A MONTHLY REPORT FROM STATE CONTROLLER BETTY T. YEE

California Fiscal Focus

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CA Controller's December Cash Report Shows Revenues Surpass Estimates by $381.7 Million

Personal income tax revenues continued to surpass expectations in December, pushing the month's total state collections $381.7 million, or 2.8 percent, higher than expected, State Controller Betty T. Yee reported.

"It's encouraging to see the state's continued fiscal strength," Yee said. "But as Governor Brown stressed in his budget proposal last week, we need to be aware that the good times will not last forever. As the state's chief fiscal officer, I will be closely monitoring revenues to detect signals of a downturn."

Total revenues for December were $14.1 billion. Personal income tax for the month came in at $9.5 billion, $388.3 million more than expected when the budget was enacted last summer. Corporation tax revenues of $1.7 billion beat projections by $25.8 million, or 1.5 percent. These gains were offset slightly by retail sales and use tax revenues of $2.4 billion, short of estimates by $35.8 million, or 1.5 percent.

For the first half of the fiscal year that began in July, total revenues of $51.1 billion exceeded projections by $884.6 million, or 1.8 percent, with higher-than-expected personal income tax revenues more than offsetting shortfalls in the corporation tax and the sales and use tax. Personal income tax since the beginning of the fiscal year beat estimates by $1.3 billion, or 3.9 percent. The corporation tax fell short by $120.6 million, or 3.6 percent, while the sales and use tax slipped $262.5 million, or 2.1 percent, compared to projections.

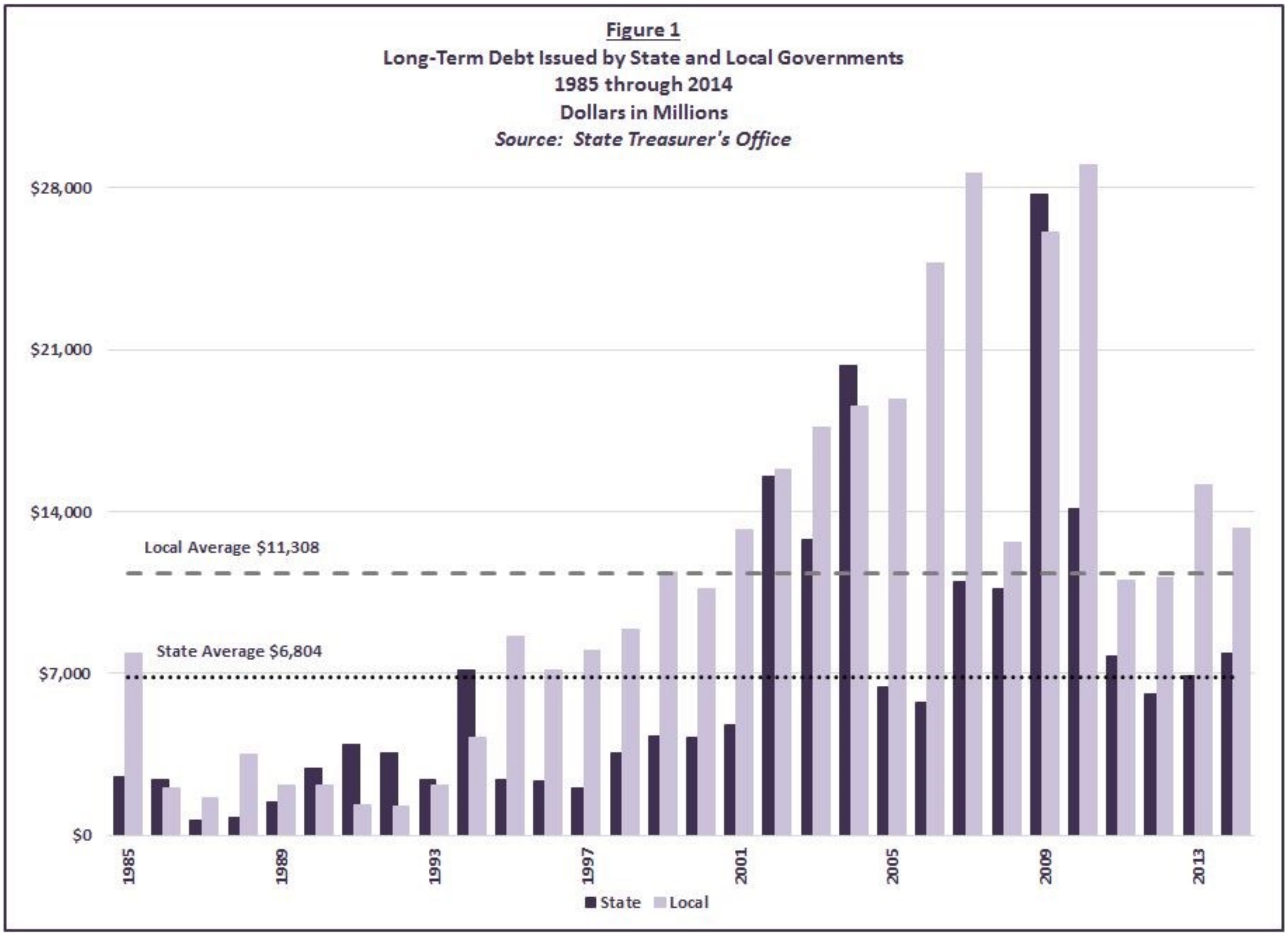
This month's edition of the Controller's *California Fiscal Focus* analyzes the influence of low interest rates on state and local government borrowing.

The state ended the month of December with $11.1 billion in outstanding loans — $1.4 billion, or 11.4 percent, less than expected. For the first year in 15 years, the state is covering month-to-month shortfalls exclusively through internal borrowing from special funds rather than external loans, such as revenue anticipation notes. The improved fiscal condition of the General Fund, the source of most state spending, has saved the state tens of millions of dollars in interest costs.

For more details, read the monthly cash report.

Inside this issue

Low Interest Rates Just One Factor in State and Local Debt Issuance



The Federal Reserve began raising interest rates in December, after holding them at extraordinarily low rates since the start of the Great Recession. Will higher rates reduce debt issuance by the state and local governments in the coming years? Recent history suggests that issuance patterns respond to a variety of factors beyond interest rate fluctuations. Despite the period of low rates, state and local governments issued debt at a rate consistent with their 30-year averages. State and local governments have been modest in issuing debt, especially since 2010.

Figure 1 shows the annual issuance of new long-term debt by the state (displayed in the dark bars) and local governments (in the light bars) over a 30-year period starting in 1985. Issuance in the last four years has fallen well below the long-term trend, highlighting how many factors other than low interest rates may come into play. Of particular interest:

- State and local governments together reported issuing $558 billion in long-term debt over the 30 years. Local governments accounted for $352 billion (63 percent) of this debt.

- On average, local governments issued about $11.3 billion

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Long-Term Outlook: Cost Pressures

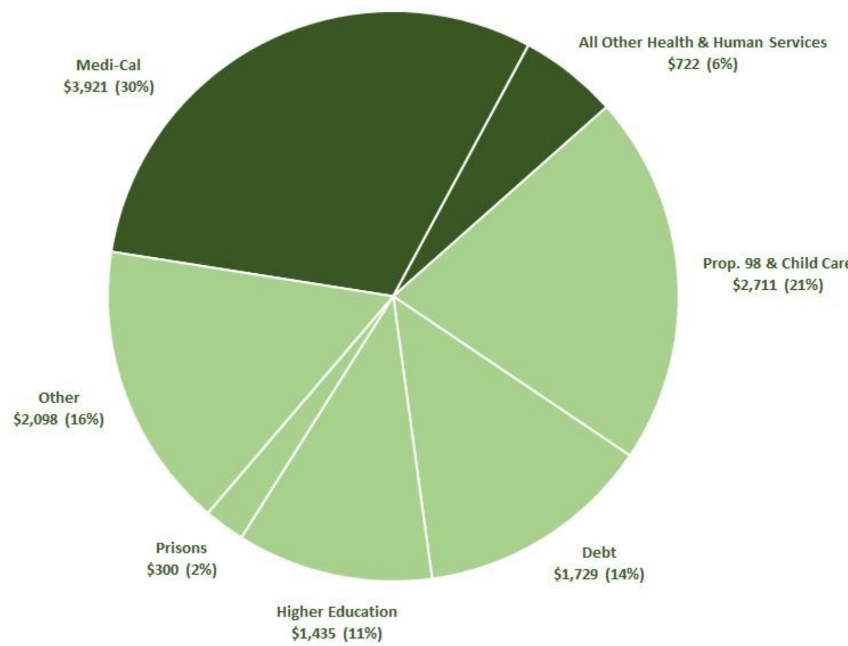
Can the Legislature anticipate which programs will draw the most from state funds in future years?

Part of the answer can be found in the Legislative Analyst's Office's (LAO) recent estimate of the General Fund condition for each fiscal year through June 30, 2020. The LAO expects total annual General Fund spending to grow from $110.6 billion in 2015-16 to $123.6 billion by 2019-20, an average annual growth rate of about 2.8 percent.

This $13.0 billion increase factors in caseload and cost changes but not changes in policy.

The estimates, broken out by major program, give a perspective on which programs are putting the most pressure on state finances. These pressures likely would expand or contract should the Legislature or voters make substantive changes to fiscal policy in the intervening years.

Figure 2
Where Will the Budget Grow?
Increase in Spending, by Major Program
2015-16 through 2019-20
Dollars in Millions
Source: Legislative Analyst's Office 2015 Outlook and State Controllers' Office



More than 60 Percent of All New Spending Will Be in Three Areas

LAO expects Health and Human Services (H&HS) spending to increase by $4.6 billion in the next four years, about 36 percent of total growth. Medi-Cal alone accounts for about $3.9 billion. Spending associated with K-14 schools (including funding to meet the Proposition 98 guarantee and child care programs) will likely grow by more than $2.7 billion.

In looking at long-term liabilities, LAO identified separate cost increases for the California State Teachers Retirement System, retiree health benefits (pay-as-you-go premiums), debt service for capital projects, and payments required under Proposition 2 (Rainy Day Fund). These debt costs are likely to rise by about $1.7 billion.

As displayed in Figure 2, these three areas — H&HS, K-14 schools, and debt — will account for 70 cents out of every new General Fund dollar spent in 2019-20. This result should not be very surprising to budget watchers, considering that Proposition 98 and Medi-Cal are the largest programmatic areas of the General Fund.

Fastest Growing Programs

Another way to consider cost pressures is to look at rates of growth.

(See COST PRESSURES, Page 4...)

(COST PRESSURES, Continued from Page 3)

Overall, spending is expected to grow about 2.8 percent per year. (Note that the LAO forecast is not a "straight-line estimate." The Analyst made separate estimates for each year. Some spending — like debt service — actually is forecast to grow more slowly between 2015-16 and 2016-17 than for the rest of the estimate period. See Figure 3.)

Figure 3
Rate of Growth
Legislative Analyst's Office (LAO) Forecast, by Program
2015-16 to 2019-20
Source: LAO 2015 Outlook and State Controller's Office

	Average Annual Growth
Retiree Health Pay-as-You Go Payments	10.2%
Prop. 2 Debt Payments	8.5%
CalSTRS State Contribution	7.9%
Medi-Cal	5.3%
Higher Education	4.4%
General Government	4.3%
Infrastructure Debt	3.3%
TOTAL	***2.8%***
Judiciary	2.2%
Prop. 98 & Child Care	1.4%
All Other Health & Human Services	1.4%
Prisons	0.8%

Several programs are expected to grow more slowly than the average, including the judiciary, K-14 (Proposition 98 and childcare), and prisons, projected to expand by less than 1 percent per year.

Medi-Cal, on the other hand, experiencing both caseload expansion and high cost inflation, may grow as fast as 5.3 percent per year — nearly double the rate of the budget overall. Various debt costs also show very high growth rates. Some of these costs, especially debt payments associated with Proposition 2, will cease when they are paid off.

(INTEREST RATES, Continued from Page 2)

in new long-term debt each year. Local volumes rose for a 12-year period starting in 1996, fell dramatically in 2008, but rose again in 2009 and 2010. Since 2011, local volumes have hovered around the 30-year average.

- State issuance patterns have been more sporadic. The average annual volume was $6.8 billion, peaking in 2002, 2004, and 2008. Like local volumes, annual state issuances have hovered around the 30-year average since 2011.

- Local governments issued more debt than the state did in 22 of 30 years. This included five consecutive years in the mid-1990s when local governments were dealing with a recession and the state's decision to transfer a share of property taxes to schools that had previously gone to them.

www.sco.ca.gov

EOinquiry@sco.ca.gov

P.O. Box 942850
Sacramento, California 94250-5872
(916) 445-2636

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