

INSTITUTE OF REGIONAL AND URBAN STUDIES

610 UNIVERSITY AVENUE • PALO ALTO • CALIFORNIA • 94301

TELEPHONE: (650) 326-5770

FAX: (650) 321-5451

www.ccsce.com

DATE: February 13, 2004

TO: Budget Project Friends

FROM: Stephen Levy

SUBJECT: The Economic Impacts of Spending Cuts and Tax Increases

This is the seventh in an ongoing series of memos on state budget issues and their relationship to the California economy. Our work is supported by a grant from The James Irvine Foundation. Previous memos are posted at www.ccsce.com.

Based on current spending and revenue trends, California faces budget deficits over the next several years. A growing economy may reduce, but will not eliminate, the state's long-term budget gap. It is virtually certain tax increases and/or additional spending cuts will be required to achieve long-term balance for the state budget.

While there are different opinions about how to achieve budget balance, there is no disagreement that the state faces a long-term budget imbalance and no disagreement that Californians this year will, once again, be debating the merits of tax increases versus spending cuts.

The Legislative Analyst's Office (LAO) has called on the Legislature to immediately address whether tax increases should be part of California's long-term budget solution. **Noting that the deficit after next year would be at least \$6 billion, even if all of the Governor's proposals were adopted, the LAO wrote in January 2004 (www.lao.ca.gov):**

“Should Additional Revenues Be Considered? There are several reasons to ask this question. One involves the large magnitude and potentially far-reaching effects of the proposed budget reductions on state programs. A second is the multibillion-dollar ongoing budget shortfall that would still remain unresolved even under the Governor's plan, and that would have to be dealt with through more borrowing or further spending cuts if additional revenues are “left off the table.” We believe the Legislature should consider whether solutions involving taxes — such as the elimination of selected tax expenditures or increased tax rates — should be part of the 2004-05 budget plan. Even if limited tax increases have certain negative effects on the economy, these consequences should be weighed against the negative consequences of the alternatives, including deeper

cuts in public spending in infrastructure, education and other areas, or more borrowing.”

The major focus of discussion about balancing the state budget will be on questions of priorities, values and fairness. This memo responds to the LAO’s call for discussion of tax increases as a budget choice by focusing on three topics related to the economic impacts of these choices:

- How economists measure spending cuts or increases
- The latest data on tax, spending and income trends in California
- The economic impacts of spending cuts versus tax increases

The memo begins below with a summary of key findings. Following the summary are three sections related to the topics listed above. The budget and income data presented in the memo come from Schedule 6 and tables REV-21 and REV-23 of the Governor’s Budget Summary for 2004-2005 published in January 2004.

SUMMARY

How Economists Measure Spending Cuts or Increases

- An increase in spending is “**real**” in economic terms if it allows the purchase of more goods and services. If prices rise by 3% from one year to the next, then spending levels would have to rise by 3% to maintain the same level of **real spending**, i.e., to keep pace with inflation.
- To maintain the same level of real per capita or per pupil spending, spending levels would need to rise by as much as inflation plus population or student growth.
- If prices rise by 3% and caseload growth for a program area is 2%, then a spending increase of 5% would be needed to maintain the same level of real spending. An increase of 3% would really be a **decrease of 2%** in real spending while an increase of 7% would be equivalent to a 2% real increase in spending levels for that program.
- Spending levels are often measured against whether they keep pace with the economy, i.e., whether spending keeps pace with the growth in residents’ income. Income normally rises faster than population growth plus inflation; that is one way that economists measure rising living standards. As a result, if spending just keeps pace with population and inflation growth, then residents will be devoting a decreasing share of state income to state public services over time.

The Latest Data on Tax, Spending and Income Trends in California

- General fund spending and tax revenues both surged between 1998 and 2000. Then tax revenues fell after the stock market turned lower with the dot-com bust and the recession. Spending continued at approximately the same levels and the general fund deficit began to grow. Between the 1998-1999 and 2003-2004 budget years, general fund spending grew by 34.9% while general fund tax revenues grew by 18.8%
- Part of the increase in general fund spending was to compensate local governments for the loss of revenue from cuts in the vehicle license fee. Spending growth minus the tax cut backfill was 31.0%. During the same period, personal income for California residents grew by 28.7%.
- If tax revenues had grown by 28.7%, keeping pace with income growth, the general fund deficit would have been much smaller. The share of personal income devoted to general fund taxes and vehicle fees **fell** from 6.9% in 1998 to 6.1% in 2003.
- The data comparing the growth in total general fund revenues and spending are not helpful in understanding budget trends because they include a variety of one-time adjustments, which mask the underlying trends in revenue and spending. The 2004-2005 Governor's Budget reports that general fund spending rose 34.9% between 1998 and 2003 while general fund revenues rose by 32.5%, nearly the same rate of growth.

The Economic Impacts of Spending Cuts versus Tax Increases

- Both public sector spending cuts and tax increases reduce the level of spending and create job and income losses. If taxes are raised to maintain public spending levels, the spending cuts come from private spending, instead of from public spending, but the immediate economic impacts are the same. There are no macroeconomic differences between cuts in public transportation versus private sector construction cuts or between job layoffs for teachers versus job layoffs in the private sector.
- Taxes are the price we pay for public services. A tax increase transfers resources from private spending to public spending but does not change the level of resources available to the public and private sectors combined.
- The economic concern about tax increases is that they will induce firms and talented individuals to leave the state and work and live elsewhere. This is a valid concern if the tax increases are permanent and higher than in other locations.

- Spending cuts can also reduce the state's economic competitiveness. Business groups that express concern about tax increases also express concern about the state's level of investment in K-12 education, higher education and infrastructure construction such as transportation.
- Since both tax increases and public investment spending cuts could have negative impacts on the state's job and income growth, **residents must decide which choice is better in the long-term for the economy.**

I. HOW ECONOMISTS MEASURE SPENDING CUTS OR INCREASES

The words "spending cut" and "spending increase" appear often in public discussion about California's budget choices. What constitutes a spending cut? If spending on education remains constant from one year to the next, is it fair to say that spending hasn't been cut?

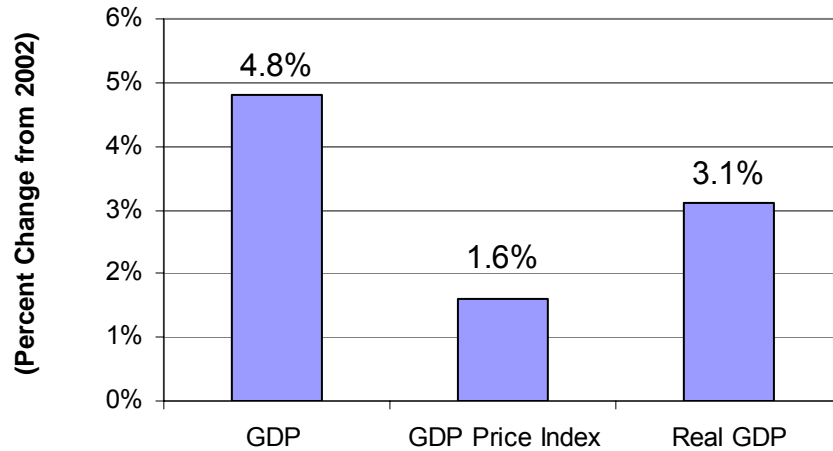
If education spending grows by 3% instead of 5% as a result of legislative action, is that a "cut" or a smaller than expected increase? If education spending increases, but at less than the rate of enrollment and inflation growth, can that still be considered an increase in spending? Are there any objective standards or at least common language that we can use in describing budget changes?

Economists have a clear definition of how to measure cuts or increases in economic variables. **The first adjustment is to account for the impact of price increases.** For example, economists call an increase in income **real** if that increase exceeds the rate of inflation (i.e., increase in the overall price level).

The concept of adjusting income or spending growth for the impact of inflation is to allow a comparison of **changes in buying power**. When economists say that **real** income in California increased, they mean that Californians have **more** buying power. When economists say that **real** spending increased, it means that the spending bought **more** goods and services.

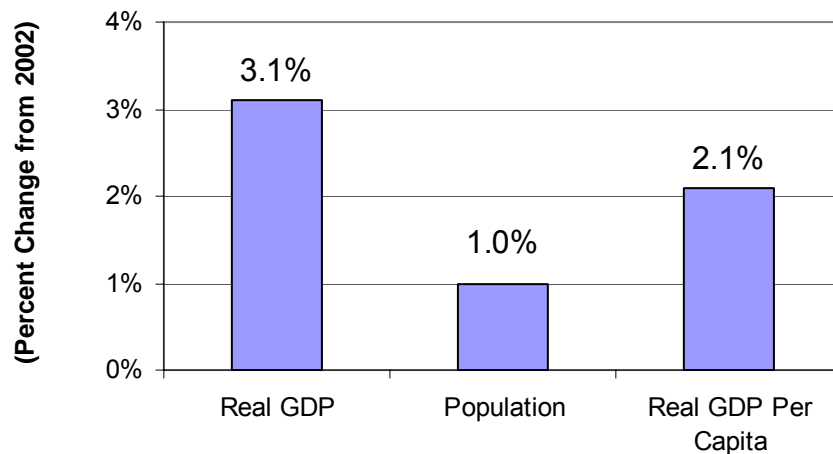
In discussions about U.S. economic growth, the press has learned to focus on and report the **real** GDP growth estimates. In January 2004, the United States Department of Commerce announced that real (i.e., inflation adjusted) gross domestic product (GDP) had increased by 3.1% in 2003. GDP, which measures the value of goods and services produced in the nation, increased by 4.8% between 2002 and 2003 before adjusting for the impact of price increases. The GDP price index increased by 1.6% and the resulting **real** increase in the value of goods and services produced in 2003 was 3.1%.

U.S. Gross Domestic Product (GDP) Growth in 2003



Economists often use a second adjustment to reported income estimates to analyze the changes **on a per capita basis**. The graph below shows real GDP growth per capita (per person) in 2003. The real GDP growth of 3.1% reported above is equal to a growth of 2.1% per capita more than the rate of inflation.

U.S. Per Capita GDP Growth in 2003

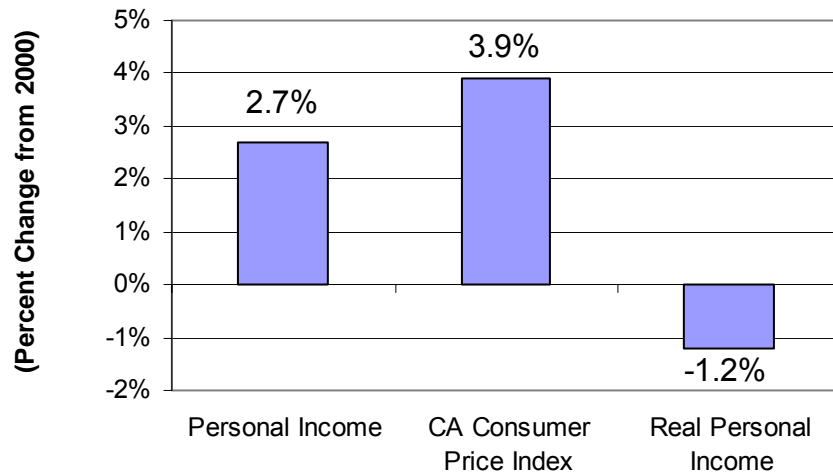


When is an Increase in Income Not an Increase?

In 2001, total personal income in California grew by 2.7%. However, the California Consumer Price Index grew by 3.9%. As a result, real personal income (i.e., adjusted

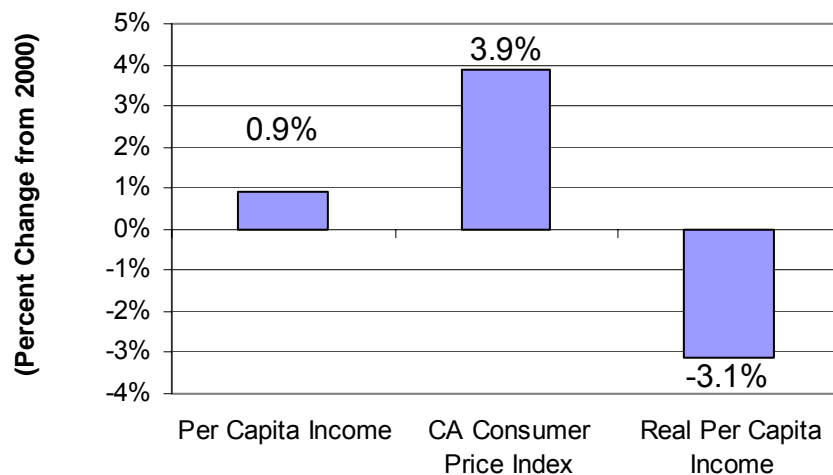
for inflation) **actually fell by 1.2%**. Even though reported income rose, **buying power fell**, so economists would say that **real income decreased**.

California Personal Income Growth in 2001



And **real per capita income fell** by even more. Reported per capita income in California increased by 0.9% in 2001. However, after adjusting for inflation, **real per capita income fell by 3.1%**. This means that the average resident had 3.1% less total buying power in 2001 versus 2000 even though reported per capita income rose from \$32,363 in 2000 to \$32,655 in 2001.

California Per Capita Income Growth in 2001



Families know that their buying power falls when income gains do not keep pace with inflation. The same is true for state governments.

Applying These Concepts to the State Budget

The concept of adjusting spending changes for the impact of inflation and population change applies to evaluating whether state spending levels have increased or decreased in real buying power and by how much.

For some areas of spending, for example education, it is standard practice to replace the general concept of accounting for population growth with a more specific concept of “caseload”, in this case the number of students. And, for some areas of spending, for example in health care, it may be appropriate to use a specialized price index applying to health care costs rather than a general price index. But the main concept still applies. **To find out whether and by how much real spending is rising or falling, it is necessary to take account of caseload and price changes.**

The following hypothetical example shows what it means to keep **real** per pupil K-12 education spending constant, i.e., no increase or decrease. The example assumes 2002 spending of \$30 billion, enrollment growth of 1% from 6 million to 6.06 million students and an inflation forecast of 3%.

As shown in the table, under these assumptions per pupil general fund spending in 2002 would have been \$5,000 per pupil. In order to keep pace with expected inflation, per pupil spending would need to increase by 3% to \$5,150 in 2003. In order to fund the enrollment increase of 1% and the inflation estimate of 3%, total funding would need to increase by 4.03% to \$31.209 billion.¹

Hypothetical Change in General Fund K-12 Spending					
	2002	2003	% Change	2002 in 2003\$	% Change
Total Spending (\$Billions)	\$30.000	\$31.209	4.03%		
Enrollment (Millions)	6.00	6.06	1.00%		
Per Pupil Spending	\$5,000	\$5,150	3.00%	\$5,150	0.0%

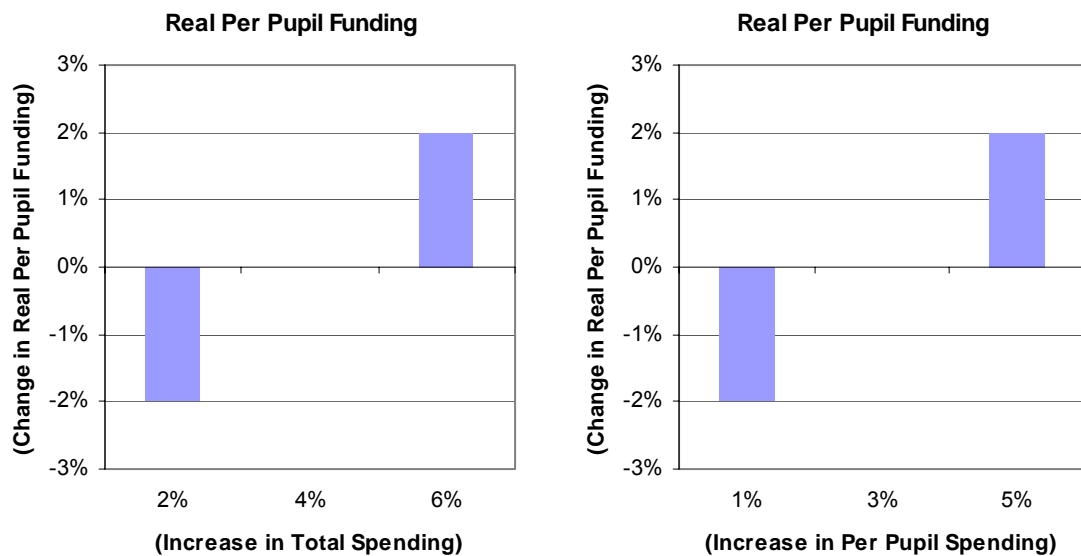
The concept of adjusting for inflation and caseload changes focuses on **providing access to the same dollar level of resources**. The concept of adjusting for inflation and caseload changes does not mean that the level of educational services is the same in each year. The level of educational services is also affected by how efficiently the resources are used.

Sometimes, what appear to be spending increases can result in real spending declines, i.e., providing access to fewer, not more, resources.

¹ The increase is 4.03%, not 4.0%, because the increase is calculated by multiplying 1.01 (a 1% increase) by 1.03 (a 3% increase). The word explanation is that spending would need to increase by 3% for the original 6 million students to keep pace with inflation, by 1% to support the added students at the original (\$5,000) per pupil spending and by .03% to support the added students at the 2nd year (\$5,150) per capita spending.

The previous example showed that a 4% increase in total school spending could be equivalent to **no change in real spending per pupil**. It follows that a 6% change in spending would result in a 2% **increase** in real spending, but that a 2% increase in total spending would result in a 2% **decline** in real spending. That case is illustrated in the left-hand graph below.

Similarly, a 3% increase in per pupil spending was equivalent to **no change in real per pupil spending**—i.e., the \$5,150 in per pupil spending in 2003 provides the same access to resources as the \$5,000 in per pupil spending in 2002. So a 5% change in per pupil spending would result in a 2% real increase in access to resources, but a 1% reported increase in per pupil spending would actually result in a 2% decline in access to resources.



Is Keeping Pace with Inflation and Population (Caseload) Growth the “Right” Standard to Apply to State Spending?

Some people have advocated that keeping pace with population and inflation growth is the “right” standard for evaluating whether state spending is “too high” in California. Moreover, there has been discussion of a November ballot initiative to limit the growth of state spending to the rate of growth of population and inflation.

There has also been discussion of a spending limit tied, not to population and inflation growth, but to the growth in population and per capita income. How do these two alternative measures compare? What does it mean for future growth in real spending to pick one measure over the other?

Tying spending growth to population and inflation increases would result in devoting a steadily smaller share of residents’ income to state services over time, while tying

spending growth to population and per capita growth would result in spending a constant share of residents' income on state services.

The difference between the two measures is that per capita income normally grows faster than the rate of inflation. Why is that?

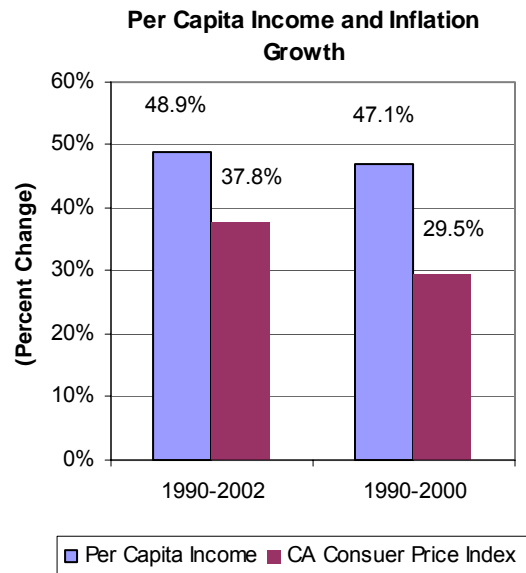
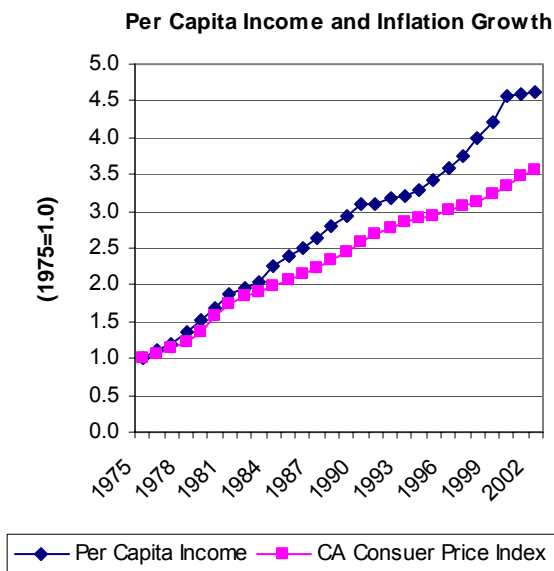
Productivity Growth, Per Capita Income and Keeping Pace with the Rate of Economic Growth

Wage levels normally grow faster than the rate of inflation. This is how families experience rising living standards. Wage levels can rise faster than the rate of inflation as a result of productivity growth. Productivity growth is the economists' term when output per worker rises from year to year. The main causes of long-term productivity growth are technological advances and improvements in the way that businesses organize to produce goods and services.

Productivity growth allows real (i.e., inflation adjusted) wages and profits to increase and causes per capita income to grow faster than inflation.

The graphs below show the long-term trend is for per capita income to grow faster than consumer prices in California. During periods of rapid productivity growth as between 1995 and 2000, per capita income grew much more rapidly than the rate of inflation. In some periods of recession or very high inflation, per capita income may grow more slowly than inflation.

Between 1990 and 2000, per capita income rose by 47.1% compared to a 29.5% increase in the California consumer price index. For the 1990-2002 period, per capita income rose by 48.9% compared to a 37.8% increase in consumer prices.



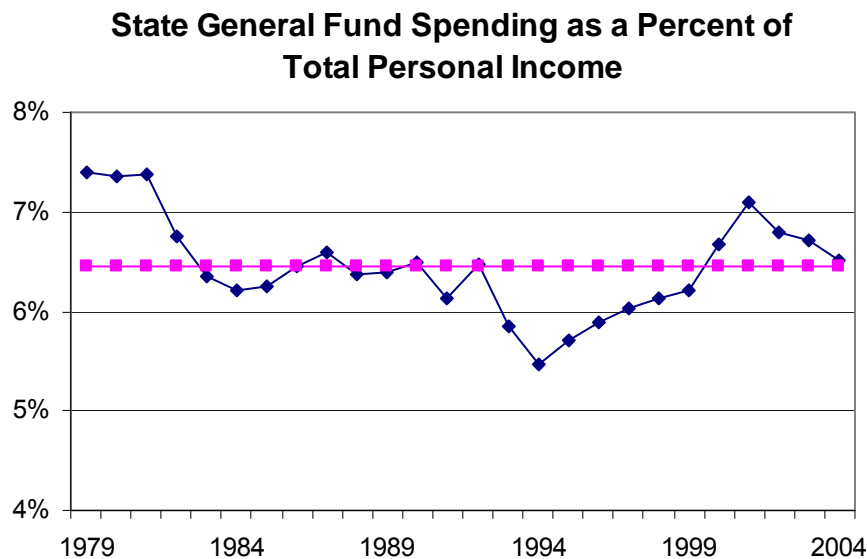
While per capita income is the measure of income per resident, total personal income (per capita income times population) is a measure of the total income of all residents combined. **Total personal income is the most widely used measure of the size and growth rate of the California economy.**

Comparing the growth rate of general fund spending in California with the growth rate of total personal income shows **what share** of their income residents are choosing to spend on state government services over time. If state spending grows at the same rate as personal income, then residents are choosing to **spend a constant share of income on state services.** In other words, the growth in state government spending would be keeping pace with the growth rate of the state economy.

If spending growth exceeds the growth in total income, residents are spending an increasing share of their income on state services and vice versa.

The share of personal income devoted to state general fund spending is regularly reported in state budget documents and the graph below is taken from Schedule 6 of the Governor's Budget Summary for 2004-2005.

The highest share of income devoted to state spending was 7.4% in the late 1970s as the state took over major school funding obligations after Proposition 13 and again over 7% at the height of the stock market boom. The share varied from a high of 7.4% in 1979 to a low of 5.5% in 1994. The average share of personal income devoted to state general fund spending was 6.5% as shown on the graph.



So, there are four broad categories of public choice with regard to future state spending:

--Residents can choose to restrict spending increases to **less than the rate of population (caseload) and inflation growth**. In this case, **real (i.e., adjusted for inflation) spending levels would fall**.

--Residents can choose to have spending growth exactly keep pace with population and inflation growth, in which case, **real spending levels would remain constant**.

In both of the first two cases, state spending levels would fall as a share of the total economy.

--Residents could choose to have spending growth keep pace with economic growth, in which case **the share of the state economy devoted to state government services would remain constant**.

--Residents could choose to **increase the share of total income spent on state government services**.

II. RECENT TRENDS IN SPENDING, TAXES AND INCOME

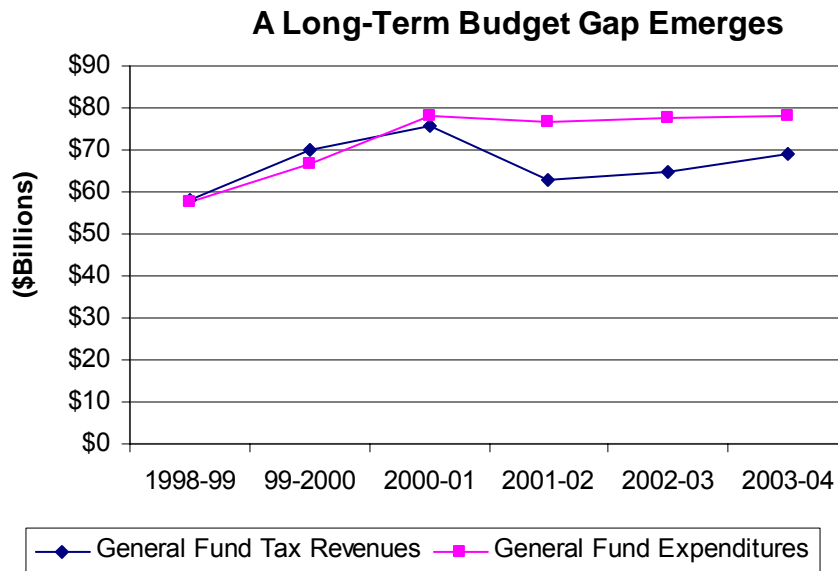
The data in this section come from Schedule 6 and Chart REV-21 of the Governor's Budget Summary for 2004-2005 released in January 2004, except as otherwise noted. A table with data from the 1998-99 through 2004-2005 budget years is shown on the next page. There are four series—1) total general fund spending, 2) total general fund revenues, 3) total general fund **tax** revenues and 4) total personal income. All data are in billions.

Spending, Revenues and Personal Income in California
(\$Billions)

	1998-99	99-2000	2000-01	2001-02	2002-03	2003-04	2004-2005	Percent Change	
								1998-2003	1998-2004
General Fund Expenditures	\$57.8	\$66.5	\$78.1	\$76.8	\$77.5	\$78.0	\$76.1	34.9%	31.5%
General Fund Revenues	58.6	71.9	71.4	72.3	80.6	77.6	76.4	32.5%	30.4%
General Fund Tax Revenues	58.2	70.0	75.7 ²	62.7	64.9	69.1	73.3	18.8%	26.0%
Total Personal Income	\$931.6	\$995.3	\$1,100.7	\$1,129.9	\$1,155.2	\$1,199.0	\$1,266.4	28.7%	35.9%

² The table shows that total general fund revenues in 2000-2001 were **less than** total tax revenues. The explanation is that reported general fund revenues on Schedule 6 actually include direct revenues and transfers. In 2000-2001, \$6.3 billion of general fund revenues were transferred to pay for energy costs. The money was repaid (transferred back) to the general fund in 2001-2002. The 2004-2005 Budget Summary also shows \$9.2 billion in bond funds as miscellaneous revenues for 2002-2003 and \$3.0 billion in bond funds as miscellaneous revenues in 2003-2004. Additional one-time transfers and loans are included in various years. See page 17 for a discussion of the problems in interpreting reported general fund spending and revenue estimates.

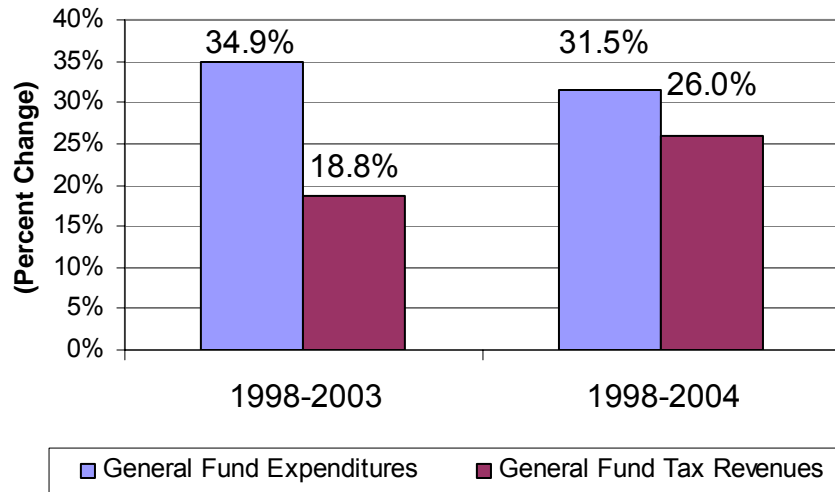
The first graph shows how the recent budget deficit occurred. The graph compares general fund spending with general fund tax revenues for the five years ending with the current (2003-2004) budget year. The graph shows that tax revenues and spending rose sharply in the first two years as stock market related income surged.



After that, tax revenues fell sharply from \$76 billion in 2000-2001 to \$63 billion in 2001-2002 and have increased slowly since but have not yet returned to the previous peak. In response, spending remained above \$75 billion each year after revenues fell. Even though the nearly constant level of spending resulted in a **decrease in real spending levels**, the budget deficit grew each year that revenues remained below spending levels.

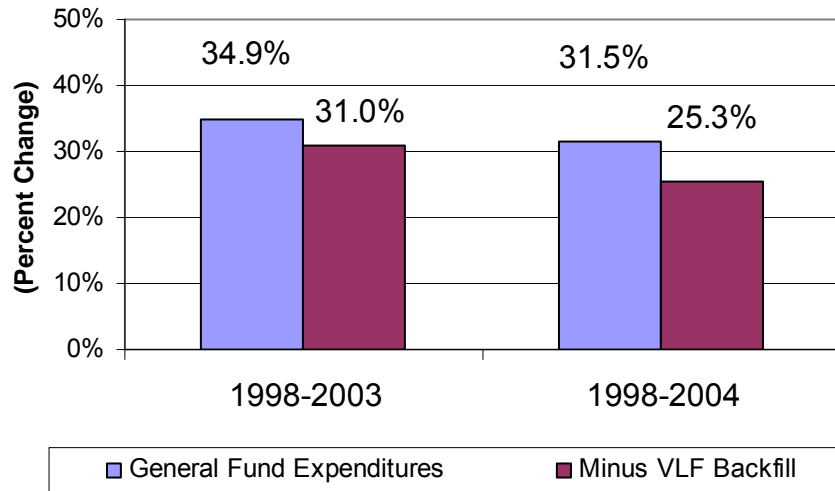
The next graph compares general fund spending to general fund tax revenues. As shown, general fund spending increased by 34.9% between the 1998 and 2003 budget year while tax revenues increased by 18.8%. When the analysis is extended one year to include the upcoming 2004 budget year, the increases are 31.5% for spending and 26.0% for tax revenues.

Spending and Tax Revenue Growth in California



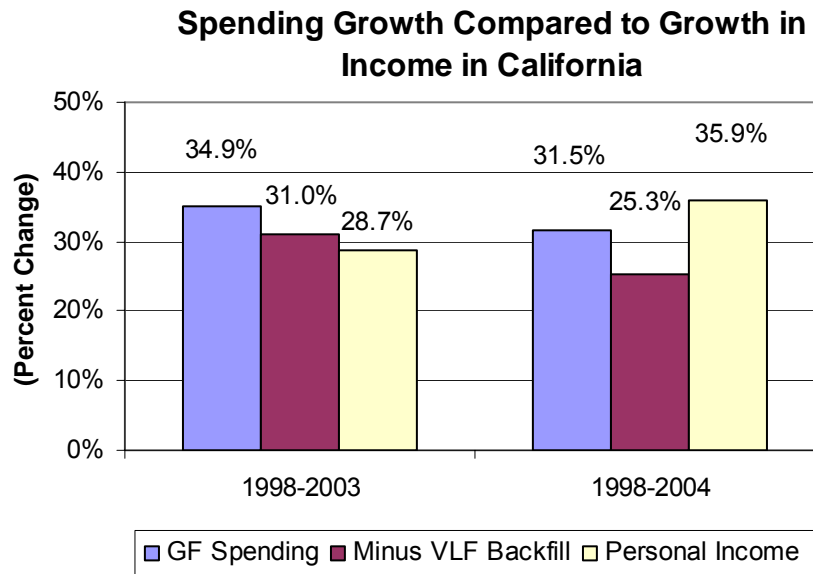
The budget counts the backfill funds given to local governments to replace the tax losses from cutting the vehicle license fee as an increase in spending even though it is **the result of the tax cut**. If this spending is backed out, the increase in general fund spending to 2003 is reduced from 34.9% to 31.0% and the increase from 1998 to 2004 is reduced from 31.5% to 25.3%.

Spending Growth in California



The next graph compares general fund spending growth to the increase in total personal income. Between 1998 and 2003, general fund spending rose by 34.9% (31.0% accounting for the VLF tax cut) and personal income increased by 28.7%. It is true that general fund spending rose faster than personal income but the 31.0% versus

28.7% difference is not large and would not have caused the very large budget deficits that the state faces.

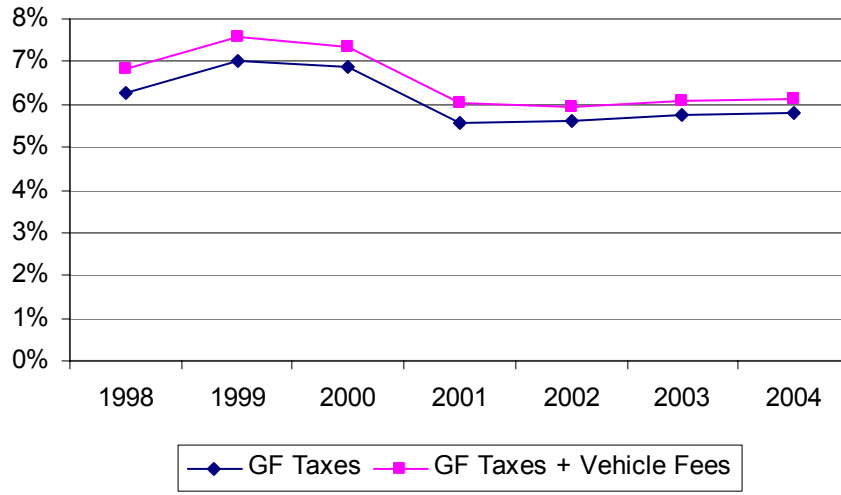


And between 1998 and the proposed 2004 budget, general fund spending minus the tax cut backfill is forecast to rise by 25.3% while personal income is forecast to grow by 35.9% according to the data published in the Budget Summary.

How could this happen? The answer is that the Budget Summary reports that the share of California personal income devoted to general fund **taxes actually went down between 1998 and 2004**. General fund taxes were 6.2% of personal income in the 1998-1999 budget and 5.8% of personal income in the 2003-2004 and proposed 2004-2005 budget. The tax share was temporarily higher in 1999 and 2000 with the stock option and capital gains swings.

The tax share drop was even larger when the vehicle license fee cuts are included. General fund taxes plus vehicle fees dropped from 6.9% of state personal income in 1998-99 to 6.1% in the 2003-2004 and proposed 2004-2005 budgets. While the share of personal income devoted to state taxes fell by 0.4% (6.2% - 5.8%) between 1998 and 2003, the share devoted to general fund taxes plus vehicle fees dropped by twice as much or 0.8% (6.9% - 6.1%).

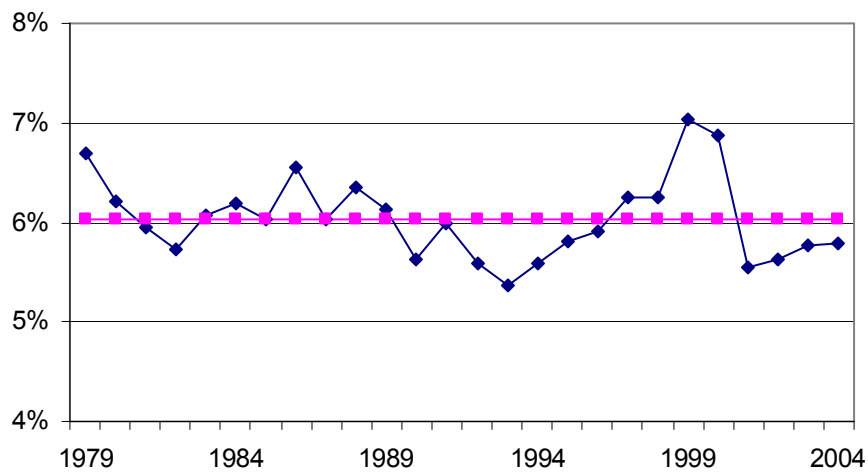
General Fund Taxes and Vehicle Fees as Percent of Personal Income



The explanation is that tax rates fell between 1998 and 2004 — both for vehicle license fees and some corporate taxes as well.

The share of personal income devoted to state general fund taxes has varied from a high of 7.0% in 1999-2000 to a low of 5.4% in 1993-1994. The average share from 1979 through 2004 is 6.0%.

State General Fund Taxes as a Percent of Total Personal Income



Why Does the Amount of Taxes Paid Vary as a Share of Income?

The **share** of income paid in state taxes can vary even if tax **rates** do not change. The share of California income devoted to state general fund taxes **rose** from 5.4% in 1993

to 7.0% in 2000 **even though tax rates fell during this period.** The tax share increased because rising incomes (fueled in 1999 and 2000 by stock option gains) pushed some residents into higher tax brackets.

The share of income devoted to state and local taxes also rose dramatically in the mid 1970s with no change in tax rates as a result of economic growth plus rapidly rising property values. This rise in the tax share created the political momentum for Proposition 13.

The share of income devoted to state taxes normally falls in recessions as income losses push residents into lower tax brackets. The tax “share” fell in the early 1990s even though some tax rates were raised temporarily. The share of income paid in state taxes has fallen sharply since 2000 as the state entered a recession and the stock market plummeted.

While in most years the tax share varies even though there are no changes in tax rates, sometimes residents make a conscious choice to vary tax rates. This was true for Proposition 13, for the temporary tax increases in the early 90s, for the tax rate cuts in the late 90s and may be true again this year as residents face difficult choices in the 2004-2005 budget.

Tax rate increases will raise the share of income devoted to state taxes while tax rate cuts will decrease the share of income paid in taxes unless the rate changes are offset by large changes in income growth. For example, the immediate effect of Proposition 13 was to lower the share of income that Californians paid in state and local taxes.

On the other hand, the tax rate increases in the early 1990s did not result in a higher share of income going to state taxes compared with the late 1980s while the tax rate cuts in the late 1990s did result in a decrease in the share of income going to state taxes in California.

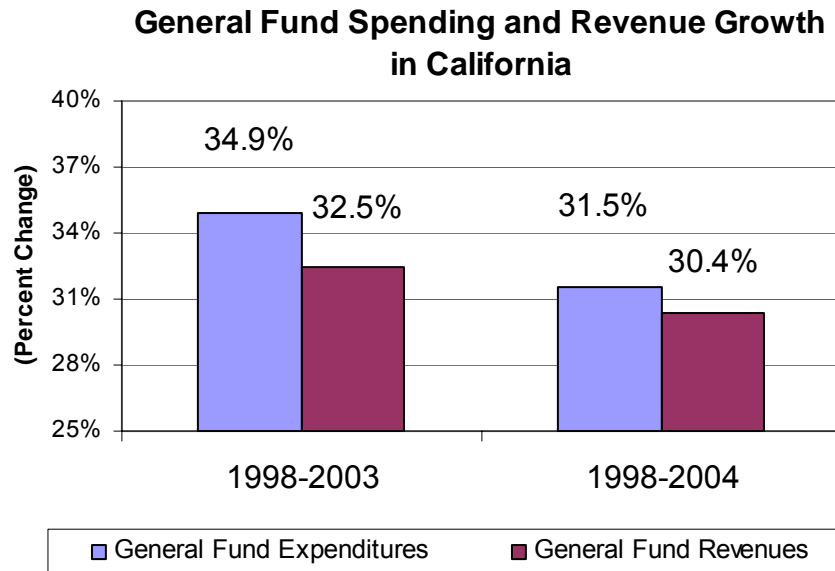
Economics does not tell us what the “right” share of our income is to spend on state government services or what the “right” share is for taxes. Likewise, the average share is no guide as to what is right. And, finally, the data cannot tell us whether the deficit was caused by “too much” spending or “too many” tax cuts. **All of these decisions rightfully reflect our values and priorities as residents.**

The Problem Caused by Including One-Time Spending and Revenue Shifts in Budget Data

One set of data is not particularly helpful in determining what is happening to underlying spending and revenue trends. Unfortunately, the less helpful series is the direct comparison of general fund spending and revenue, which is often the most widely reported series. The reason is that total revenues include tax revenues plus other revenue sources including transfers of funds, which were used extensively in the past

two budgets. And spending totals also include a number of one-time shifts between fiscal years.

After all of the transfers were made to boost revenues and after all of the one-time shifts were made to reduce expenditures, **reported spending and revenue growth rates are nearly equal for the past five years.** The Budget Summary reports that between 1998 and 2003, the time during which the large deficits were incurred, that general fund spending rose by 34.9% and general fund revenues rose by 32.5%.



III. THE ECONOMIC IMPACT OF SPENDING CUTS AND TAX INCREASES

Spending and taxation decisions usually reflect our values and priorities. Should we be devoting more or fewer resources to education? To health care and social services? To prisons or infrastructure?

Currently in California, residents and policy makers are concerned about the slow pace of growth in the state economy. So, residents are also debating whether there any overall economic considerations in making the choice between spending cuts and tax increases.

Will the choice between tax increases and spending cuts make any difference in the short or long-term economic growth rate in California? **Are tax increases or additional spending cuts in 2004 better for the economy?**

The economic impacts of the choice between tax increases and spending cuts are discussed below using the example of a choice between \$6 billion in general fund tax increases and \$6 billion in general fund spending cuts.

The \$6 billion represents the minimum deficit expected by the LAO even if all of the Governor's current-year proposals are accepted. The \$6 billion is equal to 8% of the approximately \$75 billion in California general fund spending and is equal to 0.5% of the approximately \$1.2 trillion in personal income of California residents in the current fiscal year.

Short-Term Impact of Spending Cuts

Cuts in public sector spending act the same as cuts in private sector spending. In both cases, some residents lose their jobs. In both cases, spending on goods and services is cut. In both cases, spending on major capital projects may be delayed or cancelled.

A \$6 billion spending cut takes \$6 billion of demand out of the economy whether it starts with a reduction in private sector spending or a reduction in public sector spending. The large protest against base closures in California shows that residents understand that cuts in public sector spending have real impacts on the economy of affected communities. The same kind of impacts occurs if the cuts are in education or transportation spending.

A reduction in construction spending has the same affect on the economy in the short term, whether it is a cut in transportation construction as has been the case in recent state budgets or a decline in office construction, which occurred as a result of rising vacancies. Layoffs create losses in income whether in the public sector or private sector. Cuts in payments to recipients or providers of public health and social services create losses in income just as do cuts in payments from private companies to suppliers.

The immediate impacts of spending cuts on job and income levels in California are the same whether the cuts come in private or public sector spending.

Short-Term Impact of Tax Increases

Taxes are the "price" of public services. In the short term, an increase in tax rates is a decision to buy more public services and a decrease in tax rates is a decision to buy fewer public services.

The direct impact of tax increases is to cause taxpayers (whether businesses or individuals) to have less income to spend. A \$6 billion tax increase will result in an approximately \$6 billion decline in private sector spending. **Tax increases are the way we choose to transfer resources from private spending to public spending.**³

³ It is likely that a tax increase to fund state spending will result in a small increase in total spending in California because part of private income is saved and probably a higher share of private spending is spent on goods and services produced outside of the state. These differences are too small to be important in choosing between tax increases and spending cuts.

Residents face a choice between cutting public sector spending and cutting private sector spending by raising taxes, which would force the cuts to be made in spending by individuals and businesses. However, because there is no significant difference in the short-term impact on total job and income levels between cuts in private and public sector spending, there is also no significant short-term difference between tax increases or public sector spending cuts.

Long-Term Impact of Tax Increases

One argument against tax increases is that tax increases will restrain long-term job and income growth in California. The argument is that tax increases raise the “cost” of doing business or living in California and that some businesses and high-income households will choose to move away or not come to California in the first place. Residents are familiar with the increased cost of doing business argument because it is in current public discussion regularly with regard to California’s workers compensation rates.

While most individuals would rather not pay increased taxes unless they feel it is absolutely necessary, it is the fear that tax increases will harm the prospects for economic growth that is mentioned most often in arguments against tax rate increases. The LAO quote on page 1 acknowledges that tax increases can have negative impacts on the economy.

This argument has merit if 1) the tax increases are permanent, 2) the tax increases are higher than being enacted in other states and 3) the spending supported by tax increases is considered less important for the economy than the private spending that would be eliminated by the tax increases. Let’s consider, for purposes of discussion, that condition 2 is true and focus on conditions 1 and 3.

If a tax increase is temporary (**and believed to be temporary**), the impacts on firms and households are likely to be small. It takes a long time to plan and implement a move and there are substantial one-time “moving costs” in changing locations from state to state.

So, if taxes are raised temporarily (and believed to be temporary), by the time most households or businesses could implement a long-term move, the tax increases would have been eliminated.

California has direct experience in imposing temporary tax increases to balance the state budget. Total tax increases of more than \$5 billion were adopted in the 1990-91 and 1991-92 budgets. These increases were equal to more than 12% of the \$40 billion in 1990-1991 general fund spending and 0.8% of state personal income. The tax increases in the early 90s were a higher proportion of state spending and personal income than a \$6 billion tax increase in 2004-2005 would be.

The most important determinant of the impact of tax increases on the economy requires an assessment of the spending that would be supported by the tax increases.

Long-Term Impact of Spending Cuts

The rationale for tax increases as part of a budget solution is to prevent spending cuts that would otherwise occur. **Taxes are the price we pay for public services.**

There is broad agreement among economists, business leaders and residents that state spending on K-12 education, higher education and infrastructure investment in areas like transportation provides important foundations for economic growth. Public investment provides the foundation to attract private investment.

Business groups like the California Business Roundtable, the Silicon Valley Manufacturing Group, the Bay Area Council and many others regularly take the lead in supporting higher taxes in local areas for education and transportation investment. These groups are also leaders in recognizing the importance that adequate housing and great cities play in attracting private investment for the kinds of innovative, entrepreneurial activities on which the California economy is based.

Currently, the state is reducing the absolute amount of spending on higher education and transportation. The higher education cuts come at a time when the growth in prime college-age groups is projected to be more than 20% in the next ten years. As a result, students are being turned away from some UC and CSU campuses and class offerings are being curtailed on most public college campuses. Real spending on higher education is declining and students are feeling the impacts.

The absolute dollar levels of spending on transportation investment are also being reduced while California has an acknowledged \$100 billion plus backlog of transportation investments and reportedly ranks in the bottom 10% of states on transportation investment per capita.

K-12 funding per pupil has kept pace with enrollment and inflation growth but California is, once again, falling in comparison to other states on per pupil funding.

The question of remaining competitive that is raised often with regard to workers compensation rates and taxes can also be raised about the level of investment in education and infrastructure. If California falls behind in education and infrastructure investment, that can create the same kind of competitive “gap” as higher tax rates or workers compensation costs. A tax increase, which might make California less competitive (other things being equal), might fund investment spending which would make California more competitive (other things being equal).

The choice of tax increases versus spending cuts ultimately depends on how residents assess the value of each choice.

Can California Afford to Spend More?

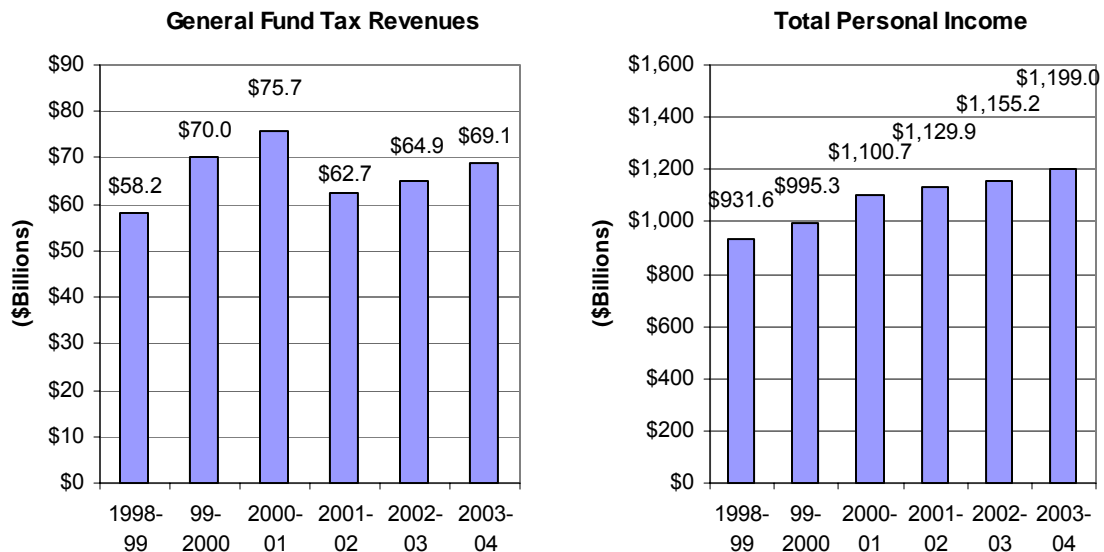
The phrases “can’t afford to” and “spending beyond our means” appear frequently in discussions about California’s budget choices. These phrases raise a serious question, i.e., **what is the relevant measure of “our means”?**

General fund tax revenue fell sharply in the state after 2000 while total state spending remained nearly constant. If “can’t afford to” or “spending beyond our means” refers to matching spending to existing tax revenue, then, indeed, the state is spending beyond our means.

If the “right” level of taxes is the existing level, then spending must be cut whenever revenues fall or the state will run deficits.

The following analogy of how a family operates is often suggested as a guide to how the state budget choices should be made. Families, the analogy goes, must cut spending whenever their income falls and so must state government, it is alleged.

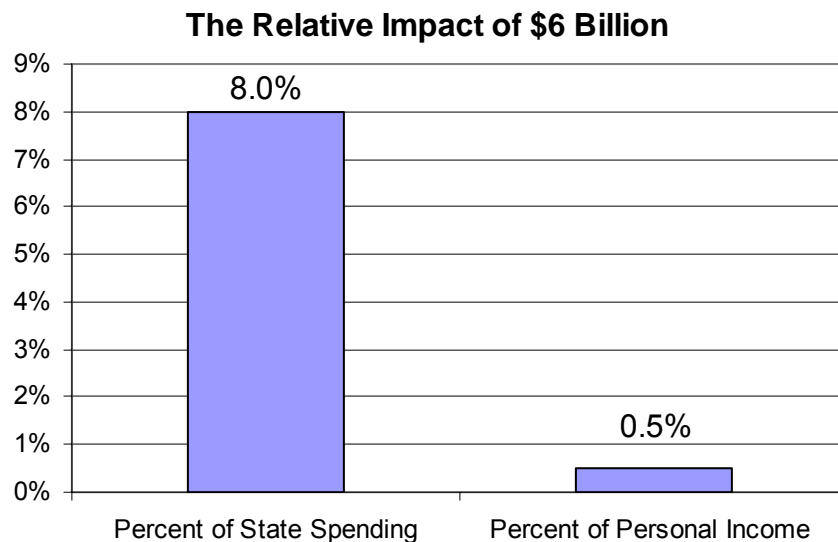
Besides the obvious problem with the analogy that families can borrow, for example to buy a house or send their children to college, there is no agreement in the public debate about how to measure “our means”. **The resources available to fund state government are not the taxes brought in by the current tax structure but the underlying income and wealth of residents.** Residents exercise **choice** over what share of their income to devote to state services.



In recent years, total personal income in California has grown less rapidly than in the mid and late 1990s, but is has grown enough to keep pace with population and inflation growth and is expected to grow even faster in the next few years. If the share of income devoted to state general fund taxes had been equal to the 1998-1999 share from 2001 through 2004, the resulting state budget deficit would have been much less.

The idea that residents have choice over the share of income devoted to public services is central to our language about public budget choices. We talk about what share of GDP is devoted to the federal budget and how large is our public debt in relation to GDP. It is clear in most debates about critical public choices that “our means” refers to our total resources as a society.

Since there is no “right” or “wrong” level of public spending, the issue always comes back to **evaluating choices**. With regard to the impact of spending cuts versus tax increases on California’s economy, we, as residents, have to make the decision about whether the marginal spending (the last \$6 billion in our example) will be better spent on state government priorities or our private sector spending priorities. In other words, should we transfer 0.5% of our total personal income to avoid a reduction of 8% in state spending?



Reducing “Waste”—Another Option for Reducing the Deficit?

There is a strong public perception that substantial waste exists in state government spending. In the January 2004 poll by the Public Policy Institute of California (PPIC), 67% of respondents said that the state could spend less and provide the same level of services. More than half (56%) thought that the state “wastes a lot of money”. One third of respondents thought the state could spend at least 20% less and still provide the same level of services, while 55% thought the state could spend up to 20% less.

And in the January 2004 Field Poll, 59% of respondents thought that their taxes were too high. In the PPIC poll, 46% agreed with this view.

The allure of cutting waste is strong. If even 10% of the state budget were “wasted”, that would produce nearly \$8 billion in annual savings.

The problem is that there are no objective standards for identifying waste. One person's "waste" is another person's salary or medical care or college grant. Most proposed budget cuts in any year are cuts in the number of eligible recipients (for example in Medi-Cal or college enrollment), cuts in salaries or construction projects or payments to service providers or cuts in the number of state jobs.

Economic theory is clear that cuts in compensation should affect the ability of the state to hire talented people and that cuts to Medi-Cal or social service providers should result in fewer people being served or longer waits or both. While there is probably scope for improving efficiency in any organization run by humans, there are likely to be impacts on "service levels" from most of the cuts in state spending that legislators control.

Residents often contradict their statements about government waste when presented with specific choices. In the PPIC poll, 60% of respondents said that the state is not spending enough on local education and 67% said they were willing to pay higher taxes to fund K-12 education. In fact, 56% said yes to higher taxes for local government services and 54% said yes to higher taxes for health and human services. Yet, only 43% said they favored higher taxes and more services.

The majority of people in both the PPIC and Field polls supported or expected a mixture of tax increases and spending cuts to balance the budget. In the PPIC poll, 50% favored the "balanced" approach versus 28% for spending cuts alone and 7% for mostly tax increases. In the Field poll, 59% expected tax increases as part of the budget solution while 61% supported temporary higher income tax brackets and 60% favored a ½ cent sales tax increase.

The end result is that residents appear capable of believing both that waste exists in state government, that education and other areas deserve more funding and that tax increases are justified as part of the solution to balancing the state budget.