

The Budget and the Drizzling Day Fund

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 June 2017

It is budget season in Sacramento again, and the legislature fresh off of several years of plenty with Prop 30 tax revenues is looking at continuing to restore funding for programs that were hit with a cleaver after the 2008 downturn.

On top of this restoration of funding is the stated goal of countering a potentially impaired social safety net as contemplated in the Federal Budget proposal through new State funding. The proposed budget calls for \$124B in General Fund expenditures, up by \$1.7B from the current year. But, Governor Brown in his May Budget message to the State Legislature warned “the budget—which remained precariously balanced even in the strongest revenue years—is considerably more constrained than in any year since 2012. “ This precarious balance exists even after a forecast of an increase in revenue and transfers of \$7.5B.

But, California is close to, if not at full employment. Growth in revenues must come from growth in income and that almost always slows down at full employment. And in the meantime, the State has only accomplished relatively minor adjustments to fiscal policy to counter the Prop 30 increased volatility of its primary revenue stream; personal income taxes.

Like the hit TV show Game of Thrones which will begin its 7th season shortly after the new budget is enacted, “winter

(insert downturn here) is coming” and the preparations for it might not be adequate. In this California Report we explore the budget and the consequences of an extended Prop 30 income tax surcharge on future General Fund expenditures.

Employment and wage growth

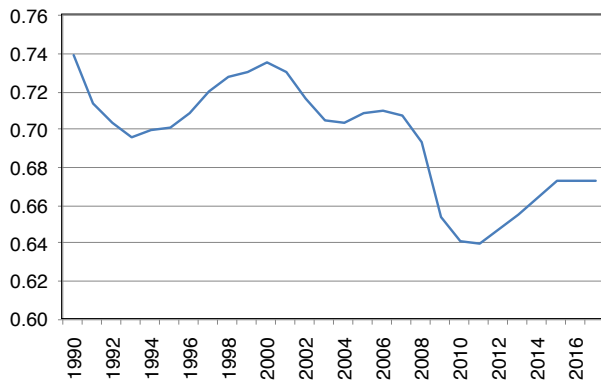
The April jobs numbers brought good news to California. The State continued its downward trend in the unemployment rate landing at 4.8% in April, just 0.4% above the National rate. Since California’s population is on average younger than the rest of the U.S. due to it being an immigrant heavy state, one expects the unemployment rate differential to be at about these levels. This is because younger workers take longer to find employment lacking as compelling a resume as older workers, and because younger workers tend to change jobs more often as they experiment with alternatives for life-long careers.

One way to look at full employment is the employment to population ratio for prime age workers (18-65). By this metric California has, after adjusting for demographic changes, returned to levels near those prior to the 2008/2009 recession and the long secular decline in the employment to population ratio appears may be over. However, a return to the pre 2007 level has not occurred.

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1. On November 9, 2016 A joint statement of the State Senate and State Assembly stated “California was not part of this nation when it began, but we are clearly now the keeper of its future.” This was considered the clarion call to counter Washington policy under President Trump.
 2. DOF.CA.gov

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Chart 1 Ration of Employment to CA Population, Ages 18-64



Source: BLS, California Department of Finance

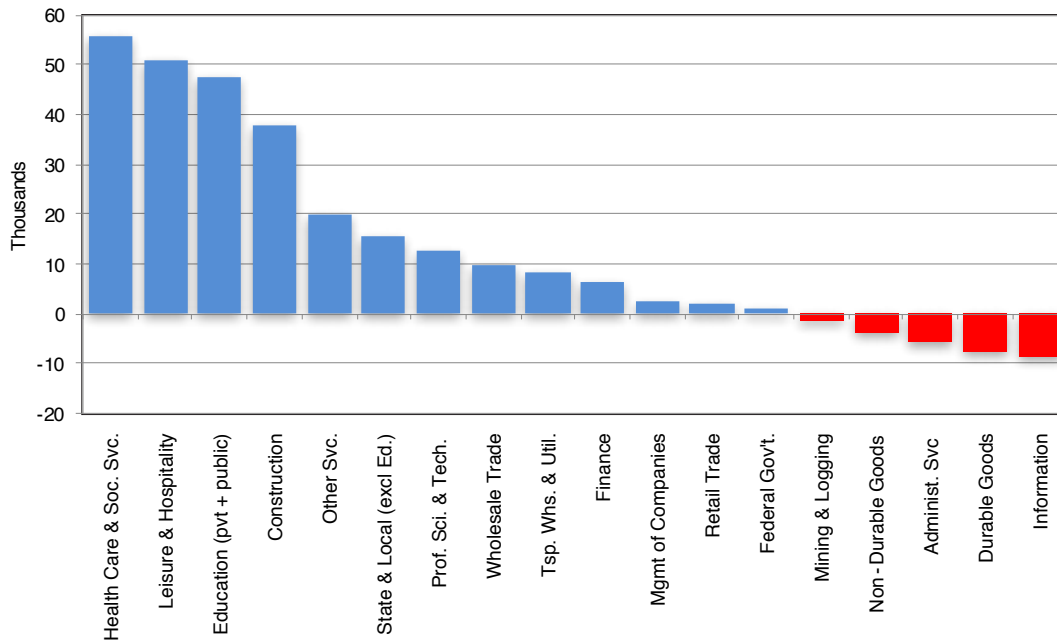
This suggests that there may be room for increased employment and therefore increased revenue, but the potential increased employment does not appear to be on the high end where it might affect State income tax revenue in a significant way. On the lower end of the income spectrum, the increases in the minimum wage will have little impact on State revenues.

Today in California employment is at record levels with 16.7 million payroll jobs. Over the past 3 months (February to April) job gain has been widespread but less so than previously. Manufacturing, government, retail, temp agencies, information and finance all posted payroll losses. The big winners have been construction, education health care and social services, and leisure & hospitality. Continued growth in the first of these is threatened by higher interest rates, and the latter two are at risk from changes to Obamacare and reductions in international tourism.

This being the case, how can California experience increasing income, and by implication income tax receipts, at the same or faster rates than before? What is required is either immigration increasing the population, or tight labor markets and company valuations increasing taxable income. The problem with an assumption that relies on this is that neither one is in the “very-likely” camp.

Population growth from domestic migration will be restrained by the high cost of housing. Even if efforts underway today to build out more housing and the infrastructure to support it come to the fore, it will be years before the impact will be felt. Population growth from international migra-

Chart 2 Change in Jobs by Sector (April 2016 to April 2017)



Source: EDD.ca.gov

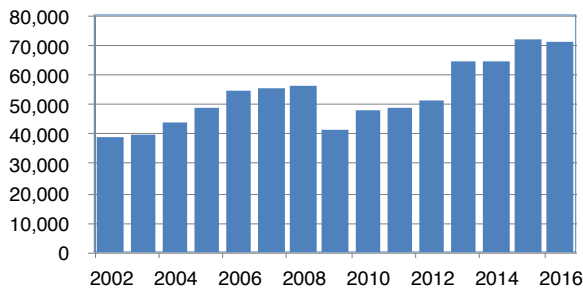
tion will run into a Trump wall. Thus higher taxes through increased immigration, whether domestic or international is not apt to occur.

Current Income Tax Revenue

Figuring out the impact of income growth on fiscal year budgets is a bit subtle as income is earned and taxed in a calendar year, but paid over more than one calendar year, and fiscal years run from July to June. For the purposes of this analysis, I will focus on income and tax revenues in calendar years.

As can be seen from Chart 3, income tax revenues have trended upwards since the depths of the last recession, and plateaued in 2014 and 2016. The 2014 plateau is easily explained as changes in tax rates, they increased at the Federal level January 2013, resulted in income shifting back to 2012. The increase in tax revenues with Prop 30 did not result in income shifting as Prop 30 passed in November 2012 and was retroactive to January 2012. However, the plateau in 2016 admits no such explanation. An examination of the

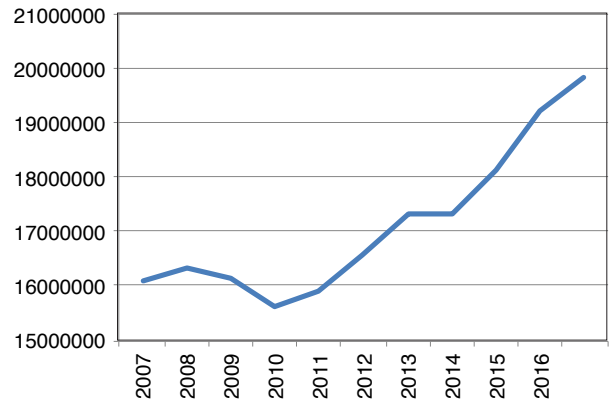
Chart 3 California Calendar Year Personal Income Tax Revenue (Billions of FY '83)



Source: California Department of Finance

data (Chart 4) shows that in fact real personal income growth continued in 2016 but the rate of growth relative to 2015 fell even as California continued its faster than the U.S. economic expansion.

Chart 4 CA Real Personal Income



Source: BEA.gov

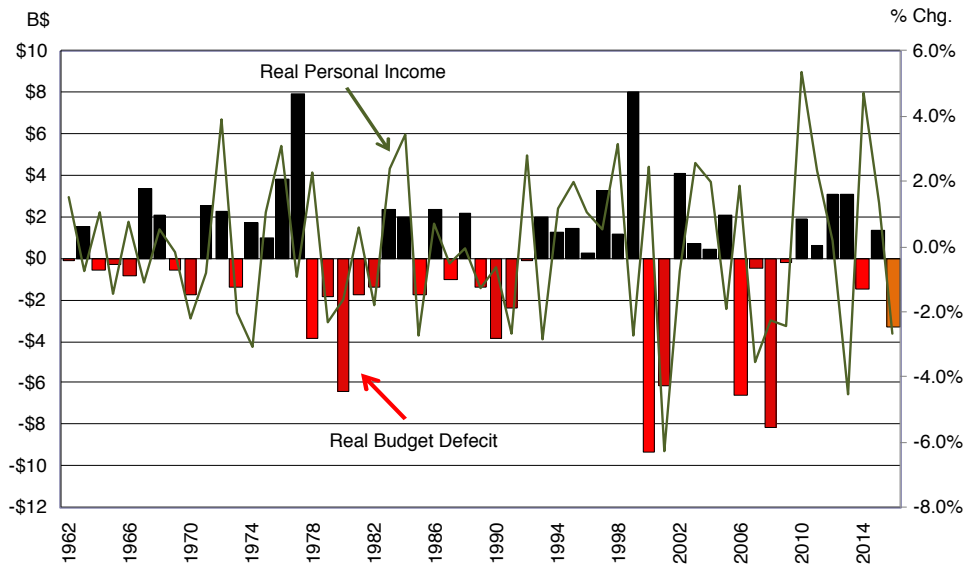
The Historical Record on General Fund Deficits

To explore this further consider Chart x. The columns in the chart are the actual surplus and deficits in the State General Fund. These are not from the budget itself, but from the ex-post reconciliation of what the State received in General Fund Revenue and what it paid out in expenditures from the General Fund. The line in the chart is the change in the rate of change of real personal income. That is, after adjusting for inflation, these data describe whether or not personal income is growing at a faster, slower or at the same rate.

Prior to 1967, the year of the Reagan tax increase which gave us the progressive tax system we enjoy today, there is little relation between the line and the surplus/deficit columns. To be sure, there is also little data. But afterwards, virtually every time the line goes negative there is either a deficit in the current or following fiscal year. And tellingly, those deficits tend to be clustered in multiple years of deficits. As well, they get larger over time. The recent exception of the 2013 fiscal year is because of the income shifting previously described.

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Chart 5 Real California Budget Defecit and Change in % Change of Real Personal Income



Sources: California Department of Finance, BEA.gov, BLS.gov, UCLA Anderson Forecast

Implications for the forecast

And that is bad news for the coming year as the measures to stabilize the volatility of income tax revenues have been rather tame. The rainy day fund at the end of this fiscal year will be around \$7B. If we ignore the huge drop in revenues due to the Great Recession, deficits and expenditure reduction since 1980 have averaged about 8% of the General Fund. This would yield a shortfall after using all of the drizzling-day-fund of around \$3B. While not great, it is small enough that borrowing could cover it.

If there are multiple years of deficit as in the past, subsequent years will not have a reserve to work with. A two year run of deficits at historical levels yields a \$17B shortfall which will have to be made up through budget cuts or borrowing. So those State programs that have been receiving restored funding get whipsawed once again.

To get out of this bind, either the legislature has to ramp down expenditures to a level that is sustainable with the average revenue over the business cycle, build up a true rainy-day fund to smooth out revenue fluctuations, or revamp the tax system in such a way as to move the State's dependence off of its highly volatile tax base. Neither is

expected in the near term. Taking a conservative approach, our forecast for California will have little growth in State and Local government in 2018 and 2019.

The Forecast

The current forecast is slightly lower and pushed out in time than our previous one. This reflects the difficulties that the Trump administration is having in getting its stimulus packages passed. For example, the increase in the size of the Navy through the addition of a large number of ships, a purchase which would have benefited San Diego, did not even appear in the budget proposal. In addition, deportations, or the threat thereof, of unskilled workers will impact food harvesting and food processing. We expect California's unemployment rate to have its normal differential to the U.S. rate at 4.5% by the end of the forecast period (2019).

Our forecast for 2017, 2018 and 2019 total employment growth is 1.4%, 1.0% and 0.9% respectively. Payrolls will grow at about the same rate over the forecast horizon. Real personal income growth is forecast to be 3.1%, 3.3% and 3.2% in 2017 and 2018 respectively. Homebuilding will continue in California at about 118,000 units per year through the forecast horizon.