just 2.2 percent between September 1996 and September 1997, down from the prior-year increase of 2.6 percent.

Figure 2

U.S. Economy Expected to Slow To Sustainable Pace

Percent Change in Real GDP



The National Outlook

Slowing But Sustained Growth. We project that the U.S. economy will experience moderate growth with continued low inflation over the next three years. As shown in Figure 1 and Figure 2, we forecast that U.S. Gross Domestic Product (GDP) growth will slow from 3.7 percent in 1997 to between 2 percent and 2.5 percent per year through the end of the decade. The projected slowdown is consistent with the consensus of economic forecasters, which believe that with the economy operating at near full capacity, 2 percent to 2.5 percent growth is the maximum that can be sustained without a significant acceleration in inflation.

Consumer expenditures and business spending on capital equipment are expected to be the main forces behind the continued expansion, reflecting high confidence levels as well as the continued emphasis on investments in new technologies.

Inflation to Remain Low. Figure 1 also shows that we forecast that inflation will remain low. After dipping to just 2.3 percent in 1998, the U.S. CPI is projected to rise slowly to 3.1 percent by the year 2000. This outlook assumes some acceleration in wages, but it also assumes that strong foreign competition will limit the ability of domestic businesses to significantly raise product prices over the next several years.

Stock Market Turmoil Poses Risk. The recent volatility in the stock market is not expected to have a major impact on the national economy. Even with the declines experienced in late October and early November, the market remains significantly above its level at the beginning of 1997. However, further declines of a sufficient magnitude could depress consumer and business wealth, confidence, and ultimately, spending in the U.S. economy. As of mid-November, a wide diversity of opinion existed as to the market's likely future course, especially in the near term, ranging from continued expansion to significant downward corrections.

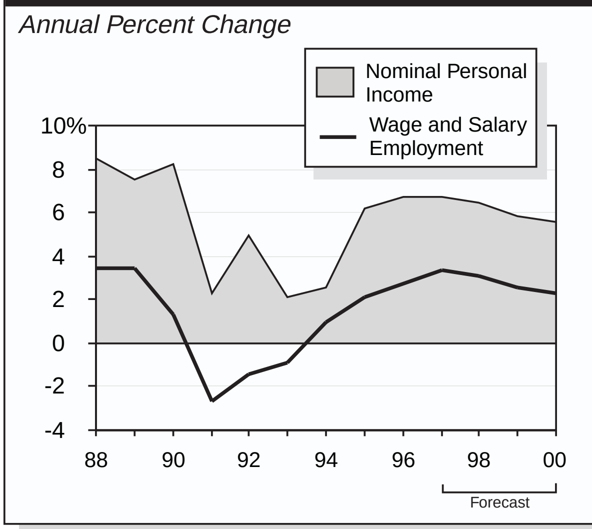
California Outlook

Healthy Growth to Continue. In contrast to the nation, we expect economic growth in this state to continue near its current pace in 1998 (see Figure 3). For example, wage and salary employment is projected to increase by 3.1 percent next year, down only slightly from 3.4 percent in the current year. The continued healthy growth is partly due to the upturn in residential construction, which will give an added boost to California's economy in 1998.

Our forecast assumes that employment and income growth will moderate a bit more in 1999 and 2000, as the state's economic expansion matures and the impact of a slowing U.S. economy takes effect. However, we project that California will continue to grow faster than the nation as a whole, reflecting the ongoing beneficial effects of the upturn in home construction and the continued growth in the state's high-technology manufacturing and services sectors.

Figure 3

California Income and Employment Growth to Continue



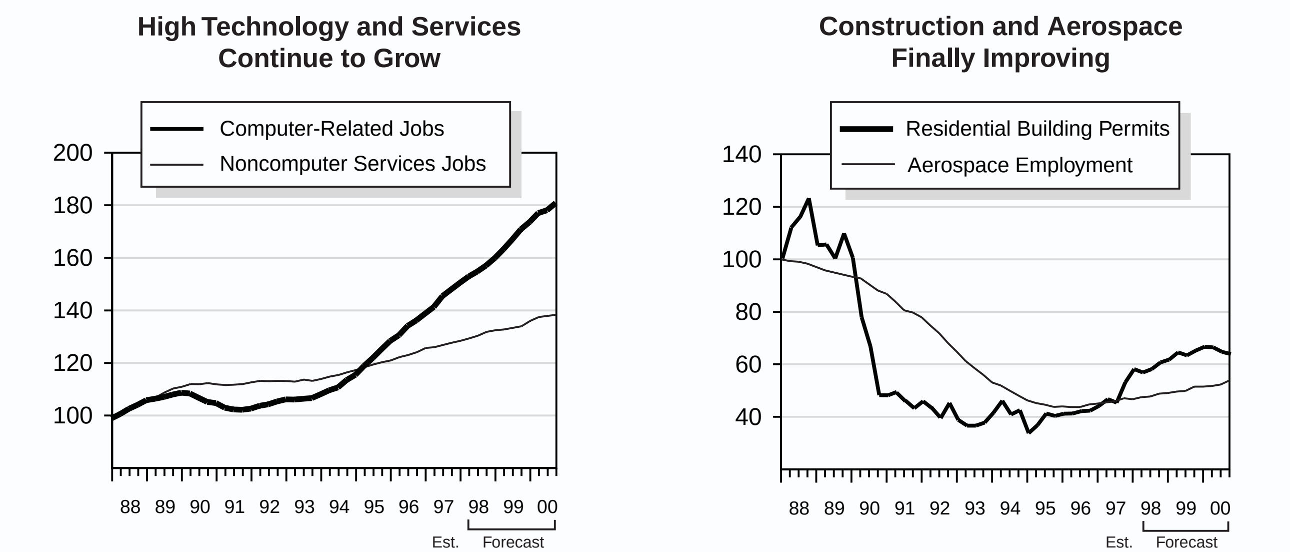
State's Expansion Broadening. The California economic expansion continues to broaden, both in terms of industries and geographic regions that are contributing to the overall growth in the state.

In terms of industries, Figure 4 (see next page) shows that employment in the state's high-technology manufacturing and services sectors is expected to continue growing at a healthy pace over the next three years, moderating only slightly from the recent past. Growth in these sectors will be joined in 1998 and beyond by significant increases in two industries that have lagged in the current economic expansion—aerospace and residential construction activity.

Figure 4

Economic Expansion Broadening in California

Indexed to 1988 = 100



Aerospace Stabilizing. After declining dramatically for several years in the early 1990s, aerospace employment has finally turned the corner, and is now growing modestly again. The growth in this sector partly reflects expanding production of commercial aircraft and parts in this state, as well as a stabilization of defense-related contract spending. While this sector is expected to recoup only a fraction of the jobs lost in the previous decade, the gains will give an added boost to California in the late 1990s.

Home Construction Picking Up. A key positive factor for California's economy in 1998 is the outlook for growing home construction activity. Based on improving home sales and an upturn in home prices, we forecast permits for new construction to increase 14 percent this year, to 107,000 units, before growing further to 132,000 units in 1998 and 144,000 units in 1999. Although these totals are still well below those of the 1980s, when permits for new construction averaged more than 200,000 per year, the gains have positive implications for both the economy and revenues. For example, increased home construction will boost state sales tax receipts related to the sales of building materials, home furnishings, appliances, and other home-related goods.

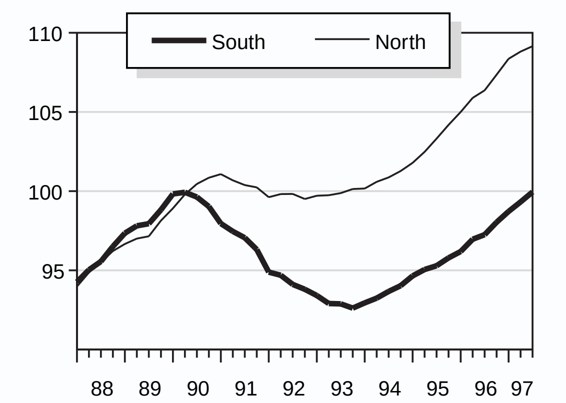
Regional Economic Growth

Figure 5 compares the relative performance of the northern and southern California regions during the recent recession and subsequent recovery. The recession hit southern California much harder than the northern part of the state. This was due partly to the greater impact of the declines in housing construction and aerospace in that region. In addition, the figure shows that the north also emerged from the recession earlier, reflecting the rapid growth in commercial electronics in the San Francisco Bay Area. However, the southern California economy has gained some momentum over the past year, reflecting balanced growth in many industry sectors. As shown in Figure 5, the southern California economy, although still less robust than the north, has finally recouped the jobs lost in the 1990s' downturn.

Figure 5

South Has Recouped Recessionary Losses—All Regions Now Expanding

Employment Level (Indexed to 1990 = 100)



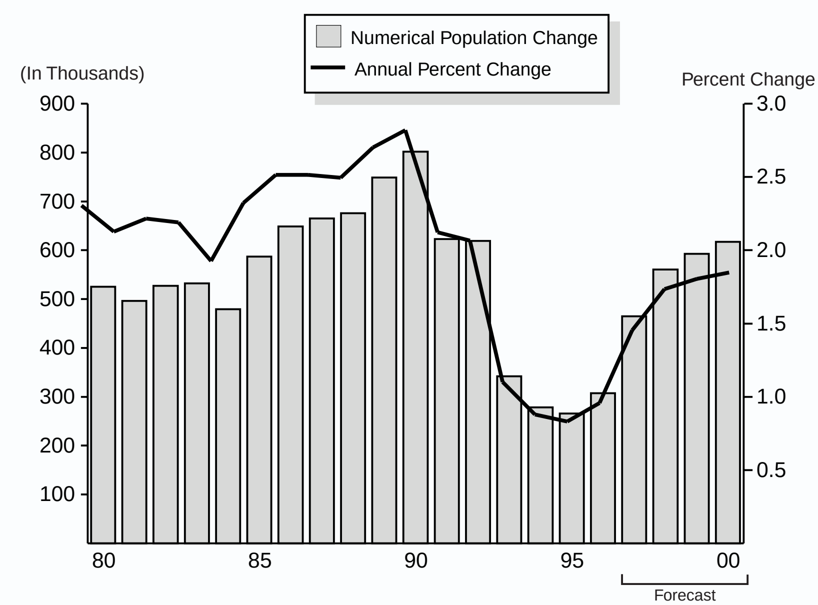
We expect that economic growth in the two regions will converge over the next two years, with the north moderating some from its recent pace, and the south continuing to accelerate.

THE DEMOGRAPHIC OUTLOOK

We project that California's population will expand over the next three years at an annual average rate of almost 1.8 percent. This is shown in Figure 6, which presents our forecasts for population growth in both percentage and numerical terms. While our pro-

Figure 6

California's Population to Grow Moderately



jected growth is well above the pace of the recession-plagued first half of the 1990s, it is well below the 2.5-plus percent average of the rapid-growth years during the latter half of the 1980s. Numerically, we are projecting that California will add an average of close to 590,000 persons annually during the three-year period, with total population reaching more than 34.6 million in 2000.

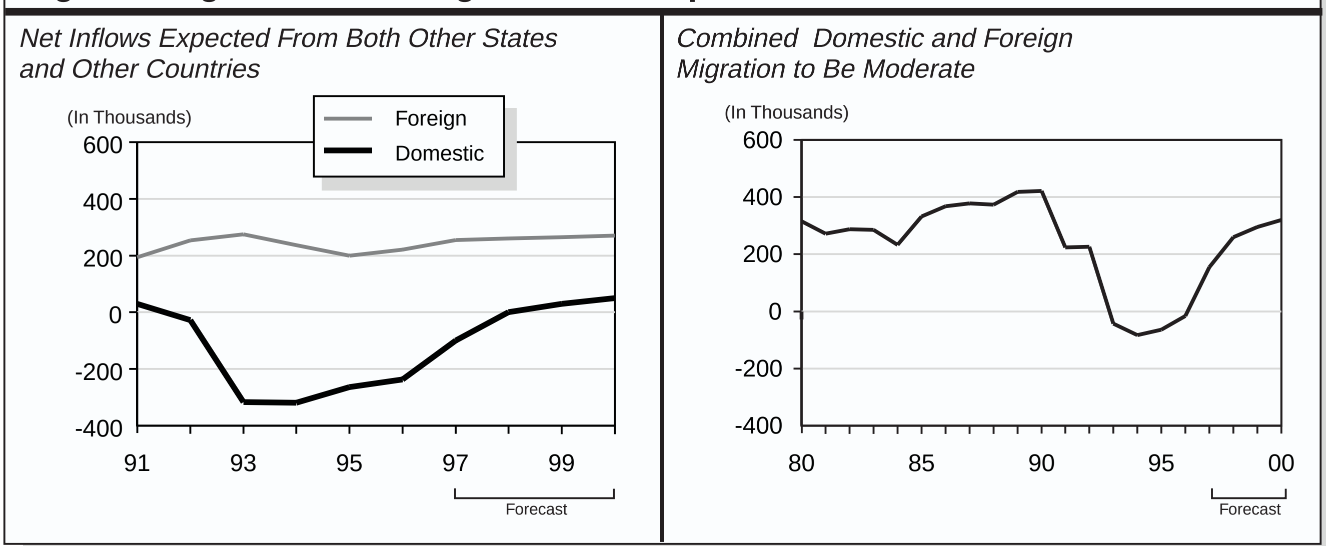
Population Growth Components. A state's population growth can be broken down into two main components—*natural increase (*births minus deaths) and *net migration* (persons moving *into* California from other states and countries, minus people *leaving* the state for other destinations). We project that natural increase will average close to 300,000 annually, while net migration will average somewhat over 290,000 annually.

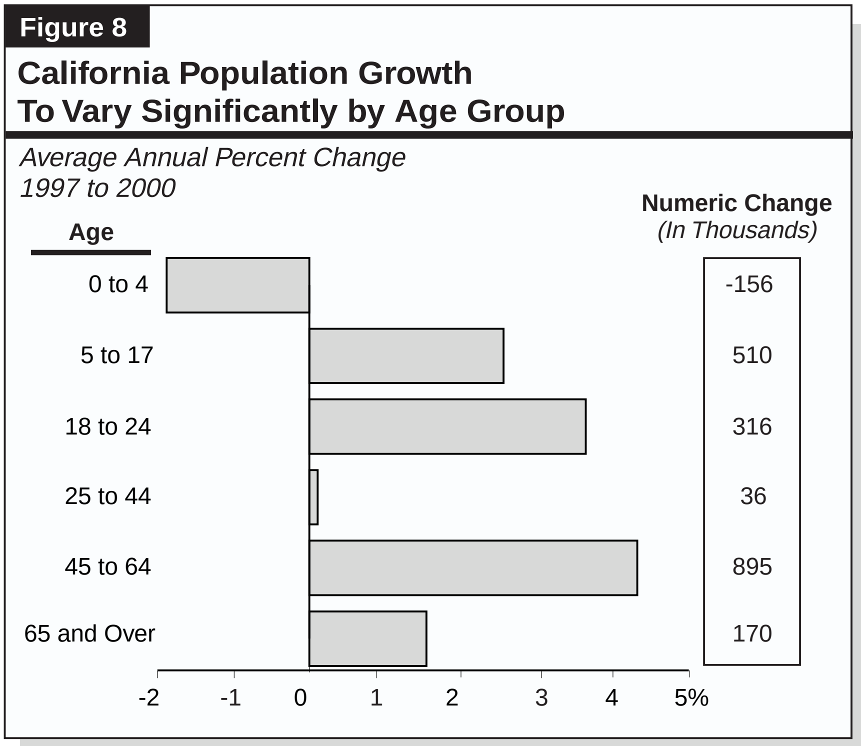
Net Migration Rebounding. Figure 7 shows our forecast for net migration and its two major components—net *domestic* migration (population flows between California and other states) and net *foreign* migration (population flows between California and other nations). It indicates that total net migration (right panel) is projected to rebound to close to its prerecession level by the end of the forecast period. The primary reason involves a sharp turnaround in net domestic migration (left panel). Specifically, we forecast that net domestic migration will turn positive after 1998, compared to net population outflows to other states in excess of 300,000 at the depth of the recession.

Growth to Vary by Age Group. Figure 8 shows our population growth projections by age category, in terms of both percentage and numerical change. The most rapidly growing groups are the 45-to-64 age group and K-12 school-age

Figure 7

Migration Again Contributing to Overall Population Growth





children (aging baby boomers and their children). These various age-group projections have significant implications for state expenditures in many different program areas, including education, health, and welfare. For example, population growth in the 5-to-17 and 18-to-24 age groups influence K-12 and higher education enrollments.

Chapter 3

Revenue Projections

We expect that California's ongoing economic expansion will result in moderate General Fund revenue growth through 1999-00.

Current-Year Revenues. As indicated in Figure 1, we estimate that revenues and transfers in the current year will total $53 billion, a 7.5 percent increase from 1996-97. Our current estimate is up $507 million from the *1997-98 Budget Act* estimate.

Revenues in the Budget Year and 1999-00. Figure 1 also shows that we project revenues to increase to $55.8 billion in 1998-99 and $58.4 billion in 1999-00. Overall, we project that revenues will increase at an average annual rate of 5.8 percent between 1996-97 and 1999-00. Our estimates take into account our updated economic projections, as well as the estimated impacts of (1) the recent federal income tax rate reduction on capital gains and (2) California's tax reduction package adopted in September, which phases in beginning in 1997-98.

Figure 1

LAO General Fund Revenue Projections

(Dollars in Millions)

Revenue Source	1996-97	1997-98	1998-99	1999-00
Personal income tax	$23,400	$26,150	$27,700	$28,900
Sales and use tax	16,480	17,450	18,430	19,410
Bank and corporation taxes	5,840	5,950	6,300	6,600
All other sources	3,605	3,488	3,339	3,446
Totals, revenues and transfers	**$49,325**	**$53,038**	**$55,769**	**$58,356**
Annual percent change	6.5%	7.5%	5.1%	4.6%

Recent Cash-Revenue Trends

Total General Fund revenue receipts during the July through October period were down by $210 million from the budget estimate, primarily due to lower-than-expected quarterly estimated payments toward personal and corporate 1997 income tax liabilities.

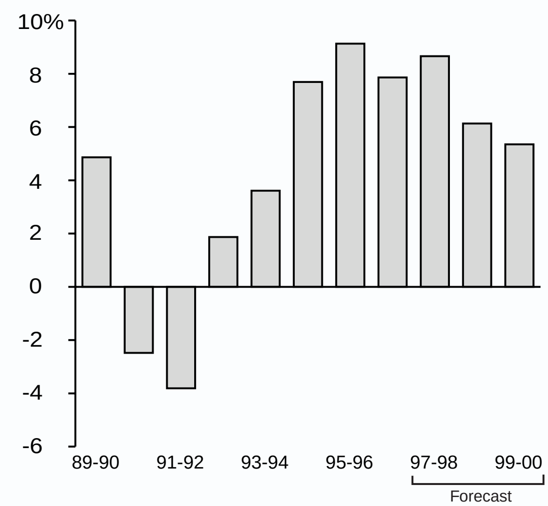
At this point, we are assuming that most of the softness from these sources is due to the normal volatility in the month-to-month timing pattern of estimated payments, as opposed to any unexpected, fundamental weakness in investment income or business earnings that underlie such payments. The main reasons for this view are (1) the documented strength of the economy and (2) the fact that withholding and sales tax payments—which normally are good indicators of current economic activity—exceeded the budget estimate during the first four months of this fiscal year.

Underlying Revenue Growth Forecast To Remain Healthy

To provide a picture of the underlying revenue trend, Figure 2 shows the year-to-year change in revenues adjusted to remove the impacts of legislation passed since 1990, including the tax reduction package passed in September. It shows that the state's overall revenue performance has closely followed the changes in California's economy. After declining during the early 1990s' recession, revenues bounced back in line with California's economic recovery. Consistent with our economic outlook, we project that underlying revenue growth will continue at a healthy though moderating pace over the next three years.

Figure 2

Underlying General Fund Revenue Growth[a]



[a] General Fund revenues excluding transfers and the effects of revenue-related legislation enacted in the 1990s.

California's 1997 Tax Reduction Package

In September, the Governor signed legislation that reduces individual and corporate income taxes by a combined total of $189 million in 1997-98, $593 million in 1998-99, and $1.1 billion in 1999-00 (when its provisions are fully phased in). As indicated in Figure 3, the majority of the ongoing fiscal impact from this tax package is related to an increase in the dependent exemption credit claimable on personal income tax returns. Specifically, the per-dependent exemption credit will rise from $68 in 1997 to $120 in 1998 and to $222 in 1999.

The provisions of the tax package are described more fully in *California Spending Plan for 1997-98,* which our office released in October 1997.

MAJOR REVENUE SOURCES

As indicated in Figure 1, the majority of General Fund revenues are from the personal income, sales and use, and bank and corporation taxes. These three sources are estimated to account for about 93 percent of total revenues in 1997-98.

Personal Income Tax

The personal income tax (PIT) is California's single largest state General Fund revenue source, accounting for 49 percent of total estimated receipts in 1997-98. This tax has marginal tax rates ranging from 1 percent to 9.3 percent, depending on a taxpayer's income level.

PIT Liabilities. As indicated in Figure 4 (see next page), PIT liabilities have increased by an average of 11.9 percent during the past three years. These gains partly reflect the general increases in employment and personal income that have occurred in California, but also are due to rapid increases in capital gains, dividend income, bonuses, and business receipts. These forms of income accrue primarily to high-income taxpayers, who are subject to the highest marginal income tax rates.

We forecast that PIT liabilities over the next couple of years will continue to grow, although at a pace which is more in line with the growth we project for California personal income generally. Our expectation of a somewhat reduced rate of liability growth is partly related to the outlook for a mild slowdown in annual personal income gains. It also reflects our assumption that a relatively smaller share of the income gains will be from above-average increases in bonuses, capital gains, and other forms of income subject to high marginal income tax rates.

Revenue Forecast. Based primarily on our forecast of PIT liabilities, we currently estimate that fiscal-year PIT collections will total $26.1 billion in 1997-98, an 11.8 percent increase from 1996-97. Our current projection is up $628 million from the *1997-98 Budget Act* forecast. We further project that PIT revenues will expand to $27.7 billion in 1998-99, and to $28.9 billion in 1999-00. The revenue estimates for 1997-98 through 1999-00 reflect the impact of the recently

Figure 3

Fiscal Effects of 1997 Tax Relief Package

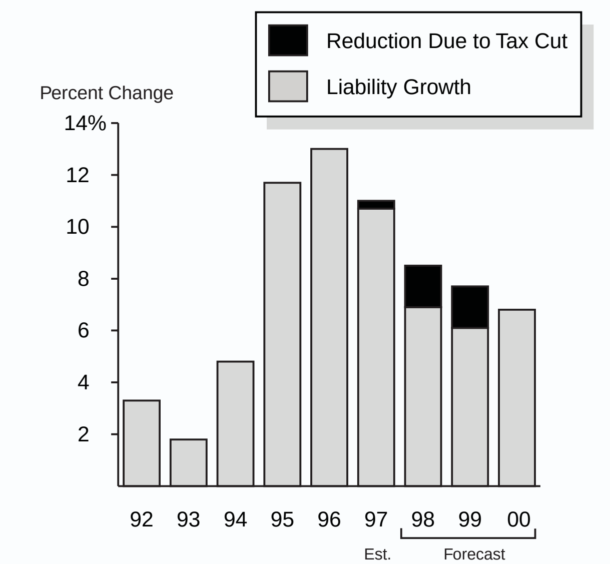
(In Millions)

	1997-98	**1998-99**	**1999-00**
Increase in PIT dependent exemption credit	-$15	-$295	-$780
Change in calculation of research & development credit	-63	-58	-48
Capital gains exclusion on sales of principal residences	-25	-110	-70
Alternative Minimum Tax (AMT) exemption increase and indexing	-44	-74	-85
Subchapter S corporation conformity to federal law	-18	-21	-22
Other provisions[a]	-24	-35	-81
Total	**-$189**	**-$593**	**-$1,086**

[a] Includes conformity to federal law regarding Roth Individual Retirement Accounts (IRAs) and Education IRAs, corporate prepayment rules, and various amortization rules.

Figure 4

PIT Liability Growth To Be Moderate



enacted tax reduction package discussed above, as well as the impact of the recent federal tax rate reduction on capital gains, which we estimate will increase state PIT revenues by $450 million in 1997-98 and by $250 million annually through the remainder of the forecast period.

Sales and Use Taxes

Sales and use taxes represent the second largest General Fund revenue source, accounting for about 33 percent of total estimated revenues in 1997-98. (When state special fund and local sales tax receipts are counted, the sales and use tax is California's largest overall revenue source.)

The state sales and use tax rate is a combined 6 percent, which includes a 5 percent General Fund rate and a 1 percent rate allocated to special funds. Additional local rates ranging from 1.25 percent to 2.5 percent are imposed by cities, counties, and transportation districts, bringing the combined state-local tax rate to between 7.25 percent and 8.5 percent, depending on the county involved.

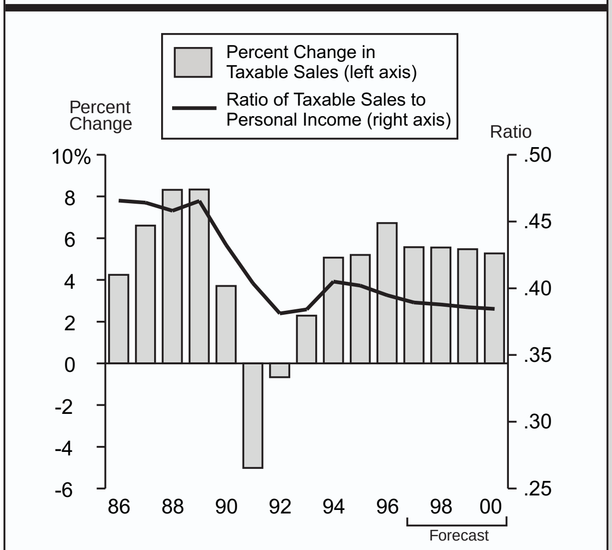
The key factor determining the level of sales and use tax receipts is the strength of taxable spending by consumers and businesses in California. As shown in Figure 5, taxable sales fell sharply during the early 1990s' recession, but have recovered during the subsequent economic expansion. We forecast that taxable sales will continue to expand over the forecast period, increasing by 5.6 percent per year during both 1997 and 1998, before moderating slightly to 5.5 percent in 1999 and 5.2 percent in 2000.

Despite the taxable sales gains projected for the next three years, the share of total personal income devoted to taxable spending is expected to fall slightly over the next three years. The declining share reflects the ongoing shift in share of total consumption away from commodities and toward services (which are not generally taxable).

Revenue Forecast. Based on our projections for taxable sales, we estimate that General Fund sales and use tax receipts will total $17.5 billion in the current year, representing a 5.9 percent increase from 1996-97. This estimate is $120 million above the *1997-98 Budget Act* forecast, reflecting slightly stronger economic growth in late 1997 and early 1998 than was previously assumed. We project that sales and use tax re-

Figure 5

Taxable Sales to Grow Slightly Slower Than California Personal Income



ceipts will grow to $18.4 billion in 1998-99, and further to $19.4 billion in 1999-00.

Bank and Corporation Taxes

Bank and corporation taxes are the General Fund's third largest revenue source, accounting for about 11 percent of total receipts in the current year. The current tax rate applied to the net income of corporations is 8.84 percent. Banks and other financial institutions are subject to an add-on tax rate of 2 percent, which is in lieu of certain local taxes.

The key determinant of bank and corporation tax revenues is California taxable profits. (We note, however, that tax receipts in recent years have been significantly influenced by a number of other factors, including large audit-related collections and certain tax law changes.)

California taxable earnings fell sharply in the recession, but bounced back during the early stages of the current economic expansion, growing by as much as 19 percent in 1995. Over the past year, profit growth has subsided some. Although underlying business sales and earnings appear to have been strong, total earnings were affected by one-time charges against earnings related to restructurings in the state's finance and utility industries. As a result, profits grew by an estimated 8 percent in 1996, or about one-half the rate of the prior year. We expect profit growth to continue to moderate over the next three years, increasing at an average annual rate of 5.5 percent between 1997 and 2000.

Revenue Forecast. We project that bank and corporation tax revenues will total $6 billion in 1997-98, a 1.9 percent increase from the prior year. Our current estimate is $78 million below the *1997-98 Budget Act* estimate. The small gain from the prior year reflects the impact of both the tax-rate reduction that took effect in January 1997, and the tax package enacted in September of this year. We project that bank and corporation tax receipts will continue to grow in the following two years, reaching $6.3 billion in 1998-99 and $6.6 billion in 1999-00.

Other Revenues

We estimate that revenues from all other sources, including insurance premiums taxes, estate taxes, tobacco and alcohol-related taxes, interest earnings, and a variety of fees, will decline slightly—from $3.6 billion in 1996-97 to $3.3 billion by 1998-99—before turning upward in 1999-00. The main reason for the decline between 1996-97 and 1998-99 is the reallocation of trial court revenues from the General Fund to a trust fund, beginning in the current year. The shift will lower both General Fund revenues *and* expenditures by over $300 million when fully phased in during 1998-99.

Alternative Outlooks

There are three main factors that could cause revenues to differ significantly from our forecasts for 1997-98 through 1999-00. The first is the economy's performance. As discussed in Chapter 2, we are assuming that the state's economy will continue to expand over the next few years, although at a slightly moderating pace in 1999 and 2000. Should the economy fail to grow as we expect, revenues could come in significantly weaker than our forecast. For example, under a mild economic slowdown, the revenue drop-off could be several hundred million dollars. Under a severe slowdown or recession the drop-off would be much larger, possibly in the billions of dollars.

A second uncertainty relates to taxpayer responses to recent federal law changes relating to capital gains. Specifically, our forecast assumes that the reduction in the maximum federal tax rate on such gains from 28 percent to 20 percent will result in a moderate increase in capital gains realizations in 1997 and beyond. Our estimates assume that the increased level of these realizations will translate into a $450 million increase in PIT receipts in 1997-98 and approximately $250 million annually through the remainder of the forecast period. These assumptions are somewhat conservative relative to those used by federal revenue estimators in preparing fiscal estimates of the federal implications of the rate reduction. If the increase in realizations turns out to be more in line with the federal assumptions, 1997-98 revenues would be $250 million more than our estimate.

A third, and more general, uncertainty relates to the compositional characteristics of recent and projected taxable income growth in California. As indicated above, much of the extraordinary increases in the PIT during the past two years has been related to major increases in capital gains, investment earnings, and bonuses. Unexpected strength or weakness in these extremely volatile taxable income components could cause revenues to be several hundred millions of dollars higher or lower than our projections—even if our overall estimates of economic growth turn out to be correct.

Chapter 4

Expenditure Projections

In this chapter, we present and discuss our General Fund expenditure projections for 1997-98 through 1999-00, both in the aggregate and by individual program areas.

Methodology and Assumptions

Our projections are based on the following methodology and underlying assumptions:

- ***Current Law.*** As noted in Chapter 1, our projections assume the requirements of current law, including restorations of certain welfare grants and cost-of-living adjustments (COLAs), and the renters' tax credit. The estimates include the impact of the recent agreements affecting trial court funding and children's health care. Our expenditure projections for K-14 education meet the minimum funding requirements of Proposition 98 and incorporate repayments of past Proposition 98 loans consistent with the settlement of *CTA vs. Gould*.

- ***LAO Caseload/Enrollment Projections.*** Spending projections for programs driven by caseload or enrollment growth are based on our projections of that growth.

- ***Adjustments for State Operations.*** As discussed in Chapter 1, our projections assume a state employee cost-of-living increase of 3 percent effective both July 1, 1998 and July 1, 1999. Apart from this, for most state operations programs, we have applied a growth adjustment equivalent to the state / local price deflator in lieu of making specific price and workload adjustments. The adjustments we used for this purpose were in the mid-2 percent range, depending on the year involved.

PROJECTIONS OF TOTAL GENERAL FUND SPENDING

Figure 1 (see next page) presents our General Fund spending projections, both in the aggregate and by major program area. As shown, projected total General Fund spending grows from

$48.9 billion in 1996-97 to $52.7 billion in 1997-98, $55.7 billion in 1998-99, and $58.9 billion in 1999-00. This amounts to an annual average growth rate between 1996-97 and 1999-00 of 6.4 percent.

Figure 1

Projected General Fund Spending for Major Programs[a]

(Dollars in Millions)

	1996-97	Projected 1997-98	Projected 1998-99	Projected 1999-00	Projected Annual Growth
Education programs					
Proposition 98/K-14 education	$20,153	$22,266	$23,905	$25,079	**7.6%**
Higher education—UC/CSU	3,687	3,930	4,194	4,354	**5.7**
Health and Welfare programs					
Medi-Cal benefits	6,380	6,312	6,372	6,663	**1.5**
CalWORKs	2,842	2,485	2,610	3,028	**2.1**
SSI/SSP	2,021	2,029	2,090	2,172	**2.4**
Selected other programs	2,048	2,380	2,724	3,058	**14.3**
Department of Corrections	3,284	3,471	3,692	3,926	**6.1**
Debt service[b]	2,315	2,285	2,516	2,750	**5.9**
Other programs/costs	6,143	7,556	7,599	7,857	**8.5**
Totals	**$48,873**	**$52,714**	**$55,702**	**$58,887**	**6.4%**

a Detail may not add to totals due to rounding.
b Includes both general obligation and lease-payment bonds.

Spending by Program Area

Figure 2 shows the current distribution of General Fund spending, by major program area. It indicates that slightly less than three-fourths of total 1997-98 General Fund spending is devoted to education, health, and social services, with education alone accounting for nearly half. Given this, spending trends in these three major program areas have significant implications for overall General Fund spending levels.

Faster-Growing Program Areas

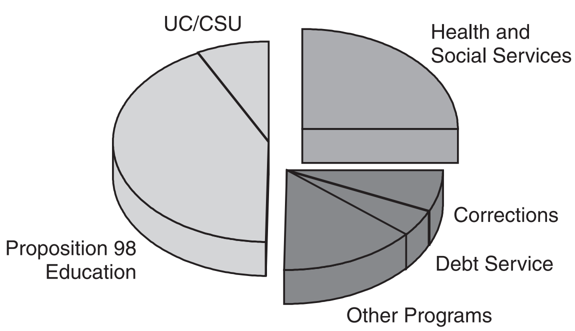
Proposition 98. Almost half of the total General Fund spending increase we project over the forecast period is for Proposition 98 K-14 education. This is the largest single category of General Fund spending, accounting in 1997-98 for 42 percent of the total. Figure 1 shows that the amount of state funding required to meet the Proposition 98 minimum guarantee grows relatively rapidly during the forecast period—an average annual growth of 7.6 percent—reflecting a large increase in 1997-98, and more moderate gains in future years. In addition to Proposition 98 spending, other areas of above-average growth include:

- ***Corrections.*** We forecast that support costs for the Department of Corrections would experience an underlying annual growth rate of 6.1 percent in order to accommodate projected increases in the prison population. However, federal funds in support of incarcerating undocumented felons, that help fund these support costs, are projected to *decline* during

Figure 2

Education, Health and Social Services Account for Three-Fourths of Spending

General Fund by Program 1997-98



the forecast period. After adjusting for this, the growth in state General Fund costs is projected to average 9 percent.

- ***Selected Health and Social Services Programs.*** The portion of General Fund spending in this area—excluding Medi-Cal, California Work Opportunity and Responsibility to Kids (CalWORKs) (formerly Aid to Families with Dependent Children [AFDC]), and Supplemental Security Income/State Supplementary Program (SSI/SSP) which are discussed below—is projected to increase at an average annual rate of 14.3 percent during the forecast period. This reflects the implementation of the Healthy Families Program, as well as large increases in Foster Care, Child Welfare Services, and In-Home Supportive Services.

- ***The "All Other" Category.*** The above-average growth displayed in this category reflects a combination of factors, including the restoration of the renters' credit and increases in trial court funding.

Program Areas With Slow or No Growth

Figure 1 indicates that program areas with below-average projected spending growth include:

- ***Medi-Cal.*** The below-average 1.5 percent annual average growth in the projected cost of Medi-Cal benefits results from projected declines in Medi-Cal recipients and modest increases in the costs per eligible recipient.

- ***CalWORKs.*** Annual average spending on CalWORKs increases by 2.1 percent between 1996-97 and 1999-00. However, spending for this program actually *declines* in 1997-98, before increasing during the two subsequent years. The drop-off in 1997-98 primarily reflects a sharp decline in caseloads.

- ***SSI/SSP.*** These expenditures are projected to experience a 2.4 percent annual average growth over the forecast period. This reflects relatively slow growth in SSI/SSP cases.

We next discuss in greater detail our projections for spending in major program areas.

HEALTH AND WELFARE

CalWORKs

Federal welfare reform legislation replaced the AFDC program with the Temporary Assistance for Needy Families (TANF) program. Assembly Bill 1542 (Ducheny, Ashburn, Thompson, and Maddy) created the CalWORKs program, which is California's version of the TANF program. The CalWORKs program provides cash grants and welfare-to-work services to low-income families with children. (For a description of the program, please see our October 1997 report *California Spending Plan 1997-98*.)

The Spending Forecast. General Fund spending in 1997-98 for the CalWORKs program (including child care within the Department of Social Services [DSS]) is estimated to be $2.5 billion, a reduction of 13 percent from the prior year. General Fund spending is projected to increase by 5 percent in 1998-99 and 16 percent in 1999-00. These increases will occur, despite continued caseload declines, because of increased costs for welfare-to-work services and the restoration of the 4.9 percent statewide grant reduction and the statutory COLA in November 1998. In comparison, expenditures increased by about 3 percent in 1994-95 and *decreased* by about 1 percent in 1995-96.

Key Forecast Factors. Federal welfare reform and the CalWORKs program made extensive changes in California's welfare system for families with children. As with any new program, multi-year expenditure projections for CalWORKs are potentially subject to a significant margin of error. This is because of uncertainty surrounding the program—for example, the pace at which counties will implement it, how certain program provisions (such as county fiscal incentive payments for meeting performance standards) will be implemented, and the behavioral impact of the policy changes on recipients.

For 1997-98, General Fund expenditures are down 13 percent from 1996-97 primarily due to savings from (1) a declining caseload, (2) the full-year impact of the statewide and regional 4.9 percent grant reductions, and (3) modifications to the income disregard system for determining grant levels. These savings were partially offset by increased costs for welfare-to-work services and child care.

Even with this decline in General Fund expenditures, we project that combined federal and General Fund monies are over-budgeted in the current year because counties appear to be implementing the program more slowly than assumed in the budget. Nevertheless, General Fund spending is likely to remain at the budget act appropriation level in order to satisfy the federal maintenance-of-effort spending floor. This can be achieved by spending General Fund monies ahead of federal funds and rolling over any unspent federal funds into subsequent years. (We note that funding for welfare-to-work services was provided to the counties in the form of a block grant, and any unexpended funds may be rolled over until July 1, 2000.)

For 1998-99, we project that even though caseloads will continue to decline, General Fund spending will increase by $125 million. Increased costs include welfare-to-work services and child care ($900 million), restoration of the 4.9 percent grant reduction ($132 million), and resumption of the statutory COLA ($75 million). State savings include an estimated $223 million in federal TANF funds that are carried over from 1997-98 and offset General Fund costs. Other savings include a caseload reduction ($277 million) and the full-year impact of modifications to the income disregard system ($135 million).

In 1999-00, we project that spending will increase by $418 million because costs for employment services, county fiscal incentive payments, and the full-year impact of the 4.9 percent grant restoration and COLA will exceed projected grant savings from declining caseloads and increased earnings by CalWORKs recipients.

All of these spending projections exclude any potential federal penalties under the federal Welfare Reform Act.

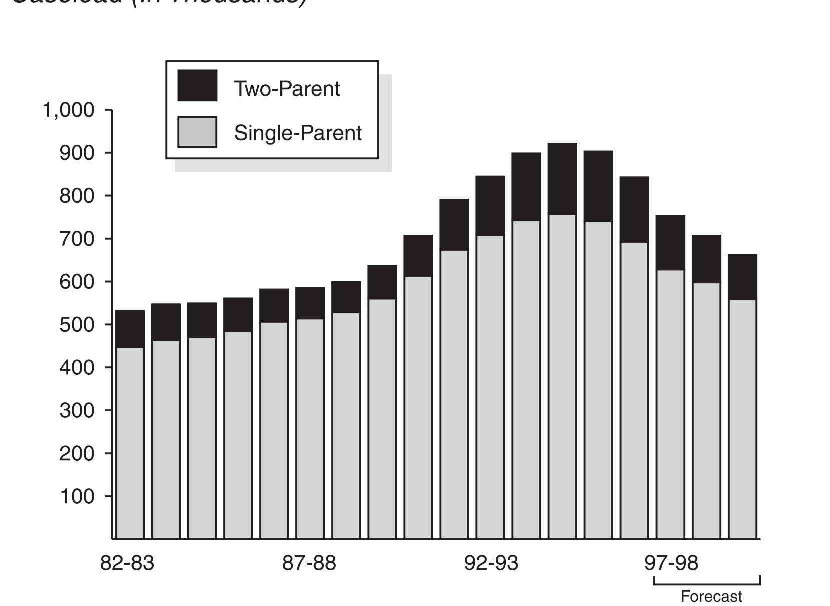
Caseload Trends and Projections. Following a period of rapid increase in the early 1990s, the caseload peaked at 921,000 in 1994-95 and has since declined by 2 percent in 1995-96 and 6.7 percent in 1996-97. About two-thirds of the recent decline in welfare caseloads can be explained by demographic trends and the current economic expansion. Other factors that may explain the balance of the sharp caseload decline include (1) an "announcement effect" of federal and state welfare reform that affects behavior prior to policy implementation, and (2) a labor market effect whereby welfare recipients benefit more as the economy approaches full employment (where the supply of labor is more scarce) compared to the early stages of economic recovery.

Figure 3 shows our caseload projections for 1997-98 through 1999-00. The figure shows that the caseload will decline by 11 percent in 1997-98, 6.1 percent in 1998-99, and 6.7 percent in 1999-00. These projections are based on (1) a trend analysis of caseloads, birth rates, and unemployment rates; (2) an assumption that other contributing factors to the caseload decline will continue (but at a reduced rate); and (3) an estimate of the impact of additional welfare-to-work services.

Figure 3

TANF/CalWORKs Caseloads Declining

Caseload (In Thousands)



Potential Availability of Proposition 98 Funds for Child Care. In 1998-99 and 1999-00, we project that net annual General Fund costs for child care will exceed $600 million in the DSS budget. This assumes that less than $100 million per year in Proposition 98 funds will be used to pay for child care for TANF recipients (in the State Department of Education [SDE] budget). Assuming the Legislature elects to fund child care for all welfare recipients who need it in order to work or meet their participation mandate, there would be three basic funding options: (1) provide new non-Proposition 98 General Fund monies (as our projections assume); (2) spend some, or all, new Proposition 98 revenues for child care; and/or (3) allocate some funds in the SDE child care programs for welfare recipients only, rather than for anyone who meets the income criteria.

AFDC-Foster Care

The AFDC-Foster Care (AFDC-FC) program provides cash grants for children if they are living with a foster care provider under a court order or a voluntary agreement between the child's parent and a county welfare or probation department.

The Spending Forecast. We estimate that General Fund expenditures in the AFDC-FC program will increase from $387 million in 1997-98 to $464 million in 1998-99 and $546 million in 1999-00. This represents a 20 percent increase in 1998-99, and an 18 percent increase in 1999-00. In comparison, expenditures increased by 14 percent in 1996-97 and 16 percent in 1997-98.

Key Forecast Factors. The projected increases are due to: (1) caseload growth (about 7.5 percent annually); (2) an increase in the proportion of children placed in group homes (which are more expensive than other placements), reflecting a continuation of recent trends (about 6 percent annually); (3) statutory COLAs for group homes and rate increases for foster family homes; and (4) placement in group homes of a higher proportion of children requiring a higher level of service, pursuant to current law.

Child Support Enforcement—Potential Federal Penalties

Federal law requires that states operate statewide automated child support data processing and information retrieval systems by October 1, 1997. Because California has not implemented the Statewide Automated Child Support System, the state risks decertification of its child support enforcement (Title IV-D) program. Under current federal law, decertification would result in suspension of federal Title IV-D payments (approximately $425 million in 1997-98). Under state law, most of the burden of the loss of federal funds would be borne by the counties. We note that only 17 states are operating federally certified automated child support systems.

It should be noted that if California's child support enforcement program were decertified, the state risks subsequent decertification of its TANF plan. Without an approved TANF plan, California would no longer be an "eligible state" and would not be entitled to its federal TANF block grant ($3.7 billion per year). In 1998, Congress is likely to consider changes to current law that may substantially reduce this potential loss of federal funds.

Supplemental Security Income/ State Supplementary Program

The SSI/SSP provides cash assistance to eligible aged, blind, and disabled persons. The SSI component is federally funded and the SSP component is state funded.

The Spending Forecast. General Fund spending for the SSP is projected to be $2 billion in 1997-98, essentially unchanged from the prior year. General Fund spending is estimated to increase 3 percent in 1998-99 and 4 percent in 1999-00. In comparison, spending in 1996-97 increased by less than 1 percent; and in the three fiscal years prior to that, spending declined, ranging from 3.6 percent to 9.9 percent annually.

Key Forecast Factors. For 1997-98, we estimate that spending will exceed the budget act appropriation only slightly ($7 million). This increase is due primarily to the net effect of (1) *costs* associated with the inability to implement the 4.9 percent statewide grant cut during October 1997 and an increase in the federal administrative fee, largely offset by (2) *savings* from fewer disabled noncitizens joining the caseload than had been budgeted.

We project that spending will increase by $61 million in 1998-99 because of (1) restoration of the statutory state COLA ($27 million) in January 1999, (2) an additional increase in the federal administrative fee ($17 million), and (3) additional disabled noncitizens joining the caseload ($17 million).

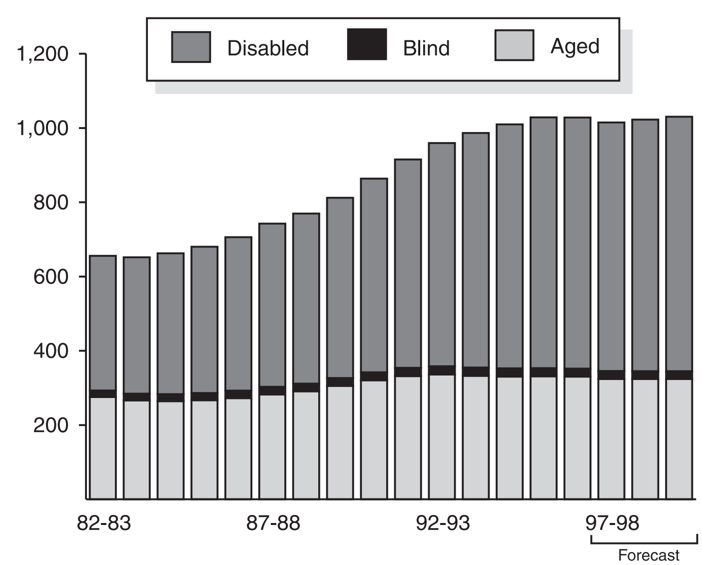
Our projections call for spending to increase by $82 million in 1999-00 due to (1) the statutory state COLA ($58 million), (2) a modest scheduled increase in the federal administrative fee ($6 million), and (3) more disabled noncitizens becoming eligible for the program ($18 million).

Caseload Trends and Projections. Figure 4 shows historical and projected changes in the components of the SSI/SSP caseload.

Figure 4

SSI/SSP Caseloads Leveling Off

Caseload (In Thousands)



From 1981-82 through 1996-97, the state's SSI/SSP caseload grew by 340,000 cases, or 49 percent over the 15-year period. Most of the growth was in the disabled category, increasing by 303,000 cases. More recently, the growth in the disabled SSI/SSP cases has moderated from 7.7 percent annually in 1991-92 to 0.1 percent in 1996-97. The high rate of growth in the number of disabled cases in the early 1990s can be attributed to factors such as AIDS-related disabilities, federal expansion of eligibility, and outreach programs.

The recent experience of essentially no growth in caseload is partially attributable to federal policy changes that (1) eliminated drug or alcohol addiction as a qualifying disability and (2) made *aged* noncitizens in the U.S. prior to August 1996 (but not yet on SSI/SSP) ineligible for assistance. (The federal *Balanced Budget Act of 1997* reversed an earlier federal policy and retained eligibility for all noncitizens receiving aid as of August 1996.)

The recent federal changes have essentially moved the caseload into a state of equilibrium, whereby the number of new cases each year is approximately equal to the number of cases leaving the rolls. For 1998-99 and 1999-00, we project annual increases in the caseload of less than 1 percent. Most of this increase is attributable to the federal requirement to provide grants to *disabled* noncitizens (who were U.S. residents prior to August 1996, but were not receiving aid).

In-Home Supportive Services

The In-Home Supportive Services (IHSS) program provides various services to eligible aged, blind, and disabled persons who are unable to remain safely in their own homes without such assistance.

The Spending Forecast. General Fund expenditures in the IHSS program are estimated to be \$386 million in 1997-98, \$431 million in 1998-99, and \$451 million in 1999-00. This represents an increase of 12 percent in 1998-99 and 4.6 percent in 1999-00.

Key Forecast Factors. The increase in expenditures is primarily due to caseload growth (3.9 percent annually) and increases in the minimum wage, pursuant to federal and state law. (Most IHSS providers are paid the minimum wage.) The rate of growth is higher in 1998-99 than 1999-00 due to the minimum wage increase.

Department of Developmental Services—Regional Centers

The Department of Developmental Services (DDS) contracts with 21 nonprofit regional centers to coordinate services for persons with developmental disabilities. A developmental disability is defined as a disability, related to certain mental or neurological impairments, that originates before a person's 18th birthday, constitutes a substantial handicap, and is expected to continue indefinitely. In addition to providing some services directly, such as diagnosis and case management, regional centers purchase a variety of services from providers in the community.

The Spending Forecast. We estimate that General Fund expenditures in the DDS program will increase from $485 million in 1997-98, to $514 million in 1998-99, and $543 million in 1999-00. This represents about a 6 percent increase each year.

Key Forecast Factors. The projected increases are primarily due to: (1) estimated basic caseload growth of 5 percent annually; (2) increases in the minimum wage, pursuant to federal and state law; and (3) an increased average cost per client, due to factors such as the *Coffelt* court settlement concerning the provision of services to former developmental center residents being placed in the community. Under this 1994 settlement agreement, the DDS must find or develop appropriate community living arrangements for at least 2,000 developmental center residents over a five-year period. More than 2,300 residents have moved into community placements since the agreement was reached. This population generally requires a higher level of services compared to the average regional center client, leading to increased costs for the centers.

Medi-Cal

The Medi-Cal Program (the federal Medicaid Program in California), provides health care services to recipients of CalWORKs and SSI/SSP grants, and to other low-income persons who meet the program's eligibility criteria (primarily families with children and the elderly, blind, or disabled). The state and the federal governments share most of the costs of the program on a roughly equal basis.

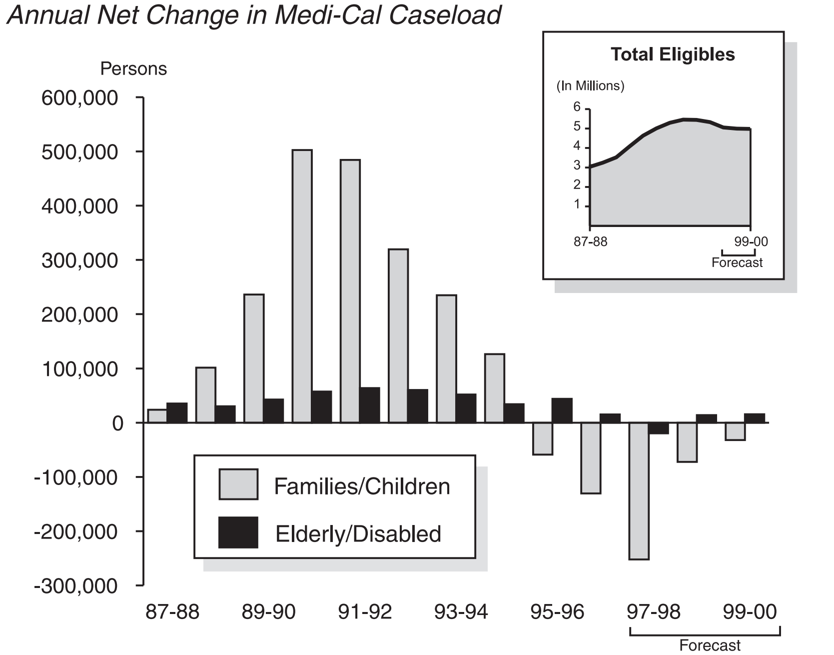
The Spending Forecast. We estimate that General Fund spending for Medi-Cal benefits (excluding administrative costs) will be $6.3 billion in 1997-98, which is $281 million less than the estimate when the budget was enacted. The primary reason for the savings is that our estimate of the 1997-98 caseload (the number of persons eligible for services) is lower than the May Revision estimate by 4.3 percent (226,000 eligibles). The cost of benefits per eligible also has grown less rapidly than anticipated in budget estimates. After the current year, however, the caseload stabilizes while benefit costs increase in line with medical price inflation. As a result, our forecast indicates that General Fund benefit costs will grow slightly in 1998-99—by $60 million (1 percent)—and moderately in 1999-00—by $290 million (4.6 percent).

Key Forecast Factors. As shown in the inset box in Figure 5 (see next page), the total Medi-Cal caseload peaked in 1994-95 and then declined slightly in 1995-96 and 1996-97. The forecast indicates that this caseload reduction will accelerate in the current year—the average Medi-Cal caseload in 1997-98 will drop by 5.1 percent compared with 1996-97 and 7.4 percent less than the 1994-95 peak caseload. Figure 5 also shows that both the rapid growth of the Medi-Cal caseload in the early 1990s and the current caseload decline primarily reflect changes in the number of families and children on Medi-Cal, rather than changes in the elderly and disabled components of the caseload. The earlier growth reflected eligibility expansions (particularly for children, pregnant women, and immigrants) and increased welfare caseloads due to the recession.

Figure 5

Number of Families and Children in Medi-Cal Declining After Period of Rapid Growth

Annual Net Change in Medi-Cal Caseload



The recent caseload declines result from a signifi cant reduction in the CalWORKs welfare caseload (which comprises half of the total Medi-Cal caseload).

For 1997-98, the number of CalWORKs recipients on Medi-Cal declines by 273,000 (9.7 percent) and by an additional 210,000 over the following two years through 1999-00, in line with our overall forecast of CalWORKs caseload. However, increases in the number of nonwelfare children on Medi-Cal offset more than a quarter of the reduction in the CalWORKs Medi-Cal caseload over this period. This increase is due to recently enacted state legislation to ease eligibility requirements and expand outreach to parents of uninsured children.

Our forecast includes the effect of an increased federal share of Medi-Cal benefit costs, which rises from 50.23 percent to 51.55 percent over the forecast period, under the federal formula. The increased federal match results in a cumulative General Fund savings of $453 million over the forecast period, including savings already reflected in the current-year budget act.

"Crossover" Savings at Risk. The forecast includes a total of $345 million of savings through 1999-00 from implementing "crossover" limits on payments for services to Medi-Cal eligibles who also are Medicare beneficiaries. Under the crossover limits, Medi-Cal will only pay deductibles and copayments for Medicare-covered services to the extent necessary to meet the Medi-Cal payment rate, which generally is less than providers charge other Medicare patients. Federal legislation recently authorized such crossover limits, and the savings were included in the enacted 1997-98 state budget. However, implementation of the inpatient portion of the limits has been enjoined by a federal court. If the state's appeal of that decision is not successful, almost $150 million of the assumed crossover savings could be lost.

New Healthy Families Program

The federal *Balanced Budget Act of 1997* created the State Children's Health Insurance Program. The program will provide California with federal funds on approximately a two-to-one matching basis to provide health care coverage for children in families with incomes that are less than 200 percent of the federal poverty level (FPL)— $32,100 for a family of four—but are too high to qualify for Medi-Cal. Subsequent to enactment of the state budget, the Legislature and Governor approved legislation to implement the program in California. The new program, to be administered by the Managed Risk Medical Insurance Board (MRMIB), will help low-income families purchase health coverage for their children.

To qualify for coverage, a family's income must be between 133 percent and 200 percent of FPL for children ages 1 through 5, and between 100 percent and 200 percent of FPL for children ages 6 through 18. Currently, children at the lower income levels (and infants up to 200 percent of FPL) are eligible for Medi-Cal coverage. Children currently or recently covered by employer-sponsored insurance are not eligible.

Families will purchase coverage directly through MRMIB or receive purchasing credits from MRMIB to participate in employer-sponsored coverage, if available. Coverage will be equivalent to state employee health benefits. Monthly premiums paid by families for the lowest cost plan will be $7 per child (up to 150 percent of FPL) or $9 per child (up to 200 percent of FPL), with family maximums of $14 and $27, respectively.

The Spending Forecast. Because the new insurance program is not planned to operate until 1998-99, General Fund costs in 1997-98 will only be about $2 million for start-up activities. On a full-year basis, the administration estimates that the new insurance program will cost a total of $485 million ($170 million General Fund) at current costs to cover all currently eligible uninsured children. Our forecast uses this estimate and phases in participation from July 1998 to July 1999.

Key Forecast Factors. The administration's estimate assumes coverage of *all* currently uninsured children in qualifying families. While this assumption of 100 percent participation is unlikely to occur, the estimate does not allow for any "crowd-out"—a shift from employer-based coverage to the new subsidized program. Our forecast assumes that crowd-out costs will offset any savings from lower participation by the uninsured. Actual General Fund costs will depend on the net effect of these two factors, the speed of program implementation, and the extent to which the cost of this program is offset by savings in other existing children's health programs.

K-14 EDUCATION

This section reviews our estimates of state Proposition 98 costs for K-14 education (K-12 schools and community colleges).

Proposition 98 sets the minimum amount that the state must provide for California's public K-12 education system and the California Community Colleges. About 85 percent of total funding for these school programs is from the state General Fund and local property taxes. Public K-12 education in California is provided to about 5.6 million students—ranging from infants to adults—through about 1,060 locally governed school districts and county offices of education. The California Community Colleges provide instruction to about 1.4 million adults at 107 colleges operated by 71 locally governed districts.

The Spending Forecast. We estimate that annual growth in total Proposition 98 spending (General Fund and local property taxes) for K-14 education will be 6.5 percent in 1998-99 and 5 percent in 1999-00. This is lower than the 8.8 percent increase in 1996-97 and the projected increase of 8.2 percent for the current year. This forecast reflects the reduction in taxes approved by the Legislature during the 1997 session and our moderate revenue forecast.

Key Forecast Factors. General Fund expenditures for Proposition 98 depend on the following factors: General Fund revenues, state population, K-12 average daily attendance (ADA), per-capita personal income, and local property taxes. Figure 6 summarizes our assumptions for these factors. Our economic forecast assumes state tax revenues will grow by about 5 percent in 1998-99 and 1999-00. We also assume that growth in local property tax revenues will continue to recover from the relatively low rates of the past few years.

Higher 1996-97 and 1997-98 Estimates. We estimate higher Proposition 98 funding levels for 1996-97 and 1997-98 than anticipated in the *1997-98 Budget Act*. Specifically, we estimate spending increases of $63 million and $220 million, respectively, above the amounts assumed in the *1997-98 Budget Act*. These higher estimates stem from our revised estimates of General Fund revenues in the two fiscal years.

K-12 Funding Projections. Any increase in Proposition 98 is shared between K-12 education and the California Community Colleges. Figure 7 displays our projected K-12 per-pupil spending from 1994-95 through 1999-00 (in both "current" and inflation-adjusted dollars). These estimates, which are derived from our Proposition 98 forecast, reflect real per-pupil increases of about 2 percent each in 1998-99 and 1999-00. This funding level would permit continued support for existing programs—including class-size reduction.

Figure 6

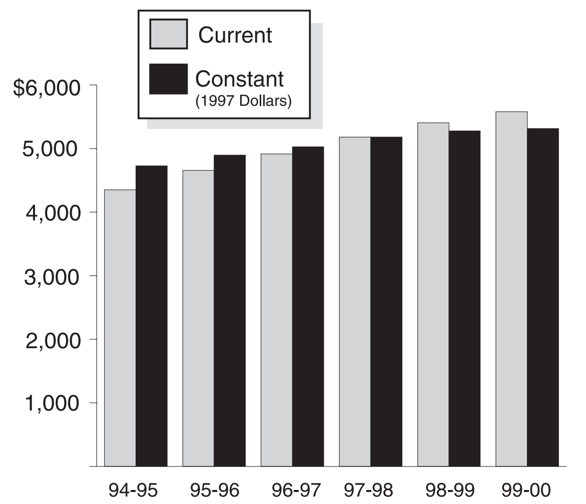
LAO Proposition 98 Education Forecast Annual Percent Change

	1997-98	1998-99	1999-00
State population	1.7%	1.8%	1.8%
Per-capita personal income	4.7	5.0	4.5
Local property taxes	3.5	4.6	5.3
K-12 average daily attendance (ADA)	2.5	2.0	1.6
Proposition 98 guarantee (General Fund and local property taxes)	8.2	6.5	5.0

Figure 7

Proposition 98 Funding Per Student

Current and Constant Dollars



In addition, there would be available about $500 million in 1998-99 and an additional $200 million in 1999-00 for program increases and new school improvement activities. As discussed in the "Health and Welfare" section of this chapter, we estimate that child care costs associated with welfare reform will increase by almost $400 million in 1998-99 (rising to $620 million). This estimate assumes full funding of all eligible child care services identified in the new state welfare program. One of the major issues for the 1998-99 budget is whether these costs should be funded with Proposition 98 funds, non-Proposition 98 General Fund monies, or whether a major portion of these costs can be addressed by redirecting existing child care services to welfare recipients. If Proposition 98 funds are used to support all or a major share of the new costs, it will severely limit the scope of any new program or school improvement activities.

Community College Funding Projections. Based on our Proposition 98 projections, we estimate total community college funding will increase by between 5 percent and 6 percent each year in 1998-99 and 1999-00. After adjusting for enrollment growth and inflation, this would provide a 1 percent to 2 percent increase for additional enrollment and / or program improvements. This assumes no change in the proportion of Proposition 98 funds going to community colleges.

HIGHER EDUCATION

In addition to community colleges, the state's public higher education systems include the University of California (UC) and the California State University (CSU). The UC consists of eight general campuses, one health science campus, and numerous special research facilities. The UC awards bachelor's, master's, and doctoral degrees, as well as various professional degrees. The UC has primary jurisdiction over research. The CSU consists of 22 campuses and several off-campus centers. The CSU grants bachelor's and master's degrees and may award doctoral degrees jointly with the UC or a private university.

The Spending Forecast. We estimate that spending for UC and CSU (excluding funding for debt service) will increase from $3.9 billion in 1997-98 to $4.2 billion in 1998-99, or by 6.7 percent (the percentage increases at UC and CSU are similar). For 1999-00, we estimate that spending for UC and CSU (excluding funding for debt service) will increase to almost $4.4 billion or by 3.8 percent compared to 1998-99.

Key Cost Factors. For the 1998-99 fiscal year we assume that UC and CSU will receive "base" budget increases of 4 percent, as contemplated under the Governor's four-year "compact" with the systems. This assumption is broadly consistent with actions taken by the Legislature and Governor in the last three annual budget acts. For the 1999-00 fiscal year, when the Governor's present "compact" will no longer be in effect, we assume that UC and CSU budgets will grow by (1) the rate of inflation and (2) the marginal cost associated with 1.4 percent enrollment growth (a level consistent with recent budgeted levels). To the extent that faculty salaries are increased above the inflation rate, state expenditures would increase further, potentially by tens of millions of dollars.

General Fund Replacement of Foregone Fee Revenues. Chapter 853 Statutes of 1997 (AB 1318, Ducheny), reduces UC and CSU systemwide fees for resident undergraduates by 5 percent for 1998-99 and "freezes" those fees at the reduced level for 1999-00. Chapter 853 appropriated $41.9 million from the General Fund for the 1998-99 fiscal year to compensate UC and CSU for reduced fee revenues. Our projection for 1998-99 includes an additional $66 million to "buy out" a 10 percent fee increase. This assumption is consistent with similar actions taken by the Legislature and Governor in the last three annual budget acts.

JUDICIARY AND CRIMINAL JUSTICE

The major state judiciary and criminal justice programs include support for four agencies in the executive branch—the Departments of Corrections, the Youth Authority, Justice, and the Office of Criminal Justice Planning—as well as expenditures for local trial courts and state appellate courts. The largest expenditure programs—the Department of Corrections and the Trial Court Funding Program—are discussed in more detail below.

Department of Corrections

The California Department of Corrections (CDC) is responsible for the incarceration, training, education, and care of adult felons and nonfelon narcotics addicts at 33 state prisons. The CDC also supervises and provides services to parolees released to the community.

The Spending Forecast. The department's General Fund support budget is forecast to grow between 1996-97 and 1999-00 at an average annual rate of 6.1 percent, exceeding $3.9 billion at the end of that period. (This does not include General Fund support for capital outlay or lease-payment bonds, which are accounted for elsewhere in our projections.) The department's General Fund costs will be partially offset by the federal government to reimburse the state for the costs of housing undocumented immigrants convicted of felonies in California. After adjusting for receipt of these federal funds, the annual

General Fund growth is projected to be 9 percent because the federal funds are expected to steadily decrease during this period.

Federal support is expected to drop from $441 million in 1996-97 to $244 million in 1999-00 for two reasons. First, we note that the anticipated reimbursements for 1996-97 and 1997-98 ($323 million) are artificially high. As regards 1996-97, this is because the state received two federal fiscal year appropriations within that single state fiscal year. As regards 1997-98, the state took advantage of federal legislation permitting grants for prison construction to be used on a one-time basis to offset the costs of holding undocumented immigrants in state prison. Second, the state's federal funding is likely to decline because federal law permits *local* governments throughout the nation to claim reimbursement for the costs of housing undocumented felons in local jails, thereby spreading the available federal appropriation to more agencies.

The projected growth in adult correctional expenditures continues a trend of steadily larger CDC budgets that has existed since the early 1980s.

Key Forecast Factors. The significant increases projected in General Fund support for the CDC reflect major growth in the prison inmate population expected during the forecast period. Our estimates through 1999-00 are based on the CDC's projections of the inmate population, which we believe are reasonable. The CDC anticipates that the prison population will exceed 180,000 by June 2000. This is a slightly greater increase than previously forecast by the CDC. The new, higher projection means that the CDC inmate population will jump by more than 40,000 or almost 30 percent over the four-year period ending June 30, 2000. (The projections are shown graphically in Figure 4 in Chapter 5.)

The increase in prison population is largely the result of tougher sentencing measures approved by the Legislature, Governor, and the voters, including the "Three Strikes and You're Out" law enacted in 1994. Also, demographic shifts, in particular the growth in the state's 18-to-24 age group, can increase the prison population. On the other hand, the state of the economy and the availability of jobs to persons who might otherwise commit financial crimes can work to reduce the growth in the inmate population. Local law enforcement practices also have an effect on the numbers of persons arrested and convicted of crimes. The most recent increase in CDC projections appears due largely to a new Board of Prison Terms policy that has resulted in the revocation of parole for a large number of additional parolees who tested positive for illegal drug use.

Meanwhile, the number of parolees under the supervision of CDC parole agents is also expected to increase, reflecting the overall growth in the state's population of criminal offenders. The CDC projects that the parolee population will grow by almost 19,000, or almost 20 percent, over the four-year period ending June 30, 2000. We discuss the long-term fiscal considerations of the prison population growth in Chapter 5.

Trial Court Funding

The Trial Court Funding Program pays for a portion of the salaries and operating expenses of superior and municipal courts (the counties pay the remainder). Recent legislation—Chapter 850, Statutes of 1997 (AB 233, Escutia and Pringle)—restructured the program and significantly increased the state's fiscal obligation for support of the courts, beginning in 1998-99. Specifically, the measure reduced and capped each county's financial obligation, and increased the state's obligation by providing that the state will be responsible for supporting future cost increases for the trial courts.

The Spending Forecast. Total General Fund expenditures for support of the courts, excluding fine revenues, which will be transferred from the General Fund to a special fund as a result of Chapter 850, will increase from $193 million in 1996-97 to $686 million in 1999-00—more than a three-fold increase.

Key Forecast Features. Most of this increase will occur in 1998-99 when the state takes over primary responsibility for the support of the trial courts. We assume that the costs will increase by $450 million in that year over state expenditures in 1996-97. This is due to several factors. First, Chapter 850 requires the state to assume some specific new costs, including $274 million to provide minimum levels of state support to courts in all counties, thereby resulting in a corresponding reduction in county costs. In addition, consistent with assumptions made by the legislative leadership and the Governor at the time Chapter 850 was enacted, we assume that projected growth in trial court operating costs and funding to promote court improvements and efficiencies will result in additional costs of $100 million in 1998-99. Even if these growth assumptions and the agreement on funding for improvements do not hold, the requirements for additional state funding pursuant to the provisions of Chapter 850 will probably increase costs by at least $350 million in 1998-99. Costs for 1999-00 are based on assumptions regarding workload growth and inflation. We discuss the long-term fiscal considerations of trial court funding in Chapter 5.

DEBT SERVICE

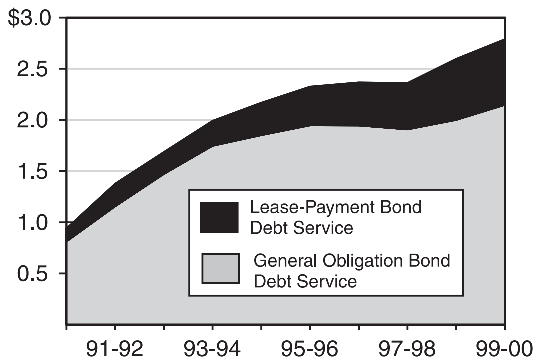
Debt Payments. As shown in Figure 8, we estimate that General Fund debt-service costs (for general obligation and lease-payment bonds) will increase to about $2.8 billion in 1999-00. This forecast assumes that about $5.5 billion in currently authorized bonds will be sold by 1999-00. The figure also shows that debt payments for lease-payment bonds is an increasing share of total debt service costs.

Debt Ratio. The state's debt ratio (debt service payments as a percentage of General Fund revenues) increased from 2.5 percent in 1990-91 to a high of 5.1 percent in 1994-95. We expect that General Fund revenues will increase at a faster rate than the increase in debt payments as currently authorized bonds are sold. As a result, our forecast indicates that the state's debt ratio will decline to 4.4 percent in the current year, increase to 4.8 percent in 1999-00, and then decline thereafter. Voter approval of additional general obligation bonds or legislative authorization of new

Figure 8

Bond Debt-Service Payments Increase After Period of No Growth

General Fund Debt Service (In Billions)



lease-payment bonds would, of course, increase the debt ratio.

OTHER PROGRAMS

Renters' Credit

The Renters' Tax Credit provides a refundable tax credit of $60 to single renters and $120 to married couples and heads of households. The credit has been suspended for the past five years, from 1993 through 1997. The program is scheduled to be reinstated January 1, 1998 and will result in an estimated cost of $530 million in 1998-99 and $540 million in 1999-00.

Retirement Programs

Payment of Deferred PERS Obligations. In May, the California Supreme Court refused to hear an appeals court ruling which had found the deferral of General Fund contributions to the Public Employees' Retirement Fund in the early 1990s unconstitutional. As a result, the state was ordered to repay $1.2 billion in principal plus interest. Under a continuous appropriation provision in existing law, the administration made the $1.2 billion principal payment to the Public Employees' Retirement System (PERS). The PERS has filed a claim with the State Board of Control for $308 million in interest charges. We have assumed that legislation will be enacted in 1998-99 appropriating this $308 million.

General Fund Savings in Contributions to the State Teachers' Retirement System (STRS). In settlement of the state's claim on federal lands in the Elk Hills Naval Petroleum Reserve (in Kern County), the state is to receive about 9 percent of the sale proceeds when the federal government sells the property. The property is expected to be sold early in 1998 and the state's share is expected to be at least $300 million. In anticipation of this transaction, the Legislature enacted and the Governor signed Chapter 939, Statutes of 1997 (SB 1026, Schiff). This measure provides for (1) an increase in the level of purchasing power protection for the State Teachers' Retirement Fund benefits and (2) the reduction of the 1998-99 General Fund contribution to the STRS for purchasing power protection by the amount the state receives from the sale of the reserve. As the state's contribution to STRS for purchasing power protection would otherwise exceed $300 million in 1998-99, there should be a General Fund savings of at least $300 million in 1998-99 as a result of the lands sale.

State Employee Compensation

Late in the legislative session, the Governor committed to negotiate in good faith with employee organizations for a pay raise. We have included $150 million in our estimated expenditures for 1998-99 and another $150 million for 1999-00 for pay increases. These amount to a compensation package equivalent to an average of about a 3 percent pay increase in each year.

Information Technology Projects

The state has undertaken a number of major information technology projects which could have significant General Fund fiscal implications during the forecast period. The three largest projects are (1) the efforts to modify state computer programs to accommodate the Year 2000; (2) the Statewide Automated Welfare System (SAWS), designed to improve the information technology capability of county welfare departments; and (3) the Statewide Automated Child Support System (SACSS), intended to provide a statewide child support enforcement tracking and monitoring capability.

We estimate that the General Fund costs of these projects will increase from $87 million in 1997-98 to $135 million in 1999-00 (the projects will also be supported by substantial amounts of federal and special funds). These estimates contain a high degree of uncertainty because of such factors as when the costs will occur, the impact of changes to the projects that are currently under consideration, and the amount of federal financial participation that may be forthcoming. Because of such uncertainties, the costs could be tens of millions to hundreds of millions of dollars higher than estimated during the period.

Chapter 5

Long-Term Considerations

For planning purposes, it is important for the Legislature to have information about the various factors which will influence the state's longer term fiscal condition beyond 1999-00. Although the near-term budgetary outlook is favorable over the forecast period, the budget's condition in later years will depend on a variety of factors. This chapter discusses some of these factors. As shown in Figure 1, they include demographic trends, economic and revenue developments, current-law expenditure trends, and policy-related decisions affecting both revenues and spending.

DEMOGRAPHICS

California's population will be experiencing significant changes in the future, in terms of both numbers and composition. As shown in Figure 2 (see next page), we project that the state's population will exceed 40 million by 2010. This represents a growth of more than 7.9 million persons (about 24 percent—or an average increase of 1.7 percent annually) from 1997. The figure also shows that all population age segments will increase, but at varying rates. This will lead to changes in the population's age mix. These trends will have a variety of fiscal implications for the state. For example, over the period, the college-age population will increase by roughly 50 percent, or about twice as fast as the population generally. In contrast, the under-18 population will increase much more slowly—only 12 percent in total.

Figure 1

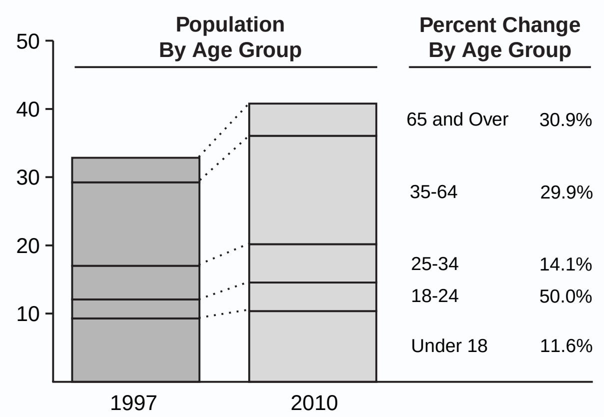
Key Factors in California's Long-Term Fiscal Outlook

- Demographic trends, including population growth and its composition.
- Economic performance and its impacts on state revenues.
- State expenditure trends under current law and the factors affecting them, including school enrollments, prison populations, and health and welfare caseloads.
- Management of state public infrastructure needs.
- Federal law changes.
- State law changes involving both revenues and expenditures.

Figure 2

California's Population to Expand Significantly and Become Older

(In Millions)



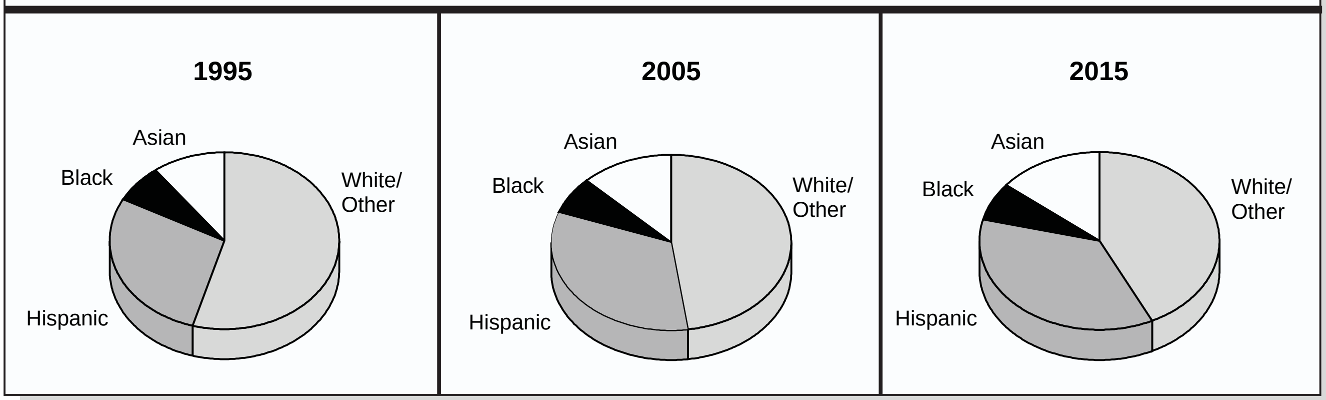
There also will be various other demographic changes occurring. For example, Figure 3 shows that the state's ethnic mix will be changing significantly.

LONG-TERM ECONOMIC AND REVENUE GROWTH

The principal determinant of revenue growth over the long term is the performance of the California economy. This reflects the fact that the state's tax collections over time are strongly influenced by California employment, personal income, profits, and spending. Assuming that California's economy experiences, on average, moderate economic growth (for example, employment growth of 2 percent to 3 percent annually) and reasonably low inflation (in the range of 2.5 percent to 3.5 percent annually), we estimate that revenues would grow at an average rate of *5 percent to 6 percent* per year. As recent experience has shown, revenue growth in any individual year can vary significantly from this range, depending on the stage of the business cycle, as well as year-to-year fluctuations in such volatile factors as taxable capital gains and audit receipts.

Figure 3

California's Ethnic Mix — Significant Changes Will Be Occurring in the Future



STATE PROGRAMS

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

CalWORKs

Long-Range Projections. Our long-term projections indicate that spending will remain just under $3 billion in 2000-01 and 2001-02 and will then decline by over $200 million per year in 2002-03 and 2003-04. This out-year spending reduction is mostly attributable to (1) modest declines in welfare-to-work and support services costs as the existing caseload moves through the system, (2) continued caseload declines from service intervention, and (3) the impact of the five-year time limit on adults. By 2003-04 we project that state spending will be at the federal maintenance-of-effort floor. We note that these projections assume restoration of the statewide 4.9 percent grant reduction and the statutory cost-of-living adjustment beginning in 1998-99.

Impact of a Recession. Our spending projections assume continued economic growth. Because federal funding for CalWORKs is provided as a block grant, the state bears *all* of the risk in the event of a recession. For example, if a recession occurred and it resulted in a 5 percent caseload increase during 1999-00, projected CalWORKs spending would increase by over $500 million in that year alone.

Healthy Families Program

The newly enacted Healthy Families Program, along with Medi-Cal, offer health coverage to almost all of the uninsured children in the state who are in low-income families (with incomes of up to 200 percent of the federal poverty level). Currently, there are about 500,000 uninsured children in California in families whose incomes are in this range, but not low enough to qualify for Medi-Cal coverage. The administration estimates an annual General Fund cost of $170 million for the Healthy Families Program (when fully implemented), based on the cost of covering all of these uninsured children.

Over the long term, the cost of this program will depend on the actual participation rate of families and on the amount of "crowd out" of private coverage. Some families with uninsured children will not participate in the program, and this will tend to reduce costs somewhat below the estimate. On the other hand, the availability of low cost children's health coverage may crowd out dependent coverage provided by employers of lower-wage workers and shift coverage of these children to the Healthy Families Program. The cost of crowd out could be substantial and probably would outweigh savings from less than full participation by uninsured families. There are almost 900,000 low-income children who currently have some form of private health coverage in California. Depending on the extent of crowd out that occurs, the cost of covering all eligible children could increase by up to several hundred million dollars annually.

Proposition 98

A significant factor affecting the level 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 earmarked for 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 portion of *new* General Fund revenues each year. (For example, in 1998-99, we estimate that 56 percent of the $3 billion in *new* General Fund tax revenues will go toward the Proposition 98 guarantee.) As a result, we forecast that Proposition 98's share of state General Fund revenue will increase from 41 percent in 1996-97 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, we think it is likely that Proposition 98's share of the budget will stabilize. It is possible in future years, however, that slower student enrollment growth and faster growth in local property taxes could result in a *decrease* in the General Fund share going to Proposition 98.

Higher Education

Our projection of cost increases at the University of California (UC) and the California State University (CSU) assumes a 1.4 percent annual rate of enrollment growth through 1999-00, which is consistent with current rates of college participation and anticipated increases in the college-going population.

Long-term enrollment growth will depend largely on demographic changes. For instance, increased enrollments over the next decade will depend in large part on increases in the young-adult population. This group is projected over the next decade to grow at over 2 percent annually, as the children of the "baby boomers" move into their college-age years. (Many refer to this growth as the next "tidal wave" of students.)

How these population numbers translate into increased higher education enrollment is subject to much uncertainty about the percentage of college-age students who will be eligible, apply, and ultimately attend the community colleges, UC, and CSU. Assumptions regarding the participation rates of young adults and older Californians are critical. These rates are influenced by general economic conditions, the educational goals and achievement of students, and the tuition and benefits of various public and private education opportunities. We estimate that if recent participation rates for all ages continued into the future, the annual increase in higher education enrollment would average about 1.2 percent.

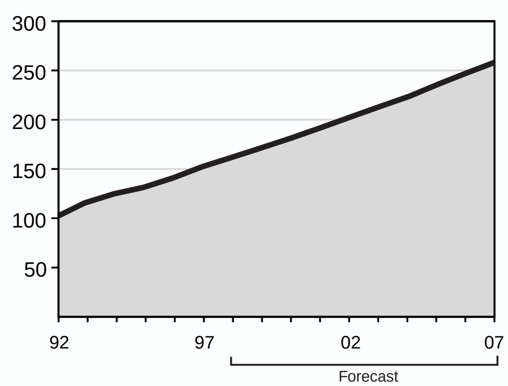
Department of Corrections

Figure 4 shows that we anticipate that the prison population, which is now about 155,000, will reach about 260,000 by June 2007. This continued high level of inmate growth represents a major operational and fiscal challenge to the state. Should it persist, we estimate the Department of Corrections' (CDC) support budget would reach almost $6.6 billion by the 2006-07 fiscal year, or roughly double the present funding

Figure 4

State Prisons Face Continued Inmate Population Growth

Inmates as of June 30 (In Thousands)



level, after adjusting for anticipated federal funds. The CDC support budget would grow at an average annual rate of about 8.7 percent, compared with an annual 5 percent to 6 percent growth in revenues that would occur for the state General Fund under a moderate economic growth outlook during that same ten-year period.

Based on the CDC's projections, the inmate population will reach the capacity of the state prison system (two inmates per cell and double-bunking in dormitories and gymnasiums) by early 2000. If new state prisons were to be authorized in mid-1998, they could not be occupied until mid-2001—about 16 months after the system reaches capacity given current prison population projections. The CDC projections indicate that inmate population will increase by about 14,000 inmates during this 16-month period. On this basis, the state will need to accommodate these inmates—the equivalent of almost three prisons—in other than new prisons.

During the period from 2001 to 2007, an additional 67,000 inmates are projected to enter the system. Accommodating these inmates in new state prisons would require one-time capital outlay costs of about $3.2 billion for 13 prisons. However, the cost of CDC operations and capital outlay could be lower if the Legislature and Governor or the courts took actions which either slowed inmate population growth or provided alternative forms of punishment for some offenders.

Trial Court Funding

Under Chapter 850, Statutes of 1997 (AB 233, Escutia and Pringle), costs to the counties for support of trial courts are capped. The state will be responsible for all future growth in trial court costs, including costs resulting from workload increases, inflation adjustments, and new programs. These cost increases will likely be significant (at least $30 million to $80 million annually in the out years). An important factor in determining the state's future costs will be the amount of control the state (particularly the Judicial Council) exercises over the operations and expenditures of the trial courts which, up to now, have largely been controlled by counties and the courts themselves.

In addition, Chapter 850 establishes two task forces to examine and make recommendations to the Legislature on two significant areas regarding the change in state and local responsibility for funding the courts. The first is related to the future personnel structure of the trial courts (including studying whether trial court personnel should be court employees, state employees, or continue as county employees). The second is related to future funding responsibility for court facilities, which are the obligation of the counties under Chapter 850. Depending on the actions of the Legislature and Governor with regard to whatever recommendations are produced by these task forces, the state's long-term costs could change significantly.

State Infrastructure

In our spending projections, we forecast that expenditures on debt service (for both general obligation and lease-payment bonds) will reach 4.8 percent of General Fund revenues by 1999-00. These debt service payments primarily pay for existing facilities. The state, however, will face significant demands for additional capital outlay expenditures in the coming years.

Figure 5 shows the capital outlay needs projected for the next five years. It indicates that state agencies and K-12 education have needs totaling about $35 billion over that period. Most of the identified projects fall in the areas of transportation, education, and corrections. The amount for higher education is significantly less than in prior years. This is because the Chancellor's Office of the Community Colleges has identified significantly fewer statewide needs.

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. Presumably, future capital outlay projects would be financed similarly.

Deferred Maintenance. In addition to the need for capital improvements, the state faces the consequences of a long-term problem of deferring routine ongoing maintenance of state and K-12 facilities. This has resulted in large backlogs of deferred maintenance—a problem that is most pronounced in education facilities. The deferred maintenance backlogs total billions of dollars for K-12 schools and hundreds of millions of dollars at the universities. Any long-term solution to this problem involves not only addressing the current backlogs but also sufficiently increasing ongoing maintenance efforts in order to avoid any further buildup of deferred maintenance.

Figure 5

Projected Capital Outlay Needs For the State and K-12 Education 1997-98 Through 2001-02

(In Millions)

	Five-Year Total
Executive	$70
State and Consumer Services	540
Transportation	14,920
Resources	670
Health and Welfare	260
Youth and Adult Corrections	1,980[a]
K-12 Education	11,000[b]
Higher Education	3,900
General Government	210
Total	**$33,550**

[a] Incorporates LAO estimate for new prison construction. Assumes that 14,000 inmates will have to be accommodated in other than new state prisons due to a short-term lack of space. Building new prisons for these inmates would cost an additional $800 million.

[b] Assumes historical costs and continuance of existing state programs for funding school facilities.