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California State Controller's Office

Jan. 9, 2013 | Summary Analysis | Volume 7, Issue 1

State Finances in December 2012

December 2012 totals vs. monthly estimates in the **2012-13 Budget Act**	December 2012 *adjusted* vs. monthly estimates in the **2012-13 Budget Act**
Total Revenues: -$896.6 million (-9.6%)	**Total Revenues:** $103.4 million (1.1%)
Sales Tax: -$1,108.2 million (-70.1%)	**Sales Tax:** -$108.2 million (-6.9%)
Income Tax: $767.6 million (13.4%)	
Corporate Tax: -$445.9 million (-31.2%)	

December Adjustments

Approximately $1 billion of sales tax was deposited into the Board of Equalization's agency bank account on Dec. 31, but not transferred to the General Fund until Jan 2. Because January sales tax is not collected until the end of the month, this appears to be a significant timing anomaly. The numbers above make adjustments for that timing issue.

Is California's Budget Expanding?

During these winter holidays, when some people sentimentalize their past -- and the Governor prepares his budget -- there might be a tendency to remember earlier budgets with a certain fondness. Were prior budgets better? How does the current budget compare to prior budgets?

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What the Numbers Tell Us

While the new calendar year has just begun, the State's fiscal year is already at the halfway point. What is California's fiscal condition at halftime? The answer is fair or at least close to what was expected at this time of the year.

After accounting for apparent timing issues (see box at left), December's adjusted cash totals were $103.4 million above estimates. But let's look at the big picture.

The gap between spending and revenues is still wide in terms of cash flow, although the State has ample means to finance its obligations.

Income tax revenues ran above expectations as individuals may have moved certain types of income, such as capital gains, to 2012 to avoid the possibility of higher federal taxes in 2013. January's revenue totals will bear close scrutiny to see if these timing discrepancies have been resolved and whether revenue projections remain on track. Disbursements

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What the Numbers Tell Us

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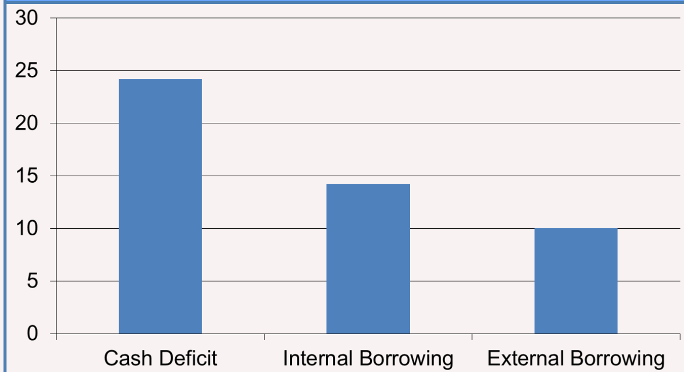
totaled to $54.5 billion during California's first six months. This amount exceeded State Budget estimates by $2.7 billion. Timing discrepancies again accounted for a significant amount of the divergence. A total of $1.8 billion was paid early to local governments, especially for K-12 education. The State Budget estimates had assumed that these payments would be made in January.

Looking at the fundamentals on the revenue side, signs of California's economic recovery are evident. Although timing disparities caused a shortfall relative to projections, total revenue in December was 2.7% above last year's total. The major disappointment has been the performance of corporate taxes. This continues to run well below both expectations and last year's totals.

The cost of State operations, including various government agencies, is running about 6% below expectations in terms of the total for the July-December period. It is also well below last year's actual sum. Abstracting from timing issues, the most significant overruns of spending are in Health and Developmental Services.

The bottom line for Dec. 31, 2012, was that California had a cumulative cash flow gap of $14.6 billion for the first six months of the fiscal year. Added to the $9.6 billion carried over from the previous fiscal year, the State had a loan balance of $24.2 billion (See Figure 1). This was financed through a combination of borrowing from internal sources ($14.2 billion) and external lenders and investors ($10.0 billion). As we look to the second half of the fiscal year, several issues will be important. Will the economic recovery remain strong enough to support increases in income and sales taxes along with some firming in corporate taxes? Will spending on various State operations remain constrained? Will spending obligations for health care and services for the disabled show any moderation? The answers to these questions will determine whether California can move to a sounder financial footing.

Figure 1: Financing California's Cash Deficit



Source: The Fermanian Business & Economic Institute

Table 1: General Fund Receipts

July 1, 2012 – Dec. 31, 2012 (in Millions)

Revenue Source	Actual Revenues	2012-13 Budget Act		2011-12 Year-To-Date	
		Estimate	Actual Over (Under)	Actual	Actual Over (Under)
Corporation Tax	$2,112.1	$2,997	($884.9)	$3,127.3	($1,015.2)
Personal Income Tax	$25,418.4	$24,768	$650.4	$21,868.4	$3,550.1
Retail Sales and Use Tax	$8,393.3	$9,569	($1,175.7)	$9,791.8	($1,398.5)
Other Revenues	$2,207.2	$2,496.1	($288.9)	$2,403.9	($196.7)
Total General Fund Revenue	**$38.131.1**	**$39,830.1**	**($1,699)**	**$37,191.4**	**$939.7**
Non-Revenue	$1,741.7	$1,405.5	$336.3	$2,215	($473.2)
Total General Fund Receipts	$39,872.8	$41,235.5	(1,362.7)	$39,406.3	$466.5

Is California's Budget Expanding?

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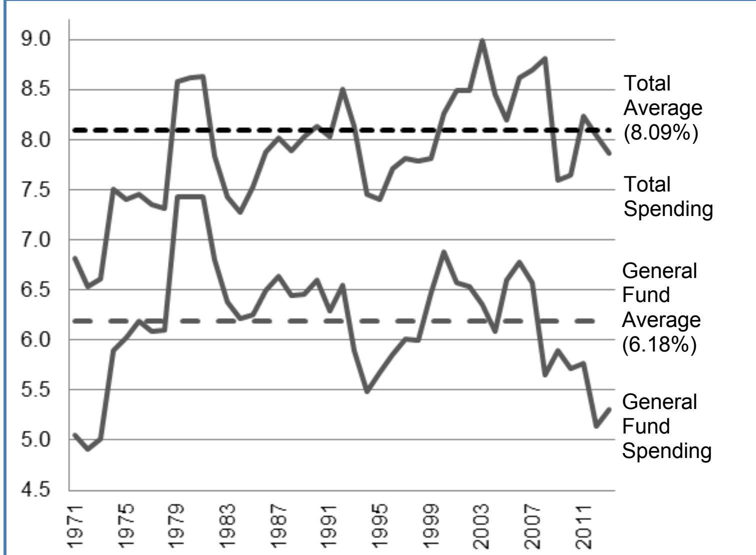
Over the course of administrations and economic cycles, State spending has gone through expansions and contractions. One way of evaluating spending patterns is to index spending totals against the economy. This helps identify the extent to which government spending is keeping pace with its taxpayers' ability to pay. The bottom line graphed in Figure 2 shows that General Fund spending was around 5.0% of the economy in the early 1970s, and rose steadily through the mid-1980s. Since 1970-71, the average ratio of General Fund spending has been about 6.2%. The ratio peaked between 1979 and 1982. In those three years, in direct response to the passage of Proposition 13, the Legislature increased General Fund spending by nearly 1.5% of the economy. During this three-year spike, State General Fund money replaced those local revenues lost in the wake of the Proposition 13's tax cut. Between 1987 and 2006, General Fund spending hovered between 5.5% and 6.7% of the economy.

Beginning in 2007, the index began a downward slide to its lowest ratio since the early-1970s. The ratio in General Fund spending since 2007 is explained in part by recent statutory and constitutional changes which shifted General Fund revenues into special funds.

The combined spending from the General Fund and all special funds is also falling relative to the economy in recent years, as can be seen in the upper lines in the figure. The upper lines track total spending and show that average total State spending was about 8.1% of the economy for the entire period. Overall spending hit a high for the period -— about 9.0% of the economy -- in 2002 when the state was in recession (thereby reducing the denominator) without a commensurate reduction in spending (keeping the numerator high). Since 2007, the total spending index is below the long-term average.

Nostalgia? By indexing spending to the economy, there may be little sentiment that prior budgets were better. Despite the Proposition 30 tax increase, total spending in 2012 is likely to be about 3.0% lower than average over the last 40 years. Spending from the General Fund is about 15% lower.

Figure 2: Spending as a Share of Personal Income
1970-71 through 2012-13 (estimated)



Spending excludes federal expenditure offsets (2008-09). Chart covers General Fund and Total Spending for fiscal years ending June 30. Source: Department of Finance

Table 2: General Fund Disbursements

July 1, 2012 – Dec. 31, 2012 (in Millions)

Recipient	Actual Disbursements	2012-13 Budget Act		2011-12 Year-To-Date	
		Estimates	Actual Over (Under)	Actual	Actual Over (Under)
Local Assistance	$42,286.6	$38,895.8	$3,390.8	$39,236.8	$3,049.8
State Operations	$12,000.1	$12,726.2	($726.1)	$13,132.4	($1,132.3)
Other	$216.5	$134	$82.5	($85.4)	$301.9
Total Disbursements	**$54,503.2**	**$51,756**	**$2,747.3**	**$52,283.8**	**$2,219.4**

Mexico: Myths and Miracles

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When Californians think of Mexico, images frequently come to mind that contrast the stunning beauty, rich culture, and food (incredible street tacos) with the violence depicted in recent headlines. These disturbing reports obscure the underlying reality that despite its close ties to California, all too often Mexico is a nation that is both misunderstood and underestimated by most of us.

Mexico's impact on California cannot be overestimated. As our most important trading partner, California saw exports to its southern neighbor reach an estimated $28 billion in 2012. This represents 18% or nearly one-fifth of the state's total exports. (See Chart 1.) California exports have climbed 75% over the past ten years. (See Chart 2.) Each day large numbers of Mexicans come to California to shop or take vacations. Many Hispanics residing in the state also have family, friends, and business connections in the country.

A Solid Economy

While much of the focus in recent years has centered on China, India, and Brazil, major advances have taken place in Mexico. The country is enjoying the benefits of solid economic growth, low inflation, and stable finances. This is a compelling and important story that is not being told but should be known by Californians.

Mexico is poised to achieve another good year of economic gains in 2013, with real gross domestic product growth of an estimated 3.6%. This will track similar gains of 3.5% to 4.0% reached during the prior two years. Job growth has been sizable and the nation's jobless rate is less than 5.0%. Mexico should benefit in the year ahead not only from some improvement in the United States but also from its solid internal fundamentals.

Latin America's second-largest economy has brought inflation down to a moderate and steady pace of around 3.5%, which has enabled it to achieve a low level of interest rates and a stable exchange rate. Monetary policy deserves high marks for this accomplishment and has been

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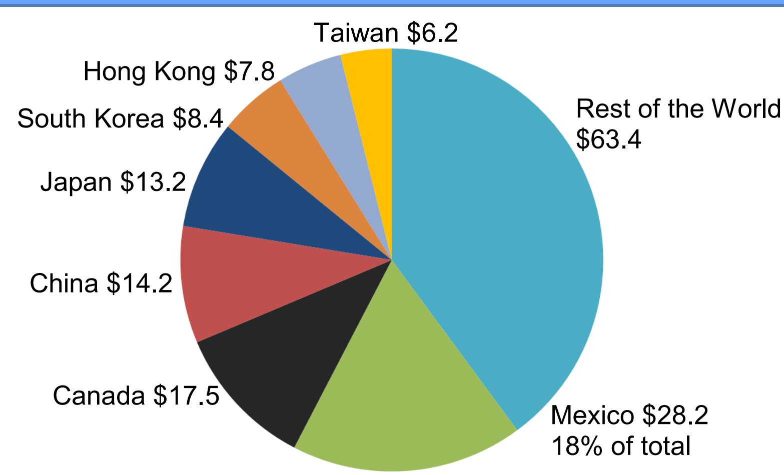
Chart 1: Mexico Dominates California Exports
Billions of dollars, 2012 estimated



Source: U.S. Dept. of Commerce, Office of Trade and Industry Information; Fermanian Business and Economic Institute

The opinions in this article are presented in the spirit of spurring discussion and reflect those of the authors and not necessarily the Controller or his office.

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reinforced by sound fiscal policy. The government's gross debt is equal to only about 43% of GDP, which compares very favorably to other nations. The comparable number for Germany is about 83%, while the U.S. ratio exceeds 100%, and Japan's number is over 200%.

Mexico's trade picture also is positive. The nation has endorsed and implemented a policy of openness to trade and investment that is yielding rich dividends. The country now has trade agreements with 44 nations, which is four times as many as held by Brazil. Despite the slowdown in global trade, Mexico is achieving annual real export gains of 6-7% and has a current account deficit equal to only about 1% of its GDP.

Mexico's Manufacturing Renaissance

Over a decade ago, it appeared that Mexico was rapidly fading under the shadow of China. The general consensus was that a global shift of factories to the lower wages of China would cause a dramatic "hollowing out" of the Mexican industrial sector and overall economy.
Today, a dramatically different picture has developed. Mexico's share of factory goods imported into the U.S. has increased from just 11% in 2005 to 14% today. In contrast, China's share has slipped by three percentage points during the past three years to 26%. Mexico is rapidly becoming a global manufacturing player. It currently exports more factory goods than the rest of Latin America combined.

Several forces have contributed to this trend:

⇒ Rising wage rates in China, which have narrowed the pay gap of Mexico over China to a premium of 22% from about 365% a decade ago. The minimum wage in Mexico City is now less than that in Shanghai.

⇒ The high skills level of Mexico's workers, with large numbers of engineers, architects, and other professionals graduating from Mexican universities.

⇒ High energy costs, which give Mexico a major advantage in terms of transportation expenses and allow companies to maintain lower levels of inventories.

"Hecho en Mexico" is swiftly transforming the auto sector and is no longer a term of scorn but one of great potential. In 2012, Mexico exported more than 2.14 million vehicles and accounted for one of every ten cars sold in the United States. Our southern neighbor now ranks as the world's fourth-largest car exporter, trailing only Germany, Japan, and South Korea. It could overtake South Korea within a few years.

Immigration and Demographic Changes

In addition to the manufacturing and economic revival taking place across the border, most Californians are not aware of the changes taking place in immigration and population trends.

The large-scale migration from Mexico to the United States has come to a sudden halt. In the five years between 1995 and 2000, approximately 3 million Mexicans moved to the U.S. while only 700,000 people moved in the other direction. In the next five years, about 1.4 million people moved out of Mexico. Roughly the same amount of people moved from the U.S. to Mexico during that same time period. Net immigration from Mexico to the U.S. is now probably negative. The shift in trends is due to an improvement in economic prospects in Mexico relative to those in the U.S., stricter border laws and enforcement, and population changes.

Mexico's population growth has slowed markedly. In the 1960s, the typical Mexican woman had seven children. That number is now 2.4 and could drop below 2.0 in less than ten years. This would put the rate at below that of the U.S., which is approximately 2.1.

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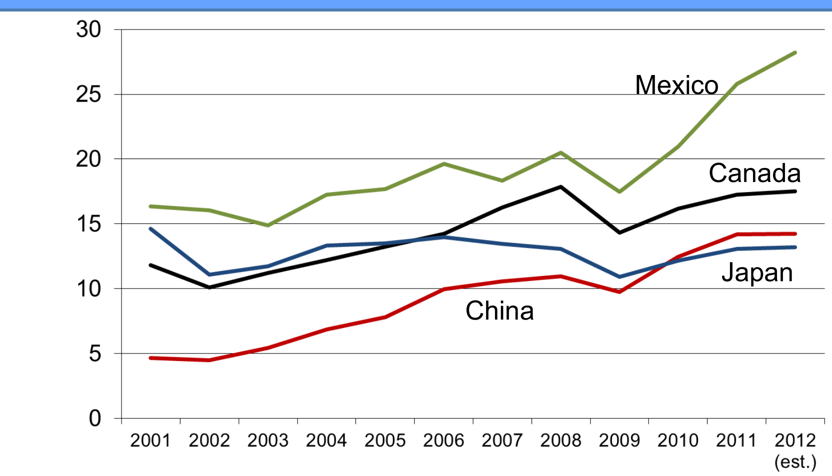
Chart 2: California's Exports to Mexico Accelerate
Billions of dollars



Source: U.S. Dept. of Commerce, Office of Trade and Industry Information; Fermanian Business and Economic Institute

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Turning the Tide against Violence

Mexico has been ravaged by violence linked to drug cartels, which has claimed 55,000 or more lives over the past six years. While this tragic story has been widely reported, there are some encouraging signs. These include a drop of about 7% in the number of killings during the first seven months of 2012 versus the prior year. Many areas are relatively peaceful, including Mexico City, and the overall murder rate is no higher than that in Brazil, while lower than that seen through much of Central America. While the country remains dangerous for many residents, businesses, and visitors, we must welcome any positive signs and seek to encourage Mexico and help where we can.

Challenges for Mexico

Mexico has formidable hurdles to mount if it is going to realize its full potential. Under Mexico's new president, Enrique Peña Nieto, the nation will need to take major steps to maintain the economy's strong momentum. Major efforts will be needed to:

⇒ Improve the country's legal structure by enforcing the rule of law and reducing the prominence of the underground economy

⇒ Open up the energy sector, now controlled by Pemex, Mexico's national oil monopoly, to competition. Monopolies or near monopolies in industries including telecommunications, cement, bread, and television, also need to see more competition.

⇒ Stem the escalation in violence linked to the drug cartels, an endeavor that will need the cooperation of the United States in reducing the demand for drugs from the north.

Conclusions and Implications for California

The U.S. Congress and the President may finally tackle the issue of immigration reform this year. It will be important that Californians pay close attention to developments and also have a strong voice at the table. Meanwhile, the emergence of Mexico as a manufacturing and economic powerhouse carries important implications on many levels.

Rising incomes and the growing consumer market promise many opportunities for exporters of various products as well as retailers on this side of the border. Hotels, restaurants, and entertainment venues could see more upside. California firms could capture roles in the expanding supply chains of auto and other manufacturers, with benefits also accruing to transportation and warehousing facilities. Financial firms could further develop their connections with Mexican investors and find lending opportunities across the border.

With engineers and other technical skills in demand by California employers, Mexico could help fill some of the gap. Our Southern neighbor could even help alleviate the rapid rise in health care costs and possible shortages of providers as the expansion of Californians covered by health insurance surges. Many Mexican doctors, hospitals, and other facilities provide high-quality care at lower costs than found in the U.S., although Medicare rules would have to be changed to allow for reimbursement.

On balance, major changes are taking place south of the border. Although Mexico faces large hurdles, it also could realize enormous potential. Many of these gains could benefit California and those benefits extend far beyond those scrumptious street tacos. The time has come for a reconsideration of Mexico and recognition of its importance to the economic health of California.

California Economic Snapshot

New Auto Registrations (Year-to-Date Through September)	**986,595** 2011	**1,245,700** 2012
Median Home Price (for Single-Family Homes)	**$244,000** In November 2011	**$291,000** In November 2012
Single-Family Home Sales (Houses and Condos)	**32,669** In November 2011	**37,481** In November 2012
Foreclosure Filings (Notices of Default)	**23,785** In November 2011	**11,533** In November 2012
Total Civilian State Employment (Seasonally Adjusted)	**16,366,000** In November 2011	**16,589,000** In November 2012
Newly Permitted Residential (Single and Multifamily) Units (Year-to-Date)	**40,361** In November 2011	**52,114** In November 2012

Data Sources: New Car Dealers Association, DataQuick, California Employment Development Department, Census Bureau, State Department of Finance, Foreclosure Radar