STATE BOARD OF EQUALIZATION

# ECONOMIC PERSPECTIVE

*Summary of Recent Economic Developments* *July 2000*



## ❖ *U.S. Economic Developments*

### Slower Economic Growth in First Quarter Still Well Above Average

Real gross domestic product (GDP) increased 5.5 percent in the first quarter of 2000, according to the U.S. Department of Commerce's final estimate released in late June. While slower than the 7.3 percent growth reported for the fourth quarter of 1999, this is still extremely strong growth. To put these numbers in perspective, real GDP rose an average of 4.2 percent per year from 1997 through 1999.

### Slower Growth for the Rest of 2000?

In late June, the UCLA Anderson Forecasting Project released its quarterly economic forecast. UCLA expects growth in real GDP to be much slower than the first quarter rate during the remainder of the year. For 2000 as a whole, they forecast real GDP to rise 4.6 percent. This is slightly lower than forecasts made recently by many other economists. The average 2000 real GDP growth rate forecast from a panel of 32 economists surveyed by the National Association for Business Economists (NABE) was 4.9 percent growth. The forecast for 2000 real GDP growth in the *Governor's Budget*, May Revision, 2000-01 was also 4.9 percent. (Sources: U.S. Department of Commerce, STAT-USA website: www.stat-usa.gov; *The UCLA Anderson Forecast*, June 2000; *NABE Outlook*, May 2000; California Department of Finance website: www.dof.ca.gov.)

## ❖ *California Economic Developments*

### Strong Start to 2000 Employment Growth

One of the most comprehensive measures of economic well being available for states on a timely basis is nonagricultural employment. California employment growth was extremely strong in the first half of 2000. Nonagricultural employment for the six-month period of January through June 2000 increased 4.3 percent over January through May of 1999. The UCLA Anderson Forecasting Project and other California economists expect growth to slow in the second half of 2000. The June 2000 UCLA forecast calls for California nonagricultural employment to increase 3.8 percent in 2000. This is faster than the 3.1 percent employment growth reported for 1999, and well above average for recent years. For the five-year period 1995 through 1999, nonagricultural employment increased an average of 2.9 percent per year.

## Extremely Strong Taxable Sales Growth Accelerates in Early 2000

The Board of Equalization's preliminary estimate shows that taxable sales increased 13.4 percent in the first quarter of 2000 compared to the first quarter of 1999. This is even faster than the third and fourth quarters of 1999, which had taxable sales increases of 9.9 percent and 10.7 percent respectively. To put these numbers in perspective, annual taxable sales rose 5.2 percent in 1998 and 6.2 percent in 1997. The last time quarter-to-quarter taxable sales increased as fast as the first quarter 2000 was in 1984. (Sources: California Employment Development Department (EDD), "Interim Industry Employment," *Labor Market Conditions in California,* June 9, 2000; EDD Labor Market Information website: www.calmis.ca.gov; California Department of Finance, *Economic Indicators*, March-April 2000, website: www.dof.ca.gov; Board of Equalization, News Release #37, June 13, 2000, website: www.boe.ca.gov.)

# ❖ *Trends in the Stability of the California Sales and Use Tax as a Revenue Source*

Is the California sales and use tax stable, growing, or declining as a revenue source? This is an important state and local government fiscal policy question. However, the answer to this question is not straightforward, and it depends on the time period considered as well as the basis of comparison. The long-term trend since the 1970s is that the sales and use tax declined in its relative importance, as measured by the taxable sales proportion of California personal income. However, during most of the 1990s taxable sales have been fairly stable as a share of personal income. Despite this stability, sales and use tax *revenues* have declined relative to personal income tax revenues during the 1990s. This relative decline was largely caused by a tremendous increase in personal income tax revenues.

## Taxable Sales to Personal Income Ratio

One commonly used measure in assessing the stability of sales and use tax revenue growth trends is the relation of taxable sales to personal income. This ratio declined from an average of 50 percent in the decade of the 1970s to 47 percent during the 1980s. The trend accelerated in the 1990s, averaging about 40 percent.[1] The ratio decreased an average of 1.4 percent per year from 1990 through 1994, then stabilized within a narrow range of within one percent (38.6 to 39.5 percent) since the economic expansion began in California in 1994.[2]

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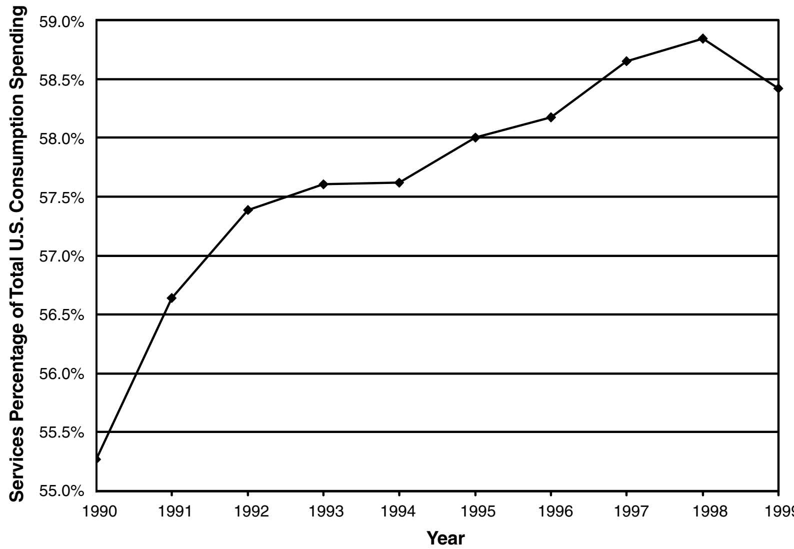
[1] The source of the 1990 through 1999 personal income data is a fax from California Department of Finance staff, May 16, 2000. These data include upward revisions in personal income compared to other decades, largely resulting from major definitional changes made by the U.S. Department of Commerce in 1999. These revisions reduce the ratio for the 1990s by about one percent compared to previous decades. In addition, the taxable sales base changed during the early 1990s recession, which slightly distorts figures for 1991 and 1992. Candy and snack food became subject to sales and use taxes in August 1991, and were then restored to tax-exempt status in December 1992. Their inclusion had the effect of slightly increasing the ratio of taxable sales to income during these two years. There were other permanent changes made in the tax base in the 1990s, but these were of relatively minor importance in relation to the taxable sales to personal income ratio.

[2] The average annual change in the taxable sales to personal income ratio for the 1995 through 1999 period was 0 percent.

## Services Share of U.S. Total Consumption

The long-term decline, followed by the recent stability, of the taxable sales to personal income ratio is associated with a long-term trend of consumers spending relatively less on goods and more on services. In California's sales and use tax system, most services are exempt, while most goods are taxable (major goods exemptions include food consumed at home and prescription drugs). The U.S. Department of Commerce does not estimate state-specific consumption values, but economists generally believe that the state's spending patterns are similar to those of the nation as a whole. During the decade of the 1970s, services accounted for an average of 46 percent of all U.S. consumer spending. The services share average increased to 52 percent during the 1980s, and then to 58 percent during the 1990s. The rate of increase in the services portion has slowed during the latter half of the 1990s (see chart). From 1990 through 1994, the ratio increased an average of 0.6 percent per year. However, from 1995 through 1999 the ratio increased by an average of only 0.2 percent per year, settling within a range of 58 to 59 percent of all spending. In 1999, the services share of spending decreased slightly (0.4 percent) for the first time since 1973. It could be that the long-term trend of services increasing as a share of spending is approaching its peak.

**Services Shares of U.S. Total Consumption in the 1990s**




## Taxable Sales Share of General Fund Revenue

Another measure of the relative importance of the sales tax is to compare its contribution to total general fund revenues.[3] Traditionally, sales and the personal income taxes have been the two most important sources of general fund revenues, together accounting for approximately 80-90 percent of the total. In 1989-90, the personal income tax comprised 45.4 percent of general fund revenues, and sales tax accounted for 37.4 percent. By 1998-99, the general fund share derived from the personal income rose by 7.3 percent, to 52.7, while the sales tax share declined by 1.6 percent to 35.8.[4] The personal income tax share is forecast to continue increasing by an additional 3.1 percent, to 55.8 in fiscal year 2000-01, while the sales tax share is forecast to continue declining to 32.1 percent (a decline of 3.7 percent).[5] Based on this measure, the sales and use tax appears to be declining in its relative importance to general fund revenues.

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[3] The term "sales tax revenue," as used here, includes both sales and use tax revenues to simplify the discussion.

[4] Other general fund revenue sources, such as the bank and corporation tax, account for the increase not being equal to the decrease. Also, single points in time are compared here, rather than multiyear averages, because comparisons of shares during the first half of the 1990s are distorted by changes in the rates enacted to both taxes during the recession.

[5] Source: *Governor's Budget*, May Revision, 2000-01, May 15, 2000.

## Tremendous Growth in Personal Income Tax Revenues in Late 1990s

How could taxable sales as a percentage of personal income have been stable, while sales and use tax revenues as a percentage of general fund revenues have been falling in the latter half of the 1990s? The structure of the California personal income tax and growth in personal income tax revenues explain this apparent dichotomy. In recent years, the sales and use tax has been declining in its relative importance as a revenue source because of extremely strong growth in personal income tax revenues. Three major factors are responsible for such exceptionally strong personal income tax revenue growth. These interrelated factors are: (1) taxable income growth at the high end of the income distribution spectrum, (2) growth in capital gains, and (3) the progressivity of the California income tax system. All of these factors have combined to cause personal income tax revenues to increase faster than personal income during the late 1990s. A February 2000 report by the Legislative Analyst's Office (LAO), *The 2000-01 Budget: Perspectives and Issues*, provides an excellent discussion of this issue.[6]

Personal income tax revenues have grown much faster than sales and use tax revenues over the last several years, which is causing their importance to grow relative to other sources of general fund revenues. In fiscal year 1997-98, personal income tax revenues rose 20.0 percent, while sales and use tax revenues increased 6.1 percent. In 1998-99, personal income taxes increased 10.6 percent, while sales and use tax revenues rose 7.5 percent. Estimates for the recently completed 1999-00 fiscal year from the *Governor's Budget*, May Revision, 2000-01 forecast show this trend to be continuing even more dramatically. Sales and use taxes were estimated to have increased about 10 percent in fiscal year 1999-00. Though this is a brisk growth rate, it pales in comparison to estimated growth in personal income taxes, which were estimated to have jumped approximately 26 percent. (Sources: California Department of Finance website: www.dof.ca.gov; California Legislative Analyst's website: www.lao.ca.gov; U.S. Department of Commerce, STAT-USA website: www.stat-usa.gov; *2000 Economic Report of the President*, Council of Economic Advisors, website: w3.access.gpo.gov/eop/index.html.)

[6] A background note to this discussion is that the U.S. Department of Commerce definition of personal income excludes capital gains, but the California definition of taxable income includes them. Therefore, when capital gains increase rapidly, personal income tax revenues will increase faster than Commerce-defined personal income because of the definitional difference alone.

### n o t e s

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