A MONTHLY REPORT FROM STATE CONTROLLER BETTY T. YEE

California Fiscal Focus

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CA Controller's June Cash Report Highlights Volatility of Personal Income Taxes

California total revenues fell short of expectations for the third straight month in June, but overall revenues for the fiscal year outpaced projections made in the 2015-16 budget by $978.6 million, according to State Controller Betty T. Yee's monthly report of California's cash balance, receipts, and disbursements.

June revenues were $524.4 million—or 3.1 percent—lower than anticipated in the Governor's revised budget released two months ago. Of the state's three major revenue sources, only corporation taxes outpaced expectations in June, coming in at $2.5 billion, which was 7.8 percent higher than anticipated.

Personal income taxes, the primary and highly volatile source of California's General Fund revenues, fell short of May Revision estimates by $803.8 million in June. Retail sales and use taxes also missed projections by $14.5 million.

For the entire 2015-16 fiscal year that ended June 30, personal income tax accounted for the bulk of growth, beating last summer's budget projections by almost $1.8 billion. Corporation taxes came in $698 million lower than anticipated, while sales taxes fell $307.5 million short.

While fiscal year revenues beat 2015-16 budget projections, they fell $678.8 million short of rosier estimates released in May. The Governor's Department of Finance anticipated personal income taxes would continue their recent growth trend, but these taxes are a notoriously unpredictable revenue source, as outlined in a recent report by Controller Yee and her Council of Economic Advisors on Tax Reform.

California disbursed $7.8 billion more in the 2015-16 fiscal year than in the previous year. This amount included $6.7 billion for local assistance—mostly K-12 school spending set by Proposition 98 of 1988. However, total disbursements for the fiscal year were $1.5 billion lower than projected in the May Revision.

As Controller Yee predicted last summer, California did not have to pursue external borrowing in 2015-16. California did end the fiscal year with $646.2 million in internal borrowing, which was $896.2 million less than May Revision expectations. The state ended the fiscal year without a positive cash balance for the first time since FY 2012-13.

As of June 30, the amount available for internal borrowing from the state's own funds was $35.9 billion, exceeding the May Revision estimate by almost $3.5 billion.

For more details, read the cash report.

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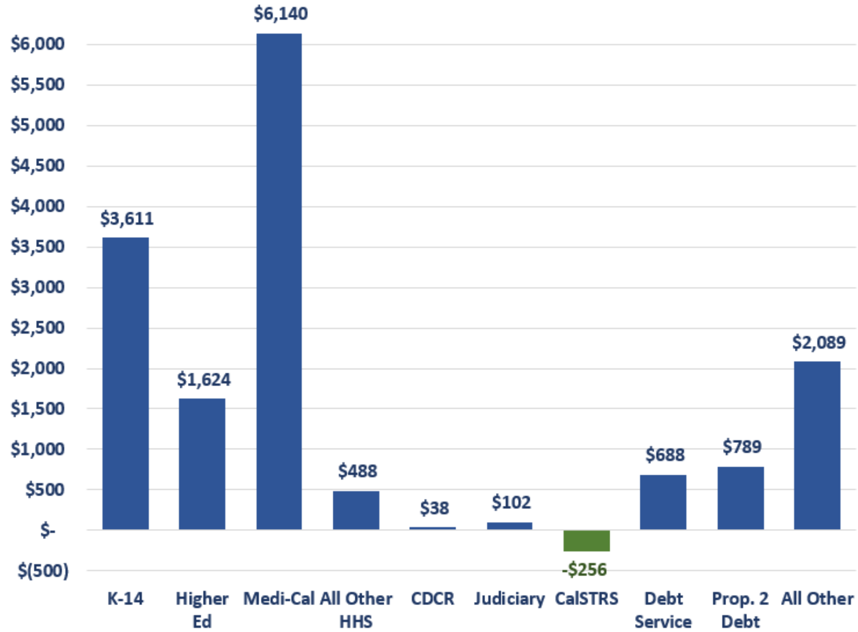
What is Driving Up Costs for the General Fund?

Figure 1

What Programs Will Add the Greatest Costs to California's General Fund between 2015 and 2020?

Source of Data: CA Legislative Analyst's Office Long-Term Forecast (November 2015); Dollars in Millions.



The California Legislative Analyst's (LAO) General Fund expenditure estimates show California faces most of its cost pressure from three specific programs. Comparing FY 2015-16 spending to FY 2019-20 estimates, the LAO expects the General Fund to rise by $15 billion. Nearly three-quarters of this cost increase will be directed at Medi-Cal, K-14 education, and higher education, as seen in Figure 1. This has at least three fiscal implications:

1.) Controlling overall state costs will be dependent on finding ways to reduce education and health costs.

2.) Minor increases in state education and health costs will crowd out discretionary spending in other areas.

3.) Other aspects of the budget will likely require alternative funding sources, including local spending.

General Fund Resources Running Ahead of Expenditures for Foreseeable Future

In May, the Governor's Department of Finance (DOF) released its long-term General Fund forecast. After accounting for prior-year transfers—and before making any transfers to the Rainy Day Fund—DOF expects General Fund resources (revenues and transfers) to rise from $131 billion in 2016-17 to $136 billion in 2019-20. This is a growth rate of about 1 percent per year.

Over the same time period, DOF expects expenditures to grow from $122 billion to $136 billion—an average annual growth rate of about 4 percent.

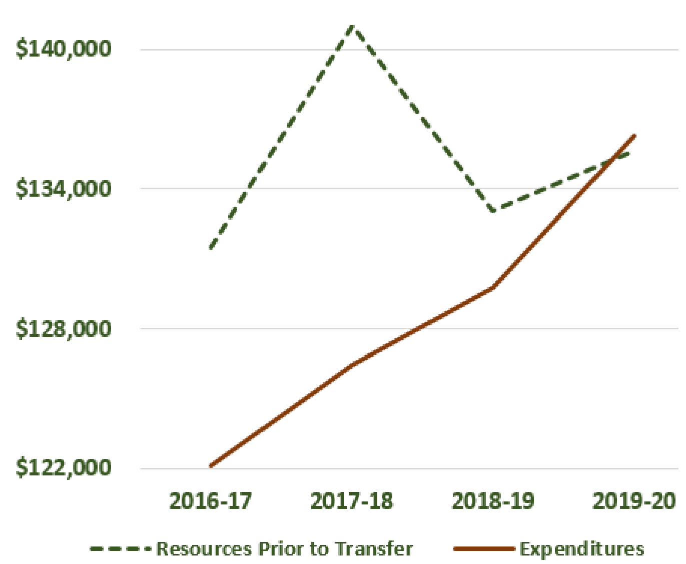
The difference in average growth rates, as illustrated in Figure 2, yield the following details:

(See RESOURCES, page 3)

Figure 2

Long-Term General Fund Forecast: Resources Exceed Expenditures

Source of Data: CA Department of Finance (May 2016); Dollars in Millions.



2014 Tax Revenues on Capital Gains Highest on Record

Each spring, the California Franchise Tax Board (FTB) publishes data from a sample of the prior year's tax returns. In late April, FTB released its estimates of capital gains activity for the 2014 tax year. As displayed in Figure 3, FTB staff estimated both the amount of net capital gains reported and the amount of tax paid on capital gains.

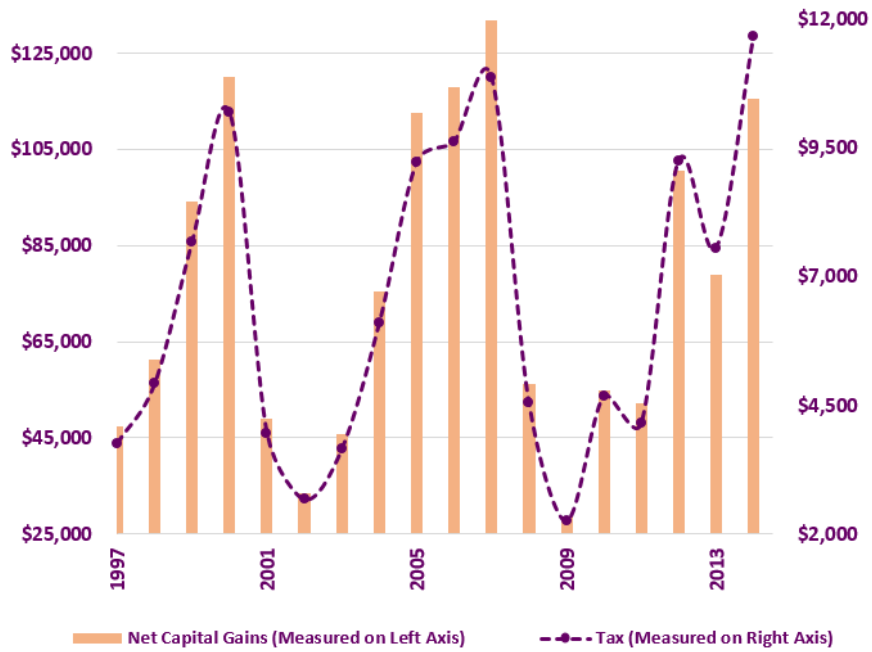
In looking at FTB's historical sequence starting with the 1997 tax year, the 2014 returns showed the following:

- The taxes paid on capital gains, $12 billion, were the highest recorded.
- The amount paid in 2014 was about $4 billion more than was paid in the previous year.
- The taxable base ($115 billion) was the fourth highest recorded, falling below the amounts reported for tax years 2000, 2006, and 2007.

Figure 3

Capital Gains Activity, 1997-2014

Source of Data: CA Franchise Tax Board (April 2016); Dollars in Millions.



(RESOURCES, continued from page 2)

- While the growth rate for expenditures over the four-year period is greater, resources experience a spike next year.
- Given the difficulty in estimating long-term growth patterns, particularly for General Fund revenues, the difference between resources and expenditures could be easily over- or under-estimated.
- The transfers to the Budget Stabilization Account and Rainy Day Fund may help cushion any short-term budget imbalance.

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