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DATE: April 16, 2004
TO: Budget Project friends
FROM: Stephen Levy
SUBJECT: What Can California Afford?

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

The phrase "California cannot afford" has been a prominent part of state budget discussions in 2003 and 2004. This memo continues the analysis of what "affordability" means in making budget choices and presents recently released data that relates to the issue of affordability.

The memo is being released together with a memo updating national and state economic trends. This period is the interlude between passage of Proposition 57, which provides funding to cover past deficits, and the debate over the 2004-2005 budget, where the prospect of difficult choices and an impending long-term structural deficit of at least \$5-7 billion will face legislators and residents.

ONE MEANING FOR "CALIFORNIA CANNOT AFFORD"

If the question of what residents "can afford" means only whether the existing tax structure is likely to provide enough revenue to pay for the level of services provided in recent years, then the answer is probably no. Even with stronger economic growth than currently anticipated, it is unlikely that today's tax rates will provide enough revenue to cover the existing level of services adjusted for caseload and price increases.

THE IMPACT OF RECENT TAX CUTS

Both the state and federal government have passed substantial tax cuts in recent years. The federal tax cuts bear on the question of "What can

Californians afford?” because they affect the disposable income of residents and, hence their ability to “afford” taxes.

The state tax cuts, which total about \$5.6 billion per year since 1998, directly affect the amount of revenue available to the state government. The \$5.6 billion is made up of \$4 billion in vehicle license fee reductions, more than \$1 billion in personal income tax cuts (through raising the exemption credit for children) and modest corporate income tax reductions, which follow a small cut in the corporate income tax in 1996.

So, in a simple mathematical sense, the \$5.6 billion in tax cuts since 1998 approximately match the \$5-7 billion long-term structural deficit identified by the Legislative Analyst’s office.

THE “TAX BURDEN” IN CALIFORNIA

Another claim in the current budget debate, in addition to the claim that California is “hemorrhaging” jobs, is the claim that Californians are “overtaxed”. Comparative data on job growth by state is contained in the companion memo **An Update on the California Economy**.

The data on comparative tax burdens are clear. In the late 1990s, state and local taxes in California were a relatively high percent of total personal income compared to other states. In 2004, the tax burden in California is average to below average depending on what measure is used. For an “average” year, it is likely that combined state and local taxes as a percent of income in California are slightly above the national average.

A New Comparison of State and Local Tax “Burdens”

The Tax Foundation in Washington, D.C. has released their 2004 rankings of state and local tax burdens. The data can be found at <http://www.taxfoundation.org/statelocal04.html>.

There has been a continuing barrage of stories about California’s “tax burden” compared to other states and the main thrust of these stories is that Californians are heavily taxed. Paying a higher share of income for public services is a choice that residents can make, so a higher “tax burden” may be a good choice for residents if they get value from the extra public spending.

Since the passage of Proposition 13, which dramatically lowered local property tax rates, California has been a state with comparatively high state tax collections as a percent of income and comparatively low local taxes as a percent of income.

California’s ranking among states is shown below from two sources—1) the just revised Tax Foundation estimates through 2004 and data from the 2003 **California Statistical Abstract**. Both sources use data published by the United States Department of Commerce. The tabulations have slight

differences in how the measures were constructed and the Tax Foundation data is more up to date than the data in the Statistical Abstract.

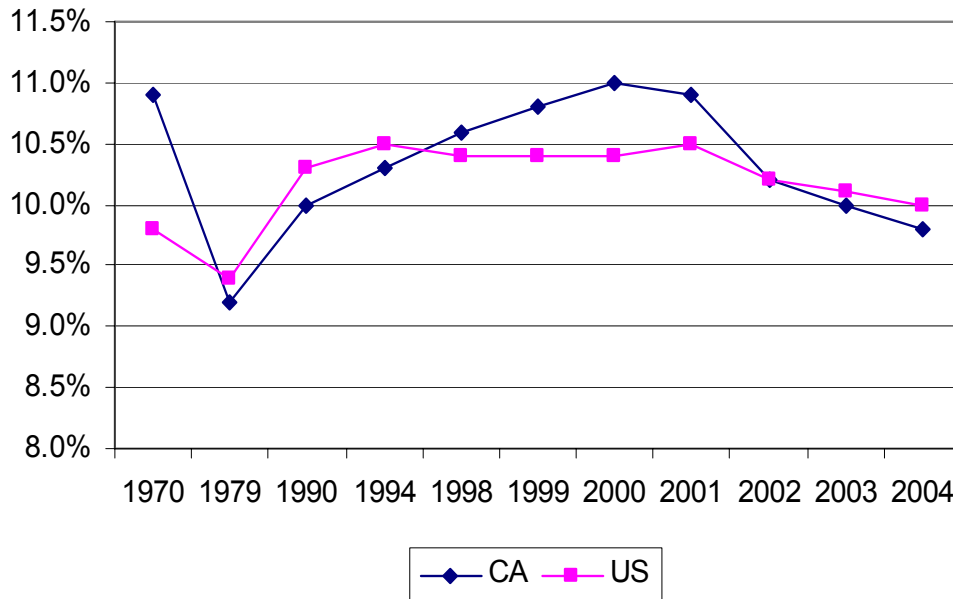
A ranking of 1 means that the state has the highest percent of income going to state and local taxes and a ranking of 50 means that the state has the lowest percent of income going to taxes. The rankings are similar in the trend over time and tell the same story.

California's Tax Burden Ranking
(1 is Highest, 50 is lowest)

YEAR	TAX FOUNDATION	CA STAT ABSTRACT
1970	8	8
1979	25	24
1990	25	20
1994	24	34
1998	16	16
1999	11	15
2000	11	8
2001	10	
2002	25	
2003	24	
2004	26	

The Tax Foundation study includes data on the actual percent of income going to state and local taxes, shown in the graph below.

State and Local Taxes as % of Income



State tax receipts rose as a percent of income in the late 1990s, as a result of the strong economy and, particularly, as a result of large tax receipts from stock option income and capital gains. At the peak in 2000, Californians paid 11.0% of income in state and local taxes, compared to 10.4% nationally and ranked about 10th from the top among states.

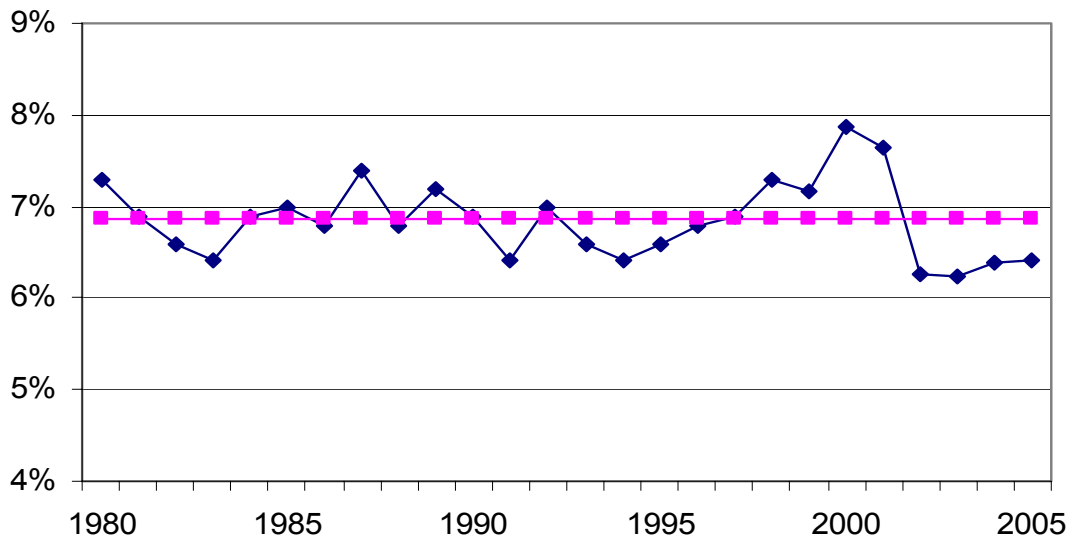
California's move from number 16 in 1998 to number 8 or 11 in 2000 came as **tax rates were being lowered**. The "high tax" status came purely as a result of strong economic growth.

The 2004 Tax Foundation rankings place California 26th or nearly in the middle among states in terms of tax burden. In fact, California ranked 24th to 26th in 1979, 1990, 1994, 2002, 2003 and 2004 according to the new Tax Foundation rankings.

Fluctuations in State Tax Shares in California

Trends in the share of income devoted to state income, sales, corporate income and vehicle-related taxes and fees are shown below. The data is from the California Department of Finance as reported in the Governor's 2004-2005 Budget published in January 2004.

State General Fund and Vehicle-Related Taxes as a Percent of Total Personal Income



This graph tells the same story as the data shown above. The share of income devoted to state taxes rose sharply in the late 1990s, even as vehicle license fees were reduced. However, after the stock market plummeted, California experienced both falling income tax revenues and a continuation of the vehicle license fee cuts started in 1998. The percent of personal income devoted to these state revenue sources dropped from a high of 7.9% in 1999-

2000 to between 6.2% and 6.4% in the past three years and expected in 2004-2005 at current tax rates.

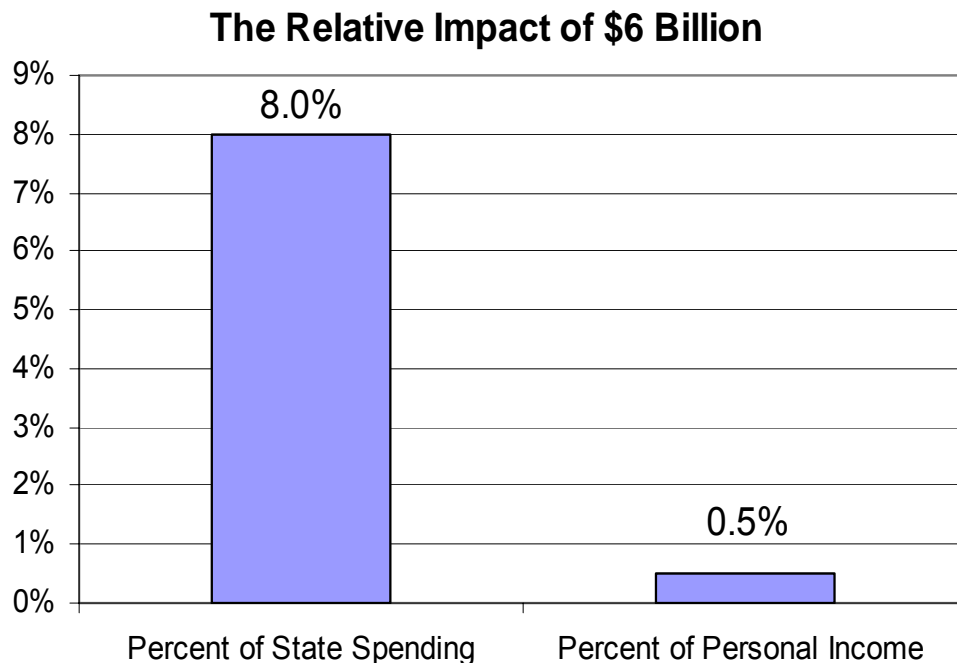
AN ALTERNATIVE MEANING FOR AFFORDABILITY

In the past year, when people have said, “California cannot afford” a particular level of state government spending, they have typically meant that the existing tax structure (including recent tax cuts) does not provide enough revenue. This definition of affordability uses the existing tax structure as the principal criterion.

A more universal criterion is the level of resources available to individuals in California. This meaning preserves the important idea that affordability is related to the growth in income and wealth but leaves open for residents to decide what is the appropriate mix between private and public spending.

While many residents hope that “extra money” can be found by eliminating “waste, fraud and abuse”, there is broad agreement that the state faces more choices about reducing service levels or raising revenues.

Therefore, it is important to determine if our discussion about affordability is constricted to the approximately \$75 billion that will be raised this year by the existing tax structure or to the \$1.2 trillion in personal income this year for California residents. A \$6 billion shift represents 8% of \$75 billion but only 0.5% of \$1.2 trillion.



If residents decide to spend an additional \$6 billion based on their assessment of the level of state government services they want, it represents a shift of \$6 billion from private spending to public spending. Taxes are the “price” of public services and as with any set of services and related prices, consumers can decide to buy more or less.

In theory, residents should be interested in “buying” more state government services depending on their income levels and how they evaluate these services versus other uses of their money. **So, total income and relative value become the determinants of how we choose to spend our money and “affordability” disappears as a word relevant to state budget debates – unless affordability merely means what the existing tax structure will produce.**

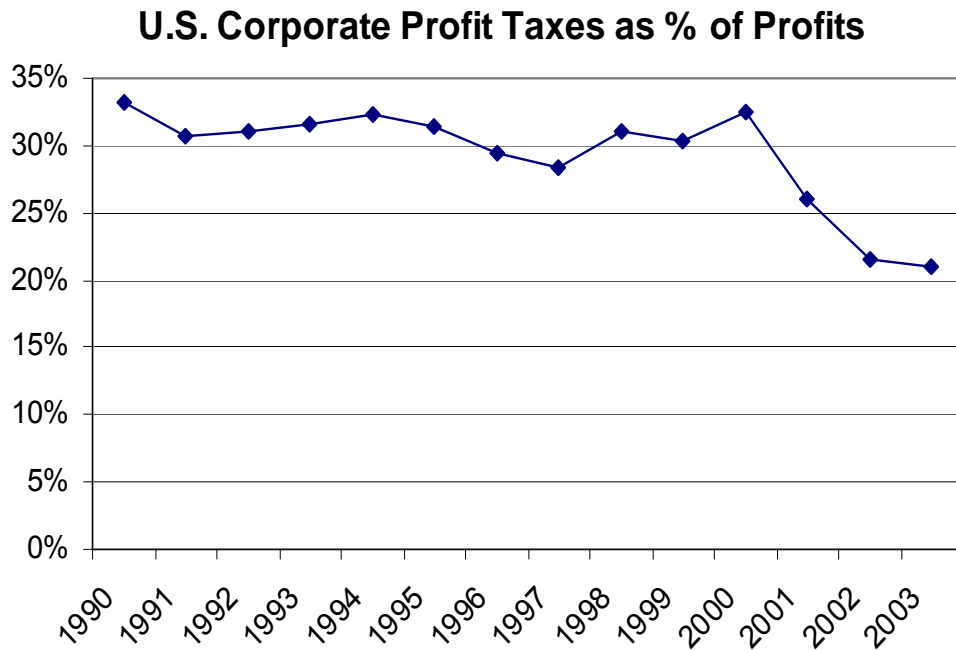
RECENT DATA ON CORPORATE PROFITS AND CORPORATE TAXES

Corporate profits in the United States reached record levels in 2003 according to data from the U.S. Department of Commerce. Profits rose \$1166 billion or 18.3% in 2003 to reach a record \$1.07 trillion. The 2003 increase came after a 17.4% gain in 2002.

The large profit gains came during a period in which U.S. job levels were falling.



During the past three years, the share of corporate profits paid as U.S. income taxes went from 32.4% in 2000 to 21.0% in 2003. Part of the reason was corporate tax cuts enacted since 2000 and part may be due to the increased use of legal tax avoidance tactics.



An independently developed, but similar looking, graph appears in a Wall Street Journal article of April 13, 2004 under the headline “Corporate Tax Burden Shows Sharp Decline”.

Corporate Profits for Bay Area Companies

Two Bay Area newspapers have recently published data for companies headquartered in the Bay Area. Many of these companies have operations throughout the world and these results are for the entire company, and not just for their California operations.

The San Francisco Chronicle 200 covers the region’s largest 200 public companies measured by total sales. The Silicon Valley 150, published by the San Jose Mercury News, covers the top 150 public companies headquartered in Silicon Valley measured by total sales.

There is some overlap between the two lists.

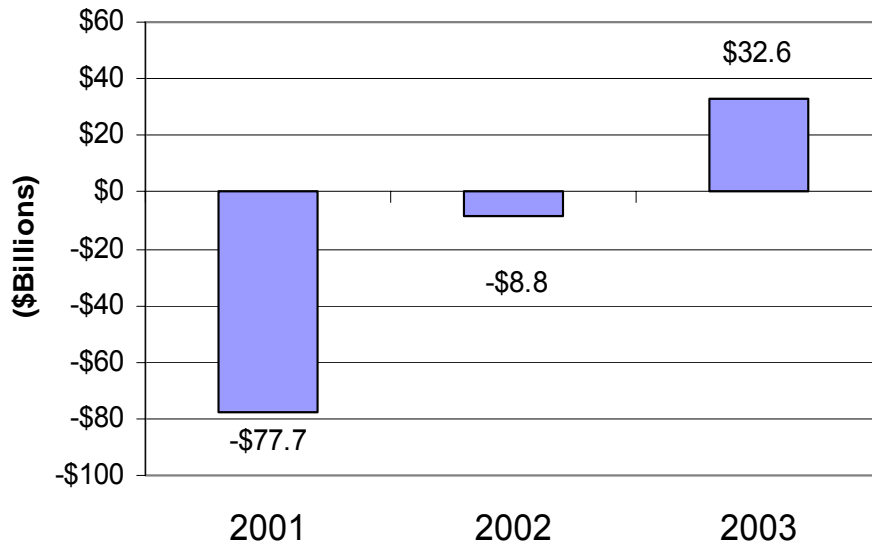
Both lists show a strong rebound in profits and market value in 2003. The Chronicle top 200 companies had a profit increase of \$41.4 billion and a stock valuation gain of \$5125 billion or 58.2% between 2002 and 2003. The Silicon Valley 150 companies had profit increases of \$30.0 billion and a stock valuation gain of \$385 billion or 64%.

**Increase for Bay Area Public Corporations
(2003 versus 2002)**

	Chronicle 200	Silicon Valley 150
Sales	7.6%	11.0%
Profits	\$41.4	\$30.0
Stock Value (\$Billions)	58.2%	64.0%
Employees		-4%

The profit rebound came after two years of losses. The Chronicle 200 companies lost \$77.7 billion in 2001 and \$8.8 billion in 2002 before posting a profit of \$32.6 billion in 2003. The expectation is that corporate profits will remain strongly positive in 2004.

Profits by Year for the "Chronicle 200"



Corporate Profits and California Budget Choices

Recently, the U. S. Government Accounting Office released a report stating that approximately 60% of U.S. corporations did not pay income tax between 1996 and 2000. Then, the U.S. Department of Commerce published the data shown on a previous page showing a decline in the effective corporate tax rate.

These data have already become part of the political debate about equity in the U.S. tax system. The data also bear on the question of affordability. The profit increase nationally is another indicator (along with strong GDP growth) that our annual ability to afford goods and services is increasing. Whether the

profits are retained, reinvested or paid out as dividends, they represent increased buying power.

The issues raised nationally have counterparts in California. The state is in the midst of a “performance review” initiated by Governor Schwarzenegger to examine the results produced by state spending to see if residents “are getting their money’s worth”.

The counterpart to a performance review of spending programs is a performance review of tax credits or “tax breaks”. Dollars saved from reducing spending on “poorly performing” programs and dollars saved from “poorly performing” tax credits are both dollars that can be used to maintain high priority spending by producing additional resources for state government services.

The data on corporate profits and corporate tax rates are likely to spark increased interest in examining the “performance” of corporate tax policies.

CAN CALIFORNIA STATE GOVERNMENT “AFFORD” NOT TO INVEST

There is broad agreement that investments in education, transportation and other infrastructure investment are part of what makes the California economy “competitive” and also broad agreement that the state is not investing enough. The current proposed 2004-2005 budget follows the practice of recent state budgets in eliminating or deferring investments in higher education and transportation.

The question of “can we afford” applies equally to reducing public investments as it does to increasing taxes or reversing previous tax cuts. The LAO has asked the Legislature to consider whether the state can “afford” to make cuts in public investment in the 2004-2005 budget. The LAO’s 2004-2005 Issues and Perspectives report

(http://www.lao.ca.gov/analysis_2004/2004_pandi/pandi_04.pdf) advises:

“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.”

As part of the Department of Finance (DOF) preparation of updated analyses for the 2004-2005 budget, DOF surveyed state departments on the impacts of recent staffing reductions. Their very detailed report is found at http://www.dof.ca.gov/HTML/BUD_DOCS/Bud_link.htm. Readers can make their own determinations about the economic and equity implications of the staff reductions reported by the departments.

The Language of California's Budget and Economy Debates

Debates about budget and economic policy choices are usually intense and, sometimes, subject to inflammatory language. The following suggestions are made partly "tongue in cheek" and partly based on economic and budget data.

Three phrases have been prominent in California's recent budget and economic policy debates—"hemorrhaging jobs", "job-killer legislation" and "spending addicts". Here are some suggested modifications or additions.

With regard to California "hemorrhaging jobs", the evidence is that the state's job losses have been of the same magnitude as those in the nation and less than in many large, industrial states. So, perhaps, the "hemorrhaging" phrase could be dropped or changed to "participating in the nation's poor jobs performance".

Individuals are certainly entitled to their opinions as to how legislation affects the environment for job growth and, therefore, to feel that specific legislative proposals are "job killers". But most regional and business groups in California also have identified positions in favor of increased spending on education and infrastructure, citing the importance of these investments to creating a good environment for private sector investment and job growth.

So, perhaps it would add appropriate balance to the public debate if the phrase "job-killing spending cuts" were added to our budget/economy debate vocabulary.

Finally, the phrase "spending addicts" appears often in public debate referring to the Legislature's approval of spending increases based on revenue growth that subsequently dried up. It is often alleged that the "spending addicts" caused the state's budget deficits. However, the evidence is clear that between \$5 billion and \$6 billion per year in tax cuts were approved during the same period and for the same reasons—that revenue growth was temporarily large enough to support both the spending increases and tax cuts.

So, perhaps it would add balance to the public debate if either the phrase "spending addicts" were dropped or the phrase "tax cut addicts" were added to public discussion.