A MONTHLY REPORT FROM STATE CONTROLLER BETTY T. YEE

California Fiscal Focus

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CA Controller's November Cash Report Shows State's Three Major Taxes Beating Expectations

Led in November by the retail sales and use tax, the state's three major sources of revenues beat projections, State Controller Betty T. Yee reported.

Sales tax revenue of $3.0 billion surpassed projections in the budget for the 2015-16 fiscal year by $154.5 million, or 5.4 percent. Personal income tax revenue of $3.8 billion beat estimates by $47.5 million, or 1.3 percent. The corporation tax brought in $89.1 million, almost double the anticipated amount, mostly the result of higher-than-expected estimated payments by corporations.

Overall, revenue for November fell short of projections by $39.8 million. However, this did not occur because of a fiscal downturn but because a $300 million payment the state expected in November had been received three months early. The payment was a settlement between the California Public Utilities Commission and Pacific Gas & Electric Co. over a 2010 pipeline explosion in San Bruno.

For the fiscal year that began July 1, higher-than-expected proceeds through November from the personal income tax were more than enough to offset shortfalls in the sales and corporation taxes. The personal income tax generated $888.2 million, or 3.8 percent, more than anticipated. The sales tax fell short by $226.7 million, or 2.3 percent, while the corporation tax trailed projections by $146.4 million, or 8.6 percent.

Overall, total fiscal year revenues through November of $37.1 billion beat projections by $502.9 million, or 1.4 percent.

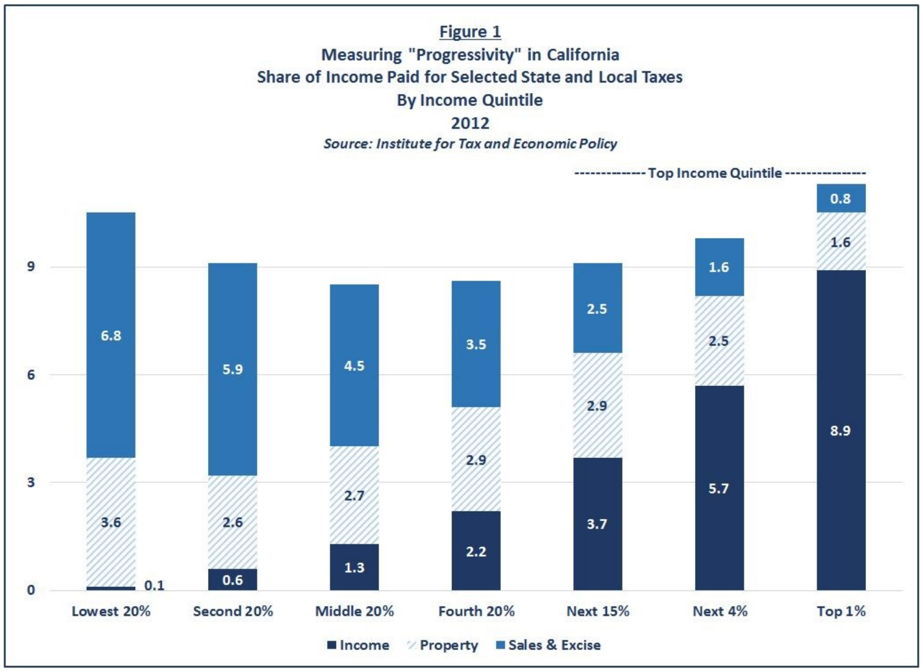
This month's edition of the Controller's *California Fiscal Focus* examines the question of whether volatility in state revenues is the inevitable outcome of a progressive tax system.

The state ended the month of November with $12.2 billion in outstanding loans — $752.5 million, or 5.8 percent, less than expected. For the first year in 15 years, the state is covering month-to-month shortfalls exclusively through internal borrowing from special funds rather than external loans, such as revenue anticipation notes. The improved fiscal condition of the General Fund, the source of most state spending, has saved the state tens of millions of dollars in interest costs.

For more details, read the monthly cash report.

Inside this issue

Should We Listen to Motown When Considering Tax Reform?



Buy a sandwich — or a record? In his glittering heyday, Motown's Berry Gordy vetted singles by playing a song and asking staff whether they would give up lunch to buy the 45, according to an October article in the Financial Times. That's how "Stop! In the Name of Love" got released in 1965. Gordy's question — wildly successful when picking tunes with lasting appeal — shows how hard decisions can be reduced to a stark tradeoff between two alternatives.

Could Gordy's rhetorical exercise be applied to tax policy? Discussions of "progressivity" in the tax system sometimes get limited to whether the state should maintain tax rates to promote tax "equity," or reduce them to moderate revenue "volatility." However, this limited choice is misleading. In practice, the preference for a more progressive tax system need not lead to more volatility.

Measuring Progressivity on a Continuum. In a progressive tax system, wealthy taxpayers pay a greater share of their income in taxes than do those who are less well off. According to former Congressional Budget Office Director Rudy Penner, a preference for progressivity assumes that the loss of each tax dollar is less hurtful to higher-income people than it would be to lower-income earners. Tax equity is enhanced by increasing the share of taxes paid by higher-income Californians.

We can scale the progressivity of a particular tax across income cohorts by comparing the ratio of taxes to income. For example, a flat-rate tax imposed on each taxpayer, irrespective of wealth, is at the low end of the scale while California's current personal income tax (with its steeply graduated tax rates) is far more progressive.

A recent study by the Institute for Tax and Economic Policy (ITEP) calculated the progressivity of California's major taxes. ITEP divided households into income quintiles, from poorest to richest. It further subdivided the richest quintile into three categories, consisting of the next 15 percent, the next 4 percent and finally, the top 1 percent. ITEP calculated the amount of taxes paid by each of the income cohorts, measuring the relative progressivity of the sales, income, and property taxes.

For the personal income tax (PIT) and corporation tax combined, ITEP measured a steeply progressive impact, as seen in Figure 1. The poorest Californians (those in the bottom 40 percent of income) pay less than 1.0 percent of their income for these taxes, while the richest 5 percent pay more than 5.7 percent.

Contrast this result with the estimated impact of the state's sales and excise taxes. The poorest 20 percent of Californians paid 6.8 percent of income in sales tax while the top 20 percent paid at most 2.5 percent.

ITEP also determined that the impact of the property tax, while regressive, is less so than the sales and excise tax,

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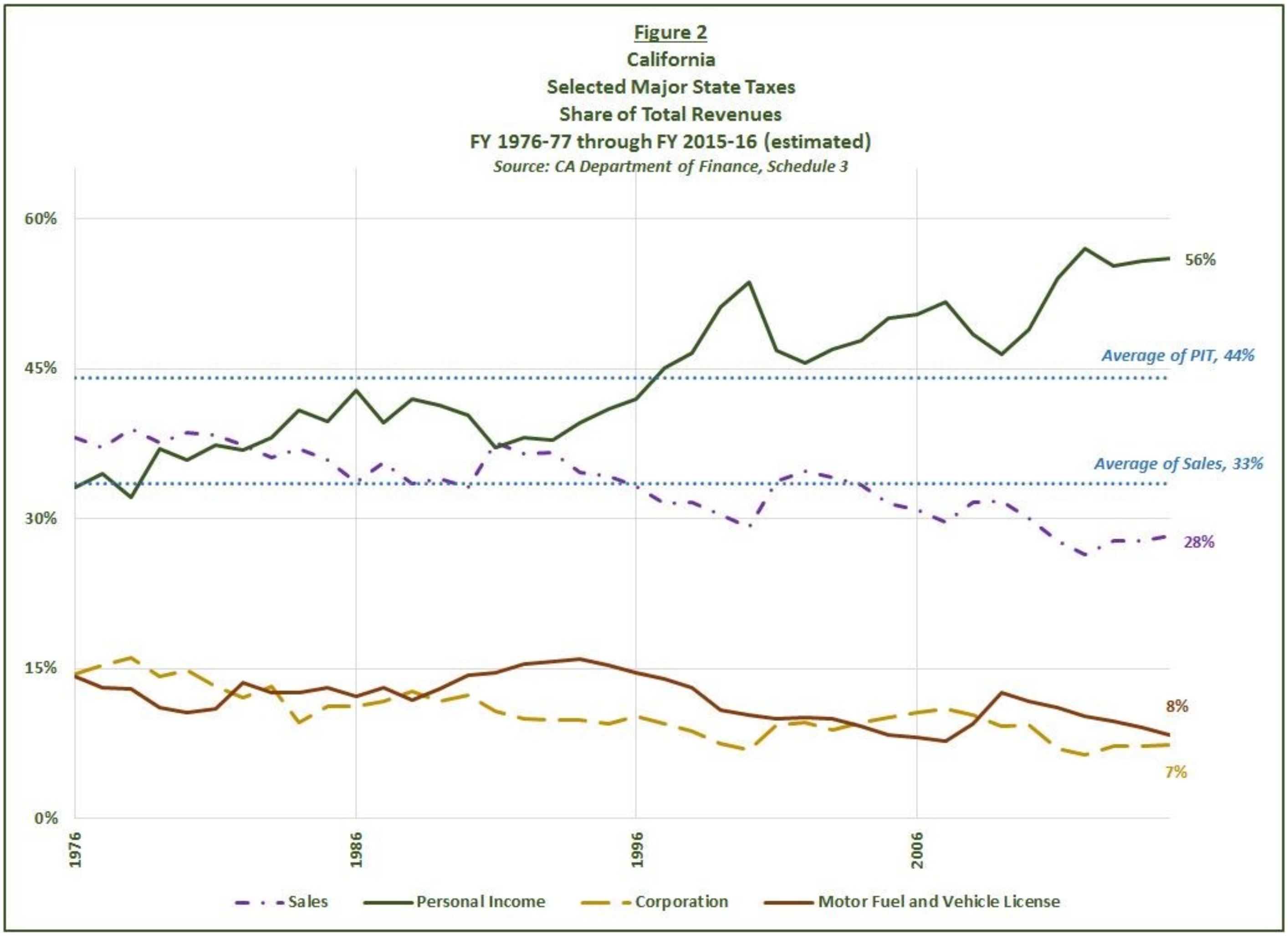
The Shifting Importance of the State's Major Taxes



The state's relative dependence on different types of taxes evolves over time, sometimes in response to conscious decisions but also as the result of larger changes in the economy. Figure 2 shows this trend using California Department of Finance data that track five major general taxes levied by the state over time. The figure does not track proceeds from minor general taxes (including the cigarette and alcohol taxes) or proceeds from user fees (such as day-use park fees). Taken together, the excluded minor revenue sources generally account for less than 10 percent of annual revenues.

Shares Have Evolved. Over the past 40 years, the state relied on three major taxes — retail sales and use, personal income, and corporation — to generate at least 80 percent of general revenues. The breakdown of tax proceeds varies from year to year, depending on changes in taxpayer behavior, the economy, and state policy. However, over time, the state has come to rely most heavily on the personal income tax (PIT).

In the 1976-77 fiscal year, the largest single revenue source was the sales tax, generating 38 percent of all state revenues. But the share of sales tax has been falling and is expected to add up to only 28 percent of overall revenue in the 2015-16 fiscal year. In total, since the 1976-77 fiscal

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How Is the Affordable Care Act Changing Enrollment and State Health Costs?

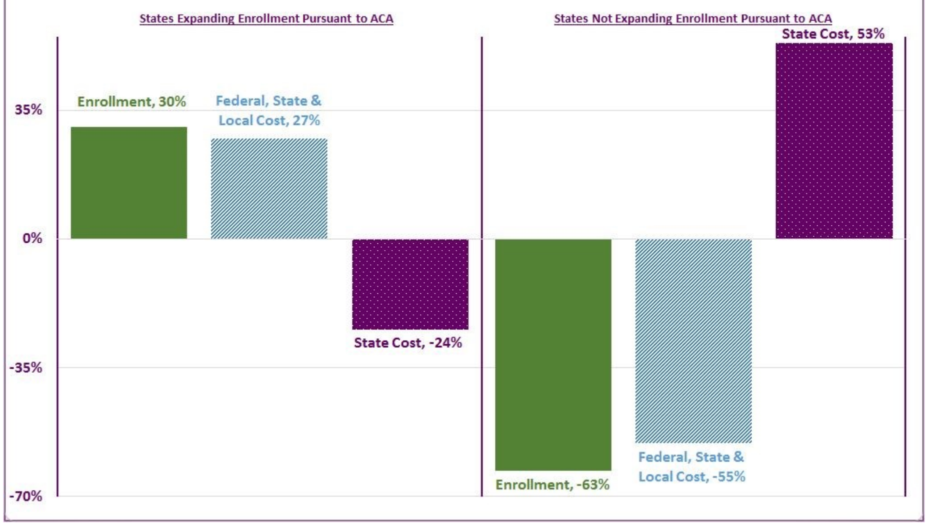
As part of the Affordable Care Act (ACA), Congress authorized states to expand enrollment in Medicaid in 2014. States using this authorization will receive more generous federal medical reimbursements. Twenty-nine states used this authority in fiscal year 2015-16.

ACA Facilitates a Cost Shift to Federal Government. Nationwide, total Medicaid costs are expected to rise by 13.9 percent in 2015-16. This increase, according to the Kaiser Commission on Medicaid and the Uninsured, results from higher enrollments (increasing by 13.8 percent), care provider reimbursement rates, and prescription costs.

State costs rose at a much smaller rate of 4.5 percent. Not all states are experiencing enrollment and cost pressures in the same way. The commission highlighted the differences between the states that expanded enrollment using the ACA authority and those that did not.

Enrollment. For states using the ACA authority, enrollment rose by 18.0 percent, about one-third higher than the national average. Other states expect enrollment to rise by 5.1 percent, nearly two-thirds lower than the national average. In California, a portion of the new Medicaid enrollment will reduce caseload from state-only or county programs (like general assistance).

Figure 3
The State Cost of Providing Medicaid Under the Affordable Care Act
A Comparsion of Patterns in Medicaid Spending among States
Growth Relative to National Average for Enrollment, Overall Medicaid Cost & State Cost
Source: Kaiser Commission on Medicaid and the Uninsured



Total and State Costs. The 29 states that used the ACA authority expect costs to rise by 17.7 percent (27 percent more than the national average). The other states estimate total costs to rise by about 6.1 percent, about half the national average.

Not all states are experiencing enrollment and cost pressures in the same way...

The difference for state costs is the most dramatic: Despite higher enrollments and total Medicaid costs, the 29 expanding states report that their costs will rise by only 3.4 percent — or about three-quarters of the national increase. Meanwhile, states that did not adopt the expansions expect their Medicaid costs to rise by 6.9 percent, or about 50 percent more than the national average.

At least in the short term, it appears that the ACA facilitated a major shift in health costs from states to the federal government. Figure 3 shows the relative rates of growth in enrollment, overall Medicaid costs, and state Medicaid costs for both the expansion and non-expansion states.

(TAX EVOLUTION, Continued from Page 3)

year, the sales tax generated about one-third of all state revenues. During the same time, the share for the corporation tax fell from 15 percent to about 7 percent of all state collections.

Meanwhile, the share of taxes generated by the PIT rose from 33 percent in 1976-77 to 56 percent in the current year. Over the last 40 years, the PIT accounts for about 44 percent of total revenues. These changes have implications for annual budget policy. For example:

- The state's increased reliance on the income tax can make state revenue collections more dependent on high-income taxpayers, who pay a disproportionate share of the PIT.

- The greater reliance on the income tax may make the state more vulnerable to changes in variables such as employment rates and "unearned income" such as investment gains.

- The sales tax still accounts for more than a quarter of the major taxes, so its annual performance remains significant to the state's fiscal condition. When Californians cut back on their retail shopping — as they did in the 2007-08 fiscal year — state revenues will show the effect. At the beginning of the Great Recession, sales tax revenues dropped more precipitously than did PIT revenues.

- Revenue performance among the major taxes is not synchronous. A mix of tax revenues may moderate year-over-year revenue volatility.

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declining from a 3.6 percent share among the poorest Californians to a 1.6 percent share among the richest.

Assessing and Modifying the Tax Structure as a System. The figure shows that, taken together, California's major taxes fall most heavily on the top 1 percent and the bottom 20 percent, who pay 11.3 percent and 10.5 percent of their income, respectively. The more progressive impact of the personal income tax moderates the less progressive impact of other taxes. These offsetting effects suggest that policymakers could consider balancing the progressivity of one tax by adjusting the burden imposed by others.

At the same time, the volatility (the year-over-year rate of change) of the tax system is also a concern. Some policymakers argue that the volatility has led to erratic or unsustainable budget decisions since 2000-01. Though volatility is most often attributed to the performance of the PIT, changing the PIT is not the only available solution. Perhaps volatility, like progressivity, can be addressed through changes to other aspects of the tax structure and to budget practices. In Gordy's terms, we may be able to eat our sandwich while enjoying the new 45.

P.O. Box 942850
Sacramento, California 94250-5872
(916) 445-2636

sco.ca.gov

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