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Summary Analysis

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State Finances in February 2013

February 2013 compared to monthly estimates in the 2013-14 Governor's Budget	February 2013 monthly totals compared to February 2012
<p>Total Revenues:</p> <p> -\$1.8 million (0.0%)</p>	<p>Total Revenues:</p> <p> \$899.6 million (20.5%)</p>
<p>Sales Tax:</p> <p> \$363.5 million (13.8%)</p>	<p>Sales Tax:</p> <p> \$567.3 million (23.4%)</p>
<p>Income Tax:</p> <p> -\$441.2 million (-18.6%)</p>	<p>Income Tax:</p> <p> \$267.7 million (16.1%)</p>
<p>Corporate Tax:</p> <p> \$26.3 million (22.3%)</p>	<p>Corporate Tax:</p> <p> \$59.5 million (70.1%)</p>

What the Numbers Tell Us

Total February revenues came in on target with estimates contained in the 2013-14 Governor's Budget that was submitted in January. Better-than-expected showings for corporate and retail tax receipts offset a shortfall in personal income taxes. Total revenues were also up sharply over this time last year. (See Figure 1.)

The corporate tax numbers were a particular surprise since they have generally been running below expectations during the past two years.

February's miss in personal income tax receipts relative to the Governor's Budget reflected the large number of tax refunds that went out in February instead of January, when they were originally expected to be sent.

Congressional delays in deciding on taxes until the end of 2012 and resulting confusion may have caused many individuals to delay filing returns. It remains to be seen

What's Happening With Corporate Tax?

Three tax sources dominate California's General Fund revenues: personal income, sales, and corporate. Let's take a closer look at the corporate tax, the least productive of the three main taxes.

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What the Numbers Tell Us

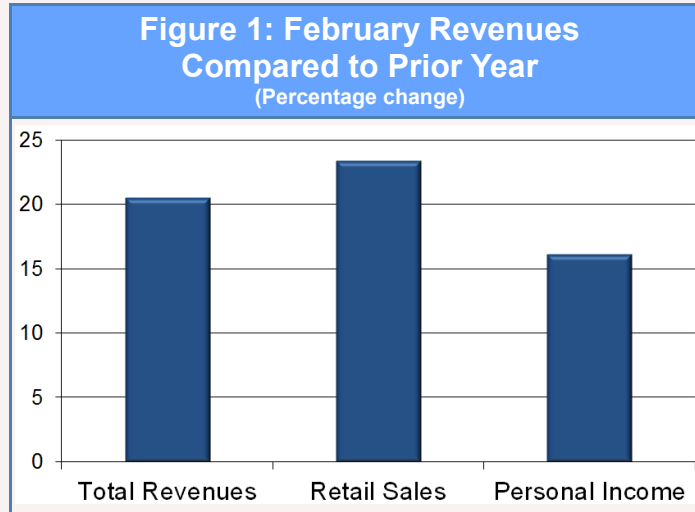
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whether the economy will retain enough vigor to support continued outperformance in terms of corporate and retail sales taxes.

With two-thirds of the fiscal year now on the books, what is the report card on taxes, spending, and the deficit? The answer is better than estimates contained in the Governor's latest budget. Total receipts for the period starting July 1, 2012, through February 28, 2013, were \$4.5 billion above expectations, while outlays were \$0.5 billion less than anticipated. The result was that the deficit was \$5.0 billion less than projected although the eight-month total shortfall still equaled \$6.6 billion.

The eight-month \$6.6 billion deficit plus the \$9.6 billion negative balance carried over from the prior fiscal year meant that there was an outstanding loan balance of \$16.2 billion. That balance was financed through \$10 billion of external borrowing from banks and investors and \$6.2 billion of borrowing from other state funds.

Total receipts so far in the fiscal year were up by an impressive 13%, with personal income taxes providing the greatest thrust. Spending is holding even with the prior year's total with a 6% drop in the cost of general state operations offset by a relatively modest 0.5% rise in lo-



cal assistance for schools, health care, social services, and other activities.

While the results so far for the first two months of calendar 2013 are encouraging, it is still a time to be cautious. The economy could lose momentum, which could adversely impact tax receipts even with the effect of higher tax rates. It will also be critical that spending remain restrained to keep the State on a track toward fiscal health.

Table 1: General Fund Receipts

July 1, 2012 – Feb. 28, 2013 (in Millions)

Revenue Source	Actual Revenues	2013-14 Governor's Budget		2011-12 Year-To-Date	
		Estimate	Actual Over (Under)	Actual	Actual Over (Under)
Corporation Tax	\$2,292.8	\$2,255	\$37.8	\$3,346.2	(\$1,053.4)
Personal Income Tax	\$40,795.3	\$36,482.9	\$4,312.5	\$31,345.5	\$9,449.9
Retail Sales and Use Tax	\$12,963.1	\$13,183.6	(\$220.4)	\$13,027.9	(\$64.8)
Other Revenues	\$2,709.9	\$2,555.4	\$154.6	\$2,883	(\$173.1)
Total General Fund Revenue	\$58,761.2	\$54,476.8	\$4,284.4	\$50,602.6	\$8,158.6
Non-Revenue	\$2,146.5	\$1,951.1	\$195.4	\$3,458	(\$1,311.5)
Total General Fund Receipts	\$60,907.8	\$56,427.9	\$4,479.9	\$54,060.6	\$6,847.1

What's Happening With Corporate Tax?

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Some commentators have begun to fear that corporate tax is on a long, slow fade, like the Wonderland cat. In 2000-01, the tax generated about \$5.3 billion. Collections rose steadily until 2006-07, when they peaked at \$11.8 billion, representing an average annual increase of about 11%. However, collections fell off significantly in the following years — falling to about \$7.5 billion by 2011-12. (See Figure 2.)

The figure also shows the yield of the tax — expressed as an index to the economy — follows a similar performance pattern over the 13 years. Starting at a low of about 0.47% of personal income in 2001-02, the tax generated a yield of about 0.79% in 2007-08, but fell to about 0.46% before the tax increase.

What can account for the decline of the tax yield? Tax experts are reviewing the data, but at least three explanations can be explored:

⇒ **Rising Inventory of Net Operating Losses (NOLs)?** The tax board estimates that the inventory of NOLs was about \$310.6 billion at the beginning of 2007. By the end of the 2011 tax year, corporations had added more than \$400 billion to their carry-forwards, but subtracted less than \$30 billion. (See Figure 3.) At the beginning of 2011, the carry-forward totaled more than \$640 billion. After the net additions

to the inventory for 2011, Californian corporations have an inventory of roughly \$700 billion in NOLs that they could deduct from future tax liabilities. This suggests that even as corporations begin to have tax liabilities, some will have large outstanding NOLs that can reduce their tax payments.

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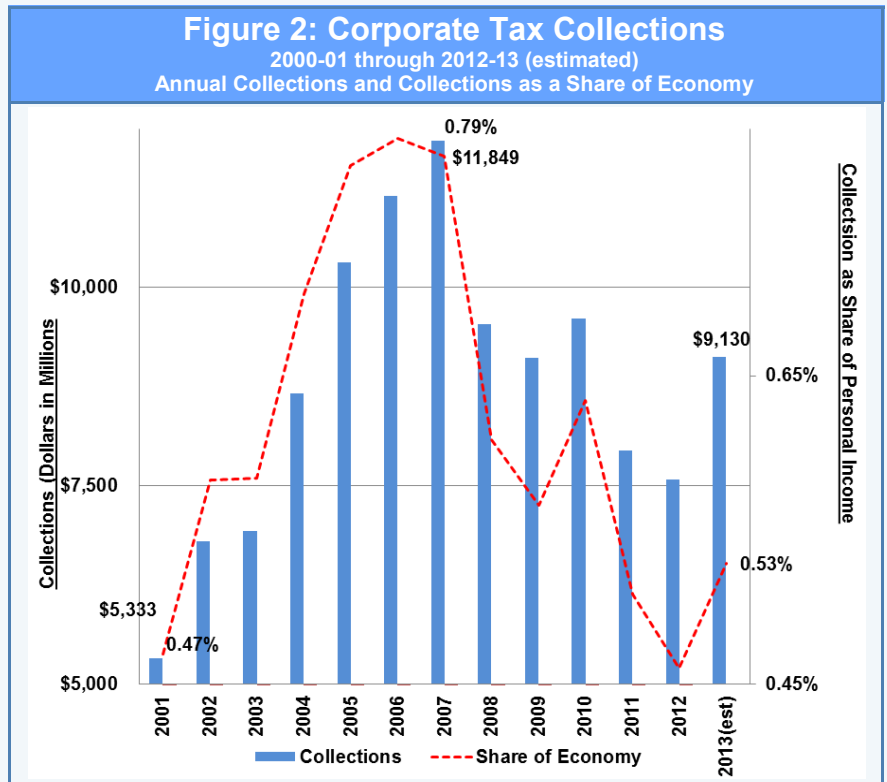


Table 2: General Fund Disbursements

July 1, 2012 – Feb. 28, 2013 (in Millions)

Recipient	Actual Disbursements	2013-14 Governor's Budget		2011-12 Year-To-Date	
		Estimates	Actual Over (Under)	Actual	Actual Over (Under)
Local Assistance	\$51,493.1	\$51,764.3	(\$271.3)	\$51,228.3	\$264.8
State Operations	\$15,333.8	\$15,554.6	(\$220.8)	\$16,280.9	(\$947.1)
Other	\$709.3	\$764.2	(\$54.9)	\$4.3	\$705
Total Disbursements	\$67,536.2	\$68,083.1	(\$546.9)	\$67,513.4	\$22.7

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⇒ **Shrinking Tax Base?** In addition to NOL changes, the Legislature and voters have adjusted the tax base since 2006. Most notably, the Legislature contracted the base when it allowed elective use of the single sales tax factor, a contraction the voters reversed in 2012 with adoption of Proposition 39. At the same time, it expanded on a net basis the value of tax preferences for tax years beginning in 2009-10. The Franchise Tax Board identified six statutes that changed tax preferences. In December 2012, the Franchise Tax Board estimated the effect of legislation affecting corporate tax liabilities since 2009-10. On a net basis for the period 2009-10 through 2013-14, these changes reduced corporate tax payments by \$2.5 billion.

⇒ **Signs of the Times?** Ernst and Young, the accounting firm, recently published a survey of state corporate income taxes and determined that most states are experiencing dramatic reductions in their receipts since 2007. According to the study, 47 states (including the District of Columbia) reported levying a corporate tax. Taken together, these states reported that collections had dropped an average of 28% between 2006-07 and 2007-08. California's reduction,

**Figure 3: Net Operating Losses
Inventory Changes**

2007 through 2011 (Dollars in Millions)

Year	NOLs Carried Forward	NOLs Deducted	New NOLs
2007	\$310,578	-\$13,630	\$69,408
2008	\$366,356	-6,333	\$108,325
2009	\$468,348	-3,280	\$111,378
2010	\$576,445	-3,129	\$69,516
2011	\$642,832	-\$3,130	\$60,216
Totals	\$2,364,559	-\$29,502	\$418,843

about 18 percent according to the study, was below average.

The corporate tax is unlikely to fade like the Cheshire Cat. Rather, it probably is experiencing one of its cyclical contractions. As the Dormouse might say, there is "much of a muchness" left in the tax.

California Economic Snapshot

New Car Registrations	179,185 4 th Quarter 2011	232,512 4 th Quarter 2012
Median Home Price (for Single-Family Homes)	\$236,000 In January 2012	\$290,000 In January 2013
Single-Family Home Sales (Houses and Condos)	28,111 In January 2012	28,871 In January 2013
Foreclosure Filings (Notices of Default)	61,517 4 th Quarter 2011	38,212 4 th Quarter 2012
Payroll Employment (Professional & Business)	2,164,600 In December 2011	2,213,400 In December 2012
Newly Permitted Residential (Single and Multifamily) Units	2,116 In January 2012	4,972 In January 2013

Data Sources: New Car Dealers Association, DataQuick, California Employment Development Department, Census Bureau