



California Fiscal Focus

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CA Controller's September Cash Report Shows Revenues Slightly Lower than Estimates

State revenues fell short of Department of Finance projections by 2.6 percent in September, but are still outpacing estimates for the first quarter of the 2015-16 fiscal year, State Controller Betty T. Yee reported.

In September, two of the state's three top revenue sources failed to match projections. Retail sales and use tax revenues of \$1.7 billion were \$392.5 million, or 18.8 percent, less than estimates. Corporation tax revenues of \$836.6 million came up \$135.2 million short of projections, or 13.9 percent.

Only the personal income tax beat Department of Finance expectations. Revenues of \$6.7 billion were \$447.0 million (or 7.2 percent) greater than anticipated in the budget, driven by strong proceeds from paycheck withholding, tax returns, estimated payments, and other categories.

Overall, when other taxes and revenues are included, the state in September brought in \$9.6 billion, or \$252.2 million less than projected in July.

For the first quarter of the 2015-16 fiscal year, revenues outpaced estimates, driven by personal income tax proceeds that surpassed projections by \$606.2 million, or 4.1 percent.

This was more than enough to offset shortfalls in the corporation tax of \$100.6 million, or 7.3 percent, and \$379.1 million, or 6.3 percent, for the retail sales and use tax.

Compared to a year ago, September revenues came up short by 1.8 percent. However, for the first quarter as a whole, revenues exceeded last year's by \$1.6 billion, or 7.5 percent.

This month's edition of the Controller's *California Fiscal Focus* takes a longer view of state fiscal trends, showing that over 40 years revenues as a share of total personal income have fallen, resulting in a modest reduction in the bite of the state tax system.

The state ended September with \$26.9 billion in unused borrowable resources—\$3.8 billion, or 16.7 percent, more than expected. This is money available from other funds to the General Fund, the source of most state spending, to even out variability in revenue and disbursement patterns without having to seek external loans such as a revenue anticipation note.

For more details, read the [monthly cash report](#).

Inside this issue

Forty-Year Trend: State Revenues As Share of Personal Income Keep Falling	2
Picturing State Receipts and Disbursements	3
A Partial Explanation of Swings in Revenue from Taxes on Capital Gains	4



Forty-Year Trend: State Revenues As Share of Personal Income Keep Falling

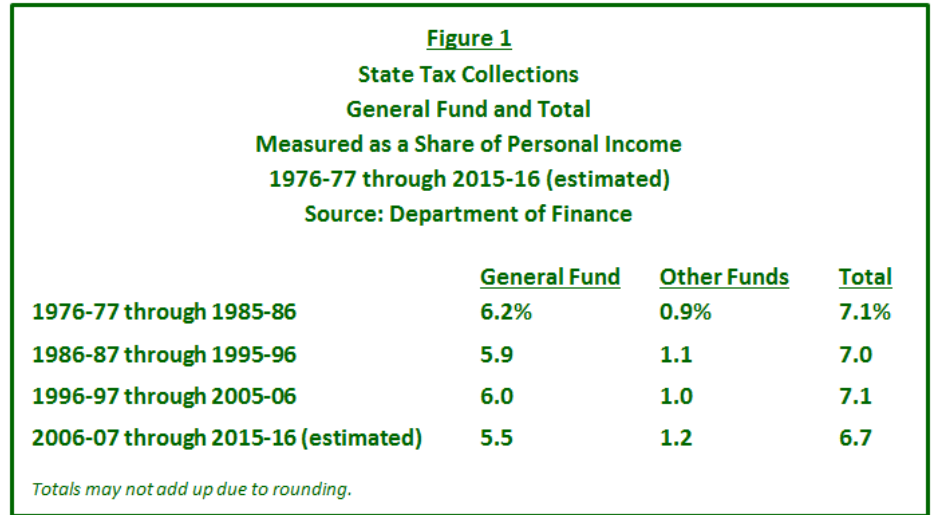
When the Legislature adjourned last month, it deferred action on the hot-button topic of tax reform. Next year could be different, as several major tax proposals will vie for the Legislature’s attention. For example, two proposals would extend the Proposition 30 tax hikes, one permanently and the other until 2030. Meanwhile, the chair of the Senate’s tax policy committee expects to hold hearings on a broad range of tax base expansions and rate reductions.

How would these proposals affect Californians’ tax load? One way of comparing tax impact is to calculate the ratio of total collections to personal income. While of limited value in explaining any one taxpayer’s situation, such an index gauges ability to pay for the entire taxpayer cohort.

This index facilitates comparisons under different tax structures and over time because it accounts for year-over-year changes in wealth and inflation. For example, calculating this index for the last 40 years shows that Californians as a whole paid at least 6.0 percent and no more than 8.0 percent of personal income in taxes to the state.

State’s Tax Bite Has Been Decreasing

A single index, no matter how robust, cannot easily summarize tax loads, so use of this ratio requires judgment and context. Because the calculation responds to changes in the economy, it may fluctuate from year-to-year even when the tax burden on individuals does not change. Averaging the burden over many years helps address the year-over-year fluctuation and is a better measure of the state’s long-term tax burden. For example, during three ten-year periods starting in 1976-77,



the state’s total collection rate averaged about 7.1 percent of personal income. In the most recent decade starting in 2006-07, we expect total collections to fall to an average of about 6.7 percent of personal income. The falling collection rate indicates a modest, though significant, reduction in the bite of the overall state tax system. Had the index stayed at 7.1 percent of personal income, Californians would have paid roughly \$5.0 billion more in state taxes during 2013-14 alone.

The drop in the General Fund rates is even more pronounced. In the decade starting in 1976-77, the General Fund received revenues representing about 6.2 percent of personal income. But in the most recent decade, the General Fund rate dropped to about 5.5 percent of personal income. As shown in Figure 1, the rate for non-General Fund taxes moderated, but did not fully offset, the reduction in General Fund taxes.

The reduced General Fund collections directly affect the state’s ability to finance discretionary programs, including higher education, parks, and libraries. By shifting state revenue

collections from the General Fund to other funds, the state limits more of its spending to specified (so-called “earmarked”) purposes.

Summary Statistics Do Not Measure Changing Burden by Income

The measure is a simple ratio of total tax collections to statewide personal income. We have not calculated the ratio by income groups, which we know have experienced much different growth rates. Typically, income groups are identified in quintiles, from the poorest 20 percent to the richest 20 percent. According to a 2009 [study](#) by the Center for Budget and Policy Priorities, the income of the poorest quintile in California rose by a modest 3.1 percent after accounting for inflation between 1977 and 2007. The income for the middle quintile grew by about 19.6 percent, while the richest quintile saw its income grow by a healthy 74.6 percent during the same period in the state. The effect of these disparate growth rates on the tax-burden ratios would depend on how each income group responded to changing tax levies over the period.

Picturing State Receipts and Disbursements

“Cash is king,” and state fiscal managers were reminded of that aphorism during the recent recession.

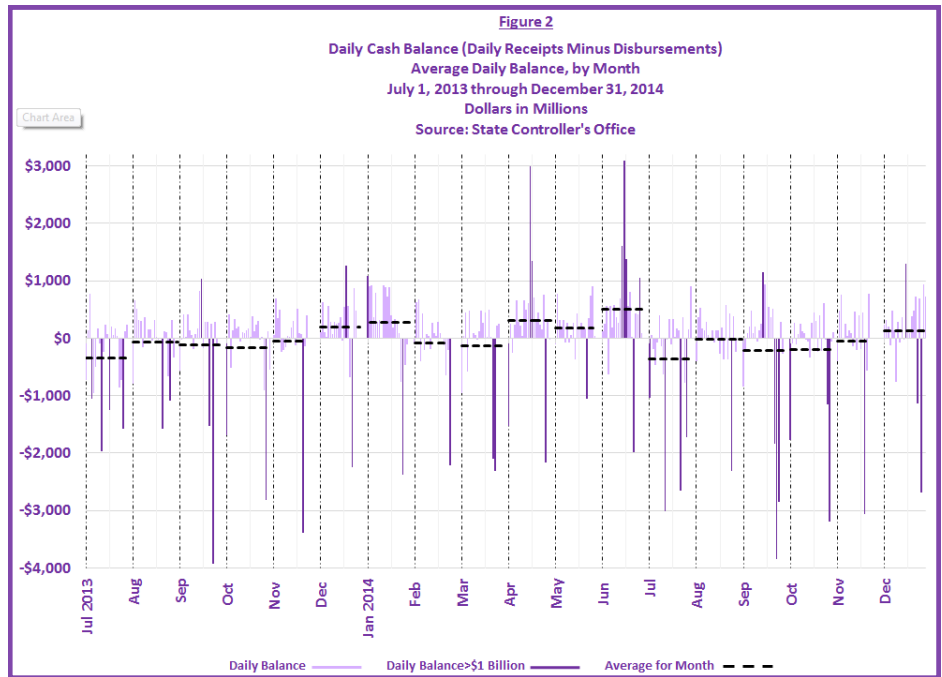
To cope with cash shortfalls in the General Fund over the last seven years, the state modified its cash-management practices so it could more easily meet daily cash needs using internal sources instead of being forced to pursue external borrowing through instruments such as revenue anticipation notes.

To anticipate the availability of internal cash, the Controller’s team tracks daily General Fund inflows and outflows. These two rarely match, but the size of the variations fluctuates by month.

Figure 2 tracks the daily and monthly average flow of General Fund receipts and disbursements for the 18-month period starting on July 1, 2013. The bars measure the daily net flow for cash in each of the nearly 375 working days for the period.

On most days, inflows and outflows are within \$1 billion. But on roughly 40 days (about 10 percent), the mismatch was even greater. These days are marked by the darker bars. Three-quarters of these largest variations were negative — that is, spending exceeded receipts — with at least one occurring in each of the 18 months.

The negative mismatches typically,



though not always, occur in the last five working days of the month, when the state makes its monthly disbursements to schools. The large upticks, when revenue outstrips outlays, occur in April, June, September, and December.

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The dashed horizontal lines in the figure show the monthly average net flow. Five months have positive flows—January, April, May, June, and

December. The rest of the months, including the first five months of the fiscal year starting in July, show negative averages.

This pattern of positive and negative balances has implications for cash management. For example, because the General Fund runs a cash deficit for nearly all of the first half of the fiscal year, it must start the year with access to other sources of cash (so-called “borrowable resources”) so the state can meet its disbursement claims. These borrowable funds may come from reserve accounts, surplus balances in other funds, or external sources (such as a revenue anticipation note). Access to borrowable funds must continue at least until the state’s cumulative cash flows are positive in the second half of the year.

A Partial Explanation of Swings in Revenue from Taxes on Capital Gains

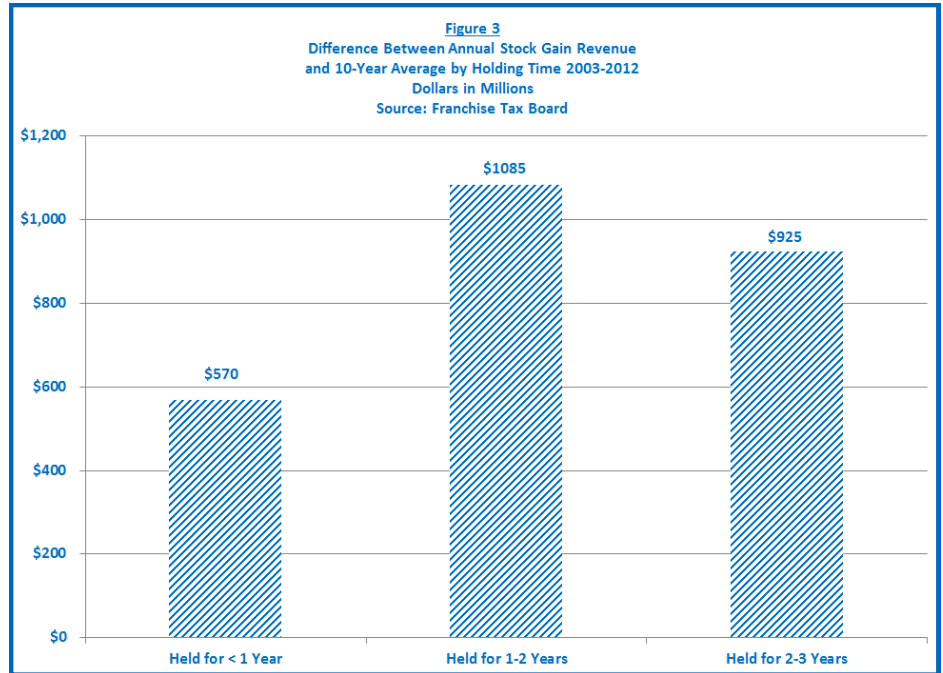
Since the dot-com bubble in the early 2000s, tax experts have cautioned budget writers about the difficulty of estimating revenue associated with stock gains. That’s because taxable gains show year-over-year variations seemingly unrelated to economic or fiscal indicators.

(Governor Jerry Brown’s Proposition 2, approved by the voters in November 2014, is intended to help the state better manage these fluctuations by placing in a reserve extraordinary revenues attributable to capital gains.)

How do capital gains get taxed? Following federal practice, state law imposes a tax on investment income in the year a taxpayer realizes investment gains. Gains accumulate without triggering a tax levy until the taxpayer sells the stock.

Might it be possible for budget writers to discern patterns in how long investors hold their stock as a way to model some of the yearly variation in revenue attributable to gains?

If taxpayer behavior and the amount of realized gains could be estimated



around an historical average, then much of the year-over-year volatility could be anticipated.

Figure 3 shows the variation in taxation of stock gains in relation to how long the taxpayer holds the stock. The three bars illustrate the average annual variation compared to a ten-year average for stocks that are held for three different intervals: less than a

year, one to two years, and two to three years. The data show that revenue from stocks held for less than a year is less volatile than that from stocks held from one to three years.

For tax estimators, these differences in stock realizations may provide insight into how to anticipate revenue from stock gains.



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