

November 1996

FEDERAL DOLLARS AND THE CALIFORNIA BUDGET

INTRODUCTION

Federal dollars are a significant source of income for state programs, individuals, and California's private economy. In FFY95, the federal government spent \$152.5 billion in California, almost three times the amount that the state spent from its own funds.¹ This federal spending represents amounts distributed to the state and local governments, payments to individuals, and wages and contracts paid within the state. Many state administered programs, such as transportation and Medi-Cal, rely heavily on federal dollars as a source of funding. Federal dollars also provide support to individuals through federal employees' wages and federal benefit programs, such as Social Security. In addition, federal dollars support the private economy through programs such as crop subsidies and defense contracts.

A large portion of the federal money spent in California benefits low income families, children, elderly persons, and the disabled. In FFY95, seven of the ten largest federally funded grant programs in California provided assistance to low income families and children. These programs accounted for 77 percent of federal grant dollars allocated to California. In addition, in FFY95, California's seniors and the disabled received \$50.8 billion in Social Security and Medicare benefits.

Current efforts to balance the federal budget and transfer program responsibilities to the states will result in reduced federal spending. Because changes in federal spending patterns will have a significant impact on California, especially the state's most vulnerable populations, it is important to understand the current role of federal dollars in the state.

Table 1: Top 10 Federally Funded Grant Programs In California (FFY95)

	Dollars (In Millions)
Medi-Cal	\$8,777
Aid To Families With Dependent Children (AFDC)	\$3,846
Highway Trust Fund	\$1,880
Housing Payments (Section 8)	\$1,729
Child Nutrition Programs	\$899
Children's and Family Services	\$763
Federal Transit Administration	\$762
Education For Disadvantaged	\$735
Disaster Relief	\$710
Foster Care and Adoption Assistance	\$633

Source: US Bureau of the Census, *Federal Expenditures By State*

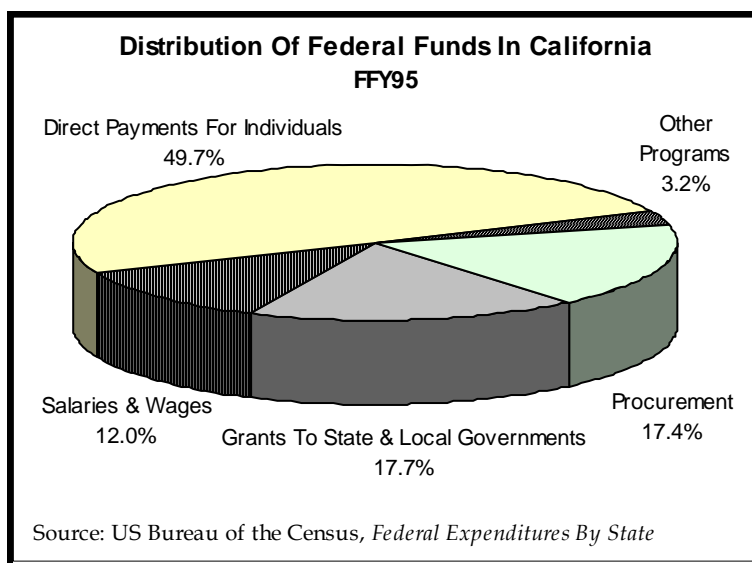
¹ Unless otherwise noted, federal expenditures are from US Bureau of the Census, *Federal Expenditures By State For Fiscal Year 1995* (Washington DC: 1996). FFY95 refers to federal fiscal year 1995, which runs from October 1, 1994 through September 30, 1995. 1994-95 refers to the state fiscal year which runs from July 1, 1994 to June 30, 1995.

HOW ARE FEDERAL FUNDS DISTRIBUTED?

Direct payments for individuals totaled \$75.8 billion, 49.7 percent of all federal funds allocated to California. Payments for individuals accounted for the largest share of federal expenditures in California in FFY95. The federal government fully administers and funds direct payment programs. Examples of direct payment programs include Social Security, payments to health care providers for seniors (Medicare), veterans' compensation, and Pell grants to students enrolled in higher education.

Grants to state and local government totaled \$26.9 billion, 17.7 percent of federal expenditures in California in FFY95. Federal grants, often called aid, are the second largest federal spending category. Federal grant programs differ from direct payment programs as they are administered and jointly funded by the state and/or local governments and federal government. The majority of grants flow through the state budget. Examples of grant programs include Aid To Families With Dependent Children (AFDC), Medicaid (Medi-Cal in California), the Women, Infant, and Children (WIC)

supplemental food program, Supplemental Security Income (SSI), and Cooperative Extension.²



Procurement contracts in FFY95 totaled \$26.5 billion, 17.4 percent of federal expenditures in California. Procurement refers to the purchase of goods and services by the federal government. Approximately 69 percent of California's procurement contracts are attributable to the Department of Defense.

Salaries and wages for federal employees working in California accounted for \$18.4 billion, 12 percent of federal expenditures in California in FFY95.

Other programs totaled \$4.9 billion, 3.2 percent of federal expenditures in California in FFY95. The two most significant components of this category are crop subsidies and research grants.

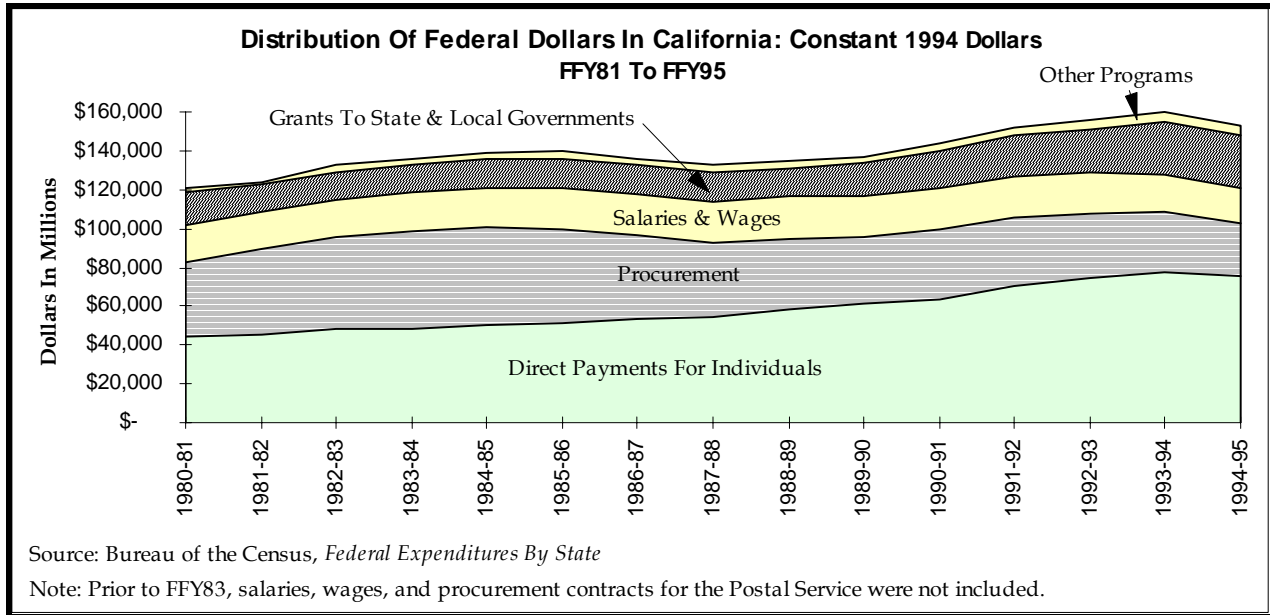
HOW HAS THE DISTRIBUTION OF FEDERAL FUNDS CHANGED OVER TIME?

Between FFY81 and FFY95, federal expenditures in California increased from \$69.4 billion to \$152.5 billion, a 26.5 percent increase when adjusted for inflation.³ The most significant changes in the distribution of federal funds in California within this period occurred in procurement contracts and direct payments for individuals. Procurement contracts, as a share of federal spending in California, declined from 31.2 percent (\$21.6 billion) in FFY81 to 17.4 percent (\$26.5 billion) in FFY95. Adjusting for inflation, this represents a 29.4 percent decline. The relative decline in procurement contracts is primarily attributable to reductions in defense spending as a percentage of the federal budget. Although procurement as a share of federal expenditures in California has declined since the mid-1980s, California's share of all US federal procurement funds has remained fairly constant.

² The AFDC program has been replaced by Temporary Assistance to Needy Families (TANF) effective October 1, 1996.

³ Inflation adjustment based on US CPI-U.

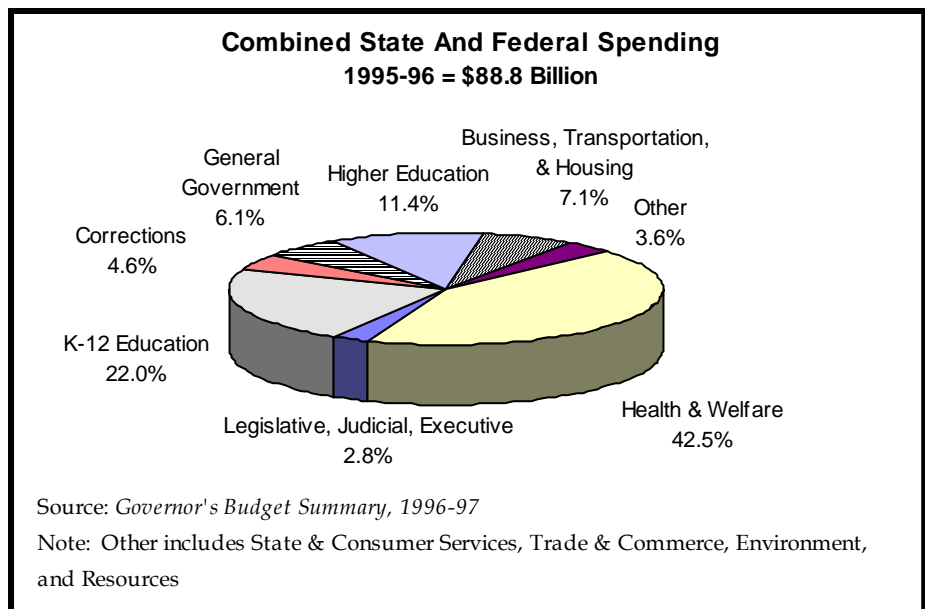
A second major change in the distribution of federal funds has been in direct payments to individuals. Direct payments to individuals, as a share of federal expenditures in California, increased from 37.1 percent (\$25.7 billion) in FFY81 to 49.7 percent (\$75.8 billion) in FFY95. Adjusting for inflation, this represents a 69.6 percent increase. The increase in direct payments reflects both the relative decline in federal defense spending and increased spending on programs benefiting California's growing numbers of senior citizens.⁴



Social Security and Medicare accounted for 67.1 percent of direct payments in FFY95. Growth in these two programs are responsible for most of the increase in direct payments to individuals. Social Security payments have increased due to longer life expectancies and the growth of the elderly population. Medicare expenditures have increased as a result of the higher health costs of aging seniors. California's share of all US direct payments to individuals has increased only slightly, reflecting the fact that increasing health care costs and an aging population are national trends.

FEDERAL DOLLARS AND THE STATE BUDGET

Federal dollars are an important component of state administered programs, such as Medi-Cal. In 1995-96, the federal government spent \$31.6



⁴ The California Institute for Federal Policy Research, *Balance of Payments Data: FFY81-FFY95* (June 1996).

billion on programs funded through the state budget.⁵ Taken together, state funds and federal dollars administered through the state totaled an estimated \$88.8 billion in 1995-96, with federal dollars accounting for 35.6 percent of combined spending.

In 1995-96, federal dollars accounted for over 30 percent of funding in four branches of state government: Health and Welfare, Higher Education, Business, Transportation and Housing, and Legislative, Judicial, Executive. Three of these areas, Health and Welfare, Higher Education, and Business, Transportation, and Housing, have received a fairly large share of their funding from the federal government since at least 1982-83.⁶ The current high federal contribution to Legislative, Judicial, and Executive programs reflects the receipt of federal disaster assistance in response to various earthquakes, fires, and floods.

Table 2: Federal Share Of California's Program Dollars: 1995-96

	Federal Dollars In Millions	Federal Share
Health & Welfare	\$20,843	55.2%
Higher Education	\$4,043	39.9%
Business, Transportation, & Housing	\$2,283	36.3%
Legislative, Judicial, & Executive	\$758	30.6%
General Government	\$692	12.9%
K-12 Education	\$2,498	12.8%
Corrections	\$288	7.1%
Other	\$193	6.1%
Total	\$31,599	35.6%

Source: *Governor's Budget Summary, 1996-97*

Note: Other includes State and Consumer Services, Trade & Commerce, Resources, and Environment

- Health and Welfare.** The federal share of funding for Health and Welfare decreased by 15.7 percent between 1982-83 and 1989-90 and increased by 22.4 percent between 1989-90 and 1995-96. The increase in the latter period is primarily attributable to increased federal funding for Medi-Cal, which in 1995-96 accounted for 42.5 percent (\$8.9 billion) of federal Health and Welfare dollars administered through the state budget. Medi-Cal expenditures have risen in response to higher health care costs and the expansion of the Disproportionate Share Hospital (DSH) program in 1987. DSH payments equaled 18.8 percent of combined state and federal Medi-Cal spending in 1993.⁷
- Transportation.** The federal share of expenditures for programs administered by the Business, Transportation, and Housing Agency has fluctuated since 1982-83, reflecting numerous state and federal changes in transportation funding.
- Higher Education.** Between 1982-83 and 1995-96, the federal share of support for Higher Education averaged 38.5 percent of total expenditures on Higher Education. Federal dollars, as a share of Higher Education spending, increased during the early 1990s to a high of 43.1 percent in 1993-94, as the state decreased its support for Higher Education.

THE COUNTERCYCLICAL ROLE OF FEDERAL FUNDS

Federal dollars, as a share of total state and federal spending administered through the state budget, peaked at 33.1 percent in 1982-83, fell to a low of 27.4 percent in 1987-88, and peaked again in 1993-94

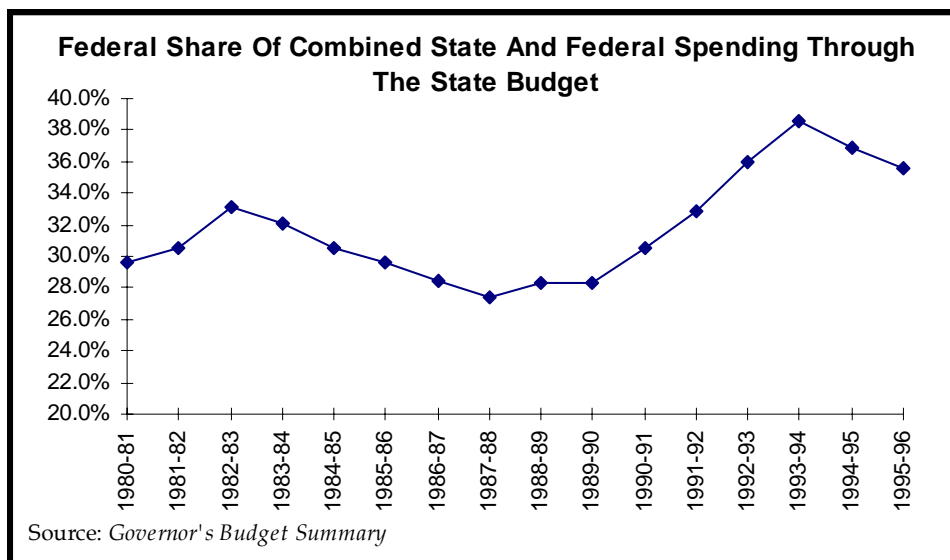
⁵ Dollar amounts in this section are from California Department of Finance, *Governor's Budget Summary*, various years.

⁶ Actual federal dollars administered through the state budget are not included in the Governor's Budget prior to 1981-82.

⁷ Colin Winterbottom, David Liska, Karen Obermaier, *State-Level Databook on Health Care Access and Financing* (Washington DC: Urban Institute Press, 1995), p. 137.

at 38.6 percent. The peaks in federal spending occurred during the economic downturns of the early 1980's and 1990's. These peaks illustrate the countercyclical role of federal funds, which increase during economic downturns and decrease as the economy recovers. Three factors help explain the countercyclical role of federal funds:

- Unemployment benefits:**
 Unemployment benefits, which are funded through a payroll tax, are distributed by the federal government. Spending on unemployment benefits grows as unemployment increases and shrinks as unemployment decreases.



- Health and Welfare benefits:** AFDC and Medi-Cal spending historically increase during economic downturns, since more people are eligible for benefits and receive benefits for longer periods of time. Prior to the passage of the federal welfare reform bill, AFDC was an entitlement program. When caseloads rose due to a recession, federal spending automatically increased. Under welfare reform this is no longer the case. States will receive no additional funds for AFDC in the event of an economic downturn.⁸
- Slowdowns in state spending growth:** During economic downturns, state revenues are depressed, which limits state expenditures. As state expenditures decline, the share funded by federal dollars increases.⁹

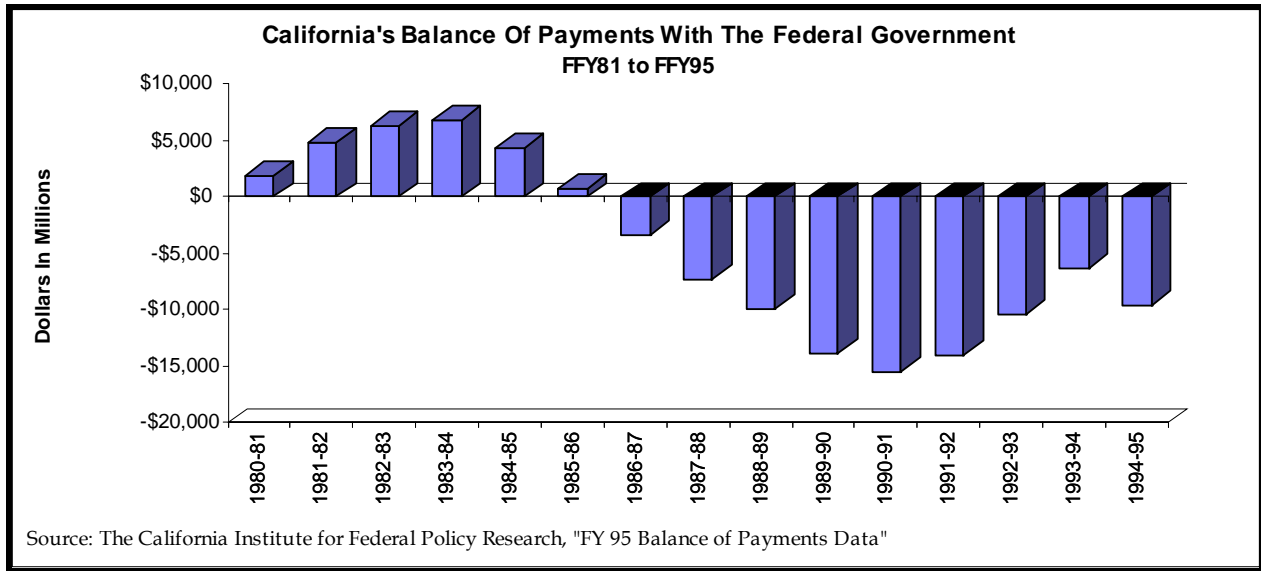
CALIFORNIANS PAY MORE IN FEDERAL TAXES THAN THEY RECEIVE IN FEDERAL EXPENDITURES

In FFY95, California paid \$9.5 billion more in taxes to the federal government than it received in federal expenditures.¹⁰ This difference between tax burden and federal expenditures is called the *balance of payments*. California has been a “donor state” since FFY87, meaning it has had a negative balance of payments and thus has paid more in federal taxes than it received in federal dollars. Prior to FFY87, California had a positive balance of payments. Between FFY94 and FFY95, the difference between what California paid in taxes and received in federal expenditures increased 49.5 percent (\$3.2 billion).

⁸ Although the welfare reform bill does include a small contingency fund, states must meet strict maintenance of effort requirements in order to access these funds. Moreover, the amount available is not likely to meet the additional need in the event of a national downturn.

⁹ Legislative Analyst's Office, “Federal Spending in California,” *The 1996-97 Budget: Perspectives and Issues*, pp. 153-4.

¹⁰ The California Institute for Federal Policy Research, *FFY95 Balance of Payments Data* (June 1996). This number reflects an adjustment to set federal spending equal to federal taxing.



What factors explain changes in California's balance of payments? In the early to mid 1980s, high levels of federal defense spending insured that California received more in federal spending than it sent to the federal government as taxes. In addition, California's rate of personal income growth closely matched that of the rest of the US, so that California bore a fairly constant share of the US tax burden. This changed in FFY84 when California's personal income began to grow at a faster rate than the US as a whole, causing California's share of the US tax burden to increase. At the same time, federal defense spending declined. As a result of these two factors, California became a donor state beginning in FFY87. The imbalance between federal dollars received and taxes paid peaked at \$15.4 billion in FFY91. Between FFY92 and FFY94, the particularly harsh impact of the recession in California slowed California's personal income growth to a rate less than that of the United States as a whole. This produced a decrease in California's share of the US tax burden and narrowed the gap between taxes paid and federal dollars received.

CONCLUSION

In FFY95, the federal government spent \$152.5 billion in California, accounting for approximately 19.4 percent of Gross State Product.¹¹ Between FFY81 and FFY95, two major shifts in the distribution of federal dollars occurred: a relative decline in procurement contracts and an increase in direct payments to individuals. Declining defense spending combined with an increasing tax burden helped transform California from a recipient state into a donor state beginning in FFY87. Future changes in federal funding will impact many state administered programs that rely on federal funds, placing additional demands on the state and local governments.

¹¹ US Bureau of the Census, *on-line data*. Calculations based on 1992 Gross State Product, the most recent available.

Understanding the Federal Budget Process

- The federal budget process begins when the President submits a budget to the Congress at the beginning of the year. Congress then releases a **budget resolution** which outlines overall limits on spending and revenues. A budget resolution must be passed by both the Senate and House of Representatives but does not require presidential approval.
- The next stage in the federal funding process is the passage of **appropriations bills**. Appropriations bills detail funding levels for discretionary programs such as defense and agriculture. These bills must meet the overall limits outlined in the budget resolution, be passed by both houses, and receive presidential approval by the start of the new fiscal year (October 1).
- If appropriations bills are not enacted before October 1, Congress and the President must pass a **continuing resolution** in order to keep federal agencies operating.
- Tax changes and savings in mandatory or discretionary programs required by the budget resolution are implemented by the passage of the **budget reconciliation bill**. Modification of funding for mandatory programs requires legislation that allows for changes in eligibility or benefits prior to, or concurrent with, the passage of the budget reconciliation bill. The budget reconciliation bill implements the spending and revenue levels outlined in the budget resolution. Unlike the budget resolution, a budget reconciliation bill must be passed by both houses and receive presidential approval. In the case of a presidential veto, a two-thirds vote is required by both houses in order to override the veto.
- It is important to note that last year and most likely this year, the budget reconciliation bill is also a **balanced budget bill**, setting funding levels for the next six to seven years.

The California Budget Project (CBP) is a nonpartisan, nonprofit organization whose goal is to promote a better understanding of state fiscal issues in order to promote a healthy public sector based on a fair and equitable tax system. General support for the California Budget Project is provided by grants from James Irvine, Ford, and Annie E. Casey Foundations and individual donations and subscriptions.
