CALIFORNIA
• BUDGET PROJECT •

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Is the Sales Tax Trigger a Tax Increase?

Some members of the Legislature have voiced opposition to the Budget Conference Committee's spending plan on the grounds that it contains a tax increase, specifically the reinstatement of the ¼-cent sales tax rate suspended for calendar year 2001. Many of the same members have called for a larger reserve than that provided by the Conference Committee's spending plan. This paper examines the history of the sales tax trigger, recent tax reductions approved by the Legislature, and the consequences of continuing the sales tax suspension and increasing the budget reserve.

How Does the Sales Tax Trigger Work?

The tax package enacted to balance the 1991-92 Budget included an increase in the state's sales tax rate. A portion of the rate increase was linked to the level of the state's budget reserve. This so-called trigger maintained the rate in years where the state's reserve was less than 4 percent of General Fund revenues and reduced the rate in years when the reserve exceeded 4 percent of anticipated revenues for two successive years, beginning in 1993. Last fall, for example, the Director of Finance looked back at the 1999-00 reserve and revenues and looked forward at the estimated 2000-01 reserve and revenues and ordered the ¼-cent reduction for calendar year 2001.

The law specifically provides that the rate reduction would apply for a single year. The intent of this provision was to serve as a safety valve. If the state's fiscal condition remained strong, the rate reduction would continue. If the state's fiscal condition worsened, as is currently the case, the rate would go back up to the level enacted in 1991. No action of the Governor or Legislature is required for the rate to go up or down.

The trigger mechanism has been in place for eight budgets since its enactment (see table). Only once, in the current year, has the reserve in both the past and current years been sufficient to trigger a reduction in the sales tax rate. In fact, the reserves provided in both the prior (1999-00) and current (2000-01) years' budgets were not sufficient to trigger a reduction at the time the budgets were signed into law. Stronger than anticipated revenue growth *after the budgets were enacted* boosted the size of the reserves sufficiently to trigger the reduction in the current calendar year. If 2001-02 revenue growth exceeds expectations – which does not appear likely – boosting the reserve above 4 percent, the sales tax rate would again be reduced in 2002.

Recent Budgets Have Had Small Reserves When Enacted

	Revenues Assumed by the Budget as Enacted (in Millions)	Reserve Assumed in the Budget as Enacted (in Millions)	Reserve as a Percent of Revenues
Wilson Budgets			
1993-94	$40,622.6	$612.3	1.5%
1994-95	$41,891.5	$5.6	0.0%
1995-96	$44,057.0	$28.0	0.1%
1996-97	$47,642.9	$305.0	0.6%
1997-98	$52,530.5	$111.7	0.2%
1998-99	$56,985.3	$1,254.5	2.2%
Davis Budgets			
1999-00	$62,980.9	$880.2	1.5%
2000-01	$73,861.8	$1,781.5	2.4%
2001-02	$75,158.0	$2,203.0	2.9%

Revenues and Reserve as of final change book. 2001-02 as of SB 75 Conference Committee report.
Note: Reserve level does not include special set-asides.

Recent Budgets Have Included Large Tax Reductions

Recent years' budgets have included a number of sizeable tax cuts. Tax reductions approved as part of the 1998-99, 1999-00, and

2000-01 Budgets reduced current year (2000-01) revenues by an estimated $5.2 billion. Tax reductions approved since 1991 will reduce state revenues by an estimated $6.3 billion in 2000-01. While proponents of additional tax reductions point to the rapid increase in state spending over the past several years, the fastest growing part of the budget actually reflects a tax cut. Since 1998-99, General Government expenditures reimbursing local governments for revenues lost as a result of the Vehicle License Fee reduction have exceeded $7.7 billion. While this is scored in the budget as a General Fund expenditure, it actually reflects the impact of a tax reduction.

California is an Average Tax State

California's total state and local tax burden ranked 27th among the fifty states in 1996-97 (the most recent year for which data are available), according to recent Census data. California's state sales tax burden ranked 20th among the fifty states in 1998-99, the most recent year for which data are available.

What Would a Sales Tax Reduction Mean to the "Average Family"?

The impact of a lower sales tax rate would be minimal for most Californians. "Average" California taxpayers – the 20 percent of households in the middle of the income distribution – would save an average of $30 per year from the lower sales tax rate.[1] California's poorest households – the bottom 20 percent of the income distribution – would save an average of $12. The wealthiest one percent of California households, whose average income was $833,000 in 1998, would save an average of $216.

What are the Consequences of Reducing the Sales Tax AND Increasing the Reserve?

Proponents of continuing the sales tax trigger also call for a larger budget reserve. Continuing the sales tax trigger and boosting the reserve would necessitate substantial spending reductions in addition to those already incorporated into the Conference Committee's spending plan. Suspending the ¼-cent sales tax for calendar year 2002 would reduce state revenues by $1.2 billion. Approximately half the loss would apply to 2001-02, with the remainder occurring in 2002-03. The 2002-03 revenue loss is particularly significant, since the Legislative Analyst projects that the state will face an operating deficit in excess of $4 billion in 2002-03, even if the sales tax returns to its pre-suspension rate.[2]

If, for example, proponents wished to increase the reserve by $500 million and continue the lower sales tax rate, approximately $1.7 billion in spending reductions in excess of those approved by the Conference Committee would be needed in the 2001-02 and 2002-03 Budgets ($500 million to pay for the added reserve and $1.2 billion to pay for continuation of the sales tax reduction). However, even cuts of this magnitude would not bridge the projected operating deficit, which potentially will require even deeper spending reductions.

Conclusions

1. The sales tax trigger serves as an important "safety valve." It provides relief to taxpayers when revenue growth is strong, and resources to support vital state services, such as education, public safety, and health care when revenue growth lags.
2. Suspending the sales tax trigger for an additional year leaves the state in a precarious fiscal condition in 2002-03. The Legislative Analyst estimates that the state will face an operating deficit in excess of $4 billion in 2002-03 even if revenue growth rebounds. The deficit would be larger if the sales tax reduction continues, potentially requiring deep spending cuts to bring the Budget into balance.

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[1] CBP calculations from Institute on Taxation and Economic Policy data. Based on 1998 tax burden.

[2] The operating deficit estimate is based on the Governor's May Revision and Senate and Assembly Budgets prior to the actions of the Conference Committee.