A MONTHLY REPORT FROM STATE CONTROLLER BETTY T. YEE

California Fiscal Focus

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June Cash Report Shows Another Surge to End 2014-15 Fiscal Year

California ended the fiscal year with another unexpected revenue surge in June, with total General Fund receipts surpassing the Governor's May estimates by $859.4 million, according to State Controller Betty T. Yee's monthly report of California's cash balance, receipts, and disbursements.

For the second year in a row, the General Fund ended with a positive cash balance.

June capped a 12-month boom in state revenues, driven largely by personal income tax. For the fiscal year ending June 30, total revenues for the General Fund (the source of most state spending) were $6.8 billion more than anticipated a year ago, when the 2014-15 budget was enacted. This was 6.4 percent higher than projected. Compared to the previous fiscal year, California revenues were $12.7 billion higher, a bump of 12.5 percent.

June's revenues easily outstripped projections included in the Governor's revised budget released only a month earlier. Personal income tax led the way, coming in $762.5 million higher than anticipated in the May Revision. Much of this windfall was split almost evenly between taxes withheld from workers' paychecks and estimated payments. Second-quarter estimated payments were due June 15.

Retail sales and use taxes exceeded May Revision estimates by $31.4 million, or 1.5 percent. Of the state's three major revenue sources, only corporation taxes fell short in June, coming in $9.7 million lower than expected.

For the entire 2014-15 fiscal year that ended June 30, personal income tax likewise led the surge, accounting for $5.8 billion of the $6.8 billion windfall, compared to 2014-15 budget estimates. Corporation taxes beat projections by $1.6 billion, while retail sales and use taxes for the year came in $395.9 million lower than expected.

Of the $12.7 billion revenue increase over the previous year, $10.1 billion, or 80 percent, consisted of personal income taxes. California's high revenue volatility is tied to swings in personal income tax, especially on capital gains.

The state disbursed $16.2 billion more in the 2014-15 fiscal year than in the previous year. This amount included $9.5 billion for local assistance – mostly K-12 school spending set by Proposition 98 – and $4 billion for state operations.

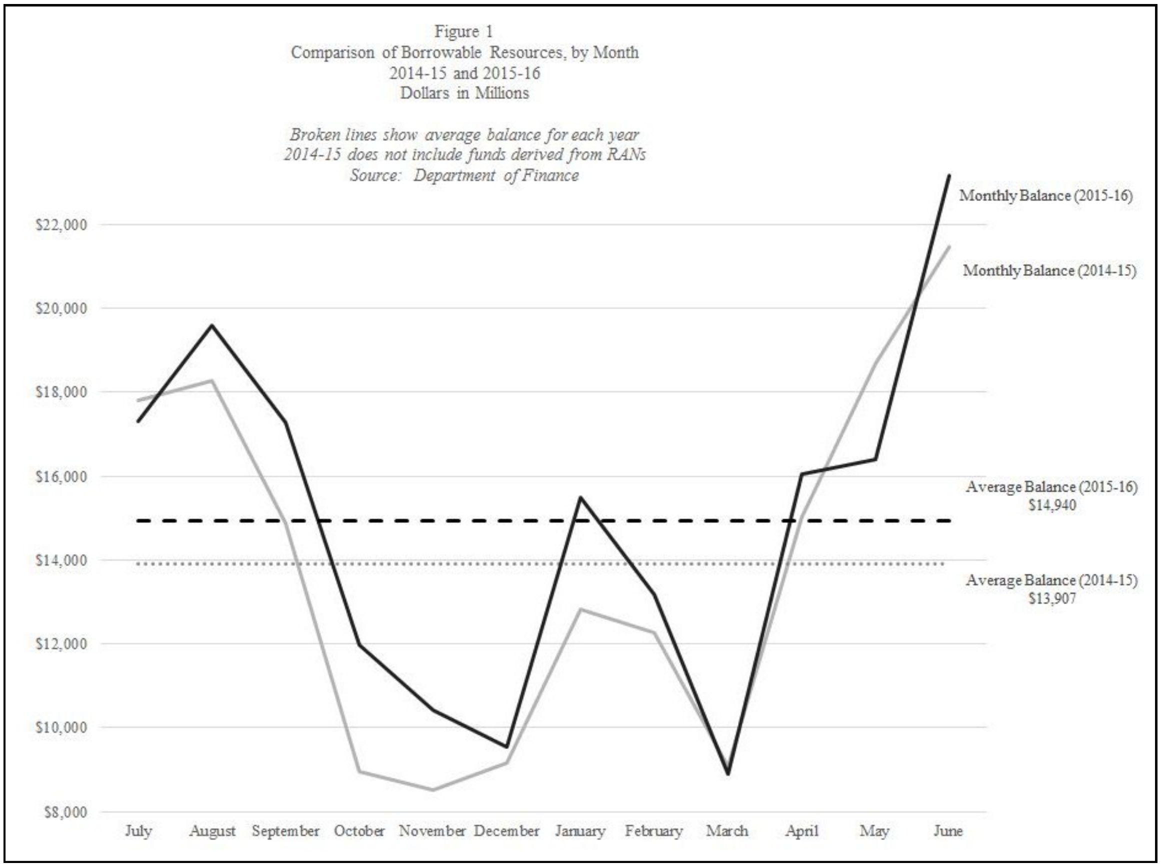
On June 22, the state repaid $2.8 billion in Revenue Anticipation Notes (RANs) from summer 2014. The Controller pursues external borrowing when cash available from special funds is projected to fall short of General Fund obligations. The Controller may ask the Treasurer to sell short-term RANs that are repaid by the end of the fiscal year.

As of June 30, the amount available for internal borrowing from the state's own funds was $28.3 billion, exceeding the May Revision estimate by $1.7 billion.

For more details, read the financial statement.

Inside this issue

Cash Forecast: Rising Confidence in State Finances and Fiscal Management



According to legendary French director Francois Truffaut, "Making a film is like a stagecoach ride in the Old West. When you start, you are hoping for a pleasant trip. By the halfway point, you just hope to survive."

Making movies and managing state finances are two very different enterprises but sometimes, life in California imitates the movies.

During the global credit crunch, the state's cash position was so stretched that some fiscal managers could be excused for wanting to just "survive" the daily struggle to match inflow and outflow. However, fiscal managers dug in and used that time to hone cash management practices. So now state finances are on the mend and the state's cash position is strong. And getting stronger.

Figure 1 shows resources available from General Fund reserve accounts and unused special-fund balances – the money the state can use to pay bills during times when expenditures temporarily outstrip revenues. (The balances do not include proceeds of a $2.8 billion revenue anticipation note (RAN) sold in summer 2014 and paid off in June 2015. The current year anticipates no RAN sales.)

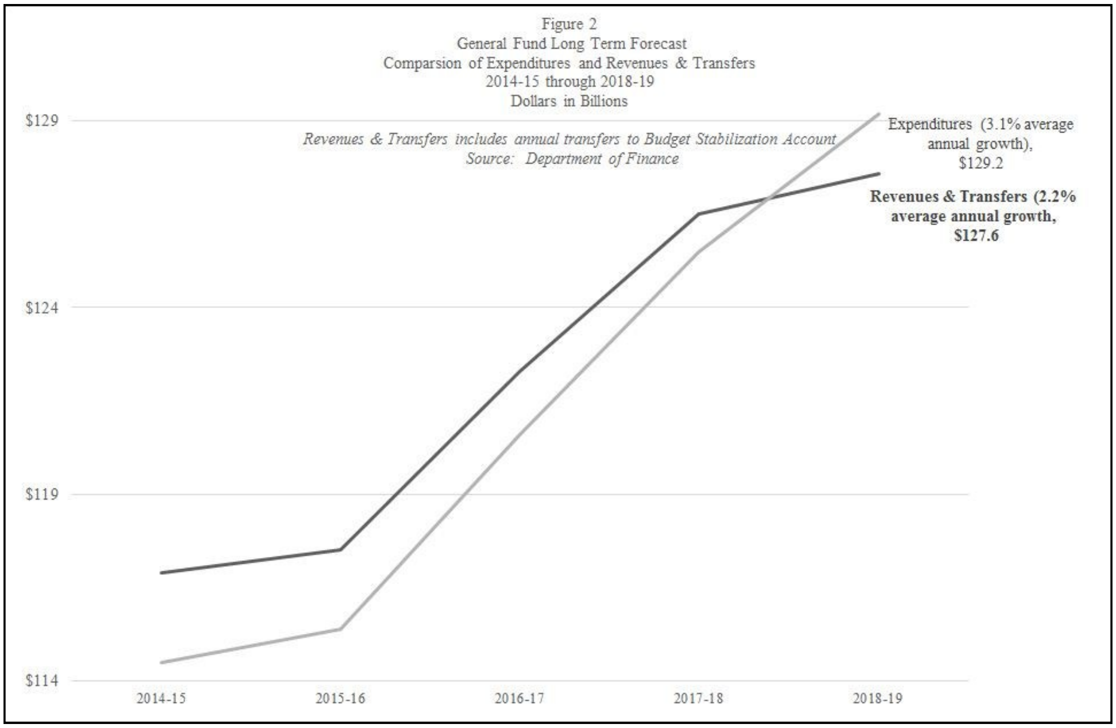
The state started the year with borrowable resources of about $17.8 billion. The amount of borrowables eroded throughout the first half of the year, dwindling to around $9 billion for the three-month period of October through December 2014. Balances improved in the second half of the fiscal year, with the amount of borrowable resources rising to about $21.5 billion in June 2015.

The Governor's Department of Finance (DOF) expects the borrowable balances to show a similar monthly pattern in the current year, with an estimated $17.3 billion balance growing by the end of the year to about $23.2 billion. DOF expects the state to reach its lowest point in March 2016, when there could be about $8.9 billion in borrowable resources.

The balances identified in the 2015-16 line surpass the expected monthly balance for the previous year in every month but May. In fact, DOF expects that over the coming year, the average borrowable balance will rise from $13.9 billion in FY 2014-15 to $14.9 billion in FY 2015-16. These healthy monthly balances and the rising average borrowable balance indicate a strengthening cash position for the state.

Perhaps California can expect a pleasant cash trip in 2015-16 after all.

Godot and Recessions: What to Expect in the Next Few California Budgets



Sometimes fiscal managers can seem a little like playwright Samuel Beckett's Estragon, pacing an apocalyptic stage and waiting for Godot—or the next recession—to show up. The good news: the state's finances are healthy for the foreseeable future, at least as long the recession stays off-stage.

In preparing the annual state budget, the Governor's Department of Finance (DOF) estimated General Fund resources and expenditures for the five years starting in FY 2014-15. For this estimate, the department assumed continuation of policies established in the current budget and steady economic growth.

Resources in Figure 2 are the sum of estimated carry-over surpluses (deficits), revenues and transfers for each year. The line does not include resources transferred to the reserve (sometimes referred to as the Budget Stabilization Account). Overall, resources are expected to grow from $116.9 billion in FY 2014-15 to $127.6 billion by FY 2018-19, representing a roughly 2.2 percent average annual growth rate.

Estimated expenditures are projected to grow from $114.5 billion in FY 2014-15 to $129.2 billion in FY 2018-19. DOF expects expenditures to grow at about 3.1 percent each year on average for the period.

As displayed in the figure, DOF expects resources to exceed expenditures for all years until FY 2018-19 when spending should surpass revenues by $1.6 billion.

As the current economic expansion runs its course, fiscal managers have begun to warn about a coming slowdown, even as they are unable to identify when the dip in the business cycle will occur.

Fiscal managers know that they are unlikely to predict the timing and severity of downturns in the business cycle. But they know that when the economy cools, forecasted revenues can vanish. For example, in November 2014, the state's Legislative Analyst predicted an "economic slowdown" for 2016 and 2017. The LAO found that if the growth rate in personal income were reduced by 30 to 40 percent for those two years, General Fund resources could fall by $2.6 billion in the 2015-16 fiscal year. In subsequent years, annual revenues could fall by as much as $9.9 billion.

In its "hypothetical scenario," the office estimated that the General Fund could lose $38.4 billion over five years.

Should Californians worry? Assuming no recession and no expansion of state policy, most estimates show that the state's fiscal condition will remain healthy at least until 2019. With memories lingering of the deep cuts to accommodate the effects of the Great Recession, one understands the cautions of fiscal hawks.

A ‘Failed State’ No Longer, California’s Fiscal Health Stronger than Most

In 2008 and 2009, pundits pooh-poohed the prudence of California’s financial management. Most commentators deemed the state’s finances a wreck, while some went so far to say that California was a doomed and “failed state.”

Things change.

In the spring, the ratings agency [Standard and Poor’s published its report]() on the current condition of all 50 states. More than half of all states were showing signs of fiscal stress, as their revenues were not recovering as fast as the economy. The stress is evident in large and small states and across every region. California was conspicuously missing from the ranks of the distressed.

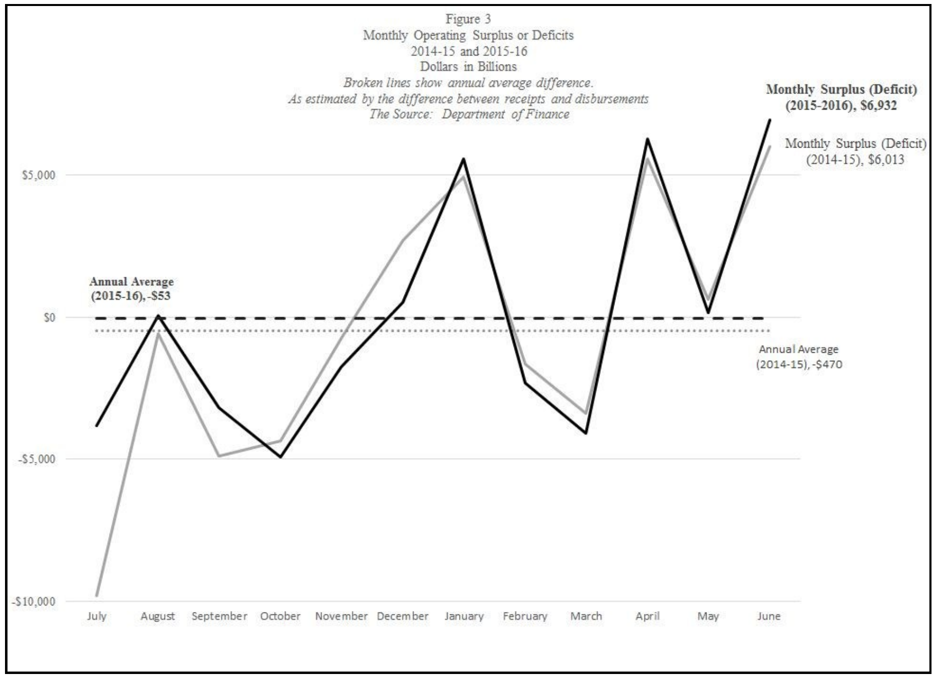


Figure 3
Monthly Operating Surplus or Deficits
2014-15 and 2015-16
Dollars in Billions
Broken lines show annual average difference.
As estimated by the difference between receipts and disbursements
The Source: Department of Finance

In another recent report, [the Rockefeller Institute]() assessed state fiscal health over the seven years since the start of the recession. The institute notes that after adjusting for inflation, 21 states have lower revenue totals now than they did at the start of the recession (this may be accounted for in part by lagging employment in at least 13 states.) The report notes that sales tax revenues have been the “weakest” tax source, but that income tax revenues also lag. According to the report, capital gains are two-thirds of their peak in 2007.

On the spending side, the report notes significant changes in the character of state and local spending. Relative to 2007 spending, inflation-adjusted spending on “social benefits” increased by 29 percent, while spending on net investment (capital spending after accounting for consumption or depreciation) fell by 55 percent. According to the report, 80 percent of social spending is associated with Medicaid. The report says that consumption spending, which includes spending on compensation and general government, remained steady over the period.

Yet California shows fiscal strength during this recovery. Adoption of the state’s FY 2015-16 budget marks progress on timeliness, balance and reserves. For example:

On-Time Budget. Despite substantive differences between the governor and the legislature about how to spend rising surpluses, they negotiated a spending plan in June. The Governor signed the budget before the start of the fiscal year.

Improved Monthly Operating Balance. Figure 3 shows the difference between revenues and spending, as estimated by DOF for last year and the current year. For both 2014-15 and 2015-16, there is a consistent pattern of cash deficits in the first and third quarters, but cash surpluses around the middle and end of each year. These estimates indicate that the state’s cash surplus in the last month of the fiscal year will improve from $6.0 billion in 2014-15 to $6.9 billion in 2015-16.

The average monthly balance was -$470 million for last year and -$53 million for the current year. The shrinking difference indicates that the state’s monthly accounts are improving, as inflows better match outflows during the entire year. Overall, the state’s cash flow position is expected to improve by an average of $400 million in each month of the coming year.

Budget Surpluses in the Future. An operating surplus is the difference between resources and expenditures over a given period. Depending on the timeframe, the operating surplus can be a measure of sustainability and fiscal balance. For the foreseeable future (as

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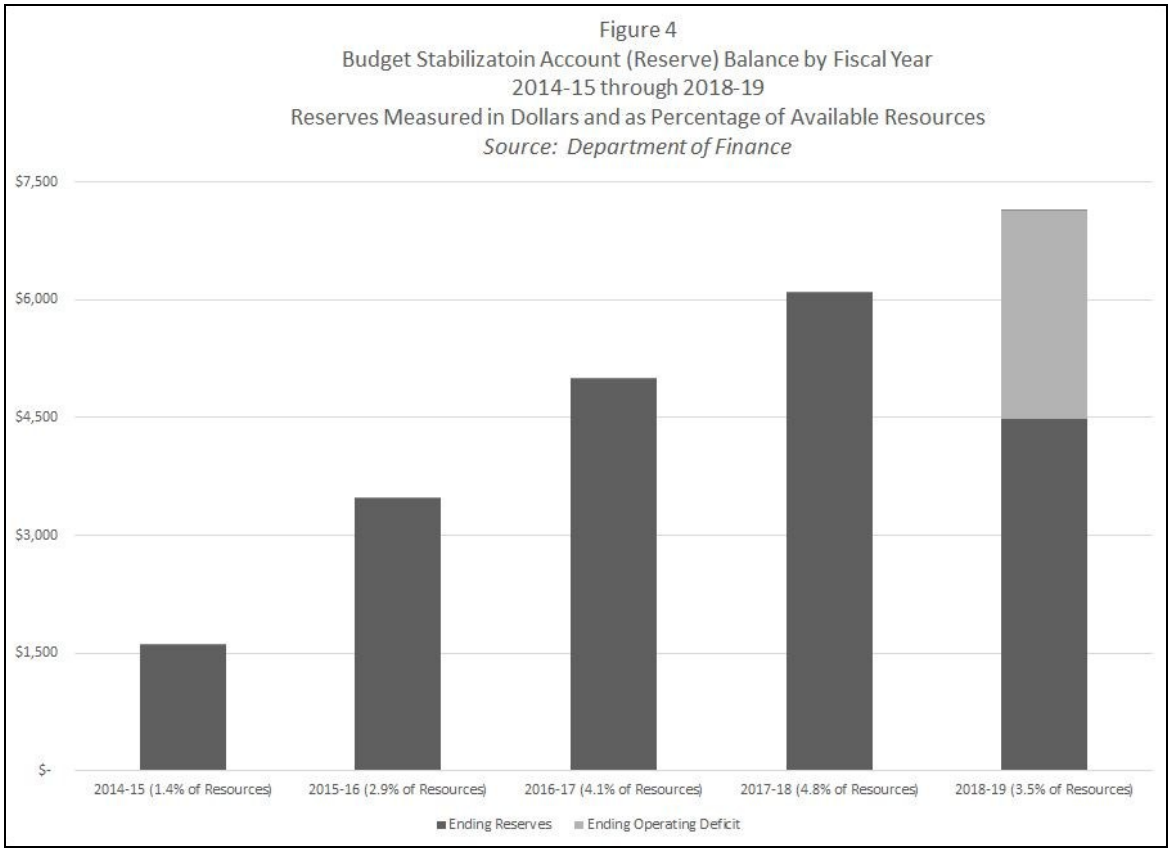
displayed in Figure 2) – and barring national or international economic downturns – the state expects to run annual operating surpluses through 2017-18.

Reserves May Peak at Nearly 5 Percent of Revenues. DOF estimated the reserve balance for the five years starting in 2014-15, with the balance rising from $1.6 billion (about 1.4 percent of annual resources) in 2014-15 to $6.1 billion (about 4.8 percent) in 2017-18.

The reserve is sometimes referred to as the Budget Stabilization Account (BSA). Although the estimated balance is supposed to rise to $7.1 billion in 2018-19, the state is likely to use some of the reserve to cover an operating deficit of about $2.6 billion. By allocating $2.6 billion from the BSA to the General Fund, the reserve balance would fall to about $4.5 billion (3.5 percent of available resources).

This trend of a growing reserve, as measured not only in dollar levels but as a percentage of the state budget, shows improving fiscal health in California.

Since the start of the recession in late 2007, most states have faced severe and sustained fiscal strains. Many were helped by the federal revenue sharing associated with the American Recovery and Reinvestment Act, and by their own actions to reduce spending and increase taxes. Most of these measures were temporary. California's fiscal actions since the recession appear to have been more substantive and longer lasting than those of numerous other states.



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