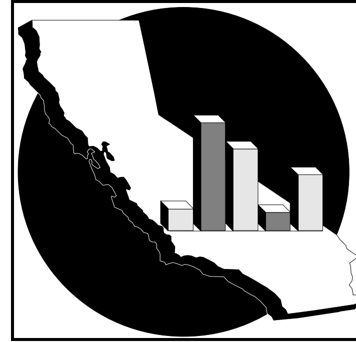


PERSPECTIVES ON STATE REVENUES

The revenues of state government in California are generally divided into two broad groups: General Fund revenues and special fund revenues. General Fund revenues can be used for a wide variety of government expenditures, while special fund revenues are usually earmarked for relatively specific purposes. Examples of special fund revenues include funds from cigarette and tobacco products taxes, which fund certain health-related programs, and hunting and fishing permit fees, which are allocated to outdoor recreation programs. The largest single category of special fund revenues involves motor vehicles and transportation.

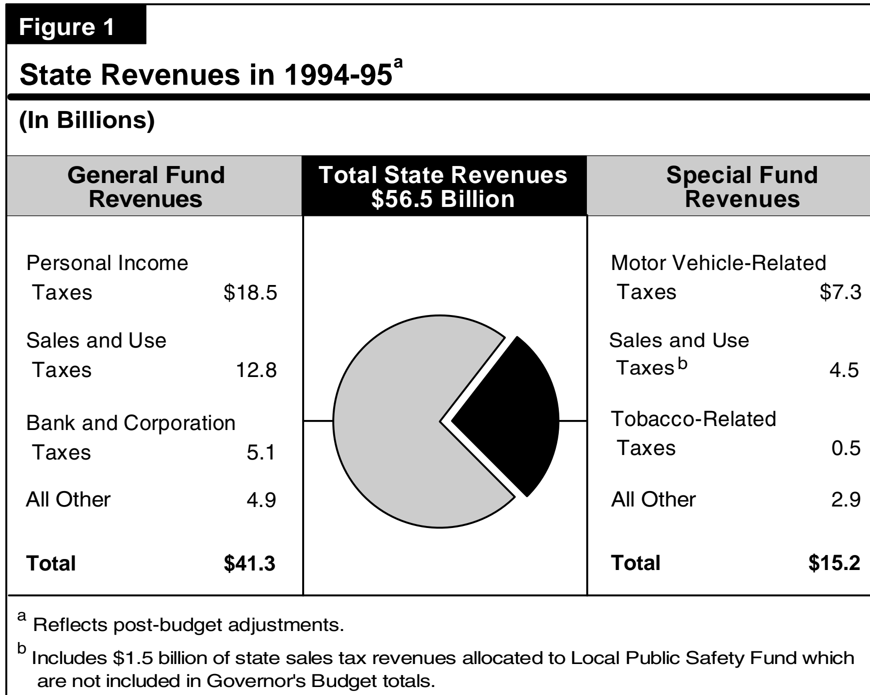
Figure 1 gives a broad overview of the major revenue sources that support General Fund and special fund expenditures, as outlined in the *1994-95 Governor's Budget*. General Fund revenues are currently projected by the Department of Finance (DOF) to total $41.3 billion, and special fund revenues are expected to be $15.2 billion. (The General Fund amount reflects two adjustments announced by the administration following the release of the Governor's Budget. In addition, we have included in the special fund totals $1.5 billion of state sales tax revenues which will accrue to the Local Public Safety Fund that are not reflected in the Governor's Budget.)

General Fund revenues are expected to support 73 percent of the proposed $55.6 billion total 1994-95 spending plan. This is a decline from the 78 percent share these revenues represented in fiscal year 1992-93, in part due to the continuing slow growth of General Fund revenues relative to special fund revenues, but primarily because of past and proposed shifts of revenues from the General Fund to special fund accounts.

Figure 1

State Revenues in 1994-95[a]

(In Billions)



General Fund Revenues	
Personal Income Taxes	$18.5
Sales and Use Taxes	12.8
Bank and Corporation Taxes	5.1
All Other	4.9
Total	**$41.3**

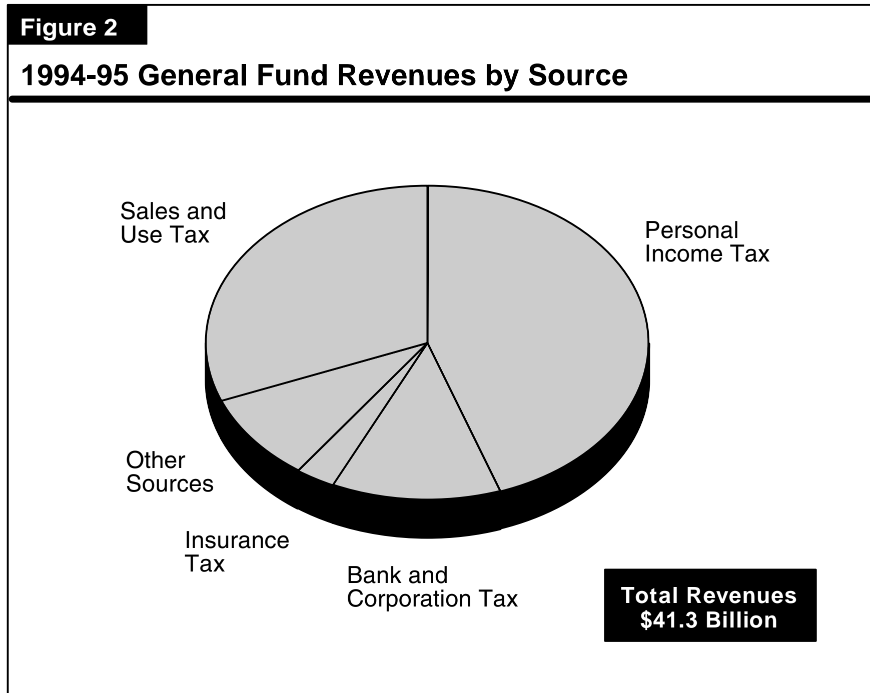
Special Fund Revenues	
Motor Vehicle-Related Taxes	$7.3
Sales and Use Taxes[b]	4.5
Tobacco-Related Taxes	0.5
All Other	2.9
Total	**$15.2**

[a] Reflects post-budget adjustments.

[b] Includes $1.5 billion of state sales tax revenues allocated to Local Public Safety Fund which are not included in Governor's Budget totals.

Figure 2

1994-95 General Fund Revenues by Source



OVERVIEW OF THE BUDGET'S GENERAL FUND REVENUE FORECAST

Figure 2 shows that the bulk of General Fund revenues are raised from three sources. The largest of these is the state's personal income tax (PIT), which is projected to generate 45 percent of General Fund revenues. The sales and use tax accounts for 31 percent, while the bank and corporation tax's share is 12 percent. Thus, these three taxes alone account for 88 percent of total General Fund revenues.

Figure 3 summarizes the administration's forecasts for General Fund revenues by major source for 1992-93 through 1994-95. This figure highlights several important trends. First, growth in PIT revenues

Figure 3

General Fund Revenues[a]
1992-93 Through 1994-95

(In Millions)

Source of Revenue	Actual 1992-93	Estimated 1993-94	Proposed 1994-95	Change From 1993-94	
				Amount	Percent
Taxes					
Personal income	$17,232	$17,535	$18,490	$955	5.4%
Sales and use[b]	15,042	13,748	12,762	-986	-7.2
Bank and corporation	4,724	4,765	5,115	350	7.3
Insurance	1,188	1,219	1,205	-14	-1.1
Estate, inheritance, and gift	466	468	496	28	6.0
Alcoholic beverage	292	279	277	-2	-0.7
Cigarette and tobacco products	173	179	171	-8	-4.5
Horse racing	75	74	70	-4	-5.4
Subtotals	($39,192)	($38,267)	($38,586)	($319)	(0.8%)
Other Sources					
Interest on investments	$228	$181	$185	$4	2.2%
Transfers and loans	697	565	138	-427	-75.6
Abandoned property	196	118	118	—	—
Other revenues	633	612	307	-305	-49.8
Federal cost recoveries	—	—	2,000	2,000	NA
Subtotals	($1,754)	($1,476)	($2,748)	($1,272)	(86.2%)
Totals	**$40,946**	**$39,743**	**$41,334**	**$1,591**	**4.0%**

[a] Reflects post-budget adjustments.

[b] General Fund sales and use taxes in 1993-94 are reduced due to shift of funds to Local Public Safety Fund (Proposition 172) and in 1994-95 due to Governor's state-county restructuring proposal.

continues to be sluggish, reflecting the weakness of the California economy. Second, major declines in the General Fund share of state sales taxes continue to offset gains from other sources (see below). Finally, most of the state's minor revenue sources are falling because of such factors as the state's weak economy, changing consumption patterns (for example, declining cigarette and alcoholic beverage consumption), and falling interest rates.

Shifts Reduce Sales Tax Receipts. Although Figure 3 indicates that sales and use tax receipts are expected to decline significantly in both 1993-94 and 1994-95, this reduction is not attributable to the state's weak economy. Rather, these reductions are entirely attributable to shifts of sales tax revenues to special fund accounts. These include:

- ***Local Public Safety Fund.*** In 1993-94 revenue attributable to a 1/2 cent rate of the state's sales tax was shifted to the Local Public Safety Fund (LPSF) for the first six months of the fiscal year by the Legislature and the Governor. The

state's voters in November 1993 approved a constitutional amendment making this tax permanent and dedicating this revenue to the LPSF.

- ***Client Services Fund.*** For 1994-95, the budget proposes another shift of General Fund sales tax revenues to a new special fund account as part of a proposal to restructure the state-county fiscal relationship. The revenue attributable to a 1/2 cent rate of the state's sales tax would be deposited into this fund and used to pay county costs for health and welfare programs previously paid for by the state's General Fund. (Please see Part Five of this volume for a complete description and analysis of this proposal.)

Tax Proposals in the Budget

Aside from the sales tax shift discussed above, the budget contains two major tax proposals that the administration is requesting legislative authority to implement. Specifically, the administration proposes to establish the following tax credits for moderate-income individuals and new businesses:

Tax Credit to Offset Federal Gasoline Tax Increase. The first proposal would reduce state income taxes for moderate-income individuals. The administration proposes to provide an income tax credit of $25 to most single taxpayers earning less than $25,000, and a $50 credit for most married taxpayers earning less than $40,000 annually. The stated purpose of this credit is to offset the increase in the federal gasoline excise tax implemented in October 1993.

According to staff at the Department of Finance, this credit would not be refundable. This means that if the amount of the credit exceeds the taxpayer's state income tax liability, the taxpayer's liability is reduced to zero. Taxpayers with no tax liability would not benefit from the credit.

As proposed, this credit would not be available for most low-income taxpayers who have children. Department staff indicate that these taxpayers would be excluded from the credit because they have been granted additional federal income tax relief with the recent increase in the federal earned income tax credit. Consequently, single parents earning less than $10,000 annually and married parents earning less than $25,000 would not be eligible for the credit.

The Franchise Tax Board estimates that this credit would reduce General Fund receipts by approximately $95 million annually, beginning in 1994-95. The General Fund revenue totals used in this document have been adjusted to reflect this loss. (Following the release of the Governor's Budget, the administration released an announcement adjusting the figures for this loss and for $300 million in anticipated federal funds that were not included in the budget due to an oversight.)

Tax Credit for New Businesses. The administration also proposes to provide tax credits to businesses that begin their operations in the next two years. These businesses would receive a $1,000 tax credit for each of the first 100 new full-time jobs they create. These credits could only be taken after an employee had been on the job for one year, and the credit could only be taken on behalf of any particular employee for a maximum of two years.

Unlike the proposed personal income tax credit, however, this credit would be refundable. This means that if the amount of the credit exceeds a new business's state income tax liability, the taxpayer receives the excess. Further, if a new business has no tax liability, the business would receive the full amount of the credit the year the credit is earned. In effect, this credit would amount to a state subsidy of $1,000 to new businesses for each full-time job they create. The Franchise Tax Board estimates that this credit would result in revenue losses to the General Fund of approximately $50 million annually for four years beginning in 1995-96.

INDIVIDUAL GENERAL FUND REVENUES

Below we examine the forecasts for the state's individual taxes. After providing some background on each tax, we review the Department of Finance's revenue projection and then compare it to our forecast.

The Forecast for Personal Income Taxes

Background

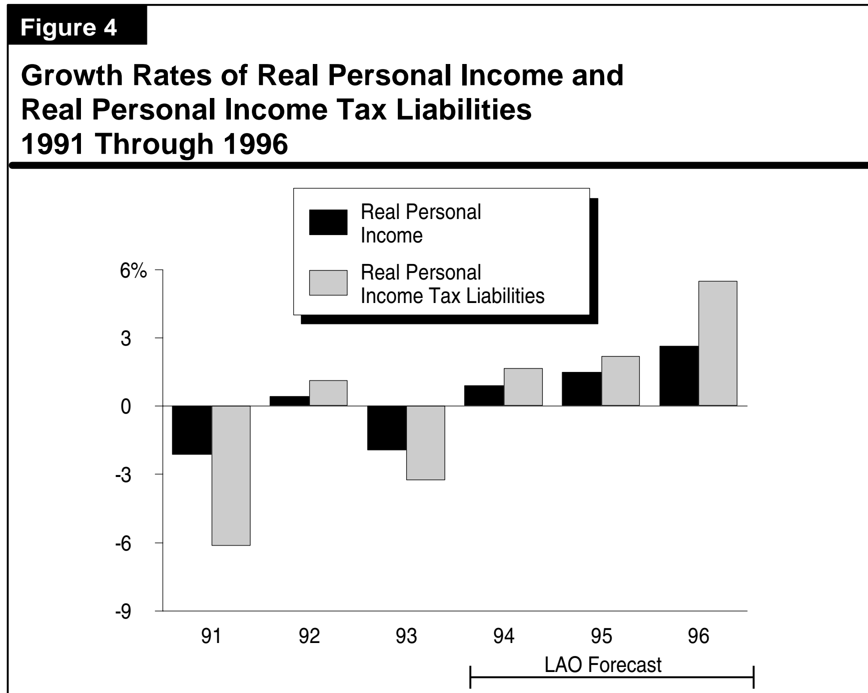
The California personal income tax provides the largest percentage share of General Fund revenues. The PIT's structure is progressive, in that higher-income households generally pay a higher proportion of their income in taxes than low-income households. This is illustrated by the fact that, in 1991, the top 4 percent of taxpayers in the state paid nearly 50 percent of the total tax collected, although they accounted for only 25 percent of the total income subject to the tax. The marginal rates range from 1 percent to 11 percent of taxable income. The PIT tax base essentially conforms to the federal tax base and includes various income exclusions, deductions, and credits. Income brackets and other key elements are indexed for inflation so that a taxpayer's real income must rise before his or her real income tax liability increases.

The PIT is also the most sensitive of the state's taxes to changes in the rate of economic growth. The progressive structure of the PIT makes it highly "elastic" relative to personal income. In general, this means that as real (inflation-adjusted) incomes rise, real tax collections rise more than proportionately. The converse is also true, in that declines in "real" personal income in the state, as have occurred in two of the past three years, result in a more than proportionate decline in real income tax revenues. Figure 4 illustrates the elasticity of the personal income tax and shows that PIT revenues are forecast to increase much faster than personal income as the economy recovers.

Weak PIT Growth in Recent Years. Personal income tax collections have grown by an average of less than one percent per year over the past four years. This very weak growth largely reflects the generally depressed economic conditions in California. After adjusting for inflation, total personal income in the state declined by over 2 percent in 1991, grew by less than one percent in 1992, and is estimated to have declined almost another 2 percent last year. More significantly, key sources of taxable income—for example, wages and salaries, business income, capital gains, and interest income—declined by even greater percentages over this period, reflecting high unemployment levels, low wage increases, reduced business profits, depressed stock and asset values, and a dramatic drop in interest rates.

Figure 4

Growth Rates of Real Personal Income and Real Personal Income Tax Liabilities 1991 Through 1996



Erratic Capital Gains Income. Projecting PIT collections is made particularly difficult by the volatility of realized capital gains income from year to year. Capital gains tend to be highly unpredictable because they are influenced by a combination of largely unrelated factors. These factors include stock market fluctuations, changes in real estate values, investment timing decisions, and tax policy changes. As reported for tax purposes, capital gains dropped sharply in 1990 and 1991—falling by 11 percent and 25 percent, respectively—reflecting a weak stock market and the plunge in California real estate values. On the positive side, the DOF expects capital gains income to contribute significantly to PIT collections in the current and budget years, primarily due to the strong performance of the equity and bond markets.

The DOF PIT Forecast

The Department of Finance projects PIT collections of $18.5 billion in the budget year, an increase of 5.4 percent over the $17.5 billion estimate for the current year. This forecast takes into account several expiring tax expenditure programs (TEPs) and the effects of recently enacted TEPs, including: (1) the December 1993 sunset for the jobs

tax credit, recycling equipment credit, and commercial solar system credit; (2) the December 1994 sunset for the employer child care credit; (3) the resumption of the suspended net operating loss carryover provisions (NOLs) beginning in 1993; and (4) the PIT provisions of Chapter 881/93 (SB 671, Alquist) which is discussed later in this part.

The LAO PIT Forecast

The Department of Finance's estimates of PIT collections for the current and budget years are generally consistent with their underlying economic assumptions. As we discussed earlier in our review of the economic outlook, however, we believe that there is a potential for the state's economy to be significantly weaker than the department has projected over the next two years. Key differences in our economic assumptions as they relate to those variables that primarily determine PIT collections are shown in Figure 5.

Figure 5

Comparison of PIT-Related Forecast Variables

(Percent Change)

	1994		1995	
	DOF	LAO	DOF	LAO
Total personal income	4.0%	3.6%	5.0%	4.3%
Wages and salaries	3.9	3.1	4.8	3.7
Proprietors' income	4.2	3.1	5.6	3.6
Interest income	0.9	1.1	3.2	3.3
Dividend income	5.4	3.7	6.9	5.3
Capital gains income	11.7	7.9	11.2	7.7
Real personal income	1.3	1.0	1.2	1.5
Consumer prices	2.7	2.7	3.8	2.8
PIT liabilities	6.0	4.4	6.3	5.1

With the exception of interest income, our forecasts of the annual growth in the principal sources of taxable personal income fall significantly below those of the Department of Finance for both the 1994 and 1995 calendar years. This primarily reflects our expectations for declining employment levels, weaker growth in business profits, declining real estate values, and lower inflation over the two-year forecast period. Largely because of our differences in the economic forecast, we estimate that total personal income tax collections during both the current and budget years could be cumulatively $770 million *less* than estimated by the Department of Finance.

The Forecast for Sales and Use Taxes

Background

The sales and use tax is imposed primarily on retail sales of goods, but not services, to consumers in the state. It also generally applies to goods purchased by business to the extent that they are not intended for resale. The "use" tax is imposed on products bought from out-of-state firms by California individuals and businesses for use in the state. Such purchases are generally difficult to monitor, and an increasing portion of purchases by individuals are escaping taxation due to the state's inability to require out-of-state "mail-order" businesses to collect this tax.

Figure 6 shows that the sales and use tax actually consists of many different rates of tax, representing the different purposes for which the sales and use tax is levied. As the table shows, both the state and local governments levy multiple rates of tax. Under current law, the basic state sales tax rate is 6 percent, of which the state General Fund portion

Figure 6

Sales and Use Tax Rates in California

	Current Law	Proposed
State:		
General Fund	5.0%	4.5%
1991 program realignment	0.5	—
Local Public Safety Fund	0.5	0.5
1993 restructuring	—	1.0
Totals, state	**6.0%**	**6.0%**
Local:		
Uniform local taxes[a]	1.25%	1.25%
Optional local taxes[b]	1.50	1.50
Totals, local	**2.75%**	**2.75%**
Statewide maximum rate	**8.75%**	**8.75%**

[a] Levied in all counties.

[b] Maximum allowable combined rate, except maximum combined rate is 1.75 percent in San Francisco and 2 percent in San Mateo.

is 5 percent. In addition, the state levies two 0.5 percent sales taxes: one to fund health and welfare program costs associated with the 1991 program realignment legislation, and one dedicated to local public safety programs. The Governor's Budget would reduce the General Fund's rate by 0.5 percent, and transfer these funds, along with the 1991 program realignment rate, to a new "Client Services Fund" to pay for increased county health and welfare program costs.

At the local level, a 1.25 percent rate is levied in all counties, under the Bradley Burns Uniform Sales and Use Tax Law. Of this amount, revenue from the 0.25 percent portion of the rate is deposited in county transportation funds, while the 1.0 percent portion of the rate is allocated to city and county governments for general purposes. City governments receive the proceeds generated within their boundaries and counties receive the remainder.

In addition to statewide sales taxes, many local governments—mostly on a countywide basis—levy sales taxes for a variety of other purposes. These taxes can be imposed at rates of either 0.25 percent or 0.5 percent, and cannot exceed an aggregate of 1.5 percent. In total, the sales tax rate ranges from 7.25 percent in counties with no optional taxes, to 8.5 percent in the City and County of San Francisco. At this time, no county levies the maximum rate of 8.75 percent.

The DOF Sales Tax Forecast

The Department of Finance forecasts General Fund sales tax collections of $12.8 billion in the budget year, nearly $1 billion lower than the $13.7 billion estimated for the current year. The budget-year forecast includes the impact of a proposed shift of approximately $1.4 billion in sales tax revenues from the General Fund to counties (as discussed earlier). Without this shift, the department's sales tax forecast for the budget year would be 3.1 percent *higher* than the current year, reflecting a projected 1.8 percent increase in taxable sales in 1994 and a 3.5 percent increase in 1995. Much of the expected taxable sales growth results from stronger sales of new motor vehicles and building materials during the next two years.

Taxable Sales Forecast Too Low? The Department of Finance's forecast of taxable sales is somewhat *weaker* than we would expect given their underlying personal income assumptions. The department is projecting total personal income growth of 4 percent in 1994 and 5 percent in 1995, while its growth rates for taxable sales are only 1.8 percent and 3.5 percent in these years. Much of the discrepancy between these growth rates can be explained by the department's very low estimate of inflation as it applies to taxable sales. These estimates of inflation are significantly lower than the corresponding percentage growth in the Consumer Price Index (CPI). Inflation in the prices of durable goods in particular has been held down in recent years due to the global recession, increasing labor productivity and stiff foreign price competition. The department's forecast appears to assume that this trend will continue.

The LAO Sales Tax Forecast

In general, we believe that the Department of Finance's forecasts of real taxable sales are consistent with their real economic growth assumptions (that is, ignoring the effects of inflation.) For the reasons discussed above, however, we believe that the department's low taxable sales inflation assumptions may tend to understate General Fund sales tax receipts relative to their economic forecast. Although our forecast for real

economic growth in the state is weaker than the department's, our baseline sales tax projections are $120 million higher in the current and budget years because of our higher taxable sales inflation assumptions. For purposes of projecting taxable sales inflation over the next few years, our forecast assumes that prices of durable and nondurable goods will trend upward in 1994 and 1995, as a fairly robust economic recovery at the national level and some recovery in international markets puts more pressure on factory operating capacities, labor costs, and other manufacturing costs. At the same time, inflation in the services sector is expected to moderate somewhat, reflecting lower home prices and the impact of increased competition on the cost of medical services. The net effect of these trends should be to increase the average prices of taxable goods somewhat and bring them more in line with consumer price inflation.

Figure 7 compares our forecast of the taxable sales and related forecast variables with the department's forecast. After adjustment for

Figure 7

Comparison of Taxable Sales and Related Forecast Variables

(Percent Change)

	1994		1995	
	DOF	LAO	DOF	LAO
Nonagricultural employment	-0.6%	-1.1%	0.7%	0.0%
Taxable sales	1.8	2.6	3.5	3.8
Real taxable sales	0.9	0.1	2.1	1.1
Consumer price index	2.7	2.7	3.8	2.8
Taxable sale inflation	1.0	2.4	1.4	2.7

inflation, our forecast assumes a nominal 0.1 percent growth in real taxable sales this year, improving moderately to 1.1 percent in 1995. We do not expect real taxable sales growth to gain significant momentum until 1996, when construction activity and vehicle sales should be showing substantial improvement. The Department of Finance real taxable sales forecast, on the other hand, assumes somewhat more improvement this year (0.9 percent growth), and a fairly significant recovery (2.1 percent) in 1995.

The Forecast for Bank and Corporation Taxes

Background

Banks and corporations doing business in California are subject to a tax rate of 9.3 percent measured against the portion of their taxable profits that are earned in California. Banks and other financial corporations pay an additional tax, currently set at 2.17 percent, which is in lieu of all state and local taxes except those on real property and motor vehicles and the local business license tax.

The DOF B&C Forecast

The Department of Finance projects that Bank and Corporation (B&C) taxes will raise $5.1 billion in the budget year, 7.3 percent higher than the $4.8 billion projected for 1993-94. This would be the first significant gain since 1988-89. This gain, however, is attributable to the inclusion of $600 million in receipts the department expects to receive from winning the Barclays and Colgate "unitary tax" cases now before the United States Supreme Court (please see below for a further discussion of this issue). Without these additional funds, projected bank and corporation tax revenues would be $4.5 billion in 1994-95, 5.2 percent *less* than the current year estimate.

B&C Profits Expected to Gain Momentum This Year. After adjusting for law changes, the Department of Finance estimates bank and corporation profit growth of 7.7 percent last year, followed by a stronger gain of 10.2 percent in 1994. The department's profit forecast for 1994 is consistent with their expectation for some marginal improvement in state employment and income levels this year. Corporate downsizing and restructuring, improved labor productivity, and increased equipment investment also are expected to contribute to higher earnings growth as domestic companies adapt to an increasingly competitive global marketplace.

The LAO B&C Forecast

As shown in Figure 8, our standard forecast is for significantly *weaker* corporate profits this year and next year (4.8 percent and 4.9 percent, respectively) than projected by the DOF.

Figure 8

Comparison of Taxable Corporate Profits and Related Forecast Variables

(Percent Change)

	1994		1995	
	DOF	LAO	DOF	LAO
Taxable corporate profits[a]	10.2%	4.8%	7.5%	4.9%
Total personal income	4.0	3.6	5.0	4.3
Proprietors' income	4.2	3.1	5.6	3.6
Total nonfarm employment	-0.6	-1.1	0.7	0.0

[a] Adjusted for law changes.

There are several reasons why we believe corporate profits growth in California could be generally constrained over the next few years. First, as discussed in our review of the economic outlook, we do not expect a significant economic recovery to occur in California until the second half of 1995. Accordingly, continued weakness in employment, real income and taxable sales in the state could continue to dampen the revenues and profits of corporations that produce primarily for the in-state market. Second, downsizing and restructuring should eventually increase the profitability of many corporations doing business in California. However, these cost-saving measures often require substantial one-time write-offs that can reduce taxable profits in the short run. Third, increased investment in equipment and other labor-saving technology can also involve start-up and training expenses that lower short-run profits. Most importantly, however, continuing defense cutbacks over the next several years are likely to have a substantial ongoing impact on the profitability of major defense contractors and other affected corporations, as well as many of their suppliers.

Based on the more conservative corporate profit levels assumed in our standard economic forecast, we estimate that bank and corporation tax collections in the current and budget years could be more than $500 million *below* the Department of Finance's projections. It is important to note that this potential for lower B&C tax revenues relates only to lower profit forecasts, and does not take into account the potential loss that would occur if the state is unsuccessful in the Barclays and Colgate court cases.

In addition, our analysis indicates that the budget overstates the amount of revenues attributable to one-time audit activities undertaken in the current year. In the 1993

Budget Act, the Legislature provided the Franchise Tax Board (FTB) $900,000, on a one-time basis, to work down its inventory of backlogged corporate audit cases during 1993-94. This one-time activity was expected to generate increased revenues of $36 million in 1993-94 only. Recent information from FTB indicates that only $10 million in revenue will be generated. The budget, however, includes revenues of $36 million in both 1993-94 and 1994-95, thereby overstating expected revenues by a total of $62 million over the two years combined.

The Forecast for Other General Fund Revenues

The other 12 percent of General Fund revenues consist of a variety of minor taxes, regulatory fees, service charges, interest income and other sources, including funds transferred from special accounts. In addition, the Governor's Budget includes as revenues $2 billion in reimbursements from the federal government. With the exception of this reimbursement, nearly all of these other revenue sources are forecast to decline in the budget year. Our review of these revenue sources indicates that the department's forecasts are generally reasonable, and we have identified no significant discrepancies.

SUMMARY OF LAO GENERAL FUND REVENUE FORECAST DIFFERENCES

The accuracy of the state revenue forecasts reflected in the Governor's Budget depends primarily on the accuracy of the underlying economic forecasts. In each of the past several years, forecasters have predicted the state would soon begin recovering from the economic recession that began in the Spring of 1990. For a variety of reasons, the California economy has yet to exhibit any clear signs of a significant and sustainable recovery despite substantial gains at the national level. As a result, revenue forecasts over the past three years have been continually adjusted downward, as illustrated in Figure 9.

Figure 9

Recent History of Governor's Budget General Fund Revenue Forecasts 1990-91 Through 1993-94

(In Billions)

Estimate Date	1990-91	1991-92	1992-93	1993-94
January 1990	$43.1	—	—	—
January 1991	40.4	$45.8	—	—
January 1992	38.2	43.6	$45.7	—
January 1993	—	42.0	40.9	$39.9
January 1994	—	—	40.9	39.7

DOF Forecast Is Reasonable

The current Department of Finance budget forecasts assume that continuing defense cuts and base closures will postpone even a nominal employment turnaround in the state until later this year. This forecast also assumes that a modest pickup in home-building, along with other areas of strength, will offset weakness in the manufacturing sector and permit a more significant recovery in 1995. Given the difficulties inherent in predicting the turning point in an economic recession, particularly a long lasting one, we believe that the Department of Finance's economic forecasts for the next two years are reasonable. We also believe that the department's General Fund revenue projections for the current and budget years are generally consistent with their underlying economic forecasts, and that these revenue projections provide a reasonable basis for making budget decisions.

Delayed Recovery Equally Reasonable

The Department of Finance's current forecast of a turnaround in the economy beginning later this year rests largely on the assumption that home building will show a significant pick up over the next several months. Given low mortgage rates, more affordable home prices, and pent-up demands for housing, we believe that there is a reasonable possibility this could occur. We also believe, however, that there is at least an *equal possibility* that declining home prices and continued weakness in the manufacturing and nonresidential construction sectors could delay a significant economic recovery in the state until late 1995. Thus, our state revenue estimates for the current and budget years reflect a somewhat weaker economic outlook.

Figure 10 summarizes the differences between our forecasts of General Fund revenues from the state's three major taxes and those assumed in the Governor's Budget. Over both the current and budget years, our forecast of major tax revenues is approximately $1.2 billion *lower* than the budget forecast.

Figure 10

Comparison of Major General Fund Tax Forecasts

(In Millions)

	Governor's Budget	LAO Forecast
1993-94		
Personal income taxes	$17,535	-$350
Sales taxes	13,748	35
B&C taxes	4,765	-171
Totals, major taxes	**$36,048**	**-$486**
1994-95		
Personal income taxes	$18,585	-$420
Sales taxes	12,762	85
B&C taxes	5,115	-416
Totals, major taxes	**$36,462**	**-$751**
Two-year forecast differences		
Personal income taxes	—	-$770
Sales taxes	—	120
B&C taxes	—	-587
Totals, major taxes	**—**	**-$1,237**

How 1993 Tax Legislation Affects the Forecast

In 1993, the Legislature enacted several significant changes to California's tax laws, which will affect General Fund revenue collections in 1994-95. The following discussion summarizes three of the most important changes.

Tax Relief for Multinational Corporations and Manufacturers

The most significant tax legislation passed in 1993 was Ch 881/93 (SB 671, Alquist). One of its provisions provides tax relief to many multinational corporations by allowing these companies to account for income on either a domestic or international basis

without paying special fees or conforming to special rules. This change was in response to challenges to California's procedure for taxing multinationals (see side bar). The provisions of Chapter 881 affecting multinational businesses will result in revenue losses of approximately $20 million annually to the General Fund and $40 million annually to special funds.

Chapter 881 also provides in-state manufacturers with tax relief from state income and sales taxes. Existing manufacturing companies are now eligible for corporate income tax credits equal to 6 percent of the value of all purchases for depreciable equipment used in a manufacturing process. If the credit exceeds a company's income tax liability, the company can use the excess to offset tax liabilities for up to seven years. Chapter 881 exempts new manufacturing companies—established after January 1, 1994—from paying the state sales tax when purchasing manufacturing equipment. The credit and exemption would be automatically reauthorized in 2001 if the level of nonaerospace manufacturing jobs is at least 100,000 jobs higher than existed in 1994.

Chapter 881 also provides tax relief to small businesses by reducing the "sub-chapter S" income tax rate by 1 percent to 1.5 percent. In addition, this measure provides relief to stockholders of small businesses and businesses which have research and development expenses.

As reflected in the DOF revenue forecast, the provisions of Chapter 881 provide over $300 million in tax relief in 1994-95, and over $600 million in 1995-96. Offsetting these revenue losses is a provision which reduces the tax relief to businesses for entertainment expenses. This provision will increase revenues by $140 million in 1994-95 and $150 million in 1995-96. Thus, on balance Chapter 881 resulted in a net revenue loss of $161 million in 1993-94 and $462 million in 1994-95.

Net Operating Loss Sunset Repealed

Chapter 880, Statutes of 1993 (AB 34, Klehs and Alpert) repeals the 1996 sunset on the authority of businesses to deduct net operating losses (NOLs) in determining their taxable income. When a business's expenses exceed its income, the business typically does not pay income taxes, other than a minimum fee of $800. Prior to the enactment of Chapter 880, businesses could deduct 50 percent of these "excess" expenses from future-year profits for a period of up to 15 years.

Chapter 880 allows businesses to *earn* NOLs after 1996, but limits the time in which businesses can *use* NOLs to five years after they are earned for existing companies, and up to eight years for new companies. In addition, new companies and small companies would be able to use 100 percent of their NOLs. By limiting the number of years NOLs can be "carried over," this measure reduces the revenue losses attributable to the existing deduction by approximately $20 million annually through 1998. After 1998, however, DOF projects that revenue losses from NOLs will *increase* by up to $120 million, as a result of allowing businesses to earn NOLs after 1996.

Income Apportionment Formula Geared to "Exporters"

Chapter 94, Statutes of 1993 (SB 1176, Kopp), changes the formula that multi-state or multinational businesses use to allocate income among states for tax reporting purposes. The formula allocates income based upon the proportion of businesses' property, payroll, and sales that are in California. Prior to enactment of Chapter 94, the formula used in California weighed each of these three factors evenly. Chapter 94 adjusted the formula so that the sales factor is *twice* as important (double-weighted) than the property and payroll factors. As a result, income tax liabilities will decline for multi-state or multinational companies that conduct a relatively large portion of their activities *in* California, but "export" a relatively large portion of their products or services *out of* California. On balance, this measure will increase state revenue by approximately $15 million annually, beginning in 1994-95.

U.S. Supreme Court To Rule

This past fall, the United States Supreme Court agreed to rule on two legal challenges to California's procedure for taxing multinational businesses. Two firms, Barclays Bank, PLC, and the Colgate-Palmolive Company, challenged California's taxation of worldwide income. In essence, these companies argue that California's tax violates the federal government's constitutional authority to regulate international commerce. The state's position is that its tax practice in this area has never been directly repudiated by the federal government, either by Congressional action or international treaty. The Court is expected to rule on these challenges by this June.

Taxation of Worldwide Income Now Optional. Until 1988, the state taxed multinational businesses and their affiliates on the basis of their worldwide income, using a formula to estimate the portion of the companies' worldwide income attributable to their business activity in California. Since 1988, the state has given these companies the option of apportioning only their United States income to California. Companies could choose this method of taxation, known as "water's-edge," only if they paid special "election" fees and conformed to special accounting rules. In response to continuing dissatisfaction with this arrangement and the threat of retaliation by foreign governments, the state in 1993 eliminated the election fees and relaxed the accounting rules. Thus, the issue before the court relates entirely to whether the state's *past* practices violate the federal constitution.

$600 Million Gain Is Optimistic. The *1994-95 Governor's Budget* assumes that the U.S. Supreme Court will rule in California's favor. As a

The Relationship Between Tax Relief and Economic Stimulus

The stated purpose for these tax changes was to help stimulate economic activity in California. Generally, these changes created new tax expenditure programs to favor California-based businesses. (Tax expenditure programs include tax credits, reduced tax rates, or prefer ential tax procedures that reduce the amount of revenue collected from the state's tax system.) In effect, these changes provide benefits to certain individuals and businesses much like direct governmental expenditures, except that they will be paid for by reduced tax collections rather than by the normal legislative appropriation process.

on State "Unitary Tax" Disputes

result, DOF's forecast for bank and corporation tax revenue includes $600 million in 1994-95 to reflect the collection of outstanding assessments from multinational businesses that have essentially been placed on "hold" pending resolution of this issue. If the Court rules against California, however, the state would not only "lose" the $600 million but it could potentially be required in 1994-95 to refund up to $2.1 billion in prior-year tax collections associated with this issue. Such an outcome would increase the state's budget gap by $2.7 billion.

The administration's assumption that the state will gain $600 million in 1994-95 from a ruling on these cases essentially represents the "best case" scenario in terms of the range of possible outcomes in these cases. We have two major concerns about this assumption:

First, the Court is not limited to a simple "all or nothing" type of decision. It may rule completely for, partially for, or completely against the state. These challenges involve many complex legal issues, some of which the Court has not reviewed in the past. The Court may determine, for example, that only certain aspects of California's tax are appropriate or that its use was valid only for a limited period of time. As a result, the budget's "complete victory" assumption is only one of several possible outcomes.

Second, the loss and gain estimates are based on preliminary information from the Franchise Tax Board (FTB). The FTB staff are currently updating their estimates to take into account additional information. Based upon our review of their preliminary estimates, we believe that the estimates of both potential gains and losses may be lowered considerably.

Together, the three measures discussed above will reduce General Fund revenue by approximately $125 million in 1994-95, or 2.5 percent of the revenue generated by bank and corporation taxes. In 1995-96, these changes will result in revenue losses of approximately $410 million, which would be approximately 8 percent of the revenue expected from bank and corporation taxes.

A significant amount of the debate on these measures focused on the question of the extent to which the measures would stimulate additional economic activity to offset their direct revenue losses. Specifically, these new tax expenditure programs are intended to cause taxpayers (both individuals and businesses) to change their behavior in ways that will cause the economy to grow faster (or decline more slowly) than it would without these changes.

Long-Term Growth Stimulus Difficult to Measure. Of course, the stimulus from these changes may not be completely realized until several years in the future. In this context, it is extremely difficult to estimate the amount of long-term economic growth that will result from marginal changes to the tax system. This is because future economic decisions by taxpayers are a function of many factors, including world-wide consumer demand, wage rates, and regulations, as well as the tax environment. Growth forecasts are complicated even further by the great uncertainty inherent in estimating the long-term economic outlook. Because the revenue losses from these changes will increase substantially over the next few years, however, whatever stimulus is produced clearly must be substantial if the direct revenue losses are to be recovered.

Substantial Increase in Growth Needed. In order to illustrate the magnitude of the growth needed, we examined this question in the one-year context of revenue losses and economic growth for 1995-96. We estimate that taxable personal income will grow by $19 billion, or 5 percent, and that taxable business income will grow by $1.8 billion, or 4 percent, in 1995-96. To fully offset the revenue losses associated with these tax changes, taxable business income would need to grow almost 4 times as fast, by $6.4 billion (rather than $1.8 billion). Taxable personal income would need to be $6 billion higher than forecast in order to offset the projected PIT losses.

What these figures demonstrate is that, *if the revenue losses were to be fully offset*, the state's investment in these tax relief benefits would have had a substantial "leveraging" effect on the economy. Specifically, each dollar of B&C tax relief would be producing about $11 of net profit growth, whereas each dollar of PIT relief would be producing about $13 of net income. While this illustration oversimplifies the relationship between tax relief and economic growth, we believe it provides some helpful perspective on the issue.

THE GOVERNOR'S BUDGET FORECAST FOR SPECIAL FUND REVENUES

Special fund revenues support a variety of specific state and local government programs. These range from transportation systems to health programs. Figure 11 indicates that motor-vehicle-related fees account for the single most important share (48 percent) of special fund revenues. While motor vehicle revenues are forecast to rise

only 2.0 percent, the remaining special fund revenues are forecast to rise nearly 32 percent. The latter increase reflects the administration's

Figure 11

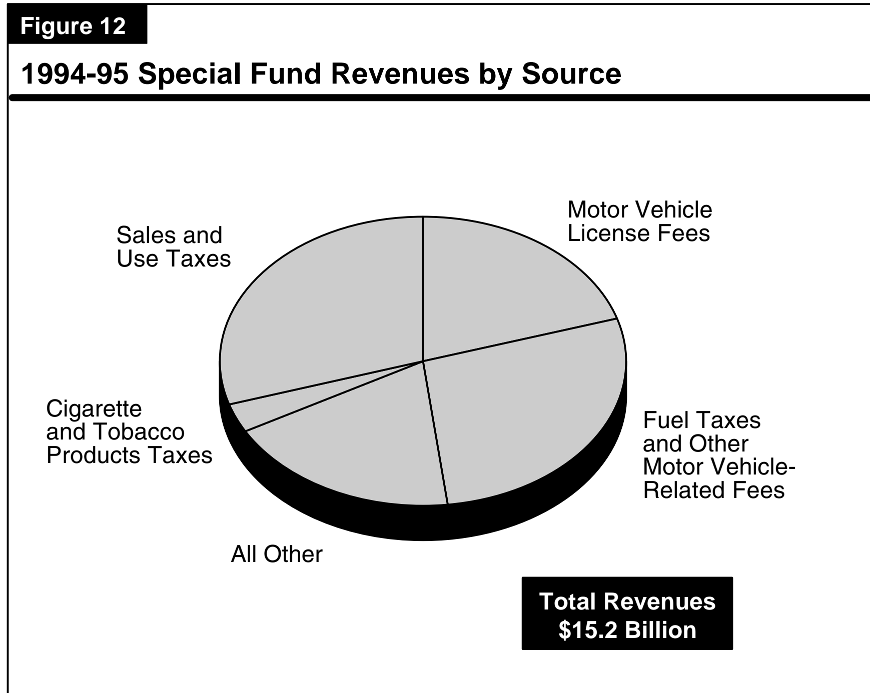
Special Fund Revenues 1992-93 Through 1994-95

(In Millions)

Source of Revenue	Actual 1992-93	Estimated 1993-94	Proposed 1994-95	Change From 1993-94	
				Amount	Percent
Motor Vehicle Revenues					
License fees (in lieu)	$2,942	$3,037	$3,063	$26	0.9%
Fuel taxes	2,468	2,596	2,675	79	3.0
Registration, weight, and miscellaneous fees	1,495	1,530	1,565	35	2.3
Subtotals	($6,905)	($7,163)	($7,303)	($140)	(2.0%)
Other Sources					
Sales and use taxes[a]	$1,570	$2,997	$4,517	$1,520	50.7%
Cigarette and tobacco products taxes	518	486	480	-6	-1.2
Interest on investments	83	56	47	-9	-16.1
Other	2,504	2,440	2,823	383	15.7
Subtotals	($4,675)	($5,979)	($7,867)	($1,888)	(31.6%)
Totals	**$11,580**	**$13,142**	**$15,170**	**$2,028**	**15.4%**

[a] Includes state sales tax revenues allocated to Local Public Safety Fund, which are not included in Governor's Budget totals.

proposal to re-allocate General Fund sales tax revenue to counties (as discussed earlier). Figure 12 illustrates the relative importance of the different sources of special fund revenue sources.



How Are Special Fund Revenues Used?

As noted above, motor-vehicle related revenues are the largest single category of special fund revenues, and these funds are used primarily for transportation-related purposes. Other sources of special fund revenues are earmarked for a variety of specific programs. Examples of special fund programs include the following:

Transportation Programs. State programs that are funded by motor-vehicle revenues include the Department of Transportation (Caltrans), the Department of Motor Vehicles (DMV), and the California Highway Patrol (CHP). A large share of these funds are distributed to local governments for specific programs, including streets and highways and mass transit programs.

Proposition 99 Programs. Cigarette and tobacco tax revenues imposed by Proposition 99 are devoted primarily to public health and natural resources programs. Starting January 1, 1994, a new 2 cents per pack tax on cigarettes (and related taxes on other tobacco products) is allocated to breast cancer research.

State-County Realignment Programs. Legislation in 1991 imposed a new 0.5 percent state sales and use tax rate to pay for increased county health and welfare program costs. Counties share of existing program costs in such programs as mental health, public health, and foster care were increased by the legislation and funded by the increased tax revenues. State costs were reduced correspondingly.

The Budget's Forecast for Individual Special Fund Revenues

Motor Vehicle Fee Revenues

Motor vehicle fee revenue estimates are shown in Figure 11 under two headings: license fees (in lieu) and registration, weight, and miscellaneous fees. Both categories are expected to increase very slowly. License fees have been negatively affected both by the sluggish economy's effect on new vehicle purchases and by changes in the fee structure that took place in 1991. The Vehicle License Fee is a tax based upon the depreciation-adjusted sales price of a vehicle. The 1991 fee structure reduced the allowed level of depreciation, especially in the early years of ownership. The structure now also assesses newly sold used vehicles at their recent sales price, rather than the prior depreciation-adjusted sales prices. These changes had the effect of dramatically increasing revenues initially, but have made the structure of the tax more sensitive to economic downturns. This change and lower levels of new car sales have dramatically reduced the rate of growth in this revenue source.

Motor Vehicle Fuel Taxes

These taxes consist primarily of per gallon excise taxes on fuels used for private motor vehicles. Most of the revenues come from gasoline and diesel fuels sold for use in autos and trucks on the public roads of the state, although there are other related fuel taxes on alternative fuels such as natural gas and alcohol. At present the tax rate on gasoline and diesel fuel is 18 cents per gallon. January 1, 1994 was the date of the last scheduled increase (1 cent per gallon) in the California fuels tax under Proposition 111, which was passed by the voters in June 1990. This final tax rate increase contributes to the budget's forecast of a 3.0 percent increase in these revenues for 1994-95, although the percentage increase in the tax rate is effectively much higher (approximately 6 percent).

The main element in low fuel tax revenue growth in the state during the past two years, despite falling gasoline prices and tax rate increases, is the general economic decline since late 1990. Forecasting revenues has also been made more difficult by unprecedented volatility in diesel fuel tax revenues, even though the diesel fuel tax accounts for only 12 percent of total revenues in the budget year. There has been a major controversy over new diesel fuel formulations required for air quality improvement purposes.

Realignment Revenues Still Sluggish

As shown in Figure 13, the budget's revenue forecasts indicate that $1,449 million of sales taxes and $741 million of vehicle license fees (VLF) would be available for deposit into the Local Revenue Fund in 1994-95. This represents an increase of $43 million, or 2 percent, over the amount deposited in this fund in 1993-94. This level of revenues continues to be less than the amount originally forecast for 1991-92, when the realignment program was first enacted.

The Governor's Budget proposes that the Local Revenue Fund be abolished and that these revenues be allocated to a new Client Services Fund, in the case of the sales tax, and a new Community Services Fund, in the case of the VLF revenues. In addition, revenue from a 0.5 percent rate of the sales tax now allocated to the General Fund would be allocated to the new Client Services Fund. (Please see Part V of this volume for a complete description of this proposal.)

Figure 13

Local Revenue Fund Tax Receipts Under Current Law 1992-93 Through 1994-95

(In Millions)

	1992-93	1993-94	1994-95
Sales and Use Taxes	$1,391	$1,412	$1,449
Vehicle License Fees	716	735	741
Totals	**$2,107**	**$2,147**	**$2,190**

Proposition 99 Revenues Falling

The Cigarette and Tobacco Products Surtax is projected to decline by 4.7 percent, to $445.4 million, in the budget year. This reflects a continuing decline in total cigarette consumption of about 4.8 percent, and a decline in per capita consumption of 6 percent.

President Clinton's health care reform proposal includes an additional excise tax on cigarettes of 75 cents per pack. Revenues from this tax would help offset costs of the proposal. A large portion of this tax, however, is likely to be fully passed on to cigarette

consumers as an increase in cigarette prices. Previous studies have demonstrated that cigarette consumers reduce their consumption in response to price increases of this magnitude. We estimate that a 75 cent per pack tax increase by the federal government would dramatically reduce cigarette consumption in California. This would result in losses of approximately $150 million annually in Proposition 99 revenues.