THE 2000-01 BUDGET: PERSPECTIVES AND ISSUES

Report from the Legislative Analyst's Office to the Joint Legislative Budget Committee

California Legislature

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INTRODUCTION

The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the *2000-01 Budget Bill* and in other legislation. It seeks to accomplish this by (1) providing perspectives on the state's fiscal condition and the budget proposed by the Governor for 2000-01 and (2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement the *Analysis of the 2000-01 Budget Bill*, which contains our review of the *2000-01 Governor's Budget*.

The *Analysis* continues to report the results of our detailed examination of state programs and activities. In contrast, this document presents a broader fiscal overview and discusses significant fiscal and policy issues which either cut across program or agency lines, or do not necessarily fall under the jurisdiction of a single fiscal subcommittee of the Legislature.

The 2000-01 Budget: Perspectives and Issues is divided into five parts:

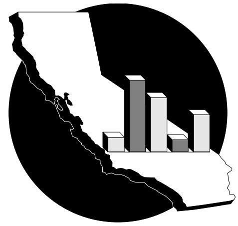
- Part One, "State Fiscal Picture," provides an overall perspective on the fiscal situation currently facing the Legislature.
- Part Two, "Perspectives on the Economy and Demographics," describes the current outlook for the economy and the administration's and our forecasts.
- Part Three, "Perspectives on State Revenues," provides a review of the revenue projections in the budget and our own assessment of revenues through 2001-02.

- Part Four, "Perspectives on State Expenditures," provides an overview of the state spending plan for 2000-01 and evaluates the major expenditure proposals in the budget.
- Part Five, "Major Issues Facing the Legislature," provides analyses of: (1) alternative ways the state could allocate property taxes to improve local finance, (2) Internet-related tax policy in California, and (3) three current lawsuits, including their fiscal and policy implications for the state.

I

State Fiscal Picture

State Fiscal Picture



California's budget outlook continues to improve dramatically, boosted by robust economic growth and major increases in state revenues. The new budget reflects a much-improved outlook since the 1999-00 budget was enacted last summer. However, further significant gains in economic and revenue activity in December and January suggest that revenues will exceed the new budget's projections by a substantial margin—$4.2 billion in the current and budget years combined. The improved picture provides the Governor and Legislature with the best opportunity in over two decades to strategically address major priorities in such areas as education, infrastructure, health care, local fiscal reform, and tax relief.

In this part, we first briefly review the *2000-01 Governor's Budget*. Next, we provide our own perspective on the budget outlook. Lastly, we highlight some of the major considerations and issues that will face the Legislature in the months to come as it evaluates the Governor's proposals, and develops its own fiscal priorities for the budget year and beyond.

OVERVIEW OF THE GOVERNOR'S BUDGET

The Governor's 2000-01 budget proposes total state spending of $85.1 billion (excluding expenditures of federal funds and selected bond funds). This represents an increase of 3.7 percent from the current year. About 80 percent of this expenditure total is from the General Fund and 20 percent is from special funds.

Figure 1 summarizes the budget's projections for expenditures, revenues, and the General Fund's "bottom line" condition. It indicates the following:

- ***Revenues.*** These are projected to total $65.2 billion in the current year, an 11.2 percent increase from 1998-99. The budget further assumes that revenues will grow at a more modest 4.7 percent in 2000-01, reaching $68.2 billion.
- ***Expenditures.*** These are projected to total $65.9 billion in the current year, a 13.9 percent rise from 1998-99. For 2000-01, the budget proposes total spending of $68.8 billion, a 4.5 percent increase.
- ***Budgetary Reserve.*** The year-end reserve for 2000-01 is estimated to be $1.2 billion, not including various set-asides. This is about 1.8 percent of total General Fund revenues.

Figure 1

Governor's Budget General Fund Condition

1998-99 Through 2000-01
(Dollars in Millions)

			2000-01	
	1998-99	1999-00	Amount	Percent Change
Prior-year fund balance	$2,920	$3,708	$3,012	
Revenues and transfers	58,615	65,160	68,236	4.7%
Total resources available	$61,535	$68,868	$71,249	
Expenditures	$57,827	$65,856	$68,819	4.5%
Ending fund balance	$3,708	$3,012	$2,430	
Encumbrances	$592	$592	$592	
Set-aside for legal contingencies	—	—	500	
Set-aside for legislation	—	—	100	
Reserve	**$3,116**	**$2,420**	**$1,238**	

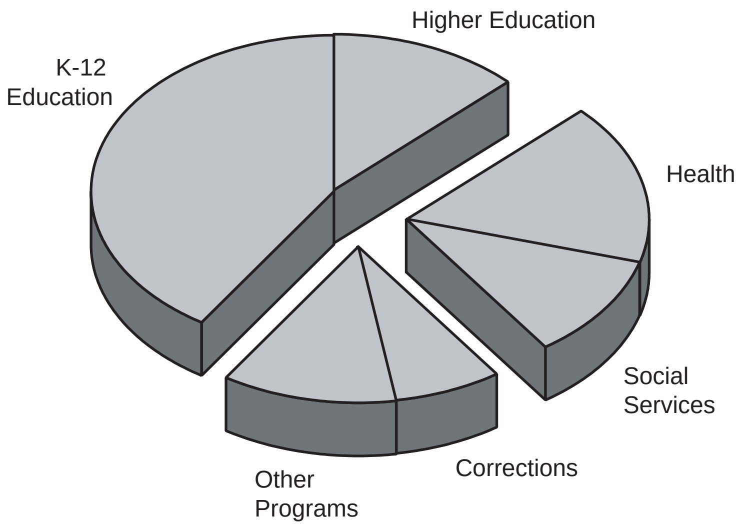
Detail may not total due to rounding.

Figure 2 shows the distribution of General Fund spending by major program area that is proposed in the budget for 2000-01. Nearly 54 percent of total General Fund spending involves education, including roughly 41 percent for K-12 and 13 percent for higher education. About 28 percent is for programs relating to health and social services, 7 percent is for corrections, and the remaining 12 percent covers general government and other programs.

Figure 2

General Fund Spending by Major Program Area

2000-01



MAIN FEATURES OF GOVERNOR'S PROPOSAL

The proposed budget is generally a fiscally prudent plan. On the whole, it relies on realistic assumptions about caseloads and federal funds, contains an increased reserve, sets aside significant funds for various contingencies, and reflects a mix of one-time versus ongoing commitments. Figure 3 (see next page) highlights the key programmatic elements of the proposal.

Budget's Focus Is on Education

As was the case last year, the Governor's budget proposal focuses on education.

K-12 Education. A 6 percent increase is included for K-12 education funding. Under the proposal, Proposition 98 per-pupil spending grows by 4.4 percent, from $6,045 to $6,313. The budget uses both Proposition 98 and non-Proposition 98 funds to support various K-12 initiatives directed at

Figure 3

Key General Fund Budget Proposals

- ✔ ***K-12 Education***. Includes $900 million for new initiatives targeting student achievement; teacher recruitment, retention, and training; and new technology. Almost two-thirds of the total counts toward Proposition 98 purposes, and the remainder is from non-Proposition 98 funds.
- ✔ ***Higher Education***. Provides significant funding increases for a new partnership agreement, acceleration of the opening of UC Merced, increases in Cal Grant awards, and teacher preparation initiatives.
- ✔ ***Long-Term Care Initiative***. Contains $93 million in spending and $47 million in tax credits for initiatives to improve senior care.
- ✔ ***CalWORKs***. Prohibits counties from earning new incentive payments in the budget year resulting in savings of $496 million.
- ✔ ***Tax Benefits***. Contains $167 million in tax benefits in 2000-01 (including the long-term care credit). Proposes increases in net operating loss deductions, expansion of the research and development credit, and a one-time tax credit for land donations.
- ✔ ***One-Time Commitments***. Contains about $2.9 billion in one-time commitments and set-asides, including $1.1 billion for litigation.

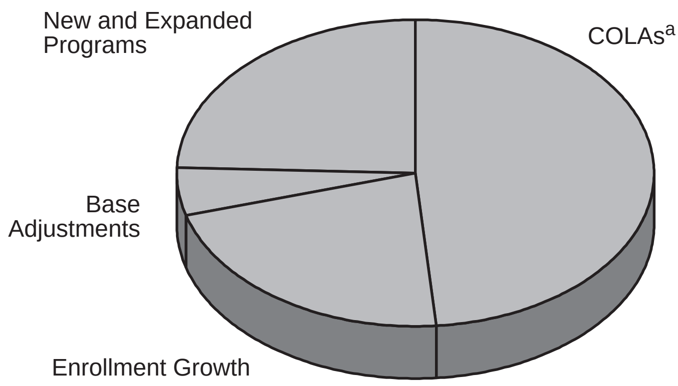
student achievement; teacher recruitment, retention, and training; and technology. Figure 4 shows how the $1.9 billion in new K-12 Proposition 98 funds are allocated in 2000-01. The budget proposes Proposition 98 spending that exceeds the estimated minimum funding guarantee by $257 million.

Higher Education. The budget includes substantial funding increases for higher education. It proposes a 6.7 percent increase for the California Community Colleges, including new funds for the Partnership for Excellence program, and for initiatives aimed at improving access for low-income students. It includes increases of 12.1 percent for UC and 8.7 percent for CSU in 2000-01. The new funds support a 6 percent base increase for both segments plus enrollment growth. They also support the various teacher-training costs associated with the Governor's K-12 education initiatives, and a variety of other costs related to research and new technologies.

Figure 4

Proposed Use of New K-12 Proposition 98 Funds

2000-01



[a]Cost-of-living adjustments.

Other Programs—Modest Changes

Outside of education, the new proposal is largely a workload budget, which funds existing programs and makes adjustments for caseloads and most cost-of-living (COLA) increases. It contains modest new spending initiatives and a tax credit relating to long-term care (the "Aging With Dignity" initiative), but no major new ongoing commitments elsewhere. Some significant programmatic features of the noneducation portion of the budget include:

- ***CalWORKs.*** The budget provides funds for the statutory COLA adjustment, as well as child care and employment services for CalWORKs recipients. It assumes enactment of legislation prohibiting counties from earning new performance incentive payments until the estimated prior obligation of incentive payments owed to the counties (approximately $500 million) has been satisfied. This policy change results in General Fund savings of $496 million in 2000-01.

- ***Medi-Cal***. The budget proposes funding for a reduction in the state "takeout" from disproportionate share hospital (DSH) funding; a 5 percent increase in wages for nursing home workers (which is part of the Governor's Aging With Dignity initiative); and some modest proposed increases in Medi-Cal eligibility.

- ***Department of Corrections***. The budget includes funding to cover a modest 1.5 percent increase in the inmate population and a 2.6 percent increase in the parole population. It also includes augmentations for substance abuse treatment program expansion, and increased parole supervision for selected parolees.
- ***Local Governments.*** The budget includes some one-time funds for local law enforcement grants, and proposes to make permanent and provide new funds for the Citizen's Option for Public Safety program. However, the budget does not propose any fundamental fiscal reforms or fiscal relief in the area of local government.

Budget Includes Large Amount of One-Time Commitments

The budget anticipates a $2.9 billion increase in prior-year and current-year revenues compared to the amount of two-year revenues estimated at the time the budget was enacted. It proposes to use these added resources for one-time commitments and set-asides in a number of areas. As shown in Figure 5, included among these are funds for the smog impact fee rebate, set-asides for legal contingencies and one-time legislative initiatives, grants for local law enforcement, rail projects, and a tax credit for land donations. In reviewing the budget, the Legislature will need to determine if these one-time expenditures are in line with its own priorities.

Recent Developments Render Revenue Forecast Conservative

The budget's economic and revenue forecast is considerably stronger than the forecast underlying the 1999-00 budget. It assumes that the state's economy will expand at a healthy pace through 2000, and is generally consistent with other forecasts made in November 1999. However, it has since been, in effect, superceded by the extraordinary economic and revenue developments that occurred at the end of 1999, *after* the budget forecast was completed. In particular, it does not incorporate the over 35 percent increase in year-end personal income tax estimated payments which suggests that the trend in personal income tax revenues is well above the budget forecast.

THE LAO'S OUTLOOK FOR THE BUDGET

This section provides our own perspective on the General Fund outlook for 1999-00 and 2000-01, based on the LAO's economic and revenue forecasts which are described in "Part Two" and "Part Three." Our ex-

Figure 5

Key One-Time Commitments Proposed in Governor's Budget

(In Millions)

Purpose	Amount
Smog impact fee rebate	$562
Set-aside for legal contingencies	500
Direct appropriations for capital outlay	383
Increase in budgetary reserve	358
Rail projects	121
Tax credit for land donations	100
Set-aside for legislative initiatives	100
Grants for local law enforcement	100
Fire suppression costs	71
School bus replacement	50
Down-payment assistance for teachers	50
UC teaching hospitals	25
Other	466
Total	**$2,886**

penditure forecasts reflect our estimates of the level of spending that would occur if the Governor's budget proposals were fully adopted. Our estimates are intended to assist the Legislature in its review of the budget proposal and in shaping its own budget priorities.

More Good News

Our General Fund outlook for 1999-00 through 2001-02 is shown in Figure 6 (see next page), and our key outlook-related findings are highlighted in Figure 7 (see page 11). Our "bottom line" is that:

- The budget outlook has *improved dramatically* from what was assumed in the Governor's budget, due to $4.2 billion more in projected revenues.
- In addition, the fiscal outlook beyond the budget year is *very favorable*, with revenues projected to exceed the ongoing costs of the Governor's budget plan by $2.1 billion annually.
- This gives the Legislature a unique opportunity to both address major priorities and strengthen the state's underlying fiscal condition.

Figure 6

The LAO's General Fund Condition Assuming Governor's Policy Proposals

1998-99 Through 2000-01
(Dollars in Millions)

	1998-99	1999-00	2000-01
Prior-year fund balance	$2,920	$3,708	$5,011
Revenues and transfers	58,615	67,231	70,384
Total resources available	$61,535	$70,939	$75,395
Expenditures[a]	$57,827	$65,928	$68,860
Ending fund balance	$3,708	$5,011	$6,535
Encumbrances	$592	$592	$592
Set-aside for legal contingencies	—	—	500
Set-aside for legislation	—	—	100
Reserve	**$3,116**	**$4,419**	**$5,343**

[a] Assumes the LAO's estimates of caseload and costs.

The 1999-00 and 2000-01 Outlooks

Economy to Keep Humming. Reflecting positive year-end national and state economic trends, we forecast that economic growth will remain strong in 2000 and continue at moderate rates in 2001 and 2002. In 1999, we estimate that California personal income increased by 7 percent—the largest gain of the decade. Thereafter, we foresee personal income growing at 6.7 percent in 2000 and remaining near 6 percent in each of the subsequent two years. Our estimates for 1999 and 2000 are above the administration's estimates of 6.6 percent and 6.5 percent growth, respectively.

Revenues—Upward Revision of $4.2 Billion. Reflecting positive developments regarding both economic growth and recent cash receipts, we estimate that General Fund revenues will exceed the budget forecast by $1.9 billion in both the current and budget years. Over 80 percent of the cumulative two-year $4.2 billion increase is related to the personal income tax, which in turn reflects our higher estimates of near-term basic economic growth and capital gains. We specifically estimate that revenues will be $67.2 billion in 1999-00 (a 14.7 percent increase from the prior year), and $70.4 billion in 2000-01 (a 4.7 percent rise).

Figure 7

Key LAO Findings Regarding the Budget Outlook

Budget Outlook Improves Dramatically

☑ 2000-01 to end with a reserve of $5.3 billion.

- This is $4.1 billion more than budget estimate.

☑ Improvement is due to revenues—up $4.2 billion over two years.

- Gain is largely from income taxes.
- Total gain evenly divided between 1999-00 and 2000-01—$2.1 billion each.

☑ Most of these funds will be available for any purpose.

Positive Fiscal Outlook Continues Beyond the Budget Year

☑ Absent a serious economic or revenue slowdown, revenues will continue to exceed expenditures by about $2.1 billion annually.

Legislature Can Address Major Priorities

☑ Reserve should be increased to at least $2 billion.

☑ Remaining funds should be used for a mix of one-time and ongoing purposes.

☑ New ongoing commitments should be limited to $2.1 billion annually.

Proposition 98 Interaction. The higher revenues that we project will *not* add to the amount included in the Governor's budget for Proposition 98. Thus, these increased resources will be available for any purpose.

Expenditure Estimates. We estimate that expenditures under the Governor's budget proposal will total $65.9 billion in the current year and $68.9 billion in 2000-01. These estimates are above the Governor's budget amounts, but only slightly—by $72 million in 1999-00 and $41 million in 2000-01. The main factor responsible for these net increases involves expenditures for state subventions to backfill local vehicle license fee (VLF) revenue losses associated with previously enacted rate reductions. We believe the state costs for this backfill will exceed the budget estimate by $86 million in the current year and $82 million in the budget year, for a two-year upward revision of $168 million.

The General Fund Condition. Taking into account both our significantly higher revenues and slightly higher expenditures relative to the budget forecast, we estimate that the current year will end with a reserve of $4.4 billion. This is $2 billion more than the budget estimate. In the budget year, the reserve increases further, to $5.3 billion. This is $4.1 billion more than the Governor's $1.2 billion 2000-01 reserve estimate.

What About After the Budget Year?

We forecast that the state's fiscal outlook beyond 2000-01 will remain positive. Specifically, our longer-term projections suggest that revenues will exceed expenditures by about $2.1 billion during the subsequent two fiscal years. This implies that the state could provide an additional $2.1 billion in ongoing commitments without diminishing the reserve over time. Of course, this scenario assumes that the California economy continues to be healthy, and that capital gains do not experience a major fall off.

CONSIDERATIONS FOR THE LEGISLATURE

In light of the significant amount of new resources we project and the overall positive budgetary environment facing the state, we believe there are three key questions the Legislature should focus on during its forthcoming budgetary deliberations:

- First, what is the appropriate size of the reserve?
- Second, what are the Legislature's priorities for using the additional resources?
- Third, what is the appropriate mix to use in allocating these additional resources between one-time versus ongoing commitments?

Reserve Should Be Increased

We believe that some of the additional resources we have identified should be used to increase the budgetary reserve—to at least $2 billion. Such a reserve would protect the state against moderate revenue shortfalls resulting from, for example, a pronounced slowdown in the economy or an unanticipated softening of capital gains. It also would soften the adverse fiscal impacts of a more severe economic and revenue downturn, and "buy time" for effectively dealing with it.

What Are the Other Priorities?

The strengthened fiscal outlook provides the Legislature with a unique opportunity to strategically address a variety of issues and problems beyond the reserve. The key question for the Legislature in this regard is: *Which issues and problems are of the highest priority and greatest importance to address at this time?* We discuss some key areas below:

- ***Education.*** K-12 education is a high priority of both the Governor and Legislature. Added funds would help schools address current problems such as recruiting and retaining quality teachers. To the extent that the Legislature wishes to increase ongoing funding for K-12 education, we believe that the emphasis should be on *general purpose* funds, which would be available for locally determined purposes.

- ***Infrastructure.*** Given the state's documented infrastructure needs in the areas of transportation, water, school facilities, and other areas, we believe that both one-time and ongoing additional funds should be committed for capital outlay purposes. The Legislature could, for example, use some of the state's increased resources to capitalize a state infrastructure fund whose balances would be available to finance projects as they come "on line."

- ***Health Care.*** The Legislature may wish to consider expanding efforts begun last year that address the lack of health care coverage available to California's lower-income uninsured families. Problems also have been identified in the state's mental health and substance abuse treatment systems that the Legislature may wish to address.

- ***Local Fiscal Reform***. As we indicate in Part Five, the current system of local finance lacks accountability. It also has the effect of skewing land-use incentives in favor of retail development at the expense of industrial and residential use. While there are a number of options available to improve the existing system, their implementation will require both one-time and ongoing resources.

- ***Tax Relief***. Under our revenue projections, all of the triggered VLF rate reductions that were enacted in 1998 will automatically occur as scheduled. However, given the state's positive fiscal outlook and depending on its own priorities, the Legislature may wish to provide additional one-time or ongoing tax relief with some of the added resources we have identified.

Balancing One-Time Versus Ongoing Commitments

One of the key questions facing the Legislature is how much of the additional resources we have identified should be committed for one-time versus ongoing purposes. This is a critical issue because one-time commitments only draw down the reserve *once*, whereas ongoing commitments impose a cost *year after year*.

Ongoing Commitments Should Be Limited to $2.1 Billion. In undertaking its budget-related decision making, we believe it is appropriate for the Legislature to view the $2.1 billion in added resources we have identified for the *budget year* as available for *ongoing* commitments. This is because our projections indicate that revenues will be exceeding expenditures by approximately this amount not only in the budget year, but thereafter as well. Thus, ongoing commitments of this magnitude will be able to be paid for each year without drawing down the reserve.

One-Time Commitments. The remainder of the additional resources we have identified—also $2.1 billion—are associated with the *current year*, and thus can be viewed as available for *one-time* purposes.

Matching Commitments With Priorities. Once its priorities are established, the practical challenge facing the Legislature will be to fashion a budget plan which not only meets these priorities, but also reflects an appropriate mix of ongoing versus one-time commitments that will keep the budget balanced. The Legislature has latitude in accomplishing this, as many of the potential priority areas we identified above have both one-time and ongoing elements.

CONCLUSION

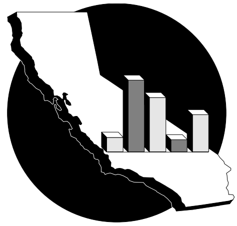
The healthy budget outlook we see provides the Legislature with an opportunity to both strengthen the state's underlying financial condition, and address high priorities in a variety of areas. In doing so, we believe that the Legislature should take advantage of these "good times" to build up the reserve to help protect against an eventual downturn in the economy and revenues. Beyond this, the Legislature is in a position to allocate a substantial amount of additional resources to high-priority areas, whether these involve education, infrastructure, local fiscal reform, health care, tax relief, or other priorities.

In allocating these additional funds, however, it is important that an appropriate balance be struck in terms of ongoing versus one-time commitments. In particular, we believe that increased ongoing commitments from the additional resources we have identified should not exceed $2.1 billion, given our current outlook for the General Fund in the budget year and thereafter.

II

Perspectives on the Economy and Demographics

Perspectives on the
Economy and Demographics



Economic and demographic developments have important effects on California's budget outlook. For example, the strength of California's economy is an important determinant of the level of revenues collected from personal income taxes, sales and use taxes, and corporate income taxes. Similarly, both economic and demographic variables affect state government expenditure programs, including education, health and social services, and youth and adult corrections.

In recent years, California's economic expansion has provided sufficient resources to enable the Governor and Legislature to simultaneously balance the budget, increase budgetary reserves, reduce taxes, and raise expenditures for education and a variety of other state programs. The Governor's budget for 2000-01 assumes that healthy economic growth will continue, albeit at a more moderate pace than in the past several years.

In this part, we review recent economic developments in the nation and state, discuss the Governor's economic forecast, and present our own perspective on California's economic outlook. We also discuss current demographic developments and highlight our population projections through 2002.

1999 IN RETROSPECT

Another Strong Year for The Nation

Once again, the U.S. economy outpaced projections in 1999. Driven by high levels of consumer confidence, strong income growth, and increased wealth, real gross domestic product (GDP) expanded by around

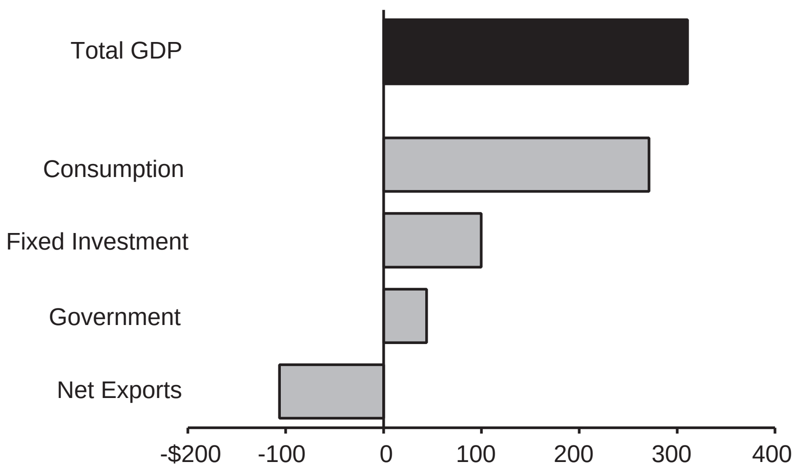
4 percent for the fourth year in a row. The increase was unprecedented for an economy in its ninth year of expansion and operating at near full employment.

Most Sectors Were Strong. As indicated in Figure 1, the majority of the dollar increase in real GDP between 1998 and 1999 was attributable to consumer expenditures. Real consumer spending grew by 5.2 percent, led by particularly rapid increases in purchases of autos and other durable goods. Business fixed investment was the second largest contributor to GDP growth last year, reflecting booming business expenditures on computers and software, and continued increases in nonresidential construction activity. The only "soft spot" in the economy was foreign trade, where strong U.S. demand for imported goods caused the U.S. merchandise trade deficit to increase sharply during the year.

Figure 1

Consumer Spending and Business Investment Led 1999 GDP Growth

Change in Real GDP, 1998 to 1999
Billions of Dollars



Yet Inflation Remained Tame. Inflation remained low nationally in 1999, despite some increases in energy and related commodity prices. The U.S. Consumer Price Index (CPI) rose just 2.1 percent during the year, while the U.S. GDP price deflator (which reflects the costs of *all* goods and services produced in the economy) was up just 1.3 percent.

Although inflation has continued to remain low, the Federal Reserve (FED) has expressed concerns that persistently strong spending growth, coupled with extremely tight labor markets, will eventually lead to price increases. In an attempt to slow growth and ease inflationary pressures, the FED raised interest rates three times last year, and additional increases are expected in 2000. In response to these factors, long-term interest rates rose during 1999—from 5.5 percent at the beginning of the year to over 6.5 percent by December—and have continued to edge up during early 2000.

Data Revisions Reveal Major Productivity Improvement

Late last year, the U.S. Bureau of Economic Analysis released major historical revisions to the nation's gross domestic product accounts. These revisions indicate that the economy has been growing faster than previously thought, largely due to higher estimates of worker productivity gains. For example, based on the new estimates, productivity gains since 1995 have averaged about 2.7 percent annually, compared to the previous estimate of about 2 percent.

The higher productivity estimate is very significant from an economics standpoint. Specifically, it provides evidence that the vast amounts of business investment in computer and information technologies over the past decade have indeed paid dividends, by raising the level of output-per-worker in a variety of industries. The higher productivity figures have caused many economists to reassess long-held assumptions about how fast the U.S. economy can grow on a sustained basis. Prior estimates of the economy's long-term GDP "speed limit" were in the range of 2 percent to 2.5 percent per year. In contrast, the recently experienced added productivity growth, if sustained, implies a noninflationary growth potential of more than *3 percent* annually—a very significant upward reassessment. As discussed below, this positive development is reflected in our economic forecasts for the nation and California.

1999 Was Best Year of the Decade for California

California enjoyed the strongest year of the current expansion in 1999. Although comprehensive GDP data are not available at the state level, evidence of California's strength is widespread (see Figure 2, next page).

It includes healthy employment growth, major increases in income tax withholding receipts (which are a reflection of large wage gains), strong gains in taxable sales, and record levels of home sales.

Figure 2

Recent Evidence of California's Economic Strength

Factor	Performance
Personal income tax withholding receipts	Up by 17 percent during the fourth quarter of 1999 compared to the prior year, signifying major gains in wages and stock-option income.
Employment	Grew by 3.4 percent in 1999, reflecting widespread gains. Unemployment was at the lowest level since 1970.
Taxable sales	Up nearly 9 percent in 1999—by far the strongest increase in the current expansion period.
New vehicle registrations	Up nearly 10 percent, reflecting major increases in sales of cars, sport utility vehicles, and light trucks.
Nonresidential construction	Surged to an over-$20 billion annual rate in November, one of the highest levels on record.
Home sales and prices	Home sales topped 675,000 units, an all-time record. Prices rose throughout the state.

Wealth Effect Boosted Sales and Income

As with the nation, California's economy was boosted by the "wealth effect" associated with the rising stock market. In addition to the general increase in the market, large gains in equity values specific to California's high-tech firms further boosted the wealth of Californians by increasing the values of stock options granted by high-tech firms to their employees. It appears that California's taxpayers "cashed out" a portion of their accumulated capital gains in 1999 to purchase autos, homes, and other "big-ticket" items. This was likely a major factor behind the nearly 9 percent increase in taxable sales that occurred last year.

Overall, we estimate that California personal income increased by 7 percent in 1999—the largest gain of the current economic expansion. Wage and salary employment increased by about 3.4 percent, reflecting particularly large gains in the services and construction industries. The unemployment rate fell from 5.9 percent in December 1998 to 4.9 percent in December 1999, the lowest level in three decades.

Exports Rebounded in Second Half of Year

A year ago, one of the few negative elements in California's economic picture involved exports to foreign countries. Asia's economic problems were resulting in substantial declines in California's exports to the region, and consequently were depressing sales and employment in California's high-tech manufacturing industries (which are major exporters to the area).

As 1999 unfolded, many Asian economies started to rebound, boosting foreign demand for California goods. Reflecting these improved conditions, California exports increased over 10 percent in the third quarter of 1999 compared to a year earlier, as shipments soared to such countries as South Korea, Taiwan, and China. Exports to Japan continued to fall, reflecting near-stagnant economic growth in that country. However, exports fell at a much-diminished rate compared to 1998.

The recovery in exports to Asia bodes well for California's producers of computers and electronics, which are the leading exporters to that region. Employment in these industries stabilized in the second half of 1999, and appears set to expand in 2000.

Problem Areas—Aerospace and Inflation

Two problem areas in an otherwise bright economic picture for California during 1999 were a resumption of job losses in the state's aerospace industry, and a significant increase in inflation.

- ***Aerospace.*** After growing at modest rates in both 1997 and 1998, employment in the aerospace industry fell about 15,000 jobs between December 1998 and December 1999. Most of the decline was among aircraft producers, reflecting cutbacks in planned commercial aircraft production in this state.
- ***Inflation.*** In contrast to the nation, inflation rose significantly in California during 1999. Growth in the California CPI accelerated from slightly over 2 percent in 1998 to just under 3 percent last year. The increase was primarily due to soaring rental housing costs in the San Francisco Bay Area, where the index for residential rent jumped by 7 percent. The spike in gasoline prices last spring also boosted the CPI, particularly in the first half of the year.

Despite these problems, 1999's overall economic performance in California was the best in well over a decade, and the state's economy entered 2000 with considerable upward momentum.

THE BUDGET'S ECONOMIC OUTLOOK IN BRIEF

The Governor's budget forecast assumes that economic growth will continue at a healthy, though moderating, pace through 2001. As shown in Figure 3, real U.S. GDP is forecast to slow significantly—from 3.9 percent in 1999 to 3.1 percent in 2000 and 2.8 percent in 2001. The administration forecasts that inflation will rise modestly in 2000 due to increases in employee compensation costs and commodity prices, before easing in 2001 in response to slower national growth.

Figure 3

Summary of the Budget's Economic Outlook

		Forecast	
	1999	2000	2001
United States Forecast			
Percent change in:			
Real GDP	3.9%	3.1%	2.8%
Personal income	5.2	5.3	5.0
Wage and salary jobs	2.2	1.8	1.6
Consumer Price Index	2.2	2.9	2.5
Unemployment rate (%)	4.2	4.0	4.0
Housing starts (000)	1,670	1,560	1,550
California Forecast			
Percent change in:			
Personal income	6.6%	6.5%	5.7%
Wage and salary jobs	3.3	2.9	2.5
Taxable sales	8.8	5.7	6.0
Consumer Price Index	3.0	3.5	3.3
Unemployment rate (%)	5.3	4.8	4.7
New housing permits (000)	140	154	167

As regards California, the budget forecast assumes that the state will continue to outperform the nation during the next two years. Personal income growth is forecast to slow only marginally—from 6.6 percent in 1999 to 6.5 percent in 2000—before further slowing to 5.7 percent in 2001. The budget forecasts similarly healthy but moderating increases for employment, led by computer-related services and the construction industry.

Finally, the budget anticipates that rising home ownership and rental costs will continue to put upward pressure on inflation in California. It forecasts that the California CPI will increase 3.5 percent in 2000 and by 3.2 percent in 2001.

THE LAO'S ECONOMIC OUTLOOK

Reflecting continued positive developments in both the U.S. and California economies, we estimate that 1999 ended on a stronger note than is reflected by the administration, and similarly that economic growth will continue at a significantly stronger pace through 2000. Our national and state economic forecasts through 2002 are summarized in Figure 4.

Figure 4

Summary of the LAO's Economic Outlook

		Forecast		
	1999	**2000**	**2001**	**2002**
United States Forecast				
Percent change in:				
Real GDP	4.0%	3.6%	3.1%	2.9%
Personal income	5.9	5.4	5.0	4.9
Wage and salary jobs	2.2	1.8	1.5	1.1
Consumer Price Index	2.1	2.5	2.6	2.5
Unemployment rate (%)	4.2	4.0	4.2	4.4
Housing starts (000)	1,668	1,575	1,520	1,500
California Forecast				
Percent change in:				
Personal income	7.0%	6.7%	5.8%	5.7%
Wage and salary jobs	3.4	3.0	2.5	2.2
Taxable sales	8.8	6.1	5.6	5.6
Consumer Price Index	2.9	3.1	2.9	2.9
Unemployment rate (%)	5.2	4.7	4.5	4.6
New housing permits (000)	139	154	164	170

National Forecast

Following its 4 percent increase in 1999, we forecast that U.S. real GDP will increase at a more moderate 3.6 percent in 2000, 3.1 percent in 2001, and 2.9 percent in 2002. The recent increase experienced in interest rates is expected to have *some* dampening effects on consumer and business spending, but their growth will nevertheless continue at a healthy pace. The same forces that boosted growth in 1999 will be present this year, and likely in 2001 and 2002 as well. Consumer spending will continue to grow, reflecting high levels of wealth, consumer confidence, and incomes. Investment spending is also projected to be strong, reflecting continued strong business spending on computers, information systems, and software. Also contributing to growth during the next two-to-three years is an improving outlook for exports, due to the strengthening of economic conditions in Asia and other foreign markets.

Despite continued robust economic growth, however, we expect inflation to remain moderate. The U.S. CPI is forecast to rise 2.5 percent in 2000 and 2.6 percent in 2001, compared to 2.1 percent in 1999. A key positive factor in the inflation outlook continues to be large anticipated productivity gains, which enable businesses to increase wages without raising the prices of their products and services.

California Forecast

We forecast that California is set for another year of strong growth in 2000, before its economy slows to a more moderate, but still healthy pace in 2001 and 2002. As shown in Figure 5, we expect California's economy to outperform the nation by a significant margin over the next two years.

Key Strengths and Concerns Regarding California

Figure 6 indicates that there are both strengths and concerns inherent in our upbeat forecast for California.

The Strengths

California's current positive economic outlook reflects a variety of both *external* factors (such as strong U.S. and worldwide demand) and *internal* forces (such as high confidence levels, rapid growth in business startups, and rising incomes). As shown in Figure 6, two particularly important factors are (1) the large and growing presence of dynamic high-tech industries in this state, and (2) the resulting increases in wealth and income accruing to many of California's households and businesses.

The High-Tech Sector. California has a large and growing presence of computer, telecommunications, electronics, software, and Internet-related firms, all of which are major beneficiaries of the continued strong national investment in new technologies. The state's high-tech manufacturing industries will receive an added boost from the recovery in foreign demand for computers, electronics, and related goods. While the San Francisco Bay Area has been California's high-tech center in the past, growth is spreading to Los Angeles and other regions of the state.

Figure 5

California to Continue Outpacing the Nation

Year-Over-Year Percent Growth in Personal Income
1995 Through 2002

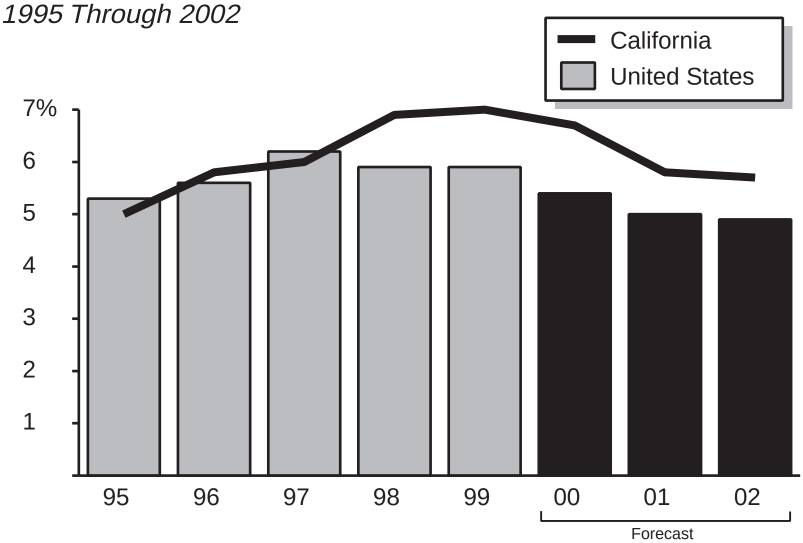


Figure 6

Key Strengths and Concerns In California's Economic Outlook

Strengths

- **Positive outlook for high-tech industries, reflecting:**
  - Continued strong national investment in high-tech goods.
  - Strengthening foreign economies to which California exports.
  - Expansion of new Internet-related technologies and applications.
- **High levels of wealth and consumer confidence**

Concerns

- **Possible major retrenchment or correction in the stock market**
- **Potential housing shortages**

The Wealth and Income Effects. As indicated above, California is the home of a large share of high-tech companies which have experienced dramatic appreciation in stock values in recent years. Absent a substantial drop in stock valuations, the tremendous amount of capital gains already "stored up" in stock options held by the employees, management, and owners of these firms will likely have significant positive impacts on wealth and confidence in California's economy for a number of years to come.

Concerns—Stock Market Uncertainties and Weak Home Construction

The past dramatic increases in stock market values, particularly in the high-tech area, are both a reflection of *past* strong business activity and, as indicated above, a positive force in the *future* economic outlook. However, the added importance of the stock market also carries risk. For example, if the market were to suffer a steep and sustained retrenchment, significant slowdowns in consumer spending and perhaps reduced levels of new business expansions, could be experienced.

A second source of concern and uncertainty, particularly for the longer term, is whether home construction will "keep up" with new demands brought about by economic growth and population increases. Home construction in 1999 was 139,000 units, which is well below the 170,000 to 180,000 annual level that many analysts believe is necessary to accommodate demand. In many areas where economic growth has been strongest—particularly Silicon Valley—there is limited land capacity for new construction. Likewise, in many other areas of the state, new housing development has become a contentious issue, due to concerns about the environmental and societal impacts of additional growth. At some point, shortfalls in new home construction could limit economic expansion in California.

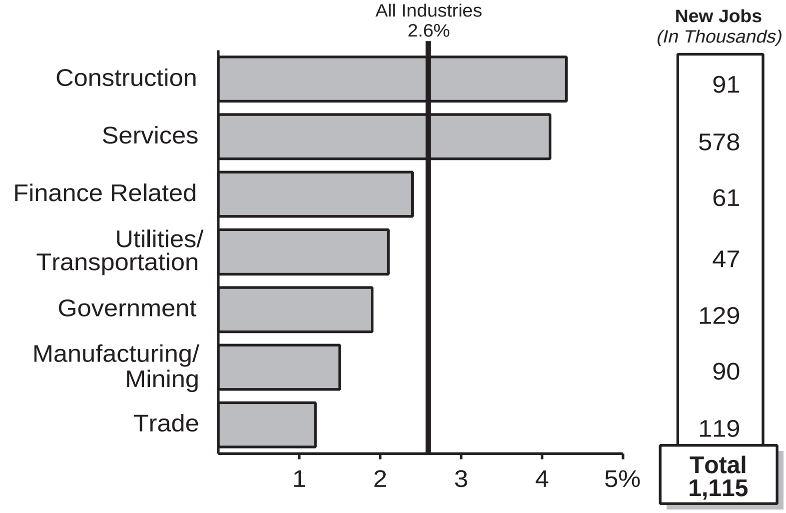
The California Outlook by Industry Sector

As indicated in Figure 7, over the three-year period 2000 through 2002, California wage and salary jobs are projected to increase at an average annual rate of nearly 2.6 percent. In numeric terms, over one-half of the new jobs are expected to be in the state's large and diverse service sector, reflecting gains in business services, hotels, automotive repair, health services, and entertainment. In percentage terms, the fastest-growing sector will continue to be construction, where employment is expected to grow by about 4.3 percent, reflecting continued gains in both residential and nonresidential building activity in the state.

Figure 7

Widespread Job Growth Anticipated

Average Annual Percent Change in California Jobs 2000 Through 2002



More moderate job increases are forecast for a variety of other sectors and industries, including trade, manufacturing, finance, insurance, real estate, and government. In the context of the current outlook, these moderate projected growth rates are not a sign of weakness, but rather reflect tight labor market conditions, and the continued utilization of labor-saving technologies by businesses.

Computer Services Employment Growing Rapidly

As indicated above, the bulk of new jobs created over the next three years is likely to be in the state's large and diverse services sector. We expect job gains throughout this sector. However, the single fastest growing individual industry is likely to be business services, which now includes over 1.2 million employees (almost 8 percent of all California jobs) and has been growing consistently in recent years by more than 8 percent annually.

In past years, business services primarily consisted of such low-wage industries as temporary employment agencies, security services, and building maintenance services. However, in the current expansion, a rapidly growing component has been computer-related services, which includes companies involved in the Internet and related software design, as well as computer systems design.

Jobs in computer-related business services have been increasing at a dramatic pace. We estimate that growth over the past year has exceeded 15 percent, and that total jobs in these industries amount to more than 300,000. The computer services industry is now about twice the size of the state's aerospace industry. As indicated in Figure 8, wages in key subsectors within the computer services industry *averaged* between $80,000 and $100,000 last year, well over twice the economy-wide average. We expect that employment in computer-related services will continue to expand by more 10 percent annually in both 2000 and 2001, making it one of the fastest growing employment categories in the state.

Nonresidential Construction to Lead Building Sector

Both residential and nonresidential construction activity were hit hard by the early-1990s' recession. The number of permits for residential units fell by nearly two-thirds and the value of nonresidential permits declined by over 50 percent between the late 1980s and early-to-mid-1990s. In the second half the decade, however, the performance of the two sectors varied significantly.

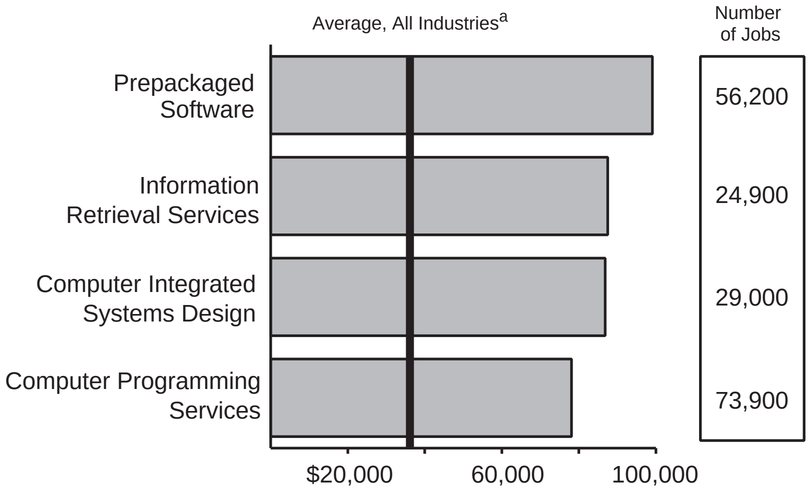
Residential Construction Has Lagged. On the one hand, the recovery in the residential construction sector has been *tepid* by historical standards. Housing permits totaled 139,000 units last year, and we expect the annual number to further increase to 170,000 by 2002. However, even if our forecast is realized, home construction will still be well below the over 220,000 average for the 1980s.

Nonresidential Construction Has Soared. In contrast, nonresidential construction has seen booming performance in recent years, and is now nearing the levels achieved in the mid-1980s (see Figure 9). Over the past five years, for example, the annual value of new industrial buildings has quadrupled while the annual value of commercial buildings has more than doubled. This growth was concentrated in the San Francisco Bay Area during the earlier stages of the recovery, but more recently has spread to Southern California and the Central Valley as well. We expect that the projected ongoing business expansion will result in even further gains in nonresidential construction activity. As shown in Figure 9, we expect that total valuations will surpass the 1980s' peak by the end of our forecast period.

Figure 8

Wages in Computer-Related Services Are Booming

Average Wages in Selected Categories (1998-99)

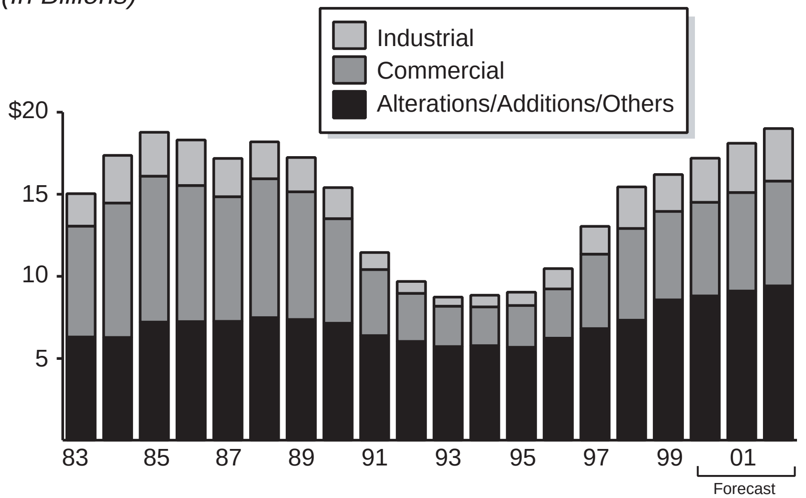


[a]Private sector only.

Figure 9

Nonresidential Construction Climbs Back to 1980s' Level

Value of Permits in Constant 1999 Dollars (In Billions)



Comparisons of Recent Economic Forecasts

Figure 10 compares our forecasts for the nation and California to those we made in November 1999 (see *California's Fiscal Outlook*), as well as those of the University of California, Los Angeles (December 1999), the consensus forecast published in *Blue Chip Economic Indicators* (January 2000), *Western Blue Chip Economic Forecast* (February 2000), and the Governor's budget forecast. Our current forecast for California is generally more optimistic than each of the other projections shown, particularly with regard to personal income.

Key factors behind our more optimistic outlook include (1) the upward revisions to historical GDP and productivity estimates and (2) recent data showing strong withholding, employment, and sales, which suggest that California is entering 2000 with more momentum than previously thought.

As discussed in "Part Three," the combination of our more optimistic near-term economic outlook and recent strong revenue receipts is responsible for our more optimistic revenue forecast compared to both our November report and the Governor's budget forecast.

CALIFORNIA'S DEMOGRAPHIC OUTLOOK

California's demographic trends both directly and indirectly affect the state's economy, revenue collections, and expenditure levels. For example, they influence the size of the labor force, the demand for autos and homes, the volume of taxable sales, and the amount of income taxes paid. Similarly, the population and its age distribution affect school enrollments and public programs in many other areas, such as health care and social services. Given this, the state's demographic outlook is a key element in assessing and projecting the state's budgetary situation.

Population to Surpass 35 Million

Figure 11 (see page 32) summarizes the LAO's updated demographic forecast. We predict that California's total population will rise from an estimated 34.6 million in 2000, to 35.2 million in 2001 and 35.8 million in 2002. This translates into an annual growth rate of somewhat over 1.6 percent—less than the boom years of the late 1980s but still well above the nation's 0.9 percent.

The number of new Californians being added each year—upwards of 600,000—is well-above the size of such cities as Long Beach, Oakland, and Fresno; and similar to a state like Vermont. About half of this yearly

Figure 10

Recent Economic Forecast Comparisons[a]

(Percent Changes)

		Forecast	
	1999	**2000**	**2001**
United States Real GDP:			
LAO November	3.9%	2.8%	2.6%
UCLA December	3.8	3.2	2.8
DOF January	3.9	3.1	2.8
Blue Chip "Consensus"[b] January	3.9	3.6	3.0
LAO February	4.0	3.6	3.1
California Wage and Salary Jobs:			
LAO November	3.5%	3.1%	2.5%
UCLA December	2.8	2.7	2.4
DOF January	3.3	2.9	2.5
Western Blue Chip "Consensus"[c] Febuary	2.9	2.7	2.4
LAO February	3.4	3.0	2.5
California Personal Income:			
LAO November	6.7%	6.1%	5.5%
UCLA December	6.4	6.1	5.7
DOF January	6.6	6.5	5.7
Western Blue Chip "Consensus"[c] Febuary	6.7	6.2	5.8
LAO February	7.0	6.7	5.8
California Taxable Sales:			
LAO November	8.1%	5.5%	5.2%
UCLA December	8.9	5.8	5.7
DOF January	8.8	5.7	6.0
Western Blue Chip "Consensus"[c] Febuary	7.0	5.9	5.4
LAO February	8.8	6.1	5.6

a Acronyms used apply to Legislative Analyst's Office (LAO); University of California, Los Angeles (UCLA); and Department of Finance (DOF).
b Average forecast of about 50 national firms surveyed in January by *Blue Chip Economic Indicators*.
c Average forecast of organizations surveyed in February by *Western Blue Chip Economic Forecasts*.

growth is attributable to net in-migration from other nations and states, while the remainder is due to "natural" increase (that is, births minus deaths). Regarding the net in-migration component, the foreign share is by far the most significant—well over 200,000 annually.

Figure 11

Summary of the LAO's California Demographic Forecast

2000 Through 2002 (Populations in Thousands)

	2000	2001	2002
Total population (July 1 basis)	34,629	35,198	35,765
Changes in population			
Natural change (birth minus deaths)	281	280	282
Net in-migration (in-flows minus out-flows)	282	289	285
Total changes	**563**	**569**	**567**
Percent changes	1.65%	1.64%	1.61%

Growth By Age Group to Vary

The implications of demographic trends for the budget depend not only on the total number of Californians, but also on their characteristics. California is well-known for having one of the world's most dynamic and diverse populations in the world, including an increasingly rich ethnic mix; a large number of in-migrants; and a wide geographic dispersion encompassing both highly urban, suburban, and rural lifestyles. The state's current age and ethnic mix is shown in Figure 12.

Regarding ethnicity, we project a continuing trend toward increased diversity, as the white share drifts down and that for Hispanics and a variety of other ethnic groups drifts up. The age-related characteristics of California's population growth are especially important from a budgetary perspective, given their implications for such program areas as education, health care, and social services. Figure 13 shows our forecasts for both the percentage and numeric changes in different population age groups. It indicates that by far the greatest growth is expected for the 45 to 64 age group (the so-called "baby boomers"). It also shows that the under 5 age group is expected to decline over the period, presaging a further slowdown in K-12 enrollment growth in coming years.

Figure 12

The Age and Ethnic Mix of Californians

July 1, 2000

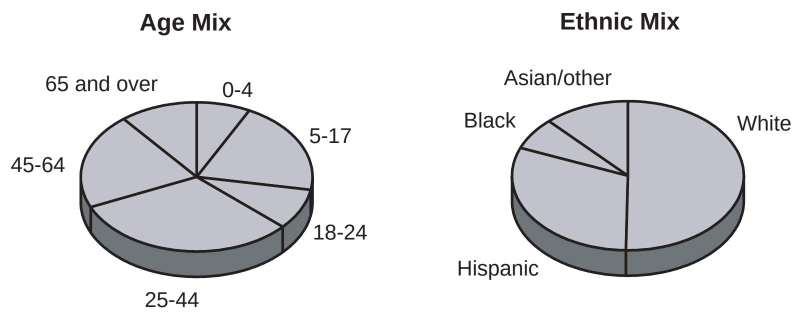
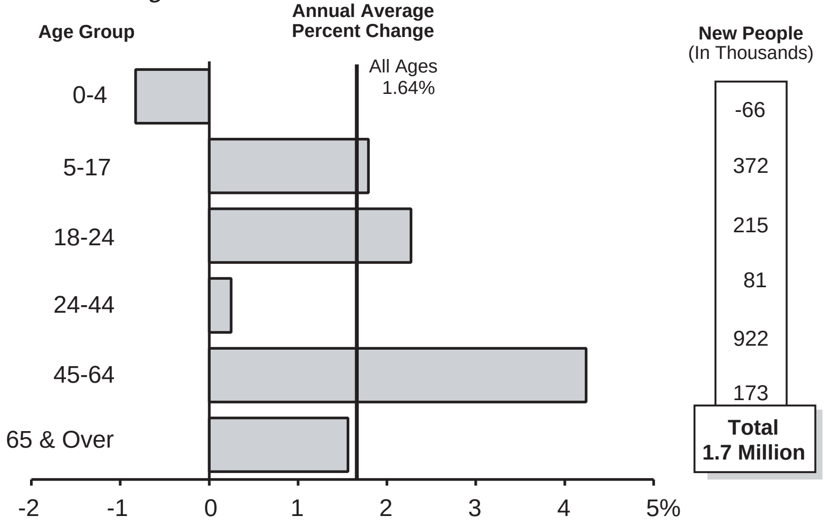


Figure 13

California's Population Growth By Age Group

Population Change 2000 Through 2002



Overall Budgetary Implications

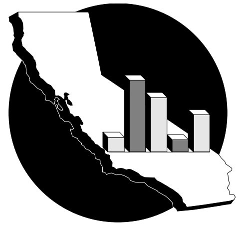
California's continued strong population growth—including its age, ethnic, and migratory characteristics—can be expected to have many implications for the state's economy and public services in the budget year and beyond. For instance:

- Economic growth will benefit from an expanded labor force and growing consumer sector; however, additional strains will at the same time be placed on the state's physical and environmental infrastructure.
- Growth in the young-adult population will place greater demands on higher education, job training programs, and possibly the criminal justice and correctional systems.
- The increasing ethnic diversity of the state's population will mean that many public institutions, especially schools, will have to serve a population that speaks a multitude of languages, and that has a wide range of cultural backgrounds.

III

Perspectives on State Revenues

Perspectives on State Revenues



As discussed in "Part One," we are forecasting that General Fund revenues will substantially exceed the Governor's budget forecast—by $4.2 billion for the current and budget years combined. This dramatic upward adjustment is a continuation of what the state has been experiencing for several years now—revenue performance that has repeatedly far surpassed initial expectations, which themselves have been positive from the start.

This part is divided into two basic sections. First, we provide a perspective on the state's recent revenue performance, including the roles of the economic expansion, capital gains, and other factors. Having this perspective is important for understanding our revenue forecast and the logic behind the specific assumptions underlying it. We then discuss our forecast itself, including how it compares to the budget forecast and the outlook for specific individual taxes.

A Perspective on California's Extraordinary Recent Revenue Performance

After lagging in the first half of the 1990s, General Fund revenues have soared during the second half of the decade. Since 1994-95, total annual receipts have climbed from $42 billion to over $67 billion this year. This $25 billion increase has occurred despite significant tax relief enacted during the period. After adjusting for law changes, underlying revenues have grown by more than 10 percent annually. While there have been times when the state has experienced larger percentage increases in past decades, these have generally been during high-inflation periods.

In contrast, the later 1990s' gains occurred in an environment where inflation was very low—only around 2 percent yearly. In addition, although the state's economic performance has been very good, revenue growth has outdistanced even what this strong economic growth would suggest.

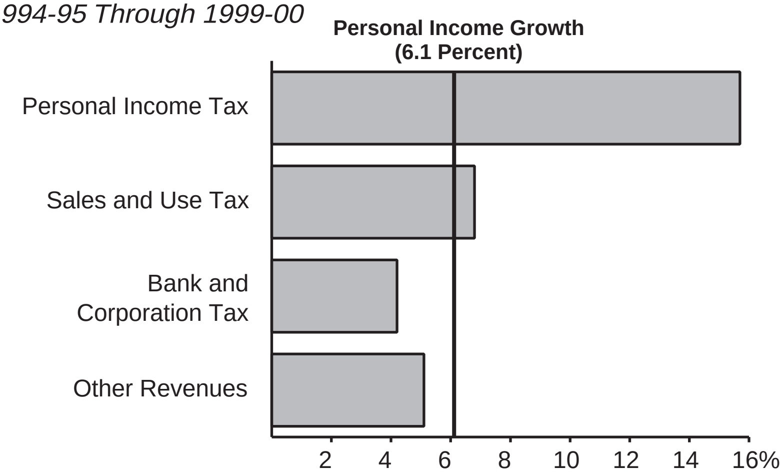
Main Source of Strength—Personal Income Taxes

Almost three-fourths of the overall growth in General Fund receipts in this expansion has been from the personal income tax (PIT), which has grown from $18.6 billion in 1994-95 to $36.3 billion in 1999-00. Figure 1 compares the percentage growth in PIT receipts (adjusted for law changes) to that of the state's other two main taxes (the sales and use tax [SUT] and the bank and corporation tax [BCT]), as well as to statewide personal income. It shows that PIT receipts have increased at an average annual rate of about 15 percent per year, more than *double* the pace of statewide personal income during this period.

Figure 1

The Relative Performance of Different General Fund Revenue Sources

Average Annual Revenue Growth[a]
1994-95 Through 1999-00



[a] Excludes transfers and the effects of revenue-related legislation enacted in the 1990s.

The figure also shows that growth in the state's other major taxes has been relatively moderate. Despite a large increase in taxable sales last year, SUT receipts during the past five years have averaged 6.8 percent, or only slightly more than personal income growth. Growth in the BCT has been even more subdued—just 4 percent annually.

Factors Behind Rapid PIT Growth

The rapid growth in PIT receipts can be attributed to two main factors—aggregate growth in employment and income, and a dramatic shift in the state's income distribution toward the "high" end.

Aggregate Growth in Employment and Income. California's PIT receipts have always been "elastic" with respect to growth in "real" (or inflation-adjusted) personal income. This is a reflection of California's progressive tax bracket structure, where increases in incomes beyond inflation are subject to higher marginal tax rates. We estimate that about 60 percent of the PIT growth in the current expansion (that is, about 9 percentage points of the 15 percent average annual increase in PIT liabilities) can be explained by the "normal" relationship that links personal income growth to PIT liabilities, given the tax-bracket structure and the way in which taxpayers are distributed throughout it.

Dramatic Earnings Growth at Top End of Distribution. The remaining 40 percent of the PIT increase during the past five years is due to the unusually strong growth in incomes (including capital gains) reported by taxpayers at the top end of the income distribution. Between 1994 and 1999, we estimate that adjusted gross income of the top one-fifth of taxpayers increased roughly *twice as fast* as that of the bottom four-fifths of returns. This rapid increase had a dramatic impact on tax liabilities, since under California's progressive tax rate structure, earnings at the high end of the distribution are subject to higher tax rates than are earnings at the lower end and middle of the distribution (see Figure 2, next page).

Why Are Incomes at the Top End Soaring?

Several factors appear to be responsible for this development. One is the increasing returns to education and skill levels in the economy, which is resulting in sharply higher wages for workers in a variety of management, professional, and technical fields. In California, the rapid growth in high-paying computer services industries (discussed in "Part Two" of this volume) also is boosting wages at the high end of the distribution.

However, the main factor sending high incomes soaring in recent years has been the extraordinary increase in the stock market, which has led to major increases in capital gains and stock option-related income. Figure 3 (see next page) shows that capital gains realized on California tax returns have quadrupled in the past five years, from under $20 billion in 1994 to nearly $80 billion last year. This increase has translated into about $5.5 billion, or over 30 percent of the total increase in PIT receipts. And

Figure 2

California's PIT Is Highly Progressive

Average Tax Rate for Joint Returns, By Income Level

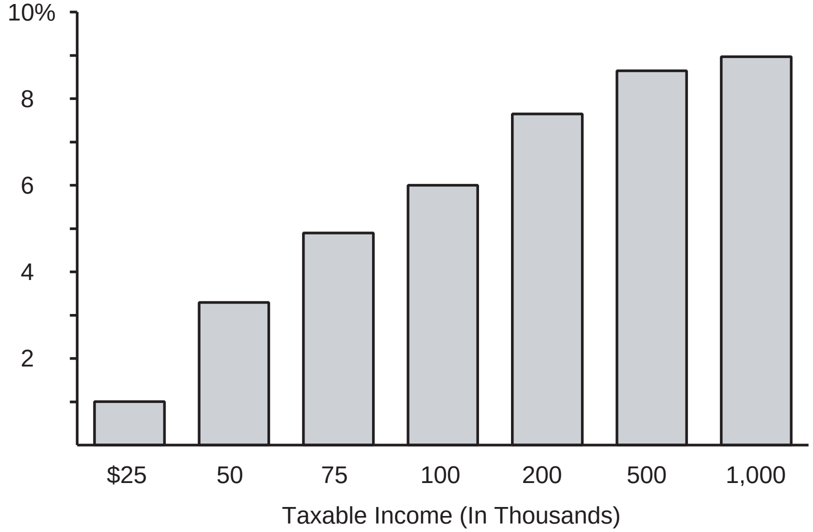
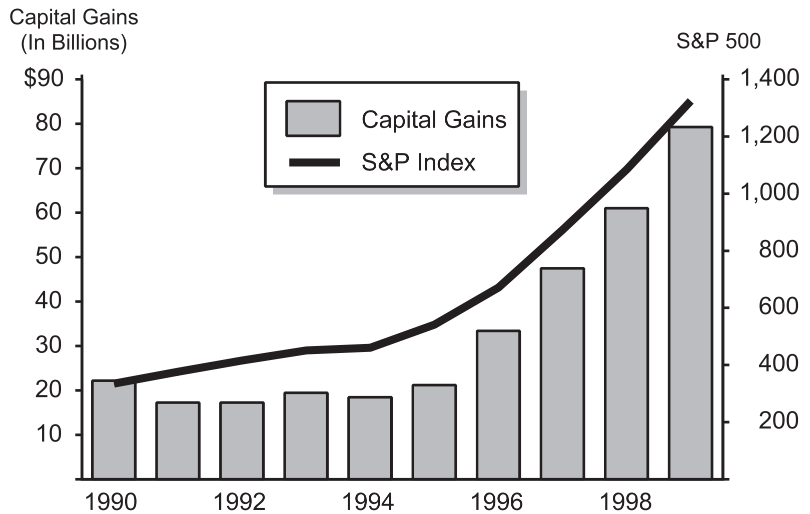


Figure 3

Stock Market-Related Capital Gains Have Soared

California Capital Gains and the S&P 500 Index
1990 Through 1999



even this is an understatement of the stock market's role. This is because the totals in Figure 3 do not include stock option income. Although comprehensive direct information on stock option income is not available, indirect information from withholding receipts and certain industry data suggest that stock option income has also risen sharply, perhaps contributing an additional $2 billion in new revenues during the past five years.

Overall, we estimate that capital gains now account for as much as 20 percent of total PIT receipts, and that stock options income accounts for an additional 5 percent to 10 percent.

What Do We Know About the Characteristics of These Capital Gains?

Given the role that capital gains and stock option income have been playing in the state's revenue picture, it is important to consider what we do and do not know about them. This is especially so since the assumptions we make about capital gains in 2000 and beyond are critical to our revenue forecast.

Capital Gains Are Primarily Related to Stocks. In 1997 (the most recent year for which detailed capital gains information is available), over 75 percent of California's net capital gains realizations were related to stocks, with the balance related to sales of real estate and other tangible assets. The large share due to stocks partly reflects the tremendous appreciation in stock market valuations in recent years. It also reflects the fact that most capital gains associated with sales of personal residences are excluded from taxation, due to the $500,000 exclusion provided under both the federal and state PIT for such sales.

Gains Reflect a Mix of Short-Term and Long-Term Investments. In 1997, net capital gains realizations related to stocks were associated with a mix of both short-term and long-term investing activity. Data on capital gains by holding period indicate that a majority of *transactions* in 1997—about two-thirds of the total—were related to stocks held for less than one year. However, these transactions accounted for less than 20 percent of the *dollar amount* of net capital gains realizations. In contrast, stocks held for more than one year accounted for only one-third of the transactions, but 80 percent of the dollar gains realized during the year. This is because sales of long-term holdings generally produce much larger gains, given the greater time over which the gains have built up.

Only Small Portion of Gains Are Realized Each Year. There is no direct information on the amount of unrealized capital gains held by households in California. However, national Federal Reserve Bank data on U.S. households' assets and liabilities suggests that total capital gains realized on federal tax returns in 1997 accounted for less than 15 percent of the annual appreciation of assets owned by households. Even after accounting for holdings attributable to pension funds, 401 (k) plans, Individual Retirement Accounts, and other tax-deferred investments, the portion of potentially taxable gains which were actually realized appears to be less than one-third. This implies that there is a very large amount of unrealized capital gains that have been "stored up" by households over time.

Substantial Gains Also Are Embedded in Unexercised Stock Options. A comparatively larger share of the stock options annually granted by companies to their employees is exercised each year. Nevertheless, our review of 10-K reports filed by companies with the Securities and Exchange Commission indicates that there is still a large amount of stock options that have yet to be exercised. This is especially the case for many of California's high-tech firms, where the average "exercise" price on outstanding options is often merely a fraction of the stock's current market price.

Implications for the Revenue Outlook—Greater Unpredictability

The state has benefitted enormously in recent years from the boom in the stock market and its associated positive effect on both capital gains realizations and stock option income. These factors have directly raised PIT liabilities, and have indirectly boosted sales and other taxes through their impacts on wealth and confidence in the state's economy.

It is also the case, however, that the rise in stock market values has made the state's revenue stream much less predictable from year to year than in the past. This is because capital gains are inherently far more volatile than, for example, wages or taxable sales. Although capital gains account for only 20 percent of PIT receipts and about 10 percent of total General Fund revenues, their greater volatility can produce as large, if not larger, a revenue drop-off than other taxes typically experience during times of economic slowdown or recession. For example, capital gains historically have fallen by as much as 50 percent in one year, which would translate into a potential reduction of as much as 10 percent in PIT revenues and 5 percent in total revenues. A decline of this magnitude would amount to about $3.5 billion. By comparison, it would take an over 15 percent decrease in SUT receipts to produce the same dollar impact—a far larger drop-off than occurred in the severe recession of the early 1990s.

Conclusion

Most of the strong growth in General Fund revenues during the past five years is a reflection of the state's healthy economic expansion, and in particular, the rapid growth in its high-wage, high-value-added computer and software industries. The state has also benefitted enormously from the unprecedented increase in the stock market, which has led to a four-fold increase in capital gains and similar increases in stock option income. While the substantial amount of stored-up gains is clearly a positive factor in the state's fiscal outlook, it is also true that their increased importance makes California's revenue structure more volatile and less predictable than in the past. In addition, it means that the assumptions one makes regarding capital gains realizations are more important than ever in constructing a reliable forecast for General Fund revenues.

With this in mind, we now present our revenue forecast and compare it to the Governor's.

THE BUDGET'S FORECAST FOR STATE REVENUES

The Governor's budget projects California state government will receive an estimated $84 billion in total own-source revenues in 2000-01, a 4.7 percent increase from the current year. These revenues are deposited into either the General Fund or a variety of special funds.

Figure 4 (see next page) shows that about four-fifths of total state revenues goes into the General Fund and the remaining one-fifth is received by special funds. General Fund revenues are allocated each year through the budget process and support a variety of state programs, including K-12 and higher education, health and social services, and criminal justice. In contrast, revenues received by special funds are primarily earmarked for specific purposes, such as transportation, local governments, or targeted health programs. Some revenues, such as sales and tobacco taxes, are allocated among both the General Fund and special funds.

Figure 5 (see next page) summarizes the budget's General Fund revenue forecast for 1999-00 and 2000-01. It shows that revenues and transfers are projected to total $65.2 billion in the current year, an 11.2 percent increase from 1998-99. In 2000-01, revenues and transfers are forecast to increase by 4.7 percent compared to 1999-00, reaching $68.2 billion.

Compared to the revenue forecast in effect at the time the 1999-00 budget was enacted last summer, the new budget forecast for 1998-99 and 1999-00 combined is up by $2.9 billion.

1999-00 Forecast

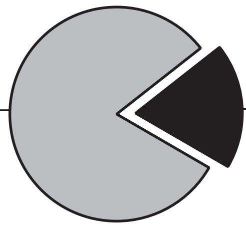
The administration's forecast for the current year reflects the positive economic outlook and strong revenue trends evident during the early months of 1999-00. The 11.2 percent increase reflects healthy gains from

Figure 4

State Revenues in 2000-01

(In Billions)

Total State Revenues $84.2 Billion



General Fund Revenues	
Personal Income Tax	$36.3
Sales and Use Tax	21.4
Bank and Corporation Tax	6.2
All Other[b]	4.3
Total	**$68.2**

Special Funds Revenues	
Motor Vehicle-Related Taxes	$8.4
Sales and Use Tax[a]	2.4
Tobacco-Related Taxes	1.2
All Other[b]	4.0
Total	**$16.0**

a Includes $2.1 billion to Local Revenue Fund and $0.2 billion for transportation-related purposes. Excludes $2.1 billion allocated to Local Public Safety Fund, which is not included in the Governor's budget totals.

b Includes transfers and loans.

Figure 5

Summary of the Budget's General Fund Revenue Forecast

1998-99 Through 2000-01
(Dollars in Millions)

		1999-00		2000-01	
Revenue Source	**Actual 1998-99**	**Amount**	**Percent Change**	**Amount**	**Percent Change**
Personal Income Tax	$30,891	$34,461	11.6%	$36,319	5.4%
Sales and Use Tax	18,957	20,236	6.7	21,396	5.7
Bank and Corporation Tax	5,724	6,092	6.4	6,236	2.4
Insurance Tax	1,254	1,277	1.8	1,304	2.1
Other taxes	1,373	1,381	0.6	1,423	3.0
Other revenues[a]	736	1,372	86.4	1,573	14.7
Transfers	-319	341	—	-14	—
Totals	**$58,615**	**$65,160**	**11.2%**	**$68,237**	**4.7%**

a Includes tobacco settlement receipts of $517 million in 1999-00 and $388 million in 2000-01, plus $191 million from one-time asset sales in 2000-01. In addition, reflects reclassification of child support reimbursements ($96 million in 1999-00 and $282 million in 2000-01) as revenues.

each of the major tax sources—particularly the PIT. It also reflects $517 million in added revenues from the tobacco settlement and a net increase in transfers from special funds to the General Fund. Absent these special factors, the underlying General Fund revenue growth rate in the current year would be about 9 percent.

2000-01 Forecast

The budget forecasts that revenues will increase to $68.2 billion in 2000-01, reflecting a comparatively modest growth rate of 4.7 percent. This modest increase is partly due to special factors and anomalies—including a decline in receipts of tobacco settlement funds to $388 million, a decline in net transfers, and the impacts of recently enacted and proposed legislation. After taking these factors into account, the underlying budget-year General Fund growth rate is slightly stronger, 5.1 percent.

The budget's prediction of a slowdown in underlying revenue growth compared to the current year reflects more moderate increases for all of the major tax sources—especially PIT. This source is projected to grow by under 6 percent next year, or about one-half the current-year's pace. The PIT slowdown primarily is due to the administration's assumption about capital gains. Specifically, the administration assumes that capital gains increased by 22 percent in 1999, but will *fall* by 5 percent in 2000.

Tax Relief Measures

The revenue forecasts by both the administration and our office (see below) incorporate the impacts of recently enacted and proposed tax relief legislation.

1999 Enacted Tax Legislation. Last year, the main tax relief legislation that was enacted involved:

- A one-year 10 percent reduction in the vehicle license fee (VLF) beginning in January 2000. The fiscal effect of this measure is reflected as a reduction in special fund VLF revenues, and an offsetting increase in General Fund expenditures (which serve to backfill local revenue losses).
- An increase in the percentage of health insurance premiums that may be deducted by self-employed individuals, up to the federal amounts. This raises the deductible percentage from 40 percent in 1999 up to 100 percent by 2003.
- The elimination of the $800 minimum corporate franchise tax for small corporations (those with less than $1 million of gross receipts) during their first two years of operation.

- An increase in the credit for certain research and development expenses, from 11 percent to 12 percent.
- The elimination of the sunset provision for the partial income tax exclusion for capital gains on small business stock held for more than five years.

2000 Proposed Tax Changes. The Governor is proposing about $167 million in new tax benefits in the budget year. As indicated in Figure 6, the main provisions are (1) a one-time credit for land donations for conservation purposes; (2) a $500 PIT credit for taxpayers who care for elderly or disabled persons in their homes; (3) a state sales tax exemption for qualified investment in rural areas; and (4) a phased-in increase in the net operating loss (NOL) carryover deduction, from 50 percent to 60 percent.

Figure 6

The Governor's 2000-01 Tax Proposals

(Revenue Effect in Millions)

Provision	2000-01	Initial Five Years
Long-term care tax credit	$47	$234
Net operating loss carryover deduction	1	137
Tax credit for land donations	100	100
Exclusion for employer-paid graduate school expenses	10	50
Increased alternative research and development tax credit	4	42
Rural investment tax exemption	5	25
Low-income housing tax credit	—	22
Biomass tax credit	—	20
Aerospace employment tax credit	Minor	Minor
Total reductions	**$167**	**$610**

THE LAO'S GENERAL FUND REVENUE OUTLOOK

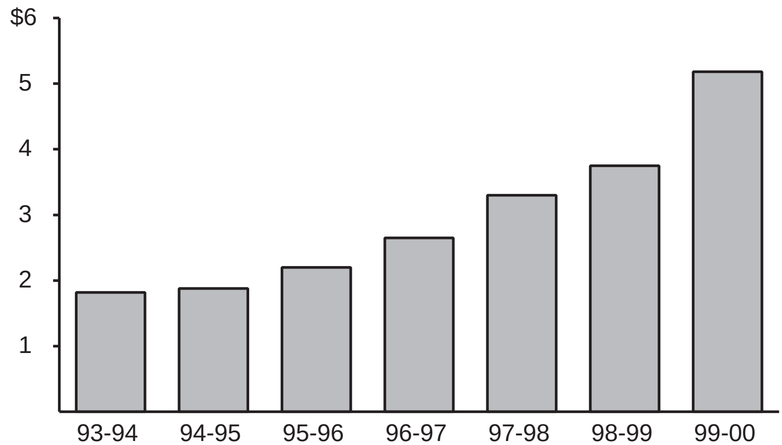
Year-End Developments Necessitate Large Upward Revenue Revision. Economic and revenue developments since the budget was published have been extremely positive. Both the national and state economies ended 1999 on a very strong note, and key revenue receipts have been much more robust than anticipated in the budget. The latter fact is particularly significant because year-end receipts constitute the "spring board" from which the revenue estimates for the remainder of 1999-00 and 2000-01 take off.

Of particular significance is the remarkable increase in year-end PIT estimated payments. These payments were up by 35 percent compared to last year (see Figure 7). This is a much larger increase than the 17 percent increase anticipated in the budget, and is one of the largest year-to-year increases in recent history. These payments are significant since they are attributable to high-income taxpayers with large amounts of capital gains and other forms of volatile nonwage income. In the past, these year-end payments have been a reliable bellwether of the strength in final payments remitted in the following April. If past trends hold, we would expect final payments in April 2000 to once again exceed the budget forecast, by a potentially substantial margin.

Figure 7

Booming Year-End Income Tax Receipts Indicate Another Strong Year

December and January Estimated Tax Payments (In Billions)



As discussed below, the positive year-end cash receipts and economic developments imply that revenues in both the current and budget years will exceed the administration's forecast by a large margin.

Revenues Up $4.2 Billion Over the Budget

Figure 8 (see next page) presents our General Fund revenue outlook for 1999-00 and 2000-01. In addition, to help the Legislature in its fiscal planning, we also provide our fiscal projections for an additional year—2001-02.

Our projections are based on our economic forecast presented in "Part Two," reflect the Governor's proposed tax reductions, and take into account revenue developments through January 2000. For the current and budget years combined, our revenues are up from the budget forecast by $4.2 billion.

Figure 8

Summary of the LAO's General Fund Revenue Forecast

1999-00 Through 2001-02 (Dollars in Millions)

	1999-00		2000-01		2001-02	
Revenue Source	**Amount**	**Percent Change**	**Amount**	**Percent Change**	**Amount**	**Percent Change**
Personal income tax	$36,300	17.5%	$38,350	5.6%	$40,670	6.0%
Sales and use tax	20,340	7.3	21,480	5.6	22,680	5.6
Bank and corporation tax	6,120	6.9	6,280	2.6	6,530	4.0
Insurance tax	1,280	2.1	1,310	2.3	1,369	4.5
Other taxes	1,472	15.7	1,417	-3.7	1,477	4.2
Other revenues	1,378	-0.4	1,561	13.3	1,462	-6.3
Transfers	341	-6.8	-14	—	100	—
Totals	**$67,231**	**14.7%**	**$70,384**	**4.7%**	**$74,288**	**5.5%**

1999-00 Revenues. We forecast that General Fund revenues will total $67.2 billion in the current year, an increase of $8.6 billion (14.7 percent) from 1998-99. This estimate is $2.1 billion above the budget forecast, mostly reflecting our higher estimate for PIT receipts. As shown in Figure 8, the main source of growth in the current year involves income taxes. The SUT and BCT are expected to grow at more moderate, but still healthy, rates.

2000-01 Revenues. We forecast that revenues will total $70.4 billion in 2000-01, an increase of $3.2 billion (4.7 percent) from the current year. This estimate also is up $2.1 billion from the budget forecast, primarily reflecting the ongoing effects of the current higher underlying trend in economic and revenue activity.

2001-02 Revenues. We forecast that revenues will total $74.3 billion in 2001-02, an increase of $3.9 billion (5.5 percent) from 2000-01. This projected growth rate is consistent with the moderate expansion in economic activity we are projecting for California through 2002.

THE LAO'S FORECAST FOR MAJOR REVENUE SOURCES

The state's three major taxes—the PIT, SUT, and BCT—account for over 93 percent of General Fund revenues in 1999-00. Thus, the performance of these taxes dominates the overall revenue outlook. In the following sections, we discuss in more detail recent developments and the outlook for each tax.

Personal Income Tax

Background

The PIT is now the state's largest single revenue source, surpassing collections from the combined state and local SUT this year. With regard to General Fund revenues, it is easily the largest individual source, accounting for 54 percent of total receipts in the current year. In general, the PIT is patterned after federal law with respect to reportable types of income, deductions, exemptions, exclusions, and credits. Taxable income is subject to marginal rates ranging from 1 percent to 9.3 percent, with the top rate applying to incomes in excess of $70,000 for joint returns and $35,000 for single filers in 2000.

Sources of PIT Liabilities As shown in Figure 9 (see next page), as of 1997 (the most recent year for which detailed data are available) almost 60 percent of total state PIT liabilities were attributable to wages and salaries. Capital gains and business income accounted for slightly less than 15 percent each, with interest, dividends, and other sources accounting for the remaining 10 percent. The continued dramatic growth in capital gains has likely boosted its share to nearly 20 percent as of 1999.

Liabilities Continue to Soar

PIT liabilities have been growing at an extraordinary pace in recent years. As shown in Figure 10 (see next page), liability growth has averaged 15 percent during the 1996 through 1998 period, and based on cash receipts, appears to have increased by approximately 20 percent in 1999. These increases are more than double the growth in the statewide economy, as measured by personal income growth.

Part of the PIT liability growth is due to the normal interaction of economic growth and California's progressive PIT tax-bracket structure. However, as noted in the first section of this part, liabilities also are being boosted by extremely rapid growth in the earnings of taxpayers concentrated in the upper end of the income distribution. These rapid high-end increases, which are subject to the state's top marginal PIT rate of 9.3 percent, primarily stem from dramatic growth in capital gains, stock options, and other sources of volatile income which are becoming an increasingly important part of California's economy.

Figure 9

Personal Income Tax Liabilities By Income Source

2000 Income Year

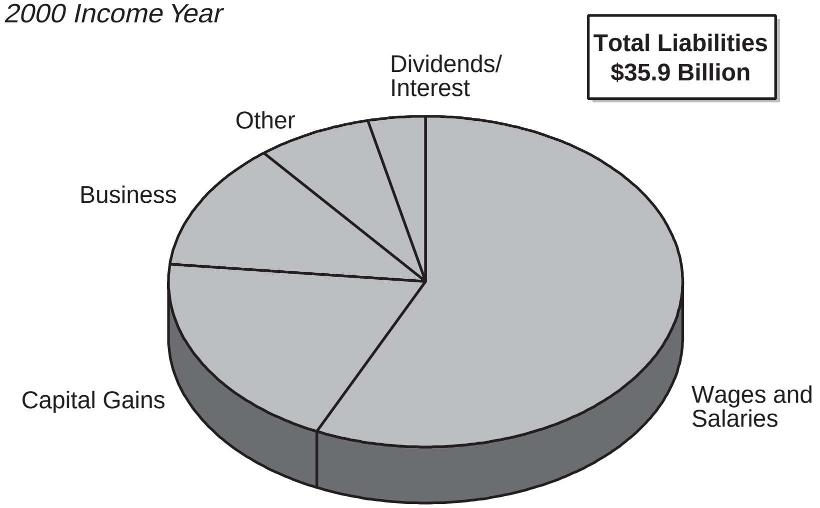
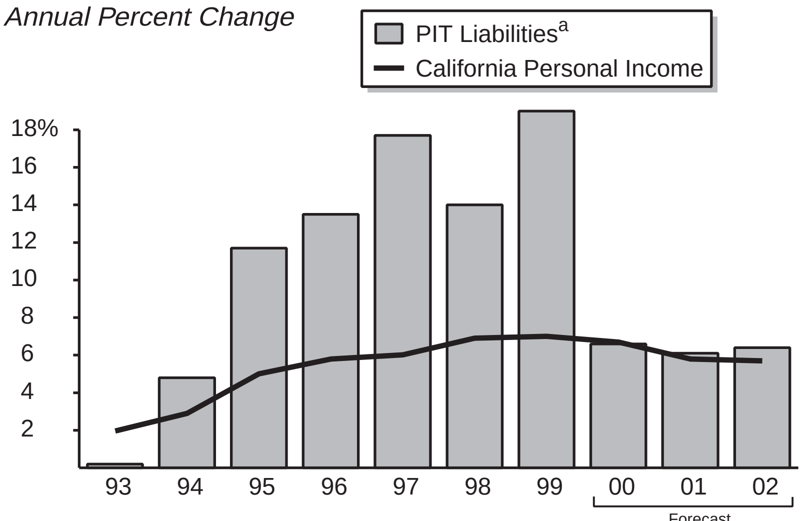


Figure 10

After Extraordinary Growth Period, PIT Liabilities to Moderate

Annual Percent Change



[a] Excludes impact of post-1996 law changes.

Moderate Outlook for PIT Liabilities

Our PIT forecast assumes that after another very strong year in 1999, tax liabilities will grow at more moderate rates in the subsequent three years. Specifically, we estimate that liabilities will grow by 6.6 percent in 2000, 6.1 percent in 2001, and 6.4 percent in 2002.

Most of the individual PIT income components are expected to grow at a healthy clip in 2000, before moderating some in 2001 and 2002. With regard to capital gains, we assume that after jumping by over 30 percent in 1999, realizations will stabilize at their all-time high level of $80 billion in both 2000 and 2001, before growing 5 percent in 2002. Underlying this forecast is the assumption that the stock market will remain relatively flat during the next two years.

The PIT Revenue Forecast

Based primarily on our forecast for PIT liabilities, we estimate that PIT revenues will be $36.3 billion in 1999-00, up $5.5 billion (17.5 percent) from the prior year. We forecast that PIT collections will increase to $38.4 billion in 2000-01 (a 5.6 percent increase), and to $40.7 billion in 2001-02 (a 6 percent rise). Our estimates for the current and budget years are up from the administration's forecast by $1.8 billion and $2 billion,

What Might Happen If the Stock Market Significantly Declined?

Given the increased importance of capital gains and stock options, as well as ongoing concerns about current stock market values, a natural question to ask is: *What would be the potential revenue effects of a major stock market sell-off?*

If the market were to suffer a deep and sustained decline, capital gains would clearly fall over the *longer term*. However, in the *near term*, the impact of a market retrenchment is much more difficult to predict. On the one hand, the capital gains income of short-term investors would fall, and capital losses (which can be used to offset gains for tax purposes) would rise. However, given the huge amount of "stored up" gains currently held by households, there also could be substantial *increases* in realizations stemming from the behavior of long-term investors. This would occur if a market decline induced them to sell stocks in order to "lock in" their remaining gains, or to shift their assets to other investments. There could also be a near-term surge in stock option income if declining markets prompted employees to cash in their options earlier than otherwise.

respectively, reflecting the recent strength of cash receipts and our more optimistic assessment regarding the near-term outlook for the economy.

Sales and Use Tax

Background

The SUT is the General Fund's second largest revenue source, accounting for about 30 percent of total collections in 1999-00. The term sales and use tax actually refers to *two* separate levies:

- ***Sales Tax.*** The main levy—the sales tax—is imposed on the sale of tangible personal property in California. It applies to 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 (such as computers and other machinery). Services are generally exempt from the sales tax, as are goods purchased for resale. The law also provides for certain exemptions from the sales tax, the largest of which is for food.

- ***Use Tax.*** The use tax is imposed on products purchased from out-of-state sources by California residents for use in the state. This includes purchases from out-of-state mail order and Internet firms. However, the state is prohibited by the federal government from requiring out-of-state firms to collect the use tax for California. Aside from use taxes imposed on vehicles, which are collected when out-of-state vehicles are registered in California, only a small amount of use taxes is collected from individuals each year.

SUT Tax Rates in California Vary

As indicated in Figure 11, the SUT rates paid in California are actually the combination of several individual tax rates levied by the state and individual local governments. These rates can be divided into three general categories:

- ***State Tax Rates.*** These include a 5 percent General Fund rate, plus two one-half cent special funds rates. These latter rates consist of: (1) a 0.5 percent tax to the Local Revenue Fund, which was enacted in 1991 to support increased local responsibilities for certain health care costs associated with state-local realignment of program responsibilities; and (2) a 0.5 percent tax to the Local Public Safety Fund—created by voter approval of Proposition 172 in 1993—which provides funds for local criminal justice administration.

Figure 11

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%**

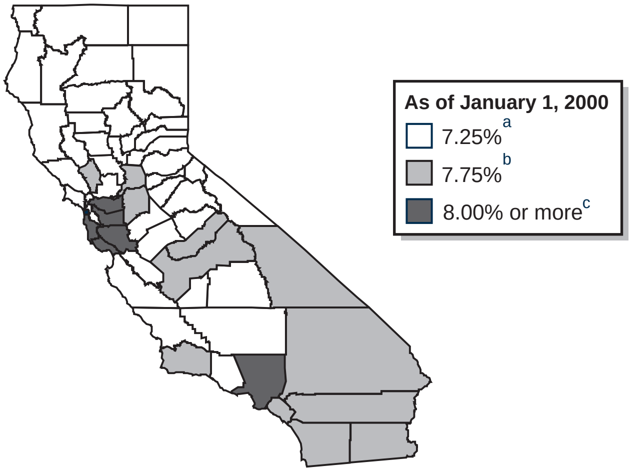
a These revenues are not shown in the Governor's budget totals.
b Levied in all counties.
c Maximum allowable rate, except maximum rate is 1.75 percent in San Francisco City and County and 2 percent in San Mateo County.

- ***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, 1 percent is allocated to cities and counties for general purposes, and the remaining 0.25 percent is deposited into county transportation funds.
- ***Optional Local "Add-On" Tax Rates.*** Local governments are authorized to levy additional local SUT rates for a variety of purposes. These taxes, which require local voter approval, are normally levied on a countywide basis, primarily for transportation purposes. These taxes generally are imposed in quarter-cent or half-cent increments, and cannot exceed 1.5 percent (except in San Francisco and San Mateo Counties, which are authorized to levy up to 1.75 percent and 2 percent in optional taxes, respectively).

Combined State and Local Tax Rates Differ. As shown in Figure 12 (see next page), the combined SUT rate varies significantly across California. Rates range from 7.25 percent in the 34 counties that impose no optional sales taxes, up to 8.5 percent in San Francisco County. No county currently imposes the maximum allowable rate.

Figure 12

Sales Tax Rates Vary by County



[a] Includes Stanislaus, Nevada, and Solano (7.38 percent); and Sonoma (7.50 percent).
[b] Includes Fresno (7.88 percent).
[c] Includes Santa Cruz (8.00 percent); Alameda, Contra Costa, Los Angeles, San Mateo, and Santa Clara (8.25 percent); and San Francisco (8.50 percent).

Taxable Sales Jumped in 1999

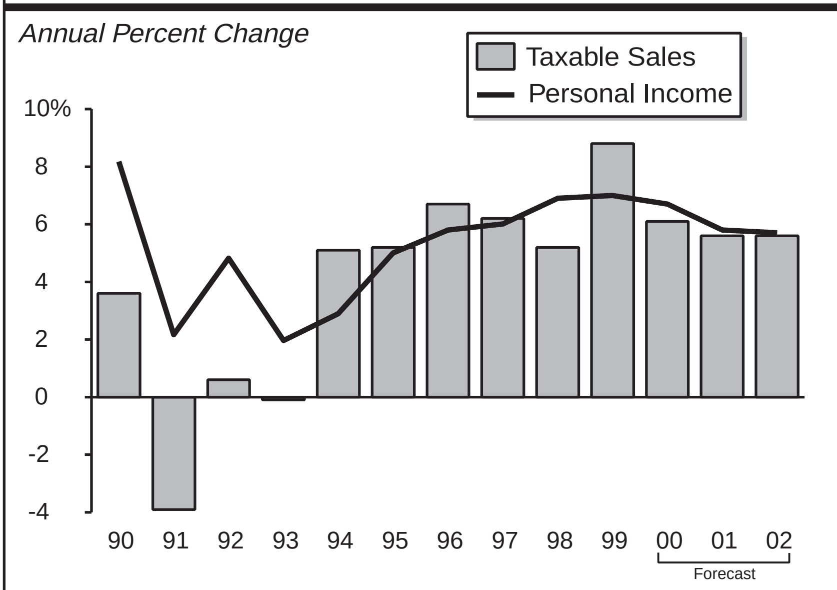
After growing at a moderate pace during the first several years of this expansion, we estimate that taxable sales jumped by nearly 9 percent during 1999 (see Figure 13). While higher fuel prices last spring played a limited role in the sales increases last year, the main factor appears to have been strong income increases and the wealth effect associated with the appreciation in the stock market. These factors provided consumers with both the resources and confidence to make major spending commitments during the year.

Taxable Sales Outlook—Healthy Though Moderating Growth

We forecast that 2000 taxable sales growth will slow from 1999's robust pace, but still remain quite healthy at 6.1 percent. This projected slowdown reflects our assumption that growth in consumer spending on cars and other durable goods peaked in 1999, and will be a bit more moderate during the next three years. Continued growth in California statewide employment and income, stock market-driven wealth increases, and high levels of consumer and business confidence are likely to remain positive forces in the outlook.

Figure 13

Taxable Sales to Moderate After Strong 1999



The SUT Revenue Forecast

Based on our forecasts for taxable sales, we estimate that SUT revenues will total $20.3 billion in 1999-00 (a 7.3 percent gain from last year), and increase to $21.5 billion in 2000-01 (a 5.6 percent rise) and $22.7 billion in 2001-02 (also a gain of 5.6 percent).

Bank and Corporation Taxes

Background

The BCT is the General Fund's third largest revenue source, accounting for about 9 percent of the total in 1999-00. Banks and corporations are subject to a general tax rate of 8.84 percent on their California taxable profits. However, special treatment applies in a couple of cases:

- ***Subchapter S Corporations.*** Since 1987, California has permitted certain corporations to elect Subchapter "S" status, as also is permitted at the federal level. Companies eligible to make this election are subject to a reduced 1.5 percent corporate tax rate on their profits; however, their earnings (and losses) are "passed through" to their shareholders where they are subject to California's PIT.

To qualify, corporations cannot have more than 75 shareholders, although there are no limits on how large the companies may be or the magnitude of profits they report.

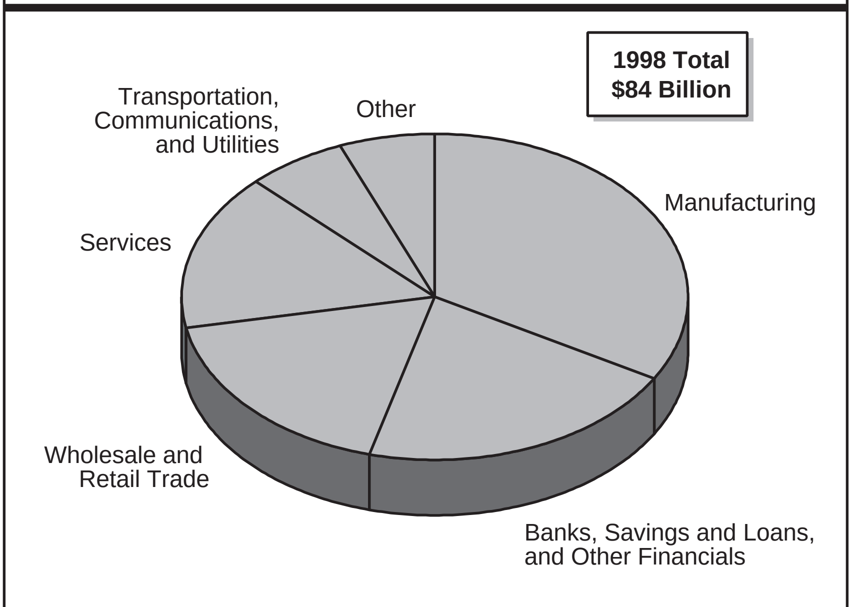
- ***Financial Corporations.*** Banks and other financial corporations pay an additional 2 percent tax, which is in lieu of all other state and local levies except taxes on real property, motor vehicle-related levies, and business licenses.

Other key elements of California's BCT law include partial deductions for NOLs, a minimum tax, rules for apportioning the income of multistate and multinational companies to California, and an Alternative Minimum Tax (AMT) similar to that imposed at the federal level. In addition, a variety of tax credits are allowed, including a manufacturers' investment credit and a credit for research and development expenses.

How Profits Are Distributed by Industry. Figure 14 shows the distribution of California corporate profits by industry in 1998 (the most recent information available). It shows that the manufacturing sector accounted for about one-third of the total $84 billion in profits reported for that year. The services, trade, and finance sectors each account for between 15 percent and 20 percent of the total, with utilities, transportation, telecommunications, and construction accounting for most of the remainder.

Figure 14

Share of California Corporate Profits by Industry



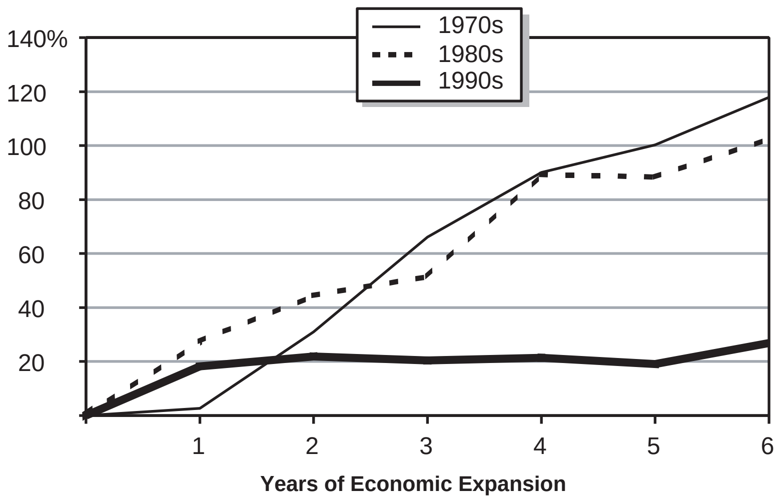
Growth in the BCT Has Been Weak

Receipts from the BCT have increased at a very restrained pace during the 1990s. We currently estimate that collections in 1999-00 will total $6.1 billion, which is just 26 percent above the level of BCT receipts at the beginning of the current economic expansion in 1993-94. As indicated in Figure 15, the increase in the current expansion is quite subdued when compared to the growth experienced in BCT receipts during the economic expansions of the 1970s and 1980s.

Figure 15

Corporate Tax Revenues Have Lagged In the Current Expansion

Cumulative Increase in BCT Receipts



What Is the Explanation?

The recent restrained growth in BCT revenues, which also has been experienced in other states and at the federal level, appears due to the effects of several factors.

Sluggish Growth in Profits. About half of the difference between current and past BCT growth rates is due to weak growth in California taxable corporate profits. These profits have grown only about two-thirds as rapidly as they did in the 1970s' and 1980s' expansions. This slow growth, which also has been observed nationally, has been puzzling to economists and tax analysts in light of the strong performance of the economy. However, one partial explanation involves the restructurings and consolidations that have taken place among some of California's largest and historically most profitable firms. Such actions, even if expected to be profitable in the long term, can involve significant short-term costs and increase the use of previously accumulated NOLs. During the decade, these factors have depressed reported earnings in such industries as aerospace, utilities, telecommunications, and banking, which have historically accounted for significant shares of overall corporate earnings. It has also been suggested by some that increased attention to state tax planning and more aggressive use of corporate tax shelters has contributed to sluggish profit growth.

Tax Relief Enacted in the 1990s. During the 1990s, the state has enacted significant BCT relief. Key provisions include the investment tax credit, a 5 percent rate reduction (from 9.3 percent to 8.84 percent), and expanded research and development credits. The aggregate revenue reductions resulting from these measures have expanded from about $100 million in 1993-94 to over $1 billion this year. Overall, we estimate that tax relief accounts for roughly 20 percent of the difference between revenue growth in the 1990s and that of the 1970s and 1980s.

Expanded Use of Subchapter S Corporate Status. Due in part to rapid growth in smaller start-up and high-tech businesses throughout California's economy during the past decade, the share of corporation profits attributable to companies electing Subchapter S status has increased sharply in recent years. The annual state BCT revenue reductions resulting from the reduced 1.5 percent Subchapter S tax rate have likewise grown—from $466 million in 1994-95 to over $1.6 billion this year. This factor accounts for about 30 percent of the slower BCT growth rate in the current expansion. It should be noted this factor also has contributed to the strong observed PIT growth, since a portion of these BCT losses are offset by the higher PIT receipts reported by shareholders when profits "flow through" to them.

The BCT Revenue Forecast

We predict that BCT revenues will continue to experience moderate growth during the forecast period, increasing from $5.7 billion in 1998-99 to $6.1 billion this year, $6.3 billion in 2000-01, and $6.5 billion in 2001-02. Our estimate assumes that California taxable profits will increase by about 6 percent in 2000, and by about 5 percent in both 2001 and 2002. Manufacturing profits should benefit from the improving exports to Asia, while the earnings in the state's trade and services industries should continue to benefit from strong consumer and business spending. On the negative side, profits in the banking and related financial subsectors will be under pressure in 2000 due to rising interest rates. While overall profit growth should be relatively healthy, BCT revenues themselves will continue to be restrained by the rapid growth in the share of earnings attributable to Subchapter S companies.

Outlook for Other General Fund Revenue Sources

The remaining 7 percent of General Fund revenues consists of insurance, estate, tobacco, and alcoholic beverage taxes, along with tobacco settlement funds, interest on state investments, and a variety of smaller taxes, fees, and transfers between the General Fund and special funds.

We forecast that these other sources will jump from $3 billion 1998-99 to $4.4 billion in the current year, and then decline slightly to $4.3 billion in 2000-01. The significant increase between the prior and current year is primarily due to two special factors: (1) the first-year receipt of tobacco settlement funds, which adds $517 million in revenues in 1999-00; and (2) a large swing in one-time transfers—from a minus $319 million in 1998-99 (associated with various court rulings) to a plus $341 million in the current year.

The small decline in the budget year reflects several offsetting factors. On the plus side, one-time receipts of $191 million from the sale of fixed assets are assumed during 2000-01. However, tobacco settlement funds are estimated to decline to $388 million and one-time transfers are expected to fall to a minus $14 million.

The Budget Forecast for Special Funds Revenues

Special funds revenues support a wide variety of state and local government programs. As shown in Figure 16 (see next page), slightly over one-half of special funds revenues are related to motor vehicle-related taxes and fees. These include motor vehicle license fees, which are in-lieu of the property tax and whose proceeds are distributed to local governments for general purposes. They also include fuel taxes and registration fees, which support transportation projects.

The remaining one-half of special funds revenues include a portion of the SUT's receipts (which support local health and social services programs), tobacco taxes (which are earmarked for various anti-smoking and health programs), and a variety of other sources.

The budget forecasts that special funds revenues will fall from $15.7 billion in 1998-99, to $15.3 billion in 1999-00, and then increase to $16 billion in 2000-01. The decline in the current year is primarily due to the phase-in of the VLF reduction. Under legislation enacted in 1998 and

1999, the VLF rate declined 25 percent in 1999, and an additional 10 percent (to a cumulative reduction of 35 percent) beginning in 2000.

Fuel taxes are forecast to rise modestly in 1999-00 and 2000-01, reflecting assumed increases in gasoline consumption averaging about 3 percent annually, and diesel consumption increases of 3.8 percent annually. The SUT special funds revenues are projected to increase by about 8.1 percent in the current year and 5.9 percent in the budget year, which is consistent with the administration's assumption that taxable sales growth will moderate in 2000 and 2001 from its recent rapid pace.

Figure 16

Special Funds Revenues and Transfers

1998-99 Through 2000-01
(Dollars in Millions)

		1999-00		2000-01	
Revenue Source	**Actual 1998-99**	**Amount**	**Percent Change**	**Amount**	**Percent Change**
Motor Vehicle Revenues					
License fees (in lieu)[a]	$3,700	$3,228	-12.8%	$3,205	-0.7%
Fuel taxes	3,026	3,092	2.2	3,172	2.6
Registration, weight, and miscellaneous fees	1,843	1,921	4.2	1,994	3.8
Subtotals	($8,569)	($8,240)	(-3.8%)	($8,371)	(1.6%)
Other Sources					
Sales and use tax[b]	$2,054	$2,221	8.1%	$2,352	5.9%
Cigarette and tobacco taxes[c]	826	1,158	40.2	1,137	-1.8
Interest earnings	242	196	-19.0	200	2.0
Other revenues	3,656	3,804	4.0	3,912	2.8
Transfers and loans	319	-301	—	39	—
Totals	**$15,666**	**$15,318**	**-2.2%**	**$16,011**	**4.5%**

[a] Incorporates impacts of Vehicle License Fee rate reductions.
[b] Excludes Local Public Safety Fund revenues.
[c] Incorporates impacts of Proposition 10 (November 1998).

IV

Perspectives on State Expenditures

Perspectives on
State Expenditures

AN OVERVIEW OF STATE EXPENDITURES

PROPOSED TOTAL SPENDING IN 1999-00 AND 2000-01

The Governor's budget proposes total spending of $85.1 billion from the state's General Fund and special funds combined in the budget year, as shown in Figure 1. This amount is $3 billion, or 3.7 percent, more than the $82.1 billion of proposed current-year spending. Of total budget-year spending, General Fund spending accounts for about 80 percent and special funds spending represents the remaining 20 percent.

Figure 1

Governor's Budget Spending Totals

1999-00 and 2000-01
(Dollars in Millions)

			Change from 1999-00	
	1999-00	2000-01	Amount	Percent
Budget spending				
General Fund	$65,856	$68,819	$2,963	4.5%
Special funds[a]	16,263	16,311	48	0.3
Totals shown in budget	**$82,119**	**$85,130**	**$3,010**	**3.7%**

[a] Does not include Local Public Safety Fund expenditures of $2.1 billion in 1999-00 and $2.2 billion in 2000-01. These amounts are not shown in the Governor's budget.

Detail may not total due to rounding.

General Fund Spending

Background. The General Fund is the predominate source of support for state programs, and thus finances a wide variety of activities. For example, it is the major funding source for K-12 and higher education; health and social services programs; youth and adult correctional programs; and tax relief. As discussed in "Part Three," the General Fund is primarily funded from tax revenues, with the state's three largest taxes accounting for 93 percent of the total. Because of this, the financing of General Fund expenditures is highly dependent on the state of the economy. The strong economic performance and dramatic revenue gains the state has recently been experiencing, combined with our forecast that healthy economic and revenue growth will continue, will enable the General Fund to both support existing programs and fund new initiatives in 2000-01, whether in the form of program enhancements, new programs, or tax relief.

Proposed Spending. In 2000-01, the Governor proposes General Fund spending of $68.8 billion. This is up roughly $3 billion, or 4.5 percent, from the current-year proposed amount of $65.9 billion.

Special Funds Spending

Background. Special funds are used to allocate certain tax revenues (such as gasoline and certain cigarette tax receipts) and various other income sources (including licenses and fees) for particular functions or activities of government designated by law. As discussed in "Part Three," a bit over one-half of the revenues that support special funds come from motor vehicle-related levies. Other major funding sources include the sales and use tax and tobacco-related levies.

Proposed Spending. In 2000-01, the Governor proposes special funds spending of $16.3 billion. This is essentially the same—up by only $48 million—from the current-year proposed amount.

Treatment of Local Public Safety Fund Expenditures. It should be noted that the spending amounts shown in the budget for state special funds do *not* include expenditures from the Local Public Safety Fund (LPSF), which total $2.1 billion in 1999-00 and $2.2 billion in 2000-01. The LPSF was established by Proposition 172 (November 1993), which made permanent a temporary half-cent increase in the state sales tax and dedicated the revenue to the LPSF for allocation by the Legislature to cities and counties. These allocations offset some of the local revenue loss from shifts of property taxes to schools during the early 1990s' recession.

We have taken the position in the past, and continue to believe, that LPSF expenditures should be included in the state's special funds spending totals for reasons discussed in last year's *Perspectives and Issues* (see pages 64-65). This is in contrast to the administration, which treats the LPSF as a trust fund and excludes it from the spending totals. Strictly for the purpose of facilitating comparisons with the Governor's budget, we do not include the LPSF in the figures appearing in this volume.

Spending From Federal Funds and Bond Proceeds

In addition to the $85.1 billion of proposed 2000-01 spending from the General Fund and special funds discussed above, the budget also proposes $40 billion of spending from federal funds and another $2.9 billion in bond proceeds used for capital outlay purposes. Including expenditures from bond funds and federal funds, spending proposed in the budget for 2000-01 totals $128 billion.

Federal Funds

Of the $40 billion in federal funds the budget proposes to spend in 1999-00, the majority—$30 billion (75 percent)—flows down through the state budget to the local level in the form of local assistance. In terms of how the $40 billion in federal funds in the budget is distributed among program areas, the largest portion of these budgeted monies is for federal contributions to health and social services programs ($25.3 billion, or 63 percent), education ($9.5 billion, or 24 percent), and transportation ($3 billion, or about 8 percent). These three program areas combined account for roughly 95 percent of the total.

Spending of Bond Proceeds

Budgetary Treatment. The yearly debt-service payments for principal and interest on general obligation bonds and lease-payment bonds *are* included in the budget's spending figures for the appropriate individual programmatic areas. The same is true for expenditures on capital outlay projects financed through direct appropriations. For 2000-01, the budget's proposed debt-service costs total $2.2 billion for general obligation bonds and $655 million for lease-payment bonds, whereas direct appropriations total $505 million ($398 million General Fund and $107 million special funds).

In contrast, however, the expenditure of bond *proceeds* is *not* included in the General Fund and special funds spending figures, but rather is reported in the budget under the heading "selected bond fund expenditures." In other words, because the spending of bond proceeds does not represent a *current* state cost as does debt service, it is not accounted for in the General Fund and special funds figures until the associated debt-service costs are actually incurred. Nevertheless, the bond fund expenditures data do give an indication of the current spending activity levels associated with capital outlay projects.

General Obligation Bonds. The budget estimates that the state will spend $2.9 billion in general obligation bond proceeds in 2000-01. This compares to $3.5 billion in the current year and $2.7 billion in the prior year. The majority of the budget-year bond fund expenditures (about $2 billion) is for various local assistance projects such as K-12 school construction and transportation. Other significant anticipated bond fund expenditures involve higher education projects ($656 million).

Lease-Payment Bonds. In addition to general obligation bonds, the state also utilizes lease-payment bonds to finance the construction and renovation of facilities. Lease-payment bonds do not require voter approval, and their debt service is paid from annual lease payments by state agencies (funded primarily through General Fund appropriations) for the facilities they use that have been constructed with the bond proceeds. For 2000-01, the budget does not include any proposed financing from lease-payment bonds.

STATE SPENDING—AN HISTORICAL PERSPECTIVE

Before looking at the Governor's 2000-01 spending plan in greater detail, it is first instructive to look at the Governor's total proposed spending from a recent historical perspective.

Figure 2 shows the trend in state General Fund and special funds expenditures over the past decade through the budget year (as proposed). Expenditures are shown in both "current dollars" (amounts as they appear in the budget) and "constant dollars" (current dollars adjusted to remove the effects of inflation). This inflation adjustment relies upon using the Gross Domestic Product (GDP) implicit price deflator for state and local government purchases of goods and services. This GDP deflator is a good general measure of the price increases faced by state and local governments and allows comparisons of the "purchasing power" of state resources over time.

Budget-Year Spending Growth Relatively Modest

The spending growth associated with the Governor's budget plan—3.7 percent for total spending and 4.5 percent for General Fund spending—is relatively modest by historical standards. However, as Figure 2 shows, spending growth has been above average in the last couple of years—especially 1999-00. The current year situation in part reflects a large amount of one-time spending. The result is that the modest total spending growth understates growth in most individual program areas.

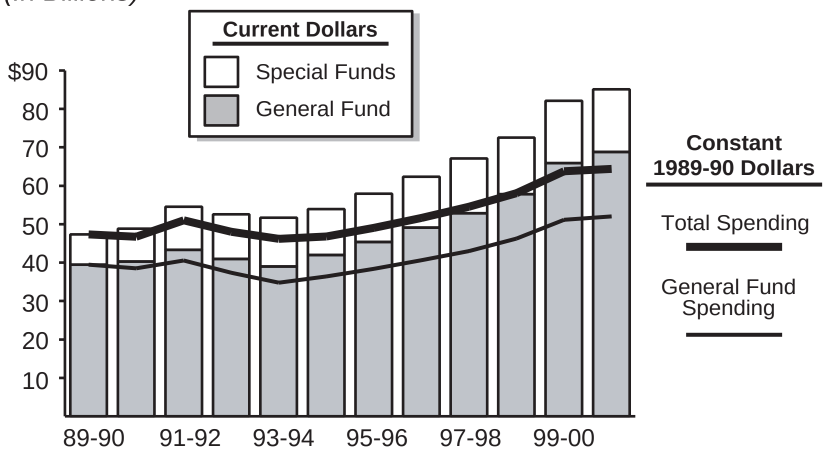
Regarding special funds spending growth, the small three-tenths of a percent rise proposed for 2000-01 is due to the reduction in vehicle license fee (VLF) subventions to counties (which are backfilled by the General Fund).

As discussed in previous editions of this volume, the trends in state spending shown in Figure 2, including the relative movements in General Fund versus special funds spending, reflect a variety of factors. The most important has been the course of the economy. Specifically, during the first half of the 1990s, the economic recession and weak revenue growth constrained spending across the board. Conversely, spending growth rebounded in the latter half of the decade, due to California's economic expansion and the accompanying strong growth in revenues. In addition to the economy, however, decisions by policy makers and the voters have affected the spending trends. Among these have been the realignment of state and county health-related responsibilities in 1991-92, and the passage of Proposition 10 (1998) which imposed additional cigarette and tobacco taxes.

Figure 2

Total State Spending Current and Constant Dollars[a]

1989-90 Through 2000-01 (In Billions)



[a] Data are on a budget basis, and exclude selected bond fund expenditures, federal funds, and Local Public Safety Fund expenditures.

Key Recent General Fund Spending Developments

As noted above, General Fund spending has been experiencing good growth in the last half of the 1990s. Underlying this trend have been a number of key programmatic changes. These are summarized in Figure 3 and discussed below.

Figure 3

Key General Fund Expenditure Developments In Recent Years

- ✔ Major Funding Increases for Education
- ✔ Slowing Caseloads—Which Have Reduced Growth in Major Health, Social Services, and Corrections Programs
- ✔ Major Reforms Adopted in Welfare (CalWORKs) and Trial Court Funding
- ✔ Significant One-Time Expenditures for a Variety of State and Local Purposes
- ✔ Major Increase in Local Government Subventions to "Backfill" VLF Rate Reduction

Major Increases in Education Funding. The main programmatic priority of the Governor and Legislature during the second half of the 1990s has been education. Based on the Governor's current proposal for 2000-01, total funding for K-12 and higher education will have increased by 90 percent between 1993-94 and 2000-01, compared to a 60 percent increase for the rest of the budget. Most of the K-12 education increase is due to the rapid increase in the Proposition 98 guarantee in the second half of the 1990s, but it also reflects explicit policy decisions to overappropriate the guarantee in 1997-98 through 2000-01. The increased funds have been used for enrollment growth, cost-of-living adjustments, and such education-related initiatives as class size reduction, lengthened school years, school district equalization, and school reforms.

Higher education has also increased significantly in recent years due to enrollment growth and additional monies provided for student fee reductions, building maintenance, new technology grants, research, and initial funding for the addition of a new UC campus in Merced.

Slowing or Declining Caseloads. Expenditure growth has been comparatively moderate in the state's major health, social services, and criminal justice budgets in recent years, and a key factor has involved caseloads. For example, California Work Opportunity and Responsibility to Kids (CalWORKs) caseloads increased by 45 percent between 1989-90 and 1994-95, but declined by 36 percent between 1994-95 and 1999-00. Similarly, annual growth in the number of inmates in state prisons has slowed to less than 2 percent in the current and budget years—down sharply from the 6.9 percent annual increases experienced over the past decade. These slowing caseloads have been the primary reason why growth in overall health, social services, and criminal justice spending has been moderate in recent years despite various program expansions (such as in the Healthy Families and foster care/child welfare services areas).

Major Reforms. The state has undertaken major reforms in two key areas in recent years. In 1997, it adopted welfare reform, in which the former Aid to Families with Dependent Children program was replaced with CalWORKs. The new program emphasizes welfare-to-work, and includes a variety of expanded job training and child-care services, as well as time limits on receiving benefits and sanctions. Taking into account both the federal and state changes in this area, it appears that welfare reform has resulted in a reduction in state spending.

The state also enacted trial court financial restructuring which includes increased state funding for trial court operations. This has resulted in several hundred millions of dollars in additional state costs each year because the local funding portion was reduced and capped.

Significant One-Time Expenditures. In recent years, the state has sharply increased one-time expenditures for a variety of state and local purposes. Examples include: over $500 million in the 1998-99 budget for Headwaters Forest preservation and Colorado River water management; $50 million in 1998-99 and $425 million in 1999-00 for the capitalization of the Infrastructure Bank; and various one-time expenditures for park acquisition, deferred maintenance, capital outlay, and education grants.

Tax Relief. In 1998 and 1999, the state enacted legislation providing for a 25 percent VLF rate reduction and accelerated an additional 10 percent reduction, with further reductions contingent on the future performance of state revenues. Since the VLF is a local tax, the state "backfills" the revenue losses to local governments. This resulted in approximately $500 million in General Fund subventions in 1998-99, an estimated $1.4 billion in the current year, and a projected $1.8 billion in 2000-01. (Various other tax relief measures have been enacted, but their effects appear on the revenue side of the budget.)

With this perspective on past spending trends, we now focus on the Governor's 2000-01 spending plan by major program area.

PROPOSED SPENDING BY PROGRAM AREA

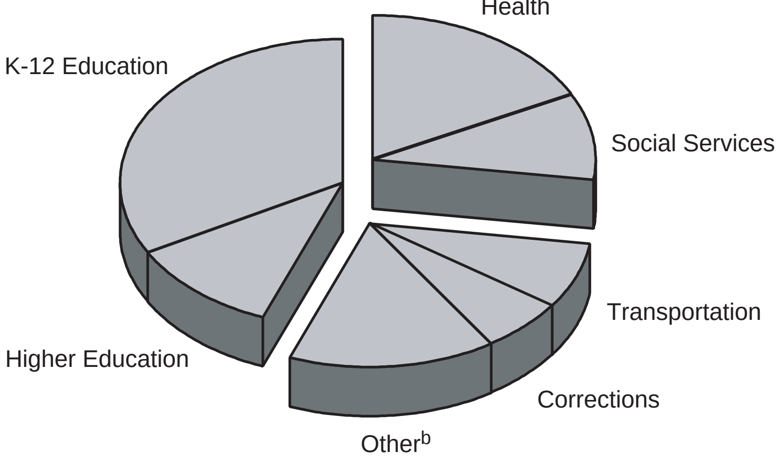
Total Spending

Figure 4 shows the allocation of the proposed $85.1 billion of total state spending in 2000-01 among the state's major program areas. Both General Fund and special funds expenditures are included in order to provide a meaningful comparison of state support among broad program categories, since special funds provide the bulk of the support in some areas (such as transportation).

Figure 4

Proposed Total State Spending By Major Program Area[a]

2000-01



[a]Excludes bond funds, federal funds, and Local Public Safety Fund.
[b]Includes general government.

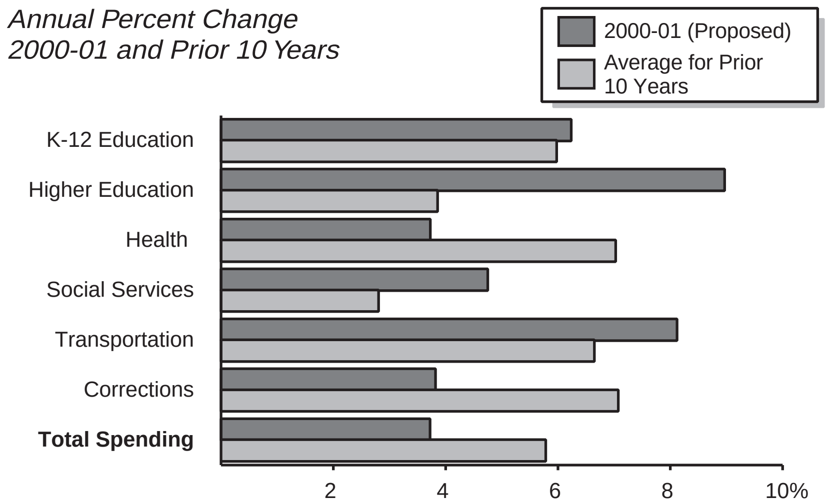
The figure shows that K-12 education receives the largest share of proposed total state spending—one-third. (It should also be noted that K-12 education receives additional funding from local sources.) When higher education is included, the education share rises to over 44 percent. (In terms of just General Fund spending, education's share exceeds 50 percent.) Health and social services programs account for about 27 percent of proposed total spending, while transportation and corrections together account for another roughly 14 percent. In the "all other" category (15 percent), the largest share is for general-purpose assistance provided to local governments in the form of VLF revenues.

Growth in 2000-01 and Over Time

Figure 5 shows proposed changes in support for major program areas in the budget year, and also provides an historical perspective by showing the average annual growth in these programs over the past ten years.

Figure 5

Growth in Total State Spending By Major Program Area[a]



[a]Excludes "all other" spending, which is propsed to decline by 7.1 percent in 2000-01, but rose by an average of 6.1 percent in the prior 10 years.

The greatest percentage growth proposed for 2000-01 is in the areas of higher education (9 percent), transportation (about 8 percent), and K-12 education (over 6 percent). In contrast, proposed total spending growth is less for social services (4.7 percent), corrections (3.8 percent), and health (3.7 percent). As shown in the figure, budget-year growth is greater than the ten-year average for all program areas other than health and corrections.

General Fund Spending

Figure 6 (see next page) details the breakout by program area of General Fund spending for the prior through budget years. It also shows the percentage growth between the current and budget years. In brief, the budget proposes an 11 percent increase for higher education; approximately 6 percent growth for K-12 education, community colleges, Medi-Cal, SSI/SSP, and "other" health and social services programs; and slightly less than 4 percent growth for Youth and Adult Corrections. The budget reflects an increase for the CalWORKs program, but this is due to technical changes related to the child support programs. After adjusting for these changes, the budget would reflect a decrease of about 6 percent.

Figure 6

General Fund Spending by Major Program Area

(Dollars in Millions)

			Proposed 2000-01	
	1998-99	**1999-00**	**Amount**	**Percent Change**
Education Programs				
K-12 Education	$23,528	$26,366	$28,014	6.3%
Community Colleges	2,260	2,452	2,613	6.6
UC/CSU	4,632	4,912	5,431	10.6
Other Higher Education	510	581	656	12.9
Health and Welfare Programs				
Medi-Cal	$7,471	$8,209	$8,749	6.6%
CalWORKs	2,022	1,994	2,072	3.9
SSI/SSP	2,242	2,483	2,620	5.5
Other	4,327	5,157	5,479	6.2
Youth and Adult Corrections	$4,547	$4,868	$5,054	3.8%
All Other[a]	$6,287	$8,835	$8,130	-8.0%
Totals	**$57,827**	**$65,856**	**$68,819**	**4.5%**

[a] The 2000-01 decline is partly due to one-time spending in 1999-00.

Finally, the budget shows that combined General Fund spending on all other programs is proposed to decline by 8 percent in the budget year. This decline reflects the large number of one-time expenditures in the current year.

In the next section, we provide additional discussion regarding the budget's proposals in different program areas.

MAJOR EXPENDITURE PROPOSALS IN THE 2000-01 BUDGET

In this section, we discuss several of the most significant spending proposals in the budget. For more information on these spending proposals and our findings and recommendations concerning them, please see our analysis of the appropriate department or program in the *Analysis of the 2000-01 Budget Bill*.

EDUCATION

Education programs account for 53 percent of General Fund spending in the *2000-01 Governor's Budget*. Below we provide an overview of the budget for K-12 and higher education, beginning with a focus on Proposition 98.

Proposal—K-12

Background. Proposition 98 establishes a minimum funding level that the state must provide for public schools and community colleges each year. K-12 education receives about 90 percent of total Proposition 98 funds.

Governor's Budget-Year Plan. The budget proposes $35.8 billion in total K-12 Proposition 98 funding in 2000-01 (consisting of state General Fund and local property tax allocations). This is an increase of over $1.9 billion, or 5.7 percent, compared to the 1999-00 revised amount. Pupil attendance is projected to increase by 1.26 percent, resulting in funding of $6,313 per pupil, an increase of $268 (4.4. percent) from the revised 1999-00 amount.

The major 2000-01 budget proposals include:

- $947 million for a 2.84 percent cost-of-living-adjustment (COLA).

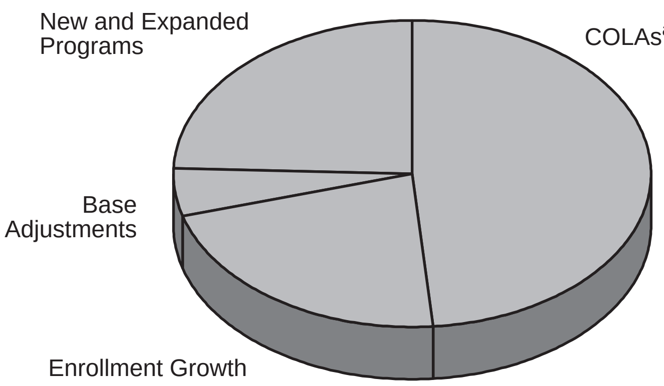
- $428 million for projected 1.26 percent growth in average daily attendance (ADA).
- $75 million for grants to schools to purchase computers.
- $62 million to increase the reimbursement rate for various supplemental instructional programs, including summer school and after school.
- $52 million for various incentives to recruit and retain teachers.

Figure 7 illustrates how the budget would allocate projected growth in K-12 Proposition 98 funds in 2000-01.

Figure 7

Proposed Use of New K-12 Proposition 98 Funds

2000-01



[a]Cost-of-living adjustments.

Budget "Overappropriates" Proposition 98 Minimum Requirement. The Governor's proposed spending level for Proposition 98 (including the community colleges) exceeds his estimate of the constitutionally required minimum amount for 2000-01 by $257 million. Our estimate of the required minimum funding level exceeds the Governor's estimate by $99 million. Both estimates, however, are somewhat academic given the current positive fiscal environment and the stated priorities of the Governor and Legislature regarding education.

Proposal—Higher Education

The University of California (UC) and the California State University (CSU). The budget proposes General Fund support for UC and CSU of $5.4 billion in 2000-01, an increase of $519 million, or 11 percent, compared with estimated current-year budgets. After adjusting for one-time spending in 1998-99, the actual increase is $557 million, or 11 percent. Budgeted enrollment levels at UC and CSU would increase substantially in 2000-01—by 6,000 full time equivalent (FTE) students at UC and 12,577 FTE students at CSU. The budget proposes a 6 percent baseline funding increase totaling $282 million in General Fund appropriations for UC and CSU. The proposed budget also includes a total General Fund increase of $30 million in lieu of student fee increases. The budget proposes $83.8 million in new funding for the two segments for teacher preparation, recruitment, and K-12 staff development aimed at improving California's K-12 educational system.

Community Colleges. The budget proposes $2.5 billion in General Fund support for the community colleges in 2000-01. All but $89 million of this amount counts towards the state's K-14 minimum funding guarantee under Proposition 98. The 2000-01 General Fund request represents an increase of $160 million, or 6.7 percent, from the current year. The combined increase proposed from the General Fund, local property tax revenues, lottery funds, and net student fee revenues (after accounting for financial aid) is $347 million, which represents a 6.5 percent increase in combined funding.

In 2000-01, the budget provides $103 million for a 2.84 percent COLA for general-purpose spending, $106 million for enrollment growth, and $25 million for the Partnership for Excellence program.

Student Aid Commission. The budget proposes a General Fund increase of $71.3 million, or 18.4 percent, for the Student Aid Commission in 2000-01. The majority of this increase, $40 million, pays for the cost increase associated with past increases in the number and maximum amount of Cal Grant awards. The budget also includes $31 million to increase the number of new first-time Cal Grant A and B awards and raise the maximum award amount. The budget eliminates the Cal Grant T program for teacher-preparation students, for a reduction of $10 million.

Issues for Legislative Consideration

Relative Needs of Education Segments. In the *Analysis,* we take issue with some of the broad priorities and approaches to higher education and K-12 education taken by the budget. We conclude that the administration's relative allocation of resources between the UC and the

CSU on the one hand, and K-12 education and the community colleges on the other, does not match the relative needs of these distinct parts of the education spectrum. We recommend transferring to K-12 education and the community colleges $149 million budgeted for base adjustments at UC and CSU. Even with these redirections, UC's General Fund budget would exceed the current-year amount by 9 percent and CSU's General Fund budget would exceed the current-year amount by 7.4 percent. In considering the relative needs of the education segments, we believe the Legislature should take into account the following:

- K-12 schools appear to face greater challenges of program quality.
- K-12 schools appear to face greater challenges in obtaining quality faculty.
- K-12 schools and community colleges have adopted accountability measures, while the universities have not.

Options for More Proposition 98 Spending. In the *Analysis,* we make various recommendations regarding the K-12 education budget that, if fully adopted, would increase Proposition 98 funding above the Governor's proposed spending level for 2000-01 by $172 million. (This amount would exceed the administration's estimate of the minimum funding requirement by $429 million.)

The Legislature may wish to allocate even more resources to Proposition 98 programs—not only for K-12 education but for community colleges as well. To the extent the Legislature wishes to do this, we would suggest that it place as much emphasis as possible on the following:

- ***Increase General Purpose Funding.*** During the recession years of the early 1990s, statutory COLAs for K-12 revenue limits were not fully funded, producing a statutory "deficit" for revenue limits. This statutory deficit is presently at 6.996 percent. We recommend in the *Analysis* (please see the Education chapter) augmenting revenue limits by $70 million to reduce this deficit. The Legislature could provide more funds for this purpose, which would help stop the decade-long downward trend in general purpose funding as a share of Proposition 98 resources. (Every $100 million of additional funds "buys" about 0.4 percentage points of deficit reduction.)
- ***K-12 Equalization***. This option is actually another form of general purpose funding, but addresses present inequalities in the per pupil distribution of revenue limit funding. In our discussion on discretionary funding in the *Analysis*, we recommend a $65 million augmentation for K-12 equalization. This level of funding, if followed by similar augmentations in the subsequent

five years, would result in 90 percent of the K-12 system's ADA receiving the same revenue limit. To the extent the Legislature provides more funds, it could shorten the time frame for reaching this target.

- ***Community Colleges Equalization***. In our analysis of the community colleges, we recommend a $28 million augmentation for equalization purposes, enough to make general purpose funding equal for slightly more than 50 percent of the system's FTE students. An additional $25 million would equalize funding for 60 percent of students.

- ***Block Grants for Disadvantaged Schools.*** The Governor's budget gives significant attention to the problems of recruiting and retaining qualified teachers in low-performing schools. This attention is warranted, as we detail in our discussion of teacher quality and supply. We point out, however, that the administration's definition of "low-performing" schools is overly broad. We also point out problems related to the lack of meaningful local discretion in the operation of the proposed programs. Our analysis indicates that the state could usefully deploy more funds to address not just the problem of teacher recruitment/retention, but the larger array of problems facing disadvantaged schools—which tend to be schools serving large numbers of children in poverty. We believe the most effective way to deploy additional resources to these schools is through one or several block grants that would allow school districts broad discretion to meet their particular local needs.

- ***Block Grants for One-Time Purposes.*** We estimate that the state has approximately $2.1 billion of additional revenues that could be used for one-time purposes beyond those already reflected in the Governor's budget. In addition, under the rules governing Proposition 98, the Legislature could spend additional funds for one-time purposes, count it towards the Proposition 98 requirement *for 1999-00*, and thereby avoid unnecessary increases in the long-term Proposition 98 "base" that might otherwise constrain future legislative options. The level of such one-time augmentations could be roughly equal to whatever amount the Legislature decides to go above the minimum guarantee for 2000-01. Again, we emphasize the advantages of block grants for one-time funding, which could allow local districts broad discretion to meet one-time needs, including, but not limited to, deferred maintenance, safety improvements, and staff development.

Logic of Accountability Calls for More Local Discretion. With regard to K-12 education, one of the salient aspects of the *2000-01 Governor's Budget* is the lack of discretion given to local school districts. The budget adds to the major area of general purpose funds—"revenue limits"—only what existing law requires to cover COLAs and enrollment growth. The budget proposes spending the remainder of new funds for K-12 education on a long list of new and expanded categorical programs. As well-intentioned as these programs are, we believe most will be diminished in effectiveness because of the constraints on local discretion.

In our view, the K-12 reforms adopted in the 1999 Special Session create both the opportunity and the need for a K-12 budget that grants greater local flexibility. In particular, the accountability framework established by Chapter 3x, Statutes of 1999 (SB1x, Alpert), and the high school exit exam established by Chapter 1x, Statutes of 1999 (SB 2x, O'Connell), logically lead to a shift in the state's budgeting and oversight emphasis—from a focus on educational *inputs* to attention to educational *outcomes*. To maximize the chances for improving educational results, however, the state must give local school districts and school sites more flexibility to fit budgetary resources to local circumstances and needs. The approach we take to the state's education budget in the *Analysis* builds on this foundation.

Funds Budgeted in Non-K-12 Entities for K-12 Purposes. Another significant aspect to the Governor's budget is the extent to which it proposes new funds to address K-12 purposes, but which are budgeted in non-K-12 entities (and thereby are "outside" Proposition 98). These proposals include—but are not limited to:

- $71 million for expansion and creation of teacher training programs to be administered by UC.
- $50 million for a Teachers Home-Buyers Assistance Program in the Department of Housing and Community Development.
- $25 million for a contract between the Secretary for Education and CSU to provide computer training to K-12 teachers.

In the *Analysis,* we address these proposals in detail and recommend transferring the funds to where they can be deployed more effectively—directly to school districts.

Higher Education Partnership. As noted above, the budget proposes to increase the base General Fund budgets of UC and CSU by 6 percent. This consists of 5 percent as part of the Governor's proposed Higher Education Partnership, plus an additional 1 percent increase for 2000-01. The partnership proposes to guarantee the 5 percent base increase every year, plus additional funds for enrollment growth and "necessary" capital outlay, plus additional funds for "high-priority" initiatives. The guaranteed increases would be contingent on UC and CSU developing accountability measures.

In our view, guaranteed annual funding is not necessary and will create the wrong incentives. The proposed partnership would:

- Not provide greater accountability than can be obtained under the annual budget process.
- Reduce the Legislature's annual budgetary discretion, undermining its ability to respond to the state's policy needs in the face of changing fiscal conditions.
- Reduce incentives for CSU and UC to reduce costs and improve outputs on an annual basis.

We, therefore, recommend in the *Analysis* that the Legislature not endorse the proposed annual funding guarantee for CSU and UC.

AGING WITH DIGNITY INITIATIVE

Proposal

The Governor's Aging with Dignity Initiative consists of numerous components administered by several departments, at a General Fund cost of $140.4 million (and 221.5 positions) in 2000-01. The purpose of the initiative is "to help elderly people remain at home, or with their families, rather than in nursing homes; dramatically increase the availability of innovative community-based alternatives to nursing home care; and enhance the quality of care in California's nursing homes." Figure 8 (see next page) lists the proposed components of the initiative that have fiscal effects. In the discussion that follows, we present our analysis of one of these components—the long-term care tax credit.

Long-Term Care Tax Credit. The budget proposes a $500 tax credit for persons who provide or pay for care at home for seniors or disabled individuals of any age. This credit would result in an estimated General Fund revenue loss of $47 million in 2000-01. In order for the taxpayer to qualify for the credit, the senior or disabled person would have to meet certain criteria for needing care.

The credit would typically be available to taxpayers for each individual residing with them who is certified by a physician as requiring long-term care—defined as a continuous period of at least six months. Individuals with long-term care needs must meet certain criteria for a tax-

Figure 8

Aging With Dignity Initiative 2000-01

(In Millions)

	General Fund	Other Funds	Totals
Community Programs			
Caregiver tax credit	$47.0	—	$47.0
In-Home Supportive Services wage increases	20.0	$35.7	55.7
Long-term care innovation grants	20.2	—	20.2
Expand no-cost Medi-Cal for aged, blind, and disabled	2.4	2.4	4.8
Senior housing information and support center	1.0	—	1.0
Senior wellness education campaign	1.0	—	1.0
Improving Quality of Care and Enforcement			
Caregiver recruitment and training	—	$50.0	$50.0
Five percent pay increase for nursing home workers	$32.5	33.3	65.8
Nursing home quality awards	8.0	2.0	10.0
Increased nursing home inspections	3.0	4.5	7.5
Focused nursing home quality review	2.5	1.5	4.0
Rapid response to nursing home complaints	2.2	1.7	3.9
Nursing home fiscal review advisory board	0.5	—	0.5
Totals	**$140.3**	**$131.1**	**$271.4**

payer to qualify for the credit—for example, those six years and older must be unable to perform without assistance at least three basic activities of daily living.

The proposal is modeled after a similar proposal at the federal level for a $3,000 credit. For calendar year 2000, the Franchise Tax Board assumes that approximately 120,000 taxpayers would take advantage of the new state credit. The estimated revenue reduction from the credit is $47 million in 2000-01, reaching $52 million by 2004-05.

Issues for Legislative Consideration

Credit Not Likely to Meet Stated Objectives. Whether tax credits are an effective and efficient means of accomplishing their objectives depends on their specific provisions and purpose. They can, for example, be a good method of providing tax *relief* to certain categories of taxpayers or outright *subsidies* to them, *if* they are well-targeted. However, if their objective is to encourage certain types of *behavioral changes*, tax credits generally do *not* score particularly well as an effective and efficient tool. This is largely because it is hard to ensure that credits go only to those persons whose behavior changes, thus, many taxpayers receiving credits are simply rewarded for doing things they would have done anyway.

Thus, in the case of the proposed credit, a key question is whether it is primarily intended to *subsidize* the care costs of taxpayers who already provide long-term care in their homes or, alternatively, to provide an incentive for expansion of home-based long-term care. In either case, the proposal raises a number of concerns:

- ***Distribution of Benefits.*** First, because the proposed credit is *nonrefundable* (only available to individuals with state tax liability), certain taxpayers who may be most effective to target will only be able to benefit partially from it, or not at all. This is especially the case for lower-income taxpayers without large tax liabilities to offset. In addition, because there is no "means test" regarding who can receive the credit, much of it could go to those taxpayers who do not have the greatest financial need.

- ***Effects on Behavior.*** Second, at $500, the credit may simply be too small to significantly increase the amount of home-based long-term care that taxpayers are willing and able to provide. Caring for an elderly or disabled person can be a large financial burden. Even with Medicare, out-of-pocket health care costs (primarily for medication) can be large and other types of costs can be significant. For example, home modifications may be necessary, or a family member may have to give up a job or limit his or her work hours to provide care. In addition to financial issues, providing in-home care may also involve major changes in living arrangements and habits. It would seem unlikely that the availability of the $500 annual credit would be the determining factor in more than a small fraction of care decisions.

- ***Potential for Abuse.*** Third, the credit has an inherent potential for abuse that could require significant monitoring and enforcement efforts. While a doctor's certification will be required, assessing the physical or mental limitations of an individual involves a degree of judgment that may get stretched over time by the natural desire of physicians to accommodate patients and their families. Moreover, taxpayers need not demonstrate that they have incurred any cost in order to claim the credit. This could make it attractive to "push the envelope" when claiming that an elderly person or child in the home meets the test for qualifying limitations.

- ***Federal Interactions Diminish Impact.*** Fourth, because California income taxes are an itemized deduction on federal income tax returns, as much as a third of the state's credit paid to certain taxpayers will wind up "in the pockets" of the federal government.

Alternative Approaches. Given these concerns, we do not believe that the proposed credit would be an effective or efficient means of providing either (1) significant assistance to those taxpayers who bear the greatest burden for the care of seniors or disabled persons or (2) an effective incentive for an expansion of home-based care for seniors and the disabled. Consequently, we recommend that the Legislature explore alternative approaches to accomplishing the objectives of the proposed tax credit that would provide both more financial relief to many families and individuals and would help more seniors avoid institutionalization. With respect to alternative approaches, please refer to the Health and Social Services chapter of our *Analysis of the 2000-01 Budget Bill*, where we discuss expanding Medi-Cal coverage for seniors and the disabled beyond the relatively modest expansion proposed in the budget.

CALWORKS PROGRAM

The federal welfare reform legislation of 1996 replaced the Aid to Families with Dependent Children (AFDC) program with the Temporary Assistance for Needy Families (TANF) program. The Legislature subsequently enacted Chapter 270, Statutes of 1997 (AB 1542, Ducheny, Ashburn, Thompson, and Maddy), which created the California Work Opportunity and Responsibility to Kids (CalWORKs) program to replace the AFDC program in the state. The CalWORKs program provides cash grants and employment and training services to eligible families.

Proposal

Background. The CalWORKs legislation requires that savings resulting from (1) exits due to employment, (2) increased earnings, and (3) diverting clients from aid with one-time payments, be paid by the state to the counties as performance incentives. Current law also requires that the Department of Social Services (DSS), in consultation with the welfare reform steering committee, determine the method for calculating these savings.

Growing Obligation to the Counties. By the end of 1998-99 counties had earned approximately $900 million in performance incentives. This amount excludes incentives based on exits due to employment during 1998-99 because the data are not yet available. By the end of 1999-00, we estimate total incentives earned by the counties (including incentives based on exits to employment) will be approximately $1.6 billion. The total of the appropriations (from 1998-99 and 1999-00) for incentive payments is approximately $1.1 billion. Thus, we estimate that the unfunded obligation to the counties will be approximately $500 million by the end of 1999-00. We note that county receipt of fiscal incentives has significantly lagged the appropriation, and that counties have spent very little of their incentive payments. As of September 1999, they had received a total of $685 million but had spent only $5.3 million.

Governor's Proposal. The Governor proposes to prohibit counties from earning additional performance incentives until the unmet obligation to the counties has been satisfied. For 2000-01, the budget proposes an expenditure of $252 million toward this obligation, which, as noted above, is estimated to be $500 million by the end of 1999-00. If $252 million is paid to the counties in 2000-01, a remaining obligation of about the same amount will be carried forward into 2001-02. The department estimates that the counties would earn an additional $496 million in 2000-01 under current law. Thus, the Governor's proposal to prohibit counties from earning additional incentives results in savings of $496 million in 2000-01. The administration also indicates that it will propose legislation to either eliminate or "sharply modify" the performance incentive program.

Issues for Legislative Consideration

To assist the Legislature in considering these issues, we begin by examining the rationale for the county performance incentive program. While the Legislature did not specify the purpose of the program, we can identify several possible rationales. Specifically, performance incentives could have been intended as (1) a *reward* for county performance, (2) an *inducement* for counties to make an effort to achieve better program outcomes, and/or (3) a *funding source* for the CalWORKs program. Below we discuss each of these potential rationales for the program.

Reward System. The incentive payments may have been intended simply to be a reward to the counties. If this is the case, however, it is not clear what distinguishes county implementation of CalWORKs from county administration of other state programs in areas such as health, welfare, and criminal justice where there are not incentive payments. There is no analytical basis for determining whether incentive payments should be provided as a reward.

Inducement for Better Program Performance. Another argument for providing incentive payments is that they may act as an incentive for counties to make extra efforts toward improving their programs. As noted above, the counties have spent very little of their incentive payments and are still in the early stages of CalWORKs implementation. Thus, while incentive payments could have some impact in the future, it does not appear that they have had any appreciable effect on county behavior so far.

We also note that, as currently structured, counties can earn substantial incentive payments without demonstrating any program improvement. About $800 million of the performance incentives owed to the counties as of 1998-99 are due to savings attributable to the earnings of recipients. According to DSS, about two-thirds of these savings would have occurred even if CalWORKs had never been implemented (because many recipients were working before CalWORKs started). We believe that for incentives to serve as an inducement, the conditions under which incentives are "earned" must be limited to situations in which program outcomes actually improve.

Finally, we note that given the way fiscal incentives have been budgeted, the counties must spend the incentive payments within the CalWORKs program. Thus, county government programs outside of CalWORKs receive no direct fiscal benefit from the incentive payments.

Program Funding. A third argument for the performance incentives is that they could provide the counties with a source of funding for the CalWORKs program. Under CalWORKs, counties have had two sources of funds for employment services: (1) the regular budget allocation to fund estimated program needs and (2) the performance incentives. Performance incentives were to be used for county-specific enhancements to the CalWORKs program. We note that this has not been the experience to date. Counties have spent only about 60 percent of their single allocation funds and hardly any of their performance incentives.

Pursuant to Chapter 147, Statutes of 1999 (AB 1111, Aroner), the regular budget allocation for employment services will be based on county expenditure plans beginning in 2000-01. The change to budgeting employment services according to individual county expenditure plans should reduce the need for county performance incentives as a *funding source*. This is because the county plans, or budgets, can include any funding proposals the counties deem appropriate.

Analyst's Conclusion and Recommendation. The experience so far with CalWORKs suggests that the county performance incentives have not served as an effective reward, inducement toward better program outcomes, or funding source for program enhancements. While it is possible that, in the future, incentive payments might have some behavioral effect in inducing better performance, we believe that there is little chance of this as the program is currently structured.

Based on the amount of prior-year obligations, we concur with the Governor's proposal to prohibit counties from earning new county performance incentives until the outstanding obligation to the counties is satisfied. With respect to whether the program should be eliminated, we have no analytical basis for determining the cost-effectiveness of fiscal incentives. Should the Legislature choose to retain such a system, however, we recommend that it (1) be funded with General Fund monies that can be used by the counties for *any* purpose and (2) tie the amount of incentive payments to *improvement* in CalWORKs program outcomes.

We believe that performance incentives would have a better chance of being effective if paid for with General Fund monies that the counties can use for any purpose. This would increase their value to the counties, making it more likely to induce the counties to make an effort to improve the program. Furthermore, it will require the Legislature and the Governor to weigh the potential benefits of the incentives against the costs because the incentives would compete with other state priorities for funding.

As we have previously recommended, tying performance incentive payments to improvement in outcome measures should increase the chances that these payments will induce counties to make an effort to improve their programs. (For a discussion of this aspect of the issue, please see our analysis of CalWORKs in the *Analysis of the 1999-00 Budget Bill*.)

Finally, we note that repealing the performance incentive system, or replacing it with a new system supported by the General Fund, will free up a significant amount of federal TANF funds which have been the principal source of funding for the incentive payments. These TANF funds could be (1) held in a reserve, (2) provided to the counties or other local governments to provide services to TANF-eligible individuals, or (3) used to fund state level initiatives for the working poor. (Please refer to "TANF Regulations Increase State Flexibility to Serve Working Poor" in the Health and Social Services chapter of the *Analysis of the 2000-01 Budget Bill* for a complete discussion of the possible uses of TANF funds.)

CAPITAL OUTLAY

The state owns a vast amount of infrastructure including nearly 2.5 million acres of land, 180 million square feet of building space, and 15,000 miles of highways. Much of this infrastructure is aging. For example, 55 million square feet in the three public higher education segments was built or renovated over 30 years ago and most of the 9.5 million square feet of buildings in the state hospitals and developmental centers was built over 40 years ago.

The state departments responsible for this infrastructure have estimated that over the next five years more than $25 billion will need to be spent on improvements and expansion. As we have consistently cautioned, some of the planning effort to develop these estimates may be incomplete and some of the estimates may contain proposals that upon further review may not merit funding. In general, however, the estimates give a reasonable overall magnitude of the capital outlay needs.

Proposal

Budget Bill Proposal. The budget includes $1.2 billion for the state's infrastructure (excluding highways and rail programs). As shown in Figure 9 over 60 percent of the proposal is for higher education with the next largest amounts in resources and youth and adult corrections.

Figure 9

State Capital Outlay Program

1999-00 and 2000-01
(In Millions)

	1999-00 Appropriations	2000-01 Governor's Budget	Difference
Legislative, Judicial, and Executive	$48.7	$19.2	-$29.5
State and Consumer Services	3.9	5.4	1.5
Transportation (excluding highways and rail)	31.7	34.4	2.7
Resources	253.3	199.3	-54.0
Health and Human Services	51.4	10.5	-40.9
Youth and Adult Corrections	485.4	143.4	-342.0
Education	1.1	8.5	7.4
Higher Education	648.5	731.3	82.8
General Government	10.7	15.6	4.9
Totals	**$1,534.7**	**$1,167.5**	**-$367.2**

Budget Increases Use of Pay-As-You-Go Funding. Nearly 50 percent of the amount proposed in the budget is for pay-as-you-go funding. Of this amount about $400 million is from the General Fund, with the balance from special funds and federal funds. These direct appropriations are for 28 departments for a variety of proposals—such as land acquisition, new courthouses, fire stations, and various infrastructure and building improvements. General obligation bond financing totals $662 million, of which $656 million is for higher education. The budget does not include any proposed financing from lease-payment bonds.

Bond Debt. The state's debt payments on bonds will be about $2.9 billion in the budget year. This is an increase of 7.5 percent over current-year payments. The payments include $2.2 billion for general obligation bonds and $665 million for lease-payment bonds. We estimate that the amount of debt payment on General Fund-backed bonds as a percent of General Fund revenue (that is, the state's debt ratio) will be 3.9 percent in the budget year. We estimate that as currently authorized bonds are sold, the debt ratio will increase to 4 percent in 2001-02 and decline thereafter (assuming no further bond authorizations).

Issues For Legislative Consideration

State's Infrastructure Planing and Financing Process. Addressing the issues of an aging infrastructure and population growth will require expenditures of billions of dollars to renovate existing infrastructure and develop new public infrastructure. To effectively address the variety and complexity of infrastructure projects, the state needs a well-defined process for planning, budgeting, and financing these projects. A significant step toward developing such a process was the Legislature's enactment of Chapter 606, Statutes of 1999 (AB 1473, Hertzberg). Chapter 606 requires that—beginning January 10, 2002 and annually thereafter—the Governor submit a proposed five-year infrastructure plan to the Legislature. The plan is to be updated each year and is to cover a five-year period. The plan is to contain the infrastructure needs of all state departments (including the State Transportation Improvement Program and higher education) and K-12 public schools.

Legislature Should Develop Strategies for Reviewing and Implementing Infrastructure Plan. As mentioned above, the initial infrastructure plan called for under Chapter 606 will be sent to the Legislature January 10, 2002. Thus, the Legislature has less than two years to establish strategies to position itself to effectively review and implement the plan. We recommend the Legislature take the following steps:

- Establish legislative committees to oversee and implement the infrastructure plan. Important considerations for the committees would include establishing statewide criteria for setting priorities across programs, reviewing and approving the statewide capital outlay plan, and determining the appropriate financing mechanisms to undertake and complete projects. The committees would also regularly review the long-range plan to determine if it is still valid with regard to program needs.

- Determine which local government infrastructure programs is appropriate for the state to continue funding and assure that these programs are included in the five-year infrastructure plan.
- Provide steady, stable funding for the infrastructure plan. We have recommended (see *The 1999-00 Budget: Perspectives and Issues*, page 109) adopting a policy to dedicate 6 percent of annual General Fund revenues to fund infrastructure investments (including debt payments). The Legislature could take advantage of the opportunity provided by the current positive budgetary situation to set aside funds—on a one-time basis and/or ongoing basis—to invest in the state's infrastructure.

In addition to these planning and process issues, there are several areas within the state's infrastructure program that merit consideration in the near term.

Setting Priorities for Higher Education. With limited resources, the state should invest in higher education capital outlay projects that will result in maximum educational benefit statewide. This can be done by considering capital outlay proposals across higher education rather than for each segment in isolation of the others and evaluating capital needs using statewide guidelines. To establish such a legislative review and approval process, we recommend the Legislature take the following actions:

- Appropriate funds on the basis of statewide priorites and criteria, not the "one-third/one-third/one-third" formula used in recent years to allocate funds to the three segments.
- Evaluate projects from all three segments as a common pool.
- Focus resources on undergraduate instruction needs and projects that bring campuses to no more than 95 percent of space guidelines.
- Recognize the existing large investment in research facilities and fund projects that bring campus research space to no more than 90 percent of space guidelines.
- Use construction cost guidelines for all segments—including the University of California.
- Use campus facilities on a year-round basis.

Management of the Capital Outlay Program. Given the need for improving and expanding the state's infrastructure, it is essential that the administration have the necessary staff available and an accountable process in place to implement approved projects in a timely manner. Unfortunately, the administration is not able at this time to undertake the current program, let alone an expanded program, in either a timely manner or, for the most part, within the approved budget. In our *Analysis of the 1999-00 Budget Bill* and again this year, we point out that a large number of approved projects are both behind schedule and over budget. As a result, many projects the Legislature funded in the current year are not proceeding as approved. The management of the capital outlay program must improve significantly if the state's infrastructure needs are to be addressed in a timely manner.

CRIMINAL JUSTICE

State and local governments in California spend more than $17 billion annually to fight crime. Local governments are largely responsible for crime fighting and, thus, spend the bulk of total criminal justice monies for law enforcement activities. State expenditures have grown significantly in recent years, however, particularly for support of the state's largest criminal justice department, the California Department of Corrections (CDC), which is responsible for the incarceration, training, education, and supervision in the community of adult criminals. Other state entities spend large sums of money on criminal justice activities as well, including the Departments of the Youth Authority and Justice, the courts, and the Office of Criminal Justice Planning.

Proposal

The budget proposes about $7.5 billion from the General Fund and other funds for support of criminal justice programs in the budget year, an increase of 5.5 percent over the current year.

The CDC accounts for the largest share of this funding, $4.4 billion, or about 3 percent more than the current-year amount. The CDC budget provides full funding for projected growth in the number of prison inmates and parolees under current law, as well as augmentations for several programs.

Other major criminal justice program augmentations include $100 million for a new one-time grant program in the Office of Criminal Justice Planning that would provide funds to local law enforcement agencies for technology equipment and school safety, and $21 million for state assistance to local law enforcement through the Citizen's Option for Public Safety (COPS) program.

Issues for Legislative Consideration

Declining Crime Rates. Since 1991 California has experienced a steep drop in crime. In fact, the 1998 rate is the lowest the state has experienced since 1966. This decline has not been confined to any one type of crime, but rather has been across-the-board.

There are probably many reasons for this sharp drop, including the improved economy and greater access to jobs, demographic shifts in the population away from persons in the most crime-prone age brackets (ages 18 to 49), the incapacitation and deterrent effects of longer criminal sentences enacted in recent years, improvements in policing and other law enforcement techniques, and the decline in usage of some types of serious drugs.

Slowdown in Correctional Population Growth. Among the consequences of the steep drop in crime rates has been the slowdown in the growth of the state's correctional populations. The CDC expects the prison population to increase about 1.9 percent in the current year and about 1.2 percent in the budget year, reaching about 167,100 inmates by June 2001. The CDC projects that the number of inmates will exceed 183,000 by June 2005. These growth percentages are significantly smaller than actual and estimated rates of recent years. Still, our review indicates that the actual growth rates will be slower than projected.

Focusing Crime-Fighting Efforts. The Legislature could allocate resources to crime-fighting activities that could help further reduce the already declining level of crime in California. In our view, some of the Governor's budget proposals meet that objective. For example, the Governor's budget provides $126 million (an increase of about $40 million) for programs for inmates and parolees, such as drug treatment and casework services in communities that are designed to prevent the future criminality of these offenders.

Other proposals are not well justified. For example, the $100 million augmentation for local law enforcement agencies for technology equipment and school safety lacks important details, contains no evidence of demand, and is duplicative of other programs.

TRANSPORTATION

Transportation Planning. The Department of Transportation (Caltrans) shares responsibility for developing transportation projects with local agencies. Typically, projects on the state highway system are designed by Caltrans, while projects off the state highway system, such as transit or local street and road projects, are designed by local agencies. Both Caltrans and local agencies schedule state-funded projects in a four-year programming document—the State Transportation Improvement Program (STIP).

The state also funds the intercity rail program, as well as provides local assistance funds for public transportation.

Proposal

Governor's Transportation 2000 Initiative. The budget includes a Transportation 2000 initiative designed to relieve congestion by accelerating funding for transportation projects. The key elements of the proposal are summarized in Figure 10 (see next page). As the figure shows, the initiative addresses both highway and road transportation, as well as public transit. It focuses on getting projects constructed sooner. This is to be achieved mainly by (1) scheduling more projects in the STIP to be delivered between 2000-01 through 2000-03, and (2) inducing local agencies to use their share of transportation funds more expeditiously via use-it-or-lose-it provisions.

In addition, the initiative provides funding for specific rail track and signal improvements and equipment acquisition for urban and commuter rail as well as intercity rail. The budget also provides funds for planning work to be done for a Bay Area ferry system, in accordance with recent legislation.

With the exception of expenditures for various rail and ferry projects, the initiative contains no *new* funding for transportation.

Issues for Legislative Consideration

We have identified several issues that the Legislature should consider when assessing the Governor's transportation initiative.

Availability of Projects for Expanded STIP Is Questionable. We think that scheduling more projects in the STIP would allow project design work to proceed sooner. However, the Governor's initiative would result in a 2000 STIP that is about 23 percent larger than the program would otherwise have been under current law. We question whether the state and local agencies can deliver, in short order, a program of this magnitude. Because neither Caltrans nor local agencies could have anticipated this substantial acceleration of funds for additional projects, it is highly unlikely that they will have even close to $3.6 billion worth of planned projects to use the advanced funding generated by the Governor's initiative.

Figure 10

Key Provisions of Transportation 2000 Initiative

Funding Proposals

- Accelerate $3.6 billion of funds into the 2000 State Transportation Improvement Program (STIP).
  - $3 billion in bonds backed by future federal transportation funds.
  - $600 million from the State Highway Account by lowering reserve.
- Amend Article XIX of State Constitution to allow a portion of fuel taxes to be used for transit capital and operating costs.

Transportation Programming

- Extend the STIP from four years to seven years to allow work to begin on projects that would otherwise be delayed until funds become available in the 2002 or 2004 STIP.

Environmental Streamlining

- Direct the Business, Transportation and Housing Agency, the California Environmental Protection Agency, and the Resources Agency to develop methods to streamline environmental review.

Use-It-or-Lose-It Provisions

- Expedite use of $300 million in local gas tax funds and $800 million in unused local agency federal funds. If local agencies do not spend funds within certain time period, state would reprogram funds for other projects.

Public Transportation

- $50 million for intercity rail improvements.
- $71 million for specific equipment, station, and track improvement projects for commuter and urban rail.
- $12 million for planning and studies for a Bay Area ferry system.

Initiative Would Necessitate Significant Staff Expansion. Beyond the question of whether projects are ready to be scheduled is an even more critical question—whether Caltrans or local agencies have the ability to hire and train staff to perform the necessary design and project development work to deliver an additional $3.6 billion worth of projects. Depending on the mix of projects that would be scheduled, Caltrans would have to expand its capital outlay support staff significantly—ranging from an additional 4,000 personnel-years to over 8,000 personnel years, at a total cost of between $400 million to over $800 million. This increase would have to occur mainly in the next two years if the projects are to be delivered in the 2000 STIP period. Given Caltrans' current vacancy rate (about 9 percent in its project development and engineering staff), it would likely have difficulty in hiring enough staff to meet the expectations of the Governor's initiative.

Impediments to Project Delivery Need to Be Addressed. In addition to not having adequate staff to work on projects, there are other factors which cause delay in the delivery of transportation projects. One major challenge is the complexity of delivering projects that are supported with federal funds. Our review found that federal funds can add several years to the length of time it takes to deliver projects. This is due to a number of factors, such as the length of time federal agencies take to review environmental documents and the project development process that must be followed in order to receive federal reimbursement.

We recommend the enactment of legislation to allow local agencies to pool their federal funds and, in certain instances, swap them for state funds. This would allow the use of federal funds to be more concentrated on certain large projects, rather than spread out across projects of various sizes. Additionally, we recommend that the California Congressional delegation seek enactment of legislation that would (1) delegate to Caltrans the authority to review and approve federally required environmental documents and (2) require federal permitting agencies to participate earlier in the federal environmental review process.

As regards the state environmental review process required by the California Environmental Quality Act (CEQA), we recommend that legislation be enacted to require that all state permitting agencies participate earlier in the CEQA process. Specifically, if a permitting agency fails to participate and inform Caltrans of its concerns after being formally notified of the project, it would forego the right to raise issues that have already been addressed in the CEQA review process.

Use-It-or-Lose-It Provisions Not Warranted. The initiative proposes use-it-or-lose-it provisions for two types of local transportation funds—federal funds and gas tax revenues—in order to encourage local agencies to expend these funds more expeditiously on projects. Given recent improvements in the rate local agencies have expended their federal transportation funds, as well as recently enacted timely use of funds provisions, we conclude that additional changes are not warranted at this time. As regards the gas tax revenues held as reserves by local agencies, we recommend that the Governor's proposal not be adopted given the estimated backlog in local streets and road repair needs (of over $10 billion).

Funding of Commuter and Urban Rail Proposal Should Use Existing Process. The budget proposes $71 million for specific capital improvement and acquisition projects on commuter and urban rail systems. Consistent with current legislative practice, we recommend that funding for individual projects not be provided in the budget act. Instead, we recommend that the amount be appropriated as a lump sum to be allocated by the California Transportation Commission to commuter and urban rail projects in accordance with project application and evaluation processes under existing law.

RESOURCES

CALFED Bay-Delta Program. The CALFED Bay-Delta Program was created in 1995 as a consortium of ten federal and five state agencies to develop a long-term solution to water problems in the San Francisco Bay/ Sacramento-San Joaquin Delta Estuary (the Bay-Delta). The program's goals are to improve water quality, fish and wildlife habitat, flood control, and the reliability of water supplies. The program is developing a plan that, once approved by federal and state environmental agencies (likely this summer), will guide the program's implementation phase that is expected to last at least 30 years at a total cost of potentially $10 billion.

The existing organizational structure of the program, currently housed in the Department of Water Resources (DWR), is loosely configured. This reflects the fact that the program has evolved administratively and has not been spelled out in state statute.

Older School Buses Are Significant Polluters. Of the 24,000 school buses operating in the state, most have diesel engines and about 1,900 predate 1977, the year when major federal safety standards took effect. Diesel school buses are a major source of "particulate matter" pollution that has been identified by the Air Resources Board (ARB) as a toxic air contaminant. Newer diesel buses, while subject to stricter air emission standards than older ones, continue to emit significantly greater toxic pollutants than low-emission alternative fuel buses (such as natural gas).

Watershed Assessment. An effective watershed assessment can provide valuable information necessary for improving regulatory and restoration efforts on watersheds. A watershed assessment compares historical and current habitat conditions and evaluates the extent to which changing habitat conditions have affected the populations of particular species. For a watershed assessment to be most effective in achieving regulatory and restoration goals, it should include three components: (1) data collection, (2) data analysis, and (3) applications to regulatory and restoration efforts.

California Coastal Commission. The California Coastal Commission is responsible for protecting the state's coastal resources through land use regulation, planning, educational programs, and other means.

Proposal

CALFED Bay-Delta Program. The budget proposes $42.3 million for the CALFED Bay-Delta Program under DWR. Of this amount, $20 million is for ecosystem restoration projects, $12.3 million is for planning and operations, and $10 million is for local water management and water transfer programs in areas served by Delta water. Our review, however, finds that an additional $93.8 million of proposed expenditures in DWR and various other state agencies should appropriately be characterized as CALFED-related expenditures. These include, for example, $51.5 million to be allocated by the Resources Agency for Bay-Delta ecosystem restoration projects.

Older School Bus Replacement Program. The Governor proposes a new $50 million "Older School Bus Replacement Program" to be administered by ARB. According to the budget, the intent of the program is to provide grants for school districts to replace pre-1977 diesel school buses with safe and clean alternative fuel buses.

Watershed Assessment Initiative. The budget requests $6.9 million and 56 personnel-years for various resources departments to do watershed assessments on state and private lands on the North Coast. The budget proposes to compile existing data and collect a limited amount of new data on North Coast watersheds. However, the proposal indicates that the data analysis will not result in specific recommendations related to land use activities such as timber harvesting or for restoration efforts.

Coastal Commission Seeks New Enforcement Positions. The Coastal Commission requests nine new positions to supplement the five positions currently dedicated to enforcement in the coastal zone. It also requests three new positions for other purposes, as well as additional funding for operating expenses and equipment.

Issues for Legislative Consideration

CALFED Bay-Delta Program. The focus of the CALFED Bay-Delta Program will soon shift from the planning to the implementation phase. During this phase, decisions will be made on the type, location, timing, and financing of specific projects. A number of important policy decisions will also have to be made, including setting expenditure priorities among the program's several areas of activity.

Because of the substantial state funding potentially at stake and the major decisions yet to be made, it will become increasingly important that a formal organizational structure be in place that the Legislature can hold accountable for CALFED-related decisions and expenditures. We recommend the enactment of legislation that establishes a structure that provides this accountability. The structure, which could take a number of different forms, should facilitate coordination among the various agencies implementing the program and ensure that the Legislature's information needs (such as being informed of the program's expenditure priorities, work plans, and budget) are met.

Older School Bus Replacement Program. There are several policy and implementation issues that remain unresolved with the Governor's proposal. We recommend that these issues be addressed in legislation prior to approving funding for the program. These issues include deciding the following:

- ***The Program's Overriding Goal.*** Setting a clear, primary goal for the program is necessary to establish criteria and guidelines for allocating the grant funds. For example, is the primary goal to achieve the maximum possible reduction in diesel particulate, or is it rather to modernize the school bus fleet to improve safety while achieving pollution reductions?
- ***Whether Funds Are for Bus Replacement, Retrofits, or Both.*** Establishing the program's primary goal would affect the extent to which the program focuses on bus replacement versus retrofits. For example, if the goal were to achieve the maximum reduction in diesel particulate statewide, it would be more cost-effective to use at least part of the funding for retrofits.
- ***The Age of Bus Fleets Eligible for Funds.*** The proposal's emission reduction potential is also affected if funding eligibility is limited to school buses of a certain age. Focusing solely on the oldest buses in the state, while modernizing the school bus fleet to improve safety, is likely to limit the potential to reduce emissions.
- ***Whether There Should Be a Matching Requirement.*** While a matching requirement would likely result in greater emission reductions statewide than under full grant funding, such a requirement could raise issues of fairness if poorer school districts are thereby excluded from the program.

Watershed Assessment Initiative. Our review finds the proposal lacks the components of an effective watershed assessment. Specifically, we do not think the proposal will achieve the goals of improving regulatory and restoration efforts for two reasons: (1) the data collection design is flawed and (2) the finished assessments are inadequately linked to regulatory and restoration efforts. We recommend that the Secretary for Resources report to the Legislature on how data collection dissemination would be coordinated among various resource departments, and how assessment results would be used to improve regulatory and habitat restoration efforts.

Coastal Enforcement Should Be Improved. We find that the commission is inadequately carrying out some of its statutory duties. In addition, a number of local governments are not fulfilling their responsibilities under the Coastal Act. While we believe the Coastal Commission's proposed staffing augmentations are warranted, we believe the Legislature should consider additional ways to help ensure the Coastal Act is adequately enforced. Specifically, the Legislature should consider ways to:

- Restrict the use of new staff to enforcement activities.
- Ensure that the commission addresses its backlog of Local Coastal Program (LCP) reviews.
- Strengthen incentives for local governments to adopt the commission's recommendations.
- Strengthen the incentives for local governments, that have not already done so, to adopt LCPs as required by law.

V

Major Issues Facing the Legislature

RECONSIDERING AB 8:

EXPLORING ALTERNATIVE WAYS TO ALLOCATE PROPERTY TAXES

What Are the Legislature's Options for Improving the Property Tax Allocation System?

Summary

In Chapter 94, Statutes of 1999 (AB 676, Brewer), the Legislature declared the existing property tax allocation system to be "serious flawed" and stated its intent to revamp the system in order to: (1) increase taxpayer knowledge, (2) provide greater local control, and (3) correct the skewed land use incentives faced by local governments. This report discusses five alternatives to improve local finance.

- **Alternative I: Set Uniform Rates.** *Each jurisdiction would be allocated a property tax share based on the services it provides.*
- **Alternative II: Local Control Over ERAF.** *Cities and/or counties would be given direct authority over the rate and allocation of a share of the property tax.*
- **Alternative III: Property Taxes for Municipal Services and Schools.** *The allocation of every property's tax bill would be identical—half to local municipal services and half to schools.*
- **Alternative IV: Re-Balance Tax Burden.** *Three local revenue sources would be changed significantly in order to provide a sales tax reduction and create local control over property tax rates.*
- **Alternative V: Making Government Make Sense.** *State and local government responsibilities would be realigned to create more efficient program coordination.*

Introduction

California's property owners pay over $20 billion of property taxes each year. These tax revenues—the third largest source of tax revenues in California—are then allocated among several thousand local governments, pursuant to a complex state statute. While significant legislation pertaining to the property tax allocation system has been enacted over the years, the allocation system is still commonly referred to as "AB 8," after the bill which first implemented the system—Chapter 282, Statutes of 1979 (L. Greene).

Over the years, the Legislature, local governments, the business community, and the public have become increasingly critical of the state's property tax allocation system because (1) it does not allocate revenues in a way that reflects modern needs and preferences of local communities and (2) it centralizes authority over local revenues in Sacramento.

To respond to these concerns, the Legislature enacted Chapter 94, Statutes of 1999 (AB 676, Brewer). Chapter 94 declares that California's system for allocating property taxes is "seriously flawed" and states legislative intent to revamp the property tax allocation system to:

- Increase taxpayer knowledge of the allocation of property taxes.
- Provide greater local control over property tax allocation.
- Give local governments greater fiscal incentives to approve land developments other than retail developments.

To assist the Legislature in this effort, Chapter 94 directs the Legislative Analyst's Office (LAO) to develop alternatives for restructuring the property tax allocation system, including one which provides for a minimum property tax share for each county. This report is written in fulfillment of Chapter 94's requirements.

This report begins with an examination of the problems in the current property tax allocation system and a discussion of the tensions and trade-offs inherent in reform proposals. The report then discusses five alternatives for revamping the "AB 8" system and outlines a process for enacting reform.

What Are the Problems With The Allocation System?

As noted above, Chapter 94 highlights three specific problems with California's system of property tax allocation. In addition, we have identified some other concerns which are indirectly related to the current allocation system. Figure 1 lists each of these problems, which are discussed in more detail below.

Figure 1

Property Tax Allocation: Existing Problems

☑ **Lack of Information Impedes Government Accountability**

- No entity-by-entity rates.
- Outdated formulas reflect 1970s preferences.
- Lack of accountability by officials.

☑ **Lack of Local Control**

- No ability to raise or lower property tax shares.
- System susceptible to state-controlled revenue shifts.
- Inability to shift revenues among priorities.

☑ **Skewed Development Incentives**

- Fiscal incentives encourage retail over other uses.
- Fiscal incentives encourage proliferation and misuse of redevelopment.

☑ **Other Related Issues**

- Assessment practices act as barrier to new businesses.
- Reliance upon nondeductible taxes to finance government services.
- Competition for resources results in inefficient intergovernmental program coordination.

Lack of Information Impedes Government Accountability

Prior to the passage of Proposition 13 by the California voters in 1978, each governmental entity (city, county, special district, and school district) would set a property tax rate annually. This rate would be combined with other local governments' tax rates to form a property owner's property tax bill. The taxpayer's total property tax owed would be determined by summing together the various rates and applying the total to the property's assessed value. Because the rates were connected to a specific government entity and set annually, taxpayers could see what percentage of their property taxes was going to each local government.

To implement Proposition 13, the Legislature enacted the AB 8 property tax allocation system. A single countywide rate of 1 percent replaced the numerous individual government tax rates. Although taxpayers gained the assurance that their rate could not increase from year-to-year, they lost the ability to see which entities receive revenues from their payments.

Complexity and Variation in Current Property Tax Allocations. Even if taxpayers today do further research regarding their property tax bill, they are likely to be confused when they find out that the allocation of revenues to any local government:

- Is based largely on the level of property taxes that it received in the mid-1970s, relative to other local governments in the same county.
- Generally can not be changed, except by state legislation.
- Varies significantly across taxpayers in the same county—and in comparison with taxpayers in other parts of the state.

Further information regarding the complexity and variation of the property tax allocation system is provided in Appendix I.

Reduced Government Accountability. In addition to confusing taxpayers about how their tax dollars are distributed, the AB 8 system reduces government accountability. The link between the level of government allocating the tax (the state) and the entity that spends the tax revenues (cities, counties, special districts, and schools) has been severed. So, for example, if a taxpayer is not happy with the level of library services provided by an independent library district, it is difficult to hold the district accountable since the library district is not the agency responsible for determining the level of property tax revenues available for service delivery.

Lack of Local Control

The same forces that diminish taxpayers' ability to hold their governments accountable also reduce local governments' ability to control their own finances. Local governments lack the fiscal control to use the property tax for its traditional purpose: meeting the ever-changing municipal needs of a community. Local officials have no power to raise or lower their property tax share on an annual basis to reflect the changing needs of their communities.

As the property tax shifts of the early 1990s illustrated, the current state-controlled allocation of revenues leaves local governments vulnerable to changes in their base revenue levels. Even if these shifted funds (or "ERAF" funds, named after the fund into which the money was deposited, the Educational Revenue Augmentation Fund) were returned, local governments would remain susceptible to future revenue shifts. Without local control of property tax distribution, state redirections of local revenues remains a potential problem.

The state has left the distribution of property tax revenues among local entities largely unchanged since the 1970s. Counties receive a similar proportion of property tax revenues despite many changes to their program responsibilities. Water districts that received property taxes 25 years ago continue to do so, despite a general trend for these and other resource-related services to be funded by user charges rather than general taxes. Local citizens and their elected representatives lack effective fiscal authority to change the allocation of property taxes to reflect their community's current priorities. This problem is especially acute for cities and counties that provide many of their municipal services through independent special districts. If these special districts levied a property tax rate in the 1970s, they typically continue to receive a share of the property tax today.

Finally, if residents desire an enhanced level of a particular service, there is no local forum or mechanism to allow property taxes to be reallocated among local governments to finance this improvement. For example, Orange County currently receives a very low share of property taxes collected within its borders—typically only 4 percent to 7 percent. If Orange County residents and business owners wished to expand county services, they have no practical way to redirect the approximately 3 percent to 4 percent of property taxes currently allocated to water and sanitation districts to pay for this program enhancement. Instead, if residents wish to increase overall county services, they would need to finance this improvement through a mechanism such as an assessment or special tax. In this way, the *overall* level of government taxation and expenditures can be higher than it would be if communities had greater local control.

Skewed Development Incentives

Under California's system of local finance, communities receive increased tax revenues when property is developed. These taxes include: property tax, sales tax, and vehicle license fees (VLF). Typically, when a city (or a county in the unincorporated area) develops its general plan or receives a proposal for property development, it assesses the fiscal impact of the development on the community. Generally, most communities find that they receive the highest level of revenues from retail developments. This is because the state allocates one cent of the sales tax to the jurisdiction where the transaction occurs; this tax is called the Bradley-Burns sales tax and is allocated on a "situs" basis. In contrast, most communities receive only a small share of the property tax and, for residential developments, a modest per-capita allocation from the VLF. Accordingly, industrial, office, housing, and agricultural land uses generally yield much lower tax revenues than retail development.

Not surprisingly given these incentives, many cities and counties have oriented their land use planning and approval process disproportionately towards the development of retail establishments, a process referred to as the "fiscalization of land use." Some communities have even entered bidding wars with each other in order to attract a large sales tax generating establishment to their jurisdiction. Because the overall *demand* for retail services is not affected by this competition, local government's emphasis on retail development does not significantly increase the total amount of sales taxes collected by governments—or improve the state's overall economy.

The state has a clear interest in promoting land use decisions that lead to an appropriate mix of various land uses. However, the current fiscal structure fails to encourage this balance. The relatively small share of the property tax that cities are allocated, combined with the presence of a local sales tax allocated on a situs basis, disadvantages the approval of new nonretail developments.

Another consequence of the relatively low share of property taxes received from property within their jurisdiction is the proliferation of redevelopment projects. Without redevelopment, a city wishing to spend funds to upgrade a "blighted" area typically would receive less than 20 percent of the growth in assessed value resulting from any economic improvement in the area. However, by creating a redevelopment project for that same area, a city's redevelopment agency is eligible to receive *all* of the growth in assessed value (less statutorily required pass throughs)—funds that would normally accrue to the county, special districts, school districts, and the city's general fund. This ability to reap higher-than-normal property tax revenues from within redevelopment project areas has led to some abuses and questionable declarations of areas as redevelopment projects.

Three Related Issues

While Chapter 94 focuses on limited information and accountability to taxpayers, lack of local control, and skewed development incentives as the major problems with the property tax allocation system, there are several other issues which are indirectly related to the allocation system and which constrict California's ability to have a healthy state-local government relationship. Accordingly, when considering alternatives for reforming the AB 8 system, the Legislature may wish to consider solutions that address the following issues as well.

Acquisition Assessment as Barrier to Entry to Market Place

Proposition 13 instituted major changes to the method by which property is assessed. Before Proposition 13, property was revalued annually to reflect its market value. Proposition 13 instead requires property be assessed only at the time of acquisition and then increased annually at a maximum of 2 percent. Thus, assuming that property values are on the rise, a property owner who has owned property for a long time will pay significantly less in property taxes than a new property owner of an equivalent property.

For residential property, this acquisition value-based system has some policy merit. Specifically, it (1) encourages stable communities and (2) ensures no sharp increases in taxes from year to year (of particular concern for senior citizen homeowners on fixed incomes). At the same time, however, new homeowners—both first-time home buyers and those relocating—bear a disproportionate share of the residential property tax burden. It is only after a number of years of home ownership that the financial benefits of the acquisition assessment system accrue to homeowners.

The same benefits of the acquisition value system exist in terms of commercial and industrial property; however, the disadvantages of this policy for businesses in a competitive economy are somewhat troubling. The system can present an economic barrier to entry for new businesses. If a competitor has been in the same location for a number of years, a new business faces higher operating costs. This can discourage the formation of new businesses and reduce competition.

Reliance Upon Nondeductible Revenues

California's state and local governments rely on a sales tax levied at a rate higher than in most other states. California households are not able to deduct these taxes against their federal personal income tax liability. Replacing a portion of the revenues collected under California's sales tax with revenues raised from a deductible tax (property tax, income tax, VLF) would result in a net increase in after-tax income for California residents.

Inefficient Program Coordination

California's residents receive government services from a wide variety of federal, state, and local agencies. Although many services may appear to be provided by a single agency, typically more than one agency is involved in paying for the service, determining how much of the service is provided, and controlling the details of program delivery.

Viewed as a whole, California's existing "system" of government does not work together well to achieve the public's goals. Rather, the different levels of government often have no common mission and work at cross purposes to one another. Governments compete among themselves for resources and to shift program costs to other governments. The public, in turn, finds that they cannot hold any particular agency responsible for the quality of governmental services.

Several years ago, in outlining a proposal for state-local reorganization—"Making Government Make Sense" (in *The 1993-94 Budget: Perspectives and Issues*)—we concluded that California's existing system of government was dysfunctional. While the Legislature has improved upon this system somewhat in recent years, many problems of inefficient program coordination, counter-productive fiscal incentives, and reduced accountability remain. These problems span a wide variety of areas, including the provision of many social service and criminal justice programs, land use development, and the administration of the property tax collection system.

WHY IS IT SO DIFFICULT TO IMPROVE THE ALLOCATION SYSTEM?

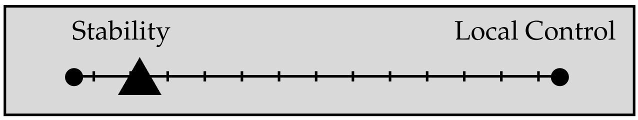
The problems with the state's property tax allocation system articulated in Chapter 94 are not new or unknown. These problems have been recognized and discussed by countless local government commissions, committees, and working groups for the last 20 years. Despite the large degree of consensus on the problems, enacting reform has proven elusive because it requires making difficult tradeoffs across multiple worthy policy objectives. That is, in most cases, making progress towards one desirable reform objective requires taking a step away from another.

Our review of previous reform efforts highlights four key areas of policy tension inherent in local finance and property tax allocation system reform proposals:

- Property Tax Rate: Taxpayer Stability *versus* Local Control.
- Property Tax Allocation: Local *versus* State Control.
- Focus of Government: Special Purpose Agencies *versus* General Purpose Governments.
- Local Finance: Reform *versus* Fiscal Stability.

In developing its proposal to revamp property tax allocation, the Legislature will confront these policy tensions—and will need to strike a balance that meets its policy preferences. Below, we begin our discussion of each policy tension with a graphic showing how the *current* local finance system is balanced between the competing policy objectives (indicated by a "▲").

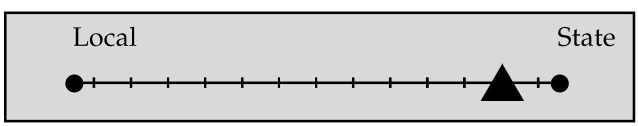
Property Tax Rate:
Taxpayer Stability Versus Local Control



The property tax is the only tax in which the maximum rate is set in the State's Constitution (at 1 percent of assessed value). Decreases in the property tax rate are authorized under state statute, but are difficult to implement. Increases *over* the base property tax rate may be authorized only for capital purposes and require approval by two-thirds of the local voters. (Proposition 26 on the March 2000 ballot would establish a *majority* vote approval requirement for *school* capital projects.) Combined, these constitutional and statutory provisions provide a very high degree of stability to the taxpayer, but limit local control over the tax rate.

For these reasons, in our chart above, we place an "▲"—representing the current local finance system—much closer to the goal of property tax rate stability than local control. In developing a reform proposal, the Legislature will need to consider the extent to which it wishes to maintain this level of property tax rate stability for all property owners—versus giving communities greater control to increase and decrease their property tax rates.

Property Tax Allocation:
Local Versus State Control



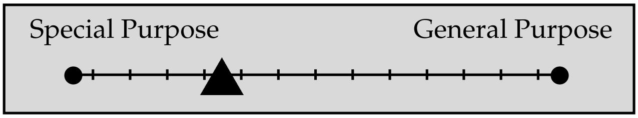
Currently, as discussed earlier in this report, the state controls the allocation of local property taxes. (Thus, the graph shows the "▲" next to "State.") State control of the property tax, however, is a relatively recent development in the state's history. Between 1910 and 1978, local governments had exclusive control over the allocation of the property tax; before 1910, this authority was shared between state and local governments.

Proposals to reform the property tax allocation system inevitably confront policy tensions between advocates for state and local control. On the one hand, keeping the state in control of property tax allocation allows the state to use the tax in a manner which reflects statewide concerns, such as funding for: education, state-county partnership programs, and newly developing or low-wealth communities. Transferring power over property tax allocation to local communities, on the other hand, would increase the likelihood that the tax revenues are used in a manner consistent with local preferences.

Because California has thousands of local governments, many with overlapping jurisdictions, reorienting the property tax allocation system to give local control requires major change. In general, we find that there are two ways to provide local control:

- Create a local forum for deciding how property tax revenues collected in a community should be allocated among local governments. The California Constitution Revision Commission, for example, suggested that each county enact a voter-approved charter defining, among other things, how property taxes are to be allocated. Alternatively, the Legislature could allocate a large share of the property tax to a single general purpose government, such as a city, and require the city to allocate the property taxes to other local governments providing services to city residents. By giving this responsibility to a local general purpose government, the allocation of the property tax could be determined annually, in a manner consistent with local priorities.
- Modify the current 1 percent property tax rate so that each local government sets its own rate. This would allow each government to raise or lower its property tax rate, possibly subject to voter approval or tax increase limitations. This option, of course, would require modification to Proposition 13.

Focus of Government: Special Purpose Agencies Versus General Purpose Governments

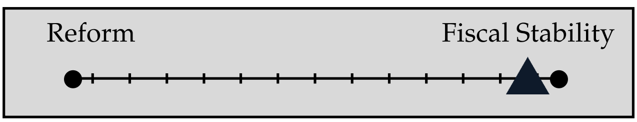


California allows special purpose governments and agencies to play a major role in providing governmental services, including fire, water, redevelopment, and parks and recreation. Local governments in other states typically have more of these services controlled by a single general purpose government, such as a city or county. Currently, it is not uncommon for a single home or business in California to be served by a dozen special purpose entities, with many of them receiving a share of property tax.

California's property tax allocation system also contains provisions which strengthen the fiscal position of some special purpose agencies. Specifically, state laws permit virtually any city to create a redevelopment agency capable of redirecting property taxes away from general purpose governments. In addition, as we discussed earlier, state laws controlling the allocation of property taxes may have worked to limit the extent that some special purpose governments (such as water and sanitation districts) are shifted from property tax to user-fee financing.

Because California's system of local government grants significant legal authority to special districts and maintains their share of the property tax, the graphic above shows California's system of local government leaning moderately in favor of special purpose governments.

Local Finance:
Reform Versus Fiscal Stability



The last of the four policy tensions pertains to fiscal stability. Given the thousands of units of local government, *any* change to the allocation system for property taxes—or to local finance in general—will cause some fiscal disruption to the state or local governments (thereby reducing California's current level of fiscal stability, at least in the short-term). In confronting this trade-off, many previous reform committees have chosen to favor fiscal stability more than reform. In fact, some previous reform efforts have sought to make improvements under the constraint of complete fiscal neutrality: no individual government would gain or lose current revenues under the proposal and no taxpayer would pay more. While the goal of maintaining a government's and taxpayer's fiscal condition is worthy, we note that there is tension between the goals of improving the system and maintaining the status quo.

In enacting Chapter 94, the Legislature recognized this tension and specified that it "intends to consider allocating an unspecified amount in additional revenues available to cities, counties, and special districts" to mitigate any fiscal disruption. We think this statement by the Legislature was an important recognition of the tension between reform and fiscal stability. While there are various options for the Legislature to consider to minimize the economic disruption (such as phasing in changes, making them optional, or providing increased taxing authority), it is important to note that the goals of local finance improvement and short-term fiscal stability are at odds.

WHAT ARE THE ALTERNATIVES?

In this next section, we describe five alternatives for revamping the property tax allocation system in a manner consistent with the goals stated in Chapter 94. In reviewing these alternatives, we note that they do not represent the only choices for the Legislature, but a look at the spectrum of options available. In addition, in many cases, elements of these alternatives can be modified to alter the emphasis given to any of the competing policy objectives discussed above, or to address other policy objectives of the Legislature.

Alternative I: Set Uniform Rates

Chapter 94 requires the LAO to consider the option of "establishing a minimum percentage of the property tax to be allocated to each California county." This concept of assigning local governments a minimum share of the property tax has been discussed over the years. The Legislature took a step in this direction in passing Chapter 1211, Statutes of 1987 (SB 709, Lockyer), guaranteeing a minimum share of property taxes to certain cities that did not levy a property tax rate (or levied only a very low rate) prior to Proposition 13. The Legislature also has considered bills to increase certain counties' shares of property taxes.

One difficulty associated with these "minimum percentage" proposals is that there is no common set of governmental responsibilities. Some cities, for instance, provide a wide array of services: police, fire, and parks and recreation. Other cities provide public protection and land use planning, but rely on the county or special districts to provide other services to their residents. Similarly, in some counties most people live within the boundaries of full-service cities. Other counties, by serving unincorporated areas, provide municipal services to a large number of their residents. As a result, assigning the same property tax share to all cities and counties disadvantages those local agencies with more service responsibilities. We note, for example, that an analysis performed for the League of California Cities found that, after correcting for their typically lower service obligations, cities with low shares of the property tax often receive a higher share of the property tax than many other cities.

If the Legislature wishes to revamp the property tax allocation to improve uniformity in the distribution of property taxes, the Legislature should acknowledge the differences in local government service obligations. Accordingly, this first alternative outlines a process by which the Legislature could assign shares of the property tax which reflect the number of services provided by the local government.

How It Would Work

Based on a statewide study of local government costs to provide services, the Legislature could enact a statute assigning specific shares of the property tax for each service. For example, the statute might assign K-14 finance a 50 percent share of the property tax; countywide services a 25 percent share; fire and police/sheriff 10 percent shares each; and library, parks and recreation, and other services a share of the remaining 5 percent.

Any individual government's share of the property tax, in turn, would reflect the number of services it provides. For example, a city that provides a full array of municipal services might receive 25 percent of the property taxes collected within its borders (10 percent each for police and fire, and 5 percent for other services). Conversely, a city that relies more extensively on special districts might receive a 10 percent share (for police services). Similarly, a county might receive 45 percent to 50 percent of the property tax collected from properties in its unincorporated area, but only 25 percent of the property tax in areas included within a city's boundaries.

The Legislature would have many options in implementing this alternative. For example, the Legislature could specify that the scheduled shares apply only:

- To the *growth* in property taxes, leaving the existing $20 billion "base" of property taxes allocated as it has in the past.
- To governments where it would *increase* their share of property taxes.
- To governments where the current per- capita amount of property taxes is lower than average.

Alternatively, the Legislature could develop a statewide uniform schedule, applicable to only a specific county or counties on a trial basis.

Discussion

Under this alternative, the differences in property tax shares which largely stem from local taxation and governmental organization decisions of a generation ago would be replaced by differences reflecting current service responsibilities. In addition, taxpayers throughout the state would have a much easier task understanding how their tax dollars are distributed, possibly improving local government accountability.

The major disadvantages of this proposal, relative to the goals specified in Chapter 94, pertain to its failure to increase local control or improve development incentives. Specifically, the uniform schedule of property tax shares would be enacted in Sacramento and is unlikely to represent local priorities or the needs of all communities, especially over time. In addition, this alternative does not alter the fiscal incentives local governments face to approve retail land uses. This is because the alternative does not:

- Decrease the reliance of cities or counties (agencies with the power to approve land developments) on situs-based sales taxes.
- Necessarily increase city and county reliance upon the property tax, a tax which provides more "neutral" fiscal incentives for local governments.

In terms of the four tensions discussed above, this alternative makes little change from the status quo. The proposal is balanced towards maintaining property tax rate stability, state control over tax allocation, and maintaining the role of special purpose governments. Finally, the extent to which the proposal was balanced towards reform or fiscal stability would depend on the implementation of the measure. For example, if the schedule applied only to the growth in property taxes, the extent of fiscal disruption and reform would be modest.

Alternative II: Local Control Over ERAF

This next alternative focuses more directly on Chapter 94's goal of increasing local control over the property tax. Specifically, Alternative II gives local governments direct authority and responsibility over part of the property tax rate and its allocation.

How It Would Work

Currently, about 18 cents of every property tax dollar paid is allocated to the fund created as part of the early 1990s property tax shift, ERAF. Money from ERAF is allocated to K-14 schools in each county. Under this alternative, the state would *reduce* the overall property tax rate from 1 percent of assessed value to 0.9 percent. *Cities, counties, and special districts would not sustain any property tax revenue losses as a result of this change.* The only effect of the tax reduction would be to decrease revenues allocated to ERAF. The state would be obligated to offset school losses with increased General Fund dollars.

After reducing the property tax rate from 1 percent of assessed value to 0.9 percent, the Legislature would instruct cities and/or counties that it is their decision whether to (1) increase city or county property taxes up to the maximum 1 percent rate and/or (2) pass on the tax cut as property tax relief to property owners in their communities. Figure 2 (see next page) provides examples of this alternative. As the figure shows, the first step in the alternative is to view the 1 percent rate as the composite of different rates for different local governments. (The rates shown in the figure represent statewide averages.) The second step is for the state to reduce ERAF's share of the property tax. Finally, in the third step, the Legislature gives cities (or cities and counties) authority to increase the rate. While our example shows local governments increasing the rate to the maximum, some local governments would choose not to increase the tax rate, and pass on the tax cut to their residents.

What Vote Would Be Needed to Increase the Tax Rate? Provided the maximum property tax rate did not exceed 1 percent, Proposition 218 (Article XIII C, Section 2 [b]) appears to give this tax adjusting authority to city councils and boards of supervisors, without requiring a vote of the local electorate. Should local residents object to their representatives' decisions, local residents could elect different local officials, or overturn the property tax change using the initiative powers set forth in Proposition 218 (Article XIII C, Section 3). Cities and counties also could choose to place these taxation matters before their local electorate.

Which Level of Government Would Have Power Over the Tax Rate? The Legislature would need to designate the extent to which cities and/or counties would have authority over the rate. Absent a constitutional change, we do not believe that special purpose agencies, such as schools or special districts, would have authority to modify the rate.

Discussion

This alternative makes significant improvements towards one of the goals specified in Chapter 94—increasing local control of property tax allocation. Specifically, it:

- ***Links the Level of Local Taxes With Local Preferences.*** Communities that prefer lower taxes can have their property taxes reduced. Communities that prefer higher levels of city or county services can forgo a tax cut and enjoy higher levels of local services. Should local preferences change over time, the local tax rate could change as well.
- ***Focuses Accountability on Locally Elected Officials.*** For much of the last two decades, locally elected officials have had limited authority to alter the level of broad-based local taxes. As a result,

some of the focus regarding local fiscal affairs has shifted from locally elected officials to state officials and state budgetary actions. This property tax alternative, in contrast, places more fiscal responsibility upon locally elected officials.

This alternative makes less progress towards Chapter 94's other goals. Specifically, taxpayer understanding of the allocation system would be limited because most tax revenues still would be allocated under the AB 8 formulas. In addition, the alternative only modestly improves local government's skewed land use development incentives.

In terms of the tensions discussed earlier, this alternative moderately shifts the balance towards *local control* of the property tax rate and its allocation. In addition, because special purpose government would not gain increased authority, the alternative shifts the focus of government somewhat towards general purpose governments. Finally, in terms of reform versus fiscal stability, this alternative makes improvements, but imposes a cost to the state. Specifically, a 10 percent reduction in the prop-

Figure 2

Local Control Over ERAF

Step 1: Current Effective Property Tax Rates (Statewide Averages)

	Rate
Schools	.35
ERAF	.18
Counties	.20
Cities	.11
Special districts	.09
Redevelopment	.08
Total	**1.00**

One way to think about property tax allocation is to consider the 1 percent rate as the composite of different rates for different local governments.

Step 2: Reduce ERAF's Tax Rate in Every Community

	Current Rate	State Change	Reduced Rate
Schools	.35	—	.35
ERAF	**.18**	**-.10**	**.08**
Counties	.20	—	.20
Cities	.11	—	.11
Special districts	.09	—	.09
Redevelopment	.08	—	.08
Totals	**1.00**	**—**	**.90**

(Continued)

erty tax, as outlined here, would cost the state approximately $2 billion annually. A 5 percent reduction would cost $1 billion annually.

Alternative III: Property Taxes for Municipal Services and Schools

The third alternative significantly revamps and simplifies the property tax allocation system to meet Chapter 94's goals. Specifically, this alternative links the property tax exclusively to two purposes: (1) municipal services and (2) school finance. Each of these purposes would receive half of the property tax revenues collected from any property.

How It Would Work

Under this option, the allocation of every property's tax bill would be identical—half to local municipal services and half to schools. For the half allocated to schools, the funds would be deposited into a countywide fund. From this fund, schools throughout the county would receive an

Local Control Over ERAF ***(continued)***

Step 3:

Option A—Authorize Cities to Increase Tax Rate

	Reduced Rate	Local Change	New Rate
Schools	.35	—	.35
ERAF	.08	—	.08
Counties	.20	—	.20
Cities	**.11**	**.10**	**.21**
Special districts	.09	—	.09
Redevelopment	.08	—	.08
Totals	**.90**	**—**	**1.00**

Option B—Authorize Counties and Cities to Increase Tax Rate

	Reduced Rate	Local Change	New Rate
Schools	.35		.35
ERAF	.08		.08
Counties	**.20**	**.05**	**.25**
Cities	**.11**	**.05**	**.16**
Special districts	.09		.09
Redevelopment	.08		.08
Totals	**.90**		**1.00**

allocation. As with current law, the state's General Fund would supplement these funds and schools would be held harmless. For the remaining half of the property tax, the funds would be allocated to the city in which the property is located. For unincorporated areas, the county would receive the funds to carry out its role as the property's municipal service provider. Funds provided to a county for this purpose could not be redirected to pay for general countywide services, such as county jails, public health, and welfare.

City or county (in the case of unincorporated areas) representatives would be responsible for providing (or contracting for) a defined set of municipal services for their residents, such as police, fire, parks, libraries, etc. Cities or counties could elect to allocate a portion of their property taxes to special districts and/or redevelopment agencies. Because this alternative provides such a large share of the property tax to municipal service providers, counties would need a replacement revenue source to pay for countywide services. This alternative shifts most city Bradley-Burns sales tax and some city VLF revenues to counties for this purpose. Counties would receive sales tax revenues from sales taking place *anywhere* within their borders, not just from sales occurring in unincorporated areas.

Discussion

This alternative would make considerable gains towards all of Chapter 94's goals. Specifically, the measure provides for:

- ***Simple Allocation System and Local Flexibility.*** For taxpayers, understanding their property tax bills and holding their elected officials accountable would become significantly easier. If they were unhappy with the level of support being dedicated to a particular service, their city council or board of supervisors would have the power to redirect resources away from another service. Property taxes formerly allocated to special districts and/or redevelopment agencies would be available to the city or county as general purpose revenues. As a result, municipal service providers (cities and, for unincorporated areas, counties) would control about $10 billion of property taxes. Local governments, however, would not receive any additional authority to increase or decrease these revenues.

- ***Balanced Land Use Decisions.*** By redirecting the Bradley-Burns sales tax (up to $4 billion) away from cities to counties, the incentives for land use practices that unduly favor retail establishments would be greatly reduced.

In terms of the tensions outlined earlier in this report, this alternative maintains the current balance towards property tax rate stability, but allows much greater local control over the allocation of property tax revenues. This proposal places a stronger emphasis on general purpose governments. For special districts or redevelopment agencies to continue to receive property tax revenues, the city or county would have to choose to dedicate a portion of their property tax revenues for these services. (In the short run, however, cities may need to allocate some of their property tax revenues to these agencies to meet debt service obligations.)

Alternative IV: Re-Balance Tax Burden

Under this alternative, a number of revenue sources are changed significantly to: reduce the state's reliance upon nondeductible taxes, provide a more balanced set of local government fiscal incentives regarding land use, give communities local control over the property tax rate and allocation, and reduce the barriers to entry for new businesses under an acquisition-based assessment system. While these goals could be achieved in a number of ways, one approach is outlined below. As summarized in Figure 3 (see next page), the alternative makes changes to the sales tax, the property tax, and the VLF in achieving its goals.

How It Would Work

Sales Tax Changes. This alternative reduces the sales tax by $5 billion (1.25 percent) in order to (1) reduce a tax which California households can not deduct against their federal income tax liabilities and (2) reduce local governments' incentives to favor retail developments. Because of differential rates across counties, this tax cut would reduce the sales tax rate in Los Angeles County from 8.25 percent to 7 percent, and in Butte County from 7.25 percent to 6 percent.

This composite sales tax reduction of 1.25 percent would come from cutting the:

- State's sales tax rate by three-quarters of a cent.
- Local Bradley-Burns sales tax rate by one half cent.

In addition, in order to further correct local government's strong incentives to approve retail developments over housing, half of local governments' remaining Bradley-Burns sales taxes would be allocated on the basis of population, not by where the sale occurs.

These sales tax cuts would have an indirect effect on future VLF rate reductions. As part of the 1998 budget agreement, the VLF was cut permanently by 25 percent, with additional VLF reductions beginning in 2001

Figure 3

Summary of Alternative IV: Re-Balance Tax Burden

✓ **Reduce Sales Taxes by 1.25 Percent ($5 Billion)**

- Reduction split between state (0.75 percent) and local (0.50 percent) rates.
- Under current law, *state's* loss of revenue would be largely offset by reduced state spending from *future* vehicle license fee (VLF) reductions not going into effect.

✓ **Increase City and County Property Tax Revenues ($1.3 Billion)**

- In exchange for the receipt of these new revenues, local governments would forego the revenues from the *existing* VLF backfill.

✓ **Increase Local Control Over Property Tax Rate**

- Each local entity would be authorized to raise or lower its own property tax rate.
- Taxpayer protections would include the requirement of a local charter and a 2 percent maximum annual increase.

✓ **Assess Nonresidential Property at Market Value ($2 Billion)**

- Business personal property and state assessed property (like public utilities) are already assessed in this manner.

if specific revenue levels are reached. (In addition, the Legislature enacted legislation increasing the VLF reduction to a cumulative 35 percent for calendar year 2000 *only*.) To offset the city and county revenue losses associated with these VLF reductions, the state provides cities and counties the same amount of revenues they would have received under prior law; these state General Fund subventions are called the VLF "backfill." Under the VLF legislation, any additional tax reductions that the Legislature enacts reduces, on a dollar-for-dollar basis, the amount of tax relief provided through *future* VLF reductions. Under this alternative then, the state's sales tax cut would *replace* the scheduled *future* reductions to the VLF over the base 25 percent reduction. This option, therefore, reduces a nondeductible tax (sales) instead of a deductible one (VLF).

Increase Property Tax Shares. In order to provide more "neutral" land use incentives to local governments, this alternative shifts about $1.3 billion of property taxes from schools to cities and counties. This redirection of property taxes would increase state General Fund costs for education. To offset these increased state education costs and hold itself harmless, the state would eliminate the $1.3 billion General Fund VLF backfill associated with the *existing* 25 percent VLF reduction currently allocated to cities and counties. (Taxpayers, however, would continue to receive the 25 percent reduction.) Thus, as a result of this revenue swap, local governments would continue to receive $1.3 billion in revenues. However, cities and counties would now receive a revenue source which enhances land-use incentives for balanced development (the property tax), as opposed to a state-controlled subvention (VLF backfill).

Increase Local Control. In order to increase taxpayer understanding of their property tax bill and facilitate local allocation decisions, this alternative would split the current 1 percent base property tax rate into a series of individual local government by local government rates. Each local government's rate would be shown on the property owner's tax bill. The total of these rates for any property would sum to 1 percent initially.

The Constitution would be amended to specify that this maximum aggregate rate of 1 percent applies in all parts of the state—*unless* it is superceded by a voter-approved local government charter which specifies a process by which the local government's property tax rate may be increased or decreased. (For example, one city's local charter could specify that property tax rate changes are permitted upon a two-thirds vote of the electorate, while another city's charter could require a majority vote of the governing board.) The Constitution would specify, however, that no local government would be permitted to raise its rate by more than 2 percent per year—for instance, from 0.50 percent to 0.51 percent. (There could be exceptions to this limit in cases where a local government was absorbing program responsibilities formerly provided by another government, such as a special district.) Thus, communities would gain a mechanism for increasing and decreasing the level of property taxes allocated to any jurisdiction. At the same time, homeowners would continue to be protected from large year-to-year changes in their property tax bills.

Reduce Barrier to Entry for New Businesses. Finally, in order to address the problem associated with higher property taxes paid by new businesses, this alternative calls for assessing all *nonresidential* property at its current market value. Business personal property and state assessed property (like public utilities) are already assessed in this manner. This change in assessment practices would likely generate about $2 billion in additional property taxes in the first year. Revenues in subsequent years would vary with economic conditions.

Discussion

The combination of changes proposed by this alternative would yield an improved system of local government finance that relies less on the sales tax and returns control over the property tax to local governments.

How Would Individuals Fare Under this Alternative? This alternative would give a sizable tax reduction to individuals in the form of a sales tax reduction. While taxpayers would forego *additional* VLF reductions, the sales tax reduction would be about twice as large as the future VLF cuts. Furthermore, VLF payments are deductible for many taxpayers whereas sales tax payments are not. In addition, taxpayers would be able to see the current allocation of the property tax through entity-by-entity rates and decide whether that allocation met their preferences. Each community could decide for itself whether it wanted to maintain the one percent rate cap or opt for a modest modification. Communities would also have a much easier task reallocating revenues, or eliminating the property tax share allocated to some local governments.

How Would Businesses Fare Under this Alternative? Under the current property tax system, business properties—on average—are assessed at about 80 percent of market value. Thus, the change in assessment practices would increase their property tax liabilities by about 25 percent. This increase in property tax liability, however, would be significantly offset by a large decrease in sales tax liability. Thus, businesses, on average, could expect to pay approximately the same amount of taxes as today. Unlike the current system, however, new businesses would not be at a competitive disadvantage with regards to property tax payments.

How Would Governments Fare Under this Alternative? Local governments in the aggregate, would be held fiscally neutral under this alternative, even without increasing the base property tax rate. Local government land use incentives also would be significantly improved. The amount of local tax revenues generated from *all* types of land uses would increase because of (1) a transfer of additional property taxes to local governments and (2) the increased property tax revenues from the assessment of nonresidential property at market value.

The state would experience a revenue loss resulting from the sales tax reduction. These state losses would be partially offset, however, by increased property taxes associated with the change of assessment for nonresidential property (which would offset state costs for K-14 education) and savings from not implementing further VLF reductions (which would require additional state backfill payments). In total, we estimate that the alternative would likely increase state costs several hundreds of millions of dollars annually.

Alternative V: Making Government Make Sense

This fifth alternative addresses the goals of Chapter 94 and the problem of inefficient intergovernmental program coordination, discussed earlier in this report. Specifically, this alternative—"Making Government Make Sense" (MGMS) (*1993-94 Budget: Perspectives and Issues*)—provides for significant fiscal changes and a realignment of the duties of state and local government. This alternative illustrates how the issues of local finance, governance, and program reform may be addressed together.

How It Would Work

A series of guiding principles underlie the MGMS proposal and direct its reforms. Specifically:

- Maximize the separation between state and local duties.
- Whenever possible, transfer program responsibilities to the level of government closest to the people.
- Focus state responsibility on programs where uniformity is needed—or where statewide benefits are to be achieved.
- Ensure that program funding responsibility and program policy control reside at the same level of government.
- Rely on financial incentives to promote intergovernmental coordination.
- Match state goals for economic development with fiscal incentives facing local communities.

The MGMS alternative relies upon these principles as it examines each governmental program and assigns principal responsibility for the program to the state—or a *single* local government entity. For most purposes, this alternative eliminates the differences between city and county program responsibilities. Thus, a city is responsible for providing *all* local services to city residents and a county is responsible for providing all services to residents of the unincorporated area. Special districts and redevelopment agencies are not assigned duties by the state, but may be delegated responsibilities by cities or counties.

Alternative V also significantly modifies the state-local financing system to reflect the changes in program responsibility and the statement of principles. Specifically, this alternative shifts a very large share of property taxes from schools to cities and counties to offset (1) the net fiscal effect of the program shifts and (2) a transfer of all of the local Bradley-Burns sales tax to the state. In order to equalize opportunities for community success, each community's allocation of property taxes would be redetermined by the state. This allocation of property taxes would consider local needs for municipal and community-based services. After this initial allocation by the state, local governments would be authorized to raise or lower their property tax rates by majority vote of the local electorate.

Discussion

This alternative makes significant progress towards the goals specified in Chapter 94. Specifically, taxpayers would have a clear understanding about the allocation of property taxes—and control over this allocation. The vast majority of any property tax bill would be allocated to a single agency—the city, or county, if the property was in an unincorporated area. Locally elected officials would be responsible for using these property taxes to pay for a wide array of local municipal and community-based services. If taxpayers wished their local government to have a higher or lower level of property taxes, taxpayers could modify the property tax rate accordingly. Finally, by shifting so much property taxes to local government and eliminating local reliance upon the Bradley-Burns sales tax, this fifth alternative substantially improves local land use incentives.

While this alternative meets all of the goals of Chapter 94 and realigns program responsibilities to focus accountability and achieve greater results, MGMS clearly demonstrates the tension between reform and fiscal stability discussed earlier in this report. Simply put, the alternative entails very significant governance and finance changes. In terms of the other tensions discussed earlier in the report, this alternative emphasizes the goal of local control over the property tax (its rate and allocation) and promotes general purpose governments.

COMPARING THE ALTERNATIVES

Each of the five alternatives described above would improve upon the current system of property tax allocation. Each alternative addresses at least one of the three major problems with the current property tax allocation system described by Chapter 94—limited accountability to taxpayers, a lack of local control, and skewed development incentives. In Figure 4 (see next page), we rate these alternatives on their ability to solve these problems, as well as the larger state-local issues of barriers to new businesses, tax deductibility, and intergovernmental program coordination. We have assigned from zero to three checkmarks to each alternative for its ability to solve these problems (with three checkmarks being the best score).

For instance, Alternative III is given three checkmarks for its ability to address skewed development incentives (since it dramatically increases property tax shares for cities and reduces the situs allocated sales taxes).

However, this alternative receives only one checkmark for its ability to enhance local control (although some fiscal flexibility is provided, there is no authority to modify the property tax rate).

An examination of Figure 4 reveals an increasing number of checkmarks as one moves from Alternative I to Alternative V. This is not a coincidence—in order to make significant progress in addressing the stated problems, the alternatives make increasingly dramatic changes to the status quo. For instance, while we believe Alternatives IV and V offer the most progress to a long-term solution to the state-local fiscal relationship, these alternatives come with a cost. In order to implement these alternatives, both statutory and constitutional changes would be needed that would reduce—at least in the short-term—fiscal stability. For example, Alternative IV and Alternative V would require changes to the constitutional provisions governing the maximum property tax rate and voter approval requirements.

Figure 4

Addressing Tax Allocation Problems: Comparison of Alternatives

Problem	I. Set Uniform Shares	II. Local Control Over ERAF	III. Property Taxes For Municipal Services And Schools	IV. Re-Balance Tax Burden	V. Making Government Make Sense
Limited accountability to taxpayers	✓	✓	✓✓✓	✓✓✓	✓✓✓
Lack of local control	—	✓✓	✓	✓✓✓	✓✓✓
Skewed development incentives	—	✓	✓✓✓	✓✓✓	✓✓✓
Barrier to new businesses	—	—	—	✓✓✓	—
Reliance on nondeductible taxes	—	—	—	✓✓	—
Inefficient intergovernmental program coordination	—	—	—	—	✓✓✓

Legend:

— Does not address problem. ✓ Some improvement. ✓✓ Moderate improvement. ✓✓✓ Significant improvement.

MOVING FORWARD TO A SOLUTION

In enacting Chapter 94, the Legislature declared its intent to revamp the state's system of property tax allocation. Given the policy tradeoffs inherent in the five alternatives and the failures to implement past reform proposals, is there hope for local finance and property tax allocation reform in the near term? We believe there is reason for optimism if the following considerations are kept in mind.

No Perfect Solution Exists

None of the five alternatives is the perfect solution to California's property tax allocation problems. Nor will the Legislature find a perfect solution by waiting to take action. In fact, the longer the current system remains unchanged, the worse the problems become. Local governments adjust to the counter-productive fiscal incentives inherent in the current finance system, and residents turn increasingly to the state to address local concerns. By acknowledging the shortcomings and tradeoffs inherent in all local reform proposals, the Legislature can make an informed determination as to which alternative best meets its priorities.

Need for Focused Attention

If the Legislature considers each reform proposal individually, each proposal likely would be rejected because entities negatively affected by it will mount strong opposition, emphasizing the proposal's imperfections. However, the Legislature could increase the likelihood of enacting reform by (1) creating a joint committee, charged with evaluating all reform proposals and (2) requiring the committee to recommend the best alternative within a specific time period. This focused attention, given to all reform proposals by a single body, would facilitate the process of appraising the strengths and limitations of reform options. This process also would increase the likelihood of compromise, innovation, and ultimately enacting an agreeable solution.

In addition to the alternatives described in this report, the committee could consider proposals from the Speaker's Commission on State/Local Government Finance, the Commission on Local Governance in the 21st Century, the Controller, and local government associations. Ideally, the administration would participate in these deliberations given the interest in local government fiscal reform it expressed a year ago.

Set Aside Funds

Given its long-standing concern about improving local finance, the Legislature should consider setting aside a realistic level of one-time and ongoing resources to implement its final reform product. As discussed earlier, many previous reform efforts have failed due in large part to their attempts to be fiscally neutral. Chapter 94, in contrast, acknowledges the desirability of providing resources to facilitate reform. Setting aside funds could ease the transition to a new system. One-time funds could reduce the fiscal impact on local governments during the initial implementation period. Ongoing resources may be needed to implement the long-term structural changes.

The magnitude of dollars needed for this purpose is difficult to determine before the Legislature has developed a local reform proposal reflecting its priorities. Given the billions of tax dollars potentially subject to reallocation and the thousands of local governments involved, however, resources in the range of hundreds of millions of dollars may be necessary to minimize the fiscal disruption associated with local finance reform.

Developing a set-aside of this magnitude would compete with other legislative priorities but need not be solely reliant on new state resources. Rather, the Legislature could consider redirecting some of the local subventions that have been created in recent years (partly in response to the impaired fiscal capacity of local governments). If the Legislature's reform proposal improved local fiscal capacity and accountability, the need for these subventions may be reduced. For example, the Legislature could consider redirecting into a local reform set-aside funds currently budgeted for some of the following programs: the Citizen's Option for Public Safety (COPS) program, property tax administration loan program, booking fees reimbursements, redevelopment subventions, and criminal justice grants administered by the Office of Criminal Justice Planning. Combined, the Governor's budget currently includes over $300 million for these purposes.

CONCLUSION

This report outlines five alternatives which would make progress towards the goals articulated in Chapter 94 and local government finance in general. None of these alternatives is perfect; each requires difficult tradeoffs across multiple, worthy policy objectives. In developing a local government reform proposal, the Legislature will confront the tensions between taxpayer stability and local preferences, local and state control, general purpose and special purpose governments, and reform and fiscal stability. Notwithstanding these tensions, the current year offers a good opportunity for the Legislature to consider making improvements in the property tax allocation and local finance systems.

Appendix I

COMPLEXITY AND VARIATION IN PROPERTY TAX ALLOCATION

Under California law, each area of the state which is served by the same set of local governments is called a "tax rate area" or TRA. Each TRA has its own detailed formula governing the distribution of property taxes collected from within its borders. A sample allocation formula—for a TRA in an older section of Anaheim—is shown in Figure 1. As the figure indicates, if a new business were constructed in this area, 11 percent of the property taxes would be distributed to the City of Anaheim, 7 percent to the County of Orange, and the rest would be allocated to various school entities and special districts.

Figure 1

Tax Rate Area Example[a]

	Percent Share
City of Anaheim	11%
Orange County	7
Orange County Water District	—[b]
Orange County Water District Water Reserve	—[b]
Orange County Transportation Authority	—[b]
Orange County Sanitation District No. 2	3
Orange County Flood Control District	2
Orange County Harbors, Beaches, and Parks	2
Orange County Vector Control District	—[b]
Orange County Cemetery District	—[b]
Anaheim High General Fund	19
North Orange County Community College	8
Anaheim Elementary	30
Orange County Department of Education	2
ERAF[c] (distributed to various schools)	16
Total	**100%**

[a] Percentages indicate allocation of taxes from a new home or business in Anaheim tax rate area 01-007.

[b] Less than 1 percent.

[c] Educational Revenue Augmentation Fund.

Few California cities have only one TRA within its borders; some have dozens. Generally, however, tax distribution formulas associated with TRAs *within* a city are somewhat similar. In contrast, tax formulas assigned to local governments that *cross* city boundaries can vary remarkably. The Rescue Fire Protection District, for example, receives property taxes from 40 TRAs in El Dorado County. In some areas, the fire district receives less than 5 percent of the property taxes; in others, it collects more than 11 percent. The difference in these tax shares does not reflect differences in the level of service the fire district provides, but the implementation of the AB 8 allocation system.

Variation in Tax Allocation Across County Boundaries

In addition to this variation within a county, there are remarkable differences in the allocation of property taxes *across* counties. In the case of fire districts, for example, our review of a small sample of California TRAs found fire districts receiving as low as a 4.5 percent share of property taxes and as high as a 32 percent share.

To illustrate this variation in the property tax allocations among local governments, Figure 2 displays tax allocation formulas for various TRAs across the state. Specifically, the figure shows how property taxes collected from a new home or business are distributed to: K-14 schools, cities, counties, and "other" local governments (special districts and city- or county-controlled library and fire districts).

School Shares. K-14 education's share of property taxes in our figure ranges from a low of 23 percent in the City of Industry to a high of 78 percent in an unincorporated area of Santa Clara. It is important to note that this variation does *not* alter the amount of revenues available to schools in these areas. This is because, under the state's school funding formulas, higher allocations of property taxes to school districts simply reduce the amount of state education assistance. Thus, the real effect of this variation in school property taxes is the variation in the residual amount of property taxes available for nonschool local programs.

City Shares. The figure also shows large variation in the share of property taxes allocated to cities. The City of Irvine, for example, receives about 3 percent of the property taxes collected in this sample neighborhood—less even, than the share of property taxes allocated to the various water districts serving the area's residents. The City of Los Angeles, on the other hand, receives about 26 percent of property taxes collected in this sample area. Most of the variation in these city share percentages reflects: (1) differences in the number of services cities provided before Proposition 13, (2) the date of city incorporation, and (3) local taxation choices by city residents before Proposition 13.

Figure 2

How Are Property Taxes Allocated?

	Property Tax Shares				
Sample Area[a]	**County**	**Schools**	**City**	**County**	**Other**
Chico[b]	Butte	58%	16%	19%	7%
Oroville[b]	Butte	49	24	16	11
Lafayette	Contra Costa	55	6	10	29
Walnut Creek	Contra Costa	54	9	14	23
Placerville	El Dorado	41	4	30	26
South Lake Tahoe	El Dorado	34	22	29	14
South Lake Tahoe[b]	El Dorado	35	22	29	14
Unincorporated	El Dorado	34	—	26	40
Industry[b]	Los Angeles	23	8	47	21
Los Angeles	Los Angeles	48	26	24	1
Unincoporated	Los Angeles	43	—	33	24
Westlake Village	Los Angeles	44	6	26	24
Anaheim	Orange	74	11	7	9
Fullerton[b]	Orange	71	16	6	7
Irvine	Orange	69	3	6	23
Laguna Hills	Orange	72	5	4	19
Palm Springs	Riverside	56	23	14	8
Rancho Mirage	Riverside	45	—	33	22
Riverside	Riverside	69	12	15	5
Citrus Heights	Sacramento	51	7	16	25
Sacramento[b]	Sacramento	56	26	18	1
Unincorporated	Sacramento	43	—	15	43
San Francisco[b]	San Francisco	34	—	65	1
Milpitas[b]	Santa Clara	50	18	24	8
Morgan Hill	Santa Clara	69	11	14	6
Palo Alto	Santa Clara	71	9	16	4
San Jose	Santa Clara	69	13	15	3
Unincorporated	Santa Clara	78	—	15	7
Rohnert Park	Sonoma	59	12	24	6
Santa Rosa	Sonoma	64	11	20	5
Unincorporated	Tulare	66	—	20	15
Visalia[b]	Tulare	64	12	18	7
Davis	Yolo	66	21	9	4
West Sacramento	Yolo	45	49	3	3

a Percentages indicate allocation of taxes from a new home or business in a tax rate area (TRA) of jurisdiction listed. Jurisdictions may have many different TRAs.

b Designates that the area is in a redevelopment project. In these areas, the allocation formulas shown are superceded, and most of the growth in property taxes is allocated to the redevelopment agency.

County Shares. The figure shows similar variation among the shares of property taxes allocated to counties and other entities (such as special districts and city- and county-controlled fire and library districts). The unusually high share for other entities in Lafayette, Walnut Creek, and the unincorporated area of Sacramento reflects the relatively large share of property taxes allocated to their fire districts.

CALIFORNIA TAX POLICY AND THE INTERNET

What Tax Issues Are Raised by Internet Activities? What Should California Do to Address These Issues?

Summary

- *The Internet and "e-commerce" activities are evolving at a rapid pace, raising important policy issues at all levels of government.*
- *One key issue involves Internet tax policy, including how to allow the Internet to continue to evolve and develop while ensuring tax fairness and considering its potential impact on tax bases. Federal and state moratoria have temporarily frozen tax law actions to facilitate resolution of these issues.*
- *The two main Internet-related tax issues are related to the sales and use tax (SUT) and involve (1) tax fairness and (2) potential revenue losses. These issues relate to collecting taxes on out-of-state sales, and the conversion of tangible taxable goods into nontaxable intangible forms.*
- *Current SUT revenue losses are small relative to the tax base, but could grow significantly in the future and materially erode the base.*
- *Other tax issues involve the appropriateness of current telecommunications taxes and determining the income taxes of multistate and multinational corporations.*
- *Regarding the SUT, immediate tax law actions are not required, given the current magnitude of the problems. However, the Legislature should (1) pursue multistate agreements, and (2) consider undertaking a comprehensive review of the SUT.*
- *The Legislature also should undertake a comprehensive review of California's different telecommunications levies. The results of this study could be used to assess the need for any extension of the current California Internet Tax Freedom Act.*

INTRODUCTION

The rapid development and growth of the Internet in recent years has resulted in fundamental changes in the manner in which communications and transactions occur between and among businesses and individuals. These changes will continue to occur—and probably accelerate—as the Internet evolves and its use becomes more widespread throughout society. Such Internet-induced changes take a variety of forms. For example:

- The *manner* in which goods and services are exchanged has been changing, as transactions previously conducted by telephone, mail, or face-to-face contact can now occur directly through the use of computers and telecommunication lines. Consumers, for instance, can purchase clothing and other items simply by connecting to a seller's web page and conducting the transaction over the Internet. Business transactions are also facilitated by the Internet.

- The *form* in which goods are exchanged also has been changing, as Internet technology has facilitated the transformation of certain goods from tangible into digitized intangible forms—as with books, movies, and musical recordings.

- Finally, *modes* of communication have been altered due, in part, to the Internet. While telephone, television, radio, and wireless communications all developed as separate and distinct technologies, the Internet and related developments have resulted in a convergence of these different technologies. As a result, they are no longer isolated from one other. Internet connections, for instance, currently can be made through both telephone lines and cable television connections, and will soon be widely available through wireless technology. Conversely, telephone service can now be obtained through Internet connections, as can radio service.

The above changes have a number of important public policy implications—including in the areas of economic growth and labor productivity, information security and privacy, and the structure of industry and the manner in which businesses operate. Of special interest, however, are the implications of the Internet for state and local tax policy.

This report, prepared at the request of Senator John Vasconcellos, focuses on tax-related issues, including the options available to the California Legislature for addressing them. The report is accompanied by a series of supplements, which are cited throughout the text and are available on our web site (www.lao.ca.gov) or upon request.

WHAT IS THE INTERNET?

The Internet is a worldwide network of computers and connections that uses a common communications language. This communications language provides a common link that enables individual computer systems to interact with one another. Individual computers are linked to Internet service providers (ISPs)—such as America Online—by a combination of wired (telephone, local area network [LAN], or cable) and/or wireless technology. These ISPs, in turn, connect to the Internet "backbone"—a large-capacity, high-speed, telecommunications network. A small percentage of the Internet-linked computers provide content via worldwide web sites that are available to other computers connected to the Internet.

Early History

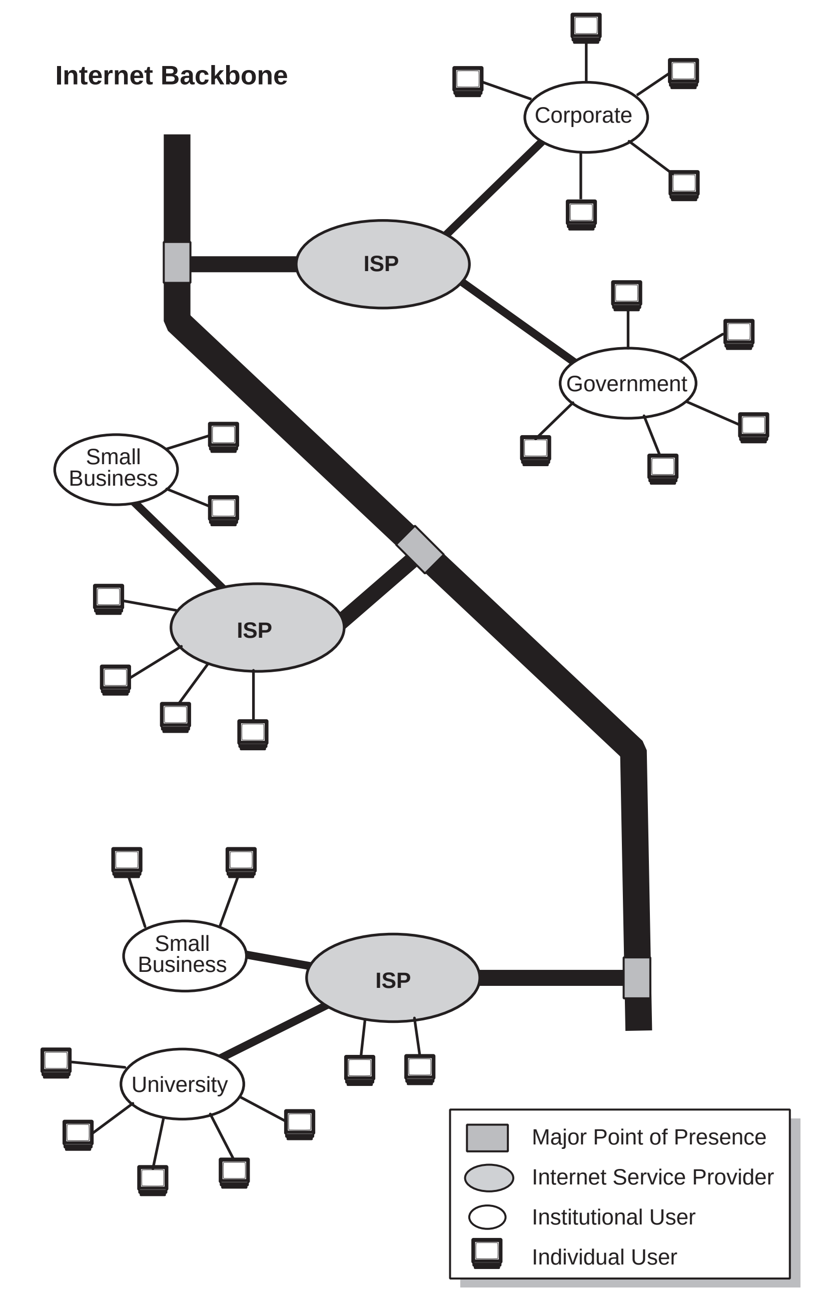
The Internet began in the late 1960s as part of a Department of Defense project aimed at developing a computer-related communications system linking government agencies, university research facilities, and high-tech defense contractors. As the original system evolved, it expanded beyond the original participating institutions, and included broader industry and government participation, as well as encompassing commercial, nonprofit, and individual users. In the 1990s, much of the Internet system was turned over to private industry.

Basic Structure

The basic "layout" of the Internet is shown in Figure 1 (see next page). It consists of (1) individual users who connect to ISPs, most often through dial-up telephone lines or cable; and (2) institutional users—such as universities, governments, and large commercial entities—which generally connect to ISPs using dedicated wiring such as LANs or leased telephone lines. The ISPs are then linked to a regional or mid-level network which, together with other regional networks, connect to a "major point of presence" (MPOP). These MPOPs are linked at very high speeds to create the Internet backbone. The U.S. Internet backbone connects to other backbones around the world. Links to web sites, e-mail to individuals, sales transactions, and other uses of the Internet go through these networks and commercial service providers.

Figure 1

Structure of the Internet



Scope of the Internet and E-Commerce Activity

As yet, no official U.S. data on Internet usage or e-commerce are available, and, as a consequence, the exact magnitude of Internet activities is not currently known. However, there is no question that Internet activity and e-commerce are extensive and rapidly expanding. For example, the number of worldwide users of the Internet is currently estimated at some 200 million, up from an estimated 3 million in 1993. In the United States, it is estimated that the number of Internet users grew from fewer than 1 million in 1993 to over 80 million by 1999. Internet penetration has reached nearly 40 percent in the United States, the largest population share among all nations.

Similarly, e-commerce has been exploding. Annual U.S business-to-business volume is estimated to reach between $1.3 trillion and $2 trillion by 2003, up from an estimated volume of approximately $100 billion to $150 billion in 1999. Internet business-to-consumer transactions, which were estimated at less than $10 billion in 1998, are estimated to have grown to $20 billion in 1999—with some estimates in excess of $35 billion. Retail e-commerce is expected to reach between $100 billion and $200 billion by 2003. Regardless of its exact magnitude, Internet and e-commerce activity is extensive and rapidly growing, with similar trends expected for the future as this new technology continues to evolve and expand in scope.

(Supplement A provides additional detail regarding the Internet's structure, technical characteristics, economic advantages, and usage, as well as further information concerning e-commerce activity.)

TAX POLICY AND THE INTERNET—A GENERAL OVERVIEW

The dramatic evolution of Internet technology raises numerous issues with respect to state and local taxes. These issues—which generally relate to the basic fairness and equity of the tax systems involved and the potential erosion of state and local tax bases—have been the subject of considerable discussion and debate for several years at both the national and state levels. Yet, they remain largely unresolved. Figure 2 (see next page) summarizes key Internet-related tax issues. These issues are briefly described below, and more fully analyzed in the following section.

Figure 2

Key Internet-Related Tax Policy Issues

Sales and Use Tax (SUT)

- ✓ Current limitations on the application of the SUT to out-of-state sales can result in unequal treatment of different businesses and consumers.
- ✓ Internet activity can result in revenue losses to state and local governments under current tax collection procedures.
- ✓ Increasing conversion of tangible goods into intangible goods has adverse implications for the SUT base and raises issues regarding the consistency of the tax.

Telecommunications Taxes

- ✓ There currently are many inconsistencies and inequities associated with these taxes.
- ✓ Technological changes in the industry and the "convergence" of various technologies raise many tax and regulatory issues.
- ✓ Changes in the competitive environment of telecommunications industries—including the Internet—make it especially difficult to apply existing taxes in an equitable and consistent manner.

Corporate Income Taxes

- ✓ Internet activity such as e-commerce raise significant issues regarding the definition of nexus and how to apportion the income of multistate and multinational corporations for tax purposes.

Sales and Use Tax Issues

The Main Issue—Tax Treatment of Remote Sales. The issue that has received by far the greatest attention in the Internet tax policy debate is the fact that often the SUT may not be paid on out-of-state sales. This occurs because Internet technology facilitates the ability of businesses to conduct commerce on a "remote" (that is, out-of-state) basis. As discussed later in this analysis, California has limited ability to require companies located out-of-state to collect the SUT on sales to its own residents that are conducted over the Internet. As a consequence, in many cases taxes go uncollected on sales of goods to Californians shipped from out-of-state. The same collection issues arise for the 44 other states which levy sales taxes. While this issue of SUT collection is not new, state and local officials recognize that as the Internet grows and this type of commerce—termed "remote sales"—increases, there will be a steady erosion of the SUT base.

How Extensive Are Internet Sales? Figure 3 presents estimates of e-commerce as a factor of various economic measures. E-commerce activity in the United States is estimated to represent three-quarters to four-fifths of the worldwide total. It does not appear as though Internet sales *currently* comprise a substantial proportion of total retail sales in our nation. This perspective is generally confirmed by a wide variety of studies and sources. Such sales do not, therefore, represent a significant loss of state and local SUT revenues *at this time*. Nevertheless, because of the ongoing rapid evolution and expansion of e-commerce and Internet activity generally, this relatively small impact certainly may not hold *in the future*.

Figure 3

Worldwide E-Commerce Is Expanding at a Rapid Rate

- ☑ Currently, e-commerce is estimated to be approximately one-third of U.S. catalog sales, but is expected to increase to eight times catalog sales by 2003.
- ☑ It is estimated that e-commerce currently comprises roughly 3 percent of U.S. credit card sales, a figure that is expected to expand to one-half of all credit card sales by 2003.
- ☑ Current estimates suggest that e-commerce sales account for approximately 1 percent to 2 percent of total retail sales. By 2003, this is expected to rise to an estimated 15 percent.
- ☑ As a percent of direct marketing, e-commerce is expected to grow from the current 2 percent of the total to over 40 percent by 2003.

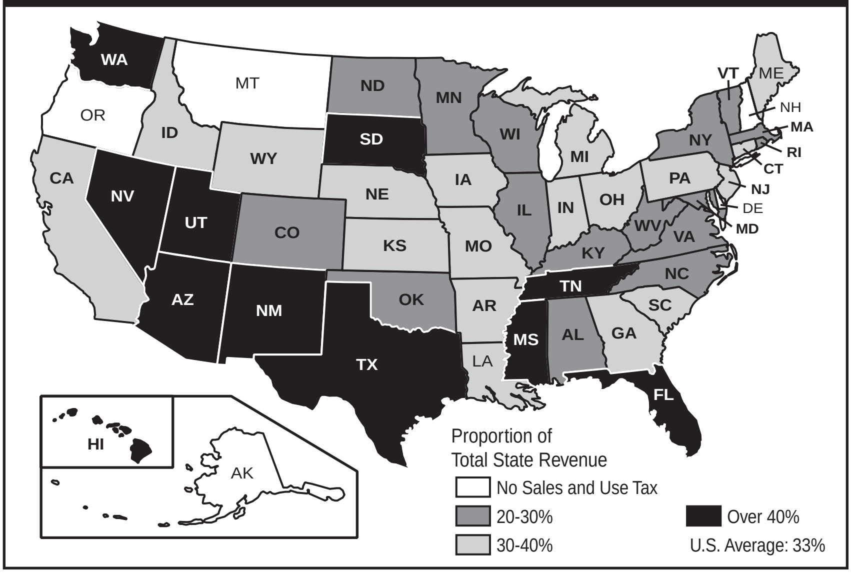
Source: Organisation for Economic Cooperation and Development.

The growth of Internet activity, coupled with substantial reliance on SUT revenues by state and local governments, poses a legitimate cause for concern on the part of public officials in California and other states regarding revenue impacts. As shown in Figure 4, many states are reliant to a substantial degree on revenues from the SUT. In addition to this potential Internet-related revenue loss, the distinction between remote sellers and traditional businesses identified above creates tax inequities. As a result of this tax differentiation, some businesses get an unfair competitive advantage over others, and some consumers get tax-related "price breaks" while others do not.

Conversion of Tangibles to Intangibles Also Is Occurring. In addition to the restricted ability of state governments to require that out-of-state companies collect the SUT, the technology of the Internet is increasing the rate at which certain types of products are no longer even subject to the SUT. In California, as in most other states levying a sales tax, the SUT is levied only on *tangible* personal property. As discussed later, the Internet makes it possible for certain types of products (such as music, books, and movies) to be easily converted to an *intangible* state for sale to the consumer. In such an intangible form, transactions involving many such products would not be a component of the SUT base in states like California.

Figure 4

Most States Rely Heavily on Sales and Use Tax Revenues



The above factors have raised concerns over the future health of the SUT base, which has already been experiencing erosion as nontaxed services have become an increasingly large share of consumer spending. The fact that the state and local governments are quite reliant on the SUT for revenues in California makes this a particularly important issue for the Legislature. Internet activity has also made more apparent the inequities inherent in the application of the tax, in that it treats remote businesses and traditional businesses (and their customers) differently.

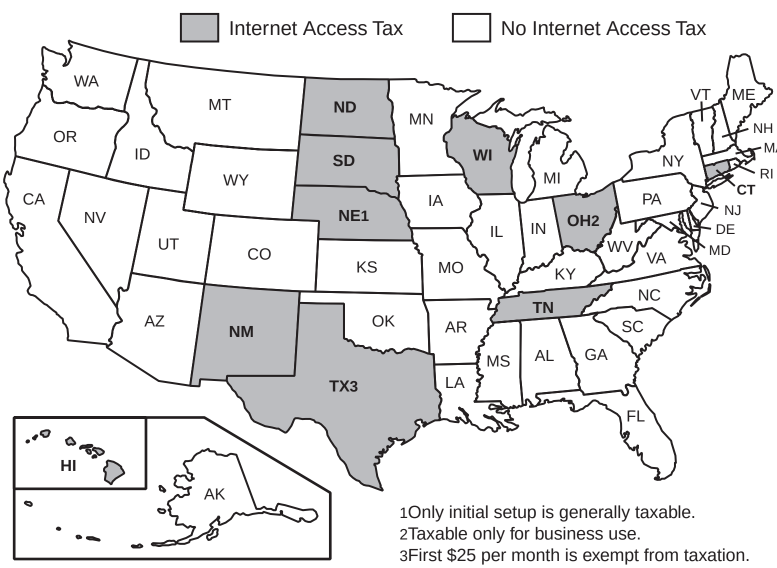
Taxes on Telecommunications

The concerns in this second area relate to the tax treatment of Internet communication activity *itself*, as opposed to treatment of sales using the Internet. In California, no Internet access tax currently is in place. However, such taxes have been proposed by some California localities in the past, and are levied in some form in a number of other states and localities (see Figure 5). Some of the states shown in Figure 5 are considering repealing these access taxes.

In addition to Internet access taxes, the convergence of Internet, telephone, and cable technologies has raised concerns related to the consis-

Figure 5

States that Currently Tax Internet Access



1Only initial setup is generally taxable.
2Taxable only for business use.
3First $25 per month is exempt from taxation.

tent tax treatment of similar types of communications activities. When these communications systems existed as separate and distinct entities, such consistency issues regarding tax treatment were neither as prevalent nor as apparent as they are today. However, as the technologies have overlapped and become intertwined, tax inconsistencies and fairness issues have become more visible and harder to disregard. Changes in the competitive structure of the industry have added additional complexity to the issue.

Corporate Income Taxes

The main issue posed by Internet activity with respect to corporate income taxes occurs because, for multistate and multinational corporations in most states, they are based on the geographic apportionment of income. In California, this apportionment is in turn based on a formula which incorporates property values, employment levels, and sales volumes. With respect to the sales component, Internet activity raises certain questions about how sales should be attributed to different states, and thus how the amount of income earned by a particular corporation should be allocated amongst such states. In addition, Internet activity raises issues regarding "nexus" (that is, degree of presence) rules for corporate income tax purposes.

Where Do Things Currently Stand On These Tax Issues?

Resolution of the above Internet-related tax issues has not yet occurred. In fact, due to the significant debate at both the national and state levels regarding them, temporary moratoria have been passed to preclude tax decisions from being made until some consensus has been reached. Such consensus will presumably attempt to balance concerns regarding: (1) the fiscal issues the Internet poses for state and local governments; (2) tax inequities, complexities, and inconsistencies; and (3) constraints on the healthy growth and evolution of the Internet-based economic subsector.

To aid in this process, several advisory groups have been formed or are involved. Some of the most prominent groups are the federal Advisory Commission on Electronic Commerce (ACEC), National Tax Association, Electronic Commerce Advisory Council, Joint Venture: Silicon Valley Network, and Organisation for Economic Cooperation and Development. (The activities of these entities, some of the findings and recommendations of which have yet to be released, are summarized in Supplement B.)

Internet Tax Moratoria

The federal Internet Tax Freedom Act. The federal Internet Tax Freedom Act (ITFA), was signed into law on October 21, 1998. It provides for a three-year prohibition against states and local governments levying taxes on Internet access, unless such a tax already was imposed prior to October 1998. It also prohibits both "multiple" taxes and "discriminatory" taxes on Internet activity. (These are described in more detail in Supplement C.)

The federal ITFA also established the ACEC, which is to study Internet tax policy issues and report to Congress as to whether e-commerce should be taxed and, if so, what the appropriate taxation method would be. The ACEC is comprised of three federal officials, eight state and local government representatives, and eight representatives from the e-commerce industry, telecommunications carriers, local retail businesses, and consumer groups. By April 2000, ACEC is to deliver its report to Congress on various tax-related matters. (Again, see Supplement C for more detail.)

The California ITFA. Prior to the passage of the federal ITFA, California passed its own version of the measure. The California ITFA—Chapter 351, Statutes of 1998 (AB 1614 [Lempert])—was signed into law by Governor Wilson on August 24, 1998. The California ITFA imposes a three-year moratorium on specifically identified new or discriminatory taxes, including taxes on Internet access or online computer services, "bit" or bandwidth taxes, or any discriminatory tax on online computer services or Internet access. Discriminatory taxes are defined as those that result in either a tax rate on online computer services or Internet access that is higher than the rate on other businesses, or results in taxes that are applied only to online computer services or Internet access.

The California ITFA does *not* preclude new or existing taxes of general application that are imposed in a uniform and nondiscriminatory manner. Thus, the collection of SUT, utility user charges (such as on basic cable television and telephone and cellular phone service, even if the lines are used for Internet access) or (under current federal law) franchise fees continues to occur under the act. The California ITFA also allows cities and counties to continue to collect business license taxes and the state to collect telecommunication taxes.

We now turn to a more detailed discussion of these issues on a tax-by-tax basis.

SALES AND USE TAX ISSUES

As noted earlier, currently the most discussed, visible, and potentially important Internet-related tax policy issues for California involve the state's SUT. One frequently voiced concern involves the tax inequities that result when some transactions trigger the collection of a sales tax, whereas other similar types of transactions do not. A second, interrelated concern involves the potential loss of SUT tax collections because through Internet activity certain types of transactions become not taxable. In addressing these concerns, one should keep in mind an important tax administration issue—namely, that the SUT's administrative and compliance costs for businesses are significant and can substantially differ for in-state versus out-of-state transactions.

The SUT issues have long existed involving tax-base erosion, inequities between different taxpayers and different transaction modes, and administrative and compliance cost differentials. The Internet, however, has exacerbated these concerns, as well as put some new issues "on the table." In this section, we discuss these issues and their policy implications. (Supplement D provides additional information on SUT issues.)

Background on the SUT

Importance of the SUT

The SUT is one of California's largest sources of government revenue. In 1999-00, it is projected to raise revenues of approximately $32.1 billion, including $24.4 billion by the state (General Fund plus special funds) and $7.7 billion by localities. The SUT is the state government's second largest source of General Fund revenue, accounting for approximately one-third of the total. The tax is also important for local governments. Statewide, it provides about one-third of total city tax revenues. For counties it is an important source of funding for certain programs (criminal justice, transportation, and particular health programs).

Tax Base and Rates

What Is Taxed? California's SUT is imposed on the retail price of *tangible personal property* sold to final purchasers (unless specifically exempt). It does not apply to either real property (for example, houses) or intangible personal property (such as stocks or items sold in digital form). Services are also generally exempt from direct SUT taxation, although they can be indirectly taxed to the extent that their value is incorporated into the final value of the tangible products they help produce. The SUT is typically collected and remitted by sellers to the administering state agency—the California State Board of Equalization (BOE). When collecting the SUT, sellers generally apply the tax rate in effect where the transaction occurs.

Tax Rates. Figure 6 shows that there are both state and local SUT rates. The basic combined rate is 7.25 percent, including an overall state rate of

6 percent and a local one of 1.25 percent. In addition, localities can impose an added tax rate which generally can not exceed 1.5 percent. The state rate includes 5 percent for the General Fund, plus two half-cent levies earmarked for localities in the Local Public Safety Fund and the Local Revenue Fund.

Figure 6

Sales and Use Tax Rates in California

	Current Rate
State	
General Fund	5.00%
Local Revenue Fund	0.50
Local Public Safety Fund	0.50
Subtotal	(6.00%)
Local	
Uniform Local Taxes	1.25%
Optional Local Taxes[a]	1.50
Subtotal	(2.75%)
Combined Maximum Rate	**8.75%**

[a] Maximum allowable rate except for City and County of San Francisco (1.75 percent) and San Mateo County (2 percent).

Sales Taxes Versus Use Taxes

The SUT is actually comprised of two separate levies. The first is the *sales* tax, which is applied to items which are both purchased and to be consumed *within* California. In contrast, the companion *use* tax is levied on goods purchased *outside* of the state for use *within* the state. These two taxes are similar in that they are both imposed on sales of goods to be used in California and are levied at the same rate. However, their proceeds going to local governments are distributed somewhat differently, and the Internet-related administrative and tax-collection issues associated with them are quite different (as more fully described in Supplement D). It is the latter characteristic of the use tax which makes it of special interest to this report.

Revenue Trends

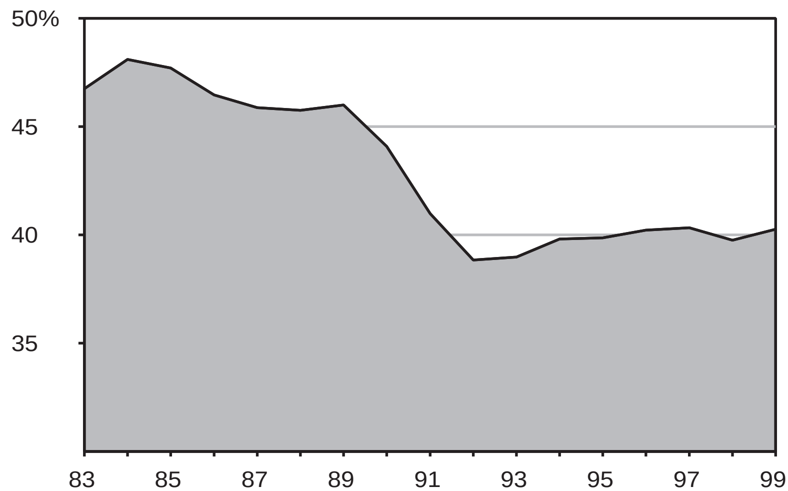
Recently, SUT collections have displayed strong performance. Taxable sales, for example, grew by over 8 percent in 1999—reflecting the state's extremely robust economic performance and booming expenditures for both consumer durables and business investments. However, SUT performance often did not keep pace with the economy during the 1980s, as evidenced by the past declines in the ratio of taxable sales to personal income and the failure of this ratio to materially rebound during economic expansions (see Figure 7).

This decline appears to reflect a variety of factors, including increased spending on nontaxable services, reduced levels of residential building activity since the mid-1970s, increased catalogue sales from out-of-state sellers, and transformations of certain products from tangible (taxable) to intangible (nontaxable) form. (See Supplements D-2 and D-5.) Although its performance has been strong recently, the possibility of further SUT base erosion—including from Internet-related activities—has been of special concern to many state and local officials.

Figure 7

Taxable Sales Have Dropped as a Percent of Personal Income

1983 Through 1999



Problems Raised for the SUT by The Internet and E-Commerce

The two problem areas for the SUT posed by the Internet and its associated e-commerce activity are (1) tax inequities and (2) potential base erosion. Below, we examine each of these issues in turn, and then discuss why they occur.

Inequities Related to the Application of the SUT

Currently, California generally collects the SUT only on sales where the seller has a *physical presence* in the state. This means that in many cases, the purchase of a tangible item—a book or item of clothing, for example—through the Internet (or other remote sales method) will not result in the payment of the SUT (as discussed below). If this same transaction were to occur instead through a traditional "bricks and mortar" business in California, the SUT would be applied by the seller to the purchase. This differential treatment in SUT responsibilities based solely on the transaction method results in unequal treatment of both sellers (based on their sales method) and consumers (based on their means of purchase). In addition, if lack of Internet access is more predominant among those in lower-income households than the population as a whole, this could result in a somewhat increased share of the existing SUT burden towards the lower end of the income spectrum, especially as the Internet continues to expand.

Potential Base Erosion

The SUT base erosion associated with the Internet involves both remote sales and the conversion of goods from tangible into intangible form.

Remote Sales. It is not clear exactly what the current volume of e-commerce sales activity is, let alone the portion subject to California's SUT and the share of this portion that is currently not collected. Making an accurate estimate of lost revenue is complicated both by a lack of reliable comprehensive information on current Internet and e-commerce activity, and the fact that not all such activities result in California SUT revenue losses. Nevertheless, as detailed in Supplement D-3, it appears that California retail e-commerce currently could be as much as several billion dollars annually.

In order to estimate SUT revenue losses due to Internet sales, this amount would be reduced by taking into account: (1) sales of exempt consumer items, (2) displaced catalogue and telephone sales on which the SUT is not presently being paid, and (3) sales that result in the collection of the SUT by businesses with nexus in the state. Based on these adjustments, current total SUT revenue losses would appear to be in the high tens of millions of dollars to $200 million annually. This figure would not include revenue losses due to nonpayment of use taxes by businesses which are not registered sellers, nor does it include SUT not collected on other remote sales. It should be noted that frequent revision of Internet and e-commerce activity occur and these revenue impacts constitute rough estimates.

The concern in this area is not so much related to *current* losses, but rather that this amount could grow substantially in the *future*, as the Internet and e-commerce continue to evolve. While the amount of estimated revenue losses is currently likely less than 1 percent of the SUT revenue base, Internet growth rates in the next three to five years equivalent to those experienced in the recent past could raise the magnitude of such losses. By 2003, such revenue losses could range into the mid- to high-hundreds of millions of dollars, constituting as much as 2 percent to 4 percent of state and local SUT revenues.

Conversion of Tangibles. One of the important and unique characteristics of Internet technology is its ability to transform vast quantities of information from physical into digital form. As a result, virtually any product which is based on information can be sold, transferred, or conveyed through the Internet. The process of reducing such items to "pure information," or "digitizing" them, transforms them from a tangible form (which generally *would* be subject to the SUT) into an intangible form (which is *not* subject to taxation). This occurs with respect to both interstate and intrastate sales.

This process of reducing goods to their pure informational form is not new. Previous telecommunications-based technologies also were used to transform information from physical to digital form (see Supplement D-5). For example, facsimile machines can be used to deliver or sell certain types of information, including reports, renderings, or similar items. However, the development and continued improvement in Internet technology has vastly expanded—in terms of both volume, variety, and complexity—the ability to engage in such digital exchanges. Examples of this process include the digitization of music, computer software, graphics programs, books, movies, and data bases.

The revenue losses stemming from the transformation of tangible goods into intangible form are unknown and difficult to estimate. At present, they are probably not all that significant relative to the SUT's base, given the technology's age and state of development. Future losses, however, are likely to be considerably more significant, as the technology used to convert information to digital form evolves and becomes more refined and widespread. This evolution also will increasingly raise tax administration issues regarding how to apply the SUT to a world where the line between tangibles and intangibles becomes more and more blurred, and the destination or place of delivery of such intangibles may be both unknown and unknowable (see Supplement D-7).

Sales and Use Tax Collections Problems—What Underlies Them?

The collections-related problems associated with the Internet and e-commerce relate primarily to the issue of nexus as it pertains to the use tax and the related administrative and legal barriers to collecting the SUT. These issues are discussed below. With respect to the conversion of taxable tangible goods to nontaxable intangible goods, this issue cannot be addressed without fundamentally altering the SUT tax base.

The Concept of Nexus. In simple terms, nexus refers to the degree of presence or connection between things. For state tax purposes, it refers to the degree of contact or connection required between a state and a taxpayer before the state has the legal authority to impose and/or require the collection of a tax by a taxpayer. In the case of California, nexus must be established before the state can require the seller to collect the use tax component of the SUT. Although states normally define nexus in statute, it still may be subject to judicial review for such purposes as determining its constitutionality. Specifically, the courts have overturned nexus statutes if they violate the due process clause or commerce clause of the U.S. Constitution (see Supplement D-4).

Nexus Rules for Out-of-State Remote Sales. Legal issues involving state tax nexus have a history which predates the appearance of Internet technology and e-commerce. In particular, catalog sales and telephone order sales both raise the same or similar issues regarding SUT nexus as do Internet sales. All such activities can be characterized as involving remote sales—that is, sales where the seller is located out-of-state but the buyer and user of the purchased item is located in-state. The legal guidelines for whether a state can require companies to collect the SUT on Internet sales were established by a series of previous Supreme Court cases dealing with non-Internet remote sales (see Supplement D-4).

The general rule is that states cannot require the collection of the SUT by out-of-state sellers without them having a sufficient physical presence in the state. Many Internet sellers do not have such a presence. As a result, states like California cannot require such retailers to collect the SUT. Many states have sought and continue to try to broaden the definition of nexus, such that more companies and transactions will meet the "physical presence" test. However, the current "bottom line" is that, short of Congressional action, it is not possible for states to require collection of the use tax component of the SUT on many Internet sales by out-of-state parties.

Does the SUT Still Have to Be Paid? California law *does* provide that *purchasers* of remote-sale taxable items are themselves liable for the use tax even if it is not collected and remitted by the seller. However, as a practical matter, the BOE reports that the SUT is routinely paid by purchasers on such out-of-state sales only in cases that involve (1) items purchased by taxpayers which are registered sellers and whose transaction records are reviewed by the BOE during the normal course of its auditing activities; and (2) items that have legal registration requirements, such as cars, trucks, and boats. Otherwise, the tax goes unpaid except for those individuals and businesses who voluntarily report it. According to the BOE, there are few such voluntary payments made.

What Should Be Done?

What, if anything, should the Legislature do about the above problems the Internet and e-commerce pose for the SUT? Unfortunately, no simple answer exists. However, in considering this question, there are several tax policy criteria that should guide the Legislature's thinking. These include the principles of tax efficiency, tax neutrality, tax equity, revenue sufficiency, and administrative cost and feasibility. (Supplement D-6 describes these principles in more detail.)

What Should the Focus Be?

Because the major SUT issues the Internet raises are not new but rather are generic to the SUT and only highlighted and exacerbated by the Internet, it is important that the Legislature decide at the outset how broad an approach it wishes to use in addressing this issue. For example:

- One alternative is to choose to do absolutely nothing and let the current SUT system operate as it presently does.

- At the opposite end of the spectrum, the state could decide to "stand back" and take this opportunity to review the entire SUT system, including the problems and issues posed by services and other intangibles (see Supplement D-7). The thrust of this approach could include broadening the SUT's base so as to reduce tax rates, to looking at how SUT revenues are distributed to localities, to replacing the SUT with a broad-based consumption or value-added tax.

- It could instead take a "middle ground" approach of viewing the basic SUT system already in law as a "given," and attempt to apply and administer it to Internet-related activities as fairly as possible.

Action-Step Recommendations

The approach we recommend depends in large part on the time frame under consideration. For the present—and in the immediate future—we recommend a cautious approach. Estimated revenue losses are not of sufficient size to warrant immediate remedial action. In addition, the tax inequities discussed here do not lend themselves to a short-term solution, given the current structure of the SUT.

However, in order to address the identified tax inequities and in view of the fact that future base erosion and potential revenue losses are expected to increase substantially, the state should begin to explore and evaluate means by which the SUT can be applied more effectively and fairly. The options California has in this regard involve both (1) taking independent "state specific" actions and (2) working in cooperation with other states. These options are summarized in Figure 8, next page (and discussed in detail in Supplement D-8). In addition, we recommend that the Legislature consider undertaking a comprehensive assessment of the SUT, with a focus on its long-term viability.

State-Specific Actions. In terms of state-specific actions, we believe that the ability of California to unilaterally address Internet-related tax issues is inherently limited. The state-specific options shown in Figure 8 (see next page) would either not be particularly effective in dealing with the underlying tax policy issues highlighted by Internet development, or would raise additional—perhaps more serious—problems. For example, pursuing a more aggressive enforcement of nexus would not address the fundamental legal issues involved and would likely entail extensive litigation. Likewise, encouraging use tax compliance would serve to educate taxpayers as to the use tax obligation, but it would be unlikely to have a measurable impact on SUT collections. With regard to shifting to an origin-based SUT, the disadvantage with this is that economic locational distortions could occur, since this approach essentially results in shifting the SUT from a consumption-type tax to a production-type tax.

The last option—that the state investigate the potential of a web-based tax calculation and collection system—would not directly address Internet-related tax issues; however, we believe that a web-based tax collection effort would at least alleviate some of the secondary issues stemming from Internet activity and remote sales. Among the advantages of this option is that it would facilitate use tax collections, avoid placing additional administrative costs on sellers, and could result in a fairer application of the SUT.

Cooperative Actions. With respect to the cooperative options, more potential exists, at least in the long term. Multistate compacts seem the most viable and appropriate of the options. This approach would focus

Figure 8

Options for Dealing With Internet-Related Sales and Use Tax Issues

State-Specific

✔ **Lessen California Nexus Problems**

- Expand the concept of nexus in California, so that it encompasses the full range of Internet transactions which would appear to be appropriately taxable under existing sales and use tax (SUT) law.

✔ **Encourage Increased Compliance**

- Have California more rigorously enforce the use tax on purchases from out-of-state sellers.
- This could be attempted in a number of ways, including providing increased information to the taxpaying public and conducting increased auditing.

✔ **Change the SUT's Application in California**

- Change how the SUT is applied in California by switching from the current destination-based system to an origin-based system.
- Under this approach, sellers would apply the tax rate at their location and not be required to determine the rate at the purchaser's location.

✔ **Have California Facilitate Tax Collections**

- California could create a web-based tax application to allow for easier collection of the SUT.
- For example, the state could act as an on-line collector of the SUT by establishing links between sellers' web sites and a state web site.

Cooperation With Other States

✔ **Federal SUT Collection**

- Work with other states and the federal government to have the latter collect the SUT for states, and then distribute collections back to them.

✔ **Individual State Agreements**

- Strike reciprocal agreements with individual states for the collection and remittance of the use tax on out-of-state sales.

✔ **Pursue Multistate Compact**

- Work jointly with other states to develop collective approaches to applying the SUT to out-of-state sales. This approach could minimize foregone revenues, reduce tax inequities, and lessen administrative costs.

on designing and implementing a simplified and streamlined SUT administration system, involving some or all of the following: (1) single or a reduced number of state rates, (2) standardized definitions of products and taxable items, (3) standardized and simplified tax calculation and collection procedures, and (4) exemptions for small sellers (see Supplement D-8). Key goals would be to reduce SUT variations among states and reduce the compliance burden for sellers, while achieving tax neutrality. California has pursued multistate approaches in the past in the areas of corporate income taxes and fuel taxes.

One specific option of this type was developed jointly by the National Governors' Association (NGA) and National Conference of State Legislatures (NCSL) and endorsed by several other state and local government membership organizations. It was presented to the ACEC at its December 1999 meeting in San Francisco. This "zero burden" proposal would establish a voluntary system where a third party would determine the taxability of and tax rate on purchased items. The third party would also collect the tax and remit the proceeds to states.

We recommend that the Legislature explore the appropriateness of this option as well as other alternative joint efforts with other states. We note, however, that any cooperative approach would not at this time result in a *requirement* that remote sellers collect and remit the use tax for all sales. This is because absent Congressional action addressing the issues raised by various legal decisions, out-of-state sellers could only be required to collect the use tax if they had physical presence in the purchaser's state.

Conclusion Regarding the SUT

California is inherently limited regarding what it can do in dealing with the SUT-related issues raised by the Internet and e-commerce. However, some steps can be taken, and pursuing a two-tiered approach offers the best prospects for addressing Internet-related SUT issues. Specifically, we believe that California should (1) pursue multistate agreements that facilitate collecting the use tax while minimizing administrative costs, such as by standardizing tax rates and adopting common definitions for taxed commodities; and (2) consider undertaking a comprehensive review of the SUT, focusing on its long-term viability.

Issues Involving Telecommunications Taxes

Internet-related tax policy issues involving telecommunications taxes, franchise fees, and utility user taxes are the result of two principal characteristics of the telecommunications industry (including the Internet)—

namely, changes in industry technology and changes involving the industry's competitive structure. These features of the telecommunications system raise two primary issues related to Internet telecommunications tax policy (1) equitable and technologically neutral treatment of taxpayers and (2) potential revenue implications for local governments and specific state programs. These issues are summarized in Figure 9, discussed below, and examined in greater detail in Supplement E.

Figure 9

Internet-Related Telecommunications Tax Issues

- ✔ Current tax treatment was designed for a telecommunications industry that is rapidly being transformed in terms of its technology and competitive characteristics.
- ✔ Increasing competition and technological convergence in the industry have strained the state's ability to apply the existing tax structure in an appropriate and fair manner.
- ✔ A confusing array of different taxes and charges are being applied to telecommunications activities, including local franchise fees, local utility user taxes, and state telecommunications charges.
- ✔ Existing taxes on telecommunications activities fund specific programs at the state level and are a discretionary source of local government revenues. However, significant issues exist regarding the rationales for many of these levies and their continued desirability.

Many levies on telecommunications activities were established for an industry that no longer exists in its original form, either in terms of technology or competitive characteristics. Furthermore, the levies involved are outmoded and have neither changed sufficiently to "mesh" with current industry competitive structure, nor possess the flexibility to accommodate future changes in the telecommunications industry. Regarding the technology area, the basic modes of telecommunications (telephone, television, radio, and the Internet), while still distinct in many respects, are increasingly "converging" (blending and overlapping). This process has made many of the current tax distinctions between the different media difficult to justify in economic terms, resulting in inefficiencies and unfairness.

Current Telecommunications Taxes

There are several types of taxes or fees in California that can be applied (directly or indirectly) to the Internet as it currently exists or which may affect it as it continues to evolve. These involve both flat-rate levies and gross receipts taxes, and include: (1) state surcharges levied on telephone service; (2) local taxes levied on utility use of telephone and cable service; (3) local franchise fees on cable service; and (4) various federally assessed surcharges, fees, and taxes. Although a few states impose Internet access taxes, California does not impose or allow state or local taxes on Internet access.

What Are the Basic Issues?

Equitable and Technologically Neutral Taxation

The Industry Has Markedly Changed. Changes in *technological convergence* and *market structure* make it increasingly possible to conduct similar activities using different means and, as a result, be treated differently for tax purposes. With respect to technological changes, for example, the blurring of the line between conventional telephones and Internet-based communications (voice and written) has raised issues related to tax fairness and neutrality. Voice communication using telephone providers is subject to direct telecommunications charges, yet similar voice communication using Internet telephony or written communication is not subject to such direct charges. Wireless cable is not subject to either local taxes or fees or state telecommunications surcharges and fees.

With respect to market structure, telecommunications have evolved from an industry characterized by monopoly to one displaying an increasing degree of competition. Statewide monopoly franchises and rights-of-way access were awarded to telephone companies and, in exchange, companies provided common-carrier service and were subject to special tax treatment. Telephone surcharges and other fees were levied on monopoly telephone utilities partially in an effort to extend telephone service to high cost areas, provide low- cost telephone service, provide emergency service, and extend access to the disabled.

Do Current Levies Make Sense? The growth of competition in the telephone-service market has weakened the original justification for many of these taxes for long-distance telephone service and, increasingly, for local telephone service as well. Retaining the existing tax structure raises issues of tax equity, in that Internet activity may be subject to certain types of taxes and tax burdens using telephone access, a different tax treatment when cable access is used, and still another if wireless Internet connections are employed—even though the activity conducted may be identical. For utility user taxes and franchise fees, the change in competitive industry structure and technological convergence raises similar issues of tax fairness and equity.

Is the Industry Under-Taxed or Over-Taxed? In addition to the issues of tax equity discussed above, changes in telecommunications raise a more fundamental question as to whether the tax burden on these services is too high with respect to other services, which may not be subject to the same level of taxes, fees, or charges. While this issue is beyond the scope of this report, the basic question is—*Should the existing system of telecommunications taxes, utility user taxes, and franchise fees be modified and, if so, in what ways given the current and evolving structure of the industry?* To the extent that any differential tax treatment between technologies persists, a situation may develop where activity moves to the lowest taxed area—based on the level of fees, taxes, and charges—instead of using the most efficient or appropriate means.

Potential Revenue Issues

Limited Revenue Loss May Be Occurring. Changes in technology and market structure present a potential for revenue losses if telecommunications activities migrate to telecommunication modes that are not taxed, such as the Internet. Generally, these fiscal concerns are of less magnitude than those related to the SUT. For telephone surcharges and fees, the potential revenue losses are rather small and do not comprise a significant portion of state revenues (accounting for less than 1 percent of total revenues). Although these revenues are earmarked for particular programs, they could be rather easily replaced from other sources. In addition, there exist no particular policy reasons why the programs should be funded from specific excise taxes, rather than from general governmental revenues.

Similarly, the fiscal effects on utility user taxes and franchise fees for local governments are likely to be substantially less important than those associated with the SUT. While revenue losses could occur due to tax differentiation between technologies—for example, telecommunications activity could move from conventional telephone lines to cable-based service if overall taxes are lower for the latter—we believe that in the short to medium term the likely fiscal effects are quite small.

Local Concerns Should Be Addressed. Potential revenue losses are an issue that may be more cause for concern for local governments in the longer term. Utility user taxes and franchise fees account for a small proportion of local government discretionary revenues but are more important for certain selected localities. Although clearly not all of these revenues would be in jeopardy due to changes in tax policy, in view of their role in local finance, any long-term restructuring of the telecommunications tax area should explicitly account for any local fiscal effects.

What Are the Policy Options?

In addressing the above issues involving telecommunications taxes associated with the changing nature of the industry—including the impacts of the evolving Internet technology—California has two basic alternatives. First, it can adopt the status quo approach of leaving the basic telecommunications tax structure as it currently stands and focus simply on trying to "patch it" so as to make its application fairer. Or second, it could take direct action to address the many underlying problems with the basic system by moving toward its restructuring. A first step with respect to the latter approach would be a thorough study of all existing telecommunications taxes and an assessment of their rationales and overall desirability.

"Patching Up" the Existing Tax System

The main action to consider here would be to extend telecommunications taxes to all types of telephone or similar communications services. Doing this, including applying them to communications conducted over the Internet, would result in a removal of the tax-generated bias towards these alternative technologies. This approach would allow for equal treatment of similar activities. To the extent that this policy results in additional revenue due to base broadening, the Legislature can adopt a revenue neutral approach by reducing tax rates accordingly. This approach may, however, suffer from certain technical difficulties since Internet telephony signals are indistinguishable from other digital transmissions. Generally, options to patch up the existing system are—due to continuing technological shifts—likely to result in only a temporary resolution of the issue.

Basic Tax Restructuring

This policy strategy could include such steps as removing some or all of the various telecommunications and utility user taxes on telephone service and treating it similarly to other services. This would put telecommunications services on an "equal footing" with other services and address the uneven treatment of the industry with respect to other telecommunications technologies such as Internet telephony. This fundamental change would necessitate alternative means of funding universal service and other similar state programs. In addition, given that such taxes are a discretionary revenue source for localities, basic restructuring would need to be sensitive to alternative funding sources for localities.

Although reducing or eliminating various telecommunications taxes may be a reasonable approach, it should not be taken "in a vacuum." Rather, it should only be undertaken as part of a comprehensive assessment of the overall tax burden on the telecommunications industry (including such levies as property and corporate income taxes). This will help ensure that the industry is not advantaged or disadvantaged by its tax treatment.

Action-Step Recommendations

As in the case of the SUT, recommended state actions regarding taxes on telecommunications are dependent on the time frame involved. In the near term, the potential revenue loss resulting from Internet activity is not substantial and the tax fairness issues cannot be cured through any "quick fix." Thus, there is relatively limited potential or need for action. In the short and medium term, any efforts undertaken should focus on applying the existing tax regime as fairly as possible—such as treating activities conducted over the Internet in a manner similar to activities conducted through other means. However, given that the Internet technology continues to evolve rapidly, any solution is likely to be short-lived.

Instead of expending substantial resources in patching the existing system, we recommend that the Legislature undertake a comprehensive study geared toward an overall evaluation of the telecommunications tax and regulatory area. The overall objective of this approach should be to examine the system and its rationales and address issues of equitable tax treatment of the industry. As part of the process, careful consideration should be given to the impact of changes on state and local fiscal conditions. The results of this study could be used to inform the Legislature regarding the appropriateness of any extension of the Internet tax moratorium.

CORPORATE INCOME TAX ISSUES

Internet-related tax issues raised for the Bank and Corporation Tax (BCT) primarily involve (1) determination of nexus and (2) the geographic apportionment of income of multistate and multinational corporations. (Additional details are provided in Supplement F.) These issues principally affect the potential of base erosion of the BCT.

The BCT Issues Are Highly Technical in Nature

Determination of Nexus. The determination of nexus for BCT purposes is less clear to begin with than for the SUT and the development of the Internet essentially lays an additional layer of complexity on this already difficult area. (This complexity is discussed further in Supplement F.) However, the bottom line is Internet development makes it *more* likely than in the past that businesses can conduct activity in the state while avoiding nexus. This is because they can conduct business on a remote basis, thereby minimizing contacts with the state. This situation could affect the state's collection of corporate income taxes in some cases.

Apportionment of Income. Regarding apportionment issues, these relate to how much of an interstate or international company's total income is subject to California's BCT. The income apportionment factor for California is based on a firm's average ratio of its corporate activity in California to its total corporate activity for three factors—property, payroll, and sales (the latter weighted twice). Sales of tangible goods to California businesses and individuals would result in California sales since these are attributed to the destination point.

Sales of intangible goods to California purchasers—such as those in a digitized form—would typically result in a California sale for tax purposes *only* if the state was the location of the greatest direct costs of production. As a consequence of these rules, even if nexus is established under current law, this may not necessarily result in a business having any California taxable income. Because the Internet may cause an increase in the sales of intangible goods relative to tangible goods, less income may be taxable.

Considerations for the Legislature

Of the tax issues raised by Internet and e-commerce activity, those involving the BCT are among the least visible and perhaps most complex. While the issue of tax fairness—regarding the treatment of tangible versus intangible goods, for example—may be relevant, this issue is more directly related to the overall design of the tax rather than the effects of the Internet *per se*. Similarly, the potential revenue impacts of Internet activity are likely to be limited at this time and are unlikely to grow in importance as rapidly as for other taxes.

The fact that the current- and near-term impacts of the Internet on the BCT are not likely to be significant at this time, coupled with the inherent complexity of the issues involved, suggests that the Legislature need not take any immediate action in this area. Rather, the appropriate approach may be to wait and see how Internet-related business activity develops and how effective the existing tax system is in meeting the challenges posed. Pursuit of multistate tax compacts and agreements involving nexus and apportionment appears to be California's best means of eventually addressing these issues in the near term and for the future.

SUMMARY AND CONCLUSIONS

As summarized in Figure 10, the Internet and its associated e-commerce raises taxation issues for the Legislature in a number of areas, including tax administration challenges, tax-equity concerns, and potential revenue losses. No simple or obvious solution to these issues currently exists, as evidenced by the ongoing debate surrounding them. In addition, identifying action steps for addressing the issues is further complicated by the fact that Internet technology is still evolving. Thus, with regard to some of the issues involved, a wait and see attitude is the best policy for the present.

There are, however, certain steps that the Legislature should initiate now in light of the issues raised by the Internet. In particular, it should pursue multistate SUT agreements to simplify, standardize, and collect the tax. Coupled with this, the Legislature should consider undertaking an overall assessment of the effectiveness and long-term viability of the SUT. We also recommend that the Legislature undertake a comprehensive review of the state's telecommunications-related tax polices in light of the issues the Internet raises in this area. The results of this study could be used to assess the need for any extension of the current Internet tax moratorium. Finally, it should pursue solutions to some of the technical issues related to the BCT raised by Internet activity by working through its affiliations with multistate organizations.

Figure 10

Key Findings and Considerations

Key Findings

✔ Internet-related sales and use tax (SUT) issues exist involving both tax inequities and revenue base erosion. These relate to collecting use taxes on out-of-state sales and converting goods from tangible into intangible form.

- While currently limited, revenue losses are increasing and will continue to do so in the future.

✔ Concerning taxing Internet activity *itself,* telecommunications media such as telephones are already subject to taxation. However, tax policy in this area is full of inconsistencies and inequities, and the "lines" are blurring between different telecommunications modes.

✔ Tax nexus and income apportionment issues complicate the calculation of income tax liabilities for multistate and multinational corporations in California.

Considerations

✔ Given that current revenue effects are fairly minor relative to the tax base, immediate action in terms of fundamentally altering the SUT tax system is not required.

✔ Since medium- and long-term issues are likely to be more substantial, the Legislature should address Internet-related SUT issues by (1) pursuing multistate agreements to minimize foregone revenues, reduce tax inequities, and lessen administrative costs; and (2) considering a comprehensive analytical appraisal of the SUT, including its long-term viability.

✔ A comprehensive review of the state's telecommunications taxes and fees generally should be conducted. This review:

- Should clarify the rationales for existing levies, and determine whether, and in what forms, such levies should exist in the future, including on the Internet.
- Should be completed prior to taking any actions regarding taxation of Internet activity and access charges, and could be used to assess the need for any extension of the California Internet Tax Freedom Act.

✔ Multistate agreements should be explored to incorporate Internet-related considerations into the determination of nexus and the apportionment of corporate income for tax purposes.

FISCAL CHALLENGE FROM THREE MAJOR LAWSUITS

How Should the Legislature Approach These Issues?

Summary

While economic and revenue developments have helped create a very positive budgetary environment for California, three legal challenges pose some fiscal concern. Specifically:

- ***Special Education.*** *Elements of the state's Master Plan were determined to be a state mandate. While one school association suggests state liability could be $1.6 billion, our review finds that the state's costs should be much lower—or nothing.*

- ***Property Tax Shift.*** *The California Constitution generally requires the state to reimburse local governments for their costs to implement a state-mandated program or higher level of service. In an unusual ruling, the Sonoma County Superior Court found that the* revenue loss *associated with the property tax shift is a state reimbursable mandate. While the state is appealing this ruling, we discuss options the Legislature could take to reduce any potential liability.*

- ***Smog Impact Fees.*** *An appellate court ruled that charging these fees on out-of-state cars is unconstitutional. While the court did not order the state to repay all fee payers, the Legislature and administration have indicated interest in doing so. We review issues for legislative consideration relating to the fee refund.*

Given the size and complexity of the state's budget, California frequently faces litigation in a variety of policy areas. Usually, the magnitude of the state's fiscal exposure associated with this litigation is small or moderate. This year, three legal challenges pose a potentially larger fiscal concern:

- ***Special Education.*** The Commission on State Mandates (COSM) determined that eight elements of the state's Master Plan for Special Education constitute a state mandate. Because this test claim spans two decades and applies to up to 1,000 school districts, one school association contends that state costs to reimburse districts could total $1.6 billion. In this analysis, we explain why the state's costs are likely to be much lower, or potentially nothing.
- ***Property Tax Shift.*** The superior court in Sonoma County ruled that the tax shift (also referred to as "ERAF", after the name of the fund the property taxes were deposited into, the "Educational Revenue Augmentation Fund") is a state mandate. Billions of dollars of property taxes have been shifted annually from local governments to schools since the early 1990s. In this analysis, we discuss the unusual nature of this court ruling and the status of the state's appeal. We also discuss options for the state to reduce any potential liability if the superior court ruling is upheld.
- **Smog Check Fees.** An appellate court ruled that the fees on out-of-state cars are unconstitutional. The Legislature and administration have indicated their interest in refunding fee payers. This analysis outlines some of the issues associated with fee repayment.

SPECIAL EDUCATION MANDATE CLAIM

During the 1970s and early 1980s, there were extensive efforts in the courts, federal government, and the states to improve special education services for children with disabilities. These efforts sought to ensure that children receive special education services reflecting their individual needs, and that school districts avoid categorizing children by handicap. To facilitate these changes, the California Legislature enacted its Master Plan for Special Education (MPSE) (Chapter 797, Statutes of 1980 [SB 1970, Rodda]).

In 1981, the Riverside County Superintendent of Schools filed a claim for reimbursement of the "state-mandated" costs of complying with the master plan's requirements. Article XIII B, Section 6, of the California Constitution generally requires the state to reimburse local governments if the state has required local governments to provide a "new program" or "higher level of service." Riverside's mandate claim—which extends to *all* local agencies providing special education services—has slowly worked its way through most of the claims reimbursement process, after twice going to court over the interpretation of Article XIII B.

The Mandate Claim Process

Pursuant to state law, local claims for mandate reimbursement are evaluated by the COSM, a quasijudicial body comprised of representatives of the Department of Finance, State Treasurer, State Controller, Office of Planning and Research, local school boards, cities or counties, and the public. Figure 1 (see next page) provides an overview of the mandate reimbursement process. For any mandate, the COSM typically takes three important actions—it adopts:

- A Statement of Decision, outlining the basis for finding that a state action imposed—or did not impose—a mandate.
- Parameters and Guidelines (P&Gs), which describe the specific costs that will be reimbursed and the documentation required.
- A Statewide Cost Estimate, an estimate of the state's cost to repay all local governments' past-year and current-year costs using the methodology set forth in the P&Gs.

Status of Legal Challenge

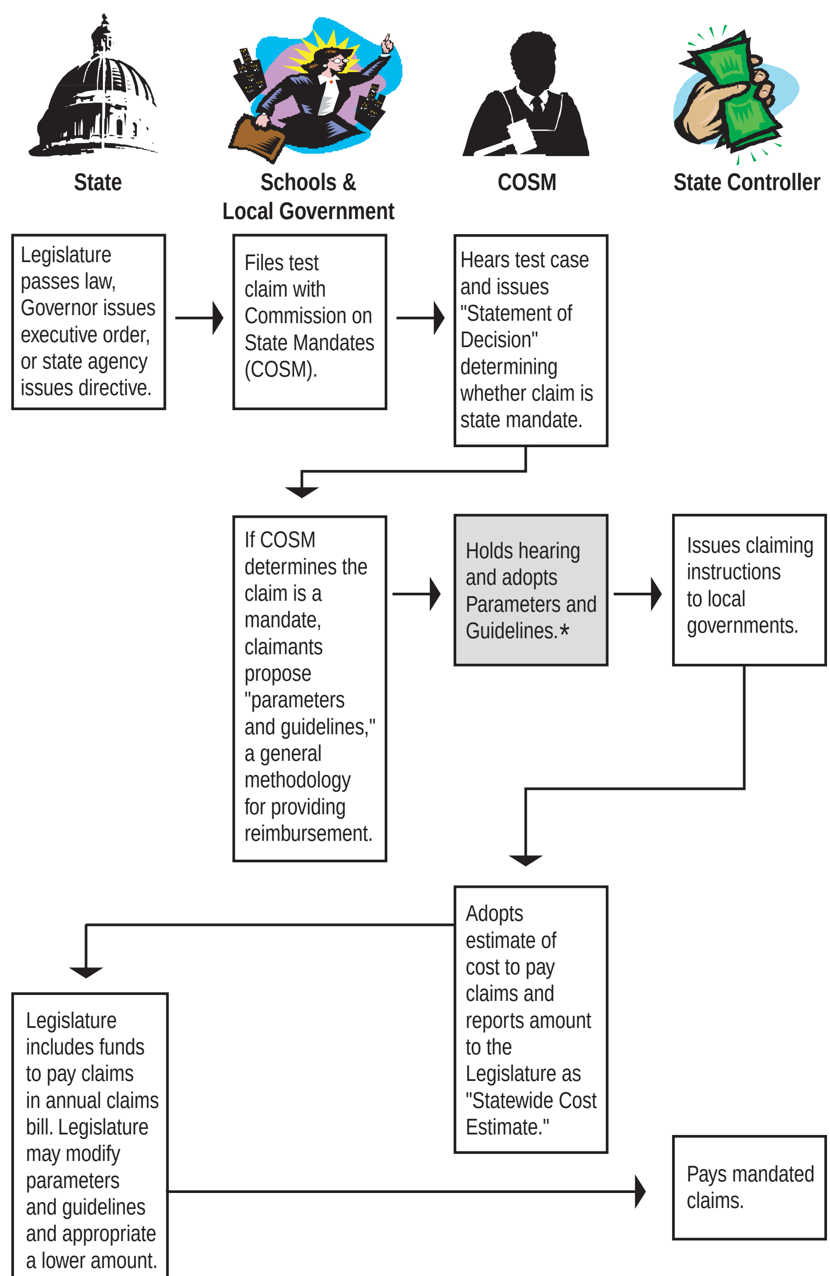
In 1992, an appellate court found that most of the MPSE was a *federal* mandate, not subject to the reimbursement provisions in the State Constitution. The court instructed COSM, however, to review state and federal law to determine the extent to which any specific activities in the state's MPSE surpassed the requirements of federal law.

In November 1998, the COSM issued a statement of decision identifying eight minor components of the MPSE as state mandates. While any single school district's costs to comply with these eight requirements would be very low, given the number of years since the initial special education claim and the number of school districts potentially eligible for reimbursement (up to 1,000), there has been significant concern about the possible magnitude of the state liability.

Within months of COSM issuing a decision establishing that a state requirement is a mandate, COSM usually adopts P&Gs specifying the general reimbursement methodology. Shortly thereafter, the magnitude of the state's liability becomes apparent as local agencies begin filing reimbursement claims. In this case, however, there has been substantial

Figure 1

The Mandate Reimbursement Process



*The special education mandate is currently at this stage.

controversy delaying COSM's adoption of the P&Gs. Specifically, the state contends that annual state budget appropriations for special education should count as an "offset" in the reimbursement methodology, while the claimants contend that these general appropriations should not be counted. (We discuss this "offset" issue below.)

In December 1999, after 13 months of debate, the special education claimants and state representatives agreed to (1) postpone until June 29, 2000 the final COSM hearing on the adoption of the mandate's P&Gs and (2) attempt to negotiate a settlement. The parties' agreement, however, specifies that either party can end negotiations and request resumption of the hearing on the P&Gs if it believes the negotiations to be ineffective. The parties also agreed to report to COSM on the status of their negotiations on March 15, 2000.

Fiscal Effect

In recent months, there have been numerous reports citing a potential state special education mandate liability of $1.6 billion. Below, we discuss the source of this number and explain why we belief the state's liability would be much lower, if anything.

Basis for $1.6 Billion Estimate

Shortly after COSM issued its decision finding eight activities to be state mandates, the school district claimants submitted their proposed P&Gs. The Department of Finance (DOF), in turn, estimated the cost of the mandate for a sample year, 1996-97, using the proposed P&G methodology. In developing its estimate, the DOF indicated that their estimate constituted a "maximum possible" cost estimate because it used assumptions favorable to school districts when needed data were not available. In addition, the DOF asserted that the proposed methodology used in the claimant's P&Gs was overly generous to districts in several respects. As Figure 2 (see next page) indicates, the DOF estimated the cost of reimbursing claimants under their proposed methodology to be about $140 million for the sample year.

The California School Boards Association, in turn, adjusted the DOF estimate for annual changes in inflation and the number of special district students served over the two decades to arrive at a total liability of $1.6 billion. This estimate cited by the school board association contains both the favorable assumptions of the DOF estimate and the overly generous methodology implicit in that estimate.

Our review of the DOF estimate found that the assumptions used result in costs that are overestimated by as much as one-third.

Figure 2

Special Education Mandates Identified by the Commission on State Mandates in 1998

(In Millions)

	Annual Cost[a]
✓ ***Maximum Age Limit***. Provide special education services for students who become 22 years old while receiving services. Federal law requires services until age 21.	$7.9
✓ ***Specialist Caseload Maximums***. Monitor specialist caseloads to ensure they do not exceed a specified number of students. Federal law does not specify caseload maximums.	4.3
✓ ***Community Advisory Committees***. Establish local advisory committees that include specified school personnel. Federal law does not require the local committees.	2.6
✓ ***Extended School Year***. Provide at least 20 days of extra school for all special education students requiring an extended year (even if the full 20 days are not required by a student's individual plan). Federal law requires extended school year if required by a student's individual plan.	51.0
✓ ***Interim Placement***. Involve a student's instructional team in the interim placement of a special education student who transfers to another district. Federal law permits fewer people involved in the decision under certain circumstances.	8.1
✓ ***Governance Structure***. Involve representatives of parents and teachers on local Special Education Local Plan Areas (regional administrative agencies). Federal law contains no such mandate.	0.7
✓ ***Written Parental Consent***. Obtain written parental consent of a student's IEP. Federal law does not require *written* consent.	3.6
✓ ***Resource Specialist Program***. Provide instructional aides to at least 80 percent of certain specialists. Federal law requires staffing as identified in a student's individual plan.	60.7
Total	**$138.8**

[a] Department of Finance estimate of maximum reimbursement amount (1996-97).

Actual costs would be even lower if the COSM reflected some of the DOF's proposed changes to the claimants P&G methodology. Even with these reductions, however, the past-years' cost of the mandates would still be quite large, probably in the range of $500 million to $1 billion, with additional annual costs of at least tens of millions of dollars.

Counting Offsetting Revenues Could Eliminate State Liability

Under mandate law, funds which the state provides to help local governments implement a mandate are called "offsetting revenues" and reduce the state's liability on a dollar-for-dollar basis. Counting as an offset some of the billions of dollars the state appropriates for special education in the annual budget act, therefore, could reduce or eliminate the state's fiscal liability. This issue of counting previous state appropriations for special education is central to the negotiations between the school districts and the administration. Few previous mandate claims, however, have relied upon this provision and its legal parameters have not been fully explored.

In general, the claimants contend that the state's previous appropriations should *not* be counted because the state, when enacting the MPSE, agreed to pay all increased program costs not reimbursed by the federal government. Claimants argue that the state has broken its commitment to maintain local special education costs "frozen" at their 1979 levels and that school districts have had to spend their state funds to meet the special education requirements set forth in federal law.

Claimants also contend that the state funding provided in the MPSE legislation and annual budget acts does not meet the statutory definition of an offset. Specifically, they argue that Government Code Section 17556 (e) requires offsetting revenues be identified as "specifically intended to fund the costs of the state mandate" and that the funds be included in the *same* statute that creates the mandate.

In fall 1999, we submitted two reports to COSM and the Legislature regarding this special education mandate. Below, we summarize information we provided regarding the claimants' allegations.

Did the Legislature Agree to Pay All Increased Special Education Costs?

In the development of any significant legislation, differing statements regarding its intent typically emerge. To ascertain the legislative and administrative intent with regards to the financing elements of the MPSE, we examined the fiscal system enacted in the measure and the bill analyses commenting on the development of that fiscal system. Our review found *no* evidence that the Legislature committed to pay all increased special education costs. Rather, the fiscal model contained in the MPSE treats special education—like other education programs—as a *shared* responsibility of state and local government. This shared responsibility is particularly apparent from the two elements featured prominently in the MPSE financing model: the (1) enrollment cap and (2) deficit factor.

Legislature Capped Number of Students Funded. For any school agency providing special education services, the MPSE specified that the state would not reimburse costs to provide services for more than 10 percent of its general student population. The DOF bill analyses at the time referred to this percentage cap as "one of the most significant fiscal aspects" of the master plan because the enrollment cap was set at a level that was *lower* than:

- The percentage of special education students some school agencies were currently serving.
- The percentage of students the state had been funding under the earlier pilot versions of the state master plan.

Thus, the enrollment cap was a clear attempt by the Legislature to limit state fiscal liability and to share some special education program costs with local agencies.

Deficit Factor Limited State Costs. The state's Master Plan also included a powerful state fiscal "safety valve," allowing the state to unilaterally and unconditionally reduce its total special education costs in any year. Specifically, Article 10 of Chapter 797:

- Directs that state special education aid be *prorated* among local education agencies if any state budget act does not appropriate sufficient money to fund all local costs.
- Does not require state funding shortages be made up in future years.

From this review, we saw no evidence that the state guaranteed to pay all future cost increases for special education.

Why Were the State Funds Not Linked To Eight Mandated Activities?

The Master Plan legislation provided $619 million in state aid for special education. This amount reflected an approximately $160 million increase in state support for special education over the prior year, and a $90 million increase in state aid over the amount required by then current law. This $90 million increase was the basis for the statements in bill analyses (developed by this office, other legislative fiscal staff, and the

DOF) that the bill included sufficient sums to offset the cost of any state mandate included in the legislation.

The use of the $90 million was not specifically earmarked by the Legislature to cover the costs of the eight "state-mandated" activities because:

- The distinction between the federally required components of the special education program *versus* the state-required activities of the Master Plan was not known yet. That is, the Legislature was aware that some elements of the state's Master Plan exceeded federal special education requirements, but the precise differences between the plans was not ascertained until COSM issued its statement of decision in 1998.
- Earmarking special education funding would be contrary to the Legislature's intent to provide school districts with broad flexibility to improve special education services.
- The Legislature had no reason to think that its significant funding increase ($90 million provided in the initial legislation and maintained, with growth, in subsequent budget acts) would not be "counted" as reimbursing state-mandated local costs. The California Constitution's mandate provisions—enacted just one year prior to the MPSE—simply call for a "subvention of funds to reimburse" local government; it does not say that the funds must be earmarked to specific activities.

Issues for Legislative Consideration

As described above, $1.6 billion appears to be a significantly overstated estimate of the cost to reimburse claimants under the terms of their own P&Gs. Moreover, there is a strong argument for modifying the reimbursement methodology to include part of the annual state special education appropriation. Counting these revenues as an offset would reduce or eliminate any remaining state mandate liability.

We note, however, that—at the urging of COSM—discussions regarding the development of the P&G reimbursement methodology are occurring behind closed doors. In addition, the Legislature is not represented on COSM. Thus, it is possible that COSM may enact a P&G methodology for this mandate that does not reflect the Legislature's perspective. It is also possible that the claimants and administration could reach an agreement calling for alternative education relief provided in the budget. Given this, we discuss options available to the Legislature under either of these scenarios.

Mandate Claim: Legislative Options

As noted above, it is not clear that the state has any fiscal responsibility to pay a mandate claim for special education. If, however, the commission finds some state liability, the Legislature has significant options available to it. Specifically, the Legislature could:

- Modify any P&G methodology adopted by COSM.
- Schedule payment of any claim reimbursement over time.
- Eliminate future mandate liability.
- Determine the extent to which a claim reimbursement is paid from revenues within the existing Proposition 98 guarantee.

We discuss these options below.

Modify P&Gs. As shown earlier in Figure 1, to request an appropriation to reimburse local agencies, COSM must submit to the Legislature a claim's P&Gs and a statewide estimate of the mandate's cost. Government Code Section 17612 specifies that the Legislature may amend, modify, or supplement these P&Gs and appropriate a *different* sum for reimbursing local agencies. Such an action must be done carefully, however. If the Legislature deletes funding for a mandate, a local agency may file an action in court to declare the mandate (in this case, the eight state-mandated activities) unenforceable and/or bring other legal actions seeking reimbursement for mandated costs. Thus, any change to the P&Gs or mandate reimbursement amount must be supported by sound legal reasoning.

Alter Timing of Reimbursement. Ordinarily, the state pays all prior years' cost of a mandate at once. Given the potential magnitude of the state's liability, however, the Legislature may wish to consider scheduling any mandate's repayment over a series of years. While the state would accrue interest on any claim paid more than a year after COSM adopts its statewide cost estimate, state law specifies that interest is charged at the Pooled Money Investment Account rate. Accordingly, the state's interest cost for postponing full payment on the mandate claim would be the same as its earnings from leaving the funds in the Pooled Money Investment Account. Thus, the state would not incur any real costs to schedule repayment of the claim over time, but would gain some funding flexibility.

Eliminate Future Mandate Liability. In 1997, the Legislature streamlined special education funding in order to increase local flexibility and reduce the impact of funding rules on local program decisions. The creation of new reimbursable mandates would partially negate these reforms by establishing funding formulas that could influence local program practices. To minimize the impact of these mandates on local decisions and to eliminate the state's liability for mandate costs in the future, the Legislature could enact legislation to make optional or eliminate the eight programs identified by COSM as state mandates.

Impact on Proposition 98 Guarantee. Our review indicates that the Legislature could fund special education mandate costs from funds already required under the guarantee. For example, past mandate costs could be repaid over several years from one-time Proposition 98 funds that are available in the budget process in most years. Future costs could be accommodated within the amounts provided annually under the existing Proposition 98 formula.

Budget Proposal: Legislative Options

It is also possible that the negotiations between the administration and claimants could result in a proposal to drop the mandate claim and provide *alternative* education funding in the budget. There are two reasons such an approach may be proposed by the administration and claimants.

- First, funds appropriated for mandate reimbursement are provided as general purpose revenues to local agencies; these revenues would *not* be earmarked for special education programs. Thus, there is little practical difference between funding this mandate claim and budgeting funds for a discretionary school spending—except that the state could have greater control over the allocation across school districts of any budgeted revenues.
- Second, developing a methodology for reimbursing local agencies is likely to be very complicated due to the difficulty of locating records spanning two decades—and the adoption of the methodology could set an undesirable precedent regarding treatment of offsetting revenues in future mandate claims.

Thus, a budgeted solution—providing schools funds through the state budget rather than the mandate claims reimbursement process—may be preferable to the administration and claimants.

Should the administration and claimants propose to drop the mandate claim in exchange for increased state funding in the budget, the Legislature would have full authority over the proposal. For example, the Legislature could modify the level of funding proposed, or the use of its resources. Similarly, the Legislature could provide school funding in the budget using one-time funds (which do not affect the Proposition 98 guarantee) or through an ongoing program which is included within the guarantee.

PROPERTY TAX SHIFT LAWSUIT

For four years in the early 1990s, the state faced annual budget gaps of $4 billion to $14 billion. To close these gaps, the Legislature and administration raised fees and taxes, cut programs, deferred costs, transferred costs to the federal government, and shifted property taxes from local governments to schools.

While the formulas underlying the property tax shifts were very complex, the concept was simple: shifting property taxes from local governments to schools reduced, on a dollar-for-dollar basis, the amount the state was required to spend for schools. In this way, the property tax shifts played a critical role in helping the state resolve its severe budget difficulties.

Because the property tax shifts were implemented on a permanent basis, cities, counties, and special districts continue to receive a smaller share of property taxes than they did before the tax shifts—and schools receive a larger share. In the budget year, the property tax shifts redirect about $4 billion of property taxes from local governments to schools. This increased local funding offsets a commensurate amount of state education spending.

Status of Legal Challenge

Shortly after the property tax shifts were enacted, local governments sought to overturn the actions in court on the grounds that (1) the state lacked the authority under Article XIII A of the State Constitution to reallocate property taxes to increase school funding and (2) the shifts violated local governments' "home rule" authority in the State Constitution. The courts rejected these arguments.

In December 1997, the County of Sonoma initiated a different challenge to the property tax shifts. Specifically, the County of Sonoma (joined later by most other counties) filed a claim with the COSM, arguing that the property tax shifts represent a reimbursable mandate. In its filings, Sonoma County argued that the state transferred part of its school funding responsibility to local governments and, thus, under Article XIII B, Section 6, is eligible for reimbursement. In November 1998, the commission issued its decision, rejecting the test claim on the basis that a reduction of revenue previously allocated to a local government does not qualify as a reimbursable mandate. Specifically, the commission found that there was "no local expenditure" within the meaning of the Constitution because the disputed property taxes are transferred directly to schools. That is, local governments never "see" these monies; they are withheld by the county auditor and deposited into a school fund.

In March 1999, the County of Sonoma petitioned the Sonoma County Superior Court to set aside the commission's decision regarding the property tax shifts. In October 1999, the court concluded that the property tax shifts created a new program or higher level of service because they compel local governments to accept partial financial responsibility for a state program—schools. The court also found that the commission erred in concluding that the Constitution requires local governments to spend tax proceeds for a program as a prerequisite for reimbursement. The court said "It is sufficient that the financial responsibility or cost of the program be shifted from the State to the local government." Accordingly, the court ordered the commission to find that the property tax shifts constitute a reimbursable mandate and to make a determination as to the amount of money that should be reimbursed. The state is appealing this decision. No court date had been announced at the time this analysis was prepared.

Fiscal Effect

The ruling by the Sonoma County Superior Court represents a major change from previous interpretations of the state reimbursement requirement. In the past, the state has reimbursed local governments' *costs* to implement a new program or higher level of service. Under this ruling, the state would be responsible for reimbursing a *loss of revenue*. Many legal experts are skeptical as to whether the court's rulings will be upheld on appeal. If the ruling is upheld, however, the state's fiscal liability could be high, given the billions of property taxes that have been shifted to schools under the property tax shift laws.

Magnitude of Revenues Potentially Affected. Although the test claim was submitted by the County of Sonoma, the mandate ruling would apply to *all* local governments sustaining property tax shift losses: cities, counties, and special districts. In addition, state law specifies that test claims, submitted before the end of a calendar year, extend to costs dating from the *prior* fiscal year. Thus, local governments could be eligible for reimbursement for property taxes shifted since 1996-97. By the end of the budget year, the amount of property taxes shifted since 1996-97 would total over $13 billion.

Offsetting Revenues. Since the first proposal for a property tax shift, the Legislature has worked to mitigate its fiscal effect. Both the 1992-93 and the 1993-94 property tax shifts were enacted in tandem with relief measures. In addition, as the state's fiscal condition has improved, the Legislature has enacted additional relief measures. An earlier publication by our office, *Shifting Gears: Rethinking Property Tax Shift Relief* (February 1999), provided an accounting and perspective on these relief measures. In 1998-99, for example, we estimated that mitigation measures enacted by the state offset more than 60 percent of local government property tax shift losses.

As discussed earlier in this document, however, previous test claims before the commission and the court have not clarified the terms under which state support constitutes an "offsetting revenue" for purposes of mandate reimbursement. A strict reading of the Government Code suggests that offsetting revenues should be appropriated *in* the legislation that creates the mandate and should be explicitly earmarked for the purpose of mandate relief. In this case, however, some of the property tax shift relief measures were enacted *after* the property tax shifts (such as trial court funding reform and the Citizens Option for Public Safety program) and the provision which provides the greatest amount of revenues, the half-cent public safety sales tax, was enacted as a voter approved proposition (Proposition 172). Thus, if the Sonoma County Superior Court opinion is upheld on appeal, it is possible that the commission may not consider all the state's mitigation measures as an offset to the state's liability.

Issues for Legislative Consideration

Given the history of other complicated mandate claims (such as the special education mandate discussed earlier), resolution of this claim could take years. While it is possible that the superior court's ruling may be overturned, given the magnitude of revenues at stake it is important for the Legislature to monitor the lawsuit and take action to minimize its potential liability.

Changes to State Law Regarding Offsets. In order to clarify how the commission should consider state subventions to local governments in the context of mandate reimbursement, we recommend the Legislature reexamine Government Code Section 17556. For example, the Legislature may wish to modify the provision to specify that offsetting revenues may be provided in legislation enacted *after* the legislation which imposes the mandate, or through the annual budget process.

Existing Local Relief Programs. In any legislation to extend or modify an existing program which was enacted to mitigate the impact of the property tax shifts, the Legislature may wish to include language stating this intent. Similarly, the Legislature may wish to include language in legislation directing COSM to consider this relief in any calculation of property tax shift mandate liability. Our earlier publication, *Shifting Gears: Rethinking Property Tax Shift Relief*, provided a list of programs which were enacted with the clear or implied goal of mitigating the property tax shifts.

New Local Relief Programs. Over the years, the Legislature has provided local relief in many ways, such as: one-time grants, annual subventions, and by assuming partial (or full) financial responsibility for local programs. Under the State Constitution, a legislative act to discontinue a grant or subvention program typically does *not* create a reimbursable state mandate. Discontinuing state support for a program for which the state has assumed responsibility, on the other hand, *can* constitute a mandate. Given the Sonoma County Court ruling and its associated large state fiscal liability, we recommend the Legislature use care to preserve a significant amount of control over the level of state funding for local assistance programs. Accordingly, in evaluating any new local fiscal relief program, we recommend that the Legislature be cognizant of whether the state could eliminate the program in the future without imposing another mandate.

Local Finance Reform. As we discuss extensively in another analysis in this part—*Reconsidering AB 8: Exploring Alternative Ways to Allocate Property Taxes*—California's system of property tax allocation and local finance has significant flaws. In Chapter 94, Statutes of 1999 (AB 676, Brewer), the Legislature stated its intent to revamp the tax allocation system and improve local finance. This pending mandate claim, and its associated large state fiscal liability, brings uncertainty to the current discussions regarding finance reform. This is because reaching agreement on reform:

- Will require a high degree of cooperation and trust between state and local governments.
- Will likely require an ongoing commitment of state resources.

This mandate claim dispute, however, need not impede progress towards reform. For example, if the Legislature developed a local reform proposal which included constitutional changes, the Legislature could specify the resolution of this property tax shift mandate claim in the measure placed before the voters. (In that way, the two matters—finance reform and the mandate claim—could be resolved together.) Similarly, if the Legislature wished to enact local reform by establishing pilot projects in some communities, the Legislature could specify that the reform program would be available to only those local governments which waive their right for property tax shift reimbursement. Finally, the Legislature could enact a statewide reform measure, but place a "poison pill" in the measure to protect the state's fiscal interests. For example, the Legislature could specify that some funding for the reform proposal is eliminated if any local government submits a claim for property tax shift reimbursement. Thus, while the pending lawsuit complicates matters, it need not stop progress toward needed reform.

SMOG IMPACT FEE

Chapter 453, Statutes of 1990 (AB 1109, Katz) imposed a Smog Impact Fee of $300 on out-of-state vehicles when the vehicle is registered for the first time in California. According to Chapter 453, the fee was implemented to ". . . ensure equity between owners of California-certified vehicles and other vehicles, provide funding for environmental programs, and to promote good health and safety standards."

Legal Status of Challenge

In October 1999, the California Court of Appeals ruled that the Smog Impact Fee violated the commerce clause of the United States Constitution (Article I, Section 8, clause 3) and Article XIX of the California Constitution. The court's judgment provided for fee refunds for the four people who were parties to the court action. The state is not appealing this decision.

Fiscal Effect

As a result of the court's decision, the Governor directed the Department of Motor Vehicles (DMV) to stop collecting the fee and indicated his intent to refund *all* persons who paid the Smog Impact Fee. Below, we discuss the:

- Magnitude of fee revenues which have been collected (and thus, may be refunded).
- Programs which were funded by the fee revenues.

Total Smog Impact Fees Collected

To date, over $500 million in smog impact fees have been collected (see Figure 3). Through 1997-98, the proceeds of the fee were deposited into the General Fund (about $410 million in total). Beginning in 1998-99, proceeds of the fee were deposited into the High Polluter Repair and Removal Account (HPRRA), pursuant to Chapter 802, Statutes of 1997 (AB 208, Migden).

Two programs currently use funding from the HPRRA:

- ***Low-Income Repair Assistance Program (LIRAP)***. Pursuant to Chapter 804, Statutes of 1997 (AB 57, Escutia), the Bureau of Automotive Repair within the Department of Consumer Affairs offers assistance to help low-income motorists repair vehicles that fail their biennial smog check.

Figure 3

Smog Impact Fee Collections

(In Millions)

Fiscal Year	Amount
1990-91	$31.2
1991-92	50.2
1992-93	44.3
1993-94	44.9
1994-95	49.6
1995-96	56.1
1996-97	63.3
1997-98	70.1
1998-99[a]	76.5
1999-00[a]	21.3
Total	**$507.6**

[a] Fee collections deposited in the High Polluter Repair and Removal Account.

- ***Vehicle Retirement Program (VRP).*** Pursuant to Chapter 28, Statutes of 1994 (SB 198, Kopp), this program provides vehicle owners with $450 to retire their vehicle if the vehicle fails its biennial smog check and is a gross polluter. If a vehicle owner decides to participate in the VRP, the vehicle is sold to a private scrap dealer.

After the Smog Impact Fee was declared unconstitutional, the state directed some proceeds from the Smog Abatement Fee (paid by owners of newer cars in lieu of biennial smog check) into the HPRRA to fund both the LIRAP and VRP. Thus, funding for these programs is not affected by the court's decision.

When prior account balances and earned interest are accounted for, we estimate the HPRRA contains approximately $100 million that could be used to fund refunds of the Smog Impact Fee.

Issues for Legislative Consideration

Currently there are six bills related to the Smog Impact Fee pending before the Legislature. As Figure 4 (see next page) indicates, most of these bills repeal the provisions of law creating the fee and provide fee refunds. In addition, the Governor's budget includes $672 million ($562 million from the General Fund and $103 million from the HPRRA) for Smog Im-

Figure 4

Smog Impact Fee
Major Provisions of Pending Legislation

As of January 28, 2000

✓ **AB 809 (Lowenthal)—Currently in Senate Transportation Committee**

- Provides refunds of the Smog Impact Fee, with interest at Pooled Money Investment Account rate.
- Establishes a verification and claims procedure for refund.
- Allows consumers up to four years to request refund.
- Companion bill to SB 215 (Karnette).

✓ **AB 1702 (McClintock)—Currently in Assembly Transportation Committee**

- Repeals the Smog Impact Fee.
- Provides refunds, with interest at rate Board of Equalization charges on delinquent sales and use tax payments.
- Does not establish a verification procedure.
- Appropriates $767 million from General Fund for refunds.

✓ **AB 1726 (Reyes)—Currently in Assembly Transportation Committee**

(Same provisions as AB 1702 above.)

✓ **SB 215 (Karnette)—Currently in Assembly Transportation Committee**

- Repeals the Smog Impact Fee.
- Appropriates $665 million from General Fund to provide refunds as provided in AB 809.
- Companion bill to AB 809 (Lowenthal).

✓ **SB 230 (Johannessen)—Currently in Senate Third Reading**

- Repeals the Smog Impact Fee.

✓ **SB 1325 (Karnette)—Currently in Senate Transportation Committee**

- Repeals the Smog Impact Fee.
- Provides for the refund of any tax or fee that is determined to be unconstitutional--not limited to the Smog Impact Fee.

pact Fee refunds—a level of funding consistent with the proposals pending before the Legislature. This amount assumes that refunds would be provided to all eligible persons.

In reviewing these various proposals, the Legislature has numerous options as to how to structure the refund program. We discuss some of these options below.

Amount of Interest to Include in the Refund. The Revenue and Taxation Code provides certain interest rate calculations for tax payments. These rates vary in amount—some are equal to a set amount (for instance, 3 percent of the total tax payment) and others are calculated (for example, equal to the state's Pooled Money Investment Account rate). Because there is no interest rate specified for the Smog Impact Fee, we believe the Legislature has the discretion to set this interest rate.

Source of Funding for the Refunds. As we mentioned previously, the state's liability to pay these refunds could be in excess of $650 million. (This amount will vary depending on the interest rate used to calculate the refund.) Given that the HPRRA contains only about $100 million, any large scale refund program will require a significant contribution from the General Fund.

Implementing the Fee Refund. The bills pending before the Legislature when this analysis was prepared included different methods of notifying consumers of the fee refund and disbursing the refund to consumers. We believe the Legislature has many options for notifying consumers and paying the refund. For example, the state could send letters to all consumers identified by the DMV as having paid the fee, or the state could allow consumers to contact DMV and request a refund. Regardless of how consumers are made aware of the refund program, we believe requiring some type of verification is appropriate. In addition, we believe the refund check should be paid by the State Controller, given that office's expertise in reviewing claims and disbursing revenues.

SUMMARY

Three legal challenges pose some fiscal concern to the state. Two of these—special education and the Smog Impact Fee—may be resolved during the budget year. As we discuss above, the cost of addressing these issues depends, to a significant extent, on *policy choices* of the Legislature. For instance, in the case of special education, the Legislature has significant authority to alter the magnitude and timing of any funding provided, as well as the extent to which the funding affects the Proposition 98 guarantee. In addition, while the resolution of the property tax shift claim may be years away, the Legislature could act now to reduce any potential fiscal liability. Finally, six bills are currently before the Legislature, each proposing a different approach to the Smog Impact Fee issue. The magnitude of the state's fiscal liability will depend on the Legislature's choices regarding the terms of the refund, the interest rate paid, and the extent of fee-payer verification required.