III

Perspectives on State Revenues

Perspectives on State Revenues

California's state government will collect an estimated $72 billion in taxes, fees, and other revenues in 1998-99. This represents a 4.5 percent increase from the current year. These revenues are deposited either into the state's General Fund, or into a variety of special funds.

General Fund revenues are allocated each year through the budget process and support a wide variety of state expenditure programs, including education, criminal justice, and health and social services. Revenues deposited into special funds are earmarked for specific purposes, such as transportation, and targeted health and welfare programs. Some taxes, such as the sales tax, are allocated among both the General Fund and a variety of special funds.

Figure 1 (see next page) shows that slightly over three-fourths of total state revenue collections are deposited into the General Fund, while the remaining one-fourth are received by special funds.

REVENUE PERFORMANCE OVER TIME

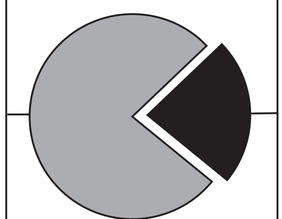
Total revenues collected by state government have risen at a moderate pace over the past decade. As indicated in Figure 2 (see next page), total revenues (excluding transfers and including Local Public Safety Fund revenues) have grown from $38 billion in 1987-88 to over $68 billion in 1997-98, an average increase of just over 6 percent per year. After adjusting for inflation, "real" (that is, constant-dollar) revenues have increased at an average annual rate of about 3 percent. During this period, total revenues have increased slightly faster than the state's overall economy.

Figure 1

State Revenues in 1998-99

(In Billions)

Total State Revenues $72 Billion



General Fund Revenues	
Personal Income Taxes	$27.6
Sales and Use Taxes	18.3
Bank and Corporation Taxes	6.2
All Other[b]	3.3
Total	**$55.4**

Special Funds Revenues	
Motor Vehicle-Related Taxes	$8.6
Sales and Use Taxes[a]	3.9
Tobacco-Related Taxes	0.5
All Other[b]	3.7
Total	**$16.6**

Detail may not total due to rounding.

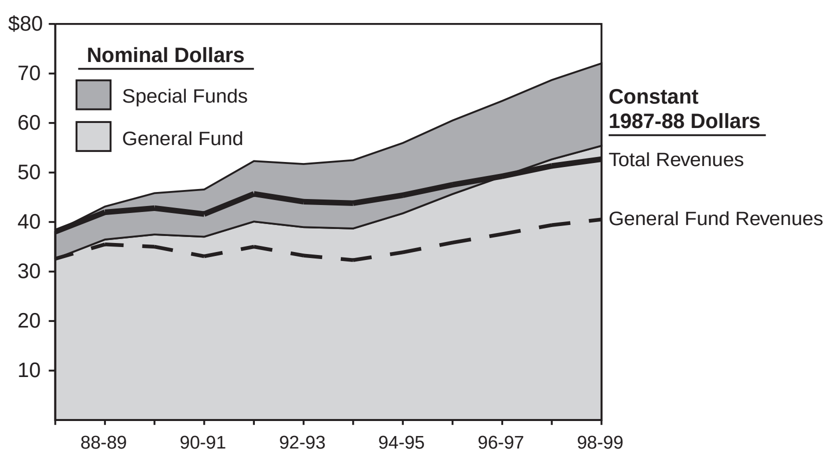
a Includes $1.9 billion to Local Revenue Fund and $0.2 billion for transportation-related purposes. Also includes $1.9 billion allocated to Local Public Safety Fund, which is not included in Governor's budget totals.

b Includes transfers and loans.

Figure 2

Historical Trends in State Revenues[a]

General and Special Funds, 1987-88 Through 1998-99
(In Billions)



a Excludes transfers, bond funds, and federal funds. Includes Local Public Safety Fund.

The figure also indicates that the rate of revenue growth has fluctuated significantly during this ten-year period, reflecting both tax law changes and the impact of the state's economy on tax receipts. After growing strongly in the late 1980s, revenues remained relatively flat during the early 1990s' recessionary period. Revenues resumed an upward path from 1994-95 through 1996-97, roughly in line with California's expanding economy. We expect that revenues will grow at a healthy pace in the current year, before moderating somewhat in 1998-99.

General Fund Versus Special Funds Revenue Growth. Despite large dollar increases in General Fund receipts during the past two years, the annual rate of growth over the entire past decade has been higher for special funds (11 percent) than for the General Fund (5 percent). This is largely a result of tax law changes affecting the special funds. The voter approval of gasoline tax increases in 1990, the creation of the one-half cent Local Revenue Fund sales tax in 1991, and voter approval of a one-half cent sales and use tax for local public safety in 1993, have significantly added to the special funds revenue totals. In contrast, most of the General Fund tax increases enacted during the early 1990s have since expired, and the state has recently enacted income tax decreases. Thus, the net impact of state tax law changes on General Fund revenues has been modest when the period is viewed in its entirety.

OVERVIEW OF GENERAL FUND REVENUES

Over 93 percent of General Fund revenues are from the state's three major taxes—the personal income, sales and use, and bank and corporation taxes. As shown in Figure 3 (see next page), the largest of these is the personal income tax (PIT), which is projected to account for nearly one-half of total General Fund receipts in 1998-99. The second largest General Fund revenue source is the sales and use tax, which will account for slightly more than one-third of the total. The third largest General Fund revenue source is the bank and corporation tax, which will account for about one-tenth of the total.

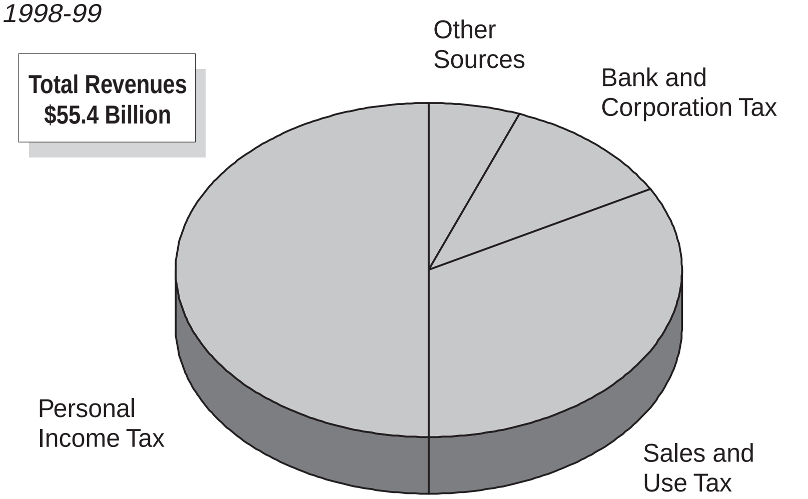
The remaining 7 percent of General Fund receipts is related to numerous smaller taxes, fees, interest earnings, and other sources. These include taxes on insurance premiums, alcoholic beverages, and cigarettes.

General Fund Revenues Closely Mirror State's Economic Fortunes. The single largest factor affecting General Fund revenues is the performance of the state's economy. This reflects the fact that changes in wages, employment, consumer spending, and business earnings directly affect state

Figure 3

General Fund Revenues by Source

1998-99



receipts from the personal income, sales and use, and bank and corporation taxes.

Revenue Estimates Reflect Recent Tax Reductions

Both the administration's and the Legislative Analyst's Office's (LAO's) revenue projections summarized later reflect the tax-relief package agreed upon and enacted last summer, which provides tax reductions to both individuals and businesses. Figure 4 shows that its provisions are projected to reduce General Fund revenues by an estimated $189 million in the current year, $593 million in 1998-99, and $1.1 billion in 1999-00 (when its provisions are fully phased in).

As indicated in the figure, the majority of the fiscal impact is attributable to the provision raising the dependent exemption credit claimed on personal income returns from $68 in 1997 to $120 in 1998 and $222 in 1999. Other significant provisions include those conforming California to federal tax law in the areas of capital gains on sales of principal residences, Subchapter "S" corporations, research and development tax credits, and individual retirement accounts. The measure also reduces the alternative minimum tax by raising its exemption amounts and indexing them in the future to changes in the California Consumer Price Index.

Figure 4

Revenue Effects of California's 1997 Tax Relief Package

1997-98 Through 1999-00
(In Millions)

Provision	1997-98	1998-99	1999-00
Increase in PIT dependent exemption	-$15	-$295	-$780
Increase in and indexing of AMT exemption	-44	-74	-85
Federal conformity:			
Capital gains/home sales	-25	-110	-70
Subchapter "S" corporations	-18	-21	-22
Research and development credit	-63	-58	-48
Individual retirement accounts	-4	-14	-31
Other	-20	-21	-50
Totals	**-$189**	**-$593**	**-$1,086**

Beyond these changes, the Governor' budget contains no new proposed tax law changes. (The only change from current law assumed in the revenue forecast is a $1 million reduction in horse racing revenues relating to legislation that would repeal certain fees collected on out-of-state wagering. The budget also proposes permanent elimination of the renters' tax credit, although we view this not as a tax program *per se*, but rather akin to an expenditure program which uses the tax structure as a convenient means of disbursing its benefits.)

THE BUDGET'S GENERAL FUND REVENUE OUTLOOK IN BRIEF

Figure 5 (see next page) summarizes the *1998-99 Governor's Budget* revenue forecast. It shows that General Fund revenues and transfers are projected to increase from $49.2 billion in 1996-97 to $52.9 billion in 1997-98 (a 7.5 percent growth), and $55.4 billion in 1998-99 (a 4.7 percent growth).

1997-98 Revenues. The administration's projected healthy revenue increase for the current year is lead by an 11.6 percent growth in personal income taxes. Sales tax receipts are projected to increase by 5.9 percent, and bank and corporation taxes are forecast to rise just 0.8 percent. The small increase in the latter partly reflects the impact of the 5 percent corporate tax rate reduction passed last year. Collections from the state's smaller revenue sources are affected by a variety of one-time anomalies and policy changes. For example, the decline in "other revenues" and transfers reflect agreements reached between the Governor and the Legislature on trial court funding and other subjects.

Figure 5

Summary of Department of Finance's General Fund Revenue Forecast

1996-97 Through 1998-99
(Dollars in Millions)

		1997-98 Forecast		1998-99 Forecast	
Revenue Source	**Actual 1996-97**	**Amount**	**Percent Change**	**Amount**	**Percent Change**
Personal Income Tax	$23,273	$25,980	11.6%	$27,640	6.4%
Sales and Use Tax	16,566	17,545	5.9	18,290	4.2
Bank and Corporation Tax	5,787	5,835	0.8	6,175	5.8
Insurance Tax	1,200	1,224	2.0	1,281	4.7
Other taxes	1,129	1,246	10.3	1,270	2.0
Other revenues	1,194	911	-23.7	720	-21.0
Transfers	70	149	—	7	—
Totals	**$49,220**	**$52,890**	**7.5%**	**$55,383**	**4.7%**

1998-99 Revenues. The 4.7 percent increase in revenues projected for the budget year assumes moderate increases in the state's major taxes, along with declines in some of the smaller revenue and transfer categories. The slowdown in personal income tax growth (from 11.6 percent in the current year to 6.4 percent in the budget year) partly reflects the impact of the increase in the dependent credit exemption that will take place in 1998. As in the current year, the decline projected for the "other revenues" and transfers categories partly reflects the impact of the trial court funding agreement reached last year.

RECENT CASH TRENDS SUGGEST BUDGET REVENUE FORECAST IS LOW

Although one-time refunds and other factors caused cash revenue receipts to lag early this fiscal year, the more recent trend in cash revenue collections has been extremely positive. Specifically, General Fund revenue receipts in December 1997 were up by well over $700 million from the *1997-98 Budget Act* forecast, more than offsetting the weaknesses that had occurred in the earlier part of the fiscal year. These strong December payments, which were received *after* the administration had completed its budget revenue forecast, reflect major increases in quarterly estimated payments toward 1997 personal income tax liabilities. Such year-end quarterly payments provide a good indication of the strength of non-wage earnings, such as business income, bonuses, stock options, and investment income. Historically, major increases in these payments have been followed by equally strong gains in final payments filed in April. If this pattern holds in the current year, we would expect revenues to *exceed* the budget forecast, and by a significant margin.

THE LAO'S GENERAL FUND REVENUE OUTLOOK

Figure 6 presents our General Fund revenue outlook for 1997-98 and 1998-99. In addition, to help the Legislature in its fiscal planning, we also provide our fiscal projections for one additional year—1999-00. Our projections are based on our economic forecast presented in Part 2 of this volume. As discussed there, our economic outlook assumes continued, though moderating, economic growth in California through the year 2000.

Figure 6

Summary of LAO's General Fund Revenue Forecast

1997-98 Through 1999-00 (Dollars in Millions)

	1997-98		1998-99		1999-00	
Revenue Source	**Forecast Amount**	**Percent Change**	**Forecast Amount**	**Percent Change**	**Forecast Amount**	**Percent Change**
Personal income tax	$26,600	14.3%	$27,800	4.5%	$29,100	4.7%
Sales and use tax	17,570	6.1	18,560	5.6	19,580	5.5
Bank and corporation tax	5,850	1.1	6,120	4.6	6,300	2.9
Insurance tax	1,220	1.7	1,280	4.9	1,330	3.9
Other taxes	1,235	9.4	1,266	2.5	1,290	1.9
Other revenues	911	-23.7	710	-22.1	735	3.5
Transfers	149	—	7	—	100	—
Totals	**$53,535**	**8.8%**	**$55,743**	**4.1%**	**$58,435**	**4.8%**

1997-98 Revenues. We forecast that General Fund revenues and transfers will reach $53.5 billion in the current year, an 8.8 percent increase from 1996-97. As shown in Figure 6, we project that personal income tax receipts will increase by 14.3 percent in the current year. This reflects the combination of healthy economic growth, an assumed increase in capital gains realizations associated with the rise in the stock market, and reductions in federal tax rates on capital gains. We assume that the sales and use tax will increase 6.1 percent, or slightly less than the rate of growth projected for statewide personal income. Bank and corporation taxes are projected to increase by 1.1 percent, reflecting modest growth in California taxable profits and the impact of the 5 percent tax rate reduction enacted in 1996.

1998-99 Revenues. We forecast that General Fund revenues will increase to $55.7 billion in 1998-99, a 4.1 percent rise from the current year. Growth in personal income taxes is expected to decline sharply in the budget year, reflecting the impact of California's 1997 tax relief agreement and our assumption that tax receipts from capital gains will fall from current-year levels. Other factors holding down the growth rate in forecasted revenues next year include sluggish gains in corporation tax receipts and a decline in "other" revenues related to recently enacted trial court legislation.

1999-00 Revenues. We forecast that General Fund revenues and transfers will be $58.4 billion in 1999-00, a 4.8 percent increase from 1998-99. Our estimates assume continued moderate growth in sales taxes. As in the budget year, growth in personal income tax receipts will be affected by the phasing in of the 1997 tax cuts.

Our forecasts for the individual major General Fund revenue sources are discussed in greater detail below.

THE LAO'S FORECAST FOR MAJOR REVENUE SOURCES

As noted above, California's fiscal performance is highly dependent on the performance of its three largest revenue sources—the personal income, sales and use, and bank and corporation taxes. Together, these taxes account for over 93 percent of state General Fund revenues. The following sections provide additional detail regarding the outlook for these three taxes.

Personal Income Tax

Background

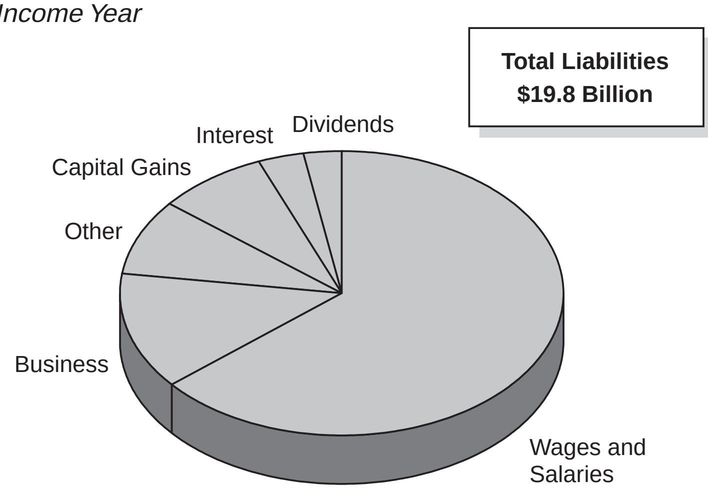
The PIT is by far the General Fund's single largest revenue source, accounting under our forecast for $26.6 billion in tax receipts in the current year. The tax is levied on personal income that is attributable to California. In general, California's income tax is patterned after federal law with respect to the calculation of most types of income, deductions, exemptions, exclusions, and credits. Taxable income is subject to marginal tax rates ranging from 1 percent up to 9.3 percent. From 1991 to 1995, high-income taxpayers were subject to 10 percent and 11 percent marginal rates.

Sources of PIT Taxes. As indicated in Figure 7, as of 1995 (the most recent year for which detailed tax return information is available), about two-thirds of total state income tax liabilities was attributable to wages and salaries. The remaining one-third was due to nonwage sources such as business earnings, interest, dividends, and capital gains.

Figure 7

Personal Income Tax Liabilities By Source of Income

1995 Income Year



The Special Importance of Nonwage Income Behavior. Although only accounting for one-third of total tax liabilities in 1995, the performance of nonwage earnings can have a disproportionate impact on the *change* in tax liabilities from year to year. This is partly because (1) nonwage earnings are more volatile than wages and (2) they accrue to higher-income taxpayers, who are subject to higher marginal tax rates (thus, their impacts on revenues tend to be proportionately greater). These factors are particularly true for capital gains, which in the past have risen and fallen by more than 50 percent from one year to the next. For these reasons, the outlook for nonwage income—and in particular, capital gains—is extremely important to the PIT revenue forecast and thus the state's overall revenue picture.

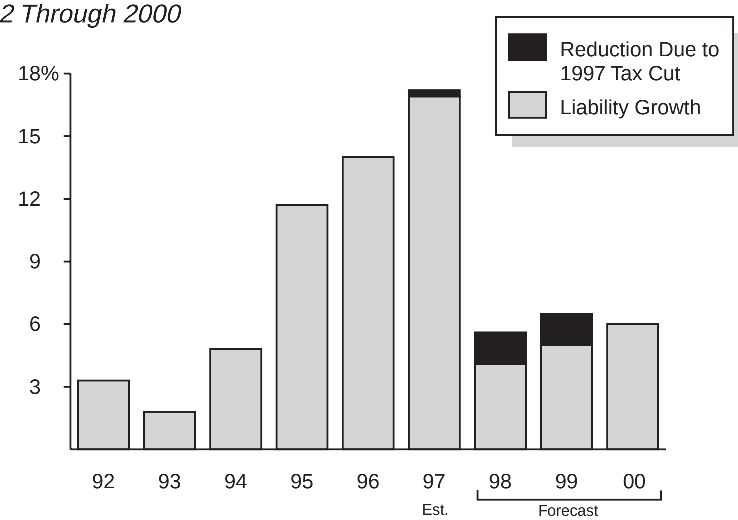
PIT Liabilities Have Soared in Recent Years

Figure 8 shows the changes in PIT liabilities reported on California income tax returns since 1992. It shows that after lagging in the early 1990s, PIT liabilities jumped by over 12 percent in 1995, and 13 percent in 1996 (despite the expiration of the temporary 10 percent and 11 percent marginal income tax brackets in that year). Based on our preliminary estimates for 1997, it appears that liabilities rose an additional 17 percent last year.

Figure 8

PIT Liability Growth to Slow After Three Strong Years

1992 Through 2000



Capital Gains a Major Factor. The especially strong growth in PIT liabilities in recent years has reflected widespread increases in earnings. As indicated in Figure 9, wages increased at a solid pace in both 1996 and 1997. However, nonwage income—and particularly, capital gains—soared during this period. Based on preliminary tax return information, it appears that capital gains increased by 60 percent in 1996, accounting for more than $1 billion of the growth in overall state tax liabilities in that year. Based on the continued strength of estimated payments in 1997, we estimate that capital gains jumped an additional 30 percent last year.

Figure 9

Growth in California PIT Components Subject to Taxation

1996 Through 2000

Income Component	1996	1997	1998	1999	2000
Wages	8.2%	7.4%	7.5%	6.0%	5.4%
Dividends	15.7	12.4	6.4	6.0	5.0
Interest	9.8	8.4	4.4	2.0	2.5
Business income	14.1	7.6	6.0	5.5	5.3
Capital gains	60.0	30.0	-10.0	0.0	5.0
Other	11.8	6.9	6.0	5.8	6.0
Totals, Adjusted Gross Income	**11.5%**	**8.8%**	**5.8%**	**5.4%**	**5.4%**

These increases in capital gains are partly related to the major rise in stock prices that has occurred over the past two years. This stock price appreciation has contributed to growth in capital gains reported by company shareholders and mutual fund investors. The stock market increases have also contributed to growth in earnings from stock options granted to employees of companies in California. We also believe that some of the 1997 strength in capital gains was related to the "unlocking" of gains that had been held in anticipation of the federal capital gains tax rate reduction, which was enacted last summer.

PIT Outlook—Slower Growth. Despite a positive outlook for California's economy generally, we are projecting a slowdown in the growth in PIT liabilities during the next three years. As indicated in Figure 8, we project that PIT liabilities will increase by between 5 percent and 6 percent during the next two years, or slightly more slowly than statewide personal income growth. This is in marked contrast to the past two years, when PIT liabilities grew by more than double the rate of statewide personal income.

Our projected slowdown in PIT receipts reflects two key factors:

- First, we anticipate that capital gains will fall slightly in 1998 and remain fairly steady the following two years. Our forecast reflects (1) the outlook for less growth in corporate profits and equity values than in the recent past, and (2) the likelihood that some of the 1997 gains were a one-time response to the federal capital gains rate reduction, and thus will not be repeated.
- Second, our estimates of PIT liability growth take into account the effects of the tax reduction package enacted last year. This legislation reduced PIT income-year liabilities by about $75 million in 1997, but is expected to lower liabilities by about $485 million in 1998 and by $950 million in 1999. As indicated in Figure 8, these tax reductions will lower liability growth rates by about 1.5 percentage points in both the 1998 and 1999 income years.

Personal Income Tax Revenue Forecast. Based primarily on our forecast for PIT liabilities, we estimate that fiscal-year PIT revenues will be $26.6 billion in 1997-98, $27.8 billion in 1998-99, and $29.1 billion in 1999-00.

Sales and Use Tax

Background

The sales and use tax is the General Fund's second largest revenue source, accounting for about one-third of total collections. When state sales tax receipts going to special funds and local governments are included, the sales tax is the state's single largest revenue source, accounting for an estimated $29 billion in receipts in 1997-98.

The term "sales and use tax" actually refers to two separate levies—the sales tax and the use tax. The *sales* tax is applied primarily to the retail sales of tangible goods purchased in California. Key components of taxable sales include retail spending by consumers, purchases of motor vehicle fuel, building materials that go into the construction of both 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 specific exemptions from the sales tax , the largest of which is for food.

The *use* tax is imposed on products purchased from out-of-state sources by California residents for use in the state. Such purchases are difficult to monitor, and the state is prohibited by the federal government from requiring out-of-state mail-order firms to collect the use tax for California. Given the above, the use tax accounts for a relatively small amount of collections each year.

Sales and Use Tax Rates

Although the sales and use tax is the General Fund's second largest revenue source, it is the single largest revenue source in California when both state and local taxes are taken into account. As indicated in Figure 10, the sales and use tax rates paid throughout 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 categories:

Figure 10

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, 2 percent in San Mateo County, and 1 percent in San Diego County.

- ***State Tax Rates***. These include a 5 percent General Fund rate, plus two one-half cent rates that go into special funds which support local programs. These consist of (1) a 0.5 percent tax to the Local Revenue Fund, which was enacted in 1991 to support local health and social services 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. The public safety sales tax monies are provided directly to localities, and the administration has chosen not to display them in the budget. However, they do represent state tax receipts and thus we report them as such.

- ***Uniform Local Tax Rate***. A 1.25 percent uniform local sales tax rate is levied in all counties (this is the so-called Bradley-Burns rate). Of this total, 1 percent is allocated to cities and counties for general purposes, and the remaining 0.25 percent is deposited into county transportation funds. Of the 1 percent general purpose tax revenues, cities receive the proceeds collected within their boundaries, while counties receive the proceeds collected within unincorporated areas.

- ***Optional Local "Add-On" Sales Tax Rates***. Local governments are authorized to levy additional local sales and use taxes for a variety of purposes. These taxes, which require local voter approval, are normally levied on a county-wide basis, primarily for transportation-related purposes. These taxes generally are levied in one-fourth cent or one-half cent increments, and cannot exceed 1.5 percent (except in San Francisco and San Mateo Counties).

Combined State and Local Tax Rates. As shown in Figure 11, the combined state and local tax rates vary significantly across California—ranging from 7.25 percent in areas that impose no optional sales taxes, up to 8.5 percent in San Francisco County. No county currently imposes the maximum allowable 8.75 percent rate.

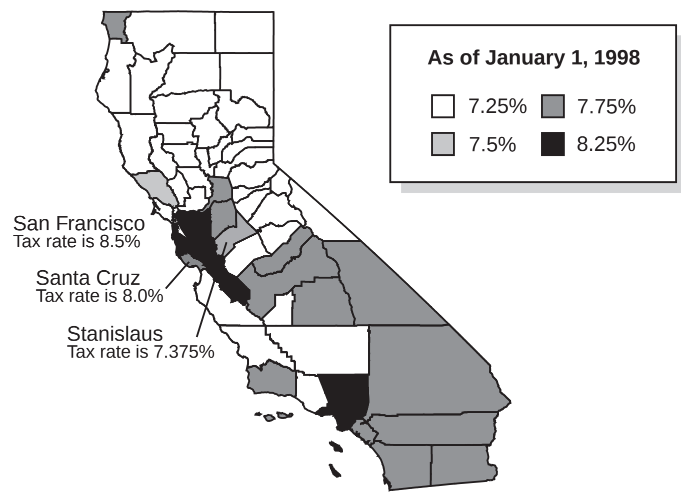
Taxable Sales Grew Moderately in 1997

Taxable sales increased at a moderate pace of just under 6 percent in 1997, or slightly more slowly than personal income growth during the year. Sales in the early part of 1997 were sluggish, increasing by just 5.4 percent in the first half of the year. However, they picked up momentum in the summer months, increasing by nearly 7 percent from the prior year.

Our forecast was prepared before taxable sales for the fourth quarter of calendar-year 1997 were known. However, based on generally positive industry reports for the western region of the United States, it appears

Figure 11

Sales Tax Rates Vary by County



that sales during the important Christmas shopping season were up by about 6 percent from the prior year.

The LAO's Taxable Sales Forecast—Continued Moderate Growth

We expect that taxable sales growth will continue at near its recent pace, increasing by 5.8 percent in 1998, 5.6 percent in 1999, and 5.1 percent in 2000. Over the next three years, sales growth will be bolstered by the impacts of rising home construction on sales of building materials, home furnishings, and appliances. We expect sales of other goods to grow at a slightly slower pace, due to our projected moderating gains in employment and incomes during 1998 and 1999.

Sales and Use Tax Revenue Forecast. Based on our projections for moderate growth in taxable sales, we project that sales tax receipts to the General Fund will be $17.6 billion in 1997-98, $18.6 billion in 1998-99, and $19.6 billion in 1999-00.

Bank and Corporation Taxes

Background

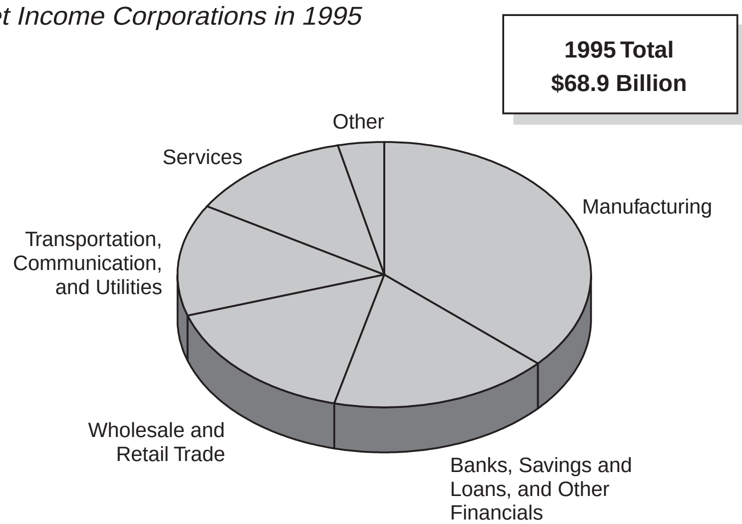
Banks and corporations are subject to a general tax rate of 8.84 percent on their California taxable profits. Corporations that qualify for California Subchapter "S" status are subject to a 1.5 percent corporate rate. The income of these companies, however, is "passed through" for tax purposes to their shareholders, where it is subject to the California PIT. Banks and financial corporations pay an additional 2 percent tax on their income, which is in lieu of all other state and local levies except taxes on real property, motor vehicle-related levies, and business licenses.

Figure 12 shows the distribution of California's corporate tax base, by industry. It shows that about one-third of total profits are related to manufacturing. The other major shares of total profits are attributable to: financial institutions; wholesale and retail trade; and the combined transportation, communications, and public utilities industry sectors.

Figure 12

California Taxable Corporate Profits By Industry

Net Income Corporations in 1995



One-Time Factors Depressed Earnings in 1996 and 1997

One of the few negative revenue surprises during the past two years has been the abrupt slowdown in bank and corporation tax receipts. Total receipts fell slightly last year, despite an otherwise healthy economy, and collections this year have increased only modestly.

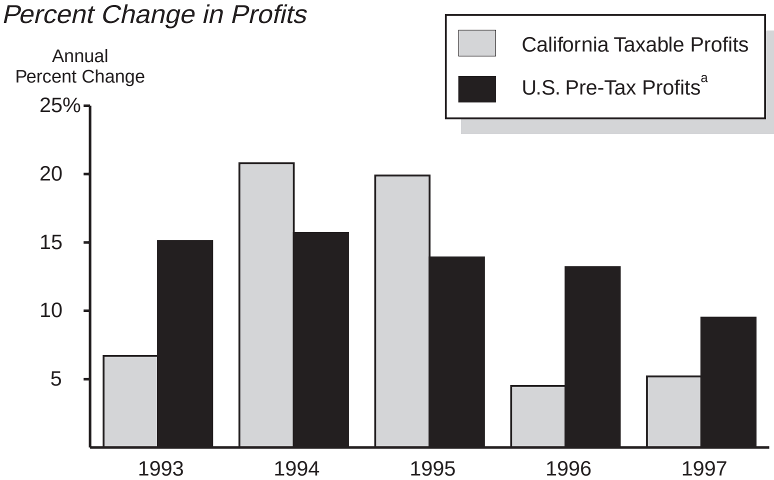
Based on preliminary tax return data for 1996 (the most recent year for which data are available), it is evident that much of the unexpected softness has been due to an abrupt slowdown in California taxable profit growth in 1996, which appears to have carried over into early 1997.

Figure 13 compares growth in California and U.S. pretax earnings from 1993 though 1997 (estimated). It indicates that after lagging the U.S. in the early stages of the current economic expansion, California profits jumped by about 20 percent in both 1994 and 1995, outperforming the nation during those years. In 1996 and 1997, U.S. earnings growth slowed but still registered good growth. In contrast, however, profit growth in California fell abruptly, to just 4.5 percent in 1996 and an estimated 5.2 percent in 1997. The slowdown in California is especially striking in view of the otherwise healthy performance in California's high-technology services and manufacturing industries during this period.

Figure 13

California Profits Growth Slowed Abruptly in 1996 and 1997

1993 Through 1997
Percent Change in Profits



[a] Includes inventory valuation adjustment (IVA) and capital consumption adjustment (CCA).

The preliminary tax data for 1996 suggest that part of California's weakness was due to a sharp decline in profits in the transportation, communications, and public utilities industry sector, which fell by nearly one-half during the year. Absent the decline in this industry, overall 1996 profit growth in California would have been much higher—11 percent. Tax-related payments attributable to this industry in 1997 remained soft. The declines appear to be related to restructurings and mergers taking place in the utility and communications industries.

The LAO's Profit Outlook—Moderate Growth

A key question regarding the outlook for California profits is whether and when profits in the utility and communications industries will return to earlier levels following the current wave of mergers and restructurings. Our profits forecast assumes that earnings will return to more normal levels over the next three years, as one-time charges associated with mergers and restructurings subside. A rebound in this sector should offset the effects of the more general slowdown in profit growth expected for the U.S. as a whole in 1998 and 1999. We specifically project that California taxable corporate profits will increase by 5.6 percent in 1998 and 5.5 percent in 1999. This compares to projected increases in national profits of less than 1 percent during the next two years.

Corporate Tax Revenue Forecast. Based on our assumption of moderate increases in taxable profits, we estimate that bank and corporation tax receipts will be $5.9 billion in the current year, up slightly from 1996-97. We project that revenues from this source will increase to $6.1 billion in 1998-99, and to $6.3 billion in 1999-00. Our estimates include the ongoing impacts of the 5 percent rate reduction enacted in 1996, as well as the expansion of the research and development tax credit and other provisions of the state's 1997 tax relief package.

Outlook for Other Revenue Sources

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

We forecast that these other sources will be declining from $3.6 billion last year to $3.5 billion in the current year and $3.3 billion in 1998-99, followed by minor growth to $3.5 billion in 1999-00. The declines in the current year and budget year are partly related to the financial restructuring of the trial courts, which resulted in the redirection of penalty and fee revenues from the General Fund to a trial court trust fund. Specifically, General Fund receipts of trial-court-related revenues are estimated to fall from $316 million last year to $158 million in the current year (a half-year effect) and to zero in the budget year and beyond. Other factors contributing to the decline include lower net transfers, the reallocation of tidelands oil revenues to special funds, and continued falling per-capita consumption of cigarettes and alcoholic beverages.

THE LAO'S FORECAST IN PERSPECTIVE

Comparison to the Budget Forecast

Our revenue forecast is above the budget forecast by $645 million in the current year and by $360 million in 1998-99, for a two-year total of just over $1 billion. The main reason for our differences involves PIT revenues. Based on recent positive cash trends and upward revisions to California's economy in late 1997, we estimate that PIT receipts will exceed the budget estimate by $620 million in the current year and $160 million in the budget year (or a two-year total of $780 million).

A second factor accounting for the difference is the sales tax. As indicated in Part II of this volume, our forecast of employment and income growth is generally similar to the administration's. However, the administration's forecast of taxable sales is significantly more conservative than our own. We believe that taxable sales will continue to grow at roughly the same pace as personal income during the next two years, rising by 5.8 percent in 1998 and 5.6 percent in 1999 (see Figure 14—next page). (As a result, the share of statewide personal income that is devoted to taxable spending should remain *relatively stable*.) In contrast, Figure 14 shows that the administration's forecast assumes that taxable sales growth will taper off significantly in the next two years, increasing by 4.8 percent in 1998 and just 4.3 percent in 1999. (This would cause the ratio of taxable sales-to-income to *fall significantly*.) The differences in our projections for taxable sales growth translate into $295 million in revenues over the current and budget years combined.

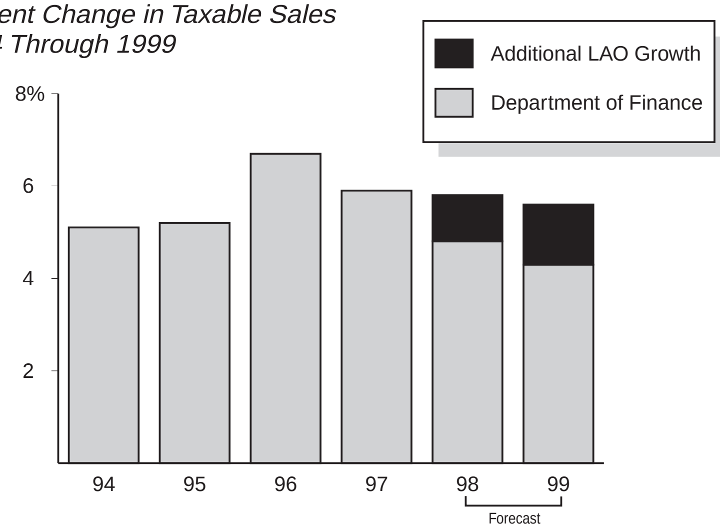
Changes in the LAO's Revenue Forecast Since November

Relative to our November 1997 forecast, our current General Fund revenue estimate is up $497 million for the current year. This increase is due to an upward revision to our estimate of PIT receipts, which we have made largely in response to the stronger-than-expected increase in 1997 year-end tax payments. Our current projections for 1998-99 and 1999-00 are similar to our November projections, reflecting offsetting impacts of downward revisions to bank and corporation tax receipts and higher sales and income tax receipts during the two years.

Figure 14

Department of Finance's Taxable Sales Forecast Conservative

Percent Change in Taxable Sales 1994 Through 1999



Upside Potential and Downside Risks

Our revenue forecast represents our best estimate of the amount of funds the state can expect to receive during the period 1997-98 through 1999-00. However, as is the case with any revenue forecast, our's is subject to both upside and downside risks.

On the *upside*, our forecast could prove to be conservative if the economy does not moderate in 1998 and 1999 as we expect, and / or if the 1997 growth in taxable capital gains does not fall off as much as we project from 1996's extraordinary performance.

On the *downside*, there is a risk that the economy could underperform, due to greater-than-expected adverse impacts associated with Asia's problems or other factors. And, given the difficulty of projecting capital gains in future years, this volatile source could underperform if, for example, the stock market weakens.

As an indication of how sensitive revenues are to these upside and downside risks, each 1 percentage point change in the rate of statewide income growth translates into over $600 million in collections, while each 10 percentage point change in the growth rate of capital gains translates into about $300 million in receipts.

THE BUDGET FORECAST FOR SPECIAL FUNDS REVENUES

Special funds revenues support a wide variety of state and local government programs. As shown in Figure 15, about one-half of special funds are related to motor vehicle-related taxes and fees. These include motor vehicle license fees (an in-lieu property tax, the proceeds of which are distributed to local governments for general purposes) and fuel taxes and registration fees (which support transportation projects). Other major special funds revenues include sales and use taxes (which support local criminal justice and health and social services programs) and tobacco-related taxes (which are earmarked for various anti-smoking and health programs).

Figure 15

Special Funds Revenues and Transfers

1996-97 Through 1998-99
(Dollars in Millions)

Revenue Source	Actual 1996-97	Estimated 1997-98	1998-99 Forecast Amount	1998-99 Percent Change
Motor Vehicle Revenues				
License fees (in lieu)	$3,636	$3,709	$3,895	5.0%
Fuel taxes	2,806	2,907	2,994	3.0
Registration, weight, and miscellaneous fees	1,653	1,692	1,727	2.1
Subtotals	($8,095)	($8,308)	($8,616)	6.4%
Other Sources				
Sales and use taxes[a]	$3,554	$3,750	$3,905	4.1%
Cigarette and tobacco taxes	497	486	479	-1.4
Interest on investments	156	142	157	10.6
Other revenues	2,963	3,314	3,656	5.5
Transfers and loans	32	-66	-73	—
Totals	**$15,297**	**$15,934**	**$16,580**	**4.1%**

[a] Includes Local Public Safety Fund revenues. These amounts are not included in the Governor's budget totals.

The budget projects that special funds revenues will grow from $15.3 billion in 1996-97 to $15.9 billion in 1997-98 and $16.6 billion in

1998-99. The modest 4.1 percent growth between the current year and budget year is largely the result of:

- Increases in sales taxes and motor vehicle license fees of 4.1 percent and 5 percent, respectively, reflecting the administration's assumption of modest increases in consumer spending on automobiles and other items.
- Growth in fuel taxes of about 3 percent, reflecting modest increases in the volume of gasoline sold.
- A 1.4 percent decline in cigarette and tobacco taxes, primarily due to falling per-capita sales of cigarettes.

Special Funds Revenues Could Exceed Budget Forecast. We believe that there is some upside potential to the administration's special funds revenue forecast for sales taxes. Specifically, our higher estimate for taxable sales during 1998 and 1999 (discussed above) would translate into increases in special fund sales tax receipts of approximately $55 million during the current and budget years combined.