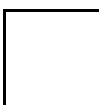
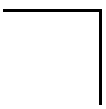
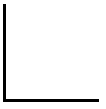
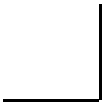




III

Perspectives on State Revenues





Perspectives on State Revenues



California's state government will collect an estimated \$66.5 billion in taxes and other revenues in 1997-98. These collections fall into two broad categories—General Fund revenues and special funds revenues.

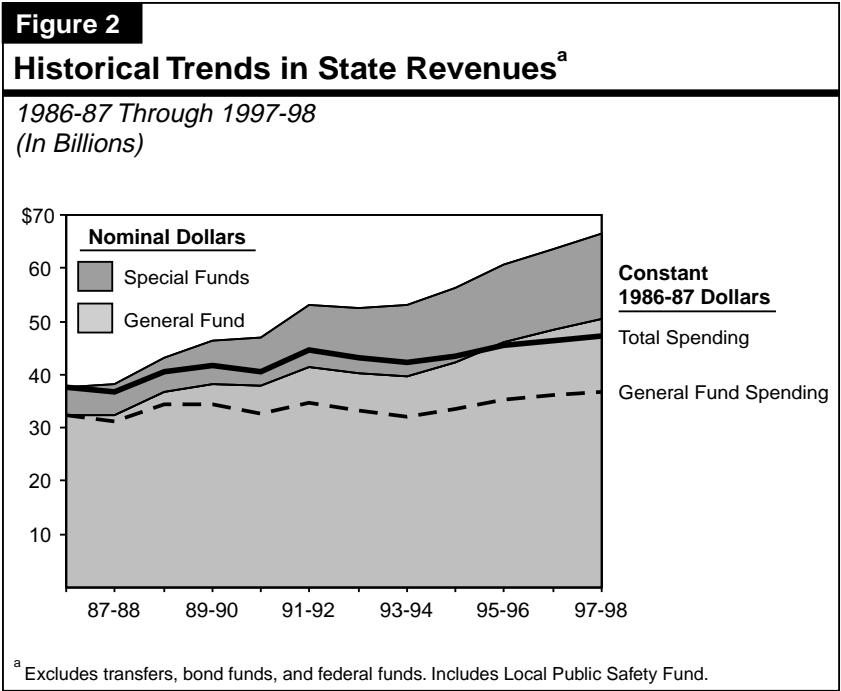
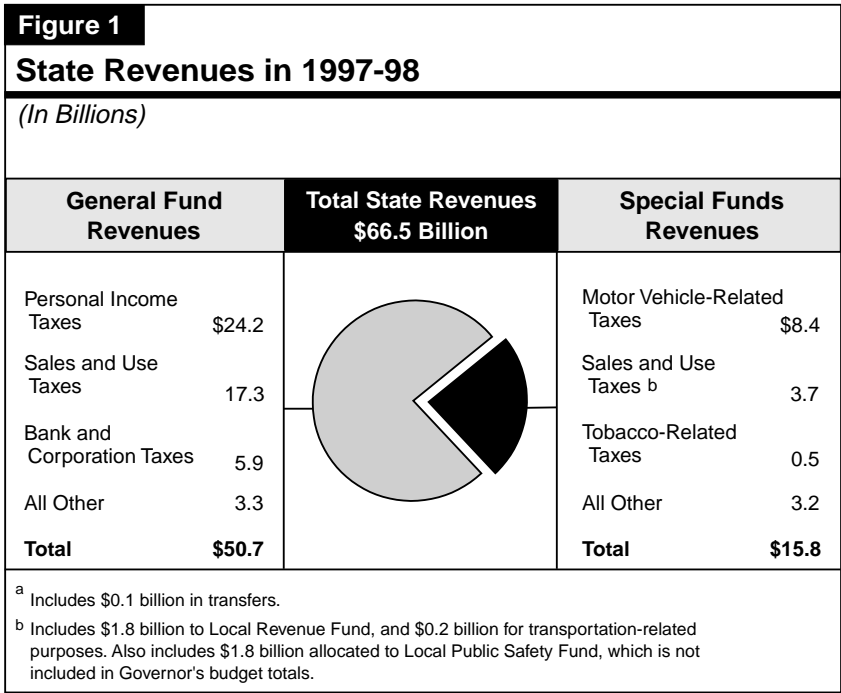
Revenues deposited into the General Fund are allocated through the budget process each year and support a variety of state programs, including education, criminal justice, and health and welfare. In contrast, special funds revenues are generally earmarked for specific purposes, such as transportation-related activities, targeted health programs, and support to local governments. Some taxes, such as the sales and use taxes and tobacco taxes, are allocated among both the General Fund and special funds.

Figure 1 (see next page) shows that slightly over three-fourths of the total \$66.5 billion in state revenues will go into the General Fund, while slightly less than one-fourth will go to special funds.

An Historical Perspective—Revenue Performance Over Time

Figure 2 (see next page) shows how state revenues have performed over the past ten years. It indicates that total revenues (excluding transfers and including Local Public Safety Fund revenues) have increased from \$37.6 billion in 1986-87 to an estimated \$63.5 billion in 1996-97, an average annual growth rate over the decade of 5.4 percent. In real (constant-dollar) terms, the average annual increase has been 2.1 percent.

The figure also shows that following three years of virtually no growth in the early 1990s, total revenue collections resumed an upward path in 1994-95 and 1995-96, reflecting the positive effects of California's economic recovery on tax receipts. We expect the positive trends to continue

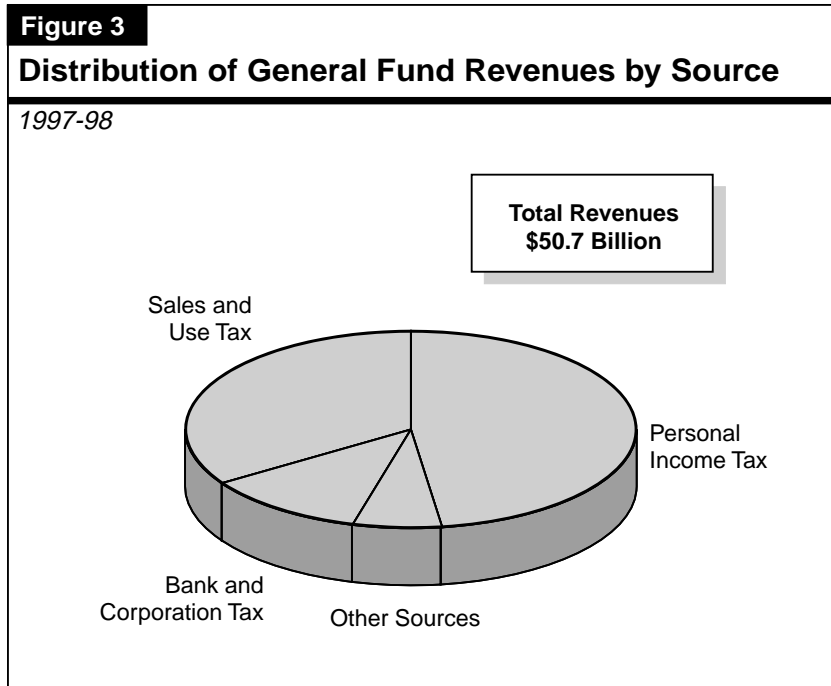


in 1996-97 through 1998-99, in line with the continued growth we are projecting for California.

General Fund Versus Special Funds Growth. The annual average growth in revenues (excluding transfers and including Local Public Safety Fund revenues) over the past decade has been faster for special funds (11 percent) than for the General Fund (4.1 percent). The difference partly reflects the impact of the recent recession on the General Fund's income and sales taxes during the early years of the 1990s. The difference also is due, however, to legislative and voter-approved tax-law changes which have raised various special fund taxes. These include the voter approval of gasoline tax increases in 1990, the creation of the one-half cent Local Revenue Fund sales tax in 1991, and voter approval of a one-half cent sales and use tax for local public safety in 1993.

Overview of General Fund Revenues

Figure 3 shows that of the roughly \$51 billion in state General Fund revenues, nearly 94 percent is from the state's three major taxes—the personal income, sales and use, and bank and corporation taxes. The largest and fastest growing of these is the personal income tax (PIT),



which is projected to account for 48 percent of the total in 1997-98. The sales tax is the General Fund's second largest tax (although when special and local funds are counted, it becomes the state's largest single tax). In 1997-98, it will account for a projected 34 percent of total General Fund revenues. The third largest General Fund revenue source is the bank and corporation tax, which will account for about 12 percent of the total in the budget year.

The remaining 6 percent of total General Fund receipts is primarily attributable to various other taxes, a variety of fees, and investment earnings. The larger components within the "other taxes" category include the insurance, estate, cigarette, and alcoholic beverage taxes.

An important feature of the state's General Fund is that all three of its major revenue sources are highly sensitive to changes in California's economic performance. Personal income taxes are significantly affected by the level of and growth in wages, business earnings, and investment income. Sales and use taxes are affected by changes in consumer spending, housing construction, and business investment. And bank and corporation taxes are highly dependent on California corporation profits. For these reasons, changes in California's economy have major impacts on the performance and outlook for General Fund revenues.

THE BUDGET'S GENERAL FUND REVENUE OUTLOOK IN BRIEF

Figure 4 summarizes the *1997-98 Governor's Budget* revenue forecast. It shows that General Fund revenues and transfers are projected to increase from \$46.3 billion in 1995-96 to \$48.4 billion in 1996-97 (a 4.6 percent growth) and \$50.7 billion in 1997-98 (a 4.7 percent growth).

1996-97 Revenues. The 4.6 percent 1996-97 growth rate understates the underlying revenue trend, due to several factors which have affected the revenue totals in both the current and prior years. These include the expiration of the 10 percent and 11 percent marginal income tax brackets at the end of 1995, the corporation tax rate reduction enacted in 1996, and a large one-time estate tax payment which was received during 1996-97 but accrued back to 1995-96.

1997-98 Revenues. The budget-year's revenue growth will again be led by personal income taxes, which are projected to increase by 7 percent during the year. As in the current year, budget-year General Fund revenues will be affected by a variety of factors in addition to the underlying revenue trend. These factors include the phasing-in fiscal impact of the

corporation tax rate reduction for 1997, the Governor's proposed additional corporate tax rate reductions for 1998 and 1999 (discussed below), and the Governor's trial court realignment proposal. Eliminating the effects of these factors, the budget's forecasted growth rate for 1997-98 would be about 5.7 percent. This underlying growth is modestly lower than the gains the administration is projecting for statewide personal income during the forecast period.

Figure 4

Summary of Department of Finance's General Fund Revenue Forecast

(Dollars in Millions)

Revenue Source	Actual 1995-96	1996-97 Estimated		1997-98 Forecast	
		Amount	Percent Change	Amount	Percent Change
Personal Income Tax	\$20,875	\$22,660	8.6%	\$24,240	7.0%
Sales and Use Tax	15,753	16,485	4.6	17,325	5.1
Bank and Corporation Tax	5,862	5,795	-1.1	5,860	1.1
Insurance Tax	1,132	1,124	-0.7	1,196	6.4
Other taxes	1,203	1,162	-3.4	1,160	-0.2
Other revenues	1,211	1,112	-8.2	784	-29.5
Transfers	261	68	—	93	—
Totals	\$46,296	\$48,405	4.6%	\$50,657	4.7%

The Governor's Revenue-Related Proposals

The budget's revenue forecast includes the revenue impact of the following two proposals referenced above.

Bank and Corporation Tax Reduction Proposal. Last year, legislation was enacted which provides for a 5 percent reduction in the bank and corporation tax rate (from 9.3 percent to 8.84 percent), beginning in 1997. The 1997-98 budget proposes to reduce corporate tax rates by an additional 10 percent over the next two years. The tax rate would decline by 5 percent (to 8.40 percent) for income years beginning in 1998, and another 5 percent (to 7.96 percent) for income years beginning in 1999. In addition, the budget proposes partial conformity to federal provisions for Subchapter S corporations, by expanding the allowable number of shareholders in such corporations from 35 to 75. The budget estimates that the Governor's proposed corporation tax reduction would reduce General Fund tax revenues by \$93 million in 1997-98, \$336 million in 1998-99,

\$562 million in 1999-00, and \$654 million in 2000-01 (the full-year, ongoing impact). A more detailed analysis of this proposal is provided in Part V of this volume.

Trial Court Funding Proposal. The Governor's budget contains a proposal to consolidate and restructure the trial court program, similar to last year's proposal, which includes the redirection of certain fines and penalties from the General Fund to the Trial Court Trust Fund. This would result in an annual General Fund revenue reduction (and a corresponding expenditure reduction) of \$290 million beginning in 1997-98.

THE LAO'S GENERAL FUND REVENUE OUTLOOK

Figure 5 presents our own updated General Fund revenue forecasts for 1996-97 and 1997-98. In addition, to assist the Legislature in its fiscal planning, we also provide our forecast for revenues in 1998-99. These forecasts are based upon our economic and demographic projections presented in Part II of this volume. The 1997-98 and 1998-99 projections include the revenue-related effects of the Governor's proposals to reduce corporate taxes and restructure trial court funding (see above). Our inclusion of these proposals allows our revenue forecasts to be directly compared to the budget forecasts, with the differences reflecting solely our differences in terms of economic assumptions and revenue estimating methodologies. This does not imply, however, what action the Legislature might take on the Governor's proposals.

Figure 5

Summary of Legislative Analyst's General Fund Revenue Forecast

(Dollars in Millions)

Revenue Source	1996-97		1997-98		1998-99	
	Estimated Amount	Percent Change	Forecast Amount	Percent Change	Estimated Amount	Percent Change
Personal Income Tax	\$22,950	9.9%	\$24,650	7.4%	\$26,200	6.3%
Sales and Use Tax	16,620	5.5	17,560	5.7	18,540	5.6
Bank and Corporation Tax	5,450	-7.0	5,470	0.4	5,480	0.2
Insurance Tax	1,120	-1.1	1,180	5.4	1,245	5.5
Other taxes	1,159	-3.7	1,160	—	1,172	1.0
Other revenues	1,115	-7.9	810	-27.4	830	2.5
Transfers	68	—	93	—	96	—
Totals	\$48,482	4.7%	\$50,923	5.0%	\$53,562	5.2%

Forecast for 1996-97. We forecast that General Fund revenues and transfers will total \$48.5 billion in 1996-97, a 4.7 percent increase from the prior year. As shown in Figure 5, we expect the fastest growing revenue source to be the personal income tax, which we project to increase by 9.9 percent from 1995-96. We expect sales and use taxes to increase more moderately, while bank and corporation tax receipts are projected to experience an actual *decline* from the prior year.

Forecasts for 1997-98 and 1998-99. We project that revenues will continue to grow in line with the increases in the California economy forecast for the next two years, with revenues reaching \$50.9 billion in 1997-98 (5.0 percent growth) and \$53.6 billion in 1998-99 (5.2 percent growth). As in the current year, personal income taxes are expected to experience the largest gains, followed by increases in sales and use taxes. Bank and corporation tax receipts are forecast to remain flat through the end of the forecast period, due to the recently enacted and proposed bank and corporation tax cuts.

Recent Cash Trends Send Sharply Conflicting Signals

Our current revenue outlook has been influenced by two strongly conflicting recent trends involving the state's cash revenue collections. On the one hand, personal income tax receipts during the first seven months of this fiscal year have been *very strong*, with quarterly estimated tax payments in January alone exceeding the budget estimate by nearly \$300 million. On the other hand, corporation tax receipts have been *extraordinarily weak*. Partly in response to these developments, we have raised our estimates of personal income taxes and lowered our estimates of corporation taxes relative to our previous forecasts in November.

One Implication—Increased Uncertainty. As discussed in more detail below, the precise causes of these developments are unknown at this time, and we will not have a clear picture of their full implications for the state's revenue outlook until final tax payments for both corporations and personal income taxpayers are remitted this spring. For example, we do not know at this time whether the strong PIT receipts will be offset, in whole or part, by lower-than-expected final tax payments or higher-than-expected refunds. These divergent trends have contributed an additional element of uncertainty to the revenue outlook.

THE LAO FORECAST FOR MAJOR REVENUE SOURCES

Given that 94 percent of General Fund revenues are related to the state's "big three" taxes, the state's fiscal performance is highly dependent on the performance of these revenue sources. In the following sections we provide a detailed discussion of the outlook for the personal income, sales and use, and bank and corporation taxes.

The Personal Income Tax

Background

Personal income tax revenues account for the single largest share of total General Fund revenues—nearly half. These revenues are collected from both California residents and nonresidents, based upon their income that is attributable to California. In calculating their PIT liabilities, taxpayers must first compute their taxable income by adjusting their gross income for various California exemptions, exclusions, and deductions. Applicable tax rates and tax credits are then applied to arrive at a final state tax liability. California generally conforms, either in whole or part, to federal tax law regarding many of its tax exemptions, exclusions, deductions, and credits. It currently has six marginal income tax brackets, whose marginal tax rates range from 1 percent to 9.3 percent.

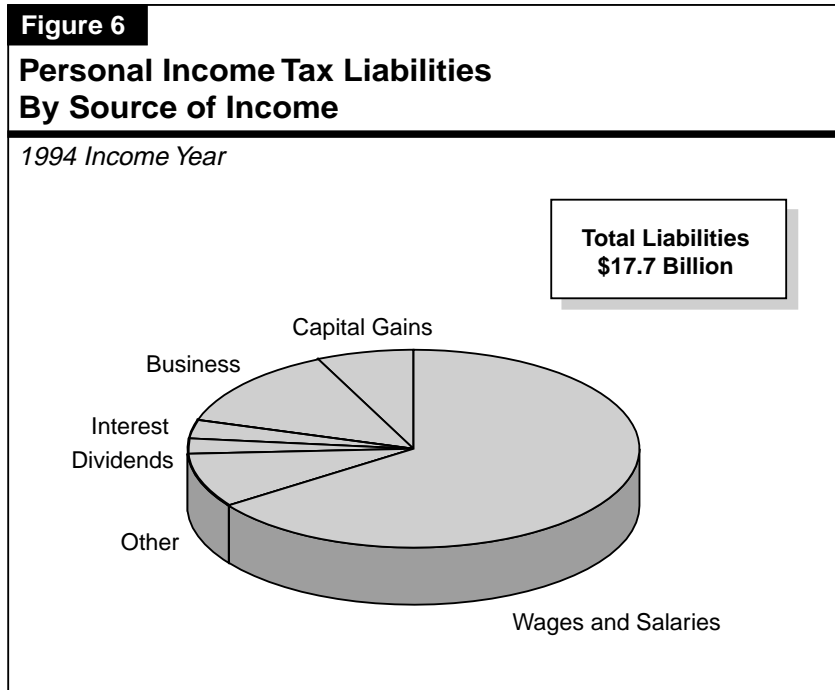
Importance of Different Types of Income. Figure 6 shows that wages and salaries are responsible for the largest single component of PIT liabilities, accounting for about two-thirds of the total. The source of the next largest single component is business income, which includes income from partnerships and sole proprietors. The remaining four major income components—capital gains, interest, dividends, and all other income sources—together account for one-fifth of total state PIT liabilities.

Moderate Growth in PIT Liabilities

The key to forecasting PIT revenues is forecasting PIT income-year tax liabilities. As California has continued to recover from its early 1990s recession, PIT liabilities have experienced solid growth.

Recent Liability Growth. In 1994, PIT liabilities expanded by a moderate 4.8 percent and then jumped by over 13 percent in 1995. This especially strong 1995 growth appears to have been due to a variety of factors, including well-above-average growth in capital gains (25 percent). Strong 1995 growth also occurred in investment and business-related income, and in wages and salaries of high-income individuals. Due to the high

marginal income tax rates that generally apply to these income components, they gave an extra “upward kick” to 1995 liability growth.



With regard to 1996, we estimate that PIT liabilities again experienced strong growth—9.4 percent. This is despite the fact that nearly \$0.8 billion essentially “disappeared” from the 1996 liability amount, due to the expiration at the end of 1995 of the temporary 10 percent and 11 percent marginal income tax brackets put in place in 1991. In the absence of this factor, 1996 liability growth would have been even stronger and on a par with 1995—over 13 percent. Our estimates of strong liability growth in 1996 partly reflects recent healthy increases in withholding and quarterly estimated tax payments, which suggest that 1996 was another good year for wages, business earnings, and investment income.

Moderate Liability Growth Forecast for 1997 Through 1999. We project continued growth in PIT liabilities for 1997 (7.7 percent), 1998 (7.1 percent), and 1999 (6.9 percent). This moderate though somewhat slowing growth reflects our projected path for California’s economy—continued though somewhat tapering growth.

Our projected growth in PIT liabilities somewhat exceeds our projected growth in California personal income, primarily because of the

state's progressive income tax structure. Figure 7 summarizes our growth assumptions for the components of taxable income, from which our forecasts for tax liabilities are derived.

Figure 7					
California Taxable Income Components 1995 Through 1999					
<i>Percent Growth</i>					
Taxable Income Component	1995	1996	1997	1998	1999
Wages	5.4%	7.1%	6.5%	5.3%	5.3%
Dividends	12.1	10.7	9.5	8.7	6.8
Interest	13.6	4.7	7.4	5.5	4.6
Business income	7.7	8.9	5.5	4.9	5.5
Capital gains	25.0	17.0	6.3	5.6	5.5
Other	6.6	7.3	6.3	5.6	5.5
Totals, taxable income	6.3%	7.4%	6.5%	5.4%	5.4%

Budget-Year Revenues to Reach \$25 Billion

Based on our liability forecasts, we project PIT revenues of \$23 billion in 1996-97 and \$24.7 billion in 1997-98 (7.4 percent growth). In 1998-99, we project PIT revenues of \$26.2 billion (6.3 percent growth).

Key Assumption About January's Cash Gain. As noted earlier, PIT-related cash collections in January 1997 exceeded the budget's estimate for the month by roughly \$300 million. This money primarily relates to payments toward 1996 PIT liabilities. Our liability and revenue forecasts assume that this is a "real" gain as opposed to a temporary "cash-flow" gain, and, thus, that it will *not* be offset by lower-than-expected final tax payments and higher-than-expected refunds when 1996 tax returns are filed in April.

Special Factors in the Forecast

The Governor's budget and our forecast both assume that the federal government will adopt an Internal Revenue Service (IRS) "tax offset" program. This would allow the IRS to collect delinquent state taxes out of refunds owed to Californians on their federal income tax returns. Such a program would result in an estimated state PIT revenue gain of \$80 million in the budget year and similar amounts thereafter (an addi-

tional \$5 million revenue gain also would result for sales and use taxes). Congress did consider such a measure last year, but it was not enacted. However, according to the Franchise Tax Board (FTB), an offset program will be reconsidered again this year by Congress.

Our forecast also incorporates the budget assumption of additional PIT revenues of \$86 million in 1996-97 and \$154 million annually thereafter due to several budget proposals that would increase auditing and improve automation technology at agencies that administer and collect personal income taxes.

Sales and Use Taxes

Background

The General Fund's second largest revenue source is the sales and use tax, which accounts for about one-third of the General Fund revenue total. This tax is imposed primarily on the retail sales of tangible goods purchased in California. Key components of the taxable sales base include retail spending by consumers, purchases of motor vehicle fuel, building materials that go into the construction of residential and nonresidential structures, and business investment in physical plant and equipment. Services are generally exempt from the sales tax, as are goods purchased for resale.

The "use" tax is imposed on products bought from out-of-state-firms by California residents for use in the state. Such purchases are difficult to monitor, and the state is prohibited by the federal government from requiring out-of-state mail-order firms to collect the use tax for California. As a result, only a small percentage of total sales and use tax revenues is from this source.

Sales and Use Tax Rates

Although the sales and use tax is the General Fund's second largest revenue source, it is the single largest revenue source in California when both state and local taxes are taken into account. As indicated in Figure 8 (see next page), the overall sales and use tax rate imposed on Californians is actually the combination of several individual rates levied by the state and individual local governments. These rates can be divided into three categories:

- **State Tax Rates.** These include a 5 percent General Fund rate, plus two one-half cent rates whose proceeds go to two special funds that support local programs: (1) a 0.5 percent tax to the Local Reve-

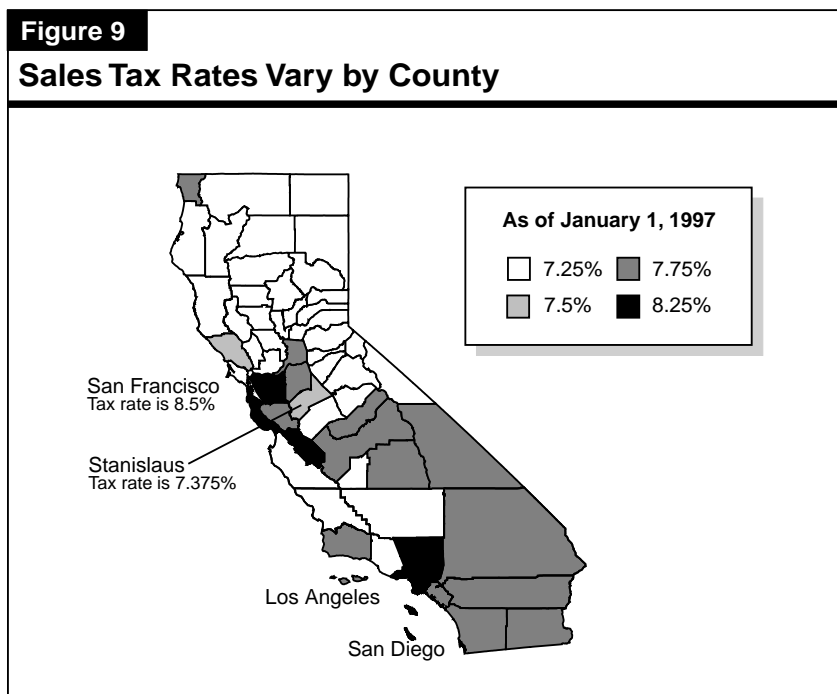
nue Fund, which supports health and welfare program costs associated with the 1991 state-local realignment legislation; and (2) another 0.5 percent tax whose proceeds go to the Local Public Safety Fund, which was approved by the voters in 1993 for support of local criminal justice administration. The public safety sales tax monies are directly provided to localities, and the administration has chosen not to display them in the budget. However, they do represent state tax receipts and thus we report them as such.

- **Uniform Local Tax Rate.** A 1.25 percent uniform local sales tax rate is levied in all counties (this is the so-called Bradley-Burns rate). Of this total, 0.25 percent is deposited into county transportation funds, while the remaining 1 percent is allocated to city and county governments for general purposes. Cities receive the proceeds collected within their boundaries, while counties receive the proceeds collected within unincorporated areas.
- **Optional Local Tax Rates.** Local governments are authorized to levy additional local sales and use taxes for a variety of purposes. These taxes, which require local voter approval, are normally levied on a county-wide basis, primarily for transportation-related purposes. These taxes generally are levied in one-fourth cent or one-half cent increments, and cannot exceed 1.5 percent (except in San Francisco County and San Mateo County.)

Figure 8**Sales and Use Tax Rates in California**

	Current Rate
State	
General Fund	5.00%
1991 program realignment (Local Revenue Fund)	0.50
Local Public Safety Fund ^a	0.50
Total	(6.00%)
Local	
Uniform local taxes ^b	1.25%
Optional local taxes	1.50 ^c
Total	(2.75%)
Statewide maximum rate	8.75%
^a These revenues are not shown in the Governor's budget totals.	
^b Levied in all counties.	
^c Maximum allowable rate, except maximum rate is 1.75 percent in San Francisco County and 2 percent in San Mateo County.	

Combined State and Local Tax Rates. The combined state and local tax rates vary significantly across California. As shown in Figure 9, the combined rate currently ranges from 7.25 percent for counties that impose no optional sales taxes, up to 8.5 percent in the City and County of San Francisco. No county currently imposes the maximum allowable 8.75 percent rate.



1996 Increase in Taxable Sales—Largest Since 1989

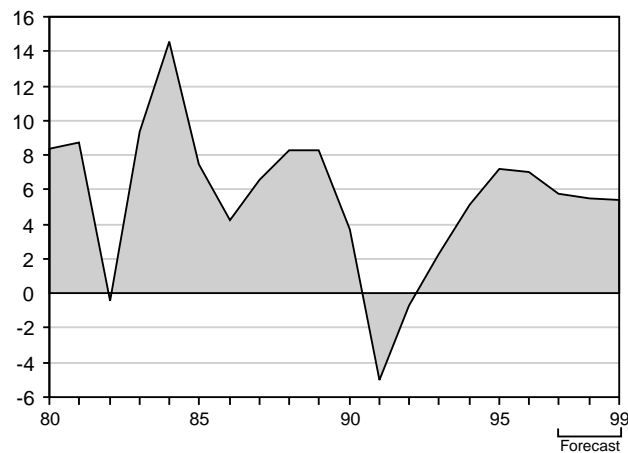
The key to the outlook for sales and use taxes is the strength in taxable sales. As shown in Figure 10 (see next page), taxable sales have generally mirrored changes in overall economic activity over the past couple of decades. After strongly rebounding following the 1981-82 recession, taxable sales grew at a more moderate, but still healthy, pace through the balance of the 1980s. They fell during the 1990s recession and were sluggish early in the recovery, but more recently have rebounded in line with the state's economic expansion.

Late 1996 Developments. Taxable sales grew strongly in early 1996, before easing in the third quarter of the year. Reports from retailers suggest that the 1996 Christmas shopping season was somewhat stronger in California than the rest of the nation, and our forecast assumes that taxable spending ended the year on a reasonably strong note. Overall, we

estimate that taxable sales totaled \$321.7 billion in 1996, a 7 percent increase from 1995. This gain represents the largest increase since 1989.

Figure 10**Trend in California Taxable Sales to be Moderate**

*Percent Change in Taxable Sales
1980 Through 1999*

**Sales Taxes to Grow in Line With State's Economy**

As shown in Figure 10, we project that taxable sales will expand at an average annual rate of 5.6 percent over the next three years, or in line with the gains we forecast for statewide personal income. Consistent with our projections for moderate taxable sales growth, we forecast that sales tax receipts will grow from \$15.8 billion in 1995-96 to \$16.6 billion in 1996-97, \$17.6 billion in 1997-98, and \$18.5 billion in 1998-99.

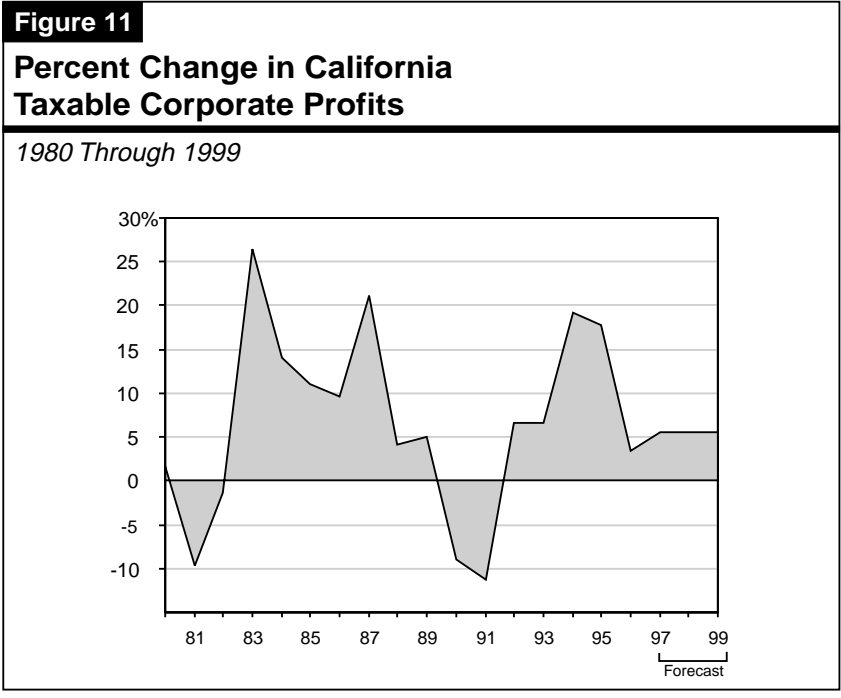
Bank and Corporation Taxes

Banks and corporations currently are subject to a general tax rate of 8.84 percent on their California taxable profits. This rate applies to corporate income years beginning on or after January 1, 1997, and reflects the 5 percent rate reduction enacted in 1996. Corporations that qualify for California Subchapter S status are subject to a 1.5 percent corporate tax rate at the entity level (the income of these corporations, however, is "passed through" to their shareholders and taxed under the personal income tax). Banks and other financial corporations pay an additional

2 percent tax on their income, which is in lieu of all other state and local levies except taxes on real property, motor vehicle-related levies, and business licenses.

Corporate Profits Have Been Volatile

Bank and corporation tax receipts are primarily determined by the performance of California taxable profits. Figure 11 shows that these profits tend to be extremely volatile. As the figure indicates, they increased by more than 20 percent in some years, and fell by as much as 10 percent in others. Following an extended period of weakness, profits rebounded sharply in 1994 and 1995, increasing by over 19 percent in each of the two years.



Recent cash payment trends indicate that this acceleration of profits did not occur in 1996. Rather, growth in California taxable profits appears to have slowed sharply. However, we are forecasting that profit growth will partially rebound over the forecast period, accelerating modestly from its 1996 level in the 1997-through-1999 period. This reflects the continued growth in output and sales of California businesses that we expect.

Corporate-Related Tax Payments Softened in Late 1996

How Corporations Remit Their Taxes. The majority of corporate taxpayers report their annual income on a calendar-year basis, and remit their required quarterly payments toward their tax liabilities in April, June, September, and December of each year. Final payments for such companies are then due the following March, but companies may and frequently do file for a three-month or six-month extension. Thus, it can be as much as nine months after the end of an income year before final tax returns are filed. The same is true for corporations that choose income years which do not coincide with calendar years.

Year-End Trends in Prepayments Are Often an Indicator of Liabilities. In general, corporations tend to file their earliest prepayments based on prior-year tax liabilities, then make upward or downward adjustments in their later prepayments once their full-year profit situation becomes clearer. For example, calendar-year corporations tend to make these adjustments in September and December. Thus, the September and December quarterly payments often provide the first good indication of current profit trends, and are often followed by similar increases or decreases in final payments later on when final tax returns are filed.

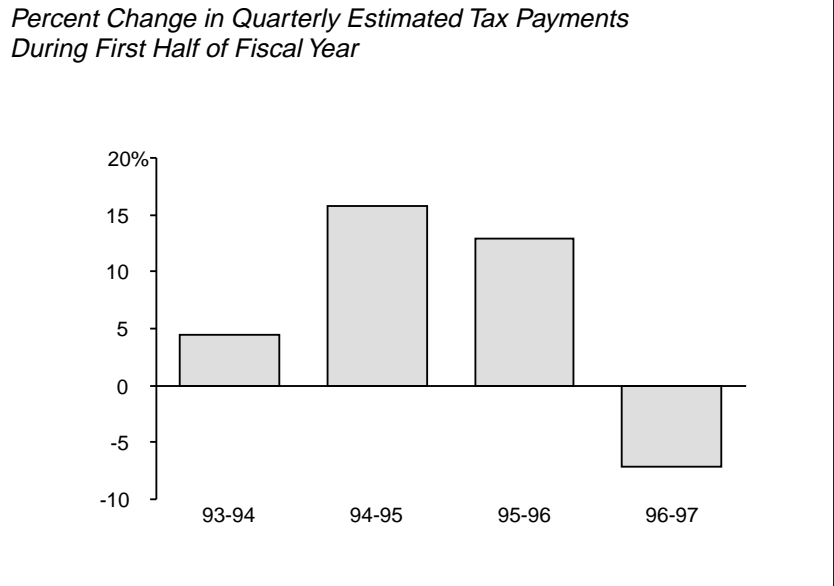
Recent Prepayments Have Been Weak. Figure 12 shows the percent change in corporate tax estimated payments for the July-through-December period of each fiscal year from 1993-94 through 1996-97. It shows that these payments increased consistently during the first three years of this period. In 1996-97, however, collections *fell* by 7 percent, reflecting especially soft payments during September and December 1996.

Implications for Revenues. At this point, it is not possible to identify with certainty the factors responsible for the weakness in prepayments, and thus its revenue implications. The softness does not appear to be occurring nationally, as federal corporation tax receipts in late 1996 were up moderately from the prior year. It also is unlikely that the softness is due to the state corporation tax rate cut enacted in 1996, since the first income year to which this reduction applies is 1997.

The prepayments weakness may be due to special factors, such as unusually large depreciation charges by certain California companies, or larger-than-expected use of the state's investment tax credit and carry-over net operating loss (NOL) deductions. It is also possible that tax-related strategies pursued by businesses are resulting in a shift in the allocation of income from corporate earnings to personal earnings—in the form of large year-end bonuses to employees. If so, this income would be reported on individual personal income tax returns, not corporate tax returns. This latter factor could account not only for some of the corporate

payments weakness, but also some of the recent strength in year-end personal income tax payments noted earlier.

Figure 12
Major Corporate Tax Payments Softening in 1996-97



We will not know the exact cause(s) of the slowdown in receipts until tax return information is tabulated for 1996. For purposes of our projections, however, we have incorporated what we believe is a reasonable assumption in the absence of any information to the contrary—namely, that the slowdown is “real,” and reflective of underlying factors like those discussed in the preceding paragraph. We have accordingly lowered our bank and corporate revenue forecast for 1996-97 and beyond to take account of the recent cash trends.

**The LAO Forecast—
 Bank and Corporation Tax Revenues to Decline**

1996-97 Revenues. We estimate that bank and corporation tax receipts will total \$5.5 billion in 1996-97, a 7 percent decline from 1995-96. This drop off reflects the recent soft cash trend noted above, as well as the 5 percent tax cut enacted last year which is projected to lower collections by \$85 million in the second half of 1996-97.

1997-98 and 1998-99 Revenues. We forecast that corporate tax receipts will grow only marginally in 1997-98 and 1998-99. As shown in Figure 11 above, our projections assume that California profits will grow at an average rate of 5.4 percent annually between 1996 and 1999. However, revenues themselves will grow more slowly because of the impacts of the recently enacted 5 percent tax cut (which lowers revenues by \$230 million in 1997-98 and \$290 million in 1998-99), as well as the Governor's proposed additional tax reduction (which would reduce collections by an additional \$93 million in 1997-98 and \$336 million in 1998-99).

Outlook for Other Revenue Sources

The remaining 6 percent of General Fund revenues consists of the insurance, estate, tobacco, and alcoholic beverage taxes, along with a variety of smaller taxes, fees, interest earnings, and transfers from special funds.

We forecast that these other sources will decline from \$3.5 billion in 1996-97 to \$3.2 billion in 1997-98, and then increase to \$3.3 billion in 1998-99. The decline between the current year and the budget year is due to the Governor's proposed redirection of trial court revenues from the General Fund to the Trial Court Trust Fund. Excluding the effects of this proposal, the underlying trend for the nonmajor revenue sources is modest growth between 1996-97 and 1998-99, reflecting *increases* in insurance and estate taxes, and *decreases* in cigarette, alcoholic beverage, and horse racing taxes.

THE LAO FORECAST IN PERSPECTIVE

Comparison to the Budget Forecast

Our revenue forecast is *above* the 1997-98 Governor's Budget revenue forecast by \$77 million for 1996-97 and \$266 million for 1997-98, or \$343 million for the two years combined. Although this two-year difference is considerably less than last year (when we exceeded the budget's projections by nearly \$1 billion for a similar two-year period), it masks striking differences between our respective forecasts for each of the state's major revenue sources. Specifically, we estimate that personal income and sales taxes will *exceed* the budget estimate significantly, but that bank and corporation taxes will fall well *below* the administration's estimates.

Income Taxes. We estimate that PIT revenues will *exceed* the budget forecast by \$290 million in 1996-97 and by \$410 million in 1997-98, for a

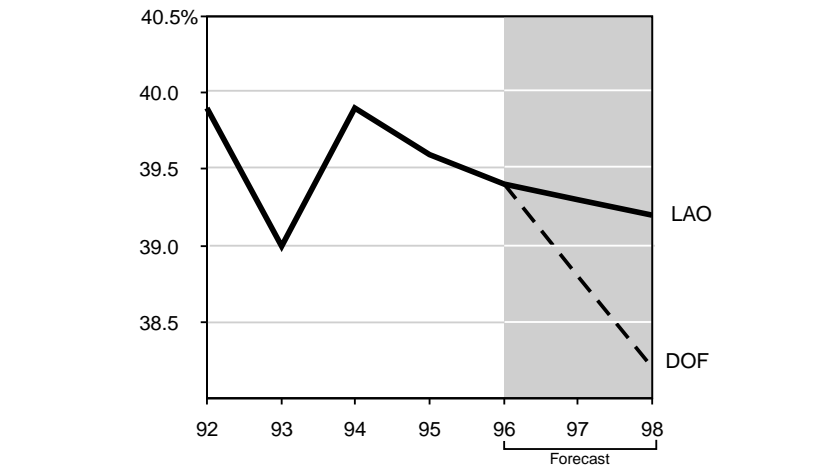
two-year difference of \$700 million. Part of the difference is related to the strong PIT performance in January, when quarterly estimated payments exceeded the budget forecast by \$300 million.

Sales and Use Taxes. We forecast that sales and use tax receipts will exceed the administration's forecast by \$135 million in the current year and \$235 million in 1997-98, for a two year total of \$370 million. As was the case last year, our higher estimate reflects our view that the share of personal income devoted to spending on taxable items will remain *stable* over the next two years, whereas the administration assumes that the ratio will *fall* during this period (see Figure 13).

Figure 13

**Department of Finance's
Taxable Sales Ratio Conservative**

*Taxable Sales as a Percent of Personal Income
1992 Through 1998*



Bank and Corporation Taxes. In contrast to our higher estimates for personal income and sales taxes, our forecast for bank and corporation taxes is *down* from the administration's—by \$345 million in the current year and \$390 million in the budget year, or \$735 million for the two years combined. As indicated above, our lower estimate is related to our assessment of recent cash trends, which suggests that bank and corporation taxes are coming in well below the administration's projections.

Changes in the LAO's Forecast Since November

After adjusting for changes in policy-related assumptions, our current revenue forecast is down from our November forecast by \$189 million for 1996-97 and \$133 million for 1997-98. These revisions are primarily due to recent economic and revenue developments, including the adjustments discussed previously that we have made for recent cash trends.

Forecast Risks and Uncertainties

On balance, our assessment of recent economic and revenue developments leads us to believe that there is some upside potential to the budget's revenue forecast. However, given the volatility and recent diverging cash trends in personal income and bank and corporation taxes, it is unlikely that a clear picture of the state's revenue outlook will emerge until final income tax payments are remitted and tabulated this spring.

It is also important to note that both the LAO and the budget revenue estimates are predicated on the assumption of continued, though tapering, economic growth. Unexpected weakening or strengthening of the economy could easily translate into revenue adjustments far greater than the current differences between the LAO and administration estimates.

THE BUDGET FORECAST FOR SPECIAL FUNDS REVENUES

Special funds revenues support a wide variety of state and local government programs. As shown in Figure 14, about one-half of special fund revenues are related to motor vehicle-related taxes and fees. These include motor vehicle license fees (which are distributed to local governments for general purposes), and fuel taxes and registration fees (which support transportation projects). Other major special funds revenues include sales and use taxes, and tobacco-related taxes.

The budget projects that special funds revenues will grow from \$14.6 billion in 1995-96 to \$15.2 billion in 1996-97 and to \$15.8 billion in 1997-98. The modest 4.3 percent budget-year growth rate reflects three main factors:

- *Moderate increases* in license fees, registration fees, and sales and use taxes, reflecting continuing growth in consumer purchases of automobiles and other commodities.
 - *Slow growth* in fuel taxes, reflecting small increases in fuel consumption.
-

- *Declines* in cigarette and tobacco taxes, reflecting a continued downward trend in the consumption of cigarettes.

Figure 14				
Special Funds Revenues and Transfers				
<i>(Dollars in Millions)</i>				
Revenue Source	Actual 1995-96	Estimated 1996-97	1997-98 Forecast	
			Amount	Percent Change
Motor Vehicle Revenues				
License fees (in lieu)	\$3,339	\$3,525	\$3,713	5.3%
Fuel taxes	2,774	2,878	2,946	2.4
Registration, weight, and miscellaneous fees	1,616	1,637	1,716	4.8
Subtotals	(\$7,729)	(\$8,040)	(\$8,375)	4.2%
Other Sources				
Sales and use taxes ^a	\$3,374	\$3,521	\$3,731	6.0%
Cigarette and tobacco taxes	496	488	487	-0.2
Interest on investments	112	116	110	-5.2
Other revenues	2,991	3,026	3,130	3.4
Transfers and loans	-127	7	12	—
Totals	\$14,575	\$15,198	\$15,845	4.3%

^a Includes Local Public Safety Fund revenues. These amounts are not included in the Governor's budget presentation.

Special Funds Revenues Could Exceed the Budget Forecast. As with the General Fund revenue outlook, we believe that there is some upside potential to the administration's revenue forecast for special funds. Specifically, assuming that the economy continues to grow as we expect during the next two years, we believe that special funds revenues relating to sales and use taxes could exceed the budget forecast by approximately \$75 million during 1996-97 and 1997-98 combined.

TAX EXPENDITURES

What Is a "Tax Expenditure"?

Incorporated within the General Fund and special funds revenue figures are the effects of various tax expenditure programs (TEPs). Gener-

ally, these TEPs are defined as tax provisions—including exemptions, exclusions, deductions, credits, deferrals, and preferential tax rates—which cause the existing tax structure to deviate from the “basic tax structure” and thereby result in reduced revenues.

Definitional Issues. Given this general definition, TEPs have meaning only within the context of what the “basic tax structure” is perceived to be, and this can be a source of considerable controversy. Indeed, disagreement is not uncommon among economists and public policymakers regarding exactly what the basic tax structure is, and thus whether or not individual tax provisions are or are not TEPs. The more all-encompassing your definition of the basic tax structure, the more TEPs you tend to have. Alternatively, the more narrowly the basic tax structure is defined, the fewer TEPs you tend to have. The appropriateness of classifying a specific tax provision as a TEP is most commonly questioned when the provision is broadly available to all taxpayers and benefits most everyone (such as the sales tax exemption on general food products). In contrast, consensus is more common regarding tax provisions that apply to only a limited number of taxpayers in special circumstances (such as certain targeted tax credits).

In recognition of the fact that individual legislators have differing views regarding which tax provisions should be classified as a TEP versus as a part of the state’s basic tax structure, the information provided below takes a fairly broad view of what constitutes a TEP. This will enable individual members to have a full array of data regarding potential TEPs available from which they can “pick and choose” in their policy deliberations, based on their own viewpoints regarding how TEPs should be defined.

TEPs—How Many Are There and What Is Their Impact on Revenues?

Under current law, there are nearly 200 state-level TEPs and over 60 local TEPs. As noted earlier, a number of these (such as the sales tax exemption on food products) affect most Californians, while others (such as certain tax credits and exclusions) affect more limited numbers of taxpayers. Numerically, nearly half of all state-level TEPs fall within the sales and use tax category, and most local TEPs are property-tax related.

Effects on Revenues. Based upon the most recent data provided to us by the tax agencies, the total revenue cost of TEPs exceeds \$30 billion. Figure 15 summarizes the composition of these costs by type of tax. It indicates that personal income tax provisions account for the single largest dollar share of the revenue effects of TEPs—over half. The largest

personal income tax TEPs are the exclusion from taxation of employer contributions to pension plans and the home mortgage interest deduction. Sales and use tax TEPs are the next largest category, accounting for about a quarter of total TEP costs. The largest sales and use tax TEPs are the tax exemption for utilities delivered through mains, lines, or pipes, and the exemption for food products. The remaining TEPs—those relating to bank and corporation taxes, other state taxes, and local property taxes—account for the remaining one-fifth of TEP-related state revenue costs.

Figure 15

Composition of TEP Revenue Reductions by Tax

1997-98



We will be issuing a detailed compendium of all TEPs later this year. This report will provide the Legislature with a comprehensive TEP listing by type of tax, and discussions of the specific tax provisions, rationales, and revenue effects of each individual program.