

Controller *John Chiang*

California State Controller's Office



August 2009 Summary Analysis

Volume 3, Issue 8

Statement of General Fund Cash Receipts and Disbursements

State Finances in July 2009

- ⇒ The State began the fiscal year without enough cash to make all payments in July. Without action from the Governor and Legislature, the State Controller's Office was forced to begin issuing Registered Warrants (or IOUs) on July 2 to any General Fund payment categories not protected by the State Constitution, federal law or court decision. In the month of July, \$1.493 billion worth of Registered Warrants were issued.
- ⇒ The figures reported in July's cash statement are distorted by \$362 million in personal income and corporate tax refunds paid with Registered Warrants that would have otherwise offset revenues. To present a true picture of cash activity in the month of July, this report adjusts receipts to account for Registered Warrants.
- ⇒ Compared to July 2008, General Fund revenue in July 2009 was down \$365 million (-8.0%). The total for the three largest taxes was below 2008 levels by \$131 million (-3.3%). This was driven by personal income taxes, which came in \$335 million below (-11.5%) last July. Yet, corporate taxes were up by \$18.9 million (9.1%), and sales taxes in July were \$185 million higher (20.8%) than last July.

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Budget vs. Cash

The State's budget is a financial plan based on estimated revenues and expenditures for the State's fiscal year, which runs from July 1 through June 30.

Cash refers to what is actually in the State Treasury on a day-to-day and month-to-month basis.

Monitoring the amount of cash available to meet California's financial obligations is the core responsibility of the State Controller's office. On average, the Controller's office issues 182,000 payments every day.

The State Controller's Office is responsible for accounting for all State revenues and receipts and for making disbursements from the State's General Fund. The Controller also is required to issue a report on the State's actual cash balance by the 10th of each month.

As a supplement to the monthly Statement of General Fund Cash Receipts and Disbursements, the Controller issues this Summary Analysis for California policymakers and taxpayers to provide context for viewing the most current financial information on the State's fiscal condition.

This Summary Analysis covers actual receipts and disbursements for July 2009. Data are shown for total cash receipts and disbursements, the three largest categories of revenues, and the two largest categories of expenditures.

A statement of estimated cash flows for the amended 2009-10 Budget Act signed on July 28, 2009 is not available, so this report compares actual receipts against historical figures from 2008.

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Summary of Net Cash Position as of July 31, 2009

- ⇒ Through July, the State had total receipts of \$4.4 billion (Table 1) and disbursements of \$9.4 billion (Table 2).
- ⇒ The State ended last fiscal year with a deficit of \$11.9 billion, so the combined current year deficit stands at \$16.5 billion (Table 3). Those deficits are being covered with internal borrowing.
- ⇒ Of the largest expenditures, \$8.4 billion went to local assistance and \$692 million went to State operations (See Table 2).
- ⇒ Without accounting for IOUs, local assistance payments were \$3.7 billion above last July (80.0%). State operations were \$1.65 billion below (-70.4%). Total State payments, including IOUs, were \$1.6 billion above last July.

How to Subscribe to this Publication

This Statement of General Fund Cash Receipts and Disbursements for July 2009 is available on the State Controller's Web site at www.sco.ca.gov.

To have the monthly financial statement and summary analysis e-mailed to you directly, sign up at:

http://www.sco.ca.gov/ard_monthly_cash_email.html

Any questions concerning this Summary Analysis may be directed to Hallye Jordan, Deputy Controller for Communications, at (916) 445-2636.

What The Numbers Tell Us

Feeling for the Bottom

While the State's General Fund Revenue came in below last July, there are signs that California's economy is feeling for the bottom. When adjusting for Registered Warrants issued on personal income and corporate tax refunds, General Fund Revenue was 8% below July 2008. However, the pace of deterioration has slowed considerably relative to the 39.4%, 39%, and 17.7% deterioration in March, April, and May, respectively.

This slowing decline can be attributed to several factors — both economic and policy changes. First, the Governor signed a bill in October that imposes a 20% understatement penalty on corporate tax. Companies were given the option to avoid the penalty by filing an amended return and paying their actual tax liability by May 31, 2009. As a result, corporate taxes saw sharp increases as firms took action to avoid the penalty.

Second, the sales tax rate was increased on April 1 from 7.25% to 8.25%. This has helped to bolster the sales tax revenues collected by the State, which were up 20.8% from last July. Another policy change that has had a positive impact on California's sales tax collections is the Federal Government's "Cash for Clunkers" program. This program, which was allocated \$1 billion, provides for up to \$4,500 in rebates for trading in used cars to purchase a new car. This program has been successful in boosting demand for new automobiles, and thus, generating additional tax revenues for California. Although this positive indicator is driven by economic incentives created by policy changes in Washington D.C. more than a genuine rebound in consumer activity, any encouraging signs in the economy were virtually nonexistent six months ago.

Finally, on the economic side, the pace of job declines has also slowed significantly. Although California's unemployment rate increased in June, it did so at a slower pace. There are signs that many sectors are nearing a bottom, including construction, which should begin to stabilize as residential building permits have leveled off in recent months. Also, as savings rates have increased — reaching 5.2% of disposable income in the second quarter of 2009 — people are beginning to develop a cash cushion that will ultimately allow them to feel comfortable spending again.

We are not ready to signal the beginning of the recovery in California yet, but there are many signs that the State is feeling for the bottom and that the end is near.

Table 1: General Fund Receipts, July 1-31, 2009 (in Millions)*

| Revenue Source | July 2009 Receipts | July 2008 Receipts | Actual Over (Under) |
|-----------------------------|--------------------|--------------------|---------------------|
| Corporation Tax | \$227 | \$209 | \$19 |
| Personal Income Tax | \$2,580 | \$2,915 | (\$335) |
| Retail Sales and Use Tax | \$1,073 | \$888 | \$185 |
| Other Revenues | \$331 | \$565 | (\$234) |
| Total General Fund Revenue | \$4,211 | \$4,577 | (\$366) |
| Non-Revenue | \$182 | \$185 | (\$3) |
| Total General Fund Receipts | \$4,383 | \$4,761 | (\$378) |

* **Note:** Personal income and corporate tax receipts are adjusted to account for Registered Warrants being issued for tax refunds. Some totals on charts may not add, due to rounding

Table 2: General Fund Disbursements, July 1-31, 2009 (in Millions)

| Recipient | July 2009 Disbursements | July 2008 Disbursements | Actual Over (Under) |
|------------------------------|-------------------------|-------------------------|---------------------|
| Local Assistance | \$8,397 | \$4,672 | \$3,725 |
| State Operations | \$692 | \$2,340 | (\$1,648) |
| Other | \$284 | \$1,844 | (\$1,560) |
| Total Disbursements | \$9,373 | \$8,856 | \$517 |
| Disbursements including IOUs | \$10,504 | \$8,856 | \$1,648 |

Table 3: General Fund Cash Balance As of July 31, 2009 (in Millions)

| | Cash Balance July 2009 | Cash Balance July 2008 | Actual Over (Under) |
|---|------------------------|------------------------|---------------------|
| Beginning Cash Balance July 1, 2009 | (\$11,908) | (\$1,452) | (\$10,456) |
| Receipts Over (Under) Disbursements to Date | (\$4,618) | (\$4,095) | (\$523) |
| Cash Balance July 31, 2009 | (\$16,526) | (\$5,547) | (\$10,979) |
| Total with IOUs on July 31, 2009 | (\$18,019) | (\$5,547) | (\$12,472) |

Borrowable Resources

State law authorizes the General Fund to internally borrow on a short-term basis from specific funds, as needed.

Payroll Withholding Taxes

“Payroll Withholdings” are income taxes that employers send directly to the State on their employees’ behalf. Those amounts are withheld from paychecks during every pay period throughout the calendar year.

Revenue Anticipation Notes

Traditionally, the State bridges cash gaps by borrowing money in the private market through Revenue Anticipation Notes (RANs). RANs are repaid by the end of the fiscal year.

Non-Revenue Receipts

Non-revenue receipts typically are transfers to the General Fund from other state funds.

California Economic Snapshot

| | | |
|--|--|---------------------------------------|
| New Auto Registrations (Fiscal Year to Date) | 1,312,090 Through April 2008 | 898,948 Through April 2009 |
| Median Home Price (for Single Family Homes) | \$328,000 In June 2008 | \$246,000 In June 2009 |
| Single Family Home Sales | 35,202 In June 2008 | 44,167 In June 2009 |
| Foreclosures Initiated (Notices of Default) | 121,673 In 2nd Quarter 2008 | 124,562 In 2nd Quarter 2009 |
| Total State Employment (Seasonally Adjusted) | 15,049,166 In June 2008 | 14,282,582 In June 2009 |
| Newly Permitted Residential Units (Seasonally Adjusted Annual Rate) | 68,852 In June 2008 | 35,276 In June 2009 |
| Data Sources: DataQuick, California Employment Development Department, Construction Industry Research Board, State Department of Finance | | |

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Featured Articles on California's Economy

The opinions in these articles are presented in the spirit of spurring discussion and reflect those of the authors and not necessarily the Controller or his office. This month's report includes an article by Christopher Thornberg, Principal, Beacon Economics, and Chair of the Controller's Council of Economic Advisors.

Whither the Golden State's Shine?

By Christopher Thornberg, Ph.D.
Principal, Beacon Economics
Chair, Controller's Council of Economic Advisors

There is little doubt that the Golden State has lost some of its luster in recent months. Its economy is one of the worst hit in the current economic downturn, parts of the state are "ground zero" in the housing market meltdown, and the budget is a catastrophe with IOU's being used to pay vendors for the first time in over a decade. As with past downturns, the state's critics have started beating the drum of long-run decline. Recently even the Economist Magazine entered the fray with its top U.S. article asking whether Texas would soon replace California as the flagship state of the U.S. economy.

Despite all of its issues, the state remains a growth engine for the U.S. economy. The table on the following page provides real growth rates for California's economy by sector, relative to the U.S. overall, from 1997 to 2008. The table is full of surprises. Overall, the state economy outgrew the U.S. economy by one full percentage point annually — 3.6% to 2.7%. The state grew faster (or declined slower) than the nation in almost every sector. GDP is not the only place we can see the success of the California economy. Aggregate personal income and per capita income have been growing faster here than in the nation overall, as has payroll employment and population growth.

Does this mean everything is fine? Of course not. The state has many issues that need to be addressed, from infrastructure to public schools to immigration to regulation to the structure of



taxes. Without these issues growth would have been even faster and the state's economy even stronger. But the success of California is a function of many other things — climate, location, amenities, world-class universities, and so on. Success here is ours to lose.

Employment



Realistically the downturn in the state started in 2006, as this is when the first noticeable slowing of employment occurred. Most sectors were performing normally, but the collapse of the housing bubble hit construction and financial services (primarily mortgage brokers) quite hard.

The second stage of the current downturn was driven by a slowdown in consumer spending. Between 2006 and 2007 the weakness in construction and finance in the state spread to wholesale and retail trade, and to administrative services where temporary employment lies.

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| Industry | Real Growth Rate | | Contribution by Sector | | CA Growth Over US |
|---|------------------|------|------------------------|------|-------------------|
| | US | CA | US | CA | |
| All industry total | 2.7 | 3.6 | | | |
| Construction | -1.7 | -1.0 | -2.4 | -0.9 | 1.5 |
| Manufacturing: | | | | | |
| Durable goods | 4.5 | 8.6 | 14.1 | 18.1 | 4.0 |
| Nondurable goods | -0.4 | 1.3 | -0.8 | 1.4 | 2.2 |
| Wholesale trade | 2.8 | 3.2 | 6.2 | 5.1 | -1.1 |
| Retail trade | 4.5 | 5.0 | 12.2 | 10.2 | -2.0 |
| Transportation | 2.5 | 2.0 | 2.9 | 1.4 | -1.5 |
| Information | 6.9 | 7.9 | 12.7 | 13.8 | 1.1 |
| Finance | 4.0 | 4.7 | 11.2 | 7.3 | -3.9 |
| Real estate | 2.6 | 3.5 | 12.2 | 15.6 | 3.4 |
| Professional | 5.5 | 5.7 | 14.9 | 14.3 | -0.6 |
| Mgmt Companies | -0.5 | -4.6 | -0.3 | -2.5 | -2.2 |
| Administrative | 2.0 | 1.1 | 2.2 | 1.0 | -1.2 |
| Education | 2.2 | 2.9 | 0.7 | 0.6 | -0.1 |
| Health care | 3.1 | 3.8 | 7.9 | 6.1 | -1.8 |
| Arts, Entertainment | 2.3 | 2.3 | 0.8 | 0.8 | 0.0 |
| Accomm. & Food | 2.5 | 3.5 | 2.5 | 2.5 | 0.0 |
| Other services | 0.3 | 0.5 | 0.3 | 0.3 | 0.0 |
| Government | 1.1 | 1.9 | 5.0 | 5.7 | 0.7 |
| Source: BEA, Calculations by Beacon Economics | | | | | |

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Problems in the consumer economy spilled over into the rest of the state's economy during the past year. Everything from professional services to local government to information jobs, have taken a hit. The only stable sectors are state and federal employment, education and health. While there is still positive job growth in health care, it has slowed sharply.

But perhaps the most important question is when the state will start to pull out of the slide. There is at the moment mixed evidence on this front. On one hand, unemployment seems to have slowed its sharp rise in recent months as it approaches 12% in California. However, the pace of payroll job losses remains at roughly 60,000 per month and claims for

unemployment insurance continue at a very high level.

Payroll figures tend to miss turning points because of how the estimates are compiled, particularly as we get farther from the last benchmark. So these figures may be overstating the problem. The issue of new claims for unemployment insurance is quite severe, however. This is a direct estimate with no sampling involved. As for unemployment, the change in the number of unemployed persons has slowed in recent months, but at the same time the labor force has also shrunk — indicating that there may be discouraged workers leaving the sample. These numbers are notoriously variable on a month-to-month basis due to the size of the sample.

Looking at the entire picture there appears to be

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little relief in the short-run for the state. It is worth remembering that employment is always a trailing variable and good news elsewhere will eventually filter through to California.

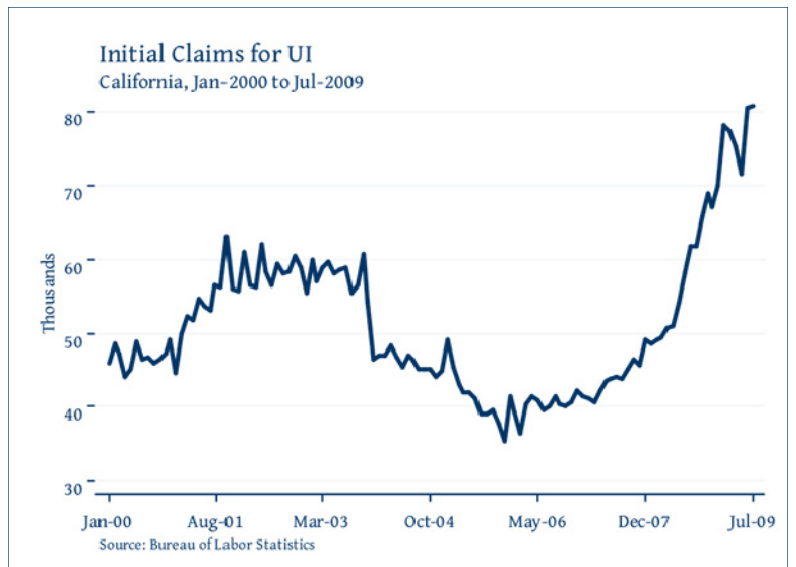
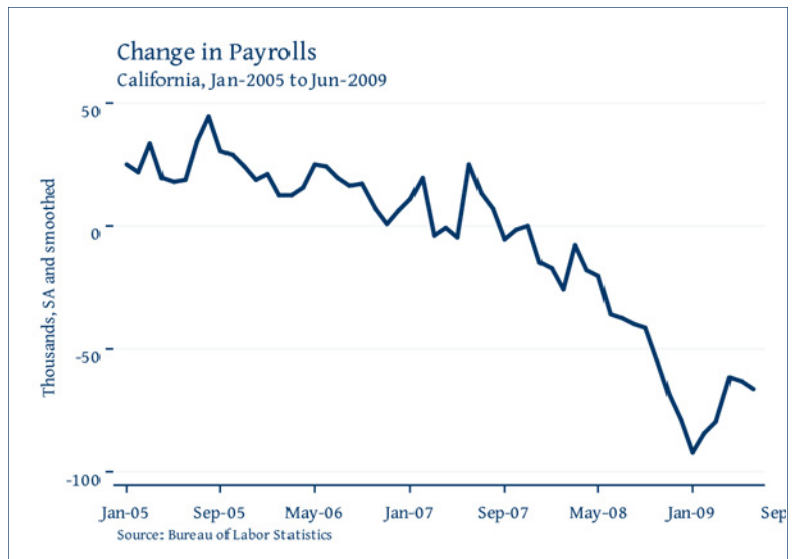
Residential Real Estate



News from the residential real estate front is slightly better, although there are still problems to work through. The price bubble in California was one of the largest in the nation, with prices rising from a median of \$150,000 in 1996 to \$300,000 in 2003 to \$500,000 in 2006. As noted this was a time of prosperity for the state. But even so, the increases imply that the ratio of home prices to median homeowner incomes rose from 3 to 5.5. Even with lower interest rates this meant that the proportional costs of owning an average home in the state doubled for the average household — clearly an unsustainable situation.

There is little mystery as to why California's housing market was hit so hard. By our estimates, 30% (by value) of all subprime and alt-A mortgages generated in the nation went to buy homes in California. Sadly, this is evidenced by the massive wave of foreclosures rippling through the state. The only mystery is why Californians (along with residents in Nevada, Florida, and Arizona) seemed so willing to get swept up in the hype surrounding the bubble. Now that the bubble has popped prices have collapsed. Median prices hit \$246,000 in June and the ratio of price to income has fallen to roughly 3.3 — far more in line with historic ratios.

Overall, home price declines are indeed decelerating, though they have not yet bounced back as some recent press reports have indicated. The small jump that occurred recently in median prices is more a function of seasonal issues and a shift in sales to more high-end units. The Case-Shiller numbers avoid these problems through their overlapping sales technique, and have shown the quarterly pace of price declines slowing over the past three quarters. This is great news — but bear in mind that prices are still falling at a 16% annualized pace.



Today, the biggest question on peoples' minds is likely to be: When will home prices start to come back? Unfortunately, it will take some time. First, there is the state economy: High unemployment, weak wage growth and uncertainty will keep many buyers wary. Second, there is the mortgage market. Underwriting standards have shifted from completely lax to strongly enforced. And while mortgage rates for conforming mortgages are still low, the spread between conforming and non-conforming remains wide.

Lastly, there is the foreclosure crisis, which is far from over. The pace of foreclosures has slowed in recent months, but this is due more to

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moratoriums injected into the process by Sacramento rather than any change in the market. According to data from Dataquik, foreclosures fell from 50,000 to 40,000 (seasonally adjusted) between Q4-08 and Q1 of this year, but defaults went from 70,000 to 120,000.

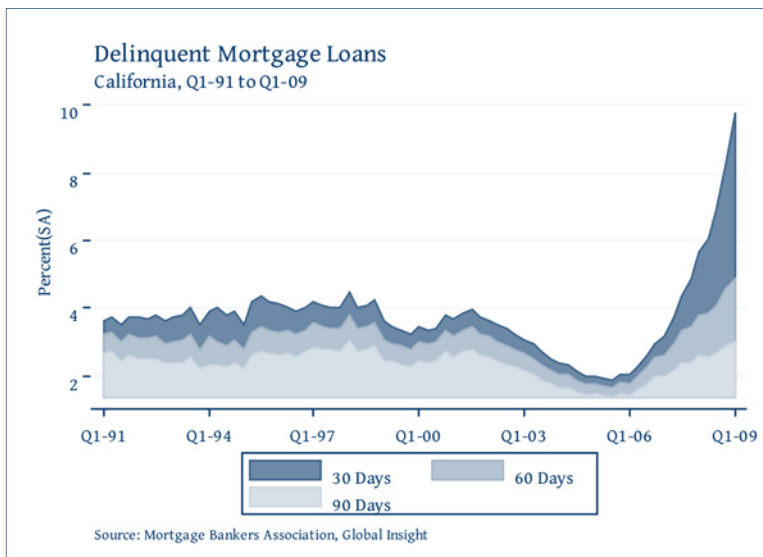
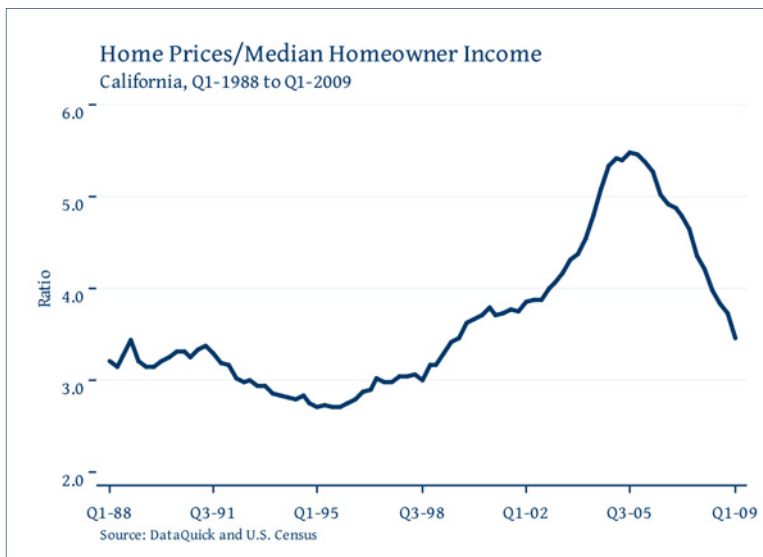
Even more startling is data from the Mortgage Bankers Association which shows that 9% of all mortgages in California are delinquent on payments. This indicates that 400,000 to 450,000 California households are behind in their payments and most if not all are likely underwater. This implies that a large proportion will eventually go into foreclosure.

There is also little to cheer in terms of construction. Sacramento shockingly enacted a \$10,000 tax rebate check for purchasers of new homes in the state even as it tipped towards insolvency. The bill was touted as a job creator by the industry, but with little justification, and sales of new units have continued to fall. New home sales are now down 35% from last year, as opposed to 25% up for all units.

The reason for this is simple — builders have been remarkably resistant to market pressures. While the prices for existing homes have returned to 2001 levels, prices for new homes are still 22% above this benchmark. In other words, all these sales and more could have occurred without any money from the state if builders had just collectively lowered their prices by the \$40,000 needed to keep up with price declines in existing homes.

Similarly, claims that the rebate program would create jobs were empty. Building permits have continued to fall from a peak of 20,000 units per month to a seasonally adjusted low of 2,500 units in May 2009. Most of the decline is among single-family units, but even multi-family permits are down with problems in the condo and apartment markets as families move into foreclosed units.

The state's housing construction market will not be down forever. Unlike Arizona or Nevada, California is still facing a chronic housing shortage. Even at its peak, the pace of building in the state was roughly enough to house 500,000 to 600,000 people. This



just matched population growth, the first time since the mid-1990s that stock growth met overall needs in California. This long-term lack of building has left the state with an enormous problem of overcrowded housing — over 12% of all rental units and 4% of owned units are overcrowded, with more than one person per room living in them. This is 2.5 times the national rate.

But what is good in the short-run is bad in the long-run. Short of substantial reform in the zoning rules that govern construction in California, look for crowded housing issues to grow worse in coming years, despite a recovery in construction.