Foreword

This report provides our projections of General Fund revenues and expenditures for 2000-01 through 2005-06. 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.

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

California is in the midst of an extraordinary economic and revenue boom. Seven years into the current economic expansion, the state's economy continues to roar ahead, with such measures as personal income, taxable sales, and employment far outdistancing previous estimates. These economic gains, coupled with stock market-driven increases in capital gains, are translating into extraordinary increases in state revenues. As shown in Figure 1, underlying General Fund receipts increased by nearly 21 percent last year, and are projected to grow by another 12 percent in 2000-01. Eliminating the effects of inflation, the recent gains in General Fund receipts are the largest in recent history.

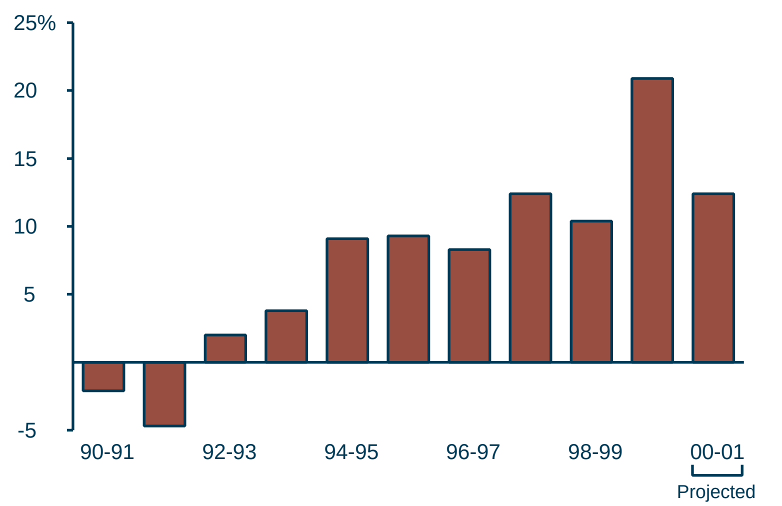
Looking ahead, we forecast that the national and state economies will slow some from their recent robust growth rates, but still remain in a solid expansionary mode. Thus, even with these slowdowns, our projections indicate that 2001-02 will be another very good year for state finances—and that, once again, substantial resources will be available for budget- and tax-related priorities.

As indicated in Figure 2 (see page 2), we project that 2000-01 will end with a reserve of nearly $6.9 billion—up sharply from the $1.8 billion assumed in June when the budget was adopted. In 2001-02, assuming current-law spending and tax policies, we forecast that revenues would exceed expenditures by $3.4 billion, bringing the cumulative reserve to $10.3 billion. In subsequent years, we forecast that revenues would exceed expenditures by well over $3 billion annually, again assuming current-law policies.

Figure 1

Revenues Have Soared in Recent Years

Percent Change in General Fund Revenues[a]
1990-91 Through 2000-01



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

The details behind our "bottom line" are summarized below.

Figure 2

LAO Projections of General Fund Condition

1999-00 Through 2001-02
(In Millions)

		Forecast	
	1999-00	2000-01	2001-02
Prior-year fund balance	$3,851	$8,509	$7,449
Revenues and transfers	71,713	77,926	81,039
Total resources available	$75,564	$86,435	$88,488
Expenditures	$67,055	$78,986	$77,646
Ending fund balance	$8,509	$7,449	$10,842
Other obligations	$592	$592	$592
Reserve	**$7,917**	**$6,857**	**$10,250**

KEY FEATURES OF THE LAO OUTLOOK

The Economy

The national, and particularly the California, economy are expanding at rapid rates—well above those envisioned in the *2000-01 Budget Act*. These increases reflect widespread gains in consumer spending and technologically driven business investments. We estimate that California personal income and taxable sales will each increase by well over 11 percent this year—the fastest rates since 1984, and considerably stronger than the roughly 7 percent increases that had been assumed.

We forecast that economic growth will ease some in 2001 and beyond, but remain strong by historical standards. Our long-term forecast reflects further upward assessments regarding worker productivity, economic output, and personal income at both the national and state levels. For example, we now project that personal income will increase at an average annual rate of 7.3 percent during the 2000 through 2006 period. This compares to last year's projection of an average annual increase of 5.7 percent for the 1999 through 2005 period.

Revenues

The strong economy translates directly into a further improvement in the General Fund's revenue outlook.

Prior and Current Years. We estimate that General Fund revenues totaled $71.7 billion in 1999-00, a 22.3 percent increase from 1998-99. This estimate is $551 million above the total assumed last summer, reflecting stronger-than-expected 1999-00 receipts from personal income and sales taxes. We further estimate that revenues will reach $77.9 billion in the current year, an 8.7 percent increase from 1999-00. This estimate is about $4.1 billion above the budget act estimate, even after accounting for the quarter-cent sales tax reduction certified by the Director of the Department of Finance in October (see discussion in Chapter 3).

The positive revenue outlook reflects both the current strength in California's economy and extraordinary growth in monthly receipts from withholding and other key revenue sources. These receipts, in turn, are partly due to another major increase in capital gains and stock options in 2000. Specifically, we estimate that, after jumping by 50 percent in 1999, income from capital gains and stock options is increasing another 30 percent in 2000.

2001-02 and Beyond. We forecast that revenues will reach $81 billion in the budget year—a 4 percent increase from 2000-01. Most revenue sources are expected to experience moderate growth next year, in line with the state's overall economic expansion. However, we believe that capital gains and stock option-related income will drop 10 percent next year from this year's extraordinary level. This projected decline is due to the lagged effects of the recent drop in stock prices on stock options and capital gains in 2001. Thereafter, we forecast that revenues will increase in line with statewide personal income, reaching $106 billion by 2005-06.

It should be noted that our General Fund revenue estimates reflect a variety of recent policy-related factors. These include (1) the diversion of sales taxes for transportation purposes included in the *2000-01 Budget Act*, (2) the certification of the quarter-cent sales tax reduction, and (3) the fiscal effects of targeted tax reductions enacted with this year's budget. The fiscal effects of these actions are discussed in Chapter 3.

The General Fund Condition For 2000-01

The 2000-01 budget signed by the Governor included a year-end reserve of $1.8 billion. We now project that the current year will end with a reserve of $6.9 billion, an increase of $5.1 billion. The improvement is largely due to our higher revenue estimates for the prior and current years, partly offset by additional spending related to legislation passed last summer following the budget's enactment.

Budgetary Outlook for 2001-02 And Beyond

Basis for Our Estimates. Our expenditure forecasts for 2001-02 and beyond are based primarily on the *requirements of current law*. Specifically, we have adjusted the underlying 2000-01 spending plan for constitutional and statutory funding requirements, as well as for projected changes in caseloads, federal reimbursement rates, and other factors affecting program costs. For example:

- Our forecast for K-14 education is determined by the changes in the Proposition 98 minimum funding guarantee.
- Spending for higher education is based on projected enrollments and inflation.
- Our projections for health and social services take into account caseloads, program service requirements, and cost-of-living adjustments required by current law.
- We have assumed annual employee compensation increases equal to projected inflation (slightly more than 3 percent per year).

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 future budgets. *Nor* are they our recommendations of what tax and spending policies ought to be. Rather, they are intended to be a reasonable "baseline" projection of what would happen if *current-law* policies were allowed to operate in the future. We recognize that the Legislature is likely to make alternative policy choices, as it has in recent years. However, by using this approach, we believe that our forecast provides a meaningful starting point for the Legislatures's evaluation of the state's fiscal condition.

Quarter-Cent Sales Tax Reduction. Consistent with the certification, our revenue forecast assumes that the quarter-cent sales tax reduction will be in effect for calendar year 2001. For purposes of our long-term forecast, we *have not* assumed continuation of this quarter-cent reduction in subsequent years. The status of the trigger in these out years will depend in large part on *policy decisions* regarding the level of reserves included within future budgets.

The 2001-02 Outlook. As indicated in Figure 2, General Fund revenues are projected to exceed current-law expenditures by $3.4 billion next year, boosting the cumulative reserve to just over $10 billion. The $3.4 billion operating surplus in the budget year reflects the combination of (1) the modest 4 percent revenue growth discussed above and (2) a *decline* in expenditures of 1.6 percent during the year.

The small decline in expenditures projected for 2001-02 is primarily related to one-time funding of over $5 billion included in 2000-01. A second factor is relatively small increases in ongoing expenditures in such key programs as Proposition 98, California Work Opportunity and Responsibility to Kids (CalWORKs), and corrections programs.

Long-Term Projections. In subsequent years, our projections indicate that General Fund revenues will again exceed expenditures—by $3.4 billion in 2002-03 and increasing amounts thereafter. This positive outlook reflects our assumption that spending for most of the state's major program areas—including education, CalWORKs, Supplemental Security Income/State Supplementary Program, and corrections—will increase less rapidly than the roughly 7 percent average growth rate expected for General Fund revenues during the period. The one major exception to this trend of moderate expenditure growth is the Medi-Cal Program, where increased health care costs and utilization are expected to result in average annual increases of nearly 8 percent during the 2002-03 through 2005-06 period.

IMPLICATIONS OF OUR ESTIMATES

Our estimates imply that there will be $10.3 billion in uncommitted resources available next year to address budget- and tax-related priorities. While this is a very substantial sum, it will continue to be important to keep in mind the out-year implications of any decisions made regarding the use of these funds. In this regard, we believe that—as in past years—it will make sense to divide the $10.3 billion into two major categories—namely, (1) funds that should be used predominately for *one-time* purposes and (2) funds that are available for *ongoing* commitments.

In the context of the current outlook, Figure 3 shows that the $6.9 billion reserve carried into the budget year from 2000-01 should be used primarily for one-time purposes, and the $3.4 billion annual operating surplus (that is, the excess of revenues over expenditures in 2001-02) can be used for ongoing purposes.

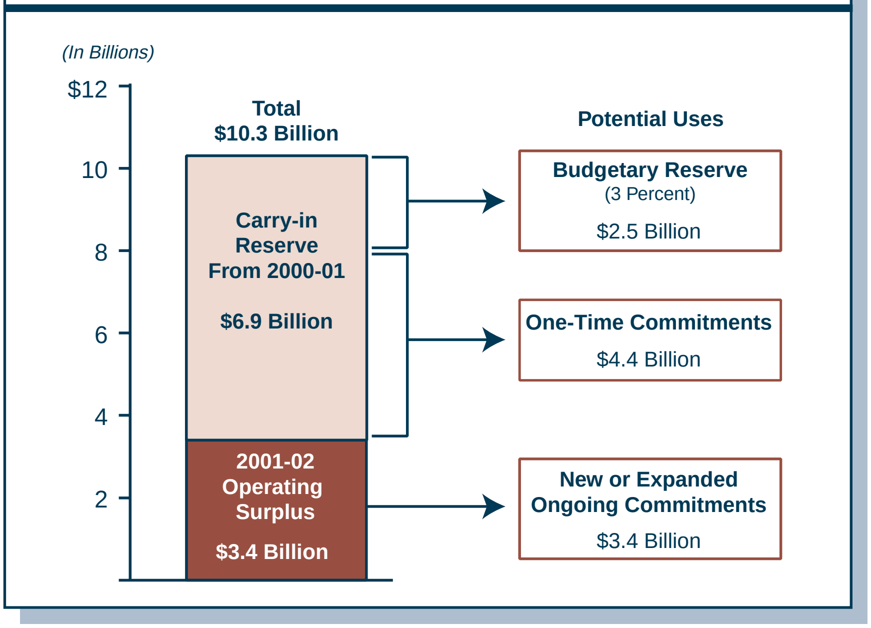
Uses of One-Time Funds

Within the one-time category, we believe that $2.5 billion—or about 3 percent of revenues—should be targeted for the 2001-02 budget reserve. This is a somewhat larger reserve than the Legislature has included in recent budgets. However, a 3 percent reserve has considerable merit in view of the current good economic times, and the ongoing uncertainty surrounding the future pace of growth in the state's revenue stream. As one indication, if continued declines in the stock market were to cause capital gains and stock options to fall 10 percent below our current estimate, total revenues would be about $1.5 billion less than the forecasted amount in 2001-02. Similarly, if employment and income growth in California were to fall just 1 percent below our forecast, the resulting reduction in revenues would be in the range of $1 billion.

After funding such a reserve, the remaining one-time funds—about $4.4 billion—would be available for such potential one-time commitments as tax reduction, infrastructure spending, and settlement of the long-standing special education mandate claim.

Figure 3

The Projected 2001-02 Surplus Sources and Potential Uses



Uses of Ongoing Funds

Figure 3 shows that the excess of revenues over expenditures in 2001-02—about $3.4 billion—would be available for ongoing budget- and tax-reduction priorities. This reflects our assumption that the $3.4 billion annual operating surplus will be maintained—and in fact grow—in future years, assuming continued economic expansion and current-law policies.

Even though they are quite large, it is important to keep our projected annual operating surpluses in perspective. They assume, for example, that Proposition 98 funding will grow at a comparatively modest pace in 2001-02 (due to the interaction of the Proposition 98 guarantee with our revenue forecast). If, in contrast, the Legislature chose to fund Proposition 98 at $1 billion above the minimum guarantee next year (an amount that would result in continued growth in real per pupil funding in 2001-02), this would "use up" roughly one-third of the operating surplus. Similarly, a decision to make permanent the quarter-cent sales tax reduction (or provide an equivalent tax reduction through some other means) would reduce the annual surpluses by another $1.2 billion. Just these two actions would eliminate two-thirds of the annual surpluses we foresee in the next two years.

Thus, even in these extraordinarily positive fiscal circumstances, it will be important that decisions made regarding the 2001-02 budget be consistent with the maintenance of balanced budgets both next year and in the future.

Chapter 2

Economic and Demographic Projections

Economic and demographic developments in California have important effects on the state's fiscal condition, as they have impacts on both tax receipts and state expenditures. This chapter presents our economic and demographic projections for 2000 through 2006, which will affect California's fiscal condition during fiscal years 2000-01 through 2005-06.

THE ECONOMIC OUTLOOK

Our forecast calls for continued healthy—though somewhat moderating—national- and state-level economic growth. This reflects such factors as: increases in technologically driven investments; large productivity gains; and high levels of wealth, consumer and business confidence, and income. Clearly, there are risks to the outlook, including further potential declines in the stock market, accelerating tensions in the Middle East, and the adverse effects of higher energy prices on overall inflation. However, none of these factors presently appears to be of sufficient magnitude to derail the current expansion. Our updated U.S. and California economic outlooks are summarized in Figure 1 (see page 8).

Recent Developments

U.S. Economy. The national economy once again is outperforming expectations in 2000. Real gross domestic product (GDP) is on track to increase by over 5 percent during the current year—a dramatic gain given that the economy is in its tenth year of expansion and is operating at full employment. The recent third-quarter report on GDP indicates that the economy is finally starting to slow some, and this is confirmed by recent monthly reports on retail sales and employment trends. This slowdown is being interpreted as a sign that the previous monetary tightening undertaken by the Federal Reserve is having the desired effect of moderating economic growth to a sustainable, noninflationary pace.

California Economy. California has been experiencing booming economic conditions in 2000. Employment in the state is up by over 3.5 percent this year, while personal income and taxable sales are up by over 11 percent. As with the nation, the state's peak growth rates appear to have occurred in the first half of the year (see Figure 2 page 8). However, monthly indicators such as state withholding and sales tax receipts suggest that California's expansion remains robust.

The state's expansion continues to be broad based, with large employment increases occurring in construction, professional services, transportation, tourism, and motion picture production. The fastest growing sector is computer-related services, which includes businesses involved in networking

Figure 1

The LAO's Economic Forecast 2000 Through 2006

Percent Change (Unless Otherwise Indicated)

	2000	2001	2002	2003	2004	2005	2006
United States							
Real gross domestic product	5.1%	3.2%	4.1%	4.5%	3.5%	3.3%	3.6%
Wage and salary jobs	2.2	1.5	1.3	1.8	1.6	1.4	1.3
Consumer Price Index (CPI)	3.4	2.7	2.4	2.5	2.8	3.1	3.2
Unemployment rate (%)	4.0	4.3	4.4	4.3	4.3	4.3	4.2
Housing starts (000)	1,631	1,601	1,666	1,750	1,746	1,739	1,707
California							
Personal income	11.5%	6.6%	6.5%	6.8%	6.8%	6.8%	6.7%
Wage and salary jobs	3.6	2.6	2.4	2.3	2.3	2.2	2.1
Taxable sales	11.7	6.7	6.0	6.2	6.4	6.6	6.5
Consumer Price Index (CCPI)	3.7	3.4	2.9	3.0	3.2	3.3	3.5
Unemployment rate (%)	4.9	4.7	4.5	4.5	4.6	4.7	4.6
New housing permits (000)	145	150	158	165	165	170	165

design and software development for the Internet and other integrated systems (see Figure 3). Overall, employment related to computer-related services is up 14 percent over the past year—despite the widely publicized shakeout among "dot-com" enterprises (that is, companies that sell products and services over the Internet).

An especially positive factor in California's near-term outlook is the resumption of growth in high-tech exports to overseas markets. Primarily reflecting improved conditions in Asia, exports of computers, electronics, and instruments produced in California are up by 27 percent in 2000 (see Figure 4).

Figure 2

California's Personal Income and Taxable Sales Growth Peaked in Early 2000

Year-Over-Year Percentage Change, by Quarter

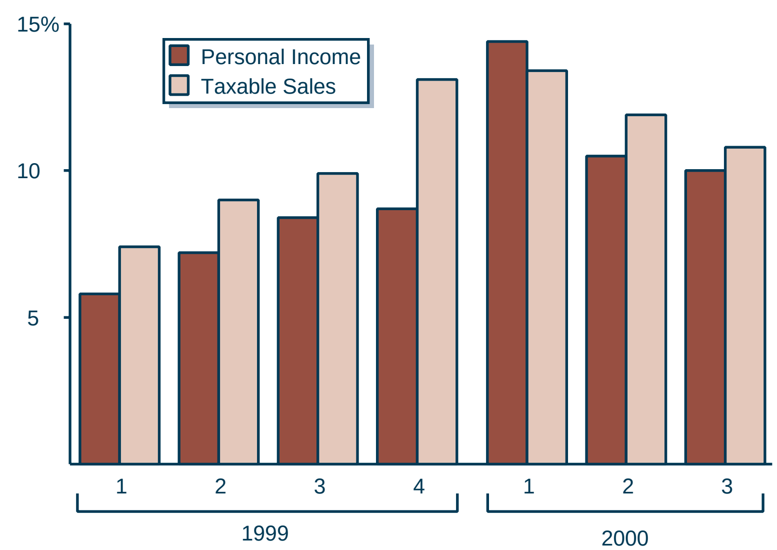


Figure 3

High-Tech Services Have Been Leading California's Economic Expansion

Percent Change in California Jobs
Third Quarter 1999 to Third Quarter 2000

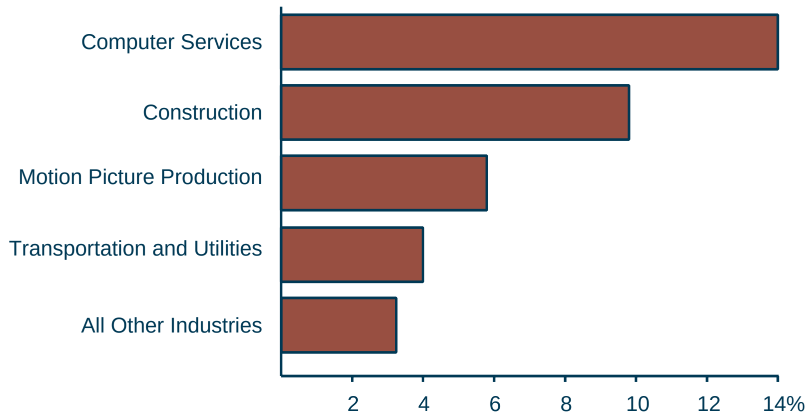
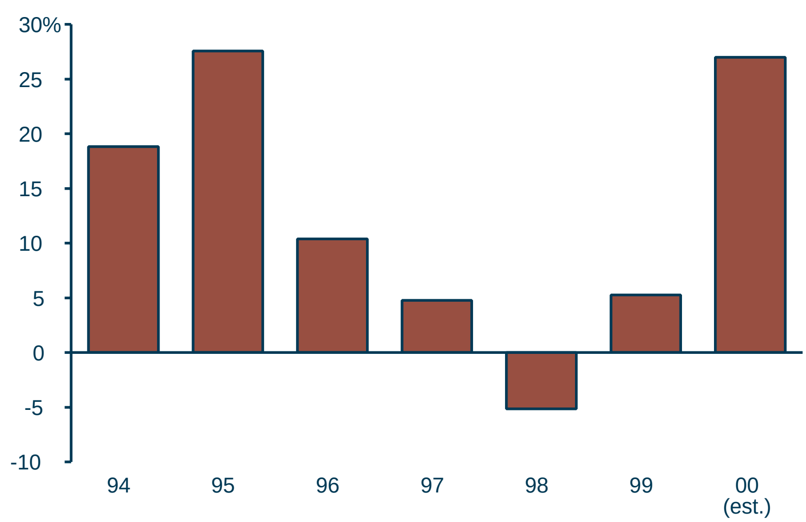


Figure 4

California's High-Tech Exports Now Growing Rapidly

Exports of Computers, Electronics, and Instruments
Annual Percent Change



U.S. Outlook

Near-Term Forecast (2000 Through 2002). Our forecast assumes that the current modest slowing in national economic growth will persist through mid-2001, as output is scaled back to bring production in line with the current moderation in sales. Following this minor inventory correction, we assume that economic growth will continue at a healthy rate during the balance of the near-term forecast period, with real GDP growth averaging 3.7 percent annually during 2001 and 2002. Although energy prices are expected to remain relatively high, continued strong worker productivity gains and somewhat slower economic growth should hold inflation in check during the next two years. The U.S. Consumer Price Index (CPI) is predicted to average about 2.6 percent during the same period.

Longer-Term Forecast (2003 Through 2006). Our long-term forecast assumes that sustained economic growth will continue through the forecast period, with real GDP expanding at a trend rate of 3.7 percent per year. The outlook for these years is tied to our assumptions of continued healthy worker productivity growth and high rates of technology-driven investment spending. We also assume that annual inflation, as measured by the CPI, will remain in the range of 2.5 percent to 3 percent during the forecast period.

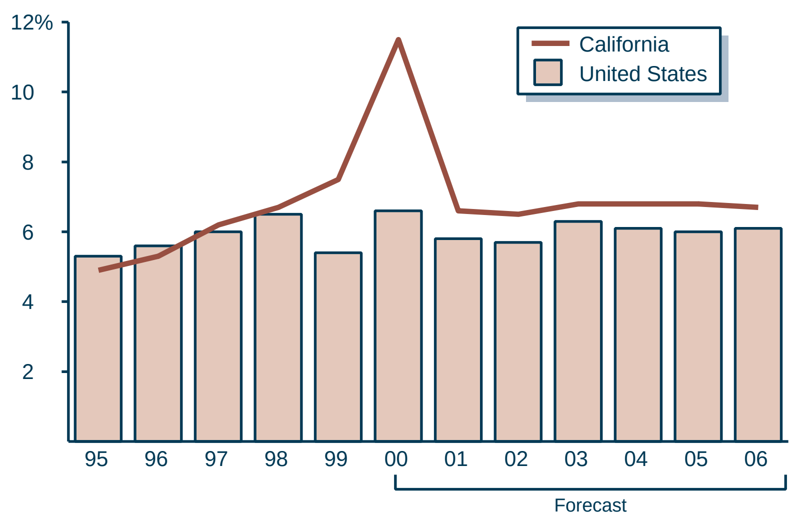
California's Outlook

Near-Term Forecast (2000 Through 2002). We expect economic growth in California to subside from its current dramatic pace, yet still remain stronger than the nation during the near-term forecast period. As shown in Figure 5, we project that personal income growth will subside from 11.5 percent this year to 6.6 percent in 2001, and further to 6.5 percent in 2002. During the same period, we expect a similar moderation in taxable sales growth.

Figure 5

California's Income Growth to Continue Leading Nation

Year-Over-Year Percent Growth in Personal Income



The marked expected slowdowns in personal income and taxable sales do not portend an underlying weakness in California's economy, however. Rather, they reflect the absence of special factors that contributed to this year's dramatic increases in these two measures. Specifically, personal income in 2000 was boosted by an extraordinary increase in stock options exercised during the year. Similarly, taxable sales have been boosted both by these income gains and by increased expenditures on gasoline, the latter attributable to higher oil prices.

Longer-Term Forecast (2003 Through 2006). Our longer-term forecast assumes that California's economy will continue to expand at a healthy pace through 2006, and that employment and income will again outpace the nation. Supporting this positive long-term outlook is California's dominant position in key "new economy" industries, including the production of computers, electronics, communications equipment, and software.

Threats and Challenges

The main threats to the positive current national economic outlook stem from rising energy prices and potential further stock market volatility.

Energy Prices. Over the past year, major worldwide increases in crude oil and natural gas prices have led to corresponding increases in energy costs and higher prices for a variety of energy-related products. So far these increases have not materially "spilled over" into the prices for other goods and services in the U.S. economy—largely because significant worker productivity gains and stiff import competition have held most prices in check. However, if energy-related price increases were to lead to higher prices in other areas, the resulting acceleration of inflation would likely result in tighter monetary policies, higher interest rates, and a sharper slowdown in economic activity than assumed in our forecast.

Stock Market Volatility. As of late October, all major stock market indexes were down for the year, with the NASDAQ off by nearly 40 percent from its March 2000 peak. These lower market valuations have not had a material effect on overall economic activity so far. However, given the still-lofty values of many stocks relative to their current and expected earnings, many market analysts believe that the market remains extremely vulnerable to any bad news regarding such factors as higher inflation, rising interest rates, and profit slowdowns. Further stock market declines could exacerbate the effects of any negative economic developments through their impacts on wealth, confidence, and spending.

In addition to the above concerns, California faces numerous pressures related to its extraordinary growth in recent years. These growth pressures are evidenced in sharply rising home prices and rents, higher energy costs, and intense debates over proposed development projects. While growth-related strains have not yet proven to be a barrier to the state's economic expansion, they clearly will pose major challenges to policymakers in the years ahead.

THE DEMOGRAPHIC OUTLOOK

California's population currently totals about 35 million, having increased by nearly five million during the 1990s. As Figure 6 indicates, we project that moderate population growth will continue over the next six years, with another three million people being added and the state's total reaching 38 million by 2006.

State to Outdistance Nation. Although we expect the state's population growth rate to slow somewhat during the next several years, it still will remain nearly twice what the U.S. Census Bureau projects for the nation as a whole.

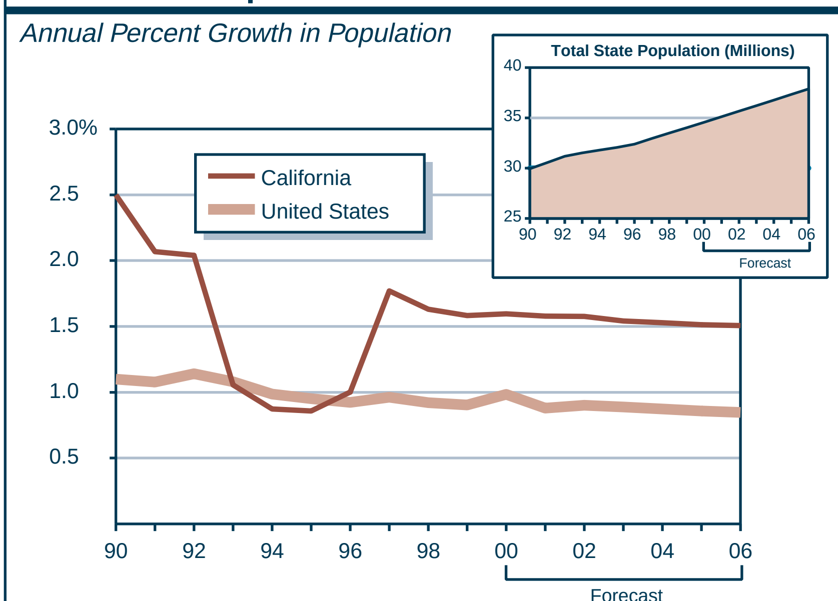
Population Growth Components

California's population growth can be broken down into two major components—*natural increase* (the excess of births over deaths) and *net in-migration* (persons moving into California from other states and countries, minus people leaving the state for other destinations).

Natural Increase. The natural-increase component is projected to account for slightly over half of the state's total population growth, averaging about

Figure 6

California's Population to Grow Faster Than Nation



Source: LAO forecast for California and U.S Census Bureau for the United States.

280,000 persons annually. This amount is similar to recent years but significantly less than for the early 1990s, when the natural increase averaged nearly 400,000. The decline largely reflects the aging of the baby boomers past their years of peak fertility, as well as reduced birth rates within younger age groups—especially the 15-to-19 age range.

Net In-Migration. We project that net in-migration will be averaging about 270,000 annually during the forecast period, or slightly less than the natural-increase component. Nearly 90 percent of this net in-migration can be attributed to net *foreign* in-migration, which has remained fairly steady over the past decade and should continue to be so through 2006.

In contrast, net *domestic* in-migration has fluctuated widely over the past decade. During the late 1980s and into the early 1990s, net domestic in-migration remained high—over 100,000 people annually. However, California's recession in the early 1990s reversed this trend and negative net in-migration emerged, as more people left California for other states than came in. California's current booming economy has stimulated a return to positive net domestic in-migration, but the amount is projected to remain relatively modest over the next six years. This is due to such factors as the rising costs of housing in California and the improved health of economies in other states.

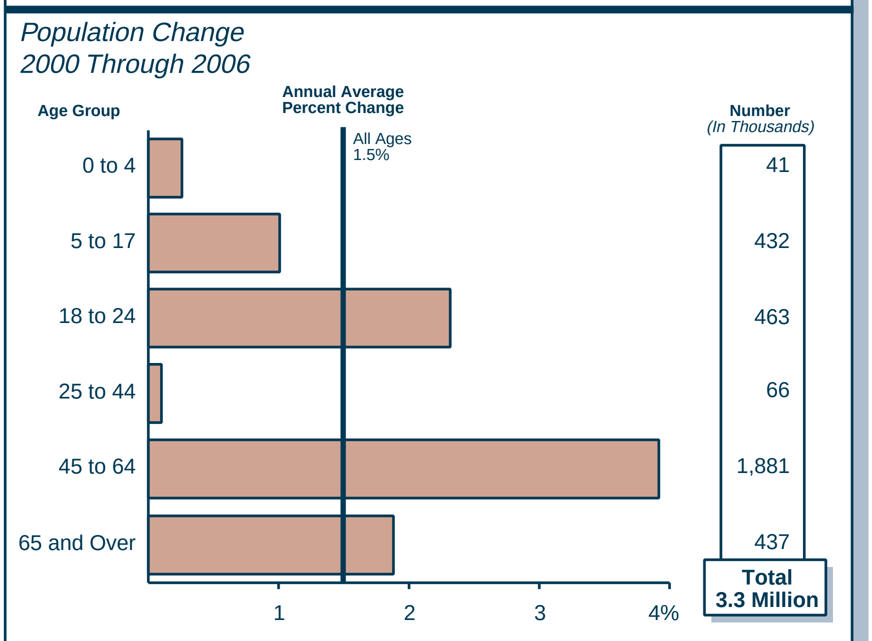
Growth to Vary by Age Group

Figure 7 shows our population growth projections by broad age categories, both in numerical and percentage terms. In numerical terms, the 45-to-64 age group (baby boomers) easily dominates. In percentage terms, the 45-to-64 age group also is growing the fastest, followed by the 18-to-24 age group.

These various age-group demographic projections can have significant implications for the state's revenue and expenditure outlook. For example, strong growth of the 45-to-64 age group can result in higher tax revenues since this is the age category that routinely earns the highest wages and salaries. Likewise, above-average growth in the young adult population should stimulate college enrollments, while the slow growth in the 0-to-4 age group is an indication that K-12 enrollments will be slowing.

Figure 7

California's Population Growth, By Age Group



Chapter 3

Revenue Projections

California's revenue outlook has continued to improve substantially since the *2000-01 Budget Act* was signed in June. The forecast underlying the budget assumed that revenue growth would slow sharply in 2000-01, reflecting more moderate economic performance during 2000 accompanied by declines in capital gains and stock options. Over the last several months, however, it has become apparent that revenue trends are much stronger than anticipated last spring.

THE LAO'S REVENUE FORECAST

Reflecting these recent positive fiscal trends, our updated forecast calls for another year of strong revenue growth in 2000-01, followed by more moderate, but still healthy gains in subsequent years. The forecast is discussed in more detail below and summarized in Figure 1.

Prior-Year Revenues (1999-00)

We estimate that revenues in 1999-00 totaled $71.7 billion, or $551 million more than assumed in the *2000-01 Budget Act*. Cash receipts in May and June 2000 were up by a combined total of $789 million relative to the May Revision forecast. The final budget recognized $238 million of that total, but did not incorporate the remaining $551 million. Total receipts in 1999-00 increased by over 22 percent from 1998-99, the largest gain in recent history.

Figure 1

The LAO's General Fund Revenue Forecast

(Dollars in Millions)

	Preliminary	Forecast					
Revenue Source	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**
Personal income tax	$39,471	$44,190	$45,810	$49,240	$53,000	$56,860	$61,060
Sales and use tax	21,109	22,068	22,910	24,960	26,590	28,380	30,300
Bank and corporation tax	6,663	7,178	7,550	7,980	8,420	8,910	9,430
Other revenues and transfers	4,470	4,490	4,769	4,978	5,147	5,400	5,675
Total revenues and transfers	**$71,713**	**$77,926**	**$81,039**	**$87,158**	**$93,157**	**$99,550**	**$106,465**
Percent change	22.3%	8.7%	4.0%	7.6%	6.9%	6.9%	6.9%

Current-Year Revenues (2000-01)

We forecast that General Fund revenues will total $77.9 billion in 2000-01, an 8.7 percent increase from the prior year. Our forecast includes the effects of legislation enacted earlier this year which will result in the diversion for transportation-related purposes of $500 million in General Fund revenues. It also includes a $540 million revenue reduction associated with the "triggering off" of a one-quarter cent share of the state sales tax rate beginning on January 1, 2001 (see shaded box). Even with this lat-

Sales Tax Rate to "Trigger Off"

On January 1, 2001, the General Fund sales tax rate will be reduced by a quarter cent—from 5 percent to 4.75 percent. This will correspondingly reduce the statewide average state and local sales tax rate from about 7.92 percent to roughly 7.67 percent. Current law requires this reduction to occur if the state's projected budgetary reserve (that is, the Special Fund for Economic Uncertainties, or SFEU) is certified to exceed 4 percent of revenues for the second year in a row.

Background

In 1991, with the state mired in a deep recession and facing severe budgetary shortfalls, the Legislature adopted a one-quarter percent increase in the General Fund's existing sales tax rate of 4.75 percent. The law also provided that it would "trigger off" in any year if the Director of the Department of Finance certifies on or before November 1 that the SFEU (1) exceeded 4 percent of General Fund revenues in the prior year and (2) also is projected to do so in the current year. The latter projection is to be made assuming that the quarter-cent reduction is in place the remaining six months of the fiscal year involved.

The law also provided that once triggered off, the quarter-cent rate would again "trigger on" if the 4 percent threshold was not met in any subsequent year. Thus, a permanent "toggle" was established whereby the quarter-cent rate could flip back-and-forth from being "on" or "off" depending on the size of the SFEU. Any required sales tax increase or decrease becomes effective on January 1 following the certification.

Fiscal Effect

This is the first time that the quarter-cent rate will trigger off, reflecting the Director's certification that the SFEU for 1999-00, and that projected for 2000-01, exceeds 4 percent of revenues. Our own projections confirm this. We estimate that the full-year effect of the 2001 rate reduction will be to reduce General Fund sales tax revenues by approximately $1.2 billion, with $540 million occurring in 2000-01 and $630 million in 2001-02.

In subsequent years, our forecast treats the issue of whether the quarter-cent rate will be on or off as a policy decision. Under *current law*, we forecast that the SFEU will exceed 4 percent of revenues throughout the forecast period. However, the Legislature's future spending and taxation decisions and the actual course of California's economy will affect this assessment in the future.

ter reduction—which the *2000-01 Budget Act* did not anticipate—our revised 2000-01 revenue estimate is still up by about $4.1 billion from the budget forecast. This higher estimate reflects California's continuing economic boom in 2000, as well as the much stronger-than-expected cash receipts from the sales and personal income taxes.

Budget-Year Revenues (2001-02)

Our forecast assumes that revenues will total $81 billion in 2001-02, a 4 percent increase from the current year. The forecast includes the effect of the increased diversion of gasoline-related sales taxes from the General Fund to transportation funds, the remaining half-year of the triggered quarter-cent sales tax reduction, and the ongoing effects of other tax-related legislation passed last year. Absent the effects of these and other special factors, our underlying revenue growth rate for 2001-02 is about 5 percent.

This underlying rate of revenue growth represents a significant slowdown from the prior and current years. The slowdown is primarily due to our assumption that, after increasing dramatically in 1999 and 2000, personal income taxes attributable to capital gains and stock options will fall modestly next year. Over the longer term, we project that General Fund revenues will increase at an underlying annual rate of about 6.8 percent, reaching $106 billion by 2005-06.

FISCAL EFFECTS OF REVENUE MEASURES

General Fund revenue performance during the forecast period will be significantly affected by tax reductions and redirections approved in conjunction with the *2000-01 Budget Act*, as well as the recent certification by the Director of the Department of Finance of a one-quarter cent sales tax reduction for calendar year 2001 (see earlier shaded box). Figure 2 (see page 16) shows the estimated fiscal effects of these and other actions.

Tax Reductions

The VLF Reduction. The 2000-01 tax package consisted principally of an acceleration of the cumulative 67.5 percent reduction in the vehicle license fee (VLF) tax rate. Under prior law, this reduction would have been phased in over several years and been fully implemented by January 2003. Under revised law, however, the full reduction will take place in January 2001. Since the VLF is a local revenue source, the accelerated reduction will result in increased General Fund expenditures to backfill local revenue losses. Compared to prior law, the increased subventions will total $887 million in 2000-01 and $1.4 billion in 2001-02.

New Provisions Affecting General Fund Taxes. The main provisions in this category are: (1) a tax credit of up to 50 percent of tax liabilities for credentialed teachers in public and private schools, with the maximum credit amount being related to years of experience; (2) a tax credit for taxpayers incurring expenses associated with long-term care of eligible elderly or disabled individuals in their homes; (3) a refundable tax credit for child care expenses for those taxpayers earning $100,000 or less; (4) targeted tax reductions, including tax credits for research and development expenses; and (5) expanded deductions for net operating losses.

Other Revenue-Related Actions

As part of the 2000-01 budget agreement, $500 million of sales taxes on gasoline will be diverted from the General Fund to transportation-related special funds in 2000-01. In the following five years (2001-02 through 2005-06), the full amount of sales taxes on gasoline (about $1.1 billion per year) will be transferred. Also, as discussed earlier, a one-quarter cent sales tax reduction will take effect for

Figure 2

Fiscal Effects of Recent Revenue-Related Measures

(In Millions)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
Tax Reductions						
Vehicle license fee acceleration	$887	$1,426[a]	$553	—	—	—
New General Fund tax provisions						
Credentialed teacher tax credit	$218	$188	$202	$217	$233	$245
Child care credit	195	189	193	197	201	210
Senior homeowners' and renters' tax assistance	154	—	—	—	—	—
Targeted tax cuts	88	161	133	136	158	190
Totals, new General Fund tax provisions	$655	$538	$528	$550	$592	$645
Other Revenue-Related Provisions						
Transportation sales tax diversion	$500	$1,060	$1,140	$1,150	$1,160	$1,170
Quarter-cent sales tax trigger	540	630	—	—	—	—
Totals, other revenue-related provisions	$1,040	$1,690	$1,140	$1,150	$1,160	$1,170

[a] Of this amount, $1,165 million was appropriated and counted as expenditures in 2000-01.

calendar year 2001. This will reduce sales tax revenues by $540 million in 2000-01 and $630 million in 2001-02.

INDIVIDUAL REVENUE SOURCES

Over the next five years, we expect overall revenue growth to slow from its dramatic pace in recent years. As shown in Figure 3, we project that revenues will increase at an average annual rate of 6.8 percent during the 2000-01 through 2005-06 period, compared to the average annual increase of 10 percent that occurred for the 1994-95 through 1999-00 period. This projected slowing is reflective of our forecast for more moderate economic growth during the forecast period. It also reflects our assumption that growth in personal income taxes related to stock options and capital gains will subside from their recent robust pace.

Personal Income Taxes

Personal income tax (PIT) receipts have continued to grow at extraordinary rates in the second half of 2000. Cumulative net collections for the first four months of this fiscal year are up by over 20 percent from the prior year, reflecting major gains in both withholding collections and quarterly estimated tax payments. As shown in Figure 4, withholding payments grew at a 19 percent year-over-year pace through the first three quarters of calendar year 2000—nearly double the pace that would normally be expected during a period of economic expansion. The growth in quarterly estimated payments has been even stronger, topping 35 percent so far this year. These increases reflect both (1) healthy underlying growth in employment, wages, and business earnings, and (2) extraordinary increases in stock options and capital gains, which are being realized at an unprecedented rate in 2000.

Personal Income Tax Payments To Slow in 2001. We forecast that payments attributable to 2000 tax liabilities will remain strong through April 2001, when final payments are due. However, we also expect that payments attributable to 2001 liabilities will subside early next calendar year. While the economy is expected to remain healthy, we project that the roughly 30 percent of PIT revenues related to stock options and capital gains will fall modestly next year.

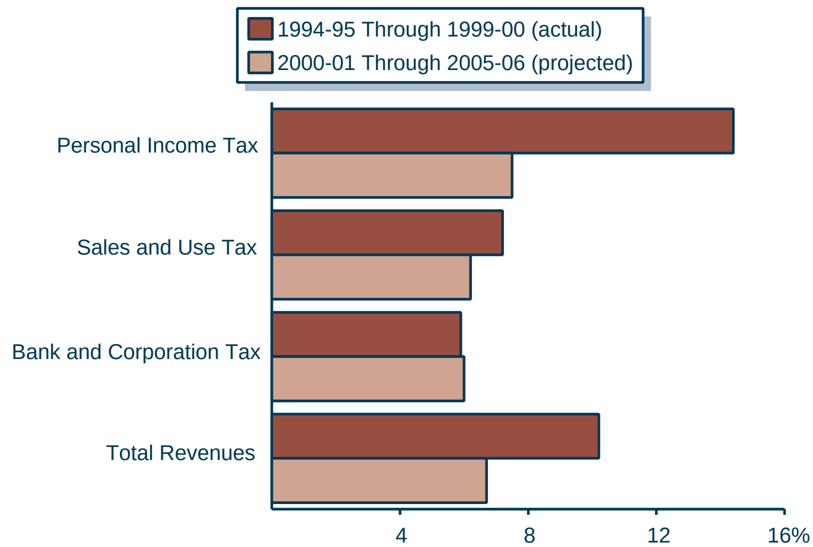
Specifically, as shown in Figure 5 (see page 18), we estimate that income related to capital gains and stock options increased by about 50 percent in 1999 and 30 percent in 2000, but that it will fall by 10 percent in 2001 before rebounding in 2002 and 2003.

Why the Drop in Options and Capital Gains? Based on company reports, it appears that the recent stock market volatility—especially in the high-tech sector—caused many company officers, employees, and investors to "cash in" stocks during 2000. This would have been done in order to "lock

Figure 3

General Fund Revenues, By Source[a]

Average Annual Percent Change

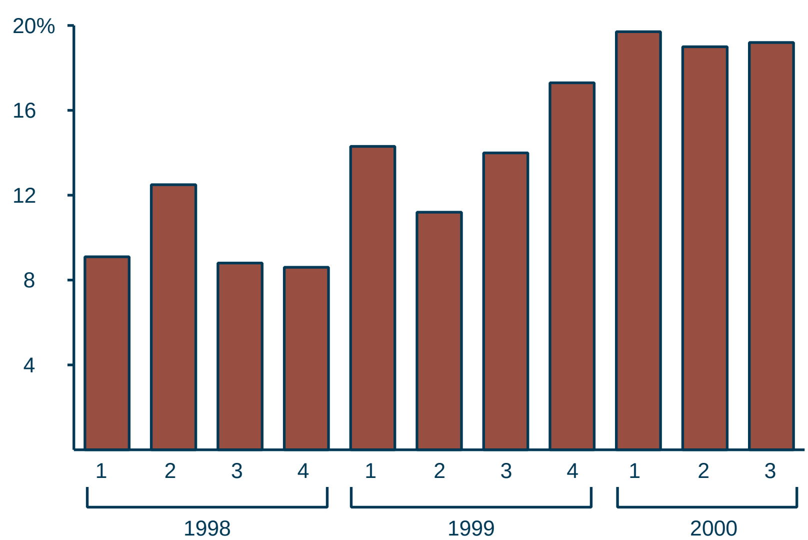


[a] Excludes effect of revenue-related legislation passed in the 1990s.

Figure 4

Withholding Payments Booming in 2000

Year-Over-Year Percentage Change, by Quarter



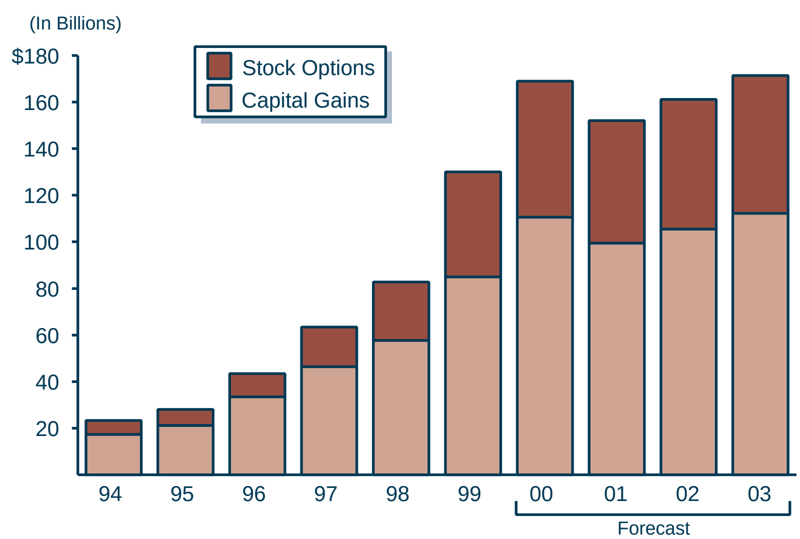
in" gains that had built up over the past several years. While this has boosted tax liabilities in 2000, this surge of activity has at the same time reduced the amount of unrealized gains available to be realized in 2001 and beyond. This is particularly true for investors and employees in high-tech companies that have experienced large declines in their share values in 2000. We expect the decline in stock market-related gains to be mitigated somewhat by increases in real estate-related capital gains. However, absent a significant upturn in the stock market, we believe overall gains and stock option-related income will fall some next year from their lofty recent peaks.

The PIT Revenue Forecast. Based on the assumptions discussed above, we estimate that PIT receipts will total $44.2 billion in the current year, up 12 percent from 1999-00. Our current estimate is up $2.9 billion from the *2000-01 Budget Act* estimate. In 2001-02, we forecast that PIT receipts will increase by 3.7 percent—to $45.8 billion. Over the longer term, we forecast the revenues from this source will grow at an average annual rate of 7.5 percent, reaching $61.1 billion by 2005-06.

Figure 5

Capital Gains and Stock-Option Income to Moderate After Strong 2000

Income Included on California Tax Returns



Sales and Use Taxes

After several years of moderate growth, taxable sales increased sharply in 1999 and 2000. We estimate that taxable sales will increase by 11.7 percent in the current year, the largest gain since 1984. While some of the increase is due to the recent surge in gasoline prices, the majority is related to across-the-board strength in consumer and business spending. Factors underlying these major spending increases include high levels of wealth (both stock market and real estate related), consumer and business confidence, and personal income growth.

Looking ahead, we forecast that sales will increase by 6.7 percent in 2001—in line with our projected gain in personal income during the year. This forecast generally assumes continued healthy growth in most sales categories in California. It also assumes that gasoline prices will decline modestly from their recent high levels, reflecting less severe worldwide supply-demand imbalances in the crude oil markets.

Over the longer term, we forecast taxable sales increasing by about 6.3 percent per year. This average increase is modestly less than the projected annual increase in California personal income (6.8 percent). While levels of wealth and confidence will remain positive factors in the outlook, we expect that taxable sales growth will be restrained somewhat by the continued trend in the economy toward consumption of services and E-commerce. Most services and certain E-commerce transactions do not generate California sales and use tax (SUT) revenues.

The SUT Revenue Forecast. Receipts from the SUT over the next several years will be affected by both underlying changes in taxable sales and a variety of policy-related factors. The main factors are the one-year quarter-cent sales tax reduction and the diversion of sales taxes on gasoline to transportation funds discussed above. Taking into account these factors, we estimate that General Fund SUT receipts will be $22.1 billion in 2000-01, which is $750 million more than anticipated in the *2000-01 Budget Act.* Thereafter, we forecast that SUT revenues will increase to $22.9 billion in 2001-02, a 3.8 percent increase from the current year, and then grow steadily to $30.3 billion by 2005-06.

Bank and Corporation Taxes

After increasing at a sluggish pace for several years, bank and corporation tax (BCT) receipts jumped 16 percent in 1999-00, reflecting increased profits in most industries. Tax payments attributable to 2000 earnings are continuing to grow at a healthy pace. Based on limited payment data for the first half of calendar year 2000, it appears that most industries are experiencing healthy profit growth, with the exception of financial services and utilities (whose profits continue to be adversely affected by industry restructurings). We estimate that California taxable profits will increase by about 12 percent in 2000, before settling down to annual growth rates of about 6 percent during the balance of the forecast period.

The BCT Revenue Forecast. We forecast that BCT receipts will increase from $6.7 billion in 1999-00 to $7.2 billion in the current year. The current-year estimate is about $378 million above the *2000-01 Budget Act* forecast, reflecting our projected higher level of corporate profits during the current year. We forecast that tax receipts will then rise by 5.2 percent, to $7.6 billion in 2001-02. In subsequent years, we project that receipts will increase by between 5.5 percent and 6 percent annually, to $9.4 billion by 2005-06.

Other Revenues and Transfers

We estimate that revenues from all other sources—including insurance premiums taxes, estate taxes, tobacco and alcohol-related taxes, interest earnings, and tobacco settlement payments—will remain flat at about $4.5 billion in 2000-01. In subsequent years, revenues from these other sources are forecast to rise at an average annual rate of about 4.4 percent, reaching $5.7 billion by 2005-06. Our forecast assumes moderate growth in receipts from insurance and estate taxes, marginal gains from the alcoholic beverage taxes, and modest declines in tobacco taxes.

Chapter 4

Expenditure Projections

In this chapter, we discuss our General Fund expenditure projections for 2000-01 through 2005-06. We first look at general budget trends during the forecast period, and then discuss expenditure projections for each of the major program areas in more detail.

GENERAL FUND BUDGET TRENDS

Distribution of General Fund Spending

Figure 1 shows how General Fund spending is distributed among major programs in 2000-01. Slightly less than half of the total is devoted to education spending, of which 36 percent is for K-12 Proposition 98 and about 10 percent for higher education. Slightly less than one-fourth of the budget is for health and social services, and about 5 percent is for corrections. The remainder is for state operations, debt service, various local subventions (including the vehicle license fee [VLF] backfill), and other purposes.

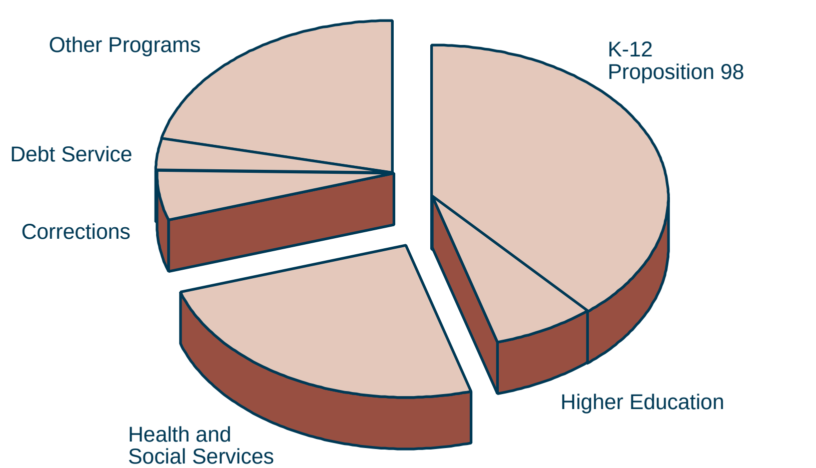
Spending Trends Over the Forecast Period

Total General Fund Spending. Figure 2 (see page 22) presents our General Fund spending forecast by major program area through 2005-06. Total spending is projected to increase from $67.1 billion in 1999-00 to $79 billion in 2000-01. Over the full forecast period, General Fund expenditures are pro-

Figure 1

Education and Health and Social Services Account for Most Spending

General Fund by Program Area
2000-01



jected to increase at an average annual rate of about 6.9 percent per year, rising to $99.9 billion by 2005-06.

Projections by Program Area. The overall 6.9 percent increase in state spending reflects divergent trends among the General Fund's major programs. As indicated in Figure 2:

- *K-12 Proposition 98* spending is projected to increase at an average annual rate of 5.8 percent between 1999-00 and 2005-06. In the current year, this spending grows 9 percent, reflecting major increases in the 2000-01 budget for general purpose funding as well as teacher recruitment and retention programs. In the subsequent 2001-02 through 2005-06 period, K-12 spending grows at an average annual rate of about 4.5 percent, which is in line with the Proposition 98 minimum guarantee. This growth rate can be attributed to two factors: (1) slowing annual increases in K-12 school enrollments, which are projected to taper from 2 percent in recent years to only one-half percent by the end of the forecast period; and (2) comparatively large increases

Figure 2

Projected General Fund Spending for Major Programs[a]

(Dollars in Millions)

	Actual	Estimated	Projected					Average Annual Growth 1999-00 Through 2005-06
	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	
Education programs								
K-12—Proposition 98[b]	$25,081	$27,334	$28,302	$30,116	$31,766	$33,459	$35,194	5.8%
Community college—Proposition 98	2,412	2,678	2,772	2,950	3,112	3,278	3,448	6.1
CSU	2,208	2,416	2,538	2,691	2,849	3,014	3,187	6.3
UC	2,627	3,106	3,177	3,355	3,535	3,723	3,918	6.9
Health and Social Services								
Medi-Cal benefits	$7,574	$8,715	$9,751	$10,627	$11,465	$12,315	$13,217	9.7%
CalWORKs	1,977	2,077	2,107	2,104	2,036	2,081	2,351	2.9
SSI/SSP	2,508	2,623	2,783	3,008	3,200	3,391	3,601	6.2
Other major programs	5,010	5,812	6,314	7,027	7,692	8,417	9,211	10.7
Department of Corrections	$3,977	$4,192	$4,275	$4,405	$4,646	$4,867	$5,089	4.2%
Vehicle License Fee subventions	$1,287	$3,614	$2,442	$3,856	$4,122	$4,407	$4,711	24.1%
Debt service[c]	$2,530	$2,730	$2,941	$3,053	$3,178	$3,318	$3,402	5.1%
Other programs/costs	$9,865	$13,690	$10,243	$10,603	$11,141	$11,896	$12,563	4.1%
Totals	**$67,055**	**$78,986**	**$77,646**	**$83,795**	**$88,741**	**$94,166**	**$99,892**	**6.9%**

a Detail may not total due to rounding.
b Projections for K-12 and community college Proposition 98 funding have been apportioned by the same percentages as actual funding in the *2000-01 Budget Act*.
c Includes both general obligation and lease-payment bonds for all departments.

in local property tax revenues, which offset General Fund spending requirements.

- *Higher Education (Community Colleges/ California State University [CSU]/University of California [UC])* spending increases occur for all three segments over the forecast period. Community college Proposition 98 spending increases at an average of 6.1 percent annually between 1999-00 and 2005-06. This growth rate includes the effects of substantial funding increases adopted in 2000-01. In subsequent years community college funding grows in line with the Proposition 98 minimum guarantee. California State University and UC spending are projected to increase at average annual rates of 6.3 percent and 6.9 percent, respectively, over the forecast period. These increases include the effects of large funding increases included in the 2000-01 budget and projected growth in enrollments and cost-of-living adjustments (COLAs) in subsequent years.

- *Medi-Cal Benefits* are projected to increase at an average annual rate of 9.7 percent during the forecast period. The factors behind the increase include the continued rise in general health care costs and growth in the caseload of elderly and disabled persons.

- *CalWORKs* spending is projected to increase at a moderate average annual rate of 2.9 percent over the period. The key factor holding down spending growth is the continued decline in caseloads through 2004-05.

- *Supplemental Security Income/State Supplementary Program* spending is projected to increase at an average annual rate of 6.2 percent. This reflects the impact of caseloads and COLAs over the forecast period.

- *Other Major Health and Social Services Programs* (which include In-Home Supportive Services [IHSS], developmental services, and the Healthy Families Program) are projected to increase at an average annual rate of 10.7 percent. This growth can be attributed to rising caseloads and costs associated with a number of individual programs. For example, recent legislation has authorized state expenditures for increases in wage and health benefits for many IHSS workers. Other growth is attributed to increases in the Healthy Families Program caseload, and the anticipated State Children's Health Insurance Program waiver (which would extend health insurance coverage to the parents of children enrolled in the Healthy Families and Medi-Cal Programs).

- *Department of Corrections* spending is forecast to grow at an average annual rate of about 4.2 percent. This moderate growth reflects an annual increase in inmate population of about 1.5 percent per year. These estimates include the effects of Proposition 36, which will divert some drug offenders into drug treatment programs instead of prison.

- *Vehicle License Fee* subventions to backfill local revenue losses associated with the VLF tax reduction increase from $1.3 billion in 1999-00 to $4.7 billion in 2005-06. The growth reflects 2000-01 budget-related actions which implemented the full 67.5 percent reduction to the tax effective January 2001.

- *Debt Service* is projected to increase an average of 5.1 percent per year, reflecting the assumption that about $2.5 billion in new bonds will be sold annually throughout the forecast period.

- *Other Programs/Costs* are projected to increase about 4.1 percent per year with rates which vary by program. Included in this category are contributions to the state employees' and teachers' retirement systems, state operations, and expenditures associated with recent and future employee compensation COLAs. Also included in this category are large one-time expenditures for transportation and other programs in both the prior and current years.

PROPOSITION 98— K-14 EDUCATION

State spending for K-14 education (K-12 schools and community colleges) is determined largely by Proposition 98 passed by the voters in 1988. Proposition 98 sets the minimum amount that the state must provide for California's public K-12 education system and the California Community Colleges (CCC). About 80 percent of operations funding for these school programs is from the state General Fund and local property taxes, pursuant to Proposition 98. Public K-12 education is provided to about 6 million students—ranging from infants to adults—through over 1,000 locally governed school districts and county offices of education. The CCC provide instruction to about 1.6 million adults at 107 colleges operated by 72 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 near 6 percent for the 2000-01 through 2005-06 period. This is lower than the 10.9 percent increase in 1999-00 and the projected increase of 8.7 percent for the current year. Proposition 98 spending in these two years reflects appropriations *above* the minimum guarantee. For these two years, the cumulative appropriation above the guarantee is about $2.3 billion, which raises the Proposition 98 base for all future years. Our forecast reflects our moderate revenue forecast and future spending at the minimum guarantee level.

For 2001-02, we estimate that Proposition 98 will require the Legislature to spend at least $2.1 billion, or 4.9 percent, more on Proposition 98 programs than in the current year. This estimate assumes a so called "Test 3-B" scenario (where annual growth in the funding guarantee is based on growth in per capita General Fund spending). The provisions of Proposition 98 would require additional spending of approximately $1.5 billion in subsequent years eventually to restore funding levels to a higher, "Test 2" level (where annual growth is based on the change in per capita personal income). Funding at the minimum level in the budget year would cover the cost of enrollment growth, COLAs, and annualizing program funding that phases in during the current year, leaving little or nothing for new programs or program expansions.

Key Forecast Factors. General Fund expenditures for Proposition 98 depend on the following factors: state population, K-12 average daily attendance, per capita personal income, per capita General Fund revenues, and local property taxes. Figure 3 summarizes our assumptions for these factors and the guarantee which results. Our economic forecast assumes state tax revenues will grow by about 7 percent annually over the forecast period.

K-12 Funding Projections. Figure 4 displays our projected K-12 per-pupil spending from 2000-01 through 2005-06 (in both "current" and inflation-adjusted dollars). These estimates, which are derived from our Proposition 98 forecast, reflect real (that is, inflation adjusted) per-pupil increases averaging 2.6 percent each year between 2002-03 and 2005-06. These additional resources—averaging over

Figure 3

The LAO Proposition 98 Forecast

Annual Percent Change

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
State population	1.8%	1.6%	1.5%	1.5%	1.5%	1.5%
K-12 average daily attendance	1.5	1.1	0.8	0.5	0.5	0.3
Per capita personal income	4.9	7.3	4.9	4.9	5.3	5.2
Local property taxes	7.4	8.2	7.4	6.9	6.8	6.7
Proposition 98 guarantee	8.7	4.9	6.7	5.9	5.8	5.7

$900 million each year—would permit expansion of existing programs and/or funding for some new programs. As noted above, however, funding at the Proposition 98 minimum guarantee in 2001-02 would leave little or nothing for new programs or program expansions.

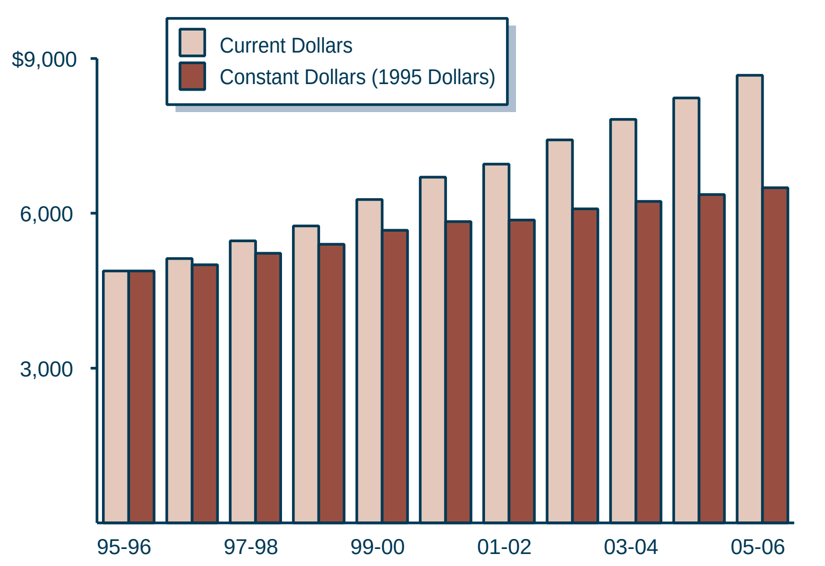
"Freed-Up" Proposition 98 Funds. Within the amounts that we have forecast for Proposition 98 is a total of $600 million that will be available each year for reallocation to other K-14 education purposes beginning in 2002-03. This amount includes $350 million that is currently allocated to a loan repayment relating to the *CTA v. Gould* lawsuit. Another $250 million will become available due to the sunset of the Schiff-Bustamante Instructional Materials Program (Chapter 312, Statutes of 1998 [AB 2041, Bustamante]).

Slowing K-12 Enrollment Growth. K-12 enrollment is projected to increase by just over 1 percent in 2001-02, bringing total K-12 enrollment to 5.9 million students. As Figure 5 (see page 26) shows, over the next eight years the rate of K-12 enrollment growth is expected to slow, then actually turn negative by 2008-09. During this period of slow growth and eventual enrollment decline, the Legislature would be able to increase per-pupil funding without expanding K-12 education's share of the state budget.

Figure 4

Proposition 98 Funding Per Student

Current and Constant Dollars

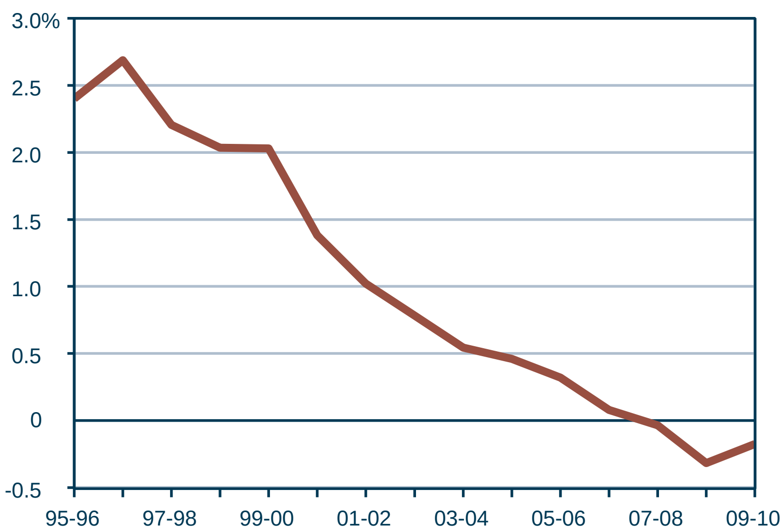


Community College Funding Projections. Based on our Proposition 98 projections, we estimate total CCC funding would increase by about 6.1 percent per year over the forecast period. (This assumes no change in the proportion of Proposition 98 funds going to the

Figure 5

Growth in K-12 Enrollment Will Slow Significantly

1995-96 Through 2009-10



CCC.) These increases would cover inflation and projected enrollment growth, with little or nothing available for new programs or program augmentations.

Proposed Special Education Mandate Claim Settlement

The Governor recently announced that his administration had reached a settlement agreement with school districts that had filed claims for the cost of certain special education programs. The settlement agreement would end a 20-year-old lawsuit in which districts alleged that the state mandated eight special education activities in excess of federal requirements without providing necessary funds. The major provisions of the settlement include a $270 million one-time payment to local education agencies in 2000-01, a series of one-time payments of $25 million per year for ten years starting in 2001-02, and $100 million of ongoing payments for special education beginning in 2001-02.

The settlement's potential effect on Proposition 98 funding requirements is uncertain. It would depend on specific funding steps taken by the Legislature in response to the proposed settlement as well as other actions the Legislature might take regarding Proposition 98 spending. For purposes of calculating a minimum Proposition 98 funding level for this report, we did not include any provision for the settlement. We would note that how payments are structured under a settlement would have varying implications on the guarantee for 2001-02 and beyond.

The settlement will not take effect unless 85 percent of the local education agencies, representing at least 92 percent of statewide K-12 attendance, sign off on it. It also will require the approval of the Legislature. The Legislature has options with respect to the settlement's parameters, including the option to modify or delete the eight state mandates in lieu of the $100 million annual payments.

UC AND CSU

In addition to community colleges, the state's public higher education system includes the UC and the CSU. The UC consists of eight general campuses, one health science campus, numerous special research facilities, and a planned tenth campus in Merced. The UC awards bachelor's, master's, and doctoral degrees, as well as various professional degrees. The UC has primary jurisdiction over research. The CSU consists of 22 campuses, several off-campus centers, and a planned campus at Camarillo. The CSU grants bachelor's and master's degrees and may award doctoral degrees jointly with UC or a private university.

The Spending Forecast. We estimate that spending for UC and CSU (excluding funding for capital outlay and debt service) will increase from $5.5 billion in 2000-01 to $5.7 billion in 2001-02, or by 3.5 percent. (This relatively low increase is due to high one-time expenditures in 2000-01.) By 2005-06, we estimate that spending for UC and CSU will increase to $7.1 billion, reflecting annual increases of about 6 percent.

Key Cost Factors. For 2001-02 and subsequent fiscal years, we assume that UC and CSU will receive "base" budget increases equivalent to the growth in inflation and enrollments. Over the forecast period, inflation is projected to average about 3.1 percent annually. With regard to enrollment growth, CSU's will vary between 2.5 percent and 3 percent over the period, with UC's growth being somewhat less each year.

In his "partnership" with CSU and UC, the Governor has committed to annual General Fund base adjustments of 5 percent plus funding for enrollment growth. The Legislature has not endorsed such automatic funding increases. Our projections for the CSU and UC budgets are lower than would occur under the partnership.

Cal Grant Increases. Chapter 403, Statutes of 2000 (SB 1644, Ortiz), significantly expands the Cal Grant program. There is much uncertainty as to the fiscal impact of the measure. This is because it is unclear how students and their families will respond to the changes in Cal Grant policies. Based on information from the Student Aid Commission, however, Cal Grant expenditures could reach over $1 billion by 2005-06.

HEALTH AND SOCIAL SERVICES

Medi-Cal

The Medi-Cal Program (the federal Medicaid program in California) provides health care services to recipients of California Work Opportunity and Responsibility to Kids (CalWORKs) or SSI/SSP grants, or other low-income persons who meet the program's eligibility criteria (primarily families with children and the elderly, blind, or disabled). The Department of Health Services (DHS) has overall responsibility for the program. The state and 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 $8.7 billion in 2000-01, essentially the same as the amount appropriated in the budget act. The caseload appears to be slightly below budget estimates, but caseload savings are more than offset by additional unbudgeted costs, including higher hospital and outpatient rates for Los Angeles County associated with the extension of its Medicaid waiver program.

We project that by the end of the forecast period in 2005-06, General Fund spending for Medi-Cal benefits will reach $13.2 billion, an average annual increase of 9.7 percent over the projection period. Spending growth in 2001-02 is especially large (11.9 percent) due to (1) the phase-in of eligibility expansions and simplifications that begin in the current year and (2) the full-year effect of provider rate increases implemented during the current year. The annual rate of spending growth is projected to be lower during the remaining years of the forecast period—an average of 7.9 percent.

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

- *Health Care Costs.* In the current year, our forecast assumes that the average cost of health care services per Medi-Cal enrollee will increase by about 9 percent, consistent with DHS' estimates for the 2000-01 budget. The relatively high rate of growth partly reflects rate increases for Medi-Cal providers that were approved in the budget. Many other purchasers of health care, such as the California Public Employees' Retirement System, also are experiencing similar cost increases. Our forecast assumes that the current spike in health care costs will moderate, and that the cost of most health care services provided to Medi-Cal enrollees will increase at an annual rate of 6 percent in 2001-02 and 2002-03, and then at an annual rate of 5 percent through 2005-06.

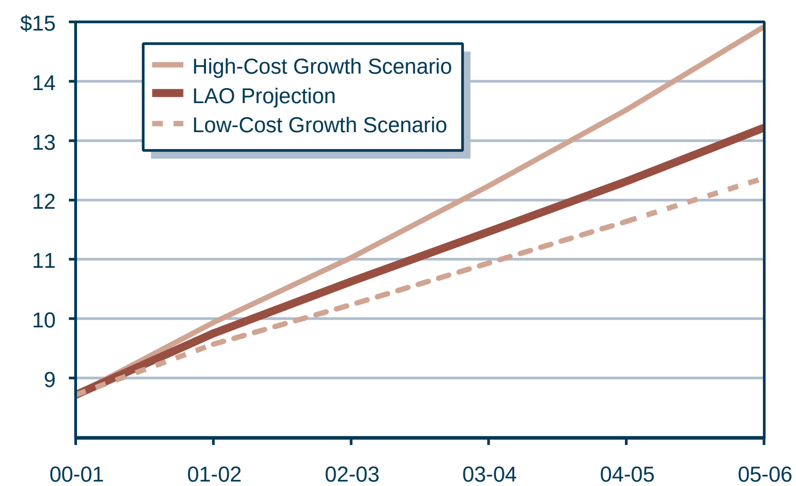
Our projected health care costs are subject to considerable uncertainty, and small changes in the rate of growth could have significant fiscal effects, as shown in Figure 6. For example, cumulative total General Fund costs under a higher growth rate scenario (8 percent annual rate of cost growth) would be $4.3 billion more than we project over the forecast period, while a low growth rate scenario (4 percent annual rate of cost growth) results in costs that would be $2.6 billion lower than our forecast.

- *Medi-Cal Enrollment Trends.* Our caseload projection indicates that the proportion of the Medi-Cal caseload consisting of the elderly or disabled increases somewhat over the forecast period. Because the elderly and disabled generally have higher health care needs

Figure 6

Rate of Health Care Cost Growth Could Significantly Affect Medi-Cal Spending

General Fund Costs (In Billions)



and costs than families and children, this change in the caseload "mix" adds to the projected spending growth. Our projection also assumes that a continued decline in Medi-Cal enrollment due to ongoing reductions in the CalWORKs caseload will be fully offset by increased enrollment of families and children who are not on welfare.

Our forecast also takes into account some significant additional Medi-Cal eligibility simplifications and expansions that were enacted as part of the *2000-01 Budget Act* that will affect caseload. For example, families will only need to file annual, rather than quarterly, reports to maintain their enrollment or that of their children. In addition, the maximum allowable income for the elderly, blind, and disabled was increased, and administrative changes were enacted to facilitate the continued Medi-Cal enrollment of families leaving CalWORKs or other recipients whose eligibility category changes. The fiscal effects of these actions are subject to significant uncertainty because these changes will not take effect until January 1, 2001, and may not be fully implemented for several months thereafter.

- *Reductions in the Federal Matching Rate.* We project that the rate at which the federal government matches state funds to support the Medi-Cal Program will decline slightly over the forecast period. Specifically, we project that the federal matching rate for California will decline from 51.67 percent in federal fiscal year (FFY) 2000 to 50.29 percent in FFY 2006, resulting in a cumulative increase in the General Fund share of Medi-Cal costs totaling $1.1 billion.

Healthy Families Program

The Healthy Families Program implements the federal State Children's Health Insurance Program (SCHIP), which was enacted in 1997. Funding generally is on a two-to-one federal/state matching basis. Families pay a relatively low monthly premium and can choose from a selection of managed care plans for their children. Coverage is similar to that offered to state employees and includes dental and vision benefits. The program began enrolling children in July 1998.

The Spending Forecast. We estimate that General Fund spending for the Healthy Families Program will be $157 million in 2000-01, consistent with the amount appropriated in the *2000-01 Budget Act*. General Fund spending will increase by almost 34 percent during 2001-02. In subsequent years, we estimate that General Fund costs will grow in accordance with demographic factors and increased medical costs, resulting in an annual General Fund cost of $270 million in 2005-06.

Key Forecast Factors. The General Fund expenditure growth during 2001-02 is due primarily to significant caseload expansion during the prior fiscal year. Specifically, we expect program enrollment to expand during 2000-01 to 80 percent of the estimated eligible population, with little further enrollment growth during 2001-02. The full annual cost impact of the 2000-01 caseload growth will not be felt, however, until 2001-02.

Another factor increasing program costs is projected growth in the caseload of legal immigrants. While the federal government pays for about two-thirds of the cost of enrollees who are citizens, legal immigrant enrollees who entered the United States after August 22, 1996, are funded solely by the General Fund. We estimate that the General Fund cost of maintaining coverage for this population will grow by 59 percent during 2001-02 primarily due to the full-year cost of serving this group.

Unexpended Federal Funds. Along with 40 other states, California has not exhausted its first SCHIP allotment over a three-year period. Pending congressional action may allow the state to retain part of the $590 million of these funds that the state has not spent. In future years, any unexpended SCHIP funds may be used to administer an SCHIP waiver program, as we discuss below.

The SCHIP Waiver

Pursuant to Chapter 946, Statutes of 2000 (AB 1015, Gallegos), California will submit an application to the federal government to extend health coverage to the parents of all children enrolled in the Healthy Families and Medi-Cal Programs. (Currently, only a portion of the parents with children in Medi-Cal are covered.)

In July 2000, the federal government announced that it will consider proposals to use states' excess SCHIP funds to help finance demonstration projects to expand health coverage and services, specifically for (1) coverage of parents of SCHIP enrollees and (2) public health initiatives designed to address or supplement targeted health needs of children. Implementation of parental coverage would begin once the state has submitted its waiver proposal to the federal government, the proposal is approved, and funds are appropriated by the Legislature.

The Spending Forecast. Our spending forecast assumes that the state will receive an SCHIP waiver to extend health coverage to the parents of all children enrolled in Healthy Families or Medi-Cal effective July 1, 2001, with the resulting additional enrollment phasing in over the ensuing 18 months. Our five-year forecast estimates a General Fund cost of $76 million in 2001-02, growing to $375 million in 2005-06.

Key Forecast Factors. Because Chapter 946 does not specify the details of the new adult health coverage program, our forecast assumes the implementation of a model similar to the one described in our June 1999 report, *A Model for Health Coverage of Low-Income Families,* with updated cost and demographic factors. However, our forecast has somewhat greater state costs than our model program because it (1) does not assume actions we had proposed to reduce county costs for Medi-Cal administration and (2) does not include all of the provisions to minimize crowd-out of private coverage that were incorporated into our model. We excluded these components because they were not included in Chapter 946.

Finally, our estimate reflects General Fund cost increases later in the projection period because, as the state depletes its SCHIP allotments, we assume that the state will rely on the normal Medicaid matching funds to maintain the program.

California Work Opportunity and Responsibility to Kids

In response to federal welfare reform legislation, the Legislature created the CalWORKs program in 1997. This program, which replaced the Aid to Families with Dependent Children program, provides cash grants and welfare-to-work services to families with children whose incomes are not adequate to meet their basic needs.

The Spending Forecast. General Fund spending in 2000-01 for the CalWORKs program is estimated to be $2.1 billion, an increase of 2.9 percent over the prior year. General Fund spending is projected to remain essentially stable through 2004-05. We project General Fund expenditures to increase by 13 percent in 2005-06, reaching $2.4 billion.

Key Forecast Factors. Our long-term CalWORKs spending projection depends on a number of factors, including caseload changes, the federal maintenance-of-effort (MOE) requirement, discretionary spending on county performance incentives, the impact of time limits, and the Temporary Assistance for Needy Families (TANF) block grant reauthorization. We discuss these factors below.

General Fund spending for CalWORKs is largely determined by (1) the federal MOE requirement and (2) available TANF block grant carryover funds. Under federal law, California must expend $2.7 billion to meet the MOE requirement and about $2.1 billion of this spending is satisfied with spending in the Department of Social Services. In 2001-02, sufficient federal carryover funds are available to enable the state to pay for anticipated program cost increases without going over the MOE floor. As carryover funds are exhausted over the following years, General Fund spending exceeds the MOE floor, especially in 2005-06, when the caseload begins to grow.

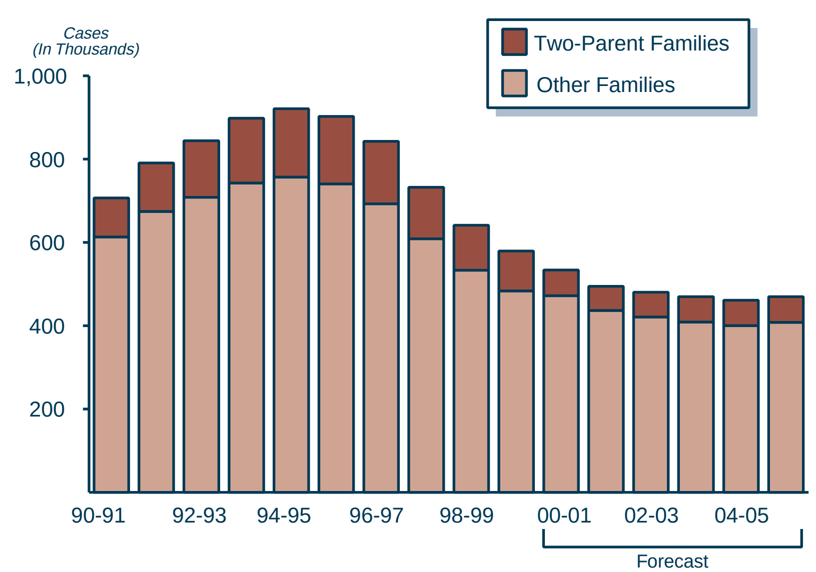
The 2000-01 Social Services trailer bill, in contrast to prior years, subjects all future county performance incentives to an annual appropriation. Therefore, our forecast assumes that performance incentives are discretionary and paid when federal funds are available through 2001-02.

Beginning in 2002-03, our forecast also assumes some savings due to adult recipients reaching their statutory five-year time limit on cash assistance. These savings, however, are offset by higher state costs due to the expiration of federal funds for the Welfare-to-Work program, increasing costs for child care and other support services, and in 2005-06, the first caseload increase since 1994-95. Finally, we note that each year of our forecast assumes that the TANF block grant will be reauthorized at its current $3.7 billion level for California.

Caseload Trends and Projections. Following a rapid increase in the early 1990s, the caseload peaked at 921,000 in 1994-95 and has declined by 37 percent since that time. The caseload reduction was 10 percent in 1999-00 and is projected to be 8 percent in 2000-01. We project that the caseload will decline by 7 percent in 2001-02, after which the reduction will slow to 3 percent in 2002-03 and 2 percent in 2003-04 and 2004-05. We project the caseload to then increase by 2 percent in 2005-06. This gradual end to the caseload decline is shown in Figure 7. Our projections are based on a trend analysis of caseloads, birth rates, grant levels, and unemployment rates.

Figure 7

CalWORKs Caseload Decline Gradually Ending



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.

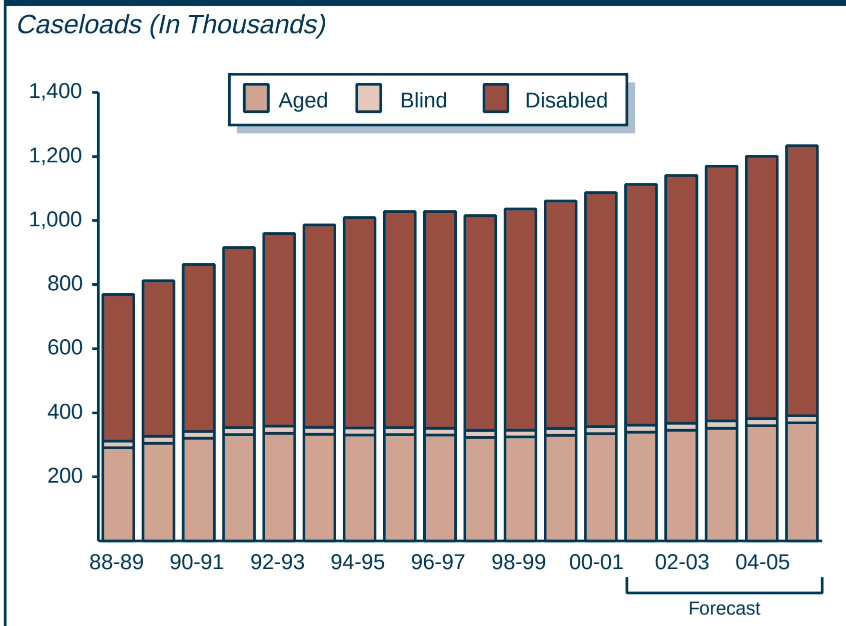
The Spending Forecast. General Fund spending for SSP is projected to be about $2.6 billion in 2000-01, an increase of 4.6 percent over the prior year. For 2001-02, we project an increase of 6.1 percent, raising total expenditures to $2.8 billion. We project that from 2002-03 through the end of the forecast period, spending for SSP will increase by an average of 6.7 percent per year, eventually reaching a total of $3.6 billion.

Key Forecast Factors. The two main components of projected cost increases in SSI/SSP are (1) caseload growth and (2) providing the statutory COLA. As discussed below, the caseload is expected to increase at an average annual rate of about 2.5 percent during the forecast period. In 2001-02, spending is projected to increase by $160 million. This increase is primarily due to the statutory COLA ($96 million) and caseload growth ($64 million). From 2002-03 through 2005-06, these factors together will result in annual spending increases of about $200 million.

Caseload Trends and Projections. During the late 1980s and early 1990s the caseload grew rapidly, with most of the growth in the disabled component of the caseload (see Figure 8). In the mid-to-late 1990s, the caseload leveled off and actually declined in 1997-98, in part because of federal policy changes which restricted eligibility. Since March 1998, the caseload has been growing. In the long run, we expect the aged component of the caseload to mirror the growth of the overall population over age 65. For the disabled, we anticipate caseload growth will be similar to the past year. In total, we project that annual caseload growth will increase gradually from 2.4 percent in 2001-02 to 2.7 percent in 2005-06.

Figure 8

SSI/SSP Caseloads Growing Moderately



In-Home Supportive Services

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

The Spending Forecast. General Fund spending for IHSS is projected to be $786 million in 2000-01, an increase of 24 percent over the prior year. For 2001-02, we project that costs will increase by an additional 6 percent, raising total expenditures to $830 million. For the next four fiscal years, we project that IHSS spending will increase by an average of 15 percent each year, eventually reaching a total of about $1.5 billion.

Key Forecast Factors. Our forecast assumes annual caseload growth of 5.5 percent and a 2 percent annual increase in the monthly hours of service provided to each client. In addition, recent legislation authorizing state participation in health benefits and wage increases for certain IHSS workers will result in substantial costs over the next five years. Specifically, we estimate that this legislation will increase state costs by roughly 7.5 percent each year compared to prior law.

JUDICIARY AND CRIMINAL JUSTICE

The major state judiciary and criminal justice programs include support for four agencies in the executive branch—the California Department of Corrections (CDC), Department of the Youth Authority, the Department of Justice, and the Office of Criminal Justice Planning—as well as expenditures for local trial courts and state appellate courts. The largest expenditure program—the CDC—is discussed in more detail below.

California Department Of Corrections

The CDC is responsible for the incarceration, 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 by about $298 million from 1999-00 to 2001-02, reaching about $4.3 billion at the end of that period. Expenditures for CDC are forecast at about $5.1 billion by 2005-06. (This includes adjustments for employee compensation increases, but does not include General Fund support for capital outlay and debt service, which are accounted for elsewhere in our projections.)

The projected growth in adult correctional expenditures continues a trend of steadily larger CDC budgets that has existed since the early 1980s. However, in a change from past projections, the CDC budget now appears likely to grow significantly more slowly than in the past. Under our new projections, the CDC support budget would grow at an average annual rate of about 4.2 percent through 2005-06, compared with substantially higher prior annual growth rates that sometimes exceeded 10 percent. Throughout the projection period, the CDC General Fund support budget is forecast to be about 5.4 percent of total General Fund expenditures, the lowest share it has been of the General Fund since the early 1990s.

The department's General Fund costs will be partially offset by reimbursements from the federal government for a portion of the state's costs of housing undocumented immigrants convicted of felonies in California. We expect this federal support to drop only slightly, from $178 million in 1999-00 to $171 million by 2005-06. The reason for the slight decline is that the FFY 2001 appropriation to reimburse states ($565 million nationwide), recently enacted by Congress, is slightly lower than the amount provided in the previous three years. (At the time this report was completed, the President had not acted on the appropriation.) We assume that Congress will continue to provide the FFY 2001 level in the future. Even if Congress increases funding to the pre-FFY 2001 level, it is likely that California's share will decline somewhat as other states and local governments become more sophisticated at tracking and claiming their costs for incarcerating undocumented felons.

Key Forecast Factors. The projected increases in General Fund support for CDC reflect the continued growth in the prison inmate population that is expected during the forecast period. The inmate population is projected to exceed 176,000 by June 2006. That represents an increase of close to 13,000 inmates, or about 8 percent, over the six-year projection period. As Figure 9 shows, the inmate population is still growing, but at a slower rate than prior years.

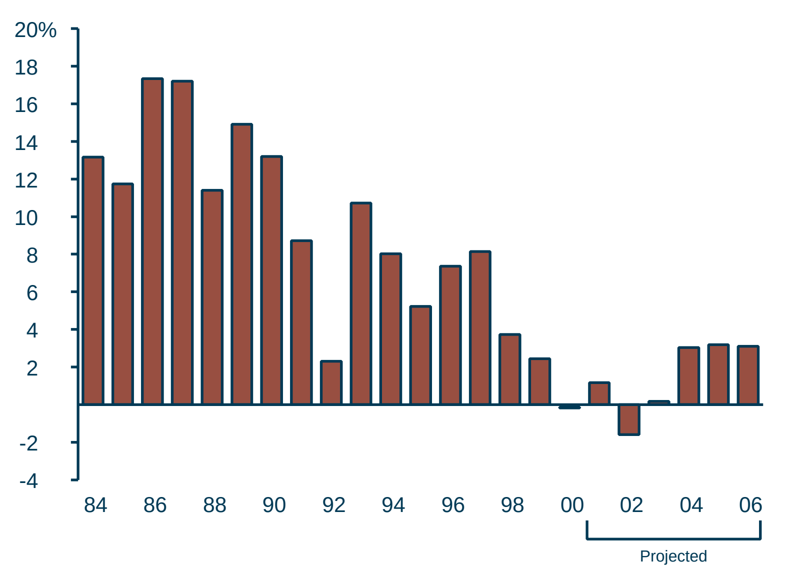
The projected changes in the inmate population are largely driven by three voter-approved initiatives. Two of these initiatives will increase the population and one will decrease it. Specifically, the "Three Strikes and You're Out" law, enacted in 1994 in Proposition 184, has increased the population because of the significantly longer prison sentences imposed upon offenders convicted under the law. The more recent Proposition 21, the Gang Violence and Juvenile Crime Prevention Act, which was passed by the voters on March 7, 2000, is expected to have a significant impact in the coming years. This law is expected to increase the prison population as it expands the definition of serious or violent offenses, potentially resulting in more "strikes" and increased penalties under the "Three Strikes" law. It also increases the penalties and enhancements for persons convicted of various felonies in association with criminal street gangs, resulting in additional time in prison.

Proposition 36, the Substance Abuse and Crime Prevention Act, which was passed by the voters on November 7, 2000, is expected to slow the growth in the prison population because it requires that persons convicted of nonviolent drug possession offenses be placed on probation and receive drug treatment, rather than be incarcerated in state prison. Similarly, the measure will redirect parole violators who commit nonviolent drug possession offenses into treatment rather than returning them to prison.

Figure 9

Prison Inmate Population Growth Has Slowed

Annual Increase in the Population



OTHER PROGRAMS

Vehicle License Fee Backfill

The VLF is an annual fee on the ownership of registered vehicles in California. It is levied in place of taxing vehicles as personal property, and the revenues are distributed to cities and counties. The Legislature reduced the fee—which was set at 2 percent of the depreciated value of a vehicle—by 25 percent in calendar year 1999 and 35 percent in 2000. For 2001 and thereafter, taxpayers will receive a 67.5 percent reduction in the fee, resulting in a tax rate of 0.65 percent. Under the provisions of these reductions, cities and counties continue to receive the same amount of revenues as under prior law, with the reduced VLF amounts replaced by General Fund spending. The fiscal effect of the 2001 tax reduction is spread over two fiscal years—resulting in total reimbursements to local governments of about $2.5 billion in 2000-01 and more than $3.6 billion in 2001-02.

Debt Service

Debt Payments. As shown in Figure 10, we estimate that General Fund debt costs (for general obligation and lease-payment bonds) will increase from about $2.5 billion in 1999-00 to about $3.5 billion in 2005-06. Our forecast assumes that $18 billion (an average of around $2.5 billion each year) in bonds will be sold over the forecast period. As a percent of total debt, lease-payment bond debt remains at about 20 percent throughout the forecast period based on currently authorized lease-payment bonds.

Debt Ratio. The state's debt ratio (debt payments as a percent of General Fund revenues) increased from 2.5 percent in 1990-91 to a high of 5.1 percent in 1994-95. In recent years, General Fund revenues have increased at a faster rate than the increase in debt payment. Thus, since 1994-95 the debt ratio has declined steadily, reaching 3.6 percent in 2000-01. We estimate that with the sale of bonds assumed in our forecast, the debt ratio will stay around this level through 2002-03 and decline gradually thereafter.

Figure 10

Bond Debt Payments Will Increase Gradually