A MONTHLY REPORT FROM STATE CONTROLLER BETTY T. YEE

California Fiscal Focus

Volume 1, Issue 9

March 2016

CA Controller's February Cash Report Shows Revenues Surpassing Estimates

February state revenues exceeded projections in Governor Jerry Brown's proposed 2016-17 budget by $439.1 million, with the personal income tax and the corporation tax both beating forecasts, State Controller Betty T. Yee reported.

"It is encouraging to see that revenues remain strong," said Yee, the state's chief fiscal officer. "At the same time, we must be prudent in setting aside money during the good times to bolster our fiscal position for the inevitable next downturn."

Total revenues for February of $6.85 billion surpassed projections in the budget for the coming fiscal year, released by Gov. Brown in early January, by 6.8 percent. Personal income tax revenues of $2.88 billion beat estimates by $304.7 million, or 11.8 percent, while corporation tax revenues of $189.5 million were more than 10 times what was expected. For the second month in a row, corporation tax refunds were lower than expected, increasing overall collections.

Of the state's three major revenue sources, only the retail sales and use tax underperformed. Revenues of $3.66 billion fell short by $37.6 million, or 1.0 percent.

For the 2015-16 fiscal year that began July 1, revenues of $70.96 billion exceeded the governor's budget by $293.8 million, or 0.4 percent, with the personal income tax and the corporation tax both beating projections and the sales tax falling short by $199.7 million, or 1.2 percent.

Total revenues are surpassing estimates made when the budget was approved last summer by $1.38 billion, or 2.0 percent. Compared to the 2014-15 fiscal year, revenues are higher by $4.61 billion, or 6.9 percent.

This month's edition of the Controller's *California Fiscal Focus* looks at the potential impact on different income groups of a sales tax on services.

The state ended the month of February with $10.41 billion in outstanding loans, which was $179.9 million less than expected in the governor's proposed budget and $1.09 billion less than projected in the budget signed last July.

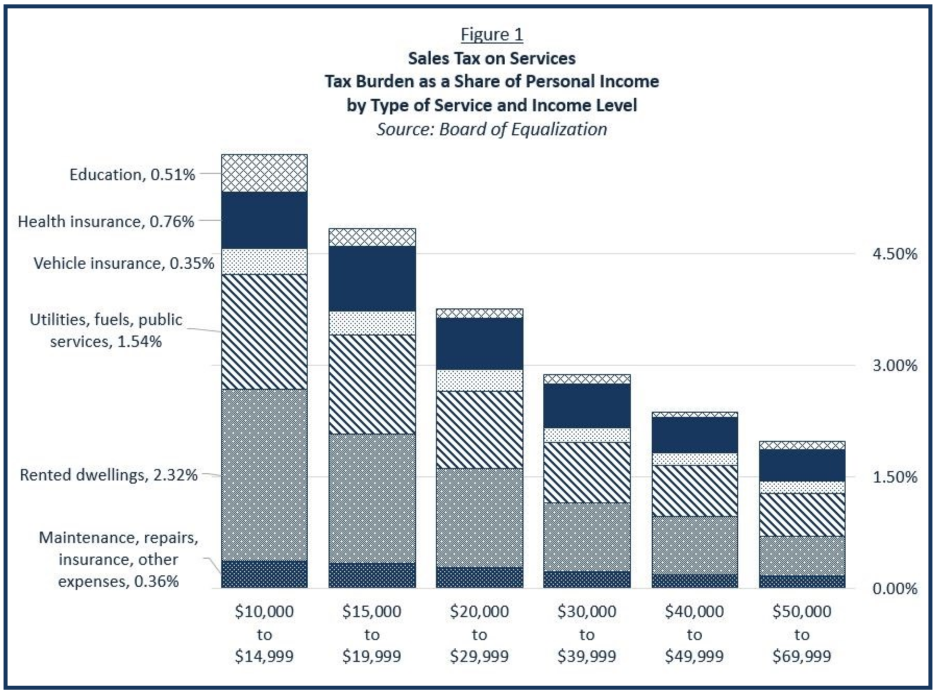
For more details, read the monthly cash report.

Inside this issue

How Would a Sales Tax on Services Affect the Tax System's Overall Progressivity?

State law imposes a sales tax on the "final transfer of tangible personal property" and applies to most retail transactions. The law exempts certain basic necessities, including food and prescription drugs.

Even so, many consider the current sales tax to be largely regressive. The value of goods purchased and subject to tax does not rise with incomes. As a result, low- and moderate-income taxpayers spend a greater share of their income on retail goods and thus on the retail sales and use tax.



Too Narrow a Tax Base?

The sales tax — once the single largest source of General Fund revenue — is now a distant second place to the personal income tax.

Critics of the present tax system worry that the sales tax base is too narrow and fails to reflect retail purchase patterns. They note the state does not tax services that can be purchased in lieu of "tangible personal property." (For example, the purchase of a lawn mower is subject to sales tax, but the purchase of a "mow and blow" service is not.)

Through the years, the Legislature considered imposing the sales tax on a limited number of services, such as dry cleaning, movie tickets, and admission to museums.

Supporters of the current system note that the state and local governments already impose taxes on income associated with services. The personal income tax applies to income earned by providing services. The state corporation tax, the emergency telephone users surcharge, and the local transient occupancy tax all generate revenue from service providers.

***Would a Tax on Services Moderate the Regressive Effects of the Sales Tax*?**

Some believe that consumers of services tend to have higher incomes, whereby extending the sales tax to certain services might shift the tax burden to higher-income taxpayers.

Recent calculations by the Board of Equalization (BOE) suggest that service taxes could make the system more regressive, depending on how the tax is imposed and how consumers respond.

The BOE calculations started with federal data on how Americans allocate their discretionary income, sorted by income class. Looking just at the households with incomes between $10,000 and $70,000 per year, BOE identified spending on services that are not currently subject to sales tax including education, housing, and entertainment.

BOE then applied the statewide sales tax rate to each of these expenditures by class and calculated the tax impact.

If taxpayers continued to spend as they did prior to the tax on services, the cumulative effect would fall most heavily on lower-income taxpayers.

(See PROGRESSIVITY, page 3...)

Department of Finance Expects Disbursements to Exceed Receipts for 8 Months

The Controller monitors monthly cash flows to keep track of deficits and surpluses that can add up to billions of dollars. For the 12 months starting July 1, 2016, the Governor's Department of Finance expects:

Eight months will have deficits, with September running the largest deficit of about $7.9 billion. October and March will also run large deficits of $4.8 billion and $4.6 billion respectively.

Four months will have surpluses, with the two biggest being April ($6.0 billion) and June ($8.2 billion).

The year starts with a $1.0 billion deficit and ends with a cumulative deficit of about $6.9 billion.

The cumulative deficit bottoms out in March, with a $20.4 billion running cash deficit. This deficit is expected to be covered by internal borrowing only: $28.2 to $31.3 from Special Funds, $1.1 to $2.2 billion in reserves from the Special Fund for Economic Uncertainties, and $3.5 to $8.0 billion in reserves from the Budget Stabilization Account.

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New Health Finance Package

On March 1, 2016, Governor Brown signed AB 133 (Committee on Budget), AB 1XX (Thurmond), and SB 2X (Hernandez) in response to federal rule changes that put about $1 billion of Medi-Cal reimbursements at risk.

With these bills, the state will continue to receive its full federal reimbursement. The package directs approximately $300 million in new funding to help persons with developmental disabilities.

(PROGRESSIVITY, continued from page 2)

Taxpayers earning between $10,000 and $15,000 a year would pay about 6.0 percent of their incomes for taxes on services, while taxpayers making between $50,000 and $70,000 would likely pay around 2.0 percent (see Figure 1).

These findings indicate that a service tax would need to be carefully constructed to mitigate disproportionate effects on lower-income taxpayers. In particular:

- If rents and utilities were exempted, the tax burden would be cut by more than half.
- Lower-income taxpayers would pay a disproportionate amount of their income for education and health insurance.
- The least regressive category appears to be maintenance, repairs, and non-health insurance.

Some of these regressive aspects could be mitigated with offsetting refundable credits administered through the personal income tax law.