Controller *John Chiang*

California State Controller's Office

November 2008 Summary Analysis | Volume 2, Issue 11

Statement of General Fund Cash Receipts and Disbursements

Tax Revenue in October 2008

⇒ In October 2008, General Fund revenue was $359 million below (-7.3%) the Budget Act estimate for the month. Corporate taxes were $84 million below (-22.4%) estimate. Personal income taxes were $146 million below (-4.5%) estimate while sales taxes were $34 million below (-3.7%) estimate. Together the three largest taxes (income, sales, and corporate) were $264 million below (-5.8%) the Budget Act estimate.

⇒ Compared to October 2007, General Fund revenue in October 2008 was lower by $274 million (-5.7%). Corporate taxes were below 2007 figures by $90 million (-23.6%). Personal income taxes were $144 million below (-4.4%) October 2007. Sales taxes were $107 million lower (-10.9%) than last October. The total for the three largest taxes was below 2007 levels by $341 million (-7.4%).

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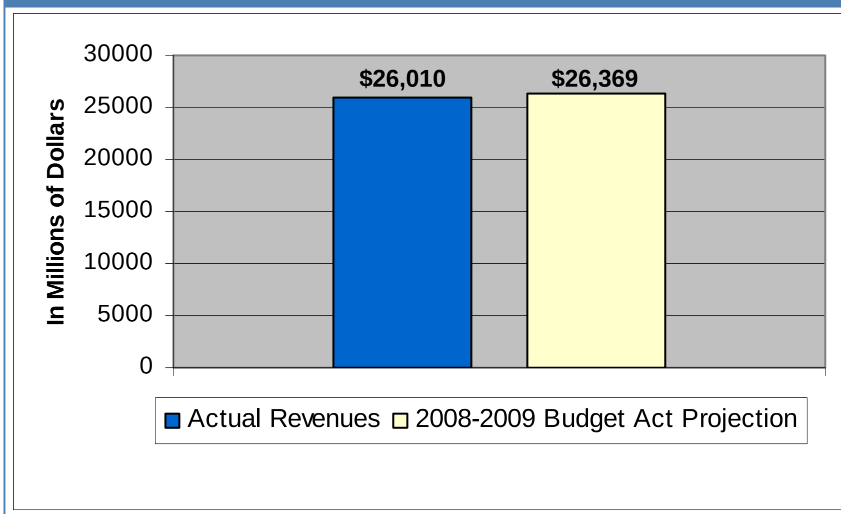
Table 1: General Fund Revenues: July 1, 2008–Oct. 31, 2008 (in Millions)



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 October 2008 and year to date for the first four months of Fiscal Year 2008-09. Data are shown for total cash receipts and disbursements, the three largest categories of revenues, and the two largest categories of expenditures. The final budget was passed on September 23, 2008. The Budget Act cash flow numbers used as a comparison this month show actual revenue through September, therefore the comparisons reflect only deviations in October.

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⇒ Payroll withholding taxes were 0.2% lower in October 2008 than in October 2007. Tax refunds to both individuals and corporations were higher in October 2008, contributing to the weakness in revenue collections.

Tax Revenue Fiscal Year to Date

⇒ Compared to this date in October 2007, revenue receipts are $512 million lower (-1.9%). The "Not Otherwise Classified" category was the only category that showed significant growth on a year over year comparison. The increase in this category is party due to unclaimed property collections that were halted in the prior year as new rules for locating owners were instituted.

Table 2: General Fund Receipts, July 1, 2008-October 31, 2008 (in Millions)

Revenue Source	Actual Receipts To Date	2008-2009 Budget Act Estimate	Actual Over (Under) Estimate
Bank And Corporation Tax	$2,530	$2,614	($84)
Personal Income Tax	$14,497	$14,643	($146)
Retail Sales and Use Tax	$7,123	$7,157	($34)
Other Revenues	$1,860	$1,955	($95)
Total General Fund Revenue	$26,010	$26,369	($359)
Non-Revenue	$838	$914	($76)
Total General Fund Receipts	$26,848	$27,283	($435)

Note: Some totals on charts may not add, due to rounding

⇒ Year-to-date collections for the three major taxes are $1.2 billion below (-4.6%) last year at this date. Retail sales are $367 million below (-4.9%) last year at this date. Corporate taxes are $612 million below (-19.5%) last year and income taxes are $190 million lower (-1.3%) than last year at this date.

⇒ Withholding taxes are 1.8% ahead of last year on a year-to-date comparison. This gain has been slowly eroding as the economy contracts. Employment is continuing to decline in California, with a loss of 78,600 jobs in the first nine months of the year. The October payroll jobs survey for the nation showed a loss of 240,000 jobs, an acceleration of the previous rate of decline. The national unemployment rate jumped to 6.5%, a rate higher than the peak reached in the last recession. California's unemployment rate was already 7.7% in September and the latest national numbers indicate that both job losses and unemployment in California will accelerate in the months ahead.

Summary of Net Cash Position as of October 31, 2008

⇒ Through October, the State had total receipts of $26.8 billion (Table 2) and disbursements of $42.2 billion (Table 4). The deficit of $15.4 billion was covered by $5 billion in Revenue Anticipation Notes (RANS) and $10.4 billion of internal borrowing.

⇒ Of the largest expenditures, $30.7 billion went to local assistance and $10.8 billion went to State operations (See Table 4).

⇒ Total receipts were $435 million lower (-1.6%) than anticipated in the Budget Act. Revenue receipts

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were low by $359 million (-1.4%), and nonrevenue receipts were lower by $76 million (-8.3%). Nonrevenue receipts are primarily transfers from other funds.

⇒ Disbursements through October were $1.6 billion lower (-3.7%) than estimated in the Budget Act. Part of the net savings is related to the timing of payments.

⇒ The State ended last fiscal year with a net cash deficit of $1.45 billion. That deficit was covered by internal borrowing. Loans

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Estimated Taxes

Estimated tax payments are generally filed quarterly to pay taxes due on income not subject to withholding. This can include income from self-employment, interest, dividends, gains from asset sales, or if insufficient income tax is being withheld from a salary, pension, or other income.

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, to bridge cash gaps the state borrows money in the private market by issuing Revenue Anticipation Notes (RANs). RANs are repaid by the end of the fiscal year.

Borrowable Resources

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

Table 3: General Fund Cash Balance As of October 31, 2008 (in Millions)

	Actual Cash Balance	2008-2009 Budget Act Estimate	Actual Over (Under) Estimate
Beginning Cash Balance July 1, 2008	($1,452)	($1,452)	$0
Receipts Over (Under) Disbursements to Date	($15,364)	($16,550)	$1,187
Cash Balance October 31, 2008	($16,815)	($18,002)	$1,187

Table 4: General Fund Disbursements, July 1, 2008-October 31, 2008 (in Millions)

Recipient	Actual Disbursements	2008-2009 Budget Act Estimate	Actual Over (Under) Estimate
Local Assistance	$30,732	$32,992	($2,259)
State Operations	$10,783	$10,200	$583
Other	$696	$641	$55
Total Disburse-ments	$42,211	$43,833	($1,622)

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from internal sources now total $11.8 billion. At the end of October, the State had $6.9 billion remaining in borrowable resources. Internal loans will be repaid according to cash management procedures as resources are available.

How to Subscribe to this Publication

This Statement of General Fund Cash Receipts and Disbursements for October 2008 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 www.sco.ca.gov/ard/cash/email-sub.shtml.

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

California Economic Snapshot

New Auto Registrations (Fiscal Year to Date)	**412,963** Through Sept. 2007	**341,878** Through Sept. 2008
Median Home Price (for Single Family Homes)	**$535,760** In Sept. 2007	**$316,480** In Sept. 2008
Single Family Home Sales (Seasonally Adjusted Annual Rate)	**255,340** In Sept. 2007	**502,190** In Sept. 2008
California Foreclosures Initiated (Notices of Default)	**72,571** In 3rd Quarter 2007	**94,240** In 3rd Quarter 2008
Total State Employment (Seasonally Adjusted)	**15,169,600** In Sept. 2007	**15,092,000** In Sept. 2008
Newly Permitted Residential Units (Seasonally adjusted Annual Rate)	**88,000** In Sept. 2007	**53,400** In Sept. 2008

Data Sources: California Association of REALTORS (sales data), DataQuick (foreclosure data), California Employment Development Department, Construction Industry Research Board

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Featured Articles on California's Economy

Controller John Chiang's Council of Economic Advisors informs the Controller on emerging strengths and vulnerabilities in California's economy, major issues and trends that may affect the State's fiscal health, and how to make the best use of limited government revenues and resources.

The advisors also contribute monthly articles on issues regarding California's economy. The opinions in the 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.

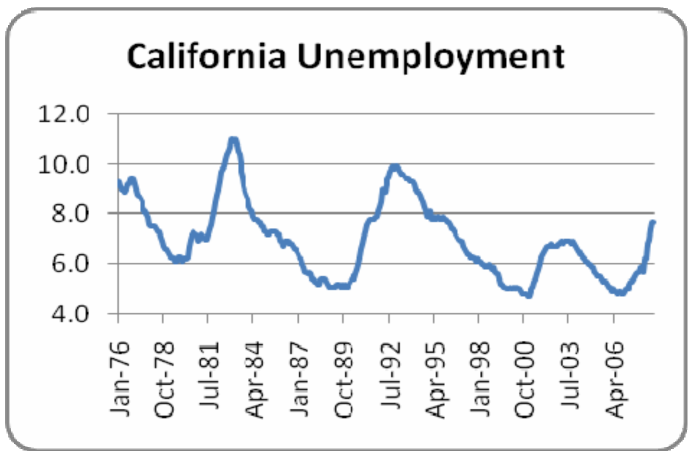
From Bad To Worse

Christopher Thornberg
Principal, Beacon Economics
Member, Controller's Council of Economic Advisors

The credit crisis that began this past August has captured headlines and caused a dramatic shift in the attitudes of policymakers and economists who previously had been bullish on the economy and denied the possibility of a recession. Now the conversation has shifted: Find a solution to the financial crisis before Wall Street drags Main Street down with it. While stabilizing the banking sector is an important step towards ultimate recovery, the causality has been completely reversed. The State of California is not threatened with recession because of what is happening on Wall Street. Indeed, the state has been in a recession for a number of quarters, and this is what is putting the pressure on Wall Street.

To paraphrase Tolstoy, all expansions look alike, but each recession is painful in its own way. This downturn has had a very slow start due to the fact that the various components of spending — housing, consumer spending, business spending, and the external accounts — have not been cycling together as they normally do. The initial weakness in the state was due primarily to problems in the housing market and slowing of residential construction. The rest of the economy continued forward.

More recently the situation has shifted. The problems that began in housing have now spread to the rest of the economy. Mortgage problems have led to a broader financial crisis. The drop in net wealth due to declining home prices and the battering financial markets have taken are now



taking a toll on consumer spending. Corporate profits are also suffering and business spending is starting to move into freefall. And the last bastion of strength in the economy — the external accounts — will start to take a turn for the worse as the U.S. dollar has surged in recent weeks to levels not seen since 2006. In short, the U.S. and

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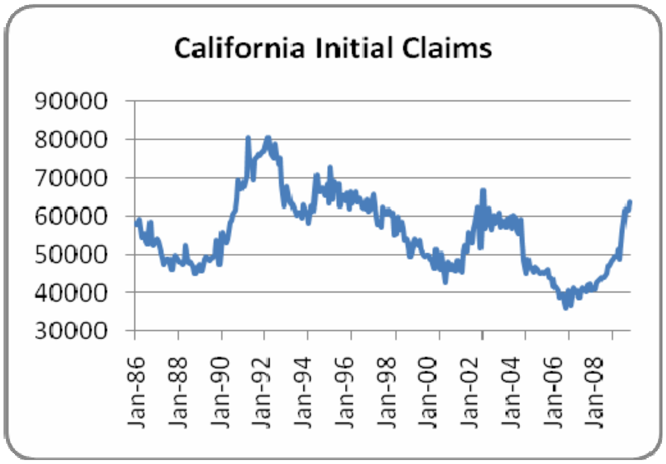
California are moving from a housing recession into a full blown recession.

Employment and Income

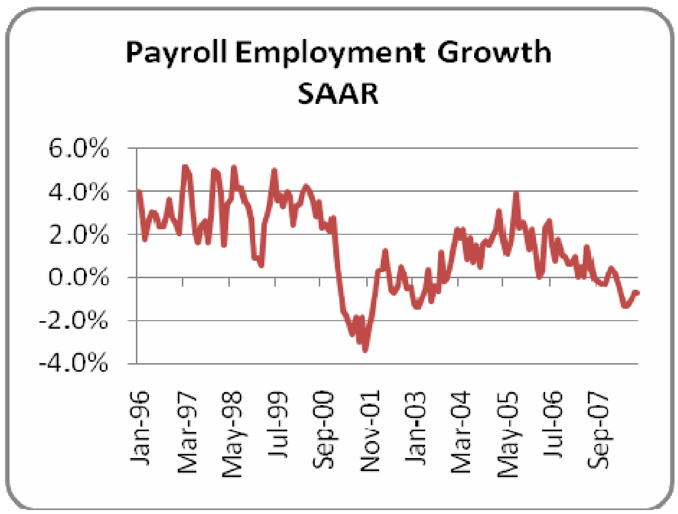
It is indeed a unique recession. Consider the most basic indicator of an economic downturn —



the unemployment rate. Typically this is considered to be a concurrent indicator — that is to say it starts to rise around when the economy is starting to suffer, and only declines again after the downturn has ended and the economy is moving forward again. For example unemployment in California started rising in May of 1981 and the recession 'officially' started in July, 2 months later. During this recession however, the unemployment rate started rising way back in 2006 and is now 2.9 percentage points above the trough. This is worse than the trough-to-peak increase during the 1980 and 2001 recessions, and rapidly approaching that seen in the 1981 recession when it increased by a total of 4 percentage points. That there was little discussion about what was happening in the labor markets is owed to the fact that one, GDP was still growing; two, the state was still adding payroll jobs albeit at a slowing pace; and three, the pace of increase was (initially) unusually slow, a situation that changed early this year when the increase started to accelerate. Still, many forecasters in the state continued to preach that there would be no recession despite the fact that it looked as if we were already in one.

This September was actually the first month for some time in which unemployment did not increase by a substantial amount — only one-tenth of one percent. Unfortunately this respite will be short lived. A leading indicator of the unemployment rate is initial claims for unemployment insurance. Claims have risen from a seasonally adjusted weekly average of 50,000 in May, to 61,500 in August, to 63,500 in the first two weeks of October. And these do not include those layoffs that have been announced but not yet enacted by a number of important employers in the state as corporate profits have swooned. At this point in time we forecast that unemployment in the state will rise close to 10 percent, putting the total increase to 5 percentage points, greater than during the 1990 downturn.

The payroll side looks less dire—at least at the moment. Overall, non-farm jobs are shrinking at a one percent (annualized) pace for most of the



year. Yet we can take little solace in this. There is a known bias in the payroll numbers that causes them to over estimate job growth as the economy slides into a recession, and underestimate them after the economy starts to recover. This bias is corrected when the new benchmark is put into place at the start of the year. We can expect a substantial downward revision in the employment data in a few months

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— making 2008 look much worse than the current estimates.

Despite this problem we can still look at the pattern of jobs changes across sectors to get a sense of how the recession is spreading. Job growth averaged 256,000 in 2004 and 2005 with solid growth in almost every sector. There was a marked slowing in job growth in 2006 and 2007 as a result of the slowing housing markets — the pace fell to a paltry 116,000 jobs per year, less than half the rate of the previous two years. Construction went from adding 56,000 jobs per year to losing 50,000 jobs. Durable good manufacturing also saw an increase in their ongoing job losses, finance and real estate tipped into negative territory, and retail experienced substantive slowing. Other sectors of the economy maintained their strength. It is worth noting that despite ample evidence of a slowing economy state and local government went on a hiring spree, adding close to 100,000 new employees to the rolls up from 32,000 in the previous two years.

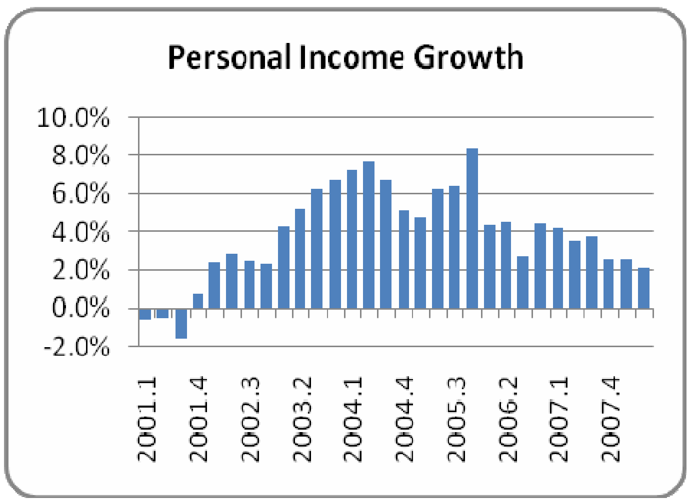
In 2008 the situation has shifted to an annualized loss of 125,000 per year, although again this will likely revised for the worse in January. The weakness in the economy has spread to most every sector with the exception of Education and Health. The only sector of the economy doing well is information as the drop in the dollar has pulled movie production back into the state and the successful conclusion of some of the labor strife has put projects back into the pipeline.

Annualized Changes in Employment by Sector

	04-05	06-07	08
Non-Farm	256.8	116.3	-125.7
Construction	56.3	-47.8	-61.0
Durables	-4.8	-20.0	-23.6
Non-Durables	-8.7	-7.9	-7.1
Wholesale	20.9	16.0	-5.9
Transport	6.4	8.8	-0.4
Retail	33.3	8.7	-27.9
Information	-9.5	-7.6	24.5
Finance	15.8	-23.0	-25.2
Real Estate	7.9	-2.9	-6.5
Professional	49.0	40.0	13.4
Mgmt of Enter.	-8.1	-3.3	-6.3
Administrative	25.7	15.1	-40.8
Education / Health	23.1	45.9	42.9
Leisure	35.3	36.1	-6.7
Other	-0.6	7.7	-6.1
Federal Govt	-2.8	-0.4	0.7
State Govt	-1.4	14.3	-3.8
Local Govt	18.5	35.8	10.1

State Income

Not surprisingly, by current estimates income growth has been slowing in the state. Although overall income grew by a strong six percent in the second quarter, driven in large part by the arrival of the Federal rebate checks that many families received, wage and salary growth was roughly two percent (smoothed), down from the already weak pace of growth seen in 2007.



There are three key issues to bear in mind when evaluating these personal income numbers and thinking about where they will head. First, current income is based on estimates derived from tax withholdings and quarterly payments from private business. These estimates will change over time, and potentially for the worse. Second, the current turmoil and the decline in the equity markets in the third quarter will have

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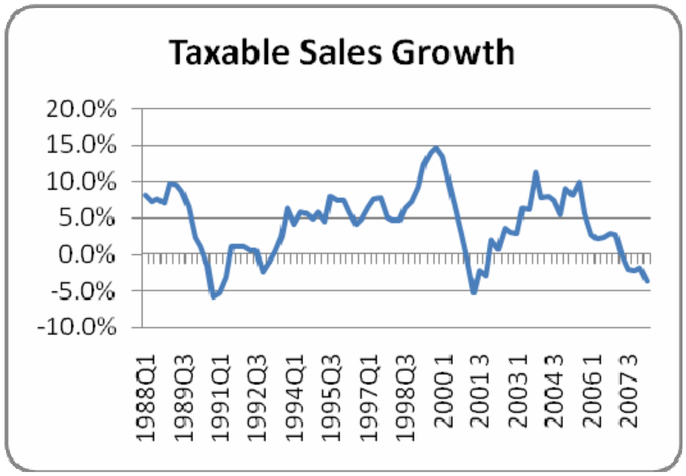
substantial implications for income tax receipts. Capital losses will be written off on gross income — a process that had substantial implications for the budget in 2001 and 2002. Finally we have to remember that layoffs are starting to pick up pace—implying that more people will be losing their jobs—and their incomes—in the coming months. In other words, incomes will continue to shrink for some time.

We are also starting to see signs of weakness on the business side of the economy. Business incorporations have fallen from 9000 to 8000 per year. Moreover, business bankruptcies surged to over 1500 in the second quarter, up from 500 per quarter in 2006. While the third quarter numbers are not yet in, the national statistics show total taxes on corporate profits falling 10 percent from the third quarter of 2007 until the second quarter of this year. The third quarter is likely to be worse, but the fourth quarter will see a dramatic decline as the equity losses filter through the system. In short, business taxes are unlikely to make up for personal income taxes.

Consumer Spending

State and local governments in California rely heavily on sales taxes as a portion of the revenue base. Indeed, one of the current discussions is a 'temporary' increase in the state rate in order to help deal with the current budget gap. Unfortunately such an effort will likely accomplish little in terms of increasing revenues. As noted above, the last shoe to drop in this recession is the pullback of consumer spending. With home equity rapidly disappearing and consumers holding record levels of debt, households have had to pull back on their discretionary spending.

Taxable sales had been growing at a substantial ten percent pace between 2003 and 2005, along with the strong increase in overall home values. This is an unusually high pace, as it typically only increases at roughly the pace of income growth. This is indicative of the home equity effect on spending. But as sales and home prices started to decline through 2006, taxable sales growth



also cooled, falling from its previously lofty level down to the two percent range before finally tipping into negative territory in 2007. The latest reading is the worst: Current estimates show sales falling at nearly a four percent annualized pace in the second quarter of the year. Similarly, new vehicle registrations fell from 160,000 in 2005 to 140,000 in 2007 to 120,000 in the first half of this year.

The big question is where we head from here. While we don't have third quarter numbers yet, they promise to be much worse. The second quarter was when the Federal rebate checks reached consumers. And despite the cash infusion, on a national basis consumer spending growth was a mediocre 1.2 percent. Third quarter numbers for national consumer spending recently arrived with the third quarter GDP figure and they showed spending falling by three percent in annualized terms, one of the sharpest consumer pull backs seen in decades. Auto sales also plummeted in the third quarter from the second quarter. In short, the trends are strongly negative at the national level and those trends will likely look worse here in California since we were ground zero for the housing bubble.

Housing Markets

Finally, there is the housing market. While the problems in the economy started here, we now know that housing is not the sole problem. Rather it was the canary in the credit coalmine. The general asset bubble that is in the process of unwinding began with housing but has spread across the financial

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system's many parts. Corporate debt and other personal debt are showing the same type of stress — rising delinquencies and heightened write-offs by banks. Even as home prices have been falling at a record pace, so too have the equity markets turned. The major indexes are down 35 to 45 percent from the start of the year. Given this, it's worth looking at the housing market to see if recovery is starting to occur — as this may also predict that the broader measures may be getting close to the bottom.

One recent sign that may seem encouraging has come from the sales markets. According to Dataquick, home sales in Southern California were up 65 percent in September from last year at this time. In the Bay Area sales were up by 45 percent. Sales activity is a strong leading indicator of the direction of the market under normal circumstances — possibly implying that prices will begin to firm up.

Unfortunately this sign of recovery is largely a red herring. Sales in the state are being driven more by foreclosures than true strength in the market. And this isn't much of a surprise — according to data from Realtytrac, approximately 3.5 percent of all housing units in the state, around 400,000 units, are currently in the foreclosure process or already REO (owned by the foreclosing bank). With such a heavy stock banks are needing to rid themselves of inventory and prices are actually falling with the sales of these units rather than firming up as is typically seen when sales activity ticks up. Indeed, well over half of all sales in the state at the moment are foreclosed property and another quarter is distressed sales.

More importantly, while an increase in sales will eventually help by drawing down the existing inventory of foreclosed units, it will have to increase much more in order to make real headway against the still rising tide of foreclosures. Of all current outstanding mortgages in the state 3.2 percent are 60 to 90 days behind on payments according to figures from the Mortgage Banker Association. Short of some radical change in federal policy, most of these will end up in foreclosure at some point in the next six months. The state passed a rule

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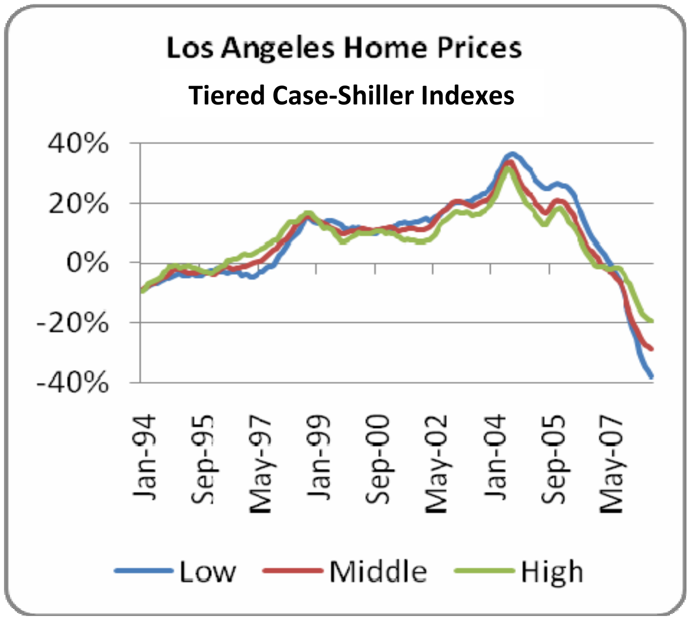

Foreclosed Units by County:
Realtytrac Data As of September 2008

County Name	Total	Share
Riverside	54,803	7.3%
San Bernardino	42,725	6.3%
Solano	8,596	5.7%
Contra Costa	19,434	4.9%
Alameda	15,283	2.7%
Orange	25,248	2.5%
Los Angeles	80,167	2.4%
Sonoma	4,669	2.4%
Napa	1,038	2.0%
Santa Clara	11,910	1.9%
San Mateo	2,934	1.1%
Marin	948	0.9%
San Francisco	1,508	0.4%

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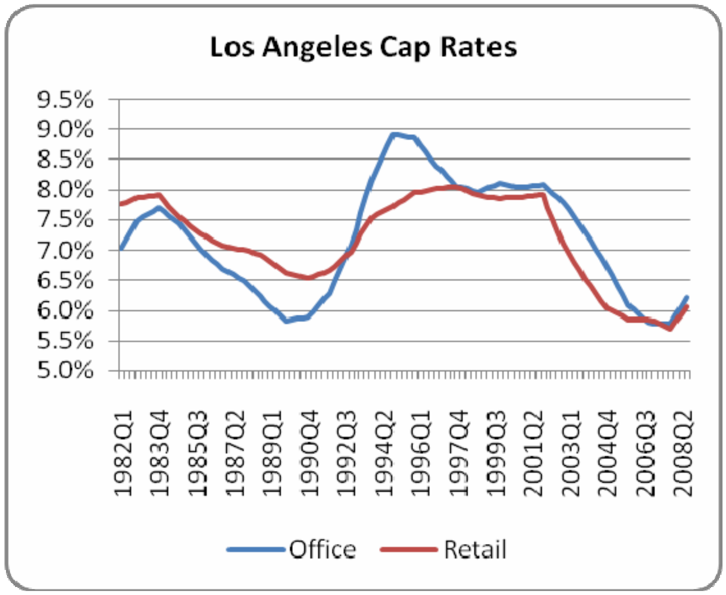
delaying the actual serving of papers — but this only pushed the problem out two months.

Building permits indicate continued problems as well. They continue to fall in the state, down 50 percent in the third quarter from where it was in the third quarter of last year.

There are also long run problems that have yet to be addressed. Quite a few recent homebuyers used exotic mortgages that have low initial payments. Many of these products do not reset (jump to a higher payment base) until 2010 and 2011. Most of these properties will likely go into foreclosure when this reset occurs, since the payments will reflect some of the outrageous prices that were being paid for homes at the peak of the bubble. Even if foreclosure rates have peaked, they will remain substantially higher than their long run average and will continue to put downward pressure on prices.

What this implies is that home prices will continue to fall for some time. The central problem with the housing market has always been prices. While the policy debate has centered on the terms of these mortgages, the problem was the amount being paid rather than the structure of the debt. Prices nearly tripled between 1999 and 2007 before they started to fall. A reasonable estimate is that home prices in the state will have to fall 40 to 45 percent to fall back in line with income levels. We also have to account for the fact that prices tend to overshoot on the way down due to the overall weakness of the economy. With this in mind prices will likely drop 50 to 60 percent by the time things bottom out. The good news is that prices have already fallen over 30 percent from their peak. But bear in mind that there will be no rapid recovery. Home prices, once they find bottom tend to stay there.

There is yet another land crisis unfolding. The bubble was not just in residential real estate, but also in commercial real estate. There the problem was in falling cap rates — the relationship between the prices paid for the buildings and their revenue streams. The same issue — too much credit



driving wild speculation — is now unwinding. Cap rates are rising as a result, even as rents are starting to succumb to the economic pressures and are starting to fall. Commercial property prices — which also add significantly to California's property tax base — will likely fall 30 to 35 percent before this portion of the cycle is ended.

The net result will be a big impact on property taxes. This year's property tax roll may have escaped the worst of the downturn. Next year's will not.