A MONTHLY REPORT FROM STATE CONTROLLER BETTY T. YEE

California Fiscal Focus

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CA Controller's March Cash Report Shows Higher-Than-Expected Revenues

March state revenues surpassed estimates in Gov. Jerry Brown's proposed 2016-17 budget by $218.6 million, with both the corporation tax and the retail sales and use tax beating expectations, State Controller Betty T. Yee reported.

Overall, total revenues of $7.40 billion outstripped projections in the proposed budget released in January by 3 percent. Corporation tax revenues of $1.71 billion were $47.5 million, or 2.9 percent, higher than expected. Sales tax revenues of $1.79 billion beat expectations by $36.0 million, or 2.0 percent. Only the personal income tax, which has normally surpassed projections in the past few years, came up short. Revenues of $3.49 billion were $31.2 million, or 0.9 percent, less than expected.

Through the first nine months of the fiscal year, revenues of $78.37 billion are $512.5 million, or 0.7 percent, more than expected in the governor's proposed budget. The personal income tax and the corporation tax are both beating projections, by 0.1 percent and 7.4 percent, respectively. The sales tax, meanwhile, is lagging by 0.9 percent for the fiscal year to date.

Compared to projections when this year's budget was signed last summer, revenues for the first nine months of the fiscal year are $2.26 billion higher than expected, with both the corporation tax and the personal income tax exceeding estimates. Compared to the prior fiscal year, revenues to date are higher by $5.20 billion, or 7.1 percent.

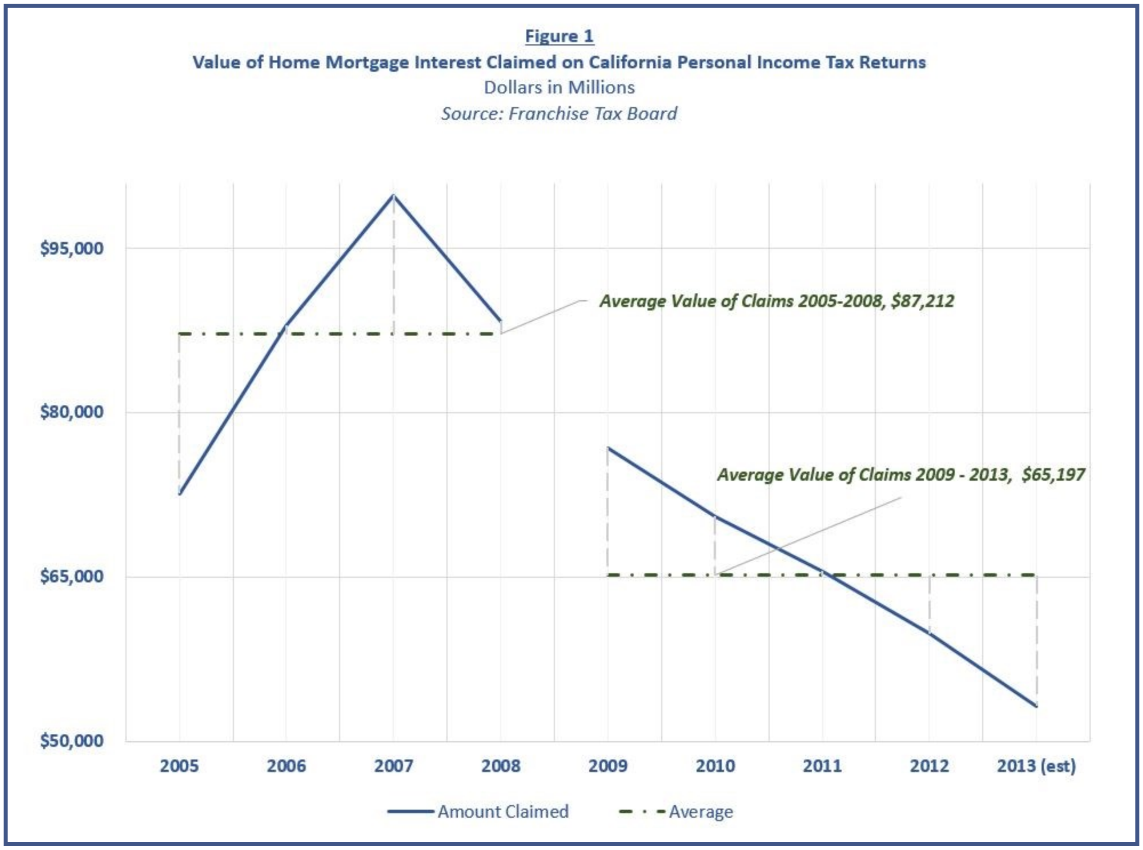
The state ended the month of March with unused borrowable resources of $19.63 billion, which was $2.60 billion more than expected in the governor's proposed budget. Outstanding loans of $14.34 billion were about $200.0 million less than projected. This loan balance consists of borrowing from the state's internal special funds.

For more details, read the monthly cash report.

This month's edition of the Controller's *California Fiscal Focus* examines trends in the home mortgage interest deduction, showing that claims have fallen in recent years.

Inside this issue

The Home Mortgage Interest Deduction: Took a Wrong Turn and Just Kept Going



As taxpayers near this year's April 18 income tax filing deadline, many will be giving thanks for the home mortgage interest deduction. By claiming it, a homeowner reduces taxable income by the amount of interest paid on a loan secured with a principal residence or second home. Despite its popularity, fewer Californians are likely to claim this deduction than they did a decade ago.

According to annual statistics collected and published by the Franchise Tax Board (FTB), California taxpayers claimed $72.5 billion in mortgage interest for the 2005 tax year. That amount rose to $99.5 billion two years later but steadily declined thereafter to $53.1 billion in 2013 — a 47 percent drop. In May, FTB will report claims activity for the 2014 tax year.

For the four-year period ending in 2008, the average statewide value of deductions was $87.2 billion. In the next five years, the average dropped to $65.2 billion (**Figure 1**).

From 2005 to 2013, the value dropped at an average annual rate of about 3.8 percent. This period coincides with broad changes in California's residential housing markets, the 2007-09 recession, and the 2009 reduction in interest rates.

Everybody Needs a Place To Rest. The number of claims followed a similar pattern, rising from 4.8 million in 2005 to a high of 5.0 million in 2007. After that, the number of claims steadily dropped, falling to about 4.3 million in 2013. From 2005, the average annual drop was about 1.4 percent, less than half the rate of decline in the value of the deductions. At a time when Californians worry about the availability of housing, are these trends evidence of a problem?

Taxpayer behavior rarely can be reduced to a single explanation. In the case of the mortgage interest deduction, changes in lending practices can affect how much

(See MORTGAGE, page 4...)

The Budget Dance: Are May Revisions Necessary?

Even as the Legislature completes its subcommittee review of the Governor's January budget proposal, Capitol watchers look ahead to the second Friday of May when Governor Jerry Brown is scheduled to release his May Revision.

The Department of Finance will review its revenue estimates, and the Governor may propose changes to his January budget. Fiscal expert Richard Krolak once called the state's budget process a dance, implying that it follows mutable rhythms and rituals. The May Revision is part of the "dance" for at least four reasons.

Statute Requires It. Though statute requires governors to revise their budget plans by May 14 of each year, they occasionally have done so earlier. In 1992 (preceding adoption of the statutory May 14 deadline), Governor Pete Wilson proposed an April Revision. Governors Gray Davis and Arnold Schwarzenegger suggested revisions in January to the budget already in place for that fiscal year even as they were proposing a new budget for the following fiscal year.

> *"By May 14, estimators have significantly more information about revenue trends for the coming year…"*

Timing is Everything. Recently, in their January proposals, governors have estimated revenues for the coming fiscal year based on data available through the preceding November or December — as much as 19 months before the end of the relevant fiscal year. By May 14, estimators have significantly more information about revenue trends for the current year, which could affect revenues for the coming year. For example: Are tax payments flowing in as expected? What do these results tell estimators about likely tax performance in the coming months?

(See REVISIONS, page 4...)

What to Look for in the April Tax Returns

During the days (and nights) following the personal income tax filing deadline, activity at FTB can be frenzied. FTB staff process the crush of income tax returns and deposit tax-return checks with alacrity and precision. Through the end of the month, FTB posts a running total for each day's processed tax returns. These daily posts can yield time-sensitive insights into the state's fiscal condition and help anticipate changes in the Governor's revenue forecast.

What do the final payments tell us about the 2015-16 tax year? The final personal income tax payments help fiscal managers better calibrate the state's likely year-end balance on June 30, 2016. Fiscal managers should get answers to many of their questions about actual tax performance for the 2015-16 year.

What do the estimated payments tell us about likely 2016-17 revenues? Taxpayers also must make estimated payments of their 2016 personal income taxes in April, even though their final payments are not due until a year later. These early payments give an indication of what they expect their overall tax liability (especially the taxes due on unearned income) will be at this time next year. Revenue forecasters can use this information to refine 2016-17 estimates they made last November and December.

Remember that stuff happens. Tax payments go awry in unlikely and unanticipated ways. One year, a truck carrying federal estimated payments from the Western U.S. accidentally dumped tax returns — and checks — into San Francisco Bay. Less dramatically, check processing can be delayed by weather or human error. Taxpayer behavior also can change and confound the best analysis. Fiscal managers have found the last two weeks of April to be the most interesting 10 working days of the year.

It's not over 'til it's over. After the checks are deposited and the FTB mailrooms return to a normal pace, research staff cull data from the returns to analyze activity by taxpayer cohort. They can get a better understanding of tax trends by conducting a careful analysis of data patterns. For example, are there indications about how future taxpayers will file for credits, refunds, and deductions? Do the returns yield any insight into future tax liability for capital gains?

(MORTGAGE, continued from page 2)

homeowners can borrow to finance their houses. Socioeconomic trends including changes in demography, taxpayer investment practices, and consumer credit also influence the amount of the deduction. For example, if younger Californians defer purchasing their first homes to preserve their mobility, a part of the decline could reflect lifestyle choices rather than housing availability and affordability. If homeowners took advantage of recent interest rate reductions, then their deductible interest costs could have fallen even when their loan principals did not.

Everybody Wants to Have a Home. The interest rate deduction statistics reflect the activity of higher-income taxpayers who own homes. As such, they are a selective and perhaps incomplete measure of California's housing (including rental) market.

To claim the deduction, a taxpayer must itemize rather than take the standard deduction. Low-income taxpayers — whether they have a mortgage or not — are less likely to itemize. More higher-income taxpayers take the deduction than do lower-income people.

Low-income taxpayers are less likely to own homes. They tend to participate more heavily in the rental market than do middle- and high-income taxpayers.

In addition, speculators ("flippers") may distort the statistics. They do not reflect the traditional homeowner market, and tend to prefer interest-only mortgages. To the extent flippers claim a disproportionate share of the deductions, their investment activity will alter the statistics irrespective of changes in the traditional market.

Recently, tax experts have engaged in a lively discussion about how to reshape the home mortgage interest deduction. If the policy goal is to promote homeownership, then there may be broad interest in changing the deduction to focus on new homeowners or lower-income taxpayers. In testimony to the U.S. House Ways and Means Committee on April 25, 2013, Eric J. Toder, co-director of the Urban Institute's Tax Policy Center, noted that bipartisan taskforces commissioned by Presidents Bush (2005) and Obama (2010) called for better targeting the deduction.

(REVISIONS, continued from page 3)

In addition, between November and the following May, economic trends may shift. Because downturns, in particular, are hard to forecast, economic data from these months might indicate a change in economic — and therefore, revenue — cyclical activity.

New Spending Proposed. Governors also may use the May Revision to revise their spending plans. While some governors have been known to delay — for strategic reasons — making some of their proposals until May, the revised spending proposals more typically respond to changes in the state's fiscal condition or critiques of the January budget proposal.

Negotiations Begin in Earnest. After governors propose their budgets, the Legislature conducts hearings to afford the public a chance to consider and comment. During this stage of the "dance," the Governor's representatives are unlikely to negotiate changes in the January proposal. The pace of negotiations can increase, however, as the legislative review approaches June 15, the constitutional deadline for the Legislature to pass a budget.

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