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THE EFFECT OF THE GOVERNOR'S STATE EXPENDITURE LIMITATION PROGRAM ON AN "AVERAGE CALIFORNIA FAMILY OF FOUR"

An Explanation and Analysis

ASSEMBLY OFFICE OF RESEARCH
CALIFORNIA LEGISLATURE
SACRAMENTO

JUNE 1973

THE EFFECT OF THE GOVERNOR'S
STATE EXPENDITURE LIMITATION PROGRAM
ON AN "AVERAGE CALIFORNIA FAMILY OF FOUR"

An Explanation and Analysis

Prepared by

The Assembly Office of Research

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June, 1973

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AOR No. 6

TABLE OF CONTENTS

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June 13, 1973

Honorable Bob Moretti
Speaker of the Assembly
Room 3164, State Capitol

Dear Mr. Speaker:

At your request the Assembly Office of Research has begun a comprehensive analysis of the Governor's proposed expenditure and tax limitation program.

This is the first in a series of reports to be published by this office dealing with major questions raised by the proposal and principal assertions advanced by the proponents.

We find no basis for the claim that the average California family of four will save more than $17,000 during the first fifteen years of the program.

We hope this information will be helpful to you.

Sincerely,

R. WILLIAM HAUCK
Director

RWH:n

INTRODUCTION

Proponents of the Governor's state expenditure limitation initiative claim that the average California family of four /emphasis added/ will save over $17,000 in taxes in the first fifteen years if the initiative is approved by the electorate.[1] The magnitude of this projected tax savings for an average family requires careful examination. The voter who, understandably, may be confused about the effects of this complicated program may be inclined to vote in favor of the initiative on the promise that his tax burden will be reduced by $17,000 in fifteen years.

In Section I, a profile of a typical California family is outlined. This family is assumed to correspond to the Governor's average California family of four. Next, the actual tax savings to this family resulting from state expenditure limitation over the first four years of the plan is shown. The actual savings is then contrasted with the Governor's claim.

Because the actual savings diverge so widely from the Governor's claim, the data and method used to support this claim are questioned.

In Section II, the data and method used to support the Governor's claim are explained and analyzed. Implications of the Governor's claim are then presented.

In Section III, related considerations of the limitation plan's effects on tax savings are presented. These considerations include the limitation plan and its interaction with federal income taxes, the effect of expenditure reduction on tax savings, and the possibility of local increases in sales and property taxes in response to the initiative.

SUMMARY

- The expenditure limitation plan does not guarantee that the net state-local tax burden of the typical family will be reduced. In fact, because of possible increases in tuition and local sales and property tax increases, the net state-local tax burden of the typical family may increase.

- To receive $804 in state tax savings in the first four years of the plan as claimed by the Governor, the "average family" would have to earn annually $35,000. Such a family ranks in the top 4 percent family income bracket according to the 1970 Census.

- The 1970 Census indicates that the typical California family earns about $13,000. This family will receive about $140 in state tax savings over the first four years of the plan. This is one-sixth the amount claimed by the Governor.

- Projecting personal income and state revenues fifteen years into the future is highly speculative. When more realistic near-future projections are used, the tax savings claim of the Governor bears no relation to fact. Therefore, the $17,000 tax savings claim appears to be grossly exaggerated and a misrepresentation of economic and fiscal realities.

- The typical family will lose 22 percent of any state tax savings to the federal government in the form of higher federal income taxes. Between 30 percent and 40 percent of the total of any state tax savings will be lost to the federal government.

SECTION I

A Typical California Family; Tax Savings Resulting from State Expenditure Limitation

Income, Family Size, Tax Burden

The 1970 Census determined that median family income in California in 1969 was $10,732.[2/] One-half of all families earned less than this amount and one-half of all families earned more than $10,732. This figure, then, is an accurate representation of the income earned by a typical California family in 1969.[3/] Adjusting for income growth since 1969 increases the typical family's earnings to approximately $13,000 in 1973.[4/] The 1970 Census also determined average family size to be 3.48 persons.[5/] Thus, it can be reasonably assumed that the typical family consists of four persons.

This typical family owns a home and one automobile. It pays about $140 in state income taxes, and its total direct state tax burden is approximately $586.[6/]

The typical California family outlined above is assumed to correspond to the Governor's "average California family of four."

Tax Savings

If the Governor's state expenditure limitation initiative is approved by the electorate in November 1973, it will first take effect in the 1974-75 fiscal year. In this year, according to the Legislative Analyst, estimated state revenues subject to limitation will actually be less than those authorized by the limitation plan.[7/] Thus, tax savings resulting from state expenditure limitation in the first year will derive solely from the permanent 7½ percent income tax credit contained in the plan.[8/] This credit will save the typical family about $12 in 1974 state income taxes.[9/] In subsequent years, estimated state revenues will exceed the expenditure limit.[10/] The excess revenues will be transferred to the Tax Surplus Fund created by the plan and refunded to the people.[11/]

In the first four years after the expenditure limitation plan takes effect, the following amounts will be transferred to the Tax Surplus Fund: 1974-75, none; 1975-76, $129 million; 1976-77, $342 million; 1977-78, $573 million.[12/] During this time, the typical family's income will increase to about $16,500.[13/] Assuming the surplus revenues will be refunded each year by means of an income tax credit, the total tax savings (including the permanent 7½ percent credit) to the typical family in the first four years of the plan will equal $140.[14/]

Comparison with the Governor's Claim

The Governor claims that the "average California family of four" will save $72 in taxes in the first year of the limitation plan and $804 in the first four years.[15/] The actual savings will be $12 and $140, respectively. Table I compares the actual savings with the Governor's claim.

TABLE I

Tax Savings to a Typical California Family

Fiscal Year	Actual Savings	Governor's Claim	Difference
1974-75	$ 12.60	$ 72.00	$ 59.40
1975-76	$ 24.20	$152.00	$127.80
1976-77	$ 41.75	$240.00	$198.25
1977-78	$ 61.55	$340.00	$278.45
Total	$140.10	$804.00	$663.90

The Governor's claim of $804 in tax savings over the first four years of the expenditure limitation plan is nearly six times greater than the actual savings.

To receive $804 in tax savings over the first four years, assuming income tax credits as the means of refund, the Governor's "average family of four" would have to earn about $35,000 annually. Less than four percent of all California families earned more than $35,000 in 1969.[16/]

Projecting personal income and state tax revenues fifteen years into the future is highly speculative. When more realistic near future projections are used, we find the actual tax savings for a typical California family bears no relation to the Governor's claim. Therefore, the $17,000 tax savings for fifteen years appears to be grossly exaggerated and a misrepresentation of economic and fiscal realities.

SECTION II

Analysis of the Governor's Claim

Explanation

Because the tax savings claimed by the Governor appear to be so widely divergent from fact, it is appropriate to explain the data and underlying methodology employed to arrive at these figures. The data and methodology are contained in the Governor's Message to the Legislature on the State expenditure limitation plan.

First, state revenues without the expenditure limitation plan were projected fifteen years into the future, to fiscal year 1989-90. This projection was based on the assumption that personal income would grow eight percent per year and that state revenues as a percent of personal income would increase by .22 percent per year. In 1973-74, state revenues will equal $9.759 billion or 8.75 percent of personal income according to the Governor's Message. By 1989-90, it is claimed state revenues will equal $47.185 billion or 12.27 percent of personal income.[17]

Second, state revenues with the expenditure limitation program were similarly projected. In 1973-74, state revenues and revenues as a percent of personal income are the same as above, $9.759 billion and 8.75 percent, respectively. Under the limitation formula, spendable revenues as a percent of personal income will decline by .01 percent per year. Thus, by 1989-90, it is claimed revenues will equal $27.436 billion or 7.15 percent of personal income if the plan is enacted.[18]

Third, revenues with and without the expenditure limitation program were divided each year by population to obtain per capita revenues, assuming an annual 2 percent population growth rate. This figure was then multiplied by four and identified as the "state revenue share" for an "average California family of four." This figure is also clearly identified as "tax dollars."[19/]

Finally, the state revenue share with limitation was subtracted from the state revenue share without limitation each year. For example, in the first year of the plan uncontrolled revenues will equal $10,851 billion and controlled revenues will equal $10.464 billion according to the Governor's Message. Dividing both of these figures by population and multiplying by four results in a "state revenue share" of $2,020 and $1,948, respectively. Thus, the savings to the "average family of four" in the first year equals $72. The "cumulative savings to a family of four" over the first fifteen years equals $17,756.

Below is TABLE 6 and FIGURE 6 from the Message which shows the results of this methodology.

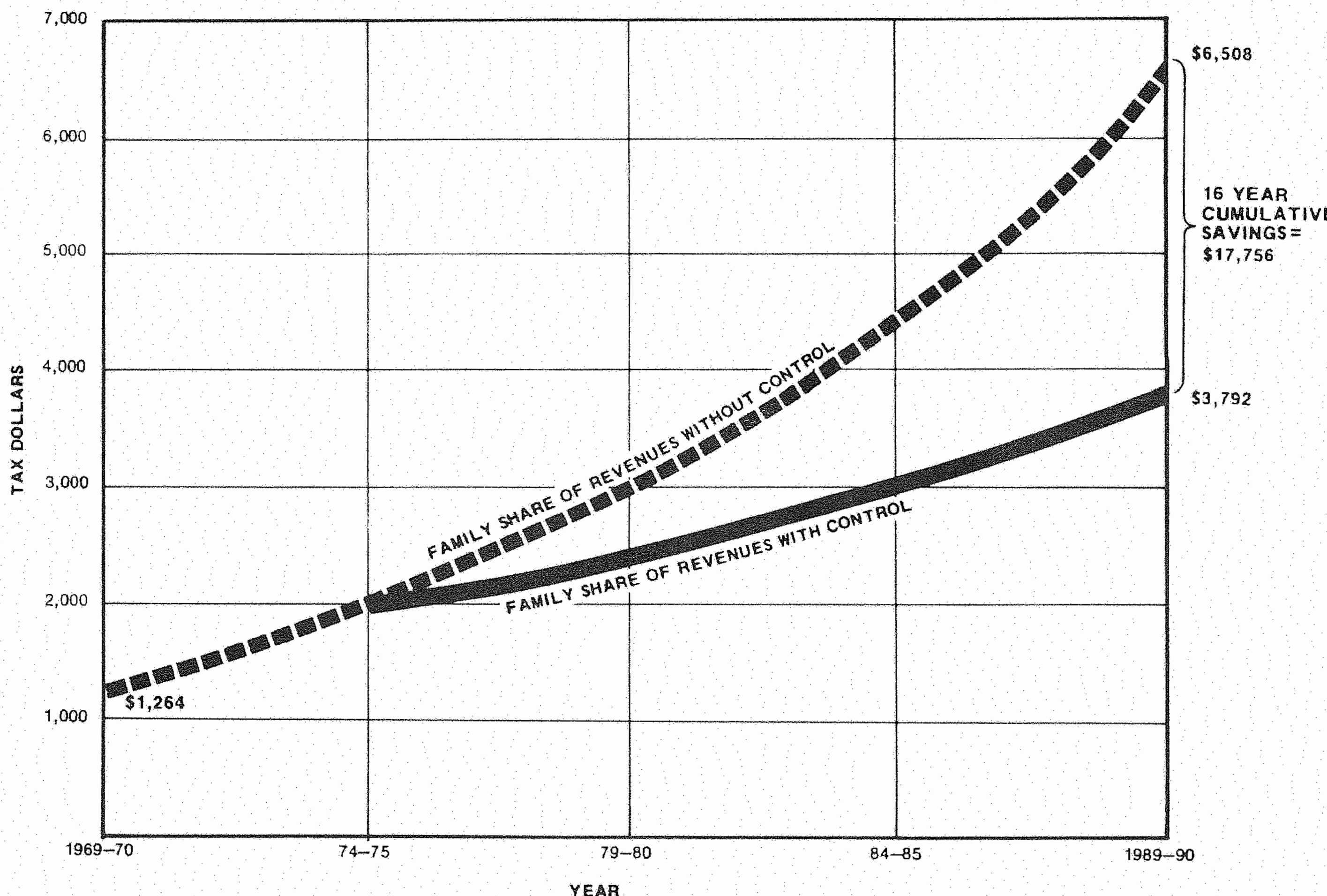
TABLE 6

EFFECTS OF TAX CONTROL PROGRAM ON AN AVERAGE CALIFORNIA FAMILY OF FOUR (1)

Fiscal Year (2)	*State Revenue (3) Share Without Control*	*Same State Revenue (3) Share Under Tax Control Program*	*Savings*
1970	$1264	$1264	
71	1304	1304	
72	1492	1492	
73	1652	1652	
74	1852	1852	
75	2020	1948	$ 72
76	2188	2036	152
77	2372	2132	240
78	2572	2232	340
79	2784	2332	452
80	3016	2440	576
81	3264	2552	712
82	3528	2668	860
83	3812	2792	1,020
84	4120	2916	1,204
85	4452	3048	1,404
86	4808	3184	1,624
87	5188	3328	1,860
88	5596	3476	2,120
89	6036	3632	2,404
90	6508	3792	2,716
Cumulative savings to family of four			$17,756

FIGURE 6

THE EFFECTS OF TAX CONTROL ON AN AVERAGE CALIFORNIA FAMILY OF FOUR



Analysis of the Data

Since the Governor's Message to the Legislature, the state expenditure limitation plan has undergone many changes. In addition, the data employed to arrive at the claimed tax savings to an "average California family of four" is questionable. The Governor's Message shows that state revenues subject to limitation for 1973-74 are $9.759 billion or 8.75 percent of personal income. The Governor's expenditure limitation task force now states that 1973-74 state revenues equal $9.3 billion or 8.34 percent of personal income. According to an opinion of the Legislative Counsel, however, the task force has incorrectly included $0.3 billion in state revenues which are not subject to limitation.[20] Thus, the appropriate figures are $9.016 billion and 8.078 percent, respectively.

The Message assumes that personal income will increase 8 percent per year for the next fifteen years. During the last 13 years, personal income grew at an average of 7.6 percent per year. This time span includes the longest period of uninterrupted economic growth in our history. It is not probable that personal income growth in the next fifteen years will exceed the exceptional growth experienced during this time. The UCLA Business Forecasting Project estimates that personal income will grow at the following rates during the first four years of the limitation plan: 1974, 7.5%; 1975, 8.4%; 1976, 8.6%; 1977, 6.5%.[21]

The Message assumes that population will grow 2 percent per year for fifteen years. The annual growth of population in California has not exceeded 2 percent since 1965. It is unlikely that the population growth rate will average 2 percent per year for the next fifteen years. The UCLA Project estimates that population growth will vary between 1.5 percent to 1.2 percent during the first four years of the plan.[22/]

The Message assumes that tax increases equal to .22 percent of personal income will occur every year for fifteen years. It is not explained why such repeated tax increases will be enacted. The Legislative Analyst has shown that state workload expenditures for the next four years can be financed without increasing tax rates.

As a result of the Governor's unrealistic projections, the Message shows that a $387 million surplus will occur in the first year of the limitation plan. However, as shown above, state revenues subject to limitation will actually be less than those authorized by the expenditure limit. Similarly, the cumulative four-year surplus resulting from the plan is shown in the Message to equal $4.53 billion.[23/] But based on the realistic projections of the Legislative Analyst, the actual surplus which can be refunded to the people, including the 7½ percent income tax credit, is $1.978 billion, or $2.55 billion less than that claimed by the Governor.

If the Governor's tax savings claim for the first four years is revised using the more reasonable projections of the Legislative Analyst, but the method shown in the Governor's Message continues to be applied, the tax savings to "an average California family of four" is $353. This is <u>less than one-half</u> the claim of the Governor. However, this revised estimate remains more than twice the actual savings to a typical California family. The reason for this rests on the misleading methodology used in the Governor's Message.

Analysis of the Methodology

The Governor's Message assumes that the total state taxes subject to limitation paid by an average family of four is equivalent to four times per capita state revenues. By the same reasoning, the income of this average family equals four times per capita personal income. If such an income is multiplied by the tax burden percentage found in the Message, 8.75 percent, the total state tax burden for this "average family" is the same as shown in TABLE 6, or \$1,852. In fact, these two methods of determining the total state tax burden of an "average family" are identical.

Method one shown in the Message divides state revenues (equal to the designated limitation percentage, (%), times personal income) by population and multiplies this number by four, or:

$$\frac{\% \times \text{Personal Income}}{\text{Population}} \times 4 = \text{Total State Taxes of an "Average Family of Four"}$$

Method two, which is implied by the methodology of the task force, divides personal income by population to arrive at per capita personal income and then multiplies this number by four and then by the designated limitation percentage (%), or:

$$\frac{\text{Personal Income}}{\text{Population}} \times 4 \times (\%) = \text{Total State Taxes of an "Average Family of Four"}$$

Thus, by this reasoning, the "average family of four" has an estimated income in 1973 equal to \$21,116. A family with this income would rank in the highest 13% family income bracket in California.[24/] In contrast, as noted above, median family income in California is about \$13,000 according to the *1970 Census*.

This is far below the income earned by the Governor's "average family of four." Thus, with respect to its income, the Governor's "average family" does not factually represent a typical, or average, California family.

Further Implications of the Governor's Claim

The Governor's "average California family of four" does not represent a typical family in many other respects as well. For example, the total state tax burden of the Governor's "average family" equals $1852 in 1973-74. As shown above, the direct state tax burden of the typical family is about $586. This implies that this family pays about $1266 in indirect state taxes. Indirect taxes are those paid by business and passed forward to consumers in the form of higher prices.[25/] To assert that the typical family pays more than twice as much in indirect taxes as direct taxes is a total rejection of all of the economic theory and empirical analysis of the incidence of taxation.

The Governor's "average" reasoning has the typical family paying not only its taxes but also a pro rata share of the taxes of families in much higher income brackets as well. For example, if estimated state personal income tax revenues for 1973-74 are divided by population and multiplied by four (the Governor's method), the personal income taxes paid by "an average California family of four" equals $413. But as shown in Section I, the typical family pays only about $140 in state income taxes.

Further, the total "taxes" paid by the Governor's "average family" include a pro rata share of tuition to higher education, teacher credential fees, payments to the Cal-Vet Home Building Fund, interest earned by the state from the Surplus Money Investment Fund, and other non-tax items. The Message does not explain how the average family will save on taxes it does not pay. Moreover, the inclusion of interest earned by the state as a "tax" paid by the average family is nonsensical. In fact, the surplus money investment operation of the State Treasurer and the Pooled Money Investment Board has saved the taxpayers of California millions of dollars.

SECTION III

Related Considerations

Federal Income Tax Interaction

Neither the tax savings estimate presented in Section I nor the Governor's message considered the interaction of the state expenditure limitation plan and the federal personal income tax. The typical California family pays federal income taxes and probably itemizes its deductions. It is in the 22 percent marginal tax bracket. For every dollar it can deduct from its adjusted gross income, such as interest payments on a home mortgage, it saves 22¢ in federal income taxes. Thus, if it saves $140 in state taxes over the first four years of the limitation plan, it will lose $140 in itemized deductions. Accordingly, it will pay 22 percent of this amount, or $31, in higher federal income taxes. Its net state tax savings is only $109. Similarly, the Governor's family which must annually earn $35,000 to receive $804 in state tax savings over the first four years will lose 36 percent, or $289, in higher federal income taxes. Its net state tax savings is $515. It is estimated that 30 percent to 40 percent of the total of any tax savings will be lost to the federal government in the form of higher federal taxes.

Expenditure Reduction

When the typical family receives its $109 tax savings, state expenditures will also be reduced. The Legislative Analyst estimates that workload expenditures will have to be reduced by $1.1 billion[26/] over the first four years if the plan is enacted.

The Analyst states that, "Most of the pressure for budgetary reductions will be centered in the budget act category."[27/] Below is a table from the Legislative Analyst showing the estimated reduction in 1977-78 budget act expenditures resulting from enactment of the Governor's plan.

Estimated Reduction in 1977-78
Budget Act Expenditures
From the Enactment of the
Governor's Limitation

(In Millions)

Program	Workload Expenditures	Required Reductions Without SB 238	Required Reductions With SB 238
Higher Education	$1,095	-$133	-$219
Department of Health	1,375	- 168	- 274
Corrections & Youth Authority	269	- 33	- 54
Local Education/1	343	- 42	- 68
Social Welfare/1	187	- 23	- 37
Other/2	2,244	- 273	- 447
Total	$5,513	-$672	-$1,099

/1 Budget Act portion.

/2 Includes salary increases, new legislation and also various state agencies such as Highway Patrol, Motor Vehicles, etc., partly or wholly funded in the Budget Act category.

To maintain existing services in higher education, additional funds must be found to offset the estimated $133 million reduction. Following recent history, the most logical source is higher tuition. If a member of the typical family desires to attend the University of California or the State University and College System, the family may find its state tax savings completely eliminated by higher tuition charges. Similarly, if salary increases to state employees must be foregone, their real incomes will fall and offset any tax savings.

Local Tax Increases

The Legislative Analyst states, "Under this initiative it is almost inevitable that reductions in state expenditures will be shifted to local governments and cause increases in local property and sales taxes."[28/] This follows from the restrictive language of the initiative which makes it easier for local government than state government to increase taxes in response to pressures to maintain, or increase, levels of government services or create new programs. The plan requires a two-thirds vote by the Legislature for any change in a state tax rate or base. Any increase in the expenditure limit requires a two-thirds vote of the Legislature and a majority vote of the people.

Local sales taxes, on the other hand, may be increased by a majority vote of the Legislature. The Legislature may also permit local entities to increase property tax rates to "allow for ... special circumstances creating hardship for individual local entities." Further, the governing boards of local entities may increase property tax rates for two years by a four-fifths vote to "defray the costs of an emergency situation..." The Legislature may not increase property tax relief to homeowners, senior citizens, or renters to offset such increases because to do so requires a corresponding reduction in other state expenditures.

Since local property taxes and sales taxes are regressive levies and at least part of the state tax surplus is refunded through the progressive state income tax, it follows that the typical family may incur an <u>increase in its net state-local tax</u>

burden if local taxes increase in response to the limitation program.

Net Effect of State Expenditure Limitation

The limitation initiative does not guarantee a net reduction in state-local taxes to the typical family. Higher federal income taxes, reduced state expenditures, and possible increases in local taxes may combine to increase the tax burden of the average family at the expense of tax savings to families in higher income brackets.

FOOTNOTES

1. For example, in remarks to the Association of Independent California Colleges and Universities, in Los Angeles, April 30, 1973, Governor Reagan stated,"The average family's per capita share of the total tax burden would be reduced by more than $17,000, if we enact this plan, over a period of fifteen years."

2. General Social and Economic Characteristics, California, p. 6-403, Bureau of the Census, 1970 Census of Population. Family income includes all earnings before deductions for taxes, dues, bonds, or other items.

3. Mean income (average income) is strongly influenced by extreme values in the distribution of income and is especially susceptible to the effects of sampling variability and mis-reporting. Therefore, median income, which divides income distribution into two equal groups, one above the median and one below the median,is a better measure of the income earned by the "typical" family.

4. Family income was adjusted by applying the percentage change in total non-property income divided by total employment from 1969 to 1973. Family income was also adjusted for changes in average weekly earnings of production and related workers in manufacturing in California from 1969 to 1973 with approximately the same results. Source: Economic Report of the Governor, 1973, and 1973-74 Governor's Budget.

5. General Population Characteristics, California, p. 6-97, 1970 Census.

6. Direct taxes include: Personal income, Sales, Cigarette, Fuel Auto registration, Beer, Wine, and Alcoholic Beverages. The auto "in lieu" tax is also included as a state tax although it is a tax collected by the state government for local government "in lieu" of local property taxation of autos. The gift and inheritance tax was not included because it is not an on-going liability. No attempt was made to determine the burden of the horse racing tax on an average family.

7. An Examination of the Governor's State Expenditure Limitation Program, p. 78-79, Legislative Analyst, April 30, 1973.

8. State Expenditure Limitation Initiative, Section 4(b).

9. Income for years after 1973 is adjusted by the method described in footnote 4, based on UCLA Business Forecasting Project estimates. To obtain an estimate of the tax savings resulting from the 7½ percent income tax credit, the average deduction in the $13,000 adjusted gross income class as shown in the Franchise Tax Board's 1971 Annual Report was subtracted from family income to derive taxable income.

10. *Legislative Analyst's Report*, pp. 78-79.

11. Limitation Initiative, Section 2(a)(1).

12. *Legislative Analyst's Report*, pp. 78-79.

13. See footnotes 4 and 9.

14. Taxable income for years 1974-77 for an average family is over-estimated for the following reasons: 1) Expenses such as business and travel expenses were not deducted from family income; 2) deductions from adjusted gross income (AGI) for years 1974-77 are the same as the average deductions for this AGI class in the 1970 calendar year. Accordingly, this figure should be adjusted downwards to take into account this over-estimate. The income tax credit was chosen as the method of distributing the tax savings because this is the method employed in the initiative and favored by the Governor.

15. *A reasonable program for - - - Revenue Control and Tax Reduction*, submitted to the California Legislature by Governor Ronald Reagan, March 12, 1973. p. 45.

16. *General Social and Economic Characteristics*, p. 6-403, *1971 Calendar Year Report*, Franchise Tax Board, p. 33.

17. *Governor's Message*, p. 39.

18. *Ibid.*, p. 42.

19. *Ibid.*, pp. 44-45.

20. Legislative Counsel Opinion, No. 7466, April 24, 1973.

21. *Legislative Analyst's Report*, p. 77, Appendix p. 30.

22. *Ibid.*, p. 76.

23. *Governor's Message*, p. 42.

24. See footnote 16.

25. Indirect taxes passed forward by business to consumers include: Bank and Corporation, Insurance, Private Car, and Liquor License Fees, plus the portion paid by business of Fuel, Auto Registration, Auto "in lieu" and Sales taxes.

26. *Legislative Analyst's Report*, p. 84.

27. *Ibid.*, p. 87.

28. *Ibid.*, p. i.

6-73 400