



December 13, 2011

Honorable Mark Leno, Chair
Joint Legislative Budget Committee
Senate Budget and Fiscal Review Committee

Honorable Bob Blumenfield, Chair
Assembly Budget Committee

Honorable Christine Kehoe, Chair
Senate Appropriations Committee

Honorable Felipe Fuentes, Chair
Assembly Appropriations Committee

2011-12 Revenue Forecast/Determination Pursuant to Chapter 41, Statutes of 2011

The 2011 May Revision revenue forecast reflected the state's continuing economic recovery with \$6.6 billion in higher tax receipts compared to the January Budget. The higher receipts in large part resulted from wage growth among higher income groups that pay a higher tax rate, outstripping wage growth in lower income levels. Though the May Revision forecast was higher than earlier projections, tax receipts in May and June were exceeding projections by an estimated \$1.2 billion. Based on the higher receipts, the Budget projected that 2011-12 revenues would be \$4 billion higher than otherwise projected in the May Revision. These revenues were not allocated to any specific revenue sources.

The Budget recognized the potential risk to the state's fiscal condition if revenues fell short of the forecast and established cuts and revenues that would go into effect in that event. Chapter 41, Statutes of 2011, requires the Director of Finance (Department) to update the estimate of General Fund revenues for 2011-12, compare those revenues to the Legislative Analyst's November estimate, and determine which estimate is higher. The Department of Finance's updated revenue estimate for 2011-12 is \$86,247,700,000. This amount is \$2,204,800,000 lower than the revenue specified in Section 3.94 of the Budget Act. The Legislative Analyst's estimate was \$84,764,000,000. The Department of Finance's estimate is higher and therefore the operative forecast.

Pursuant to Section 3.94 and other sections of law, the Legislature established certain specific spending reductions or revenues that shall occur based on the operative revenue forecast. Therefore, consistent with state law and pursuant to my ministerial duty, I hereby reduce or adjust the following expenditures effective January 1, 2012, and increase the following revenue in the amounts as specified:

| Appropriation Citation (Budget Act Item except where noted) | Description | Amount Reduced/Adjusted |
|---|---|----------------------------|
| 0690-102-0001 | Reduce Vertical Prosecution Grants | \$14,558,000 |
| 4260-101-0001 | Medi-Cal—Extend Provider Cuts and Copayments to all Managed Care Plans | \$8,642,000 |
| 4300-101-0001 | Reduction to the Department of Developmental Services | \$100,000,000 |
| 5180-111-0001 | In Home Supportive Services—20 Percent Reduction in Service Hours, Eliminate Funding for Local Anti-fraud Efforts | \$101,481,000 |
| 5225-001-0001 | Department of Corrections and Rehabilitation—Unallocated Reduction | \$20,000,000 |
| 6110-111-0001 | Home to School Transportation | \$248,000,000 |
| 6110-194-0001 | Child Care—Non Proposition 98—4 Percent Across-The-Board Reduction | \$17,084,000 |
| 6110-196-0001 | Child Care—Proposition 98—4 Percent Across-The-Board Reduction | \$5,900,000 |
| Education Code Sec. 42238 | Proposition 98—Reduce Apportionments (effective February 1, 2012) | \$79,600,000 |
| 6120-150-0001, 6120-160-0001, 6120-211-0001, 6120-213-0001 | Eliminate State Grants to Local Libraries | \$15,866,000 |
| 6440-001-0001 | University of California—Unallocated Reduction | \$100,000,000 |
| 6610-001-0001 | California State University—Unallocated Reduction | \$100,000,000 |
| 6870-101-0001 | Community Colleges—Reduce Apportionments, \$10 Per Unit Fee Increase | \$102,000,000 |
| Revenues pursuant to Ch. 36, Stats. of 2011 | Juvenile Justice—Increase County Charge for Youthful Offenders Sent to Department of Corrections and Rehabilitation | \$67,700,000 |
| Total | | \$980,831,000 |

Estimating Methodology

The Department of Finance produces an estimate of revenues for the current fiscal year as part of the development of the Governor's Budget and the May Revision. The Department has estimated baseline revenues for its December 2011 forecast using the same methodology that was used for the 2011 May Revision estimate. This estimate reflects changes in the law that occurred subsequent to the enactment of the Budget.

To build its revenue estimate, the Department starts with a national econometric model (from IHS Global Insight) and modifies it to incorporate more recent data. The Department's state econometric model uses inputs from the national model and California-specific data to build a state forecast. Inputs to the state model, as well as the reasonableness of the outputs, are reviewed by a peer group of economists who work in California.

The Department's economic forecast forms the basis of its projections for state revenues. The Department's Financial Research Unit has developed revenue forecasting models for each of the major tax revenues. These models primarily rely on regressions that use historical relationships between economic data sources and aspects of the revenues to predict future revenue collections.

Major Changes in the Revenue Estimate From Budget Act to December 2011 Forecast

Overall, the Department's December 2011 forecast is \$2.205 billion less than the Budget Act forecast. When compared to the projections for the state's biggest three tax sources, the December 2011 forecast is \$1.8 billion above the Budget Act.

- Personal Income tax revenues are estimated to be \$1.529 billion higher. High-income wages and salaries were stronger in 2011 and 2012 than previously estimated. Proprietor's income is also estimated to be higher. In contrast, capital gains are mixed: estimated to be slightly lower in 2011 and slightly higher in 2012.
- Sales tax revenues are estimated to be \$232 million lower. The lower revenues are the result of legislation that delayed the implementation of use tax collection changes, a lower projection of inflation, and a higher projection of unemployment.
- Corporation tax revenues are estimated to be \$467 million higher, primarily because of a higher corporate profits forecast.

However, this net increase in the state's biggest three tax sources was insufficient to fully offset the \$4 billion in unallocated revenues described above.

Attachment A provides more information about the economic and revenue forecasts.

If you have any questions regarding this matter, please call Mark Hill, Program Budget Manager, at (916) 322-2263.

Sincerely,

/s/ Ana J. Matosantos

ANA J. MATOSANTOS
Director

Attachment

cc: Honorable Bob Huff, Vice Chair, Senate Budget and Fiscal Review Committee
Honorable Jim Nielsen, Vice Chair, Assembly Budget Committee
Mr. Mac Taylor, Legislative Analyst (3)
Ms. Keely Bosler, Staff Director, Senate Budget and Fiscal Review Committee
Mr. Bob Franzoia, Staff Director, Senate Appropriations Committee
Mr. Seren Taylor, Staff Director, Senate Republican Fiscal Office
Mr. Craig Cornett, Senate President pro Tempore's Office (2)
Mr. Christian Griffith, Chief Consultant, Assembly Budget Committee
Mr. Geoff Long, Chief Consultant, Assembly Appropriations Committee
Mr. Eric Swanson, Staff Director, Assembly Republican Fiscal Committee
Ms. Deborah Gonzalez, Policy and Fiscal Director, Assembly Republican Leader's Office
Mr. Christopher W. Woods, Assembly Speaker's Office (2)

Economic Estimate

The economic forecast developed for December 2011 incorporates new economic data and the impact of significant national and global economic developments that have taken place since May.

New economic data had a mixed impact on the near-term California forecast. Revisions to employment estimates indicate that 2011 did not have as strong a start as had been originally thought. The temporary disruptions caused by the Japanese earthquake/tsunami and high oil prices—that were incorporated into the May Revision forecast—were followed by the federal debt ceiling controversy and the Euro zone sovereign debt crisis. As a result, state job growth remained subdued longer than originally anticipated.

California salaries and wages grew more than originally estimated in 2010. Official income estimates for the first three quarters of 2010 had indicated that total state wage income had grown 0.4 percent. Subsequent revisions increased this growth rate to 1.3 percent. Actual wages and salaries earned in the fourth quarter of 2010 grew much stronger than forecast in the May Revision—4.5 percent versus 1.9 percent. Wage growth during the first half of 2011 was also stronger than forecast in the May Revision—5.2 percent versus 3.6 percent. The upwardly revised information and above-forecast results for the most recent quarters boosted the outlook for 2011 salary and wages. A more subdued national outlook led to a more restrained projection for 2012.

Select Indicators from Recent DOF Economic Forecasts National Indicators

| | 2011 | 2012 |
|--|-------|-------|
| Real Gross Domestic Product (Yr-to-Yr % Chg.) | | |
| December 2011 | 1.8 | 1.7 |
| May Revision 2011 | 2.8 | 2.9 |
| Corporate Profits Before Taxes (Yr-to-Yr % Chg.) | | |
| December 2011 | 6.0 | 5.9 |
| May Revision 2011 | 3.6 | 2.2 |
| Automobile Sales (Millions) | | |
| December 2011 | 12.6 | 13.2 |
| May Revision 2011 | 12.9 | 14.7 |
| S&P 500 Index | | |
| December 2011 | 1,260 | 1,285 |
| May Revision 2011 | 1,361 | 1,441 |
| Consumer Goods Deflator (Yr-to-Yr % Chg.) | | |
| December 2011 | 3.4 | 0.2 |
| May Revision 2011 | 3.2 | 1.1 |

California Indicators

| | | |
|---------------------------------------|------|------|
| Unemployment Rate | | |
| December 2011 | 12.0 | 12.0 |
| May Revision 2011 | 12.1 | 10.8 |
| Salaries and Wages (Yr-to-Yr % Chg.) | | |
| December 2011 | 4.9 | 3.8 |
| May Revision 2011 | 3.8 | 4.5 |
| Proprietor's Income (Yr-to-Yr % Chg.) | | |
| December 2011 | 7.8 | 6.6 |
| May Revision 2011 | 6.8 | 7.2 |
| New Housing Units (1,000s of Units) | | |
| December 2011 | 46.4 | 52.2 |
| May Revision 2011 | 54.7 | 86.5 |

Revenue Estimate

The May Revision forecast \$6.6 billion in higher baseline tax receipts compared to the January Budget. The higher receipts resulted in large part from wage growth among higher income groups that pay a higher tax rate, outstripping wage growth in lower income levels. Tax receipts in May and June significantly exceeded projections. Based on these higher receipts, the Budget projected that 2010-11 and 2011-12 revenues would be higher than otherwise projected in the May Revision by \$1.2 billion and \$4 billion respectively.

While final income tax payments and estimate payments for April and June were higher than the May Revision forecast, some of the cash predicted in June did not materialize.

The Department has performed a full and complete re-estimate of 2011-12 General Fund revenues as described below. In total, revenues are estimated to be \$86.2 billion, which is \$2.2 billion below the Budget Act forecast.

Changes in Revenue Forecasts for Major Revenues from 2010-11 Budget Act to
December 2011

Change in DOF Revenue Forecasts

| (Dollars in Millions) | 2011-12 |
|------------------------------|----------|
| Personal Income Tax | |
| December 2011 Forecast | \$51,937 |
| Budget Act Forecast | \$50,408 |
| Sales & Use Tax | |
| December 2011 Forecast | \$18,777 |
| Budget Act Forecast | \$19,009 |
| Corporation Tax | |
| December 2011 Forecast | \$9,479 |
| Budget Act Forecast | \$9,012 |
| Insurance Tax | |
| December 2011 Forecast | \$2,042 |
| Budget Act Forecast | \$1,893 |
| Other Revenue Sources | |
| December 2011 Forecast | \$4,048 |
| Budget Act Forecast | \$3,961 |
| Unallocated Revenue Increase | |
| December 2011 Forecast | \$0 |
| Budget Act Forecast | \$4,000 |

Personal Income Tax (PIT)

New Franchise Tax Board data on 2010 returns suggests that growth rates that had been built into the Budget Act forecast for wage, dividend, net business, net partnership, and annuity incomes were understated. Though the change in 2010 income does not have a direct impact on 2011-12 revenues, this income forms the base for the estimated income in 2011 and 2012. The 2011 and 2012 income levels help to determine the tax liabilities for 2011 and 2012, and thus the revenue for 2011-12.

The Department's forecast of wage and salary growth in 2011 increased from 3.8 percent at the enactment of the Budget Act, to 4.9 percent. Proprietors' income increased from 6.8 percent to 7.8 percent. This change results in higher growth for both the Net Business and Net Partnership income components of Adjusted Gross Income (AGI).

The 2011 capital gains forecast has been reduced from \$67 billion to \$63 billion. Net 2011-12 accruals were reduced by \$64 million to account for a prior-year gain of the same amount to the General Fund for the Mental Health Service Fund adjustment settle-up in July 2011.

Over and above the changes to the input forecast variables, 2011-12 PIT cash through November is tracking \$541 million above the Budget Act estimate. While an important

factor, receipts from high-income tax payers do not follow a predictable pattern, thus, cash-to-date is not a definitive indicator of annual revenues.

Estimates for recently enacted legislation for this forecast increased \$176 million over those used in the Budget Act.

The net effect of these changes was that the December forecast is higher by \$1.529 billion for 2011-12 as compared to the Budget Act.

Sales and Use Tax

Revisions to the forecast of economic variables have had a negative impact on the revenue forecast. The California unemployment rate was revised upward by 110 basis points in 2012. Housing permits were revised significantly downward, with the largest revisions occurring in calendar year 2012. The U.S. consumer goods deflator and auto sales were also revised modestly downward, with just a small decline in 2011, but a more significant decline in 2012. However, California wages and salaries were revised upward.

The Budget Act sales tax forecast had assumed that Chapter 7, Statutes of 2011, First Extraordinary Session (ABx1 28), signed into law on June 29, 2011, would lead to \$200 million in General Fund sales and use tax revenues in 2011-12. This bill clarified the obligations under existing law for out-of-state retailers to collect and remit use tax on sales of tangible personal property to California residents. Subsequent to the Budget Act, an agreement was reached leading to the enactment of Chapter 313, Statutes of 2011 (AB 155) to delay implementation of the provisions of that bill until at least September 15, 2012. Also, certain parts of the law were revised to reduce the number of impacted firms. As a result, the forecast assumes no sales tax revenues in 2011-12 from this measure.

The December forecast of the Sales and Use Tax analyzed cash receipts from the first prepayment for fourth-quarter sales, which was due November 24, 2011. These cash receipts were strong, which led to a higher estimate for fourth-quarter taxable sales than what was suggested by the economics.

Corporation Tax

Based on higher forecast corporate profits, the taxable profits estimate for 2011-12 was \$165.1 billion, or 1.5 percent higher than the Budget Act estimate of \$162.6 billion. By itself, this change would translate into an increase of net Corporation Tax payments of \$344 million. However, the estimated impact of recently enacted legislation decreased revenues by \$132 million from the Budget Act forecast to the December forecast. Changes in the estimated accruals added \$282 million and an adjustment of -\$27 million was required to reconcile agency and final controller cash. The net impact of these changes is an increase of \$467 million.

Insurance Tax

The insurance tax revenue in 2011-12 increased by approximately \$150 million from the Budget Act to the December forecast. About \$100 million of the total \$150 million increase is attributable to the recently completed 2011 insurance tax surveys. The most recent

survey indicates that total premiums will increase by 6.5 percent and 3.8 percent in 2011 and 2012, respectively. The remaining \$50 million increase primarily reflects a combination of actual cash gains in recent months and technical calibrations made to the insurance tax revenue forecast model to more accurately attribute components of this tax (e.g., quarterly payments, final payments, refunds, etc.) to the proper time periods. The increase also reflects the updated estimate for the revenue impacts from a 2006 Board of Equalization decision in the *California Automobile Insurance Company* case. This estimate increases net Insurance Tax revenue by decreasing refunds by \$9 million.

Vehicle License Fee

The Budget estimated that an additional \$150 million in Vehicle License Fee (VLF) General Fund revenue would be collected in 2011-12. However, based upon actual receipts for the first five months of 2011-12, and a noticeable rate of decline in those receipts, the VLF estimate for 2011-12 was revised down to \$80 million.

Other Revenues

Other revenue sources (including alcoholic beverage and tobacco taxes, interest earnings, transfers, and loans) have increased by \$87 million. The largest adjustment reflects a decline in transportation debt service cost estimates that shifts \$91.5 million in weight fee revenues from reducing expenditures for debt service to instead be transferred to the General Fund. This change occurs automatically under existing law.