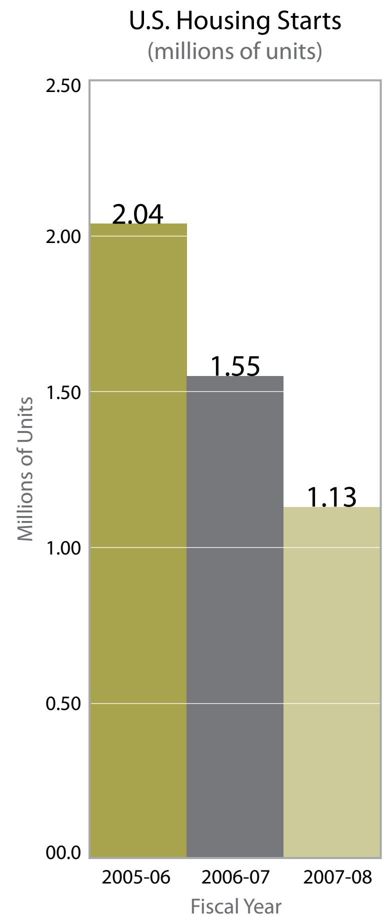
Old Town San Diego State Park, San Diego

Economic Analysis

National Economy

In fiscal year 2007-08, the national economy had below average growth, as a recession began in December 2007. The recession was brought about largely by two major factors: (1) a continuation of declines in housing activity that began in 2006-07, and (2) rising gasoline prices. Housing starts declined sharply from over 2 million units in fiscal year 2005-06 to 1.1 million units in 2007-08. U.S. gasoline prices increased 21 percent in 2007-08. During the fiscal year inflation spiked upward, led by rising gasoline and food prices. Employment growth slowed dramatically and the unemployment rate rose. Short term interest rates decreased as the Federal Reserve Board lowered interest rates in response to turmoil in financial markets and a weakening economy. Rising productivity and export demand were responsible for much of the real economic growth that was achieved.

Real Estate Bubble and Financial Turmoil

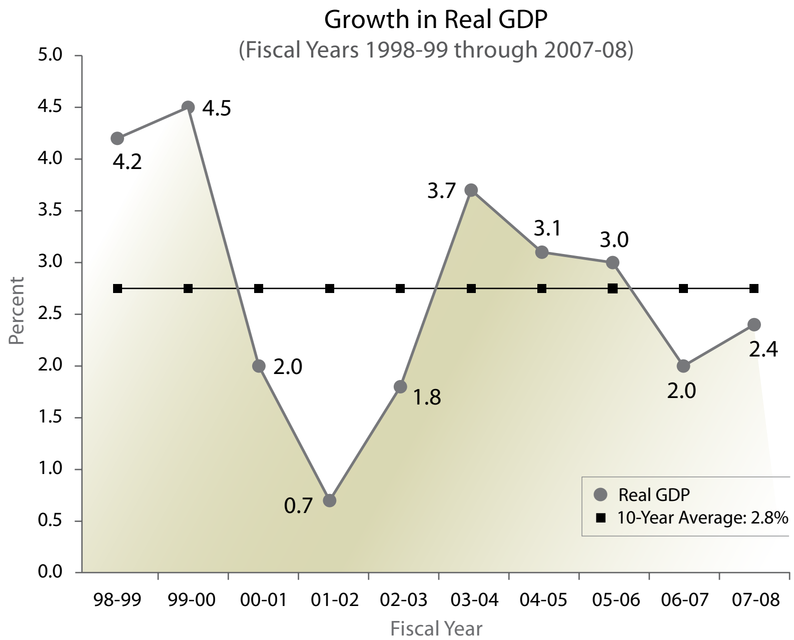


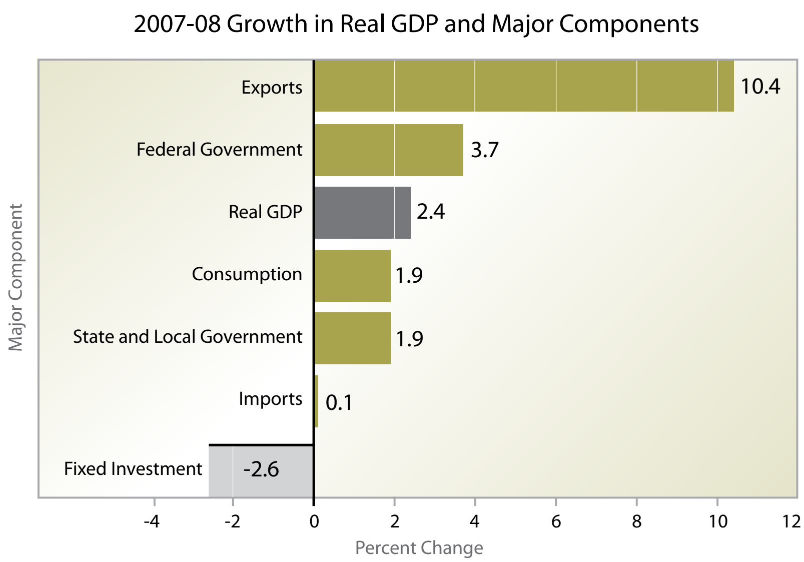
The decline in housing in 2007-08 was a consequence of what is now widely perceived as a real estate bubble that began early in this decade. Home values rose far in excess of both historic norms and reasonable estimates of fundamental determinants of value. This home price appreciation fueled expectations of a continuation of this unsustainable trend. A related component of the real estate bubble was a climate of very favorable credit market conditions for homeowners. These easy credit conditions led to explosive growth in subprime and other exotic mortgage instruments. Many of these mortgages were sold to buyers who normally would not have qualified for a mortgage and whose ability to pay was contingent on the continuation of increasing home prices. A typical feature of these exotic mortgages was a low initial "teaser" rate that would be scheduled to reset to a higher rate in two years. Another related component to the real estate bubble was the secondary mortgage market. The financial market innovation of mortgage backed securities dramatically increased the secondary market for mortgages and increased incentives for lenders to supply easy credit terms.

When double digit increases in home appreciation stopped and interest rates for many borrowers were reset to higher rates, the results included dramatic increases in foreclosures, falling home prices, sharp declines in new and existing home sales and decreased home building. In addition, financial companies holding mortgages purchased in the secondary markets saw steep declines in the values of these assets resulting in unprecedented stress in financial markets. These developments started to become evident in 2006-07 and were well established in 2007-08. Although the impacts of the bursting of the real estate bubble and subprime lending were national in scope, California suffered disproportionately. This state has a much larger share of national subprime and exotic mortgages than its share of population because of higher than average home prices and faster than average home value appreciation.

Gross Domestic Product

Real gross domestic product (GDP)—the broadest measure of the nation's output of goods and services—increased 2.4 percent in fiscal year 2007-08, up from 2.0 percent growth in fiscal year 2006-07. Despite the increase, real GDP growth was well below its ten-year average of 2.8 percent. Nonagricultural employment increased 0.7 percent, down by about half from the 1.4 percent gain of the previous fiscal year.





Real GDP by Sector

Investment spending declined in fiscal year 2007-08. Real domestic fixed investment spending, which made up 15 percent of total real GDP, decreased 2.6 percent. Major components of investment had widely varying rates of change. A sharp drop in construction activity resulted in a 19.7 percent decline in real residential investment spending. In contrast, investment in inflation-adjusted nonresidential structures, such as office buildings, jumped 13.8 percent. Increasing employment in previous years and low vacancy rates spurred nonresidential investment spending. Spending on equipment and software, the largest investment component, rose 1.8 percent.

Inflation-adjusted exports grew 10.4 percent in 2007-08, reflecting continued strength in the economies of our major trading partners and the lower value of the dollar. With slowing U.S. economic growth and a lower value of the dollar, real imports barely changed, increasing just 0.1 percent. Since exports grew faster than imports, the nation's trade balance improved.

Real consumer spending rose by 1.9 percent, the smallest increase since fiscal year 1991-92. Consumer spending is very important to GDP growth, since it accounts for 71 percent of total GDP. There was little difference in growth rates of major spending categories; real durable goods spending increased 2.2 percent, real nondurable goods spending rose 1.5 percent, and real services spending grew 2.1 percent.

Government spending on goods and services increased by 2.5 percent in 2007-08 after adjusting for inflation. Federal government spending grew 3.7 percent, while state and local government spending rose 1.9 percent. Most of the federal government growth was in defense spending, which increased 4.9 percent, while federal government nondefense spending rose 1.2 percent.

The Unemployment Rate

With relatively sluggish economic growth, not enough jobs were added to balance the increase in people coming into the labor force in fiscal year 2007-08. As a result, the average U.S. unemployment rate rose to 5.0 percent in 2007-08, up from 4.5 percent rate in 2006-07.

Corporate Profits

As the economy slowed, corporate profits declined 3.6 percent in fiscal year 2007-08. This is the largest decrease in profits since 2000-01.

Productivity and Consumer Prices

Business productivity rose 3.0 percent in 2007-08, the largest gain in four years. This is faster than the long-term average, as business productivity expanded an average of 2.7 percent per year over the past ten years.

With rising energy and commodity prices, the U.S. consumer price index rose 3.7 percent in fiscal year 2007-08, up from 2.6 percent in 2006-07.

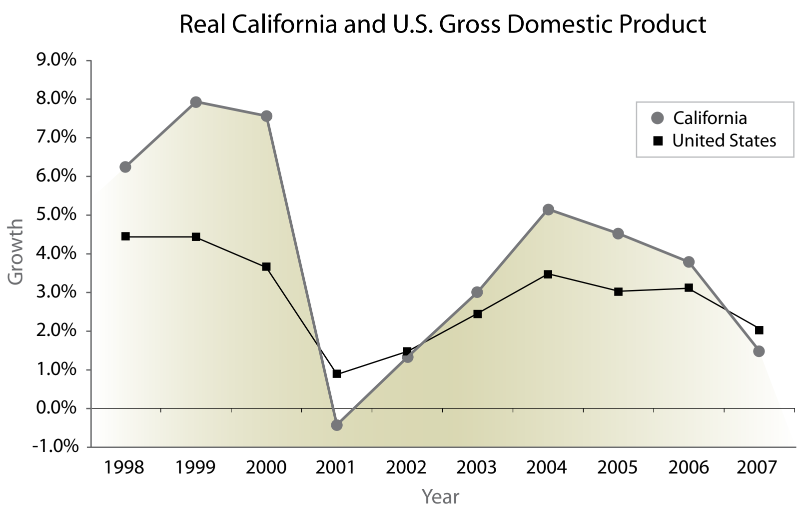
Interest Rates and the Federal Budget Deficit

In 2007-08 the Federal Reserve Board lowered interest rates through a series of rate cuts in response to deteriorating financial markets and a weakening economy. The federal funds rate declined from 5.25 percent in July 2007 to 2.00 percent by June 2008. Long term interest rates declined also but less steeply. Yields on conventional new home mortgages fell from 6.70 percent in July 2007 to 6.13 percent by July 2008.

In February, shortly after the recession began, policymakers enacted the Economic Stimulus Act of 2008. This act, combined with declines in revenues and increases in outlays, resulted in a large increase in the federal government deficit. The deficit rose from $162 billion in federal fiscal year 2007 to $455 billion in federal fiscal year 2008 (federal fiscal years ending September 30 of each respective year). In terms of percentages of GDP, the deficit increased from 1.2 percent to 3.2 percent. The last time the deficit was at least as large of a percentage of GDP was in federal fiscal year 2004, when it was 3.6 percent of GDP. The highest ratio of the past 50 years was federal fiscal year 1983, when the federal budget deficit was 6.0 percent of GDP.

California Economy

California economic growth slowed in fiscal year 2007-08 along with that of the U.S. economy. With a disproportionately large share of the nation's subprime and adjustable mortgages, California real gross state product slowed more than that of the nation as a whole. In calendar year 2007 California gross state product increased just 1.5 percent, well below recent years and below the 2.0 percent increase for the U.S. as a whole (gross domestic product for states is only available for calendar years). The poor 2007 showing also reversed several prior years when California economic growth was faster than that of the nation as a whole. With the weak economy, California nonagricultural payroll employment barely increased in 2007-08, rising just 0.2 percent. This is much less than the 1.2 percent growth of the prior fiscal year. As with economic growth, California employment rose slower than U.S. employment, which grew 0.7 percent in 2007-08.



California personal income (unadjusted for inflation) increased 4.6 percent in fiscal year 2007-08, down from 6.1 percent growth in the prior fiscal year. As with other economic indicators, California personal income rose slower than the 5.3 percent growth in U.S. personal income in 2007-08.

The California unemployment rate was 6.0 percent in 2007-08, much higher than the 5.0 percent rate for 2005-06. The California unemployment rate was 1.0 percent above the U.S. rate in 2007-08.

Employment and Income Growth

California nonagricultural employment increased just 0.2 percent in fiscal year 2007-08, as payrolls expanded by 29,400 jobs.

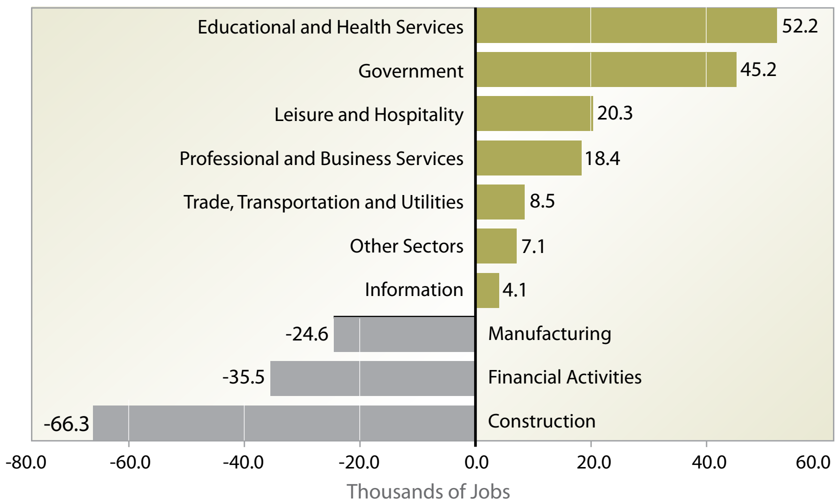
Employment Sectors

Construction. With the slowdown in housing activity in 2007-08, construction employment decreased by 66,300 jobs, more than any other sector. This was a 7.2 percent decline. About 6 percent of all nonfarm jobs are in construction.

Financial Activities. Employment in financial activities—lenders, insurance agents, and real estate brokers—decreased by 35,500 jobs, or 3.8 percent. These industries are closely associated with residential real estate activity. Financial activities account for about 6 percent of nonfarm Californian jobs.

Manufacturing. The manufacturing sector lost about 24,600 jobs in 2007-08, a 1.7 percent reduction. Jobs losses were widespread among many durable goods and nondurable goods manufacturing industries. Manufacturing employs 10 percent of workers on nonagricultural payrolls.

2007-08 Changes in California Nonagricultural Employment



Information. Information providers—publishing, motion pictures, broadcasting, telecommunications, and Internet services—gained about 4,100 jobs, a 0.9 percent increase. Print publishing and motion pictures reduced payrolls, while most other information sectors increased them. Information jobs account for a relatively small share of state jobs, about 3 percent.

Other Sectors. The remaining private industry sectors (other services, mining and natural resources) provided employment for 5 percent of nonagricultural workers. Employment in this group increased by 1.3 percent (7,100 jobs).

Trade, Transportation and Utilities. In 2007-08, about 8,500 trade, transportation and utilities jobs were added, a 0.3 percent increase. This is the state's largest employment sector, accounting for about 19 percent of all nonfarm jobs.

Professional and Business Services. Professional and business services gained 18,400 jobs, a 0.8 percent increase. Many of the added jobs in this sector were in architectural and engineering services, computer systems design, and management and scientific consulting. The professional and business services category is the state's third largest sector, employing 15 percent of Californian nonagricultural workers.

Leisure and Hospitality. Employment in leisure and hospitality industries, such as restaurants and hotels, increased 1.3 percent in 2007-08, a gain of 20,300 jobs. Most of the job gains were in food services. Leisure and hospitality industries employ about 10 percent of nonfarm Californian workers.

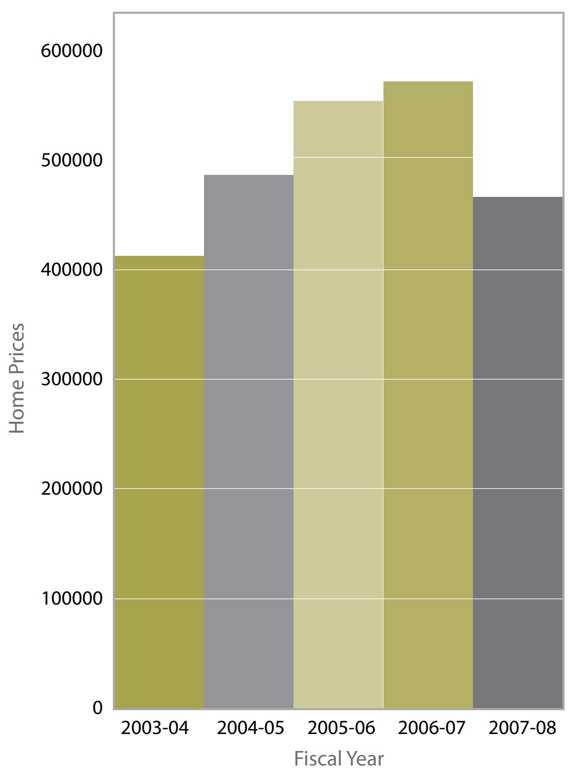
Government. About 45,200 new government positions were filled—a 1.8 percent increase. Federal payrolls decreased, while state and local government hiring increased in 2007-08. Over 40 percent of the increase in government jobs was in education. Government is California's second largest sector, with 17 percent of all California nonagricultural jobs.

Educational and Health Services. Private educational and health services gained 52,200 jobs, more than any other sector and a 3.2 percent increase. This is a relatively large sector, accounting for about 11 percent of nonfarm employment. About three quarters of the jobs added in this sector were in health care.

Building Construction and Home Prices

The value of all private building construction permits issued in California fell by 17 percent in fiscal year 2007-08, after declining by about the same amount the previous fiscal year. The value of residential construction permits issued decreased 30 percent, while nonresidential building construction permit values rose about 2 percent. A total of 85,000 home building permits were issued in 2007-08, down sharply from 133,000 in 2006-07 and a little over half of the ten-year average of 160,000. Home building permits have not been this low since the mid-1990s. Most of the weakness was in single-family home permits, which were only about one-third of the number issued in fiscal year 2004-05 at the height of the residential real estate boom.

Median Prices of Existing California Single-Family Homes



With the cooling of residential real estate markets, existing single-family home sales plummeted 23 percent to 329,000 units in fiscal year 2007-08. The last fiscal year that single-family home resales were at approximately this level was in 1992-93. To put the home resales in perspective, over the past ten years an average of about 527,000 existing California homes were sold each year.

As a result of high inventories of homes for sale and weak demand, home prices also dropped sharply in fiscal year 2007-08. In 2007-08 statewide median home prices declined 18 percent, as the median price of an existing single-family detached California home averaged $466,000. The percentage decline was the largest for any one-year period since 1975, when the California Association of Realtors started keeping records on home prices. With the drop in values, median California home prices in 2007-08 were below those of 2004-05.

Vehicle Registrations

With high gas prices and weak economic conditions, new car and truck registrations combined were down 13 percent in 2007-08. New car registrations were down about 11 percent, while new truck registrations (mostly medium and heavy duty trucks) declined 25 percent. The last calendar year with a larger decline in new car registrations was in 1980 when they declined 15 percent. The 11 percent decline in car registrations for California in 2007-08 was much steeper than U.S. car registrations, which declined about 6 percent.

Consumer Prices

California consumer prices for all urban consumers rose 3.4 percent in 2007-08, about the same as 2006-07. Over the past ten fiscal years, the California consumer price index has risen an average of 3.2 percent per year. Rising gas prices contributed disproportionately to the overall inflation rate, as California gasoline prices increased over 16 percent in 2007-08. At the national level, the consumer price index increased by 3.7 percent in 2007-08, up from 2.6 percent in 2006-07.

Taxable Sales Activity

Transactions subject to the sales and use tax totaled $552.9 billion during the 2007-08 fiscal year. This was a decrease of $11.9 billion, or 2.1 percent, over 2006-07. With the weak economy of late 2007 and the recession starting in December 2007, taxable sales declined in every quarter (see table, below). In contrast, taxable sales increased 2.0 percent in fiscal year 2006-07.

2007-08 Taxable Sales

Growth in Actual Dollars Compared to Growth in Constant-Value Dollars

	Taxable Transactions		Percent Change From Prior Year In		
Quarter	Amount	Percent of Total	Actual Dollars	Constant Value Dollars	California Taxable Sales Deflator
July-September	$139,824,975,000	25.3	-1.8	-1.3	-0.5
October-December	$145,304,568,000	26.3	-0.8	-2.7	2.0
January-March	$127,851,520,000	23.1	-3.7	-6.3	2.8
April-June	$139,913,845,000	25.3	-2.3	-5.4	3.2
Fiscal Year	**$552,894,908,000**	**100.0**	**-2.1**	**-3.9**	**1.9**

Taxable sales decreased by 3.9 percent over the previous fiscal year when measured in constant dollars. The California Taxable Sales Deflator—an index that tracks price changes only for commodities subject to the sales and use tax—showed annual inflation of 1.9 percent. By quarter, the Deflator indicated price changes for taxable goods within a range of -0.5 percent to 3.2 percent throughout the fiscal year. The 1.9 percent inflation rate shown by the Deflator contrasted with the 3.4 percent rate indicated by the California Consumer Price Index, which also measures price increases for housing costs and services, which are not subject to the sales and use tax.

Unlike prior annual reports, we do not have comparable data available to calculate percentage changes of retail stores and other businesses from fiscal year 2006-07. In early 2007, the BOE began a process of converting business codes of sales and use tax permit holders to North American Industry Classification System (NAICS) codes. Over one million permit holders will be converted over time from the previous business coding system to the NAICS codes. As a result of the coding change process, industry data for 2007 and 2008 are not comparable with data from 2006. Therefore, we will not publish percentage changes by industry until the coding process has been substantially completed.

Appendix Table 19, on page A-24, shows details on sales tax activity and the number of sales tax permittees by business type. The NAICS coding process has also caused us to change the format of this table from those of previous annual reports. We will continue to follow the general structure of our tables in past reports. However, some industries were previously listed within categories that no longer exist, and others have been combined into new ones.

Revenue Growth

Tax programs administered by the BOE produced state and local revenues totaling $53,145,812,000 during fiscal year 2007-08. This was a decrease of $0.7 billion, or 1.3 percent, from 2006-07. The revenue decline resulted from decreases in economic activity resulting from the recession.

Revenues from each tax are presented in the text table on page 64. Additional detail and historical comparisons are found in Appendix Table 2, on page A-2.

Sales and Use Taxes

Sales and use taxes contribute 84 percent of the revenue from BOE-administered tax programs. Combined revenue from all state and local sales and use taxes totaled $44,416,478,000 in 2007-08, a decrease of 1.5 percent from 2006-07. The state's portion of the sales tax was $29,173,621,000 (including the fiscal recovery fund). The portion allocated to other jurisdictions—cities, counties, and special districts—totaled $15,242,857,000, including allocations to the Local Revenue Fund and the Public Safety Fund. Sales and use tax details are provided in Appendix Tables 19 through 23B, beginning on page A-24.

By the end of the fiscal year, special district taxes were being levied by 91 jurisdictions in 38 counties (see "District Transactions (Sales) and Use Tax," on page 28). These counties are the source of 94 percent of all taxable sales in the state. Some districts cover entire counties while others are restricted to city limits or other legal boundaries. Special district information is located in Appendix Table 21C, on page A-30. Appendix Table 23B, on page A-34, lists total sales and use tax rates by county.

Special Taxes

Fuel taxes. In 2007-08, the state's fuel tax revenues totaled $3,396,594,000, a 0.8 percent decrease from the previous fiscal year. Distribution of gasoline for highway use decreased 2.7 percent to 15.4 billion gallons. Historical fuel tax data are presented in Appendix Tables 24-26, beginning on page A-35.

Alcoholic beverage tax. The state's excise tax revenues from alcoholic beverages decreased 2.0 percent from 2006-07 levels to total $327,270,000 for the fiscal year. Revenues from beer and wine decreased 7.0 percent to $157,568,000, while revenues from distilled spirits increased 3.2 percent to $169,702,000. Tax rates range from twenty cents a gallon for beer and wine to $3.30 per gallon for distilled spirits. For historical data on taxes, total apparent consumption, and per-capita apparent consumption by major type of beverage, see Appendix Tables 27-29, beginning on page A-39.

Cigarette and tobacco taxes and fees. Revenue from excise taxes on cigarettes and other tobacco products totaled $1,042,797,000 in 2007-08, a decrease of 3.8 percent from the previous year. For more information on these taxes, see Appendix Tables 30A and 30B, which begin on page A-42.

Insurance Taxes. Insurance taxes were $2,009,700,000 in 2007-08, a 1.4 percent increase. For more information on these taxes, see Appendix Tables 31-33, which begin on page A-44.

Electricity, telephone, and natural gas surcharges. The electrical energy surcharge, levied on the use of electricity in California, produced $57,040,000 in 2007-08, a 1.2 percent increase from the previous year. The natural gas surcharge produced $400,030,000, a decrease of 9.2 percent. The emergency telephone users surcharge, which funds the 911 statewide emergency number system, totaled $103,748,000, a decrease of 7.5 percent. Additional detail and historical comparisons are provided in Appendix Table 2, on page A-2.

Hazardous substance taxes and other environmental fees. Revenues from hazardous substance taxes and other environmental fees totaled $587,646,000, a 3.9 percent increase from 2006-07. These taxes and fees are used to fund specific environmental programs.

Property Taxes

Locally collected property taxes on state-assessed properties amounted to $785,570,000, an increase of 6.0 percent. The timber yield tax, which is levied when timber is harvested to substitute for an annual value-based property tax, totaled $12,831,000. This was a 16.1 percent decrease. The private railroad car tax, levied on railroad cars owned by firms that do not operate railroads, produced $6,110,000, a decrease of 8.9 percent.

Comparison of Revenues 2006-07 and 2007-08

In thousands of dollars

Revenue Source	2006-07	2007-08	Percent change
Sales and Use Taxes			
State tax (5.00%)	$28,396,242	$27,771,845	-2.2
Local revenue fund state sales tax (0.50%)	2,850,488	2,805,089	-1.6
Public safety fund sales tax (0.50%)	2,850,488	2,805,089	-1.6
Fiscal recovery fund sales tax (0.25%)	1,406,048	1,401,776	-0.3
City and county sales tax (0.75%)	4,264,888	4,228,650	-0.8
County transportation tax (0.25%)	1,419,150	1,429,075	0.7
Special district taxes	3,918,005	3,974,548	1.4
Other taxes and fees	482	405	-16.0
Totals	**45,105,793**	**44,416,478**	**-1.5**
Fuel Taxes and Fees			
Gasoline and jet fuel	2,848,664	2,807,199	-1.5
Diesel and use fuel [1]	574,874	589,395	2.5
Totals	**3,423,538**	**3,396,594**	**-0.8**
Alcoholic Beverage Taxes	333,806	327,270	-2.0
Cigarette and Tobacco Products Taxes			
Cigarette tax	115,370	109,871	-4.8
Cigarette and tobacco products surtax	335,893	327,734	-2.4
Breast cancer research cigarette stamp tax	27,273	26,400	-3.2
California children and families first cigarette stamp tax	603,385	576,857	-4.4
Cigarette and tobacco products licensing fee	2,183	1,934	-11.4
Totals	**1,084,103**	**1,042,797**	**-3.8**
Insurance taxes	1,982,588	2,009,700	1.4
Electrical energy surcharge	56,357	57,040	1.2
Natural gas surcharge [2]	440,430	400,030	-9.2
Emergency telephone users surcharge [3]	112,154	103,748	-7.5
Hazardous substances taxes and other environmental fees [4]	565,423	587,646	3.9
Local taxes on state assessed properties [5]	740,861	785,570	6.0
Timber yield tax	15,301	12,831	-16.1
Private railroad car tax	6,703	6,110	-8.9
Grand Totals	**$53,867,057**	**$53,145,812**	**-1.3**

[1] Includes diesel fuel taxes collected under the International Fuel Tax Agreement (IFTA) implemented on January 1, 1996.

[2] Rates increased effective January 1, 2006.

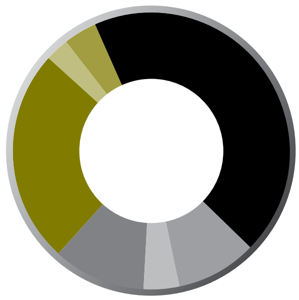
[3] Effective November 1, 2006, the tax rate was lowered to 0.5% from 0.65%.

[4] Includes revenues from the hazardous substances tax, integrated waste management fee, underground storage tank maintenance fee, tire recycling fee, oil spill prevention and administration fee, oil spill response fee, childhood lead poisoning prevention fee, occupational lead poisoning prevention fee, marine invasive species control fee, water rights fee, and electronic waste recycle fee.

[5] Collected by county tax collectors.

Sources of State Revenue July 1, 2007–June 30, 2008

Percentage of Total State Revenue



Revenue Source	Revenue *(in thousands)*	Percent Change from 2006-07	Percentage of Total State Revenue
Board of Equalization			
Major Taxes and Licenses			
Sales and Use Tax [1]	$31,972,874	-2.13	25.26
Gasoline and Jet Fuel Tax	2,829,633	-.77	2.24
Diesel and Use Fuel Taxes	591,824	1.88	.47
Insurance Gross Premiums Tax	2,172,936	-.25	1.72
Cigarette and Tobacco Products Tax	1,037,457	-3.81	.82
Alcoholic Beverage Tax	327,260	-1.96	.26
Totals, Major Taxes and Licenses	$38,931,984	-1.92	30.76
Totals, Minor Revenues [2]	1,154,572	-2.24	.91
Grand Total, Board of Equalization	**$40,086,556**	**-1.93**	**31.67**
Other Agencies			
Major Taxes and Licenses			
Personal Income Tax	$55,745,970	4.55	44.04
Corporation Tax	11,849,097	6.19	9.36
Motor Vehicle "in lieu" Tax	2,243,239	-1.09	1.77
Trailer Coach Fees "in lieu" Tax	29,755	1.31	.02
Motor Vehicle Registration and Other Fees	2,939,817	3.15	2.32
Estate, Inheritance and Gift Tax	6,303	-.71	.01
Horse Racing (Pari-mutuel) License Fees	34,949	-6.87	.03
Totals, Major Taxes and Licenses	$72,849,130	4.57	57.56
Totals, Minor Revenues	13,635,040	42.15	10.77
Grand Total, Other Agencies	**$86,484,170**	**9.12**	**68.33**
TOTAL STATE REVENUE	**$126,570,726**	**5.36**	**100.00**

Source: 2009-10 Governor's Budget

[1] Includes revenues from the state sales tax, the state disaster relief tax, the local revenue fund state sales tax, and the fiscal recovery fund sales tax.

[2] Includes private railroad car, electrical energy, natural gas, emergency telephone, and environmental taxes and fees.

Note: Percentage detail may not compute to totals due to rounding.