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State Finances in July 2013

July 2013 compared to monthly estimates in the **2013-14 Budget Act**	July 2013 monthly totals compared to **July 2012**
Total Revenues: -$306.4 million (-6.0%)	**Total Revenues:** $545.6 million (12.9%)
Sales Tax: $7.1 million (0.9%)	**Sales Tax:** $167.1 million (28.5%)
Income Tax: -$273.7 million (-7.0%)	**Income Tax:** $330.1 million (10.0%)
Corporate Tax: $10.1 million (4.9%)	**Corporate Tax:** -$46.9 million (-17.7%)

Not All Spending Decisions Spelled Out In Budget

Trying to make sense of the billions of General Fund dollars spent in the annual budget? Given all the consideration and time devoted to preparing and passing the budget, it would seem the budget would reflect California's spending priorities. In some ways, General Fund allocations do provide a

(Continued on page 3)

What the Numbers Tell Us

Revenues began the new fiscal year with a bumpy start. For the year beginning July 1, total revenues were about $300 million, or 6.0%, shy of estimates contained in the 2013-14 Budget Act. Personal income taxes were the primary culprit, as the revenue take was close to $275 million, or 7.0%, below Department of Finance projections. (See Figure 1 and Table 1.)

Projections have assumed that total personal income taxes would be lower in Fiscal Year 2013-14 than in Fiscal Year 2012-13 as many individuals may have accelerated their capital gains in December of last year to avoid the impact of higher capital gains taxes that went into effect on January 1. July withholdings, however, were below estimates and refunds were slightly more than anticipated.

The other two primary revenue drivers beat forecasts, but by smaller amounts. Corporate taxes were $10 million, or 4.9%, ahead of estimates, while sales taxes topped projections by $7 million, or 0.9%.

One should not be too alarmed by the overall shortfall in revenues as

(Continued on page 2)

What the Numbers Tell Us

(Continued from page 1)

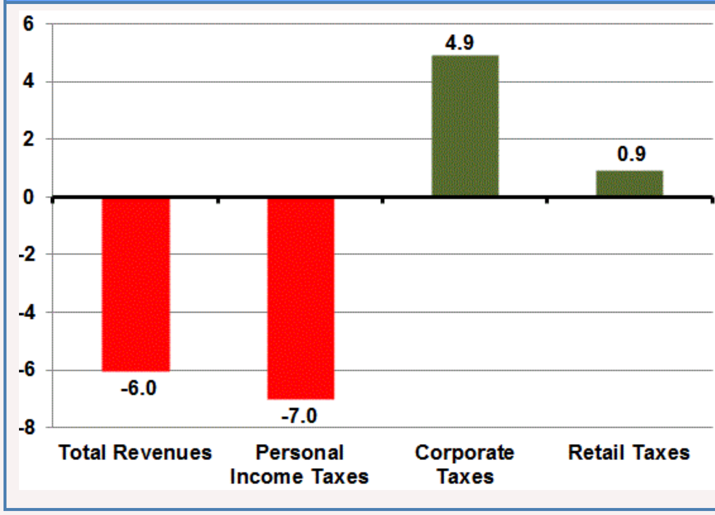
July is typically a comparatively low month for tax receipts. Total July revenues typically are equal to about 5% of the total expected for the full year, compared with what would be about an 8% share if tax receipts were spread evenly across the 12 months of the year. As a result, there is ample time for revenues to catch up, but healthy job and income gains will need to continue.

While revenues fell short of expectations by about $300 million, expenditures came in under predictions by twice as much, or close to $600 million. (See Table 2.) The cost of state operations was in line with forecasts, but local assistance in the form of disbursements to K-12 schools and Social Services was less than expected. This difference is likely to be reversed in August.

While July disbursements had been expected to exceed total receipts, July's deficit was $8.5 billion, or about $300 million, below the $8.8 billion contained in the Budget. The State's loan balance at the end of the first month of the fiscal year stood at a total of $10.9 billion. This represented the sum of the spending/tax gap of $8.5 billion plus the $2.4 billion balance carried over from the last fiscal year. All of the balance was funded through internal borrowing.

July's revenue numbers were somewhat disappointing, particularly since Budget Act projections for the 2013-14 fiscal year appear to be relatively conservative. Although spending also came in on the low side, that shortfall is unlikely to be sustained.

Figure 1: Total July Revenues Fall Short
Percent variance from budget estimates



California's economy remains on the upswing and should be strong enough to support sizable revenue flows in the year ahead. However, higher interest rates, weaker export growth, further federal budget cuts, and company concerns about health insurance costs pose possible risks. Maintaining the balance between revenue outcomes and demands for higher state outlays will remain California's chief fiscal priority.

Table 1: General Fund Receipts

July 1, 2013 – July 31, 2013 (in Millions)

Revenue Source	Actual Revenues	2013-14 Budget Act		2012-13 Year-To-Date	
		Estimates	Actual Over (Under)	Actual	Actual Over (Under)
Corporation Tax	$218.1	$208	$10.1	$265.1	($46.9)
Personal Income Tax	$3,641.3	$3,915	($273.7)	$3,311.2	$330.1
Retail Sales and Use Tax	$754.1	$747	$7.1	$587	$167.1
Other Revenues	$175	$225	($50)	$79.7	$95.3
Total General Fund Revenue	**$4,788.6**	**$5,095**	**($306.4)**	**$4,243**	**$545.6**
Non-Revenue	$34.2	$12.3	$21.9	$274.5	($240.3)
Total General Fund Receipts	$4,822.8	$5,107.3	($284.5)	$4,517.5	$305.3

Not All Spending Decisions Spelled Out In Budget

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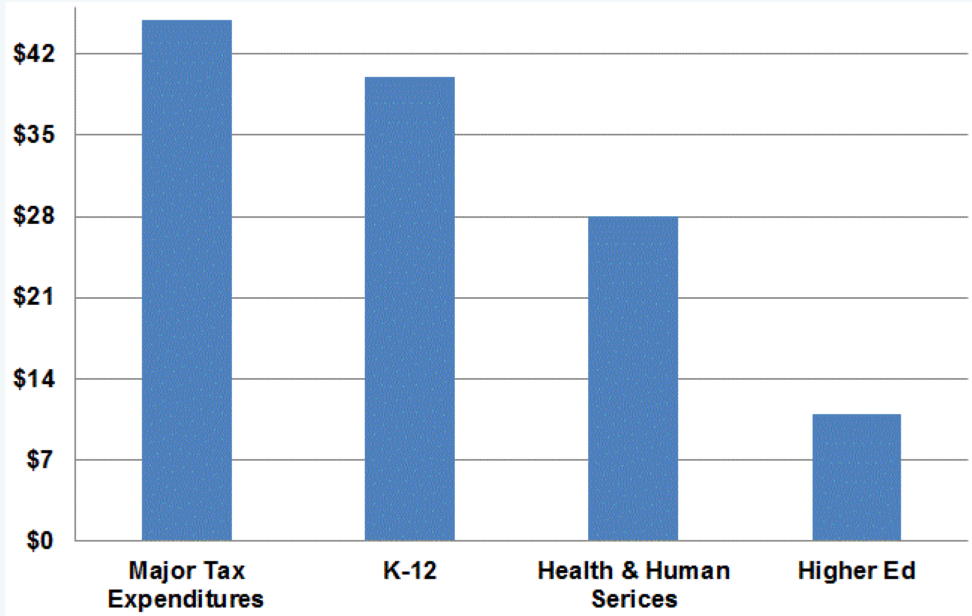
rough ranking of public priorities. Programs receiving more state assistance – especially in light of the competition for scarce resources – can be said to take precedence over other programs. In this light, funding for education – from preschool to university – is the State's highest priority. It comprises more than 50 percent of General Fund spending. K-12 spending is the largest category, with the May Revision proposing expenditures of roughly $40 billion in 2013-14.

Figure 2: General Fund Spending by Program May Revision (Proposed)
(Dollars in Billions 2013-14)



Source: Department of Finance

But not all spending decisions are listed in the Budget Act. For example, decisions to provide preferential tax treatment to certain taxpayers provide a kind of public expenditure which does not typically get displayed in the budget because the tax assistance is provided as a statutory treatment. Tax preferences, known as tax expenditures in this context, may be reductions in the tax base or reductions in tax rates.

The Department of Finance each year identifies the cost of the major tax expenditures, primarily available through the sales and income tax laws. Taken together, these major tax expenditures reduce tax revenues by $45 billion. Tax expenditures, in this light, are the single largest category of General Fund spending, about one-eighth more than K-12 education.

Table 2: General Fund Disbursements

July 1, 2013 – July 31 2013 (in Millions)

Recipient	Actual Disbursements	2013-14 Budget Act		2012-13 Year-To-Date	
		Estimates	Actual Over (Under)	Actual	Actual Over (Under)
Local Assistance	$11,975.3	$12,888.6	($913.3)	$11,453.4	$521.9
State Operations	$2,064	$2,062.2	$1.8	$1,491.8	$572.2
Other	($736.2)	($1,070.9)	$334.7	$36.1	($772.3)
Total Disbursements	**$13,303.2**	**$13,879.9**	**($576.8)**	**$12,981.3**	**$321.9**

California Economic Snapshot		
New Car Registrations	**226,715** First Quarter 2012	**255,402** First Quarter 2013
Median Home Price	**$274,000** In June 2012	**$352,000** In June 2013
Single-Family Home Sales (Houses & Condos)	**42,513** In June 2012	**41,027** In June 2013
Unemployment Rate	**9.0 percent** In April 2013	**8.6 percent** In May 2013
Non-Farm Payroll Employment	**14,394,900** In June 2012	**14,648,700** In June 2013
Newly Permitted Residential Units (Single & Multifamily)	**6,035** June 2012	**6,371** June 2013

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

China's Strategy Shift: Implications for California

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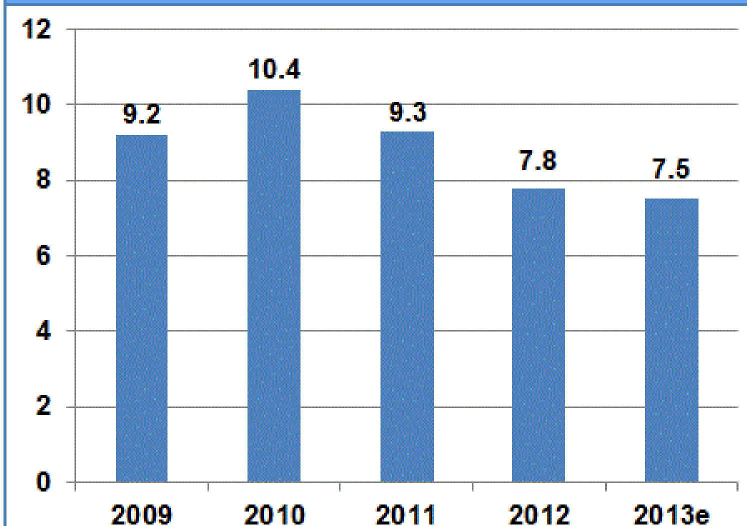
China is undertaking two major changes in its economic strategy that will materially affect California. First, it is downshifting to a more moderate growth track, which has already had cascading effect throughout the global economy. Second, it is reorienting its economy from one dependent on exports to one more reliant on consumer spending. Because of China's position as California's third largest export market (after Mexico and Canada) and the rapid growth we have seen in that market, understanding the implications of these strategic changes is vitally important.

Figure 3: China's Growth Moderates
(Real GDP, percent change over prior year)



Source: International Monetary Fund; FBEI

More Temperate Growth

Over the past three years, China's leaders have debated what annual growth rate in real gross domestic product (GDP) should be targeted as a sustainable trend. Projections regarding an aging labor force, concerns about pollution, and the country's demands on the world's natural resources have all played a role in this debate. China's economy consistently racked up double-digit growth rates of 10-14% between 2003 and 2007. Growth continued in the 9-10% zone in the subsequent four years, 2008-2011, before edging below 8.0% to 7.8% in 2012. Growth is likely to equal about 7.5% this year, which would be consistent with China's target for 2013. (See Figure 3.) Annual real GDP gains of 7.0% to 8.0% are likely to be seen as the new norm for the nation over the next five years.

As part of its strategy to moderate growth, China is trying to curb excessive credit expansion, particularly in the "shadow banking system." Pawnbrokers, trusts, and many banks through their off-balance sheet operations have sold wealth-management products, often linked to opaque and questionable real estate structures. These activities could further inflate prices in commercial or residential real estate and exacerbate problems in the banking sector China is attempting to temper the growth of money and credit, while providing enough liquidity to facili-

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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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tate business and economic gains.

Rebalancing Growth

China is also striving to rebalance its economy from exports, supplemented by large amounts of state-directed capital spending, to an economy relying more on consumer spending. Global imbalances in trade and investment flows have persisted for a number of years, with China spending too little and saving too much, while the U.S. does just the opposite. In China, the personal saving rate is about 30%, while in the U.S., it is around 4.5%. Meanwhile, consumption accounts for about 35% of China's GDP, which is half the U.S. ratio. China is now trying to rectify its side of the equation.

To boost consumer spending, China is moving to bolster household incomes by raising the minimum wage and supporting labor's drive to secure higher earnings. It is also expanding the "social safety net" by providing increased health care and retirement benefits. These policies are intended to encourage individuals to spend more in the present instead of saving large amounts for future medical and old-age needs.

The California-China Nexus

In response to China's rapid growth during the past several years, California's exports have nearly tripled over the decade. In 2003, California shipped $5.4 billion worth of goods to China. This year, exports will reach an estimated $14.8 billion. (See Figure 4.)

California companies send a wide variety of manufactured goods and commodities to the Chinese market. These range from highly-sophisticated technology products to recycled materials. Some of the largest exports by value include electrical machinery, optical equipment, nuclear reactor components, wood pulp, cotton, recycled metal, chemicals, pharmaceuticals, fish, fruit, nuts, and dairy products.

Impact on California

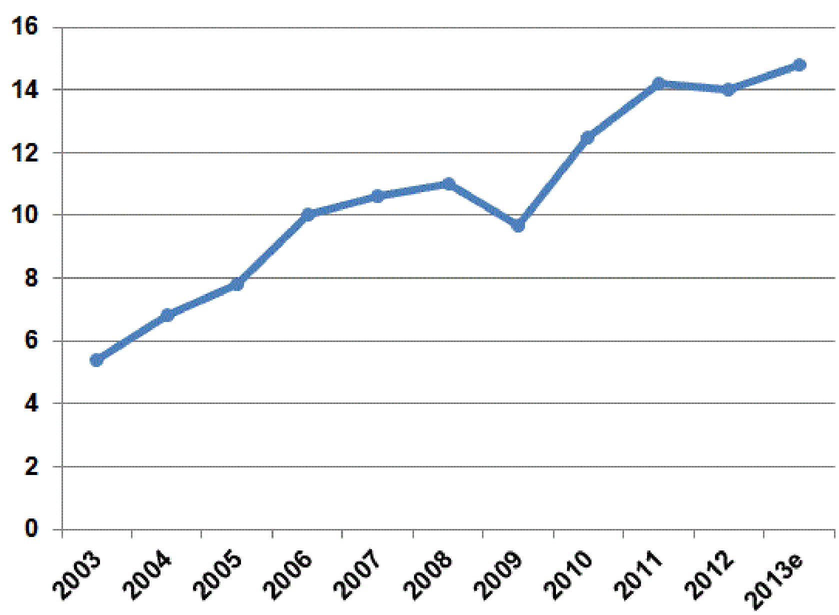
A slowing in China's overall economic growth can be expected to mean slower growth for many of the state's key exports to this important country. At the same time, California manufacturers, homebuilders, and consumers can be expected to benefit from a slowing in the pace of price increases for various commodities, including costs for various metals and construction materials.

Real GDP growth of 7-8% will still place China as one of the leading nations in the world for market expansion. California companies will need to concentrate on products with a greater technology content as China focuses on elevating productivity. Our firms that can serve a burgeoning consumer market also stand to prosper. Chinese consumers are likely to continue to place a high premium on American goods, particularly those made in a trendsetting state such as California.

It will also be vital to focus on opportunities in the services sector in addition to the goods side. Rising incomes and wealth mean that large numbers of Chinese will be traveling to our state, seeking education in California institutions and taking advantage of advanced medical care facilities located here.

On balance, China's new economic strategy to allow more moderate growth with a different mix poses risk for its own citizens, for the global economy, and for California. However, if we recognize the changes under way and prepare for them, California can take a lead role in facilitating change and benefiting from it.

Figure 4: California Exports to China Nearly Triple Over Decade
(Billions of Dollars)



Source: U.S. Bureau of the Census; FBEI