

CALIFORNIA'S BALANCE OF PAYMENTS WITH THE FEDERAL TREASURY FY 81-99

“WHEN CALIFORNIA TAXPAYERS SENT A RECORD \$23 BILLION WINDFALL TO WASHINGTON IN 1999, THE STATE BROKE ITS OWN DEFICIT RECORD AND MAINTAINED ITS DONOR STATE STATUS FOR A 13TH STRAIGHT YEAR”

NOVEMBER 2000

Last year, California's "trade deficit" with the federal government worsened for the fifth straight year. The state's taxpayers suffered through their 13th straight year of sending more money in taxes to Washington than the state received back in federal government expenditures in the state.

CALIFORNIA BALANCE OF PAYMENTS

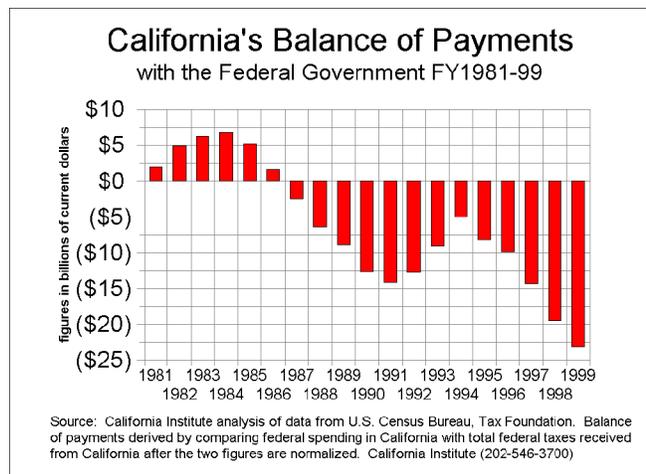
In 1999, Californians sent in excess of \$23 billion more to Washington in federal taxes than the state received back in federal spending. This total was an all-time record for any state, surpassing the previous mark -- also set by California in 1998 -- of \$19.4 billion.

It has been many years since California's federal spending surplus heyday. During the defense buildup in Ronald Reagan's first Presidential term in the early 1980s, California's federal balance of payments was in the black for six straight years, peaking at \$6.8 billion in fiscal 1984.

As defense procurement began to decline in the mid 1980s, however, California's federal funding advantage waned rapidly. The state's balance shifted from the black into the red in 1987, and it has remained there ever since.

By 1990, California's losses over just four years had more than erased the inflows won throughout the early 1980s. From 1981 to 1986, federal spending in California exceeded taxes paid by \$26.9 billion -- a sizeable surplus. From 1987 to 1990, however, California taxpayers sent \$30.2 billion more to Washington than came back in spending. By fiscal year 1999, the 13-year combined tally had grown to \$146 billion, and this trend shows no signs of abating in the foreseeable future.

The state did spy a glimmer of hope in the early 1990s, as 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 have charged forward at a steady clip ever since, rising an average of \$3.6 billion per year for the past five years.

This taxing-versus-spending imbalance means that every individual California man, woman, and child paid \$699 more in federal taxes last year than he or she received in federal services. Put differently, California receives only 88 cents in federal services for every dollar sent to Washington -- a decline from 89 cents in 1998 and 91 cents in 1997.

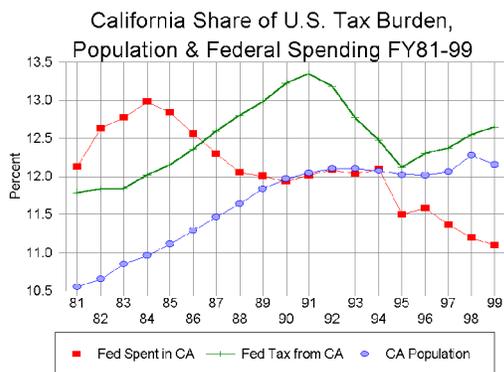
California is not the worst off among the states. According to the Washington D.C.-based, non-partisan Tax Foundation, California ranks 39th among all states in balance of payments. The biggest winner, New Mexico, ranks first with a balance of \$1.97 in return for every dollar paid to Washington, while Connecticut ranks 50th, receiving just 65 cents for each dollar paid in.

The balance of payments figure is calculated by comparing federal spending attributable to each state (excluding unallocable costs such as overseas defense operations and interest on the national debt) against federal tax and fee revenue dollars collected by state. The tax burden figure is then adjusted to provide an "apples-to-apples" comparison between the two numbers.

COMPONENTS OF THE DEFICIT: CALIFORNIA'S SHARE OF THE U.S. POPULATION, FEDERAL TAX BURDEN, AND FEDERAL EXPENDITURES

Two primary factors comprise the balance of payments: taxes and spending. For fairness and fair-share assessment purposes, we also include the state's share of the U.S. population as an illustrative benchmark.

In 1999, California housed 12.2% of the nation's residents, but it paid 12.6% of federal taxes and received back just 11.1% of federal payments and expenditures.



Source: U.S. Census Bureau, The Tax Foundation, The California Institute
 Data prepared by The California Institute for Federal Policy Research (202) 546-3700.

Taxes: California's share of the nation's \$1.9 trillion tax burden increased to 12.6% in fiscal year 1999, rising from 12.5% in 1998 and 12.1% in 1995. The state's increasing share of the nation's federal tax burden is due in part to a rebounding economy in California relative to other states. The share remains below the peak in 1991, when California shouldered 13.4% of the nation's federal tax burden. Between 1991 and 1995, a debilitating recession -- considerably worse in California than in other states -- served to reduce the relative share of federal contributions from our state's taxpayers. Yet

despite its greater misery, the state remained a donor state with respect to the rest of the country throughout the 1990s recession.

As has been true for more than half a century, California's \$227 billion contribution to the federal treasury in 1999 was by far the largest raw total of federal tax dollars of any state, well above both New York's \$143 billion and Texas's \$135 billion, according to the Tax Foundation.

Federal Spending: California's share of total federal spending receipts declined to 11.1% in 1999 -- a steady decline from 11.2% in 1998, 11.4% in 1997, and 11.6% in 1996. And these

late-1990s levels remain well below the 12% level at which California's federal receipts hovered for the preceding seven years. In the early 1980s, federal spending in California leapt from 12% in 1981 to 13% in 1984, propelled largely by military procurement contracts won by California's aerospace industry, before settling back to the 12% mark in 1988. Spending in California remained at the 12% mark until 1994 when the current decline began.

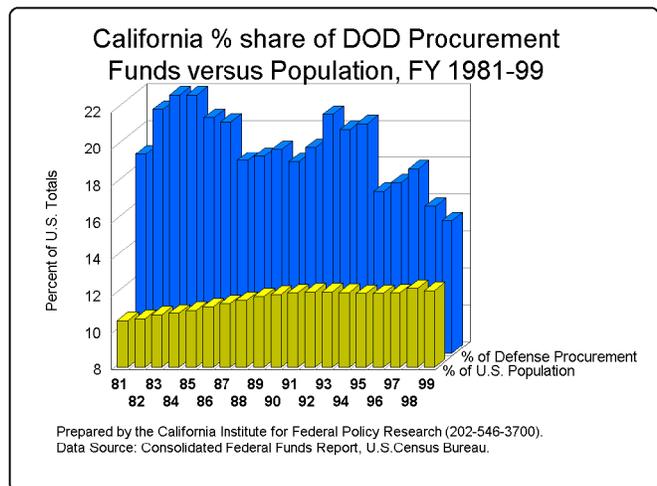
Federal spending is comprised of expenditures in various categories. In accounting for federal dollar flows, the Census Bureau divides spending into five components: Procurement; Grants to States and Local Governments (mostly formula grants); Salaries and Wages; and Direct Payments to Individuals. California's 1999 share of federal spending on procurement (which includes defense and other contract spending) declined from 13.8% to 13.6% in 1999, a small drop compared to the prior year's drastic freefall from 15.2% to 13.8%. Californians' share of all U.S. direct payments to individuals (which includes massive outlays for Social Security and medicare payments) declined from 10.5% in 1998 to 10.2% in 1999, a similar drop to the prior year's slippage from 10.8% to 10.5%. The state's share of all federal salaries and wages decreased from 10.5% in 1998 to 10.3% in 1999, matching the prior year's decline from 10.7% to 10.5%, and federal formula and categorical grants to state and local governments -- the only spending category to realize an increase from FY 1998 to 1999 -- jumped upward significantly from 12.1% to 12.6%.

It is important to remember that federal tax burden figures for each year reflect the economic condition of the prior year -- i.e., in 1999, California taxpayers filed taxes on their 1998 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 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 rules treat them identically.

PROCUREMENT

Last year, total federal spending nationwide on procurement rose 3.4%, from \$183.6 billion to \$189.9 billion. In California, the rise was half that rate, just 1.7% or from \$25.4 billion to \$25.8 billion. Despite the fact that procurement growth did not keep pace with the nation, the slight rise in the state was welcome when compared to the prior year's change: in fiscal 1998, total federal procurement in all states had risen 6.4% from \$173 billion to \$184 billion, while procurement in California had actually declined 3%, falling from \$26.2



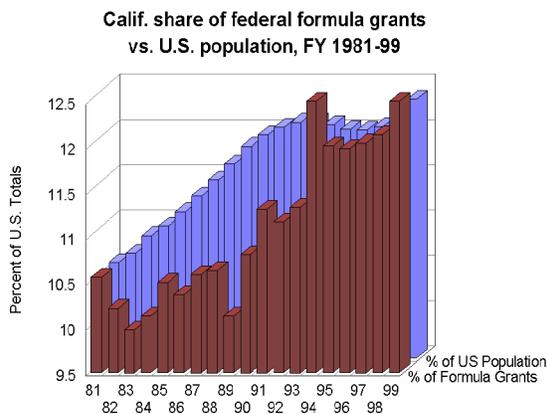
billion to \$25.4 billion.

Over the last fifteen years, no single category of federal spending in California has experienced a more precipitous decline than procurement. In 1998, federal procurement expenditures in California declined to their lowest level since 1981 in current-dollar terms, and 1999's slight uptick does not repair the situation. The figures are far more stark if inflation were taken into account. After adjusting for inflation, California's procurement receipts are now less than half of their 1985 levels.

Overall procurement expenditures by the Department of Defense, which spends nearly 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% mark for a decade, declined to about 15% for 1995-97, and dropped to its 13.6% low point over the last two years. California's share of federal defense procurement spending has been as high as 23%, a level reached in 1984. In 1999, that share was 15.2%.

FORMULA GRANTS

In fiscal 1999, California's share of federal grants to state and local governments rose significantly to 12.6% after remaining stable at roughly 12% for four consecutive years. The bulk of these funds are distributed to states by congressionally designed formulas. These formulas are often based at least partially on population and income data gathered during the decennial census, and, therefore, many of these data are significantly outdated by the time the next decennial census is conducted.



Sources: U.S. Census Bureau, Office of Management & Budget, California Institute.
Data prepared by the California Institute for Federal Policy Research, 202-546-3700.

Roughly 60% of the \$288 billion distributed nationwide in federal grants was under four programs: Medicaid, highway grants, welfare, and Title I education grants. In the single largest federal formula program, Medicaid, California's share was 11.2% in 1999. The state received \$12.3 billion of the \$110 billion distributed nationwide. This represents a major increase over the roughly 10% share the state received for the three prior years.

California has also been a "donor state" with regard to the federal highway trust fund. For many years, California has received back less in road projects than it has

put into the fund in gasoline taxes, though overall transportation fund expenditures are more closely balanced when transit funds are calculated in the mix. In 1999, California received \$2.2 billion in highway planning and construction funds of the \$24.6 billion distributed nationwide, or 9.1% of the U.S. total.

California houses 21.7% of the nation's adult welfare recipients, and thus has received the lion's share of welfare program funding for some time. Thus, even though nationwide totals for highway programs are larger than for welfare -- \$24.6 billion in 1999 for highways versus \$16.7

billion for welfare -- California received more from federal welfare payments (\$3.7 billion) than for highways (\$2.2 billion). Last year, California received 22.3% of federal welfare spending under TANF, the Temporary Assistance for Needy Families program.

In 1999, the federal Title I education program sent \$941 million (or 12.2%) of its \$7.7 billion basic and concentration grant funding to California. California houses 15% of the nation's children living in poverty, but outdated poverty data usage and unfavorable formula factors conspire to reduce the state's share of Title I dollars.

DIRECT PAYMENTS TO INDIVIDUALS

Nationwide, direct payments to individuals from the federal government continued to grow strongly, rising from \$260 billion in 1981 to \$845 billion in 1999. Last year alone, direct payments nationwide rose from \$829 billion to \$845 billion. The \$86.2 billion received by Californians in 1999 is more than triple the \$26 billion received in 1981. Roughly half of direct payments come in the form of social security checks, while another 20% are medicare payments.

Yet total payments to Californians actually declined over the past year, from \$86.8 billion to \$86.2 billion. California's 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 two years, however, that share has dropped significantly: Californians' share of direct payments declined from 10.8% in 1997, to 10.5% in 1998, and to 10.2% in 1999.

FACTORS CONTRIBUTING TO THE SHORTFALL

Several factors contribute to the state's taxes-versus-spending disparity. First, happily, California remains a relatively prosperous state. Despite a debilitating economic downturn early in the last decade, the likes of which had not gripped the state for half a century, incomes of California's residents nevertheless remain above the national average. Thus, the state's residents pay relatively more in federal income taxes.

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 1997, 11% of Californians were age 65 or older, compared to 12.7% of all U.S. residents.

A third key factor in California's ongoing funding disparity is continued slippage in federal procurement spending, both total spending and the state's share thereof. Defense contract spending fell from \$123 billion in 1991 to \$108 billion in 1998, even before accounting for inflation. While the early 1980s saw nearly one-fourth of defense contract dollars spent in California, the state's 1998 share fell below 16%, the lowest level on record.

Nevertheless, some opportunistic legislators from other states continue to view California as a drain on the federal treasury and as a behemoth competitor for the federal dollars they covet. As this report indicates, that perception is outdated at best, flat wrong at worst.

Sources: Federal Expenditures by State for FY 1999, U.S. Census Bureau, Washington, DC; Federal Tax Burden by State, 2000, The Tax Foundation, Washington, DC; California Institute.