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California State Controller's Office

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State Finances in April 2013

April 2013 compared to monthly estimates in the **2013-14 Governor's Budget**	April 2013 monthly totals compared to **April 2012**
Total Revenues: -$119.9 million (-0.8%)	**Total Revenues:** $5.4 billion (55.9%)
Sales Tax: $113.4 million (26.6%)	**Sales Tax:** $166.2 million (44.5%)
Income Tax: -$275 million (-2.2%)	**Income Tax:** $5.3 billion (73.9%)
Corporate Tax: $6.6 million (0.5%)	**Corporate Tax:** $38.3 million (2.8%)

Why Do Golden State Revenues Swing So Drastically?

The State's revenue streams do not grow at a steady, easily-predicted pace. While revenues trend with the business cycle, State revenues tend to exaggerate changes in the economy. That is, revenues accelerate faster than the

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What the Numbers Tell Us

April was another positive month for California's economy and fiscal picture. Revenues came in close to expectations, although a cautious stance remains warranted going forward.

Relative to estimates provided in January as part of the Governor's 2013-14 Budget, total revenues were down $119.9 million, or 0.8%, shy of estimates. (See table at left.) Because of its dominance as a driver of State revenues, a miss in personal income tax receipts relative to projections was the major culprit. These receipts were $275 million below, or 2.2%, estimates. Final returns filed in April were somewhat lower than estimated, while tax refunds issued during the month were higher.

In contrast, corporate taxes continued to improve and beat projections. Retail sales were the primary boost as they bested projections by $113.4 million, or 26.6%, after falling short in March.

The impact of California's recover-

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What the Numbers Tell Us

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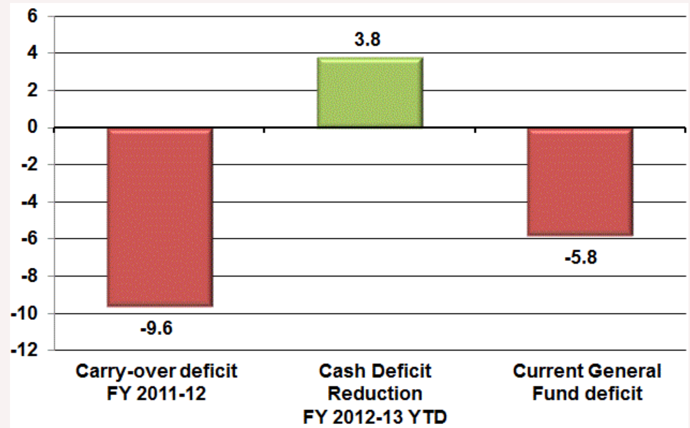
ing housing and jobs market, along with voter-approved income and sales tax increases, are clearly seen in the resurgence of revenues from a year ago. Driven by rising incomes and consumer spending, total revenues in April were $5.4 billion above, or 55.9%, their level of a year ago.

Looking at the entire fiscal year to date, beginning last July 1, total General Fund receipts are running $5 billion above, or 6.5%, estimates included in the Governor's Budget. (See Table 1.) Despite April's pickup, retail sales tax receipts are still below estimates but have been offset by better corporate tax figures and a strong performance in personal income taxes.

Total disbursements or spending for the first 10 months of the fiscal year are tracking almost precisely to Budget projections. For the fiscal year-to-date, they were just $140.8 million above, or 0.2%, estimates and remained well below the year-ago comparable figures. (See Table 2.)

However, it should be noted that for April alone, total spending did run well ahead of estimates, implying that this situation will need to be closely monitored.

Figure 1: The Fiscal Tide Turns
(Dollars in Billions)



On balance, California's fiscal health has improved materially and the state is beginning to turn the corner. At the beginning of the current fiscal year, the state had a carry-over deficit of $9.6 billion. (See Figure 1.) For the first 10 months of the current fiscal year, revenues have exceeded disbursements by $3.8 billion. As a result, the General Fund deficit has shrunk to $5.8 billion. This is still a sizable burden, but it is a start.

Table 1: General Fund Receipts

July 1, 2012 – April 30, 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	$5,217.3	$5,091	$126.3	$6,136.8	($919.5)
Personal Income Tax	$55,775.4	$51,413.9	$4,361.6	$40,807.7	$14,967.7
Retail Sales and Use Tax	$15,027.4	$15,266.6	($239.2)	$14,851.4	$176
Other Revenues	$3,667.7	$3,356.4	$311.3	$3,817.8	($150.2)
Total General Fund Revenue	**$79,687.8**	**$75,127.8**	**$4,560**	**$65,613.7**	**$14,074.1**
Non-Revenue	$2,690.6	$2,201.1	$489.5	$3,608.3	($917.7)
Total General Fund Receipts	$82,378.5	$77,328.9	$5,049.6	$69,222	$13,156.4

Why Do Golden State Revenues Swing So Drastically?

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economy in robust economic times, and fall faster than the economy during recessions. During the upside of the cycle, with the State treasury filling faster than the economy is expanding, this can give false impressions of the State's "robust" tax structure. With the disproportionate revenue uptick, the Legislature faces pressure to cut taxes or expand programs. The cycle reverses itself when revenues fall faster than the economy. While this "volatility" is not unique to California, the State's revenue structure is twice as likely to exaggerate changes in the economy as are the revenue structures in Texas or New York.

What is it about the Golden State's tax structure that tends to accent the effects of changes in the economy? The progressive nature of the dominant tax, the personal income tax, accentuates the effect of changes in the taxable income of the State's highest-income people.

A progressive system means that the highest-income people pay a higher marginal tax rate than do middle- and low-income taxpayers. Not only do they pay more because they have more income, they pay a higher rate on what is taxed. While the income tax is highly progressive, many argue this is necessary to even out the tax structure for other, more regressive taxes such as levies on sales and property.

Typically, the wealthy benefit disproportionately during economic booms, with their incomes and tax liabilities swelling faster than those of middle- and low-income taxpayers. But when their incomes fall in a recession, their tax liabilities are likely to fall more quickly.

The full taxation of capital gains has also contributed to disproportionate swings in personal income tax revenues.

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Table 2: General Fund Disbursements

July 1, 2012 – April 30, 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	$58,036.3	$57,387.1	$649.2	$59,494.7	($1,458.4)
State Operations	$19,881.3	$20,282.5	($401.2)	$20,809.9	($928.7)
Other	$685.5	$792.6	($107.1)	($94.2)	$779.6
Total Disbursements	**$78,603.1**	**$78,462.2**	**$140.8**	**$80,210.5**	**($1,607.5)**

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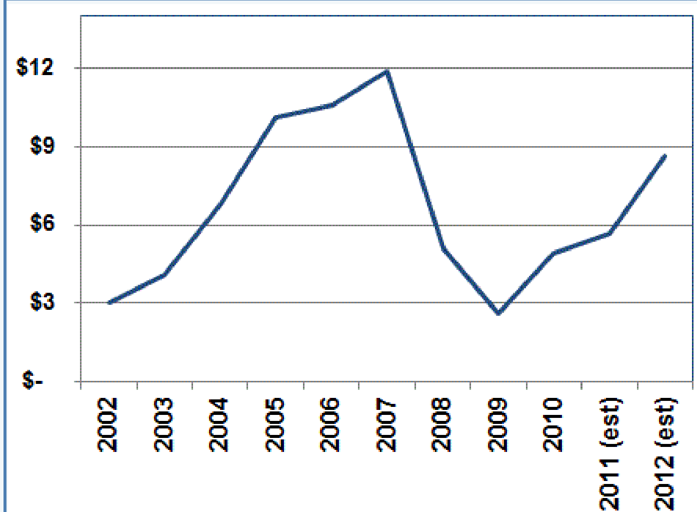
(Capital gains are the profits people make when selling stock or other investments that have gone up in price.) While the federal system taxes capital gains at a lower rate than salary income, California applies the same rate to both. Tax revenue from capital gains varies significantly from year to year, as can be seen in Figure 2. Revenues rose from $3 billion in 2002 to $12 billion by 2007, and fell back down to $3 billion two years later.

Capital gains are taxable events only when taxpayers choose to realize the gains, meaning they decide to sell the assets. If there is no realized gain, there is no "taxable event." (In contrast, taxpayers with salaried income are unable to "time" their taxable "events." They get paid weekly or monthly, irrespective of whether they want to "realize" their income. They pay withholding and taxes on the year in which the salary is earned.) As a result, idiosyncratic taxpayer behavior—and the health of an investor's stock porfolio relative to the stock market—can have a large effect on how much capital gains are realized in any given year.

Figure 2: Personal Income Tax Capital Gains by Tax Year 2002-2012
(Dollars in Billions)



Source: Department of Finance, Budget Summary (January 2012)

California Economic Snapshot		
New Car and Light Truck Registrations	**1,290,920** 2011	**1,617,103** 2012
Median Home Price (for Single-Family Homes)	**$251,000** In March 2012	**$313,000** In March 2013
Single-Family Home Sales (Houses and Condos)	**37,481** In March 2012	**37,764** In March 2013
New Monthly Mortgage Payment	**$901** In March 2012	**$1,134** In March 2013
Payroll Employment (Non-Farm Seasonally Adjusted)	**14,306,200** In March 2012	**14,592,000** In March 2013
Newly Permitted Residential (Single and Multifamily) Units	**6,181** In March 2013	**4,840** In March 2013

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

The California State Governmental Surplus: How Did This Happen? Is All Well Now?

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The 2008-2009 financial and economic meltdown had severe repercussions for the global economy. Most countries suffered serious and prolonged economic downturns; in many cases the declines were similar to those experienced during the Great Depression of the 1930s. The U.S. was no exception to this international episode, with the preponderance of local and state economies also suffering from declines in economic activity.

California saw its gross domestic state product reach a nadir in 2009, and in 2011 was only 3% greater than the low point. While the California economy has started to improve again, the growth rate is less than half the rate of growth experienced in the early 2000s.

The general decline in economic activity wreaked havoc on governmental budgets by reducing household and business incomes, which in turn reduced tax revenues and simultaneously reduced governmental fees and sales taxes. At the same time, the demand for general public services provided by government, and especially social safety net services, did not decline. This imbalance between the revenues and the governmental expenditures fed large growing public sector deficits. These conditions appeared to generate deficits not only in the short run, but they appeared to be long run and structural, especially as employment growth seemed to be unable to recover to pre-2007 levels. For example, the U.S. lost about nine million jobs from employment peak to trough, and has been recovering at a rate that will take seven years to return to the peak. California fared better than the U.S. as a whole.

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The opinions in this article are presented in the spirit of spurring discussion and reflect those of the authors and not necessarily the Controller or his office.

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It lost about 900,000 jobs between 2007 and 2010, and has recovered roughly half to date. In this light, the California deficit mushroomed, and appeared to be uncontrollable without new governmental initiatives. The California deficit generated significant political angst, with some believing the deficit was structural and not easily repaired.

The limits and implications for cutting the deficit are not always pleasant, even if the economy in general is growing. Growth may not be uniform, and may cause geographic inequities. The Central Valley and other regions of California have not grown in a similar way to the high-tech zones in the San Francisco Bay Area and parts of coastal Southern California. Furthermore, the current deficit decline masks the still unfunded public pension deficit issues. These issues remain to be dealt with directly. There are also demographic implications, as California residents, like most of the United States, becomes older. The need for medical and other social services may increase, again exacerbating the potential deficit in the future.

Fast forward to California State government surplus in 2013. In this economic context, how did the surplus occur? What were the driving forces for this unanticipated governmental surplus?

In brief, three forces generated the surplus:

⇒ The California economy recovered slowly, but faster than expected, increasing income tax and sales tax revenues.

⇒ Expenditure growth has been reeled in.

⇒ Changes in the tax revenue system (especially with Proposition 30) created unanticipated revenue by increasing personal income tax rates for the wealthiest households (through 2018) and by increasing sales tax rates (through 2016).

The simple message from this experience is that economic growth, especially through employment growth, is the most effective and the least destructive way to reduce governmental deficits. In California, the high-tech boom created high-income employment growth, and thereby created revenue. Of course, controlling expenditures can play a key role in deficit reduction – but expenditure cuts are always politically-difficult to implement and frequently have asymmetric, inequitable, undesired, and unintended consequences.

Finally, one of the expenditure sectors that the State intended to cut significantly during the downturn was education. Proposition 30, passed by a significant majority in November 2012, creates a temporary source of revenue to support education. This cannot by itself be a long-run solution. Education is the lifeblood of California. The State's efforts to maintain funding while continuing to be a competitive economic entity will offer challenges in the future.