



# California Institute Special Report: California's Balance of Payments with the Federal Treasury, Fiscal Years 1981-2002

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In fiscal year 2002, California's net fiscal outflow to the federal government increased for the eighth consecutive year, with the state's taxpayers sending more in taxes to Washington than were received back in federal government expenditures in the state.

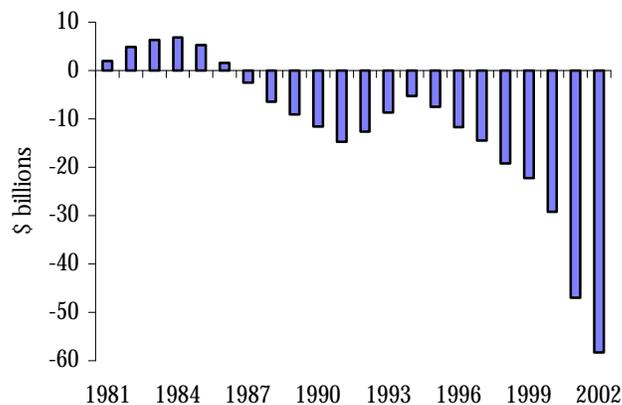
## The Balance of Payments Between California and Washington

In 2002, Californians sent \$58 billion more to Washington in federal taxes than the state received back in federal spending. Fueled largely by a sharp increase in its federal tax burden compared to other states, the Golden State's imbalance set new record for any state, surpassing the previous mark (set also by California, in 2001) of \$47 billion.

To some extent, the shortfall is understandable. Two California characteristics make it likely that the state would pay more federal taxes than the state receives back in spending. First, state residents' income levels are above the national average, yielding above-average income tax receipts – an effect amplified by the progressive nature of the federal income tax scheme. Second, California's population is significantly younger than average, so the state has fewer recipients of Social Security and Medicare payments – the fastest growing budget sector that now accounts for nearly half of all federal spending.

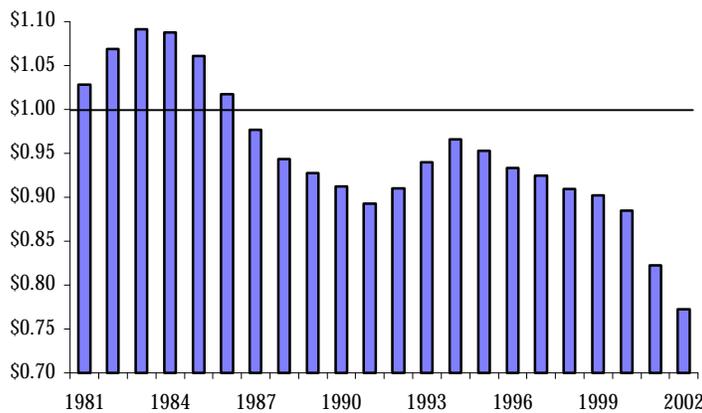
It has been many years since California's federal spending relationship was in surplus. The defense buildup during Ronald Reagan's first Presidential term in the early 1980s kept California's federal balance of payments in the black for six straight years. From 1981 to 1986, federal expenditures in California exceeded federal taxes paid by \$26.9 billion, with a

California's Balance of Payments with the  
Federal Treasury, 1981-2002



single-year high-water mark of \$6.8 billion surplus in 1984. As defense procurement began to wane in the mid 1980s, however, California's federal funding advantage declined, and the state's balance shifted into the red in 1987 and has remained there ever since. By 1990, California had erased the inflows of the early 1980s, and the 16-year combined tally since 1987 has now grown to \$280 billion. (In the early 1990s, the balance figure dipped from a nearly \$15 billion loss in 1991 to just a \$5 billion shortfall in 1994. But the retreat was short-lived, and deficits since then have risen at a steady clip, by an average of \$4 billion each year through 2000 and by far more since then.)

**California Return on Investment: Federal Expenditures in California per Federal Tax Dollar Paid, 1981-2002**



The taxing-versus-spending imbalance means that every California man, woman, and child paid \$1,660 more in federal taxes in 2002 than he or she received in federal funds and services. Put differently, California received 77 cents in federal payments and services for every dollar sent to Washington -- a decline from 88 cents in 2000 and a record low return for the state. Yet California is not the worst off among the states. According to the nonpartisan,

Washington D.C.- based Tax Foundation, California ranks 45th among states in balance of payments. The biggest receiver, New Mexico, ranked first with a balance of \$2.37 in return for every dollar paid to the federal government (at \$6.44, the District of Columbia was higher still), while New Jersey ranked lowest, receiving just 62 cents for each dollar paid in. (Other states with a very negative balance include Connecticut, New Hampshire and Nevada and Massachusetts.) The balance of payments figure is calculated by comparing federal spending attributable to each state (excluding spending in territories and non-allocable costs such as overseas operations and interest on the national debt) against federal tax and fee revenue dollars collected by states. The tax burden figure is then adjusted to provide an "apples-to-apples" comparison between the two numbers.

## **Components Of The Balance of Payments Deficit: California's Share Of Population, Federal Tax Burden, and Expenditures**

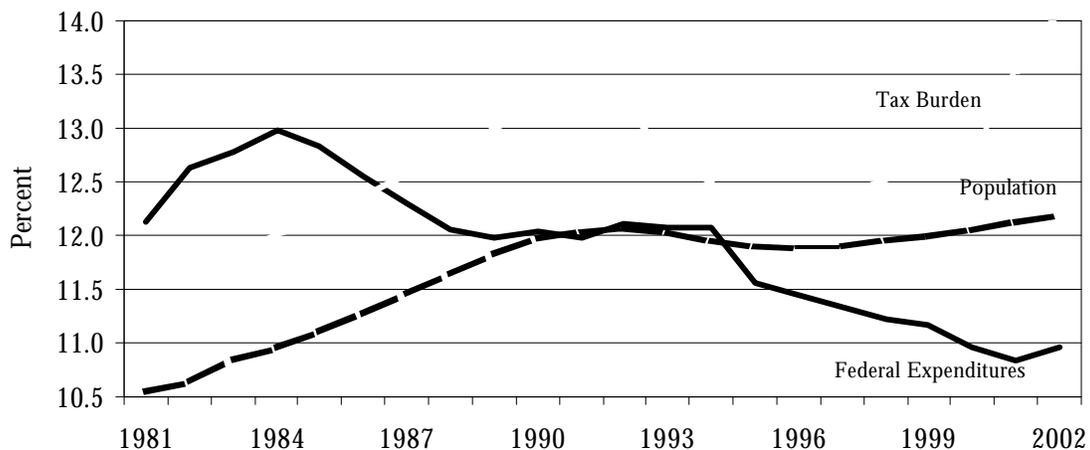
Two primary factors comprise the balance of payments: taxes and expenditures. To further explore equitableness, we also include the state's share of the U.S. population as an illustrative benchmark. In 2002, California housed 12.2 percent of the nation's residents, paid 14.1 percent of federal taxes and received back 11.0 percent of federal payments and expenditures.

### ***Population***

California is home to nearly one in eight Americans. In sharp contrast to steep population increases during the 1980s – when California's share of the national population

rose from 10.5 percent in 1981 to 12.0 percent in 1990 – throughout the 1990s the state’s share remained relatively stable. In recent years, California’s share of the nation’s population has been rising slowly, from 11.9 percent in 1996 to 12.2 percent in 2002. A number of federal grant programs distribute funds to state and local governments based in whole or in part on population data. Some argue that the methodology for collecting census population data, avoiding statistical methods for estimating totals, advantages some states over California and other rapidly-growing urban states.

### **California Share of Federal Expenditures, Tax Burden, and Population, FY 1981-2002**



#### ***Federal Taxes***

California’s share of the nation’s \$1.8 trillion tax burden climbed sharply to 14.1 percent in fiscal year 2002 from 13.5 percent in 2001 and 12.8 percent in 2000. The state’s increasing share of the nation’s federal tax burden may in part be due to a strong economy in California relative to other states. The recession of the early 1990s hurt California’s economy more than that of most other states, and the state’s relative share of federal tax contributions declined from 1991 through 1995. (Despite the hardship, however, California remained a donor state with respect to the rest of the country throughout the period.) Since then, California’s share of federal taxes paid has risen steadily. As has been true for more than half a century, California’s \$256 billion contribution to the federal treasury in 2002 was by far the largest federal tax-dollar total of any state, according to the Tax Foundation, well above both New York’s \$145 billion and Texas’s \$126 billion. Whereas most states and the nation as a whole experienced a substantial reduction in federal taxes between 2000 and 2002, from nearly \$2.0 trillion to \$1.8 trillion, California’s tax burden actually increased slightly, from \$253 billion to \$256 billion.

#### ***Federal Spending***

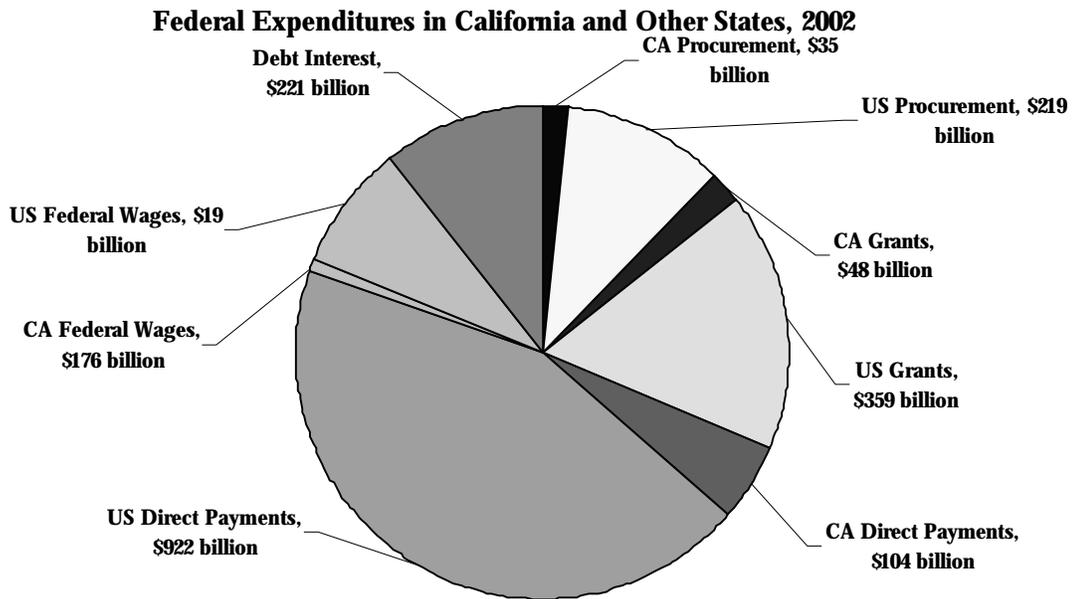
According to the U.S. Census Bureau’s Consolidated Federal Funds Report for fiscal year 2002, total federal expenditures in California rose to \$206 billion, a 9 percent increase from 2001. Calculated as a percentage of the \$1.9 trillion total that the U.S. government spent in all states, California’s share of federal expenditures rose to 11.0 percent in 2002 from 10.8 percent in 2001, a rise largely due to a faster-than-average increase in procurement

expenditures and to a relatively small increase in the state's share of the huge direct payments category.

Total federal spending in California had climbed from 12 percent in 1981 to 13 percent in 1984, propelled largely by military procurement contracts won by California's aerospace industry. Expenditures returned to the 12 percent level by 1988, remaining there until 1994, after which it began a gradual decline to the current 11 percent mark.

### ***Federal Taxation and Spending Per Capita***

In fiscal year 2002, the federal government spent a total of \$5,878 per capita in California, compared to \$6,527 per capita nationwide, a spending shortfall for the state of 11 percent. On the taxation side of the ledger, Californians paid \$7,286 per capita to the federal treasury, compared to a national average of \$6,309 per capita, or a discrepancy of -13 percent. The 2002 spending discrepancy was larger than any recorded year except 2001, and the federal tax discrepancy was the largest since data collection began.



### **Categories of Federal Spending**

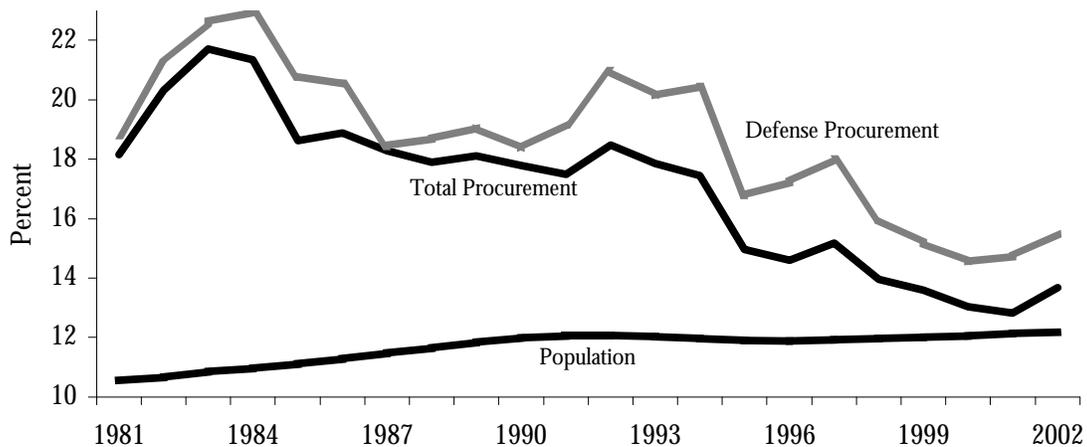
The Census Bureau divides federal spending into four components – procurement, direct payments, salaries and wages, and formula and other grants to states and local governments. California's share of federal procurement spending rebounded sharply, from 12.8 percent in 2001 to 13.7 percent in 2002, reversing a multi-year decline. Direct payments in California edged upward slightly to 10.2 percent of the nation's total, remaining near the proportion that the state has maintained for several years, though the long-term trend has been downward for a decade. The state's share of federal salaries and wages remained flat at 9.8 percent, holding below the 10 percent threshold for the third year in a row. And California's share of federal formula program expenditures and other grants dropped sharply, from 12.2 percent to 11.8 percent, falling below the state's share of total U.S.

population for the first time in a decade. Each of these four categories is discussed in greater detail below.

### **Procurement**

After nearly 20 years of decline, California's share of federal procurement (which includes defense and other contract spending) climbed to 13.7 percent in 2002. California was the destination of one-fifth of the nation's growth in federal contract expenditures between 2001 and 2002. The nation's spending rose from \$226 billion to \$254 billion, and spending in California rose from \$29 billion to \$35 billion. Despite the increase, procurement spending in California was still slightly below the actual spending level in 1985-86 (the high-water mark for the nation and the state), and thus is far below that level in inflation-adjusted dollars.

**California Share of U.S. Total Procurement, Defense Procurement, & Population, FY 1981-2002**



Over the 18 years from 1983 through 2001, no category of federal spending showed a more precipitous decline in either spending or California share than did procurement. By 1998, federal procurement expenditures in California had fallen dramatically to \$25 billion, the lowest level in current-dollar terms since 1981. An ensuing four-year rise that returned the state's total to \$35 billion for 2002 mitigated the situation but did not compensate for past losses. These numbers are starker after factoring in inflation. After adjusting for inflation, California's procurement awards are now roughly half of their 1985 levels. Overall procurement expenditures by the Department of Defense, which spends two of every three federal procurement dollars, accounts for much of the decline.

California's share of total U.S. procurement expenditures (defense and non-defense) held nearly steady at the 18 percent mark for a decade before declining to about 15 percent for 1995-97, and it has been below 14 percent ever since. California's share of procurement spending for national defense was once as high as 23 percent, in 1984. After dipping slightly below the 15 percent mark for the first time in memory in 2000 – culminating a long-term backslide that continued for more than a decade and a half – the state's share rebounded to 15.5 percent in 2002. California won \$24 billion of the \$155 billion distributed nationwide under defense contracts in 2002.

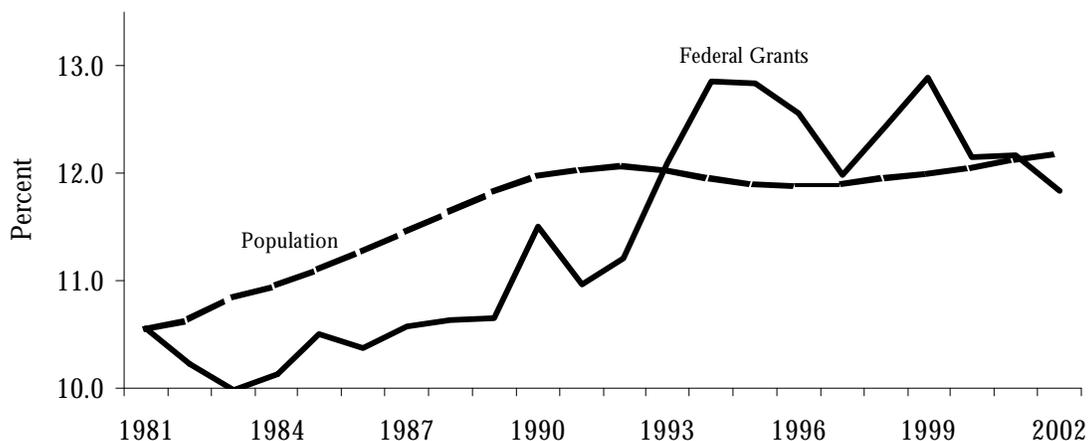
## Formula Grants

For grant payments to states – comprised primarily of federal formula grant expenditures for such programs as Medicaid, highways and transit, welfare, education assistance, and nutrition programs – California’s total receipts rose from \$44 billion to \$48 billion, but the state’s share of the nation’s total declined from 12.2 percent in 2001 to 11.8 percent in 2002. Grant expenditures in all states rose sharply, from \$364 billion in 2001 to \$407 billion in 2002. Formula grant program spending represents roughly 85 percent of the grants category, with the remainder spent on competitive or project grants.

After holding steady in the 1980s at 10.5 percent of the nation, California’s share of federal grants to state and local governments rose sharply to nearly 13 percent in 1994. The share of grant spending then fluctuated for several years between 12 and 13 percent, before settling to 12.2 percent for 2000 and 2001. The reduction to 11.8 percent brings grant spending below the state’s population share for the first time since 1992.

The bulk of grant spending is distributed to states by congressionally designed formulas, often based on population, income, poverty, and similar data. More than 60 percent of the nation’s \$407 billion in 2002 grants funding was distributed pursuant to four programs: Medicaid, highway planning and construction, welfare, and Title I education grants.

### California Share of Federal Grant Expenditures and Population, 1981-2002



In 2002, Medicaid distributions to states from the Centers for Medicare and Medicaid Services totaled \$148 billion, including \$139 billion in primary Medicaid and other funds for the State Children’s Health Insurance Program and other services. California’s share amounted to \$15.4 billion, or 10.4 percent in FY 2002 – a reduction from 10.6 percent in 2001, when the state received \$14.1 billion of the \$132.7 billion distributed nationwide. The state’s share is currently slightly more than the approximately 10 percent share the state received during the preceding decade. California’s share of Medicaid funding has long been reduced by the use of a per capita income factor, which shifts funds to states with below-average income. California’s youthful population, moreover, keeps the state’s Medicaid expenses somewhat below the national average; New York, on the other hand, with a

population only two-thirds of California's but with a larger proportion over age 65, received nearly \$3 billion more in federal Medicaid funds in 2002 than California.

With regard to transportation funding, for many years, California has received fewer highway planning and construction funds than the state's motorists have paid into the highway trust fund in gasoline taxes, and the states' share of highway money remains relatively low. In 2002, California received \$2.7 billion in highway planning and construction funds out of the \$29.5 billion distributed nationwide, or approximately 9 percent of the U.S. total. However, the state's low highway funding share appears considerably less problematic when the state's large transit fund share is considered in tandem; California received \$1 billion of the \$4 billion distributed nationally under federal urbanized area transit formula grants.

When the 1996 federal welfare reform law replaced the Aid to Families with Dependent Children entitlement program with the Temporary Assistance for Needy Families (TANF) block grant, California was home to 21.7 percent of the nation's adult welfare recipients. With that figure locked in, the state has continued to receive the lion's share of the nation's welfare spending ever since 1996. Although total national expenditures for federal highway programs (\$29.5 billion in 2002) are greater than for welfare (\$16.4 billion), California received more in federal welfare payments (\$3.7 billion) than in payments under the highway program (\$2.7 billion). In FY 2002, California received 22.7 percent of the nation's expenditures for TANF's State Family Assistance Grants.

In fiscal year 2002, California received \$1.2 billion (or 14.5 percent) of the \$8.2 billion distributed nationwide from the Title I Education for the Disadvantaged program, the federal government's largest K-12 education grant. This percentage reflects the continued growth in the state's share of Title I from an 11 percent average during the 1990s.

For further California-focused information regarding formula grant programs, including in-depth analyses of the highway and welfare programs, consult *Federal Formula Grants and California*, a joint project of the Public Policy Institute of California and the California Institute for Federal Policy Research, at <http://www.calinst.org/formulas.htm>.

## ***Direct Payments***

Representing nearly half of total federal expenditures and more than \$1 trillion annually, the direct payments category is comprised of Social Security, disability, retirement and other payments directly from the federal government to individual recipients. Direct payment expenditures in California rose from \$98 billion in 2001 to \$104 billion in 2002, and the state's share increased slightly from 10.1 percent to 10.2 percent. The change in the percentage is only the second time California's share of such payments has increased in the past decade.

Nationwide, direct payments from the federal government continued to grow strongly, rising from \$260 billion in 1981 to \$1 trillion in 2002. Last year alone, direct payments expenditures nationwide rose by \$58 billion, from \$969 billion in 2001. The \$104 billion received by Californians in 2002 is four times the \$26 billion received in 1981. Roughly half of direct payments come in the form of Social Security checks, while another 20 percent are Medicare payments. Federal spending for direct payments, both in California and nationwide, has increased every year for the past two decades. Californians' share of direct payment dollars remained relatively constant throughout the early and mid-1990s, roughly tracking California's share of the nation's older population. Through the last five years, however, that share declined from 10.7 percent in 1997 to 10.2 percent in 2002.

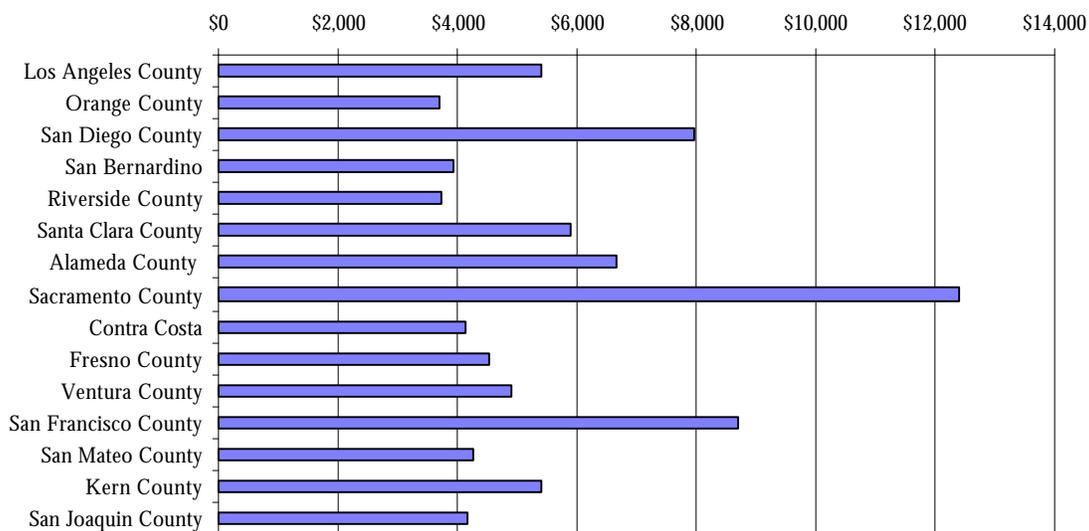
## Salaries and Wages

In the fourth major category of federal spending, California's share of salaries and wages remained at 9.8 percent of the U.S. total. Total federal salary and wage spending in the state rose from \$18 billion in 2001 to \$19 billion in 2002, keeping pace with a similar increase nationwide. Prior to the closing of a number of military installations, ordered by four base closure rounds in 1988, 1991, 1993, and 1995, California's share of federal salaries and wages had peaked in 1986 at 12.6 percent of the nation's total. Although the state housed just 15 percent of military personnel before the closures began, California shouldered 60 percent of the nation's net personnel cuts ordered by those base closure rounds.

## Spending Within California

California's 15 largest counties house 83 percent of the state's population – and a proportionate share of most federal spending categories – although that they accounted for 94 percent of the state's procurement receipts in 2002. Not surprisingly, federal receipts vary greatly from county to county.

Federal Expenditures Per Capita, 2002, in 15 Largest California Counties



While Los Angeles County's \$53 billion in federal receipts was more than 25 percent of the state total, per capita federal spending in Los Angeles county (\$5,395) was below the average for both the state (\$5,878) and the nation (\$6,527). Per capita federal receipts in the largest counties ranged from a high of \$12,399 in Sacramento County to a low of \$3,701 in Orange County and \$3,740 in Riverside County. (Because of the presence of the state government, \$8.8 billion in formula grant spending was attributed to Sacramento County, thereby artificially inflating its total. Many grant funds initially destined for Sacramento County are subsequently redistributed to other parts of the state.)

Other counties with relatively high per capita receipts included San Francisco, at \$8,686, and San Diego, at \$7,968. San Francisco's high receipts are likely attributable to federal grants receipts and federal wages, both of which are more than double the state and national averages. In San Diego, high receipts are associated with strong procurement receipts and with very strong salary and wage performance, related to the area's major

military presence. In addition to Orange and Riverside Counties, relatively low per capita federal receipts were logged in the Counties of San Bernardino (\$3,940), Contra Costa (\$4,147), San Joaquin (\$4,163), San Mateo (\$4,277), and Fresno (\$4,523).

An attached table shows total and per capita federal spending, as well as amounts for the four primary spending categories, for all 58 California counties. The table is also available on the California Institute website.

## **Factors Contributing to the State's Shortfall**

Several factors contribute to the state's taxes-versus-spending disparity. First, California remains a relatively prosperous state. Despite economic downturns in the early 1990s and this decade, incomes of California's residents remain above the national average. Thus, the state's residents pay relatively more in federal income taxes under the progressive tax system.

Second, California is a relatively young state and thus has fewer residents receiving payments under Social Security and Medicare, an increasingly large slice of the federal budget pie. In 2000, 10.6 percent of Californians were age 65 or older, compared to 12.4 percent of all U.S. residents.

A third key factor in California's ongoing funding disparity is the state's slippage in federal procurement spending. The nation's total defense contract spending had fallen from \$123 billion in 1991 to \$108 billion in 1998, a drastic drop-off even before accounting for inflation, before expenditures rebounded to \$155 billion in 2002. California's defense procurement funding, on the other hand, experienced a faster fall and a slower recovery – dropping from \$23.6 billion in 1991 to \$17.3 billion in 1998, and climbing back only as far as \$17.9 billion in 2000. Whereas the early 1980s saw nearly one-fourth of defense contract dollars spent in California, the state's share fell as low as 14.6 percent (in 2000) before recovering to 15.5 percent in 2002.

Despite the state's taxes-versus-spending disparity, some opportunistic legislators from other states may continue to view California as a drain on the federal treasury and as a competitor for the federal dollars they covet. If that perception were ever valid, it certainly is no longer. As has been the case for more than a decade, California subsidizes the rest of the nation at unrivaled levels.

## **Methodology**

The federal government generally operates in surplus or deficit, so national totals for expenditures and tax burden rarely match. Thus, this paper adjusts each year's tax burden figure to equalize it with spending, thereby controlling for deficits or surpluses and deriving California's appropriately comparable share of tax burden. The adjusted tax burden is then subtracted from adjusted spending to derive the balance of payments.

Without that adjustment, California's raw (unadjusted) balance of payments deficit for 2001 was \$76 billion, instead of the adjusted \$47 billion. (Since there was a budget surplus in 2001, the adjustment recognizes that even the average state paid somewhat more in taxes than it received in spending.) The adjustment operated in reverse in 2002 – a deficit spending year for the nation as a whole – when California's unadjusted balance of payments was \$49 billion and the adjusted balance was \$58 billion.

In addition, this paper adjusts the Census Bureau's expenditure data by deleting spending for territories and for undistributed funds (those appropriated but not spent) in order to facilitate comparisons among states. For example, the Census Bureau's total for all

federal grant spending is \$412 billion, whereas our states-only total for consistency purposes is reduced to \$408 billion. The adjustment is most pronounced in procurement, where more than \$15 billion is categorized as undistributed. (In addition, procurement contracts under \$25,000 are not tracked by state, and some defense spending is not tracked by geography.) We thus reduce the Census Bureau report's \$271 billion procurement spending total for the U.S. to a total allocable by state of only \$254 billion. As a result, the Census Bureau figures show California receiving 12.8 percent of total procurement spending, whereas we show the state receiving 13.7 percent of spending allocated to the states. Likewise, the report shows California receiving 10.8 percent of total spending, whereas our adjusting of figures returns 11.0 percent.

It may be helpful to remember that federal tax burden figures for each year largely reflect the economic condition of the prior year -- i.e., in 2002, California taxpayers filed taxes on their 2001 earnings. The federal income tax system causes states, such as California, which have an above average income level to pay more in taxes than the average state, despite the fact that vastly higher housing prices and other costs of living mean that the average Californian may actually have considerably less disposable income than the average resident of a lower-taxed state. An annual salary of \$60,000 in, say, Arkansas or South Dakota affords a vastly different buying power and standard of living compared to the same salary in Santa Clara or Orange Counties, yet federal income tax rules treat them identically.

Data sources for this document include the *Consolidated Federal Funds Report* (U.S. Census Bureau, Washington, DC, <http://www.census.gov/prod/2003pubs/cffr02.pdf>) for expenditure data; and *Federal Tax Burden by State* (The Tax Foundation, Washington, DC, <http://www.taxfoundation.org>) for tax data. For further California-focused information regarding federal grants, see *Federal Formula Grants and California*, a joint project of the Public Policy Institute of California and the California Institute for Federal Policy Research, at <http://www.calinst.org/formulas.htm>.

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