

CALIFORNIA'S BALANCE OF PAYMENTS WITH THE FEDERAL TREASURY FY 81-98

“WHEN CALIFORNIA TAXPAYERS SENT A RECORD \$19.4 BILLION WINDFALL TO WASHINGTON IN 1998, THE STATE BROKE ITS OWN DEFICIT RECORD AND MAINTAINED ITS DONOR STATE STATUS FOR A 12TH STRAIGHT YEAR”

SEPTEMBER 1999

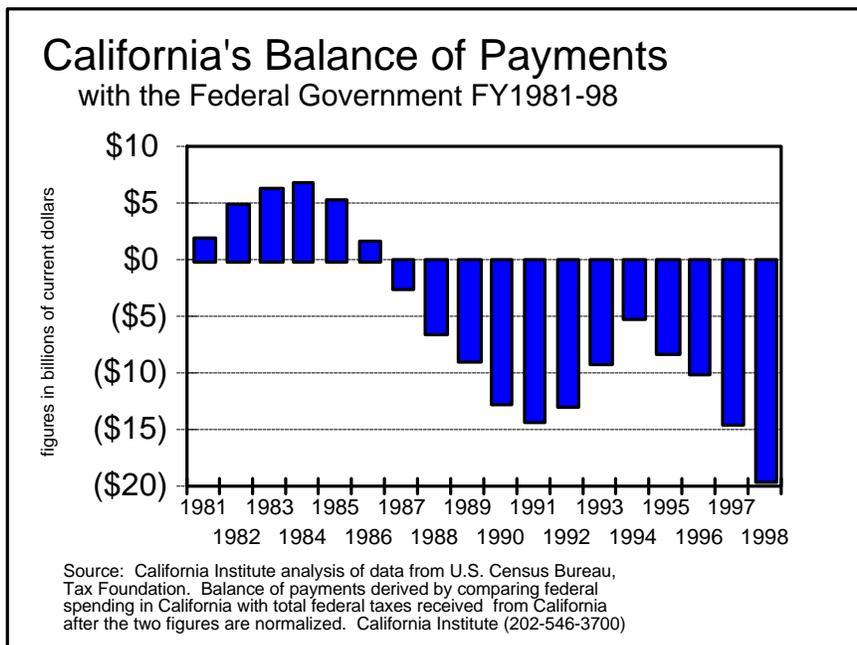
CALIFORNIA BALANCE OF PAYMENTS

Last year, Californians sent nearly \$20 billion more to Washington in federal taxes than the state received back in federal spending. The state's 1998 deficit of \$19.4 billion marked the largest such imbalance for any single state in the history of the nation, eclipsing the previous record of \$14.3 billion, set also by California in 1997.

California's shortfall has now grown for four consecutive years, and 1998 represents the 12th year in a row in which California has sent more federal dollars to Washington than it has seen in federal expenditures. During the defense spending 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 slip in the mid 1980s, however,

California's advantage lessened. 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 had more than made up for the gains it had made in the early 1980s. From 1981 to 1986, federal spending in California exceeded taxes paid by \$26.9 billion. From 1987 to 1990, California taxpayers had already sent \$30.2 billion more to Washington than the state had won from the federal budget. By 1998 the 12-



year combined tally had grown to nearly \$123 billion.

The taxes-versus-spending imbalance means that every individual California man, woman and child pays \$595 more in federal taxes than he or she receives in federal services. Put differently, California receives only 89 cents in federal services for every dollar sent to Washington -- a decline

from 91 cents in 1997. According to the Washington D.C.- based, non-partisan Tax Foundation, California ranks 39th among all states in balance of payments. New Mexico ranks first with a balance of \$1.94 in return for every dollar paid to Washington, while New Jersey ranks 50th with a balance of just 68 cents for every dollar paid in.

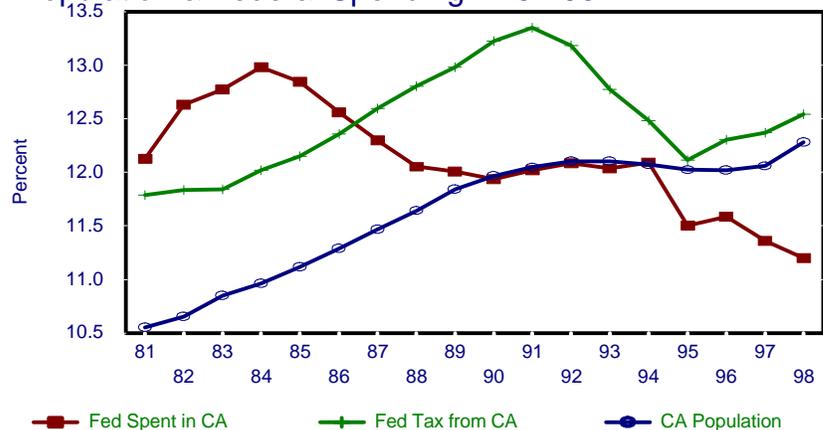
The balance of payments figure is calculated by comparing federal spending attributable to each state (excluding unallocable costs such as overseas defense operations and interest on the national debt) against federal tax and fee revenue dollars collected by state. The tax burden figure is then adjusted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

In 1998, California housed 12.3% of the nation's residents, but it paid 12.5% of federal taxes and received back just 11.2% of federal payments and expenditures.

California's share of the nation's \$1.69 trillion tax burden increased to 12.5% in fiscal year 1998 from 12.4% in 1997 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 -- worse in California than in other states -- served to reduce the relative share of federal contributions from our state's taxpayers.

California Share of U.S. Tax Burden, Population & Federal Spending FY81-98



Sources: U.S. Census Bureau, The Tax Foundation, The California Institute.
Data prepared by the California Institute, 419 New Jersey Ave., SE, Washington, DC 20003, (202) 546-3700.

As has been true for more than half a century, California's \$212 billion contribution to the federal treasury in 1998 was by far the largest raw total of federal tax dollars of any state, edging out both New York (2) and Texas (3), according to the Tax Foundation.

California's share of total federal spending receipts declined to 11.2% in 1998 from 11.4% in 1997 and 11.6% in 1996. These 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 1998 share of federal spending on procurement (which includes defense and other contract spending) declined drastically 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 considerably from 10.8% to 10.5%. The state's share of all federal salaries and

wages decreased from 10.7% to 10.5%, and federal formula and categorical grants to state and local governments increased slightly from 12.0% to 12.1%.

It is important to remember that federal tax burden figures for each year reflect the economic condition of the prior year -- i.e., in 1998, California taxpayers filed taxes on their 1997 earnings.

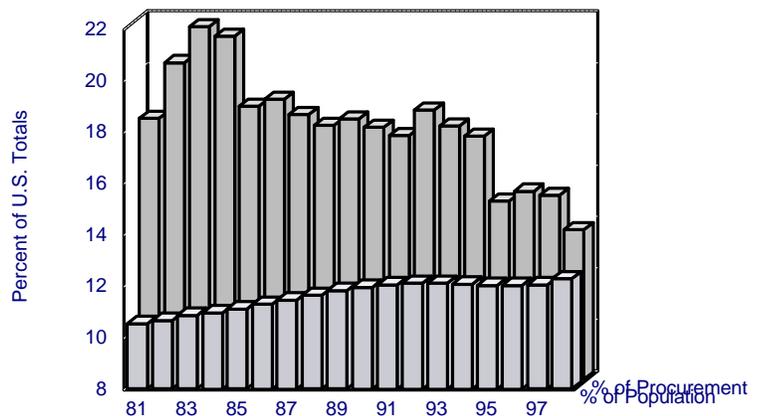
The federal income tax system causes states, such as California, which have an above average income level to pay more in taxes than the average state, despite the fact that vastly higher housing prices and other costs of living mean that the average Californian may actually have considerably less disposable income than the average resident of a lower-taxed state. An annual salary of \$50,000 in Arkansas or South Dakota is very different from than the same salary in Santa Clara or Orange Counties, yet the income taxing rules treat them identically.

PROCUREMENT

In fiscal 1998, total federal procurement in all states rose from \$173 billion to \$184 billion, while procurement in California actually declined, falling from \$26.2 billion to \$25.4 billion.

Over the last fifteen years, no single category of federal spending in California has experienced as precipitous a decline as procurement. In 1998, federal procurement expenditures in California declined to their lowest level since 1981 in current-dollar terms; the figures would be 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 held nearly steady at the 18% mark for a decade, declined to about 15% for 1995-97, and dropped to its 13.8% low point last year.

California share of U.S. Procurement Funds versus Population, FY 1981-98



Prepared by the California Institute for Federal Policy Research (202-546-3700). Data Source: Census Bureau.

FORMULA GRANTS

In fiscal 1998, California's share of federal grants to state and local governments rose slightly to 12.1% after remaining stable at 12% for the three 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. Many of these data are outdated by the time the next decennial census is conducted.

Roughly 60% of the \$264 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 10% in 1998. The state received \$10 billion of the \$100 billion distributed nationwide.

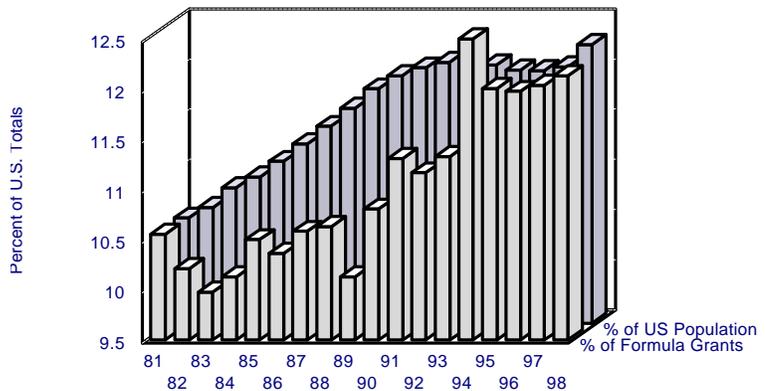
California has also been a "donor state" with regard to the federal highway trust fund. For many years, California has received back less in road projects than it has put into the fund in gasoline taxes, though overall transportation fund expenditures are more closely balanced when transit funds are

calculated in the mix. California received \$1.85 billion in highway planning and construction funds of the \$19.5 billion distributed nationwide in 1998.

California houses 21.7% of the nation's adult welfare recipients, and thus has received the lion's share of that program's funding for some time. Thus, even though nationwide totals for highway programs are larger than for welfare -- \$19.5 billion in 1997 for highways versus \$16.6 billion for welfare -- California received more from federal welfare payments (\$3.7 billion) than for highways (\$1.85 billion). California received 22.4% of federal welfare spending under TANF, the Temporary Assistance for Needy Families program.

In 1998, the federal Title I education program sent \$816 million (or 11.3%) of its \$7.2 billion basic and concentration grant funding to California. California houses nearly 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.

California share of formula grants versus population, FY 1981-98



Sources: Census Bureau, Office of Mgmt & Budget, California Institute.

DIRECT PAYMENTS TO INDIVIDUALS

In 1998, direct payments to individuals from the federal government continued to grow steeply. The \$86.8 billion received by Californians in 1998 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. California's share of direct payment dollars has remained relatively constant, growing just under 1% since 1981, which roughly tracks California's change in the share of the nation's older population. In 1998, Californians' share of direct payments declined from 10.8% to 10.5%.

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 this 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.

Information Sources: Federal Expenditures by State for FY 1998, Census Bureau, Washington, DC; Federal Tax Burden by State, 1999, The Tax Foundation, Washington, DC.