A MONTHLY REPORT FROM STATE CONTROLLER BETTY T. YEE

California Fiscal Focus

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CA Controller's July Cash Report Shows Revenues Close to Projections

California's fiscal picture held steady in the first month of the 2015-16 fiscal year, with July revenues falling short of what was expected by only $12.3 million, or 0.2 percent, according to State Controller Betty T. Yee's monthly report of California's cash balance, receipts, and disbursements.

Personal income tax, which surged throughout the previous fiscal year, continued to beat expectations. The state collected $4.5 billion in July, 2.8 percent more than expected in the budget for the fiscal year that started July 1. However, this windfall was offset by shortfalls in the state's other two main sources of revenue — sales and use tax and corporation tax.

Sales and use tax totaling $858.7 million fell short of projections by $113.8 million, or 11.7 percent. Corporation tax revenues came in $1 million, or 0.3 percent, lower than expected.

Still, revenues continued to outpace the 2014-15 fiscal year. The July revenue total of $5.7 billion was 6 percent higher than a year ago, led by a 9.6 percent boost in personal income tax. This year-over-year increase was more than enough to offset a 6.6 percent drop in the sales and use tax and a 9.1 percent decrease in corporation tax, compared to the figures from a year ago.

The state ended the month of July with unused borrowable resources of $26.1 billion, which is 11.1 percent more than anticipated when the budget was signed. The General Fund, the source of most state spending, may borrow from other funds to even out variability in revenue and disbursement patterns.

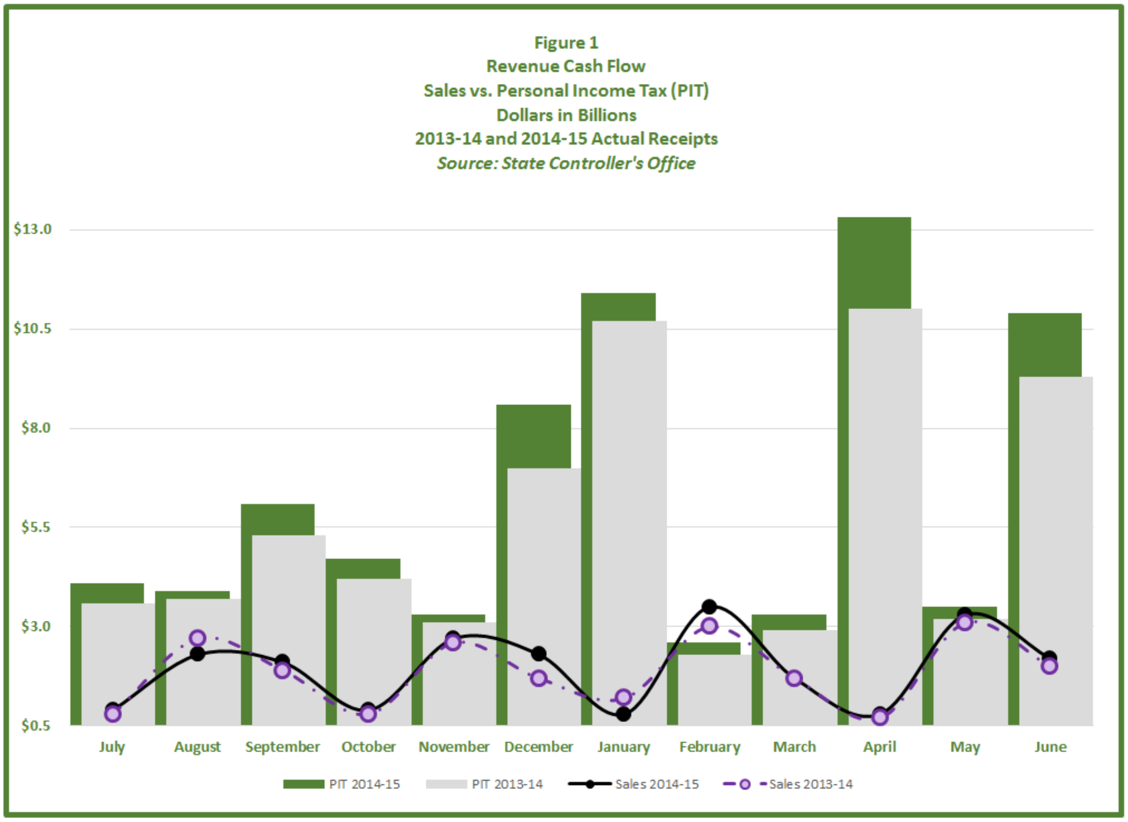
For many years, the Controller has pursued external borrowing when cash available from these special funds is projected to fall short of General Fund obligations. The Controller may ask the Treasurer to sell short-term revenue anticipation notes (RANs) that are repaid by the end of the fiscal year.

However, this year, because of the state's improved fiscal position, the Controller anticipates that internal borrowing will be sufficient to meet cash flow without having to issue RANs.

For more details, read the monthly cash report.

Inside this issue

Q&A: Why Do Tax Flows Change from Month to Month?



In the current fiscal year, two taxes — sales and use, and personal income — are expected to account for 86 cents of every General Fund dollar. If these two taxes do not perform as expected, we may have to dip into cash accounts to pay the bills.

To anticipate shortfalls, cash experts watch the monthly flow of these two taxes and use historical patterns as a guide for the future. Figure 1 shows monthly sales and income tax revenue for the two fiscal years starting on July 1, 2013, with the bars showing income tax collections and the lines marking sales tax receipts.

What drives personal income tax monthly receipts?

Most people know about the April 15 tax deadline. By that date, most of us file our taxes for the year ending in December. So expect April to be a big month; but we pay our income taxes throughout the year when our bosses withhold payments for each pay period. Some taxpayers may also pay early for non-wage income like investments.

Tax law tends to spread payments unevenly over the course of the year.

What about the sales tax?

In the past two years, collections varied from a monthly low of about $0.5 billion at the beginning of each quarter to a high of $3.0 billion later in the quarter**,** when many businesses forward their sales tax receipts to the state. Each quarter since July 2013 brought in between $5.1 billion and $6.3 billion.

Does the flow of each tax moderate — or heighten — month-to-month fluctuations in total tax collections?

Good news for the state: The flows have an offsetting pattern. When one of these taxes has a high flow, the other tax is near the bottom of its pattern.

Do other General Fund taxes need the same watching?

For 2015-16, other taxes account for about one-seventh of total General Fund taxes. They have a fairly steady pattern of monthly collections over the year.

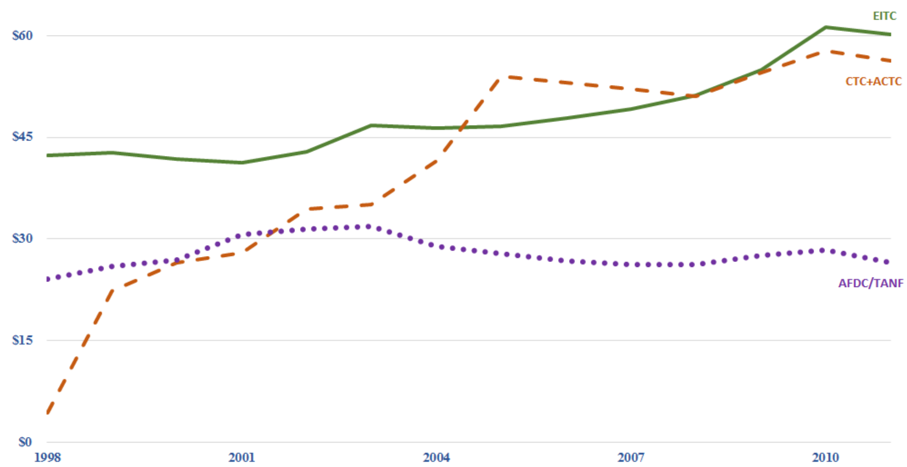
Can Tax Reform Be Part of the Budget Process?

This year's budget included a big change in state tax policy. By adopting an earned income tax credit (EITC), the legislature authorized a program that piggybacks on a federal income-assistance program. California joined about half the other states that have already adopted an EITC.

Policy wonks see the credit as a way to use the tax code to achieve major goals that are more often addressed through direct spending in the budget.

The effect can be large. At the federal level, for example, the EITC provides more income support than does the Temporary Aid to Needy Families (TANF) program. (*See Figure 2.*)

Figure 2
Comparison of Federal Expenditures on Selected Income-Assistance Programs
1998 through 2011
Dollars in Billions
Source: Tax Policy Center



Earned Income Tax Credit (EITC), Aid to Families with Dependent Children/Temporary Aid for Needy Families (AFDC/TANF), Child Tax Credit + Additional Child Tax Credit (CTC+ACTC)

California law defines a tax expenditure as "a credit, deduction, exclusion, exemption, or any other tax benefit as provided for by the state." The Franchise Tax Board calls them "deviations from normal tax law."

The major tax agencies, Department of Finance, and Legislative Analyst's Office all publish information on the nature and cost of tax expenditures.

In most years, the legislature reviews tax changes through its tax Committees — in a process distinct from the one governing its budget committees.

Tax committees often evaluate the justification and fiscal consequences before approving any tax changes. However, if a tax break is not subject to a sunset, it may never again be examined. By adopting the EITC as part of this year's budget, the legislature showed a new willingness to integrate tax policy into its annual budget review.

Why Can't We Better Integrate Tax and Budget Decisions?

California is not alone in separating tax policy from budget consideration. Tax experts often use three broad criteria when thinking about tax changes: treatment of taxpayers across time and situation ("fairness"), choices among economic activities ("efficiency"), and administration of the tax ("simplicity").

However, these criteria do not govern budget deliberations, which tend to turn on spending tradeoffs among Programs — a cut in one area may pay for an increase in another.

Because tax and budget choices involve different criteria, policymakers may find it hard to include tax decisions in a budget debate.

The Past Need Not Be Prologue.

The seeming inattention to tax policy in the annual review contrasts with the effort and care devoted to the spending side of the fiscal equation. Surely, California has the capacity for doing a more thorough review of the budget's revenue side in 2016.

The entire tax structure need not be reviewed. Because the personal income tax and sales tax account for more than 85 percent of General Fund revenues, perhaps the legislature can focus on these two large taxes next year.

In 2011, the Senate Office of Oversight

(See TAX REFORM, page 4...)

With CA Spending Swings, Few Months are "Average"

Even with a balanced budget, monthly spending may not match revenues. If outflows exceed inflows, the state takes measures to honor its obligations.

In recent years, to even out the mismatches, the state made changes to slow down spending, speed up tax receipts, and borrow when needed.

Figure 3 shows the projected 2015-16 spending pattern. Based on estimates by the Department of Finance:

The State Spends $10 Billion per Month on Average... But Few Months Are "Average."

Over the course of the fiscal year starting July 2015, the state will spend an average of $9.8 billion each month. The pattern shows that monthly payments can vary from a low of $7.7 billion in August to a high of $13.2 billion in September— a monthly swing of $5.5 billion. Spending flows fastest in the first half of the fiscal year.

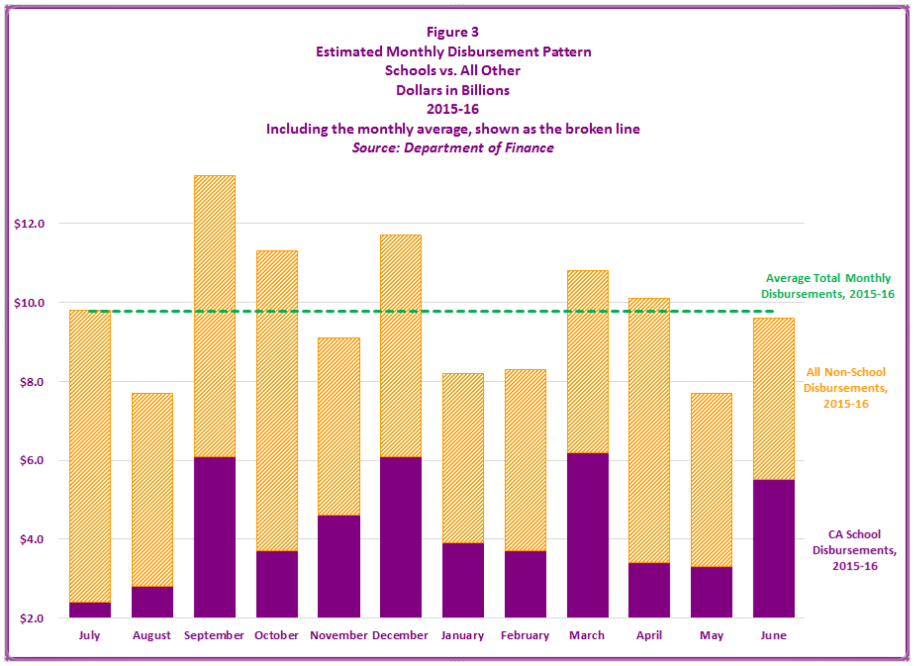


Figure 3
Estimated Monthly Disbursement Pattern
Schools vs. All Other
Dollars in Billions
2015-16
Including the monthly average, shown as the broken line
Source: Department of Finance

Much of the Monthly Difference Can Be Explained by the Pattern of School Spending.

Monthly school payments vary between a low of $2.0 billion (July) and highs of over $6.0 billion (September, December, and March).

Because schools represent 40 cents of every dollar spent, those variations make a big difference.

(TAX REFORM, continued from page 3)

and Outcomes identified ten tax expenditures that over a decade collectively cost the state $6.3 billion more than had been estimated when they became law.

If fully considered, they could yield significant budget savings. If the legislative budget review itself cannot accommodate an annual tax review, perhaps a parallel process with clear instructions from each house — analogous to a federal budget resolution — could direct a select committee to propose tax expenditure changes. The committee could propose modification or suspension, if not outright repeal, to budget writers.

The relative cost and effectiveness of tax expenditures is no more difficult to measure than the cost of opening a park or expanding a school program. This year's EITC demonstrates that the annual legislative fiscal review can incorporate tax policy.

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