Controller John Chiang
State of California

August 2007 Summary Analysis Volume 1, Issue 6

Statement of General Fund Cash Receipts and Disbursements

The State Controller's Office is responsible for collecting all state revenues and receipts, and 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 *Statement of General Fund Cash Receipts and Disbursements*, the Controller issues this Summary Analysis to provide California policymakers and taxpayers context in which to view the most current financial information on the State's fiscal condition.

The August Summary Analysis covers actual receipts and disbursements for July 2007. Data is shown for total cash receipts and disbursements, the three largest categories of revenue and the two largest categories of expenditures. The analysis compares actual figures to projections presented in the May Revision of the Governor's 2007-08 Budget (May Revise). Once approved by the Governor and the Legislature, the 2007-08 Budget estimates will replace the May Revise projections.

At the close of the 2006-07 fiscal year on June 30, Personal Income Taxes (income taxes), Retail Sales and Use Taxes (sales taxes) and Bank & Corporation Taxes (corporate taxes) comprised 94.8% of General Fund revenues. Of these, income tax receipts contributed 54.7% of General Fund revenue, sales tax receipts added 28.8%, and corporate taxes provided 11.3%.

The State of California has increasingly depended on personal income taxes as a source of revenue. Of the $109 billion estimated to be collected in 2006-07 for both the General Fund and special funds, 49% came from personal income taxes. In 1997, personal income taxes made up only 40% of the revenues in the General Fund and special funds. In 1977, personal income taxes contributed only 30% to those funds.

Revenue Expectations For 2007-08

The May Revise projected a General Fund growth of 7.4% in 2007-08 over the 2006-07 growth. In

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Table 1: Revenue Growth Rate

Revenue Source	Growth Rate Actual 2006-07	Growth Rate Projected 2007-08
Corporation Tax	3.2%	1.4%
Personal Income Tax	4.8%	6.0%
Retail Sales and Use Tax	-0.1%	2.2%
Big Three Total	**3.1%**	**4.3%**

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2006-07, revenue grew by 2.5% over the previous fiscal year.

For the three major tax sources, revenue growth in 2007-08 is projected to be 4.3%, compared to the 3.1% growth rate seen in 2006-07.

Tax Revenue in July 2007

Total tax receipts in July were $787 million below (-16%) the May Revise estimate, but were $132 million more (3.3%) than they were in July 2006.

Most of the July tax revenue shortfall is attributed to disappointing sales tax revenue. Sales taxes in July lagged behind the May Revise estimate by $465 million (-34.2%) and were $34 million below (-3.6%) the level of July 2006. Because quarterly sales taxes are not due until July 31, many of those revenues are not transferred to the General Fund until early August. As a result, August is an important month for sales tax revenue and may provide a better idea of the strength of that tax source. Sales tax receipts, however, have been weak for a year, and the July data indicates that weakness is likely to continue.

July income taxes were $165 million below (-5.5%) the May Revise estimate, but were $230 million above (8.8%) July 2006. All the components of the income tax (including withholding, estimated taxes and miscellaneous taxes) were below the May Revise estimates.

July is not an important month for corporate taxes as quarterly payments are not due until October. Corporate taxes in July were $4 million below (-1.2%) the May Revise estimate for the month and $9 million below (-3.1%) July 2006. Estimated taxes for corporations fell below both the May Revise estimate for July and below the actual corporate tax revenues for July 2006.

Summary of Net Cash Position as of July 31, 2007

In the first month of the new fiscal year, the State spent $6.1 billion more than it received in revenue.

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Table 2: General Fund Revenues: July 1–31, 2007

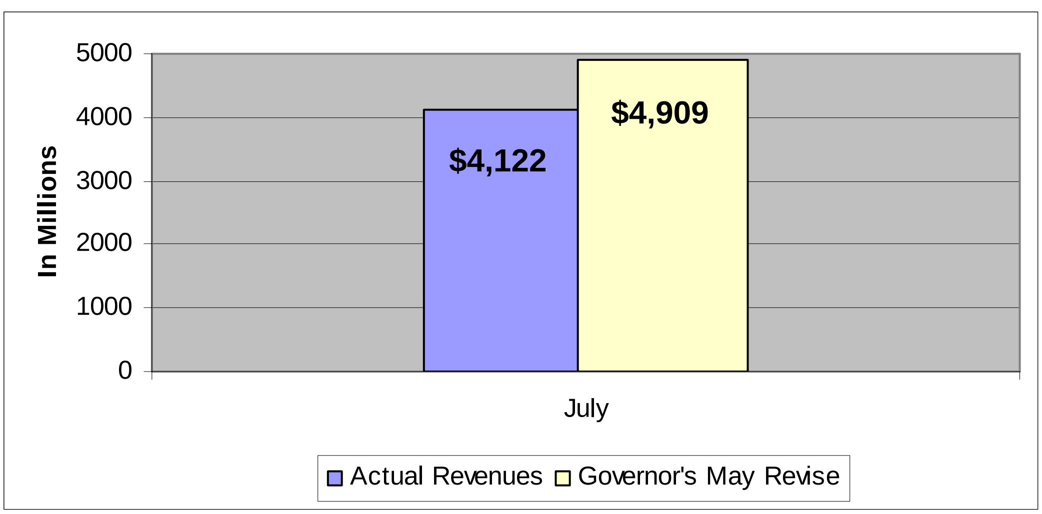

Table 3: General Fund Receipts, July 1-31, 2007 (in Millions)			
Revenue Source	Actual Receipts To Date	Projected May Revise	Variance From May Revise
Bank And Corporation Tax	$292	$296	($4)
Personal Income Tax	$2,846	$3,011	($165)
Retail Sales and Use Tax	$895	$1,360	($465)
Other Revenues	$89	$242	($153)
Total General Fund Revenue	$4,122	$4,909	($787)
Non-Revenue	$14	$679	($665)
Total General Fund Receipts	$4,136	$5,588	($1,452)

Table 4: General Fund Disbursements, July 1-31, 2007 (in Millions)			
Recipient	Actual Disbursement	Projected May Revise	Variance From May Revise
Local Assistance	$6,437	$8,944	($2,507)
State Operations	$2,392	$2,425	($33)
Other	$1,433	($301)	$1,734
Total Disbursements	$10,262	$11,068	($806)

*Note: Some totals may not add, due to rounding

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A deficit at this point is not unusual as a disproportionate share of the state's revenues come in during the last four months of the fiscal year, while a large percentage of disbursements occur in the first eight months.

Non-Revenue Receipts

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

Expenditures were $10.3 billion, while receipts totaled $4.1 billion. Although the revenue portion of receipts was $787 million less than expected in the May Revise, there also was a $665 million shortfall in non-revenue receipts. In July, the shortfall of non-revenue receipts was due to the delay of the transfer of $657 million in Tobacco Asset Sales Revenue funds to the General Fund. When a budget is enacted, that money will be transferred.

The State started the fiscal year with a $2.5 billion cash balance, and concluded July with

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a deficit of $3.7 billion. That cash deficit has been covered by internal borrowing from State special funds.

While the May Revise projected a cash deficit of another $3.1 billion in August, there are still an estimated $12.5 billion of borrowable resources available in special funds.

Of the largest expenditures, $6.4 billion went to schools and local agencies, while state operations received $2.4 billion.

Table 5: General Fund Cash Balance, July 1-31, 2007 (in Millions)

Cash Position	Actual	Projected May Revise	Variance From May Revise
Beginning Cash Balance July 1, 2007	$2,462	$1,369	$1,093
Receipts Over (Under) Disburse-ments to Date	($6,126)	($5,480)	($646)
Cash Balance July 31, 2007	($3,664)	($4,111)	($447)

Borrowable Resources

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

The Statement of General Fund Cash Receipts and Disbursements for July 2007 is available on the State Controller's Web site at

www.sco.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.

Featured Articles From the Controller's Council of Economic Advisors

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. On a rotating basis, members of the Council will contribute an article to the monthly Summary Analysis.

The Controller has asked each author to give us the benefit of his or her expert opinion on issues regarding the California economy. The opinions in these articles therefore are presented in the spirit of spurring discussion and reflect those of the authors and not necessarily the Controller or his office.

Please see the following pages for an article by Nancy Bolton, chair of the Controller's Council of Economic Advisors.

California's Real Estate Market: The Unfolding of a Story

By Nancy Bolton
Chair, Controller's Council of Economic Advisors

The headlines have been nonstop for months – home sales down, foreclosures up, mortgage firms in bankruptcy – yet the economy seems to continue sailing along. But many are wondering whether the real estate storm will hit the rest of the economy, and, if so, how bad will the damage be. While it is not possible to answer that question definitively, this article will attempt to give context to the effects so far, and explore some possible consequences of the real estate downturn.

Sales of residential real estate in California peaked in early 2005. From the second quarter of 2005 to the second quarter of 2007, sales of single-family homes fell by 43%. But in the same time period, the median price of a single-family house actually increased by 13%.

This seems especially paradoxical as the unsold inventory index, or the number of months that it would take to sell the inventory at the current rate of sales, has increased from 3.1 in June 2005 to 10.1 in June 2007.

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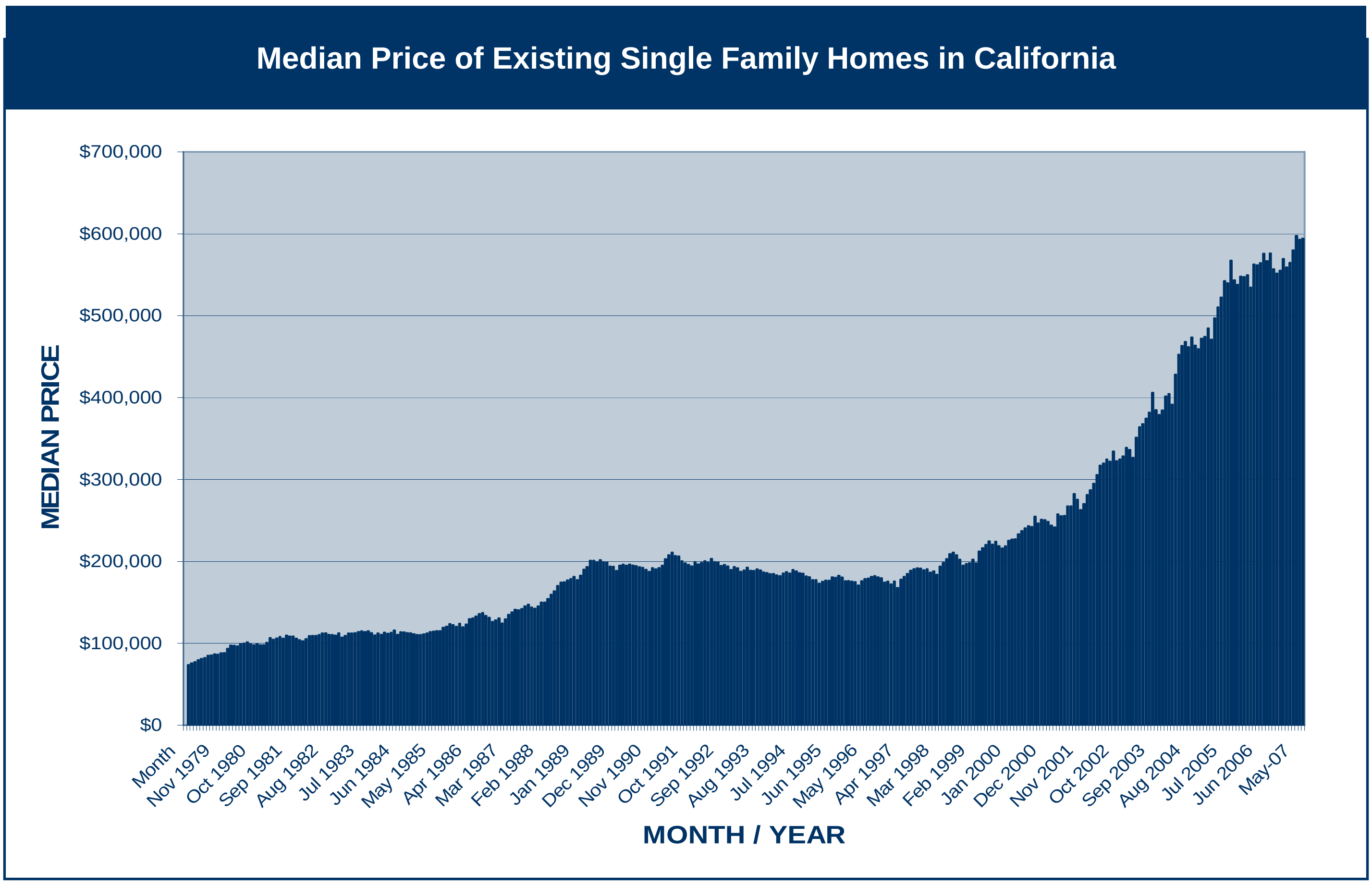
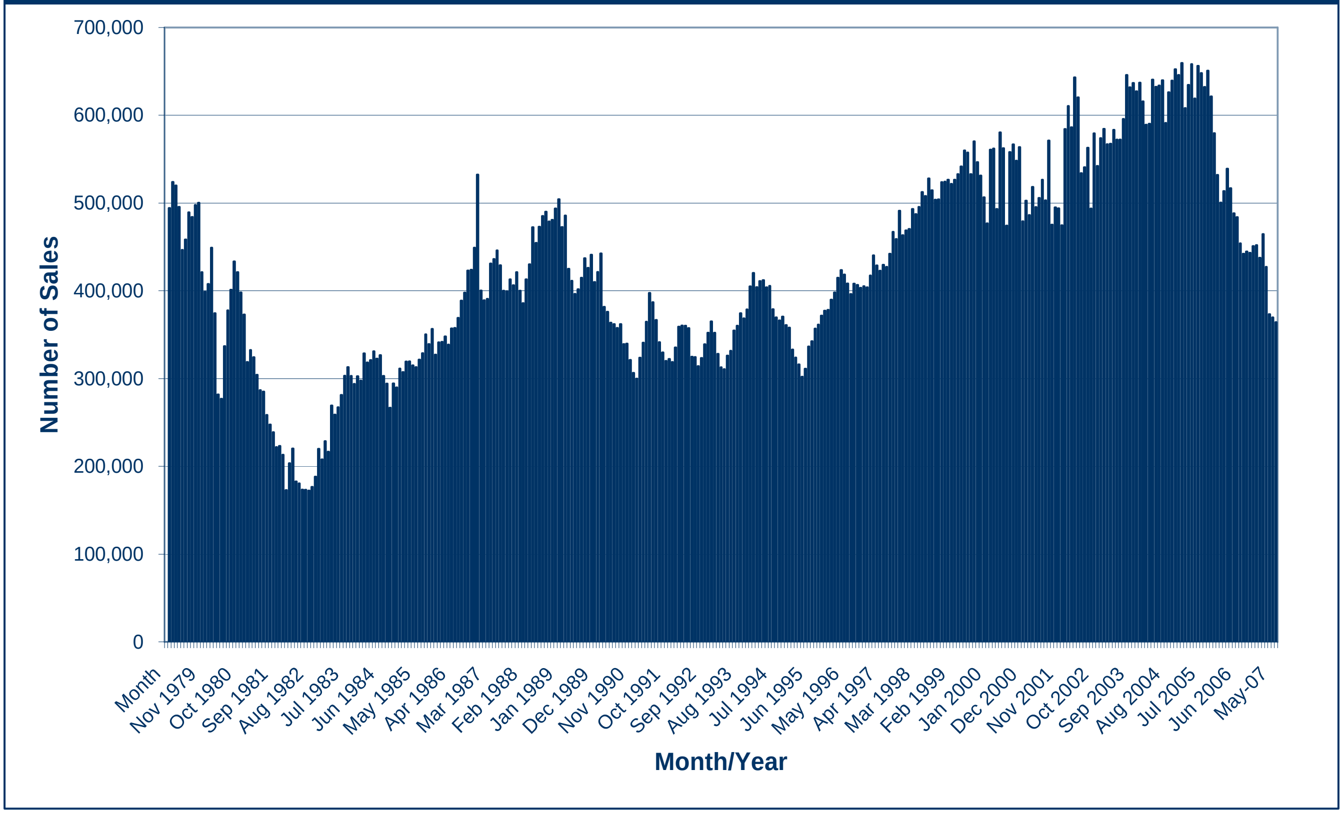


*Data Source: California Association of Realtors

Monthly Sales of Existing Single Family Homes in California
Seasonally Adjusted Annual Rate



*Data Source: California Association of Realtors

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Logically, one would think that an increased volume of houses for sale with fewer buyers in the market would result in a price decline. But the relationship between sales and prices is not that simple. This is illustrated in the two accompanying charts produced from data provided by the California Association of Realtors. While the back-to-back recessions of 1980 and 1981 caused a sharp drop in home sales, they had little impact on home prices. The recession of 1990-91 resulted in a less drastic drop in sales, but prices still stayed mostly flat until 1992, when prices began to decline. That decline continued for more than four years, resulting in a roughly 14% drop in prices from the second quarter of 1992 to the first quarter of 1997, well after the recession ended. In the end, the recession of 2001 resulted in considerable volatility in sales, but no real price declines.

Whether these prior cycles can serve as a guide as to what will happen to home prices over the next year is unclear. Housing prices tend to be "sticky" on the downside of a cycle because sellers who have the option will simply take their homes off of the market if they do not get the price they expected. That tends to keep prices from falling early in the cycle. As discussed below, the slight increase in housing prices in this cycle most likely is due to a change in the mix of homes being sold.

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Currently, we are not in an economic recession: There have been no loss of jobs, and the Gross Domestic Product (GDP) growth is still positive. Despite a reduction of 41% in California residential building permits from the peak seen in the first quarter of 2005, construction employment has shown little decline. From the third quarter of 2005 to the third quarter of 2006, California Employment Development Department (EDD) data show that construction employment actually increased by 2.3%. Since the third quarter of 2006, construction employment has declined by only 0.2%. So why hasn't construction employment declined more?

The UCLA Anderson Forecast points out that the average time for completion of a single family home is 6.3 months, and 9.7 months for a multi-family building. In other words, there is an expected lag of about a year from when permits peak until construction employment begins to decline. In the current cycle, non-residential construction has not declined – in fact, it grew by 15% from the third quarter of 2005 to the first quarter of 2007. That indicates some construction workers who lost jobs in the residential sector are finding employment in the non-residential sector. Also, job losses associated with the real estate downturn may not yet be showing up in official estimates, as many construction workers, loan brokers and real estate agents are self-employed and not yet counted in the monthly estimates of job losses. However, job losses in construction may become more apparent in the coming months. The Anderson Center for Economic Research at Chapman University estimates that total construction spending in California will decline 14.5% from the fourth quarter of 2006 to the fourth quarter of 2007.

The distinguishing factor driving this housing downturn is a credit recession, not a jobs recession. In the wake of the economic recession of 2001, the Federal Reserve dropped short-term interest rates to 1%. This easy money policy, combined with a global flood of liquidity, drove mortgage rates to the lowest levels seen in more than 30 years. In late 2004, the Federal Reserve began raising short-term rates, but, because of the enormous amounts of cash from around the world looking for investment returns, mortgage rates hardly moved through much of 2005. In the midst of all this money-making exuberance was the rise of the Alt-A and sub-prime real estate loans. Alt-A loans are a wide spectrum of loan types, including interest-only options and silent seconds, many of which require little documentation of income and are sometimes called "liar loans." But because the borrower is not a known credit risk, they are considered higher quality loans than sub-prime loans, which are made to borrowers with known credit risks.

The California Association of Realtors estimates that about half the loans originated in California in 2005 and 2006 were non-prime loans. The *Los Angeles Times* reported in July 2007 that as many as 80% of the buyers in some developments in Riverside-San Bernardino were sub-prime borrowers. Many of these loans start with a low initial payment that "resets" to higher payments in two to five years. Borrowers were qualified at their initial payment level, not their ultimate payment level. In a market with rapidly rising prices, borrowers who find themselves in trouble as their payments increase can always sell or refinance. But in 2006, as interest rates increased and prices flattened, those options were not available.

DataQuick, the real estate news and information firm, reports that in the first quarter of 2007, the number of Notices of Default (NODs) sent by lenders to California homeowners increased by 148% over the first quarter of 2006. In the second quarter of 2007, NODs increased by another 15.4%. These notices of default are considered the first step toward foreclosure. In 2006, however, 88% of owners who received an NOD were able to avoid foreclosure. This year, only 54.6% were able to do that. As a result, foreclosures this year are increasing at an even faster rate than NODs. In the first quarter of 2007, trustee deeds recorded (homes actually lost to foreclosure) were up 802% over the first quarter of 2006. In the second quarter, foreclosures were up another 57.8% from the first quarter. While NODs are not yet at the peak seen in

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the first quarter of 1996, actual foreclosures have already surpassed the peak of foreclosures seen in the third quarter of 1996.
Even as foreclosures ballooned in early 2007, there seemed to be little effect on the broader economy. But that appears to be changing. Financial firms who bought and packaged these loans and then sold the packages to investors facilitated the surge of sub-prime lending. Some of these investors were hedge funds that, in turn, used borrowed money to purchase these loan packages. As defaults increased, investors have become increasingly wary of sub-prime debt and the fountain of liquidity slowed to a trickle. In June, the disclosure that two Bear Stearns funds that had invested in Alt-A and sub-prime mortgages were in trouble further dried up the investment pool.

Since many sub-prime borrowers tend to be low-income earners, the downturn in sales has been most pronounced in neighborhoods with lower-priced homes. With a higher proportion of sales in the upper-price ranges, the average selling price has increased. But even high-end homes are seeing price reductions: New homes tend to be in the upper price range, and builders are reporting that their average prices are down 7-12%.

The sub-prime problem already has claimed several sub-prime lenders, notably New Century Financial in Orange County, and it is spreading to lenders who are a step removed from the sub-prime group. American Home Mortgage, with considerable exposure to Alt-A lending, is the latest U.S. firm to close its doors. The current downturn in the U.S. housing market also is reverberating internationally. Last week, a bank in Germany and a hedge fund in Australia were added to the list of causalities of the sub-prime meltdown in the U.S.

The credit squeeze is even impacting corporate debt as private equity firms looking to close leveraged buyouts are finding lenders to be much more discriminating than they were a year ago. Corporate borrowing in July was at its lowest level since August 2004. Payroll employment growth in the nation also has waned, with a monthly average of 135,000 new jobs in the May through July period, compared to an average of 189,000 per month in all of 2006. Much of the turmoil in the stock market in the past month has been attributed to problems that are spreading from the sub-prime credit market.

Thus, it appears that the real estate downturn has now reached the broader economy, and most economists believe it will continue to be a drag on the economy. Economy.com reports that outstanding mortgage debt that is facing a first payment “reset” will grow in volume through the last quarter of 2007. “Reset” volume is expected to decline, but remain high through mid-2008, likely resulting in a continued rise in foreclosures through most of 2008. Properties in foreclosure are sold in “distress” sales, which tends to accelerate price declines. As a result, the next 18 months do not look promising for housing prices.

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