CALIFORNIA BUDGET PROJECT

BUDGET WATCH

Volume 6, Number 1 March 2000

GOVERNOR'S BUDGET RELYING ON ONE-TIME SPENDING PROPOSALS

Gov. Gray Davis released his proposed budget for fiscal year 2000-01 on January 10. As proposed by the governor, the budget provides a modest (4.5 percent) increase in spending and modest policy initiatives focusing on education, transportation and aging. The budget is noteworthy for its reliance on one-time spending proposals, rather than ongoing programmatic commitments. The continued strength of the state's economy, as demonstrated by end of 1999 revenue collections, suggests that state revenue collections will significantly exceed the levels forecast in the Governor's Budget, offering the Legislature additional opportunities to address California's unmet needs and challenges.

The big picture: The Governor's Budget as proposed in January

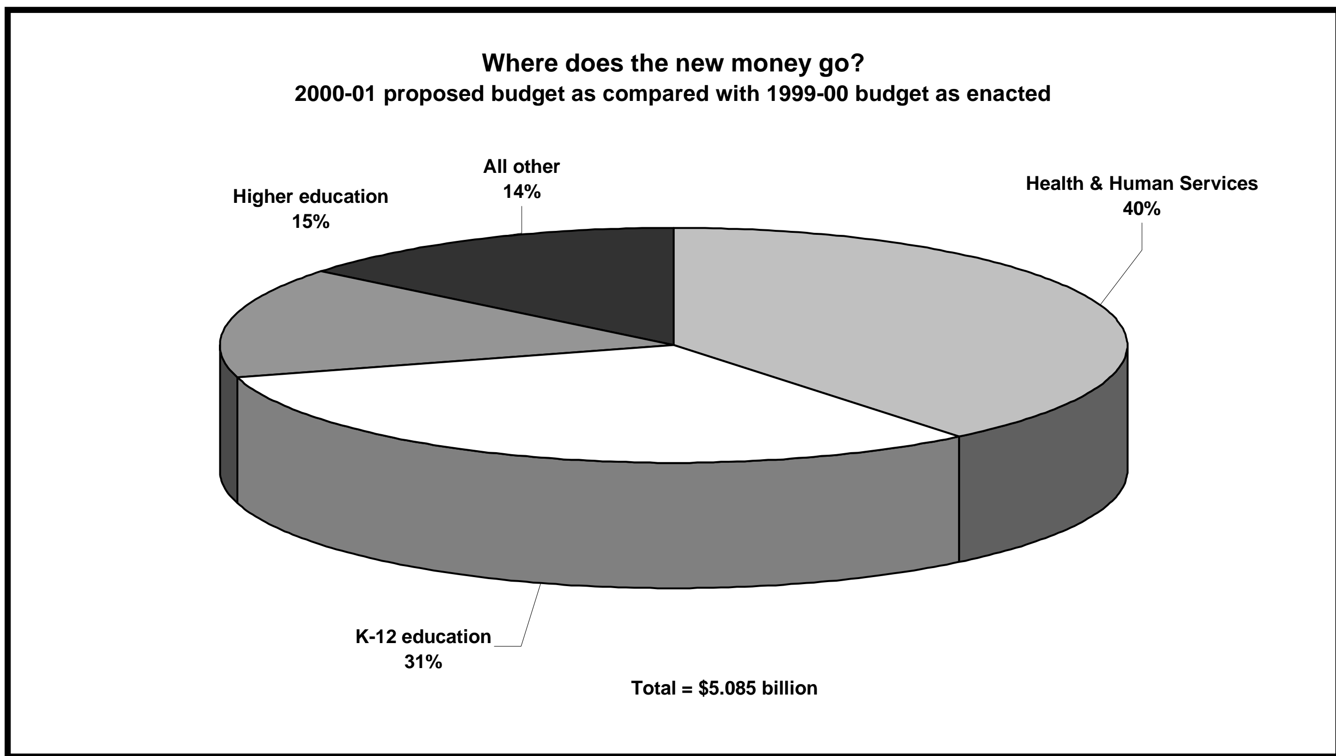
- The Governor's Budget assumes that fiscal year 2000-01 revenues will be $5.3 billion (8.3 percent) above the level assumed in the 1999-00 budget as enacted in June.
- The budget increases General Fund spending by $5.1 billion (8 percent) over the amount adopted in the 1999-00 Budget Act for a total of $68.8 billion. The budget augments 1999-00 spending by $2.1 billion over the amounts adopted in June and increases spending in 2000-01 by $3 billion over revised 1999-00 levels.
- While K-12 education accounts for the largest share of General Fund spending, Health and Human Services programs receive a larger fraction of the new money (40 percent), with K-12 education (31 percent), and higher education (15 percent) receiving significant boosts.
- The budget includes $2.9 billion in one-time spending and set-asides, including $665 million to refund smog impact fees declared unconstitutional by the courts, a $500-million set-aside for other "legal contingencies," and $100 million for one-time legislative initiatives.
- The budget provides a $1.2 billion reserve, which is equal to 1.8 percent of General Fund expenditures.
- This year's budget, unlike those of recent years, is based on realistic assumptions of federal aid.

LAO PREDICTS SIGNIFICANT REVENUE GAINS

In its February review of the budget, the Legislative Analyst's Office (LAO) forecasts that revenues will be $2.1 billion higher in both the current (1999-00) and budget (2000-01) years, for a total of $4.2 billion in additional resources. The LAO's forecast takes into account tax and economic data from December 1999, which was not available for the governor's forecast, and assumes continued economic growth and no steep declines in the stock market.

The LAO notes that half of the additional $4.2 billion in revenues it anticipates should be considered one-time in nature, in addition to the $2.9 billion set aside for one-time spending in the Governor's Budget. In recent years, the LAO's forecast has been closer to actual revenue collections than those of the state Department of Finance.

Cash receipts for the month of January alone exceeded the Governor's Budget forecast by almost $1 billion ($959 million). For the 1999-00 budget year, revenues are $1.5 billion above the governor's January forecast. Continued strong revenue collections suggest that the May Revision estimates, which are used as the basis for final budget negotiations, may exceed even the Legislative Analyst's forecast.



Revenue Trends Hint at Tax Vulnerabilities

The extraordinary growth in revenues also illustrates some of the vulnerabilities in the state's tax system. California relies on a highly progressive personal income tax to provide more than half of the state's General Fund revenues. The state's personal income tax is also responsible for most of the higher-than-anticipated growth in state revenues in recent years and approximately three quarters of the total growth in General Fund revenues over the past five years.

The Legislative Analyst estimates that approximately 60 percent of the growth in personal income tax revenues is attributable to growth in both employment and wage and salary income. The remaining 40 percent of the growth comes from the tremendous rise in incomes of high-income Californians, including capital gains, stock options and other non-wage income. Since most of this non-wage income goes to high-income households, whose income is taxed at the state's highest tax rate, each billion dollars of non-wage income growth translates into more revenues than a billion-dollar increase in wages. While desirable from the standpoint of tax equity, the high concentration of revenues deriving from non-wage income could cause problems if the stock market declines sharply.

Corporate tax collections, in contrast, have remained relatively stagnant despite strong gains in the profitability of corporations doing business in California. The share of General Fund revenues provided by corporate income taxes has declined 42 percent since 1977-78. Analysts point to several causes for the slow growth in corporate tax collections, including an increase in the use of tax credits, growth in the number of Subchapter S corporations (Subchapter S corporations pay a reduced corporate tax rate and pass earnings on to shareholders, who pay personal income taxes on the distributions they receive), and a growth in the number of corporate tax shelters. At the federal level, concern over growth in the use of tax shelters has caused Treasury Department officials to call for stepped up enforcement to stem the decline in corporate tax collections.

While sales tax collections are up significantly, the yield of the state's sales tax — the revenues raised by each percent of the sales tax rate — is falling. Analysts suggest that "e-commerce" and mail

order sales could cost California $1 billion in lost revenues by 2003. Finally, "sin" taxes provide a declining share of General Fund revenues. Between 1997-98 and 2000-01, alcoholic beverage tax revenues rose less than 1 percent, while General Fund tobacco tax revenues have dropped 15 percent due to declining consumption.

BIGGEST SPENDING INCREASE IS A TAX CUT

The reimbursement to local governments for revenues lost as a result of the reduction of the so-called "car tax" is the budget's fastest growing spending item. The Vehicle License Fee (VLF) provides general purpose revenues to counties and cities, as well as support to counties for health and social service programs as part of the 1991 realignment of program responsibility. The 1998 measure reducing the VLF rate included a complex set of mechanisms that automatically trigger larger reductions in the VLF rate if General Fund revenues exceed specified targets. Last year's budget accelerated the first of the triggered reductions. If current trends continue, all of the VLF "triggers" will be pulled, costing the state $4.2 billion in 2003-04.

BUDGET INCLUDES MODEST TAX CUTS

The governor proposes $167 million in additional tax cuts in 2000-01, including:

- A one-time $100-million credit for land donated for conservation purposes;
- A $500 tax credit for elderly or disabled persons who require in-home care or for family members who provide in-home care ($47 million);
- An increase in the amount of losses businesses can carry forward and deduct in future years ($1 million, rising to $200 million in 10 years);
- An increase in the state's research and development tax credit ($4 million);
- A $15-million increase in the state's Low-Income Housing Tax Credit;
- Allowing taxpayers to receive tax-free assistance with graduate school expenses from their employer ($10 million); and
- Various other one-time and ongoing targeted tax reductions.

THE GOVERNOR'S MAJOR POLICY INITIATIVES

The Governor's Budget highlighted policy initiatives in the areas of education, aging and transportation.

Education: The governor's education proposals focus on student achievement (including merit scholarships), teacher recruitment and training, and education technology and academic partnerships. In actual dollars and cents, education received a modest share of the additional resources available in the budget. The Legislative Analyst notes that governor increased the basic budgets for the University of California and California State University systems by 6 percent, while providing just a 2.84 percent general increase for K–12 education and community colleges. After adjusting for inflation, the proposed budget increases per pupil spending by 1 percent.

The $1.9 billion increase in 2000-01 in school spending subject to the Proposition 98 spending guarantee is divided between enrollment growth ($428 million), cost-of-living adjustments ($947 million), the governor's policy initiatives ($339 million), and other programs ($231 million). Nearly half (47 percent) of the new Proposition 98 spending proposed in the Governor's Budget is earmarked for specific programs, limiting the amount available for general classroom use.

"Aging With Dignity:" The budget allocates $140 million from the state's General Fund for a multi-part effort designed to "help elderly people remain at home, or with their families." The largest components include $52.5 million for home care and nursing home-worker wage increases, $47 million for a tax credit for seniors or family members that provide in-home care, $50 million in federal job training funds for homecare and nursing home workers, and a modest expansion of "no cost" Medi-Cal for low-income seniors.

Transportation: The governor's "Transportation 2000" plan includes a number of measures designed to expedite, rather than expand, funding for transportation by extending the planning

period for state transportation projects and imposing a "use it or lose it" policy on state and federal funds held by local governments.

Specifically, the governor proposes to extend the planning horizon for the State Transportation Improvement Program (STIP) by three years and reallocate local gas tax and federal transportation funds if local agencies fail to spend these funds within a specified time. The governor also proposes amending the state constitution to allow gas tax revenues, which are currently earmarked for highways, to be used to purchase mass transit vehicles. In addition, the budget allocates $121 million for one-time rail projects.

The Legislative Analyst's review of the budget questions whether there are sufficient projects ready for implementation during the time frame envisioned by the governor's proposal; whether CalTrans will be funded and able to expand their project and design functions at the scale needed to implement the governor's proposal; and whether the "use it or lose it" provisions are justified.

FUNDING FOR CALWORKS DOWN

The budget reduces total CalWORKs expenditures from $7.2 billion in 1999-00 to $6.9 billion in 2000-01, reflecting a 5.4 percent caseload decline, as well as California's ability to spend less under the federal TANF Maintenance of Effort (MOE) requirements by achieving federal work participation rates. The budget reduces state expenditures counting toward the MOE by $181.8 million, from approximately $2.9 billion to $2.7 billion. A greater share of state welfare dollars will go toward child care in 2000-01. The shift reflects declining caseloads and the growing need for child care as more parents enter the workforce. The budget also reduces CalWORKs spending for county substance abuse and mental health services by $5.7 million and $3.6 million, respectively.

PROGRAMS FOR IMMIGRANTS SUNSETTED

The Governor's Budget does not extend the September 30, 2000 sunsets of the Cash Assistance Program for Immigrants (CAPI) and California Food Assistance Program (CFAP) expansions for immigrants arriving in the country after August 22, 1996. This year's (1999-00) budget extended eligibility for the two programs to new immigrants on a temporary basis. The governor also proposes to extend eligibility for the Healthy Families Program, which provides subsidized health coverage, for an additional year to legal immigrant children who entered the United States after August 22, 1996. The extension, however, would only apply to children enrolled in the program before June 30, 2000. No additional children would be allowed to enroll in the program. The budget continues to fund pre-natal and long-term care for undocumented immigrants.

THE BOTTOM LINE

The state's good fiscal fortunes mean that lawmakers will have at least $4 billion, and potentially significantly more, in additional resources to consider during their deliberations over the budget. At least half of the additional funds should be available for ongoing program spending. The additional revenues provide policymakers with an opportunity to develop policies to support those families who have not benefited from the strong economy and make critically needed investments in public services, such as education and infrastructure.

WHO PAYS STATE TAXES?

California's personal income tax system is one of the most progressive in the nation. The state's use of personal credits, large dependent (child) credits and reinstatement of the renters tax credit combine to eliminate any tax liability for poor to moderate-income households. A married couple with two children would have no 1999 personal income tax liability unless they earned in excess of $38,475. A single mother with one child would owe no tax unless she earned in excess of $31,000.

California's high tax threshold also means that many families receive ***no*** benefits from the various credits and deductions in state law. (At present, California has no refundable tax credits.

Refundable credits are those that provide benefits in the form of cash back to the taxpayer if she or he has no tax liability.) A nonrefundable child care credit, for example, would provide no assistance to a single mother of one earning less than $31,000 per year. Similarly, a credit for long-term care expenses, such as that proposed by the governor, would provide no benefits to a family of four earning less than $38,475.

1999 California tax thresholds: Who pays taxes in California		
	Tax threshold	Income as a percent of poverty level
Married, 2 children	$38,475	226%
Single parent, 2 children	$36,680	259%
Single parent, 1 child	$31,000	276%
Single adult	$11,960	143%
1998 median household income	$40,934	

Assumes taxpayers claim standard deduction and renters credit

CLINTON RELEASES FINAL FEDERAL BUDGET

In early February, the White House released the final Clinton administration budget, proposing $1.8 trillion in federal spending for fiscal year 2000-2001, an increase of 2.5 percent over last year's budget. Following is an overview of health and welfare proposals included in the proposed budget.

FOOD STAMPS

The president proposes restoring Food Stamp eligibility to legal immigrants who were in the country before August 22, 1996 and either subsequently reach age 65 or have children who are eligible for food stamps. The president also proposed giving states the option of conforming policies dealing with the value of automobiles owned by Food Stamp recipients to states' Temporary Assistance for Needy Families (TANF) rules. However, states could not apply TANF policies that were more restrictive for additional vehicles in the Food Stamp household. States' TANF programs often employ more generous rules regarding the value of a vehicle that a recipient can own and remain eligible for assistance. Under the proposal, states with TANF programs that have more liberal vehicle limits than the current $4,650 limit could extend the higher limits to Food Stamp households.

MEDICAID, CHILDREN'S AND FAMILIES' HEALTH

The president's budget allows states to extend health coverage through Medicaid (Medi-Cal in California) or State Children's Health Insurance Program (SCHIP; in California, the Healthy Families Program) to legal immigrant children regardless of their date of entry into the United States. States would also gain the ability to extend coverage to parents of children who are covered by Medicaid or SCHIP under a newly proposed FamilyCare program. (see below)

The budget proposes to permit states to extend Medicaid eligibility to pregnant women who are qualified legal immigrants, regardless of their date of entry to the United States. Under current law, certain eligibility restrictions apply to legal immigrants who entered the country after August 22, 1996.

The president's proposed budget includes a 10-year, $110-billion initiative to improve the affordability of health insurance and expand coverage in several ways. A new program, FamilyCare, would be created to provide health coverage for parents of children eligible for Medicaid or SCHIP. The budget adds $50 billion over 10 years to current state SCHIP allotments. To access these funds, states would first have to cover children in families with incomes of up to 200 percent of the federal poverty level ($34,100 for a family of four). Currently, 30 states, including California, have already done this. After five years, all states will be required to expand coverage to parents with incomes of a least 100 percent of the poverty level.

FamilyCare would also assist families in purchasing employer-based health coverage. Under this option, families otherwise eligible for FamilyCare would receive assistance in purchasing their employer's health plan if it meets FamilyCare standards and their employer pays for at least half of the premium.

In order to help boost SCHIP enrollment, states would be allowed to have School Lunch Programs share eligibility information with Medicaid, allow more public sites (such as schools and child care resource and referral centers) to enroll children, and simplify Medicaid and SCHIP enrollment by eliminating assets tests, limits on the assets families can own and still qualify for coverage. The president's proposal also gives states the option to provide Medicaid and SCHIP coverage to children ages 19 and 20 up to the same income levels that apply to younger children.

SUPPLEMENTAL SECURITY INCOME ELIGIBILITY

The budget also proposes to restore Supplemental Security Income (SSI) benefits for legal immigrants who entered the country after August 22, 1996, have been here for five years, and became disabled after entry. Most states consequently will be required to restore Medicaid benefits to these individuals.

TANF AND RELATED PROPOSALS

The president's budget reduces TANF expenditures by $250 million, $240 million of which would come from eliminating the increase in TANF supplemental grant funds, allocated to 17 states based on population growth and average TANF/AFDC spending. California is not one of the states that receives these funds.

Funding for the Social Services Block Grant (Title XX) would increase by $75 million under the president's proposal, though $25 million of that total would be earmarked for "second-chance" homes for unmarried teen parents and their children.

The budget proposal includes federal funds for a new state option to pass through child support collections to families. The new proposal would disregard (exclude) these funds when determining assistance levels for TANF families. States would also gain an option to simplify the distribution of child support collections.

The president's proposal increases funding to $150 million for the Access to Jobs program, doubling current year funding. Funds are provided through the Department of Transportation to local communities to create transportation programs to help low-income families reach jobs that are not served by regular transportation services.

The Welfare-to-Work (WtW) program is designed to help move the hardest to employ welfare recipients into lasting, unsubsidized employment. While the budget proposes no new funding for WtW, it proposes to extend authority for the allowable expenditure period for the funds from three years to five years to permit optimal resource usage over the next several years.

ALTERNATIVES PROPOSED TO MARRIAGE TAX PENALTY

The federal tax code's so-called "marriage penalty" promises to be the focus of considerable congressional and presidential campaign debate this year. A $182-billion marriage tax penalty relief plan was passed by the House of Representatives in February. The Clinton administration has proposed an alternative plan to reduce or eliminate marriage tax penalties found in the federal tax code that, according to the Department of the Treasury, would cost $50 billion over 10 years.

Under current federal law, a couple essentially incurs a marriage penalty when their tax liability is greater when filing jointly than it would be if both spouses filed as single individuals. Conversely, couples who pay less in federal income taxes by filing jointly than they would as singles enjoy marriage bonuses. The Treasury Department estimates that in 1999, 48 percent of married

couples filing jointly incurred marriage penalties, which averaged $1,141. For the same year, 41 percent enjoyed marriage bonuses, which averaged $1,274, and 11 percent received neither penalties nor bonuses.

Marriage penalties arise, in part, because the standard deduction for a married couple who file jointly, $7,350 in 2000, is less than double the individual deduction of $4,400. Like the standard deduction, the tax rate brackets for married couples filing jointly are less than twice the size of single taxpayer brackets. Couples where spouses have equal incomes are more likely to incur a penalty because their combined income will be taxed at a higher marginal tax rate than their individual incomes would be if they filed as singles. Marriage bonuses typically occur in married couples where one spouse earns significantly more than the other spouse. This happens in families where the higher earning spouse has an income that would move them into a higher tax bracket if they filed as single.

The president's proposed plan would increase the standard deduction that joint filers can claim to double the single-filer level, which is how California's personal income tax is structured. It would also raise the income level at which the Earned Income Tax Credit (EITC) begins to phase down and finally phases out completely for married couples with children. The president's plan targets relief to two-wage earner couples.

In contrast, the plan passed by the House provides tax cuts for all married-filers, regardless of whether they currently pay penalties or receive bonuses. Close to 50 percent of the benefits would go to couples receiving bonuses. That plan, sponsored by Congressman Bill Archer, would increase the standard deduction that all married-filers can claim, not just two-wage earner couples, to twice the single-filer deduction.

The Archer plan also increases the income level at which the EITC for married-filers begins to phase down and phase out completely. These provisions address the penalty that low-income individuals incur when they marry and the spouses' combined income reduces or eliminates their EITC.

The most expensive provision in the House plan is a proposal to increase the 15-percent tax bracket for married filers to exactly double the single-filer bracket. The new bracket would be phased in over a five-year period beginning in 2003. Basically, this change increases the amount of income on which married filers could pay the 15-percent tax rate rather than the 28-percent rate. The Congressional Joint Tax Committee estimates that this provision would cost more than $100 billion over the next 10 years, accounting for approximately 55 percent of the plan's total cost of $182 billion.

The proposed bracket structure only benefits married filers who have taxable income that exceeds the level at which the 15-percent bracket

(continued on back page)

Marriage penalty more likely when spouses have equal incomes (examples)

	Person 1	Person 2	Married, filing jointly
Adjusted gross income	**$30,000**	**$30,000**	**$60,000**
Less exemption and standard deduction	$7,050	$7,050	$12,700
Taxable income	$22,950	$22,950	$47,300
Tax liability	**$3,443**	**$3,443**	**$7,648**
		Marriage penalty	**$762**
	Person 1	Person 2	Married, filing jointly
Adjusted gross income	**$10,000**	**$50,000**	**$60,000**
Less exemption and standard deduction	$7,050	$7,050	$12,700
Taxable income	$2,950	$42,950	$47,300
Tax liability	**$443**	**$8,679**	**$7,648**
		Marriage bonus	**$1,474**

CBP calculations based on 1999 tax information

CALIFORNIA BUDGET PROJECT
921 11TH ST STE 502
SACRAMENTO CA 95814-2820

RETURN SERVICE REQUESTED

NONPROFIT ORG
US POSTAGE
PAID
SACRAMENTO CA
PERMIT NO. 341

currently ends, $43,050 for 1999. Families earning up to $43,050 would not benefit from this provision because it only applies to *taxable* income in excess of $43,050. The proposed change only benefits families with *adjusted gross incomes* of at least $61,250. Citizens for Tax Justice (CTJ), a research organization that analyzes the effects of tax policies, estimates that 84 percent of the tax cuts from this provision alone would accrue to the 30 percent of joint tax filers earning $75,000 or more. CTJ estimates that nearly two-thirds of the benefits from all of the provisions in the House plan would go to families with incomes of $75,000 or more, and that families with incomes over $75,000 would receive reductions averaging $994, while those with incomes under $50,000 would receive cuts averaging $149.

These recent efforts to reduce the marriage penalty are motivated, in part, by Congressional Budget Office projections that the non-Social Security budget surplus will total $1.85 trillion over the next 10 years. This projection is not only based on the unrealistic assumption that federal spending will be frozen at current levels but is highly sensitive to small errors in estimating the rate of economic growth over this period. In light of this uncertainty over the actual amount of any surplus that may be available, any new tax or spending proposals should be well-designed and carefully targeted. The House plan to reduce the marriage tax penalty does not meet these criteria because the benefits are not targeted to those married joint filers who actually pay penalties, and that makes the proposal far more costly than it needs to be.

The California Budget Project is a nonpartisan, nonprofit organization whose goal is to promote a better understanding of state fiscal policy issues. The CBP seeks to encourage a healthy public sector based on a fair and equitable tax structure. Budget Watch is supported by foundation grants, subscriptions and individual donations.

The California Budget Project can be reached at 921 11th St., Suite 502, Sacramento, CA 95814-2820, by phone at (916) 444-0500, by fax at (916) 444-0172, or by email at cbp@cbp.org. Budget Watch is published six times a year. Subscriptions are $20/year. Visit CBP's Web site at www.cbp.org.