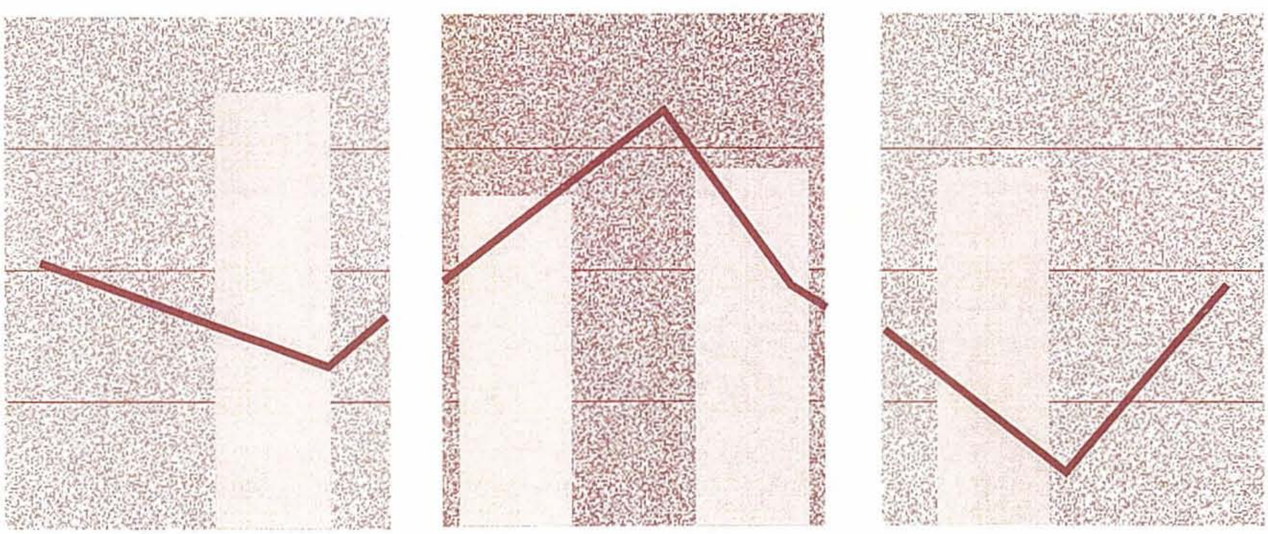
California's Fiscal Outlook

The LAO's Economic and Budget Projections 1995-96 Through 1997-98



November 1995

Elizabeth G. Hill • Legislative Analyst

Foreword

This report provides our projections of the General Fund condition for 1995-96 through 1997-98. It includes our independent assessment of the outlook for the economy, demographics, revenues, and expenditures. It is designed to assist the Legislature with its long-term 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 alternative budget outcomes which could result under a variety of circumstances other than those assumed in our projections. These include a weaker economy, the adoption of federal health and welfare reforms, adverse litigation, differing caseload and enrollment trends, and other factors.

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 the first of an ongoing series and will be updated periodically.

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Chapter 1

The Budget Outlook

This report presents our economic and budget outlook for fiscal years 1995-96 through 1997-98. Figure 1 summarizes our key findings.

Figure 1

Key Findings

- **Near-Term Budget Trends More Positive**
  - Economy and revenues up
  - Underlying health and welfare caseloads slowing
- **1995-96 Projected To End With Modest Reserve**
- **Revenue Growth Sufficient To Fund Most Current-Law Spending Requirements Through 1997-98**
- **Current-Law Spending Requirements Result In:**
  - Rapid growth in Proposition 98 and corrections spending
  - Restoration of welfare payments and renters' credit
- **Lawmakers Should Seize Opportunity To Establish Meaningful Budget Reserve**

OVERVIEW

In each of the past five fiscal years, the Legislature and Governor have faced multibillion dollar budget gaps. The near-term fiscal outlook is now significantly more favorable. As shown in Figure 2 (see page 2), we estimate that the state will end 1995-96 with a modest reserve. And while revenue growth in 1996-97 and 1997-98 will not be sufficient to fund all of the expenditures required by current law, there will be adequate funds to meet most of these requirements. The more positive budget outlook is related to three general factors:

- First, the economic and revenue outlook has improved markedly. We project that General Fund revenues will grow at an average annual rate of about 6.3 percent between 1994-95 and 1997-98, which is significantly higher than combined inflation and population increases. The revenue increases are a sharp contrast to the declines that occurred in the early 1990s.

- Second, underlying caseload growth has slowed dramatically in the state's health and welfare programs, reflecting past policy changes, improving economic conditions, and changes in demographic trends.

- Third, revenues in 1995-96 are exceeding expenditures by over $900 million as a result of past legislative actions (spending cuts, funding shifts to other levels of government, and revenue increases). This operating surplus will pay off the accumulated deficit, and enable the state to begin a new fiscal year with a modest reserve for the first time since the recession began.

Figure 2

LAO Projections of General Fund Condition 1994-95 Through 1997-98

(In Millions)

	1994-95	1995-96	1996-97	1997-98
Prior-year balance	-$1,170	-$350	$560	$270
Revenues and transfers	42,550	45,320	47,940	51,050
Total resources available	$41,380	$44,970	$48,500	$51,320
Expenditures	$41,730	$44,410	$48,230	$51,340
Ending fund balance	-$350	$560	$270	-$20
Reserve	**-$630**	**$300**	**$10**	**-$280**
Other obligations	$280	$260	$260	$260

Note: Amounts have been rounded.

KEY FEATURES OF OUTLOOK

Basis for Our Estimates—Current Law

Our budget forecast is based on the requirements in current law regarding revenues and expenditures. Specifically, we have adjusted the 1995-96 spending plan for constitutional and statutory requirements, as well as projected changes in prices, caseloads, and workloads. More specifically, we increased K-14 education funding in accordance with Proposition 98 spending requirements, and have provided for the restoration of welfare grant levels and the renters' credit in 1996-97, as required by existing statutes.

We would stress that our fiscal estimates are neither predictions of what the Legislature and Governor will eventually enact in coming budgets, nor are they our recommendations as to what spending and revenue levels should be. Rather, our estimates are based on what would happen if current policies were allowed to run their course. We believe they provide a meaningful starting point for the Legislature's evaluation of the state's fiscal condition, and its assessment of any necessary changes to the state's taxing and spending levels.

Economic and Revenue Outlooks—Moderate Growth

A key reason for the improving budget outlook is the economy. Recent developments clearly indicate that California's economy is on the upswing, and our economic forecast assumes that the state will continue to experience moderate growth and low inflation during the next three years. We project that California personal income and payroll employment will grow at average annual rates of 5.8 percent and 2.2 percent, respectively, between 1995 and 1998. Consistent with this moderate-growth economic outlook, we project that revenues will increase at an average annual rate of about 6.3 percent between 1994-95 and 1997-98.

1995-96 to End With Modest Reserve

The improving economy is having a positive impact on the current-year budget outlook. We project that 1995-96 will end with a reserve of $300 million, compared with the 1995-96 budget estimate of $28 million. The improvement is primarily related to stronger revenues, which we estimate will exceed the budget forecast by $1.3 billion this fiscal year. Under Proposition 98, about one half of the revenue gain would go towards increased K-14 school funding. Thus, the net increase to the General Fund's reserve would be about $700 million.

Partly offsetting this net revenue increase are additional state expenditures related to (1) partial loss of budgeted federal reimbursements, (2) a delay in federal law changes needed to implement certain welfare reductions assumed in the 1995-96 spending plan, and (3) higher state spending requirements for schools due to slightly higher enrollments and slightly lower-than-anticipated local property tax growth.

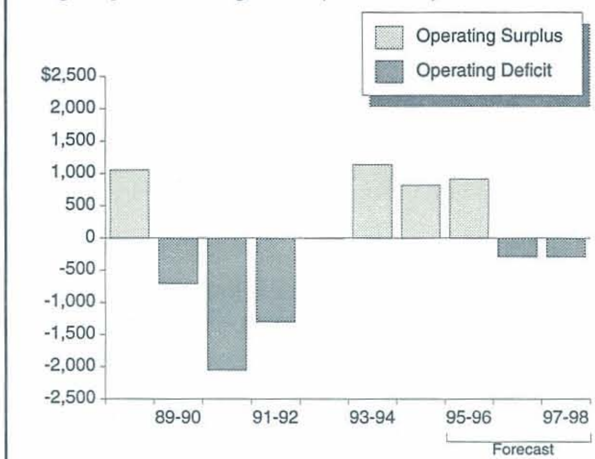
Budgets Nearly in Balance Through 1997-98

We estimate that revenues will fall short of current-law spending requirements in 1996-97

Figure 3

General Fund Operating Surplus/Deficit

Budgetary Accounting Basis (In Millions)



and 1997-98 (see Figure 3). As a result, the reserve will fall from $300 million in the current year, to $10 million next year, and to a deficit of $280 million in 1997-98, absent corrective action.

It should be stressed that the budget imbalances are *not* due to weak revenue growth. As indicated above, we project that revenues will increase at an annual rate of more than 6 percent during the next two years. Rather, the shortfalls are due to major expenditure increases that are required by existing law. As a result, total spending would increase by 7.5 percent annually over the next two years. This relatively rapid overall growth rate primarily reflects large spending increases in three key areas:

- *Proposition 98 K-14 Education Spending.* Projected General Fund costs to meet Proposition 98 spending requirements (the largest single spending component in the budget) increase by an average of 9.4 percent annually over the next two years. However, combined state and local funding available to schools and community colleges will grow somewhat more slowly than state funding (about 7.5 percent annually). This is because state funds must offset projected slower growth in local property tax revenue.

- ***Prisons.*** Continued growth in prison inmate populations increases support costs for the Department of Corrections by a projected 9.9 percent annually over the next two years.

- ***Restorations of Welfare Grants and Renters' Credit.*** Existing law requires that welfare grants for the Aid to Families with Dependent Children (AFDC) and the Supplemental Security Income/State Supplementary Program (SSI/SSP) be increased in 1996-97. This is because a 5.8 percent grant reduction enacted in 1992-93 and a 4.9 percent grant reduction enacted in the current year sunset at the end of 1995-96. In addition, the current suspension of the renters' tax credit program ends in 1995, which increases spending by about $500 million annually. In combination, these restorations add about $1.6 billion to the spending totals in both 1996-97 and 1997-98.

IMPLICATIONS OF OUR OUTLOOK

Our forecast for near-term budget improvement does not imply that California's fiscal health is fully restored. The state continues to face expenditure pressures relating to the continuing fiscal stress of counties, expanding prison populations, and demands for infrastructure spending, as well as an ongoing need to assess the viability of its tax structure and business climate. In addition, there are a number of risks to our forecast—including an economic slowdown and possible adverse court decisions—which could cause a serious deterioration in the budget outlook even in the next two years. Finally, the state will have to address whatever welfare and Medi-Cal changes that are enacted by the federal government.

For these reasons, the Legislature will face many tough decisions in the coming year and beyond. The more favorable outlook does, however, provide lawmakers with the opportunity to establish long-term budget priorities and address some of the above-mentioned issues in a more stable fiscal environment. At a minimum, we believe that the Legislature should seize the opportunity to establish a meaningful budget reserve.

Chapter 2

Economic and Demographic Projections

Economic and demographic trends are primary determinants of the state's fiscal condition, including revenues and expenditures. This chapter presents our economic and demographic projections.

THE ECONOMIC OUTLOOK

Our economic forecast calls for continued moderate growth both nationally and for California. Figure 1 summarizes the forecast.

The National Outlook

Our forecast reflects the current consensus view that the U.S. economy will continue to experience moderate growth with low inflation. The forecast assumes that federal monetary actions taken last year to raise interest rates and slow economic growth to a sustainable, non-inflationary pace were largely successful. While recent economic reports have shown a mixture of strengths and weaknesses in economic performance, the underlying trends currently appear consistent with a moderate growth outlook.

Key Features of U.S. Outlook. Real Gross Domestic Product (GDP) growth is projected to average 2.4 percent over the next three years. Business investment and exports are projected to be the fastest growing sectors. Consumer spending would grow in line with the economy while government would grow slightly slower than the economy. The forecast assumes that a federal budget compromise will yield expenditure cuts sufficient to modestly reduce future federal deficits.

Figure 1

LAO Economic Forecast

Percent Change *(Unless Otherwise Indicated)*

	1995	1996	1997	1998
United States				
Real GDP	3.1	2.4	2.4	2.3
Wage and salary jobs	2.2	1.6	1.7	1.6
Consumer Price Index	2.9	3.0	3.0	3.0
Unemployment rate (%)	5.6	5.8	5.9	5.9
Housing starts (millions)	1.34	1.86	1.30	1.28
California				
Personal income	7.8	6.2	5.8	5.5
Wage and salary jobs	2.0	2.4	2.2	2.1
Consumer Price Index	1.9	2.4	2.9	2.9
Population	1.3	1.5	1.6	1.6
Unemployment rate (%)	7.9	7.1	6.5	6.1
Housing permits (000)	95	125	141	149

The California Outlook

California's economic recovery gained significant momentum over the past year. Despite a weather-plagued first quarter, employment, income, and sales have generally exceeded forecasters' expectations in 1995. Most industry sectors except aerospace and financial services have shared in the gains.

Continued Growth Expected. Our forecast assumes that current state economic trends will continue during the next three years. Growth is forecast to average 5.8 percent for personal income and 2.2 percent for wage and salary employment. Figure 2 shows that employment is forecast to grow steadily, recouping the 725,000 jobs lost in the recession by the end of 1996. Although the projected rate of job growth is only about two-thirds that of the 1980s, this would be a sharp contrast to the job losses that occurred in the first half of the decade.

Uneven Job Growth by Sector. Underlying the overall moderate employment growth forecast is significant variation among industry sectors. As Figure 3 shows, the fastest growing sectors will be services, construction, trade and electronics-related manufacturing. In contrast, job losses are projected for financial services, the federal government sector, and aerospace-related manufacturing. The projected job losses in aerospace, although still large, are only about one-half of those of the past three years. Thus, the economic drag due to aerospace cutbacks will be less than previously experienced.

Figure 2

Moderate Job Growth to Continue

California Wage and Salary Employment (In Millions)

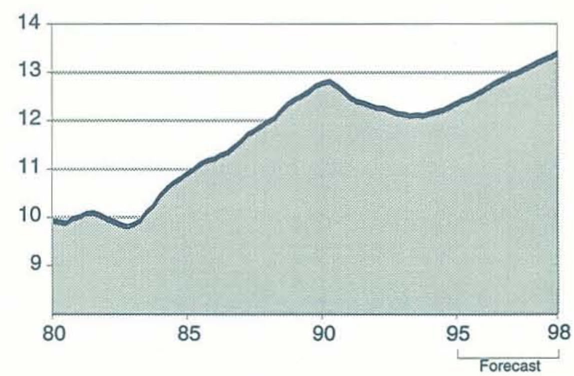
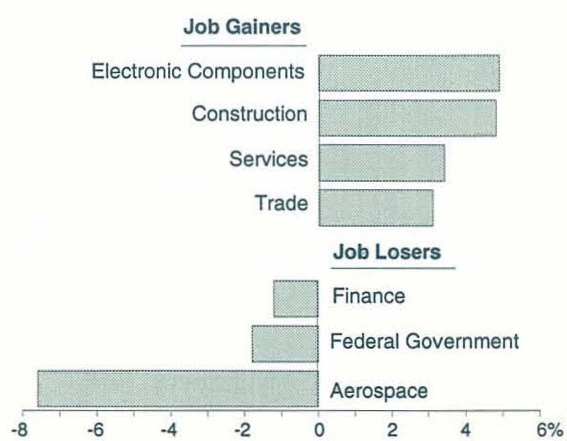


Figure 3

Job Performance Will Vary By Industry

Annual Percent Change in California Jobs 1995 Through 1998

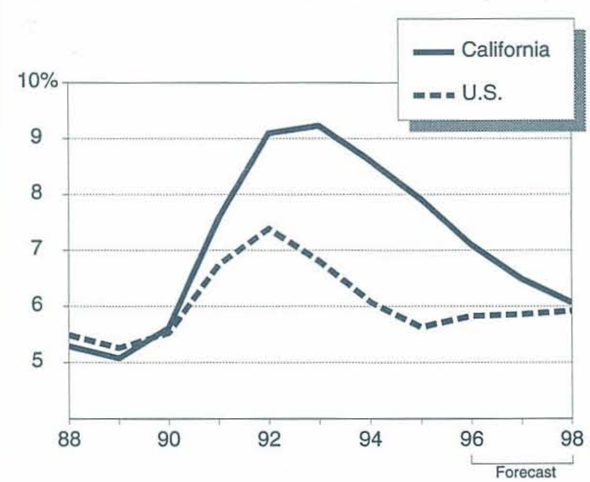


Unemployment Gap to Close. A significant feature of our forecast is that California will grow *faster* than the nation during the 1996 through 1998 period, reversing the trend that has persisted since 1990. This reversal is partly because California began recovering from the recession nearly two years after the nation. Thus, the state currently is in an earlier stage of its economic cycle. In addition, California has many businesses in the faster-growing sectors, such as electronics, selected services, and export-related industries. Figure 4 shows that, due to these factors, the state's unemployment rate, which currently is nearly 2 percentage points above the nation's, is expected to approximate the nation's by year-end 1998.

Figure 4

Unemployment Gap Closing

California and U.S. Unemployment Rates

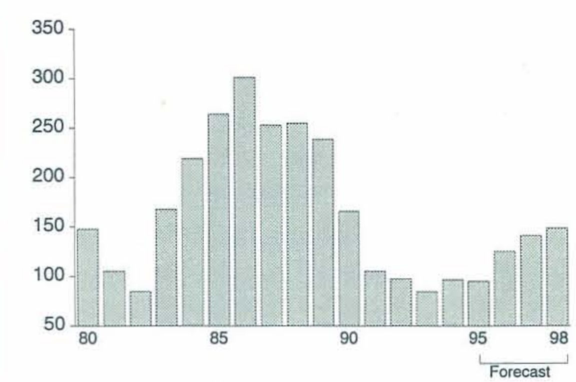


Housing to Improve Modestly. Home construction has failed to rebound as strongly as expected during the past year. However, recent data regarding home prices and construction provide some positive signs. As Figure 5 shows, we forecast that home construction will improve during the next three years. This reflects such factors as growing incomes, comparatively low interest rates, and stabilization in home prices. Despite our projected increases, however, permits will still be well below the levels reached in the 1980s.

Figure 5

Housing Sector to Slowly Recover

California Residential Building Permits (In Thousands)



Risks and Uncertainties

As with all economic projections, ours is subject to a variety of risks and uncertainties. One alternative scenario which would have especially significant budgetary implications is if the economy experienced a marked economic slowdown or downturn within the next three years. In Chapter 5, we discuss the fiscal effects of a more pessimistic economic scenario.

THE DEMOGRAPHIC OUTLOOK

California's population is projected to grow at an average annual rate of 1.6 percent during the next three years, to 34.1 million by 1998. While the projected growth is slightly more than the 1.3 percent average growth experienced from 1992 through 1995, it still is considerably below the average 2.5 percent gain that took place between 1987 and 1992. One of the main factors responsible for the population changes we are projecting involves net migration.

Net Migration to Trend Upward. Figure 6 shows that net migration rose sharply in the late 1980s, peaking at 465,000 in 1990. This reflected substantial increases in people moving to California from both other states and nations. In the early 1990s, however, the state's severe recession led to both net out-migration to other states and a marked slowdown in in-migration from other countries. Net migration fell to just 33,000 in 1994.

Although we do not anticipate a return to the high net migration levels of the late 1980s, the improved economy should cause a modest rebound during the next few years and help to produce a slight pick-up in overall population growth.

Growth by Age Group to Vary Significantly. Figure 7 shows our population projections by age group. It shows relatively rapid growth for the 5-to-17 age range (reflecting the rise in birth rates in the late 1980s), slow growth in the 18-to-24 age group, significant increases in the 45-to-64 age group (reflecting aging baby-boomers), and modest gains for the 65-and-older group. These various age-group outlooks have significant implications for state expenditures in many individual program areas, including education, health, and welfare.

Figure 6

California Net Migration Rising Following Sharp Decline

(In Thousands)

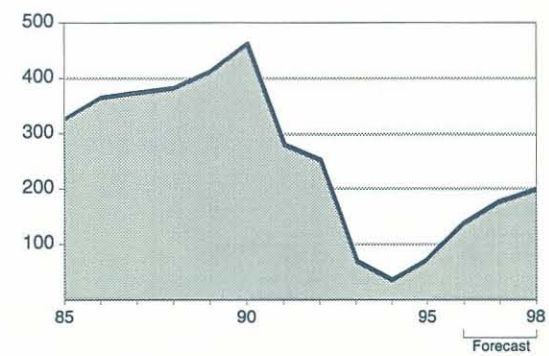
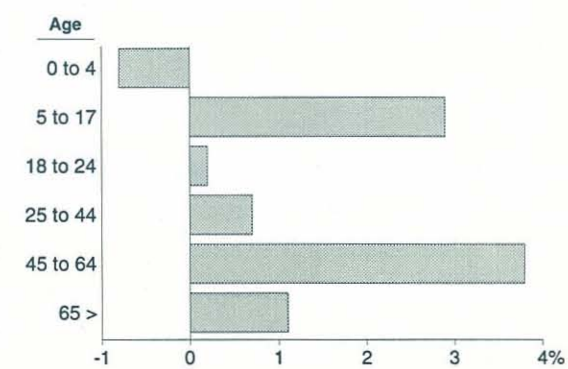


Figure 7

California Population Growth To Vary Dramatically by Age Group

Average Annual Percent Change by Age Group 1995 Through 1998



Chapter 3

Revenue Projections

This chapter discusses our General Fund revenue projections for 1995-96 through 1997-98, based on the standard economic forecast presented in Chapter 2.

FORECAST OVERVIEW

1995-96 Revenues. Following two years of declines, General Fund revenues grew by 6.5 percent in 1994-95. We expect a similar gain in the current year, as shown in Figure 1. This reasonably good growth is the direct result of the strengthening in California's economy, which has lifted personal income, retail sales, and other key revenue-related economic measures. We currently project that General Fund revenues will total $45.3 billion in 1995-96, which is $1.3 billion more than the revenue forecast contained in the 1995-96 budget adopted last August. Our forecast for stronger-than-assumed current-year revenues is consistent with recent cash trends, which show revenues through October up over $675 million, of which about $500 million appears permanent.

1996-97 and 1997-98 Revenues. Consistent with our moderate economic growth forecast, we project that General Fund revenue growth will average 6.1 percent over the following two years, with revenues totaling about $47.9 billion in 1996-97 and $51.1 billion in 1997-98.

Figure 1

LAO General Fund Revenue Projections

(Dollars in Millions)

Revenue Source	1994-95	1995-96	1996-97	1997-98
Personal income tax	$18,429	$20,470	$21,530	$23,140
Sales and use taxes	14,632	15,690	16,720	17,670
Bank and corporation taxes	5,871	5,550	5,980	6,410
All other sources	3,620	3,610	3,710	3,830
Totals, revenues and transfers	**$42,552**	**$45,320**	**$47,940**	**$51,050**
Annual percent change	*6.5%*	*6.5%*	*5.8%*	*6.5%*

MAJOR REVENUE SOURCES

General Fund revenues are derived from a variety of sources, including taxes, investment income, fees, and various user charges. However, over 90 percent of all revenues come from the state's three largest taxes—the personal income tax, sales and use taxes, and bank and corporation taxes.

Personal Income Tax

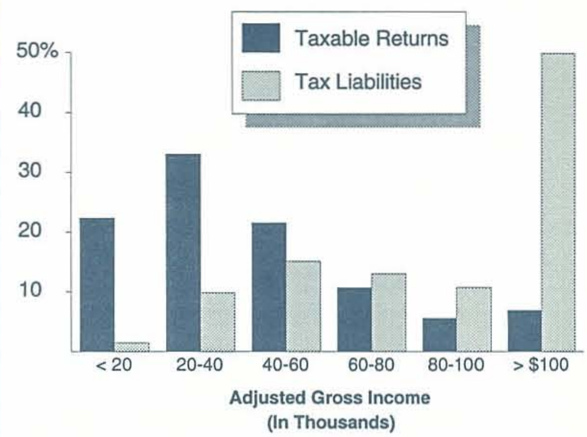
The personal income tax (PIT) is the single largest General Fund revenue source, accounting for about 45 percent of the total. The tax has marginal rates currently ranging from 1 to 11 percent, but with the top rate scheduled to revert to 9.3 percent in 1996. The tax structure is indexed annually for inflation.

California's Income Tax Is Highly Progressive. Due to the PIT bracket structure and the distribution of income in California, higher-income taxpayers account for a large share of tax liabilities. Figure 2 shows, for example, that the top 7 percent of taxpayers—those with incomes exceeding $100,000 annually—will account for nearly 50 percent of total tax liabilities in 1996. This high degree of progressivity has important implications for the revenue outlook. It means that the growth in tax liabilities is determined not only by overall increases in personal income, but also how the income gains are distributed between lower-income and higher-income taxpayers. This, in turn, depends partly on how different types of income are growing.

Figure 2

California's Income Tax Structure Is Highly Progressive

Share of Taxpayers and Tax Liabilities by Income 1996 Income Year



Income Growth to Vary by Type. A significant feature of our economic outlook is that individuals' business-related profits and investment-related earnings will be among the faster growing sources of income during the next three years. These types of earnings tend to accrue to upper-income taxpayers, who are subject to higher marginal tax rates. As a result, we project that overall income tax liabilities will grow more quickly than statewide personal income during the next three years.

Revenue Projections. We forecast that PIT revenues will reach $20.5 billion in 1995-96, an increase of about 11 percent over the prior year. For the following two years, we project that PIT revenues will continue to expand, increasing at an average annual rate of 6.3 percent to reach $21.5 billion in 1996-97 and $23.1 billion by

1997-98. Our estimates reflect the scheduled elimination of the top tax brackets at the end of 1995, which will lower personal income taxes by $325 million in 1995-96, $815 million in 1996-97, and $905 million in 1997-98.

Sales and Use Taxes

Sales and use taxes are the second largest General Fund revenue source. The overall tax is applied to sales of tangible personal property. The state-level tax rate is 6 percent, which includes a 5 percent General Fund rate. Additional rates ranging from 1.25 percent to 2.5 percent are imposed by cities, counties, and transportation districts, bringing the combined state-local rate to between 7.25 percent and 8.5 percent, depending on the local area.

Taxable Sales Rebounding. The key to projecting sales and use tax revenues is forecasting taxable sales. The performance of taxable sales in recent years has mirrored overall California economic activity. Following several weak years, sales began to grow significantly in 1994 and have continued to rise in 1995. As shown in Figure 3, we are projecting that taxable sales will continue to experience reasonably good growth over the next few years.

Taxable Sales Ratio to Hold Steady. As indicated in Figure 4, the ratio of taxable sales to personal income has fallen significantly over the past 15 years. This is consistent with the long-term shift in consumer spending toward services, which generally are not taxed. We are projecting that this ratio will be relatively stable over the forecast period at about 40 percent.

Revenue Projections. We project that sales and use tax revenues will total $15.7 billion in 1995-96, 7.2 percent above 1994-95. For 1996-97 and 1997-98, we project that sales and use tax

Figure 3

Taxable Sales Rebounding

Annual Percent Change

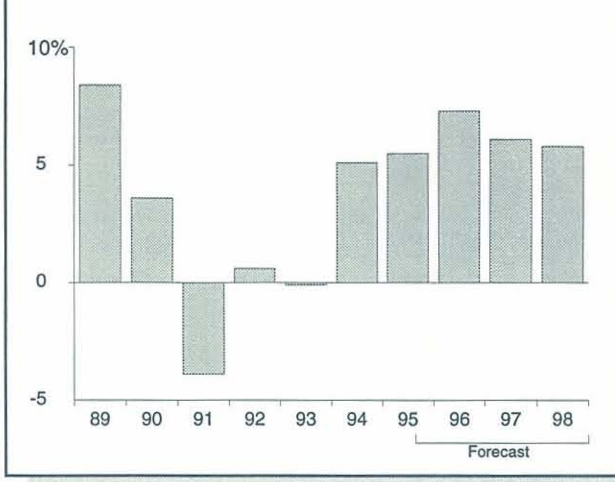
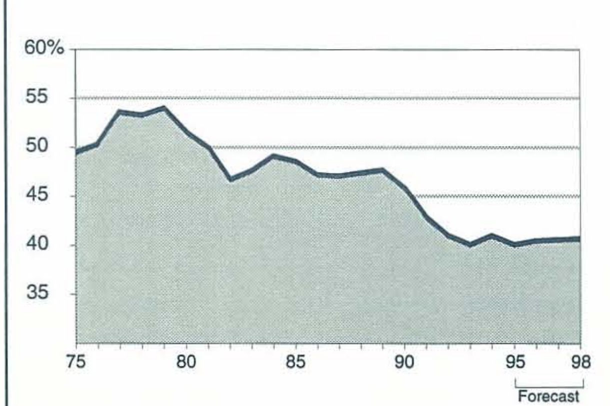


Figure 4

Taxable Sales Ratio to Hold Steady

Taxable Sales as a Percent of Personal Income



revenues will reach $16.7 billion and $17.7 billion, respectively. The average growth for these two years of 6.1 percent is slightly faster than the increase in personal income.

Bank and Corporation Taxes

Corporations are subject to a 9.3 percent tax rate on taxable profits. Banks are subject to an additional, add-on rate which is in lieu of certain local taxes. The majority of taxable profits comes from multi-national and multi-state companies, which apportion a share of their income to California.

Corporate Profits Improving. After several years of sluggish performance, bank and corporation revenues jumped 23 percent in 1994-95, to $5.9 billion. While one-time payments accounted for part of the gain, the majority was due to improving profits. Corporate tax payments have remained strong as of late 1995, indicating that favorable profit trends currently are continuing. Figure 5 shows that the ratio of corporate profits to state personal income (a key measure of the strength of profits) has rebounded from its historic 1990s low, and is forecast to trend upward. Even with our projected increases, however, the ratio will remain well below the levels attained in the late 1970s and late 1980s.

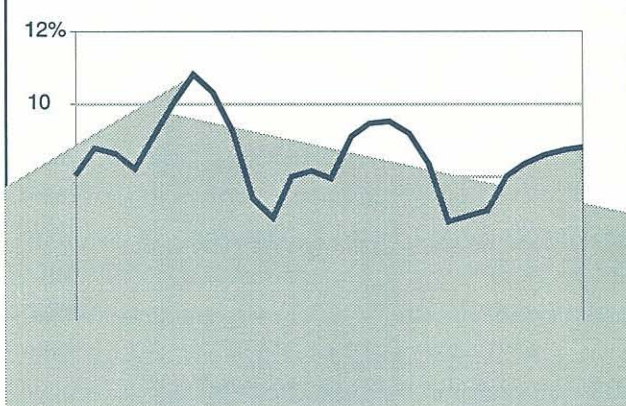
Revenue Projections. We project that bank and corporation revenues will total $5.6 billion in 1995-96. While this is down from last year, two special factors account for the decline. First, the recent *Barclay's* court decision resulted in one-time payments of $410 million in 1994-95. Second, legislation passed in 1993 provides a tax credit for equipment purchases by manufacturers beginning in 1995. This will reduce revenues by $365 million beginning in 1995-96.

Beyond the current year, we project that revenues will reach $6 billion in 1996-97 and $6.4 billion in 1997-98. The average 7.5 percent gain in these years reflects slightly above-average projected gains in corporate earnings.

Figure 5

Profits Recovering From Historic Lows

Corporate Profits as a Percent of Personal Income



ALTERNATIVE SCENARIOS

The revenue outlook is highly dependent on the economy's performance. In particular, a serious economic slowdown or recession would have a dramatic effect on receipts from personal income, sales, and corporation taxes over the next three years. The revenue implications of a weaker economy are discussed in Chapter 5.

Chapter 4

Expenditure Projections

In this chapter, we present our General Fund expenditure projections for 1995-96 through 1997-98.

METHODOLOGY AND ASSUMPTIONS

Our projections are based on the following methodology and assumptions:

- *Current Law.* Our projections assume the requirements of current law, including the restoration of temporary welfare grant reductions and the renters' tax credit. Spending for K-14 education meets the minimum funding requirements of Proposition 98 and includes repayments of past Proposition 98 loans consistent with the tentative settlement of the *CTA v. Gould* lawsuit.

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

- *Adjustments for Temporary Costs/Savings.* The projections adjust future spending for the expiration of temporary costs or savings.

- *Adjustments for State Operations.* For most state operations programs, we applied an adjustment equivalent to the state/local price deflator in lieu of making specific price and workload changes. These adjustments ranged from 2.5 percent to 2.7 percent annually.

PROJECTIONS OF TOTAL SPENDING

Figure 1 presents our General Fund spending projections. As shown, projected total General Fund spending grows from $41.7 billion in 1994-95 to $44.4 billion in 1995-96, $48.2 billion in 1996-97, and $51.3 billion by 1997-98. This amounts to an annual average growth rate between 1994-95 and 1997-98 of 7.2 percent as shown in the figure, with total spending in dollar terms increasing by $9.6 billion.

Figure 1

Projected General Fund Spending by Program Area

(Dollars in Millions)

	1994-95	Projected 1995-96	Projected 1996-97	Projected 1997-98	Projected Annual Growth
Education programs					
Proposition 98—K-14 education	$15,165	$16,930	$18,630	$20,280	10.2%
Higher education—UC/CSU	3,326	3,420	3,540	3,680	3.4
Health and Welfare programs					
Medi-Cal benefits[a]	$5,739	$5,660	$5,900	$6,170	2.4%
AFDC—family group/unemployed	2,822	2,630	2,800	2,790	-0.4
SSI/SSP	2,014	1,890	2,500	2,590	8.8
Department of Corrections[a]	$2,742	$2,800	$3,090	$3,380	7.3%
Debt service	$2,164	$2,310	$2,400	$2,500	4.9%
Other programs/costs	$7,760	$8,770	$9,360	$9,950	8.6%
Totals	**$41,732**	**$44,410**	**$48,230**	**$51,340**	**7.2%**

[a] Projections are net of offset for anticipated federal immigrant funding.

SPENDING BY PROGRAM AREA

Figure 2 illustrates the current allocation of General Fund spending by program area. As shown, more than three-fourths of General Fund spending is devoted to education, health, and social services. Consequently, spending trends in these programs have a large impact on overall spending trends.

Faster-Growing Program Areas

More than half of the dollar increase in total spending over the forecast period is for Proposition 98 K-14 education spending. Proposition 98 spending is the largest single spending component in the budget, and the amount of state funding required to meet the Proposition 98 minimum guarantee grows rapidly—10 percent annually. This is primarily a result of projected growth in General Fund revenue, which increases the amount of the guarantee.

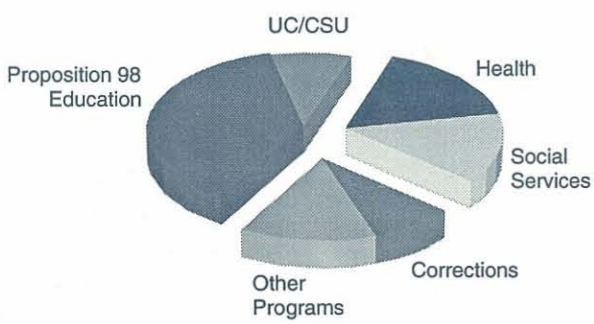
In addition to Proposition 98 spending, three other program areas will have relatively rapid spending growth:

- *SSI/SSP.* The projected cost of benefits for the elderly and disabled would grow by one-third between 1995-96 and 1996-97, primarily due to the sunset of temporary benefit reductions.
- *Corrections.* Support costs for the Department of Corrections would grow at an annual rate of 7.3 percent in order to accommodate projected increases in the prison inmate population, which result, in part, from tougher sentencing requirements.
- *Other Areas.* Large spending increases also would occur for the "other programs/costs" category, as shown in Figure 1. These increases result from two

Figure 2

Education, Health and Social Services Account for Most Spending

General Fund by Program—1995-96



changes—the end of temporary savings and cost deferrals for the state's employee retirement contributions, and the restoration of the renters' tax credit, starting in the 1996 tax year.

Slower-Growing Program Areas

Figure 1 shows that projected spending grows more slowly than average for several program areas:

- *AFDC.* Spending for AFDC welfare benefits to families with children remains almost flat over the period. Similar to the SSI/SSP, temporary AFDC benefit reductions would be restored. However, this cost increase will be offset by declining caseload (in contrast to rapidly increasing caseload in recent years) and by increased savings from other benefit reductions and eligibility restrictions that will remain in effect.

- *Medi-Cal.* The relatively slow growth in the projected cost of Medi-Cal benefits results in part from the declining AFDC caseload, since AFDC recipients comprise a significant share of Medi-Cal beneficiaries.

- *Higher Education.* Spending for the University of California and the California State University is projected to grow slowly due to minor enrollment growth.

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

HEALTH AND WELFARE

The major health and welfare programs are the AFDC program, the SSI/SSP, and the Medi-Cal program.

Aid to Families with Dependent Children

The AFDC program provides cash grants to families and children who are financially needy due to (1) the death, incapacity, or continued absence of one or both parents (AFDC-FG) or (2) unemployment of one or both parents (AFDC-U).

The Spending Forecast. General Fund spending in 1995-96 for AFDC-FG&U is estimated to be $2.6 billion—a *reduction* of 6.8 percent from the prior year, due primarily to grant reductions. General Fund spending is projected to *increase* by 6.5 percent in 1996-97 and remain at approximately the same level in 1997-98. In comparison, expenditures increased by approximately 2.4 percent annually in 1992-93 and 1993-94.

Key Forecast Factors. Although the AFDC caseload has recently begun to decline and this modest decline is projected to continue into the near future, increases in grant levels that are required by current law result in increased AFDC spending in 1996-97 and 1997-98.

For 1995-96, we estimate that spending for AFDC will be $11 million below the Budget Act appropriation because savings from lower caseloads will more than offset costs from delays in securing federal approval to implement grant reductions.

For 1996-97, spending is projected to increase by about $170 million (net) because current law provides that (1) the 1995-96 statewide 4.9 percent grant reduction be restored for 1996-97 ($67 million), (2) the 5.8 percent grant reduction implemented in 1992-93 be restored ($152 million), (3) a cost-of-living adjustment (COLA) be granted ($44 million), and (4) the full-year effect of other grant reductions and policy changes result in savings (-$92 million). For 1997-98, AFDC spending is projected to decrease slightly ($10 million) primarily because the cost of the statutory COLA is offset by a slight caseload decline and savings from not providing grant increases for children born while a family is on aid (the Maximum Family Grant provision of current law).

Caseload Trends and Projections. Since peaking above 11 percent in the early 1990s, annual caseload growth has moderated to 2.5 percent for 1994-95. Since April 1995, caseloads have actually been declining. This decline has occurred in both the AFDC-FG and the AFDC-U programs. A reduction in applications, rather than an increase in the number of families leaving the assistance rolls, has accounted for the drop in caseload growth. The downturn in welfare caseloads is due to several factors, including lower birth rates for young women, an improving economy with lower unemployment, and a decline in legal immigration to California.

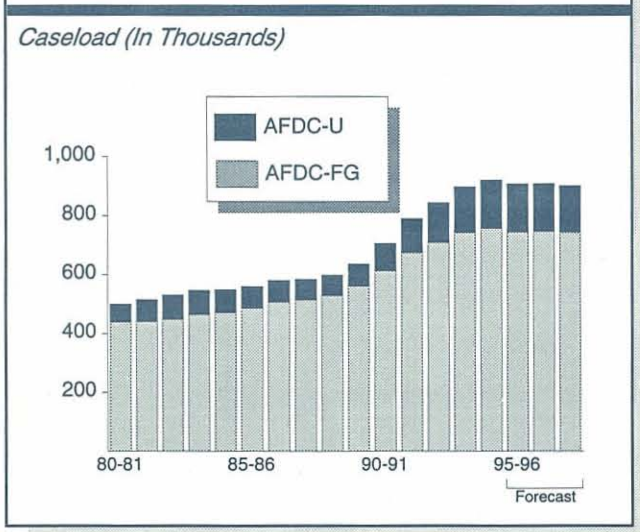
Based on a trend analysis of caseloads, birth rates, and unemployment rates, we project that the total AFDC caseload will decline by approximately 1.6 percent in 1995-96 and will decline slightly further over the next two years, as shown in Figure 3.

AFDC-Foster Care (AFDC-FC)

The AFDC-Foster Care 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.

Figure 3

AFDC Caseloads Declining



The Spending Forecast. We estimate that General Fund expenditures in the AFDC-FC program will increase from $331 million in 1995-96 to $355 million in 1996-97 and $382 million in 1997-98. This represents about a 7 percent increase each year.

Key Forecast Factors. The projected increases are due to: (1) continuation of the current caseload growth (3.4 percent), (2) statutory COLA adjustments for group homes, and (3) placement in group homes of a higher proportion of children requiring a higher level of service.

Supplemental Security Income/ State Supplementary Program

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

The Spending Forecast. General Fund spending for the SSP is projected to be $1.9 billion in 1995-96. This is a decrease of 6.2 percent from the prior year, due primarily to grant reductions. General Fund spending for the SSP is estimated to increase by 32 percent in 1996-97 and 3.6 percent in 1997-98. In comparison, spending in recent years has experienced declines ranging from 1 to 12 percent.

Key Forecast Factors. The statutory requirements to restore the 1992-93 grant reduction and part of the 1995-96 grant reduction account for 78 percent of the projected spending increases in 1996-97 and 1997-98. Caseload growth and statutory COLAs account for the remaining 22 percent.

For 1995-96, SSP spending is estimated to exceed the Budget Act appropriation by approximately $130 million because of (1) delays in obtaining federal approval to implement grant reductions and eligibility changes and (2) lack of federal legislation to eliminate the federal administration fee. In 1996-97, SSP spending is projected to increase by approximately $600 million (32 percent), due largely to the restoration of the 5.8 percent 1992-93 grant reduction ($451 million) and the 4.9 percent 1995-96 grant reduction ($136 million). We project that spending will increase by approximately $90 million in 1997-98 due to caseload growth ($68 million) and a COLA ($21 million).

Impact of Federal Welfare Reform

Both the House of Representatives and the Senate have passed welfare reform proposals which, if they became law, would have significant impacts in California on the AFDC and SSI/SSP programs and would restrict welfare for noncitizens.

AFDC. Both proposals would replace the current AFDC entitlement program with a Temporary Assistance for Needy Families Block Grant. In our September 7, 1995 policy brief on this subject, we estimated that California could lose up to $3 billion in federal funds over a five-year period under either the House or Senate versions. Also of note, the Senate version has a maintenance-of-effort provision requiring states to spend at least 80 percent of what they spent on welfare during federal fiscal year 1994. The House version has no such requirement.

SSI/SSP. The major changes in this program under both versions are the elimination of benefits for children who are relatively less disabled and the elimination of the state's maintenance-of-effort requirement for SSP. This latter change would enable the state to reduce grants, as provided in the 1995 Budget Act. We estimate that the various provisions affecting SSI/SSP would have no net effect on the amount of federal funds the state would receive under the House version and a loss of about $200 million over five years under the Senate version.

Caseload Trends and Projections. Figure 4 (page 20) shows historical and projected changes in the components of the SSI/SSP caseload.

From 1980-81 through 1994-95, the state's SSI/SSP caseload grew by approximately 300,000 cases, or 42 percent. Most of the growth was in the disabled category, increasing by 280,000 cases. More recently, the growth in disabled SSI/SSP cases has been moderating, declining from a peak of 7.6 percent in 1991-92 to 3.9 percent in 1994-95.

For 1995-96, we project that the SSI/SSP caseload will remain stable because the underlying growth rate is offset by two factors: (1) drug and alcohol abuse was eliminated as an eligibility criterion and (2) grant reductions will eliminate some cases from the program. These two policy changes will reduce the caseload by approximately 50,000. For 1996-97, we project that the caseload will increase by 8.3 percent because of (1) the eligibility effects of restoring both the 1992-93 and part of the 1995-96 grant reductions, and (2) the underlying basic caseload growth. For 1997-98, we forecast caseload growth of 2.7 percent, due to a continuation of the underlying basic trend.

Restricting Welfare for Noncitizens. With certain differences in implementation dates and treatment of the existing caseload, both federal welfare proposals prohibit noncitizens from receiving federal funds for SSI/SSP, Food Stamps, Medi-Cal, and AFDC. We estimate that, over a five-year period, the state General Fund would incur costs of up to $5.3 billion (House) or $3.6 billion (Senate) if the state elects to backfill for the estimated losses in federal funds. Alternatively, state savings of $4.9 billion (House) or $2.9 billion (Senate) would be achieved if the state conforms to federal restrictions. These state savings would be largely offset by cost shifts to the counties, primarily for General Assistance and indigent health care. We note that the fiscal effects could be significantly less than these amounts, depending on the extent to which the individuals affected become citizens, thereby retaining program eligibility.

Effect on State Spending. We estimate that over a five-year period the net fiscal impact of these provisions on the state could range from a cost of approximately $8 billion to a savings of about $5 billion, depending primarily on whether the state chooses to backfill for the loss of federal funds or conforms its policies to the eligibility restrictions (on noncitizens, for example) in the federal legislation. In 1996-97 and 1997-98, the federal changes would lead to General Fund costs of about $1.5 billion annually or savings of about $1 billion annually.

Medi-Cal

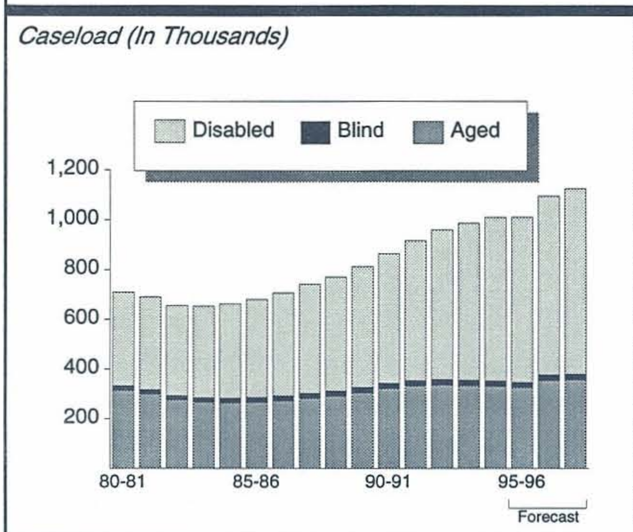
The Medi-Cal Program provides health care services to public assistance recipients and to other low-income individuals who meet the program's eligibility criteria.

The Spending Forecast. General Fund spending in 1995-96 for Medi-Cal benefits (excluding administration and capital debt) is estimated to be $5.7 billion. This is $153 million below the administration's most recent estimate, due primarily to lower-than-anticipated caseloads. General Fund spending is projected to increase by 4.2 percent in 1996-97 and 4.6 percent in 1997-98. For purposes of comparison, we note that recent changes in General Fund spending have shown considerable variation. Specifically, spending increased by 3.1 percent in 1993-94 and 8.2 percent in 1994-95, and is estimated to decrease by 1.3 percent in 1995-96 (due to various program reductions).

Key Forecast Factors. For 1996-97, projected spending will increase by about $240 million, due to a 1.3 percent increase in caseload ($98 million) and a 3 percent increase for adjustments in average costs ($171 million). These increases are partially offset by savings from the full-year effect of program reductions implemented during 1995-96 (-$37 million). For

Figure 4

SSI/SSP Caseloads Increasing



1997-98, Medi-Cal spending will increase by about $270 million because of projected caseload growth (1 percent) and adjustments in average costs (3 percent).

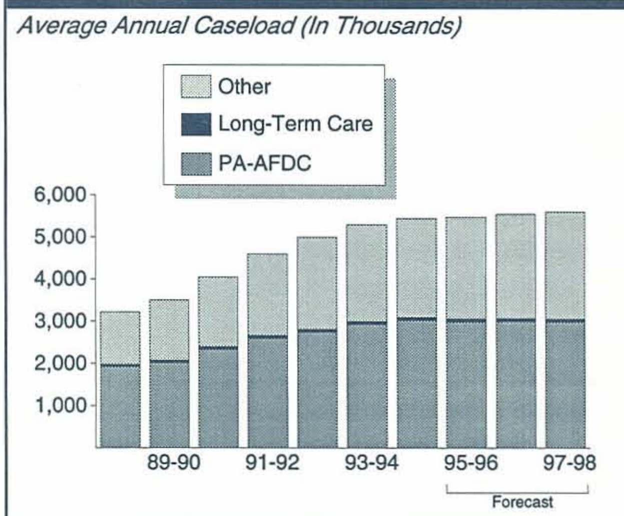
Caseload Trends and Projections. As Figure 5 shows, Medi-Cal caseloads grew rapidly in the early 1990s but the growth rate began to slow down in 1994-95. As noted above, we project that the caseload will increase by 1.3 percent in 1996-97 and 1 percent in 1997-98.

In developing our forecast, we divided the caseload into four components: (1) Public Assistance-AFDC (PA-AFDC) cases (persons receiving an AFDC grant), (2) long-term care aged (elderly) persons, (3) long-term care disabled persons, and (4) all other eligible individuals. The PA-AFDC caseload represents about 55 percent of the total caseload and about 25 percent of expenditures. While the two long-term care categories represent only about 1 percent of total cases, they account for over 15 percent of expenditures.

For purposes of our forecast, the most significant factor is the flattening of caseloads in the PA-AFDC component. We project that these cases will decline slightly in 1995-96 and continue at about the same level in the following two years. This is generally a function of our forecasted change in the caseload of AFDC grant recipients, as discussed above.

Figure 5

Medi-Cal Caseloads Leveling Off



Impact of Federal Medicaid Reform

As is the case with welfare reform, the House and Senate are considering legislation which would make major changes in the federal Medicaid Program (Medi-Cal in California).

Major Components

Changes in Entitlement to Services. While both House and Senate proposals would require states to provide some assistance to low-income persons and families, the House version would not establish an entitlement to services for any individual or category of individuals. The Senate version, on the other hand, would establish an entitlement to services for (1) pregnant women and children under age 12 with family income at or below 100 percent of poverty and (2) low-income disabled individuals.

Increased Flexibility in Some Areas. Both proposals would increase the states' discretion over several key areas, including eligibility criteria and benefit coverage. Specifically, states would no longer be required to: (1) cover specific services; (2) reimburse specific types of health care providers; (3) reimburse at specific rates; (4) provide services on a statewide basis; (5) provide services of the same duration, amount, and scope to all eligible individuals; (6) allow patients "freedom of choice" to select providers; or (7) reimburse noncontract hospitals and nursing facilities on the basis of reported actual costs.

Some Strings Are Still Attached. Under both the House and Senate versions, a state maintenance-of-effort would be required for three population groups: pregnant women and children in families with incomes below 185 percent of poverty, low-income elderly, and low-income disabled persons. In addition, states would be required to provide coverage for immunizations for eligible children. The Senate version would also require coverage of pre-pregnancy family planning services and supplies, as specified by the state.

Payments to States. Under both versions, a maximum federal allotment would be established for each fiscal year beginning with federal fiscal year 1996 (October 1995 to September 1996). States would be required to match federal funds up to the federal cap. The House version eliminates the Disproportionate Share Hospital payment program and incorporates the payments into the overall funds allotted to states according to the funding formula. The House and Senate versions differ in their funding formulas.

Impact on California Unclear

We have not estimated the potential loss of federal funds that could result from enactment of these proposals; although we note that according to the federal administration, California could lose as much as $18 billion in federal funds over seven years.

The fiscal impact on the state General Fund would depend on several variables. Additional General Fund costs would occur if the state chooses to backfill for the reduction in federal funds in order to maintain current eligibility criteria and service levels. Alternatively, savings could result if the state does not backfill reductions in federal funds and restructures the Medi-Cal program to change policies regarding eligibility criteria and benefits. Much of these savings, however, would be offset by costs at the local level for indigent health care services.

EDUCATION

This section reviews our estimates of state education costs, including Proposition 98 (K-12 schools and community colleges) and other state higher education agencies.

K-14 Education (Proposition 98)

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 tax revenues. Public K-12 education in California is provided to about 5.5 million students—ranging from infants to adults—through about 1,100 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 Proposition 98 General Fund spending for K-14 education will be in the range of 9 percent to 10 percent annually in 1996-97 and 1997-98, reaching $20.3 billion in 1997-98. This is $3.3 billion more than our revised 1995-96 estimate. This assumes the state provides the minimum level of funding required under Proposition 98 each year. We revised our estimate of the 1995-96 Proposition 98 guarantee by adding $750 million to the amount assumed in the Budget Act due to stronger than anticipated growth in state revenues and K-12 enrollment.

Key Forecast Factors. General Fund expenditures for Proposition 98 depend on the following factors: the state's personal income, General Fund tax revenues, local property tax revenues, and K-12 enrollment. Our economic forecast assumes that per capita personal income and state tax revenues will grow at about 4 percent and 6 percent, respectively, each year. We also assume that local property tax revenues will recover from the historic low rate of growth observed for 1994-95, reaching a growth rate of about 5 percent by 1997-98.

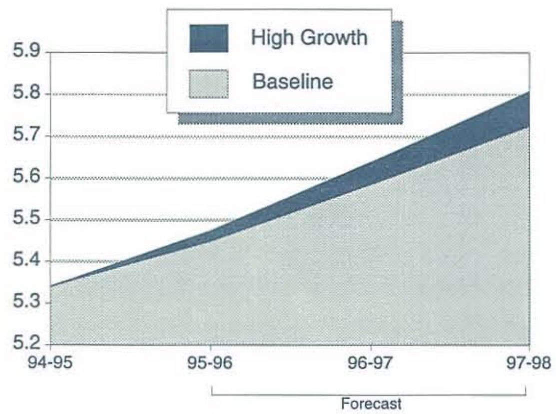
The key education factor is the growth in K-12 enrollment. Based on fall 1995 K-12 enrollment figures, our projection of Proposition 98 spending assumes that 1995-96 enrollment will increase about 2 percent, higher than the 1.5 percent pace assumed in the Budget Act. We project enrollment growth will accelerate to 2.5 percent for 1996-97 and 1997-98. This is shown in Figure 6 as our baseline enrollment projection.

Enrollment growth could be even higher, however. In 1993-94 and 1994-95, K-12 enrollment growth fell below expectations. This is most likely because more people left California than moved into the state during the early 1990s. Given improvements in the state's economy relative to the rest of the country, it is possible that in-migration will increase and enrollment growth will return to its previous pattern.

Figure 6

K-12 Enrollment Projections

Students (In Millions)

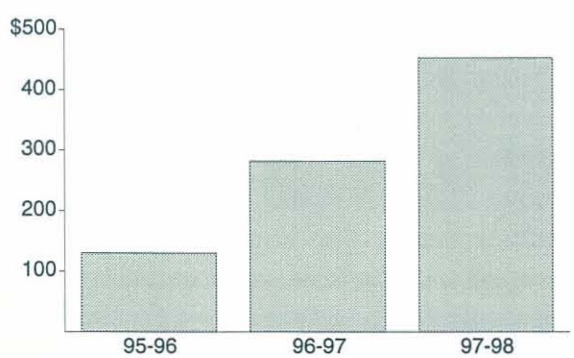


If this occurs, K-12 enrollment growth rates—and Proposition 98 spending—could be higher than we have assumed. Figure 7 displays the additional Proposition 98 spending that would result from somewhat higher K-12 enrollment growth rates (2.5 percent in 1995-96 and 3 percent in 1996-97 and 1997-98). This rapid growth scenario would require $130 million more Proposition 98 (and General Fund) spending than we have projected in 1995-96, increasing to about $450 million more in 1997-98.

Figure 7

Additional Proposition 98 Spending With High Growth Enrollment Projection

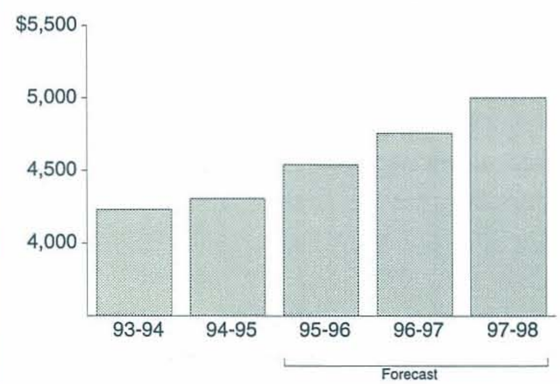
(In Millions)



K-12 Funding Projections. Figure 8 displays our projected K-12 per-pupil funding levels from 1995-96 through 1997-98. These estimates, which are derived from our baseline Proposition 98 forecasts, reflect annual per-pupil increases of about 5 percent over the three-year period.

Figure 8

K-12 Funding per Pupil Increasing



Community College Funding Projections. Based on our Proposition 98 projections, we estimate total community college funding will increase by about 6 percent each year over the three-year period.

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 $3.4 billion in 1995-96 to over $3.5 billion in 1996-97, or by roughly 4 percent (the percentage increases at each segment are similar). For 1997-98, we estimate that spending for UC and CSU (excluding funding for debt service) will increase to almost $3.7 billion or by about 4 percent compared to 1996-97.

Key Forecast Factors. Three main factors account for state expenditure growth in higher education: salary increases, enrollment growth, and increases in fees and tuition. Our assumptions in these areas are as follows:

- *Salary Increases.* Our projections reflect salary increases that are based on the inflation rate. To the extent that faculty salaries are increased above the inflation rate to permit UC and CSU faculty salaries to catch up with those at their respective comparison institutions, state expenditures could be further increased, potentially by tens of millions of dollars.

- *Enrollment Growth.* We anticipate that both segments would accommodate roughly 1 percent annual enrollment growth in 1996-97 and 1997-98, based on slight increases in college-going rates.

- *Fees and Tuition.* We assumed that increases in nonresident tuition and resident fees based on the inflation rate would offset state expenditures. To the extent these increases are above the rate of inflation, state expenditures could be further reduced, potentially by tens of millions of dollars—and vice versa.

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 32 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 more than 30 percent between 1994-95 and 1997-98, exceeding $3.6 billion annually at the end of that period. Anticipated receipt of $260 million annually in federal funds would partially offset these state General Fund costs.

The projected rapid growth in adult correctional expenditures continues a trend of steadily larger CDC budgets that has existed since the early 1980s. Between 1980-81 and 1994-95, General Fund support for the CDC grew more than 640 percent.

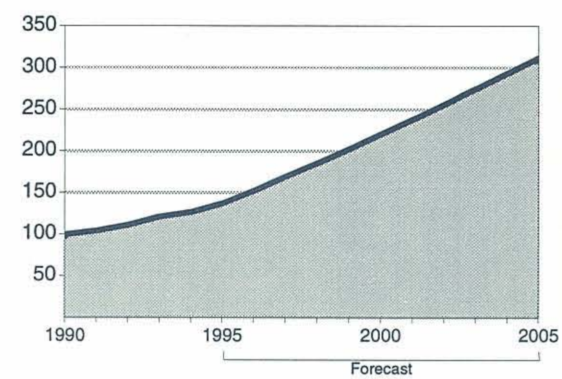
Key Forecast Factors. The significant increases projected in General Fund support for the CDC reflect major growth in the prison inmate population expected during the forecast period. Figure 9 shows that the CDC anticipates that the prison population, which is now about 134,000, will exceed 179,700 by June 1998. By June 2005, the CDC expects to house nearly 306,000 prison inmates.

The jump 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 last year. Demographic shifts, local government support for law enforcement activities, and other factors are also contributing to the prison population boom.

Figure 9

State Prisons Face Rapid Inmate Population Growth

Inmates as of June 30 (In Thousands)



Meanwhile, the number of parolees under the supervision of CDC parole agents is also expected to grow, although more slowly than the number of prison inmates. Because many offenders are serving longer prison terms, fewer are now being released on parole than would otherwise have occurred.

The state now supervises about 93,000 parolees, and the number is projected to be 97,600 by June 1998. By June 2005, the count of CDC-supervised parolees is projected to exceed 136,400.

Trial Court Funding

The Trial Court Funding Program consists of two major components: Trial Court Funding and Contributions to the Judges' Retirement Fund. Trial Court Funding includes expenditures for the salaries and operating expenses of superior and municipal courts.

The Spending Forecast. The total trial court budget forecast grows to $1.9 billion in 1997-98 from $1.7 billion in 1994-95. Currently, the state funds approximately 37 percent of the trial court costs. Assuming continuation of this funding share, the state's General Fund costs are estimated to be $526 million. This is an increase of 9 percent between 1994-95 and 1997-98, or an average annual growth rate of 2.9 percent.

Key Forecast Factors. The projected growth is due primarily to anticipated caseload increases in the trial courts, particularly criminal caseloads resulting from enhanced sentencing measures approved by the Governor, the Legislature, and the voters such as the "Three Strikes and You're Out" law. Cost increases due to caseload growth are mitigated somewhat by refinements in the budgeting process by the Judicial Council that help to better estimate trial court costs, as well as efficiencies implemented in some superior and municipal courts, such as court coordination efforts.

Other Programs

The remainder of the budget involves such program areas as debt service, tax relief (including the renters' credit and homeowners' exemption), retirement contributions, regional developmental centers, state mental hospitals, and various other smaller programs. We project these program areas will cost approximately $11.1 billion in 1995-96, $11.8 billion in 1996-97, and $12.5 billion by 1997-98.

General Fund Debt Service

This is the largest single program in this "other" category. As shown in Figure 10, we expect total General Fund bond debt-service costs to rise to $2.5 billion in 1997-98. This forecast assumes that $1.5 billion in new general obligation bond sales will occur by the end of 1997-98. We forecast that debt-service costs will decline from 5.1 percent of General Fund revenues in 1995-96 to 4.9 percent in 1997-98.

Figure 10

Lease-Payment Debt Service Becoming A Larger Share of Total Debt Service

General Fund Bond Debt Service (In Bllions)

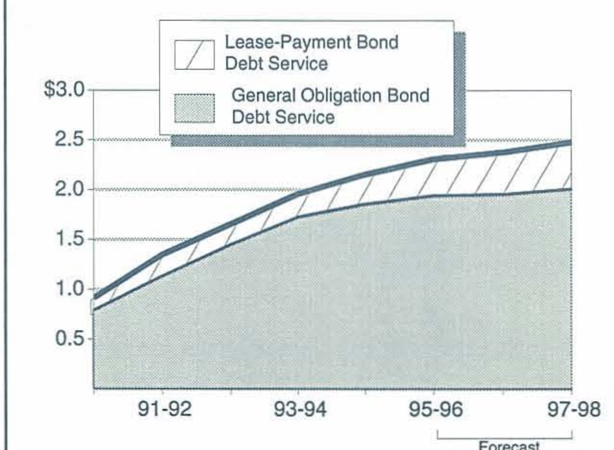


Figure 10 also shows that debt service for lease-payment bonds is becoming a greater portion of the state's total debt-service costs. For example, lease-payment debt service was 15 percent of total debt service in 1995-96, and will increase to 19 percent in 1997-98.

Renters' Tax Credit

The renters' tax credit is another large program area in this "other" category. It provides a refundable tax credit to Californians who rent their principal place of residence as of March 1. The amount of the credit is $60 for single renters and $120 for married couples or heads of households.

The renters' tax credit was suspended for three years—1993, 1994, and 1995. The program is scheduled to be reinstated January 1, 1996 and will result in an estimated cost of $517 million in 1996-97 and $525 million in 1997-98.

Chapter 5

Alternative Budget Scenarios

A variety of factors could result in the General Fund's condition turning out to be considerably different than our projections summarized in Chapter 1. These factors include: a differently performing economy than we have forecast, major federal budgetary changes (such as federal health and welfare reform), adverse litigation outcomes, natural disasters, and unexpected developments in major caseloads. This chapter discusses some of these factors.

A SLOWER ECONOMY

The single largest risk to our budget outlook is a weaker-than-forecast economy. As discussed in Chapter 2, our forecast assumes moderate economic growth and low inflation during the next three years. This is generally consistent with the consensus view of other forecasters. There is, however, a significant probability that a serious economic slowdown or recession could occur sometime during the 1996 through 1998 period. The larger forecasting services, for example, place the odds of a slowdown or recession during the next three years at as high as one-in-three.

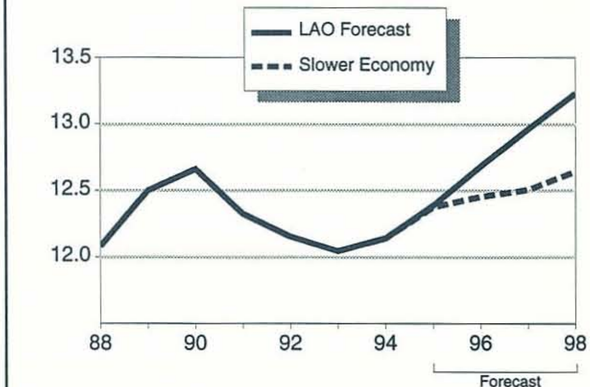
To give an idea of what a soft economy could mean for the fiscal outlook, we developed an alternative economic forecast which includes weakness in personal income, employment, retail spending, and housing activity. The impact of our slow-growth alternative on California jobs is shown in Figure 1.

This alternative would reduce General Fund revenues by close to $5 billion over the 1995-96

Figure 1

Effect of a Slower Economy On Jobs in California

California Wage and Salary Employment (In Millions)



through 1997-98 period. A full-blown recession would reduce revenues by considerably more. A weaker economy also would raise state spending in health, welfare, and other program areas affected by weak economic conditions, due to higher caseloads. At the same time, it would dampen Proposition 98 spending which is directly tied to the performance of the state's economy.

FEDERAL HEALTH AND WELFARE REFORM

As discussed in Chapter 4, pending health and welfare reform legislation in Congress would, if enacted, have significant fiscal impacts on California.

Regarding welfare reform, we estimate that the state could incur General Fund costs of about \$1.5 billion annually in 1996-97 and 1997-98 if it chooses to backfill for the loss of federal funds in order to maintain the level of services to recipients; or, alternatively, the state could realize General Fund savings of about \$1 billion annually by conforming its policies to the new federal restrictions on program eligibility (on noncitizens, for example). We note, however, that much of these potential state savings, in the absence of other state law changes, would be offset by costs to the counties, primarily for General Assistance.

While the fiscal impact of federal Medicaid reform proposals is not clear at this time, it appears that California could lose as much as \$2 billion annually in federal funds in 1996-97 and 1997-98. Thus, the state could incur substantial General Fund costs if it chooses to backfill for these losses, or achieve General Fund savings by limiting eligibility and/or benefits. Again, much of any savings at the state level would be largely offset by local costs for indigent health care services.

In addition to federal health and welfare reform, other federal budget actions could have significant fiscal implications for the state.

PENDING LITIGATION

There is a variety of pending litigation in which the state is involved. The state faces a significant budget risk due to an adverse trial court decision in the ***PERS v. Wilson*** case. If this decision is upheld on appeal, the state would have to pay contributions to the Public Employees' Retirement System (PERS) that have been deferred under previous budget-related actions. If the state loses its appeal, the General Fund exposure is in the range of \$1 billion.

OTHER FACTORS

As discussed in Chapter 4, there are a variety of other factors which could significantly affect our spending projections, such as caseload, enrollment trends, and local property tax growth, that differ from those we have projected. The state also faces a risk of about \$150 million from a federal audit exception involving the past allocation of employee retirement contribution savings. In addition, the accuracy of our projections will depend on the success of the state in achieving, on an ongoing basis, many of the savings which have been assumed in the current-year's budget.

Given these uncertainties, it is critical that the state establish a meaningful reserve as an insurance policy against these downside risks.