San Diego Institute for Policy Research

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CEO's Corner

- W. Erik Bruvold, President and CEO, San Diego Institute for Policy Research

California's fiscal structure encourages municipalities to focus on the development of those businesses that sell goods and are subject to sales tax. Proposition 13 and the 20+ years of policy responses that have flowed from it have, for all intents and purposes, created a situation in which the government entity responsible for determining how property is zoned (and thus ultimately the value of that land and the improvement built upon it) has very little incentive to approve housing, industrial, and office uses and very large incentives to approve uses that generate sales tax. Apartments are money losers and auto dealers

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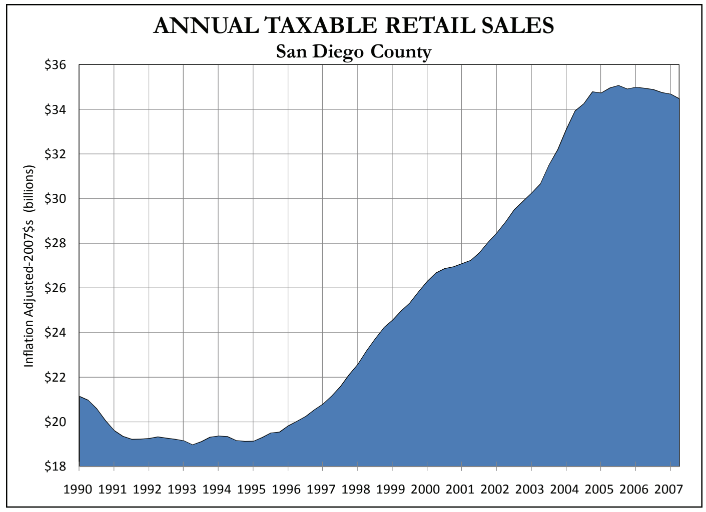
Does your company need timely and affordable economic data and forecasts? Does your association want to better understand policy choices and innovations that are occurring in jurisdictions outside of the San Diego region? Are you interested in how San Diego compares to other regions on one of more than 100 different economic and demographic measures? ***Starting this month SDI is making available to select associations and businesses its staff on a consultative basis.*** Should you have a project that you feel could benefit from the over 50 years of staff experience at SDI, please call **Erik Bruvold at 858-320-7504.**

San Diego Retail Sales Decline: The Fall Out from Declining Home Values

Consumer spending has considerably weakened in San Diego over the past three years. According to the latest report by the California State Board of Equalization (BoE), taxable retail sales in San Diego County have fallen 2.9 percent since 2005. Over this same time period, the number of retail businesses in the County has also declined by nearly 2,900. This in spite of the fact that the County population has increased by 2.3 percent and payroll jobs are up 2.1 percent over the same period.

The slowdown of local consumer spending is clearly a result of the bursting housing bubble and global credit crunch. Consumers who refinanced or took out equity loans on their homes to free up cash are now mostly spent out and highly leveraged in debt.

While banks formerly encouraged homeowners to tap into their equity for everything from paying off credit cards to paying for college, lenders are now abruptly turning the spigot off. Declining home values and spiking default rates have caused once-enthusiastic second-mortgage lenders to tighten standards and make obtaining home-equity loans more difficult. Homeowners are being told their home-equity lines of credit have been frozen, while others have seen credit limits abruptly lowered.



Homeowners' percentage of equity, the market value of a property minus the mortgage debt, declined steadily even when home values surged during the housing boom because of the high numbers of homeowners cashing-out, refinancing, taking out home equity loans, and increasing to 100 percent financing. Experts now expect equity to further decline as home prices erode and drag more homeowners "upside down" on their mortgages.

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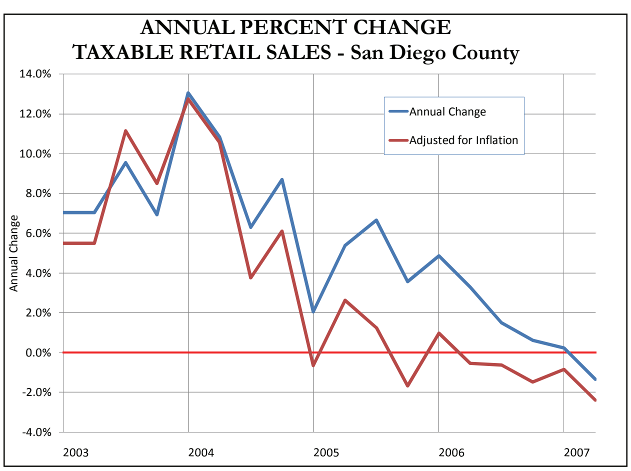
TAXABLE SALES - San Diego County

Year	Qtr	Total Taxable Sales	Annual Change	Retail Sales (000s)	Annual Change	Inflation Adj*



Retail Sales

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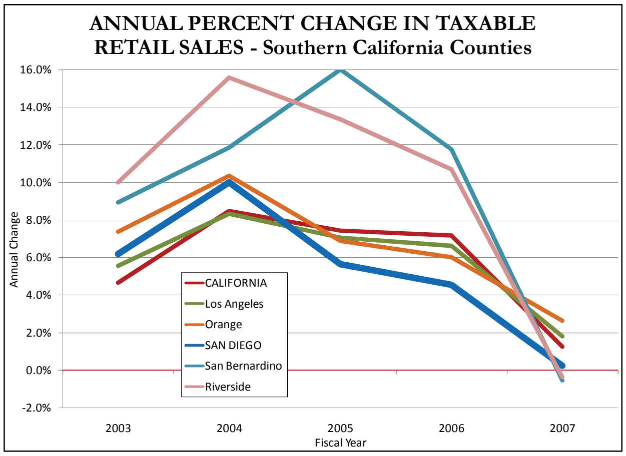


Across the nation, at the end of March 2008, nearly 8.5 million homeowners had negative or no equity in their homes, representing more than 16 percent of all homeowners with a mortgage, according to *Moody's* Economy.com Chief Economist Mark Zandi. By June 2009, he estimates the figure will increase to almost one out of every four homeowners with a mortgage. But to put that number in perspective, one out of every three homeowners own their properties free and clear, with no mortgage at all.

Still, concerns about the housing market and mortgage troubles are impacting consumer's finances and curtailing spending. San Diego was among the first housing markets to experience high increases of prices and to subsequently substantially come back down. Therefore it is not too surprising that San Diego was also one of the first areas to see consumer spending, as reflected in taxable retail sales, starting to diminish as well.

Over the fiscal year ending the 2nd quarter of 2007, San Diego County shows below average transactions with a 0.3 percent gain from the previous year. The State of California reports a 1.3 percent increase in taxable retail sales from the previous fiscal year. San Diego reported the 3rd highest sales volume in the state among all counties. Formerly fast growing San Bernardino and Riverside counties are now showing declining sales.

This is a change from what had seemed, between 1995 and 2005, like an endless march upwards. During those years San Diego retail sales increased by an average of 7.5 percent per year. But starting in the last quarter of 2005, growth slowed. Since that time, retail sales have increased only 2.7 percent per year. After adjusting for inflation, sales show an annual real dollar value decline of 0.3 percent.

Even more troubling, the pace of slowdown is accelerating. Sales were up only 0.2 percent in Q1 2007 before actually declining 1.3 percent in Q2 2007. Double-digit annual rates of gain at the beginning of 2004 quickly fell negative after adjustment for inflation in 2006 and 2007.

After adjusting for inflation, total retail sales over the past fiscal year ending in June 2007 have declined by more than $412 million in San Diego County. This represents a significant loss of economic activity for the region, as well as government revenues.

For all taxable sales, which include not only retail sales but business and service transactions that are taxable and sales made from establishments which the BoE characterizes as non-retail, the decline is not as noticeable, with the quarterly total still hovering just under $12.1 billion. As with the national economy, it seems that the current downturn is most severe among retail sectors, as businesses continue to invest.

Digging a layer deeper shows that sales of durable goods, items that are intended to last three or more years, have shown the greatest quarterly decline. New auto dealers, the single largest category for retail sales, reported sales declining 8.4 percent over the past year. Home furnishing and appliances fell 4.4 percent, while building materials dropped 14.5 percent.

In contrast, non-durable goods, such as apparel (up 5%), general merchandise (up 1.4%), food (up 0.4%) showed upward, albeit, sluggish increases.

With the downturn of spending, the number of business outlets in San Diego diminished. More than 5,900 business outlets closed over the past year, including nearly 2,350 retail outlets. This seems wholly driven by the downturn in housing prices and the related loss of consumer confidence and inability by consumers to tap into the equity of their homes to make major purchases since other factors that should fuel retail demand, such as population growth (up an estimated 68,900 between 2005 and 2007) and employment (net increase of 28,000 between 2005 and 2007) remains positive.

The number of people visiting San Diego and spending money for taxable purchases has also increased. According to the San Diego Convention and Visitors Bureau, total visitor spending in

LEADING CALIFORNIA COUNTIES TAXABLE SALES, Fiscal Year 2007

County	Taxable Retail (000s)		Annual Change Taxable	Annual Change Retail
	Taxable	Retail		

TAXABLE SALES BY TYPE OF BUSINESS SAN DIEGO COUNTY - 2nd Quarter, 2007

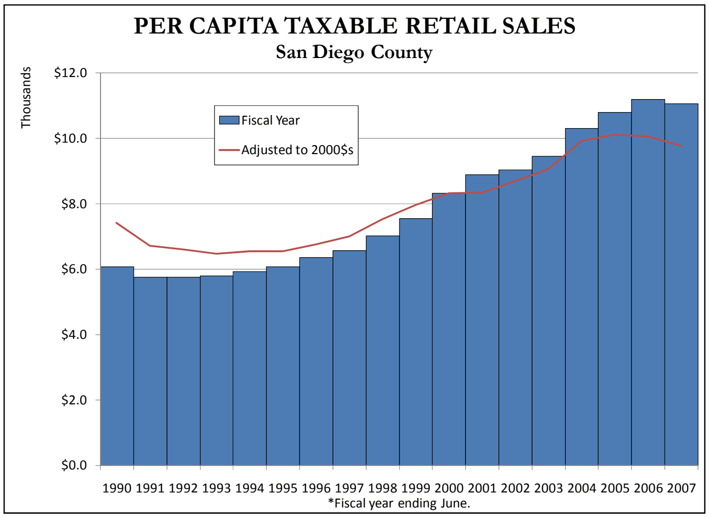
Type of business	Permits or Outlets	Annual Change	Taxable Sales (000s)	Percent Change
Retail Stores Total	**40,011**	**-2,348**	**$8,587,362**	**-1.3%**
Apparel stores group	**4,012**	**-84**	**476,901**	
General merchandise group	**1,181**	**18**	**1,319,837**	**0.6%**
Food stores group	**1,803**	**-91**	**490,189**	**0.4%**
Eating and drinking group	**7,249**	**35**	**1,212,195**	**7.5%**
Home furnishings/appliances	**2,644**	**-245**	**355,120**	**-3.3%**
Building materials	**894**	**-39**	**753,332**	**-14.5%**
Automotive group	**2,752**	**76**	**1,648,694**	**-4.8%**
Service stations	**804**	**97**	**1,004,229**	**1.5%**
Other retail stores	**18,672**	**-2,115**	**1,326,865**	**-1.9%**
Business, Personal Services	**8,701**	**-448**	**$578,494**	**-1.4%**
All Other Outlets	**36,629**	**-3,114**	**2,903,707**	**4.5%**
Totals All Outlets	**85,341**	**-5,910**	**$12,069,563**	**0.0%**

San Diego increased 2.3 percent in 2007.

Despite the larger number of residents, visitors, and jobs, total consumer spending has turned downward. On a per capita basis, San Diego spending decreased 1.1 percent in 2007 to $11,064 per person. Adjusted for inflation, per capita spending has decreased each of the past two years by a total of 3.3 percent.

While this downturn will negatively impact cities throughout the region, the extent of pain will significantly vary. Those cities that are heavily reliant upon sales tax receipts to fund general fund operations and which are home to a disproportionate share of establishments selling durable goods, are most at risk. The table below shows that cities that are particularly dependent upon auto sales, such as National City, Escondido, and El Cajon, have seen the greatest declines of taxable retail sales.

In contrast, through FY 2007, Chula Vista and Vista in particular still indicate strong double-digit gains in sales over the previous year. However, there have been several recent stories in the local press that indicate Chula Vista's sales softened considerably in the second half of 2007 and by 2008 there is every reason to expect that when the next update is released we will also see a marked decline in taxable sales for that jurisdiction.



Readers should note that higher gas prices are not yet reflected in these sales reports. As the sales tax is imposed on higher gasoline prices we expect to see increased taxable sales for service stations. But with incomes relatively flat, it is likely that the increased collections from fuel sales will be cancelled out by declines in other categories.

Municipal revenues from sales taxes

The sales tax rate charged almost uniformly throughout San Diego County is 7.75 percent. The cities of El Cajon and Vista charge a higher 8.25 percent tax rate, while National City is among the highest in the state at 8.75 percent (matched only in California by Alameda County).

The basic statewide sales and use tax rate is 7.25 percent, with the allocation divided 6.25 percent to the state, 0.75 percent to the local Jurisdiction (City or county of place of sale or use), and 0.25 percent to local transportation funds (County of place of sale or use). Additional "District Taxes" are imposed under the Transactions and Use Tax Law by the San Diego County Regional Transportation Commission (SDTC) , which adds 0.50 percent to the tax rate throughout the County. The City of El Cajon puts an additional 0.50 percent Public Safety Facilities Transactions and Use Tax, the City of Vista adds 0.50 percent Transactions and Use Tax, and the City of National City adds 1.00 percent Transactions and Use Tax within their jurisdictions.

San Diego's taxable sales are published each quarter by the California State Board of Equalization. The report for the 2nd quarter of 2007 was just released lagging by almost a year as businesses report their actual sales volume when filing sales taxes.

The 2nd quarter 2007 data was just released the second week of June, more than eleven months after the end of the quarter. Third quarter 2007 sales report will be available this September and the 4th quarter by December 2008.

California distributes sales tax on the basis of where the purchase was made. The following chart shows the percentage of local municipal's general revenues dependent upon sale taxes. Those cities with the highest percentages dependent on sales revenue are anticipated to have the greatest impact from slow and falling sales transactions.

CONCLUSION

Consumer sales are likely to continue to be weak through the end of 2007 and into 2008. With the slow housing market and households heavily indebted, a turnaround of consumer spending is not likely to occur through the end of 2008. National and state economies also continue to be weak and may currently be in recession.

Durable goods sales will be weak so long as the economy is uncertain and consumers hold back on spending. A jump in sales of durable goods will be one of the first indicators for a turnaround in consumer outlook and economic vitality.

SALES TAX AND GENERAL REVENUE

Ranked by Sales Tax Percent of General Revenues
San Diego Incorporated Cities, FY 2005-06

Jurisdiction	General Revenue	Sales Tax Revenue	Percent Gen Rev

TAXABLE SALES - SAN DIEGO COUNTY, Fiscal Year 2007

Incorporated City	Taxable Sales (000s)	Annual Change	Retail Sales (000s)	Annual Change	Inflation Adj.

Dashboard Observations—April 2008

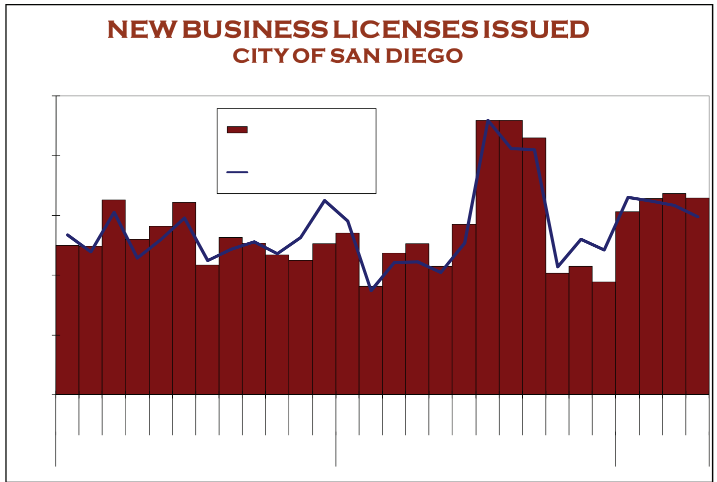
By Kelly Cunningham, Economist, Sr. Fellow

San Diego's **unemployment rate** slipped to 5.0 percent in April, down from 5.3 percent in March, but the seasonal adjustment shows no change for the month. Unemployment has risen over the year from the 4.2 percent recorded in April 2007. Although more than a full percentage point lower than the rest of California at 6.1 percent in April, San Diego's unemployment rate remained slightly higher than the rest of the U.S. for the first time since the year 2000.

Following the slight uptick of **residential building** in March, the number of units authorized for construction eased slightly in April. The annual number still shows a 32.5 percent decline over the year and only about one -third the number being built three years ago.

New **business licenses** issued by the City of San Diego show stronger activity since the beginning of the year. Although the number issued in April is down slightly from March, compared over the year the number was up 30.3 percent.

The San Diego **stock index** appears to have settled down with slight improvements since the beginning of the year. The index, however, remains lower than any month of the previous two years.



Indicator	April 2008	Month Change (Sea. Adj.)	Annual Change
Unemployment Rate[1]		▲	▲
Residential Building[2]		▼	▼
New Business Licenses[3]		▼	▲
San Diego Stock Index[4]		▲	▼

CEO's Corner

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are fiscal winners because a higher percentage of sales tax dollars "stay at home", are less subject to state raids, and because local jurisdictions and regional actors such as SANDAG have relatively more power to change sales tax rates. To understand why it is so easy to get a COSTCO through the planning process and so hard to win approval for 100 home subdivisions one has to follow the money and understand the fiscal incentives faced by city managers throughout California.

In this month's Economic Ledger SDI Senior Fellow and Economist Kelly Cunningham takes a look at retail activity in San Diego County. It is not a pretty picture. Declining sales, particularly in durable goods, has significant implications for several jurisdictions in San Diego County struggling with how to balance their budgets and is a wake-up call to fiscal watchdogs.

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