

2009 California Budget

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Introduction

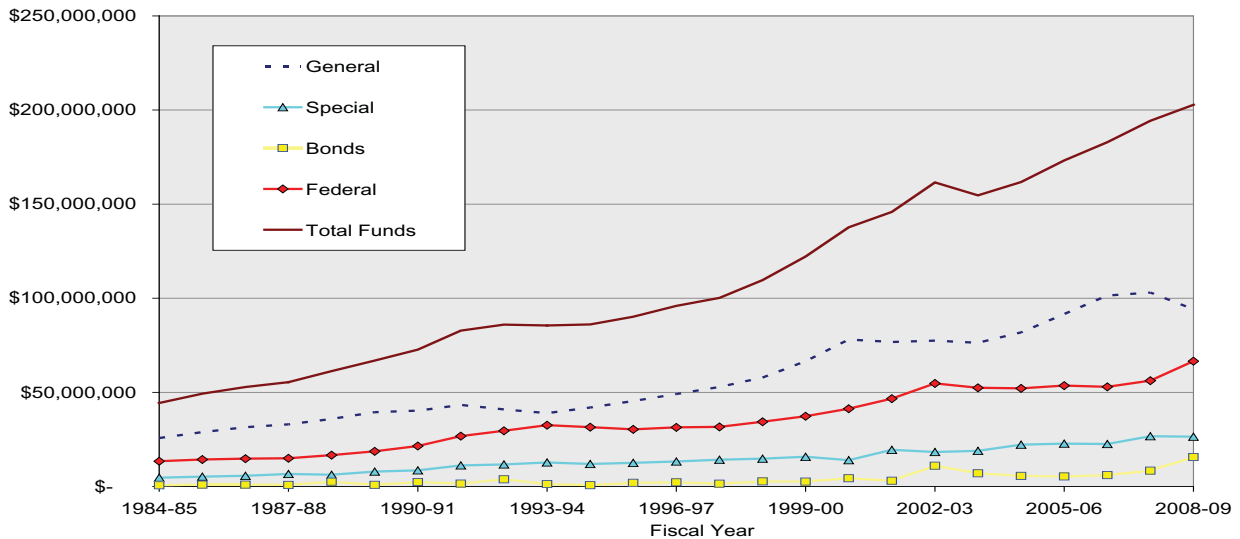
California is arguably locked in the worst budget crisis it has ever faced. Last September, after a delay of three months, the 2008-2009 budget was finally signed by Governor Schwarzenegger. The budget largely papered over an estimated \$15 billion deficit with accounting slight of hand, a tax hike and bond issuance that pushed the problem into 2009. By September, worsening economic conditions caused estimates for the budget deficit to skyrocket to \$41 billion in 18 months. Current estimates for this fiscal year are for a deficit of \$21 billion. Because of California's chronic budget problems and fiscal mismanagement, Standard and Poor's recently cut the rating on California's general obligation bonds to A (five notches below AAA). California is now the lowest rated state in the nation, falling out of a tie with Louisiana which is rated A+. The low credit rating makes the budget situation even more unmanageable by increasing the state's borrowing costs. A number of questions are raised by the current fiscal problems: How did we get in this mess? How do we get out of it? How do we keep it from recurring? What are the implications for investors? Are California bonds safe?

California Budget Expenditures: The long-term problem is spending.

For the fiscal year 2008-2009, California’s budget expenditures were \$202 billion. General Fund expenditures were the largest component at just under \$100 billion, Federal Funds or transfers totaled over \$65 billion, Special Fund

expenditures were just over \$26 billion, and Bond Funds totaled \$15 billion. California budget expenditures have doubled over the last ten years and more than quadrupled over the last 25 years. Since 1984-1985, total expenditures have grown at an annualized rate of 6.6%. The spending has gone on year after year, overseen by both Republican and Democrat governors.

CHART 1: CALIFORNIA BUDGET EXPENDITURES
FISCAL YEAR 1984-1985 TO FISCAL YEAR 2008-2009



Sources: Bailard Research, California Department of Finance

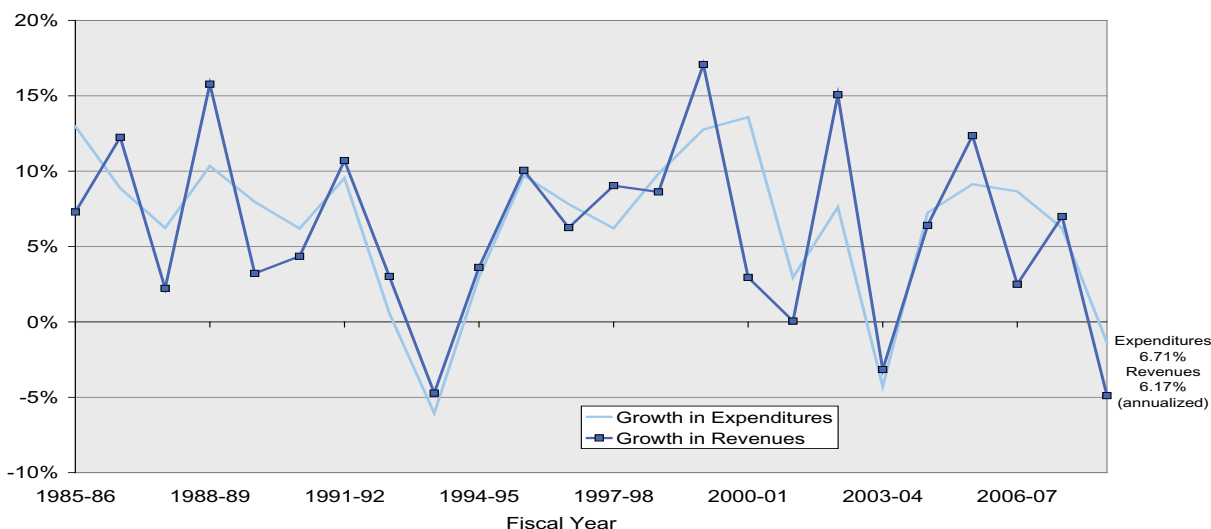
The short-term problem is that tax revenues are more volatile than expenditures.

Chart 2 illustrates the cyclical growth in revenues and expenditures. In this chart, revenues and expenditures do not include dedicated transfers from the Federal government. The first thing to note is that revenues are much more volatile than expenditures. Revenues are very sensitive to swings in the business cycle and expenditures are slow to come back into line with revenue shortfalls. Given the severity of the recent economic downturn, revenue growth is contracting sharply.

The budget process faces a chronic problem of increasing spending in the good times as revenue growth accelerates and then putting itself in crisis mode when revenue growth decelerates during the inevitable bad times. Rather

than saving the surplus or returning excess revenues to taxpayers, politicians usually assume that the good times will never end and ramp up spending to meet revenues. For example, from 2002-2007, revenues increased twice as fast as inflation but spending increased 50% faster than inflation, education spending increased 70% faster than inflation and salaries for state workers increased 100% faster than inflation. When the economy started to slow, revenues fell sharply and expenditures being more rigid were slow to react. In fact, expenditures typically go up as demand for government services for job training, welfare and unemployment compensation rise. During economic contractions when revenues fall short, the first instinct of politicians is to raise taxes and avoid cutting spending. Eventually reality sets in and, amidst tremendous wailing and gnashing of teeth, spending is cut.

CHART 2: GROWTH IN EXPENDITURES AND REVENUES
1985 -1986 TO 2008-2009



Sources: Bailard Research, California Department of Finance

There is no shortage of long-term revenues, just a lack of budget discipline.

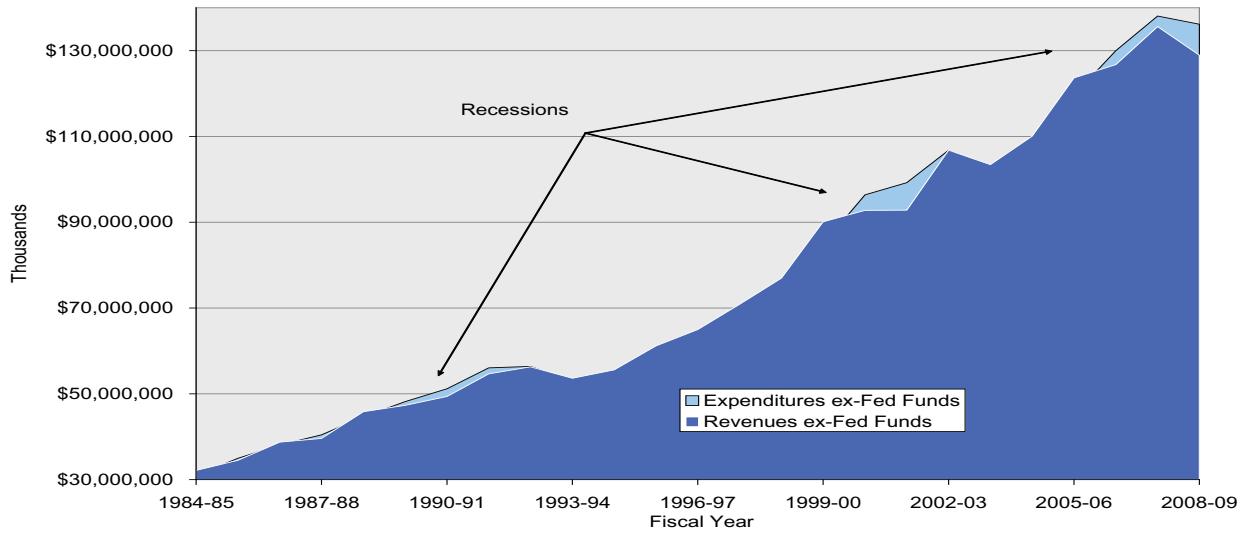
This process of overspending in the good times and having to cut spending in the bad times can also be seen in Chart 3 (on page 4), which shows the dollar amount of revenues and expenditures in the General Fund. This is the part of the budget over which policymakers exert the most control. It includes the normal day-to-day programs of the state, such as Medicaid, education, highways, DMV, and Department of Corrections. In the chart, you can clearly see the gap that develops between revenues and expenditures around periods of economic contraction (1990, 2001, and 2008). You can also see how the gaps are getting progressively worse. Part of the problem is that revenue growth has slowed more dramatically in this recession than in the last two recessions. However, you can clearly see how expenditures accelerated during economic recoveries and were stickier than revenues in coming down.

The lack of budget discipline can be linked directly to the passage of Proposition 111 in 1990. Proposition 111 modified Proposition 4 (the “Gann Initiative”) that was passed in 1979. The Gann Initiative set a limit on spending growth equal to the growth in population plus a cost of living adjustment. The inflation limit was based on the lesser of the U.S. CPI or the California per capita personal income

growth. It also precluded the state from retaining excess revenues, requiring the state to return excesses to the taxpayers in the subsequent year. During the early years after enactment of Proposition 4, with inflation running high, staying under the spending limit was not a problem.

In 1990, the limits changed. Under Proposition 111, the growth in spending was limited solely to the growth in K-14 enrollment plus per capita income growth. The tech boom in the 1990’s witnessed an acceleration in per capita income, allowing expenditures to grow at a faster pace as government coffers were filled at a faster pace. When the 2000-2001 recession hit and revenues dried up, the rate of growth in expenditures proved to be unsustainable. We are seeing the same thing today, but the collapse in revenue has been far more severe.

CHART 3: GENERAL FUND REVENUE AND EXPENDITURE (EXCLUDING FED FUNDS)



Sources: Bailard Research, California Department of Finance

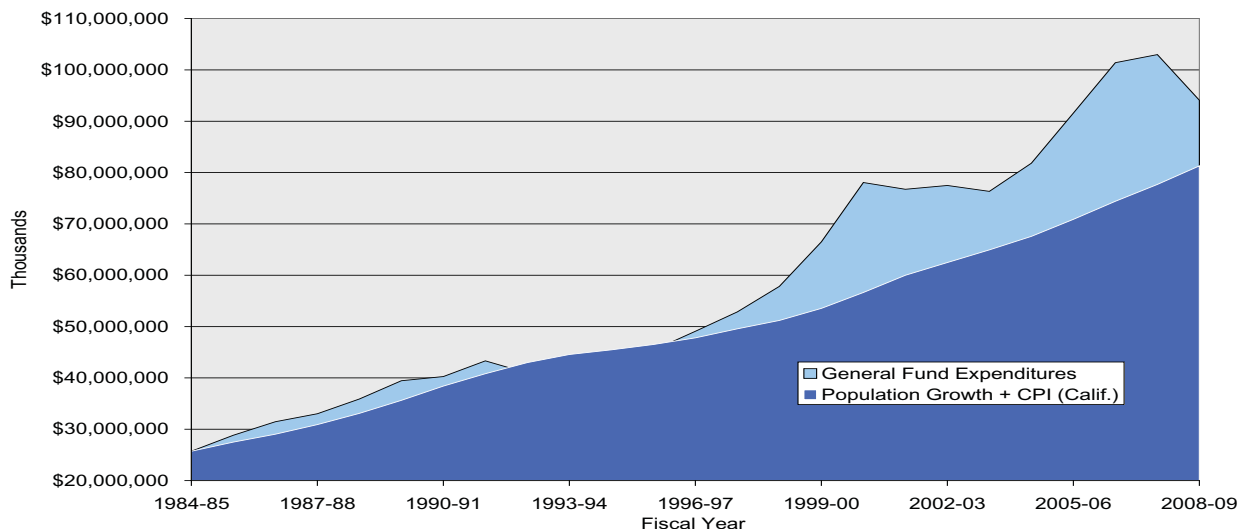
Restore Budget Discipline

How can we restore budget discipline? One approach would be to return to the discipline of limiting government spending to the growth in population plus CPI. This would provide for a less volatile expansion in the state budget and be a more effective way of budgeting than going through the fits and starts of the last ten years.

From the 1984-1985 to 2007-2008 fiscal years, General Fund expenditures increased at a 6.21% annualized rate. California's Consumer Price Index over that time was 3.27%

annualized and the state's population grew at a 1.66% annualized rate. Chart 4 shows actual General Fund expenditures compared to what spending would have been if General Fund expenditures had increased at a rate equal to inflation plus population growth or 4.93% / annum. If expenditure growth had increased at that rate rather than the 6.21% actual growth rate, the budget would have a surplus of \$10 billion even after the sharp decrease in revenues we have recently experienced. Policymakers should be looking at long-run sustainable revenue not peak cyclical revenue in setting budgets.

CHART 4: GENERAL FUND EXPENDITURES VERSUS POPULATION GROWTH PLUS CONSUMER PRICE INDEX



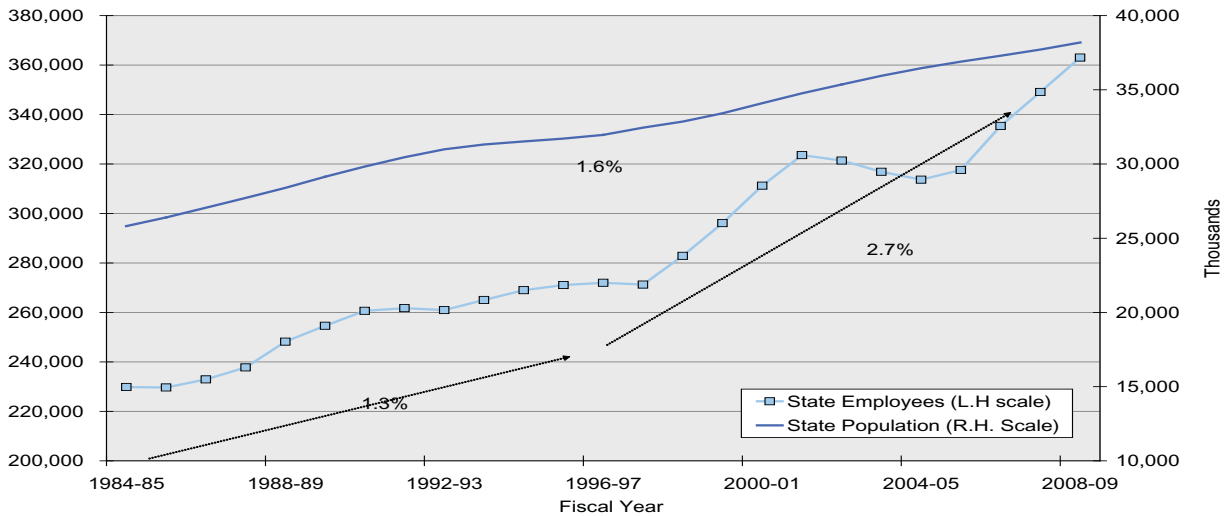
Sources: Bailard Research, California Department of Finance

Improve Government Efficiency

At a minimum, policymakers should restrict the rate of growth in government employees to the growth in population. Currently California has 363,000 workers on its payroll or 9.5 state employees per 1,000 population. Until 1997, the increase in employees actually grew less than the growth in population and state worker productivity improved. Flush with revenues from the tech bubble, the

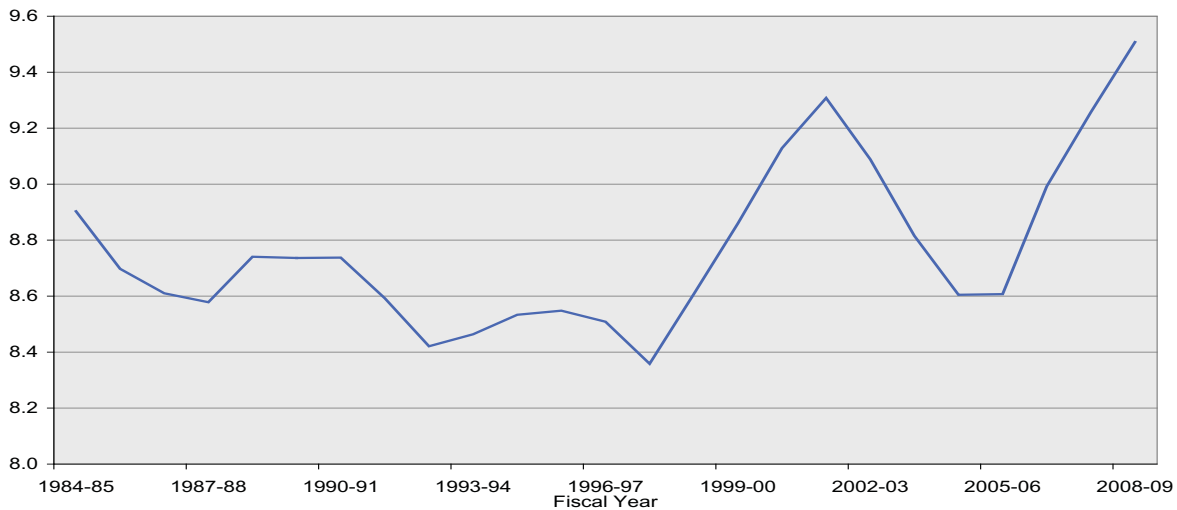
state went on a hiring binge that paused during the 2001 recession and then ramped up again in the next recovery. Not only does the expansion of government payrolls add significantly to current expenses, but the unfunded liabilities of generous benefit programs are becoming a huge burden on future resources. To improve efficiency, policymakers could consolidate overlapping agencies and improve the usage of computers and technology.

CHART 5: STATE EMPLOYEES AND POPULATION



Sources: Bailard Research, California Department of Finance

CHART 6: STATE EMPLOYEES PER 1,000 POPULATION



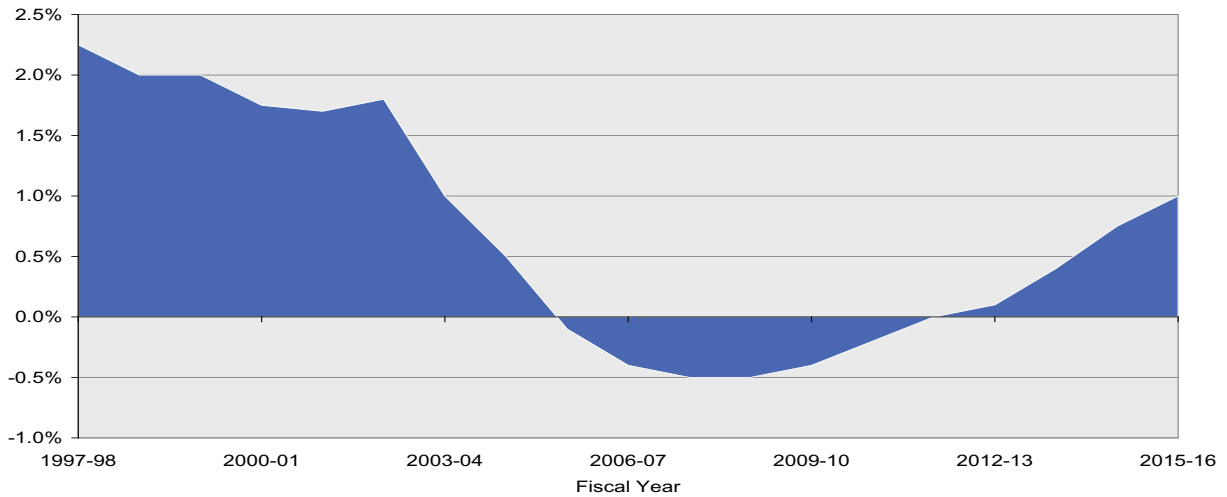
Sources: Bailard Research, California Department of Finance

Take Advantage of Declining K-12 Enrollments

Despite falling enrollment of K-12 students, education spending has been growing at a faster pace than enrollment growth plus inflation. Under Proposition 98 passed in 1988, the amount of spending on education is based on three tests: Test 1 maintains education spending at the same share of General Fund expenditures as in the base year of 1986-1987 or roughly 40% of the budget. Test 2

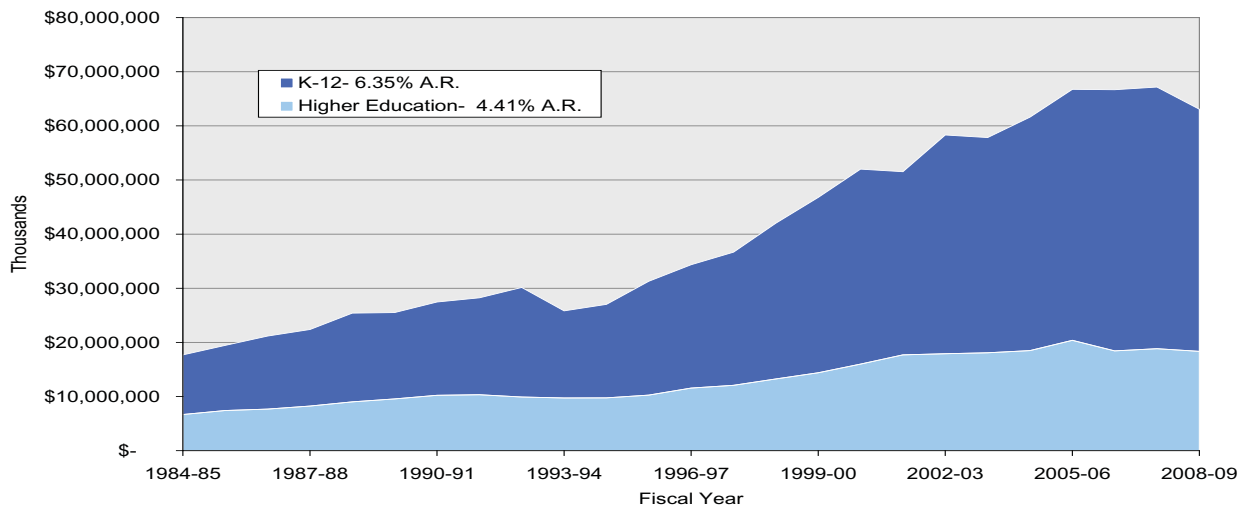
allows funding to grow in line with enrollment growth plus inflation. Test 3 bases spending increases on enrollment growth plus the growth in General Fund revenues per capita plus 0.5%. Currently, based on Test 2 and 3, K-12 spending should be growing at a much slower pace. However, because of Test 1, K-12 spending has continued to grow in line with overall expenditures. With overall expenditures being cut, K-12 spending is now declining as well.

CHART 7: K-12 ENROLLMENT GROWTH (ACTUAL AND PROJECTED)



Sources: Bailard Research, California's Legislative Analysts Office, California Department of Finance

CHART 8: TOTAL SPENDING ON EDUCATION



Sources: Bailard Research, California's Legislative Analysts Office, California Department of Finance

High tax rates are likely to slow future revenue growth.

The biggest problem for the budget is on the revenue side and not because Californians are undertaxed. If the recession is prolonged or deepens, revenues will likely continue to suffer. In addition, the ability of the state to recover in the next economic expansion may be constrained by the heavy tax burden placed on individuals and corporations. California carries the distinction of being the highest

taxed state in the union. The table below shows the top and bottom five states ranked by the sum of the top marginal income tax rate, sales tax rate and corporate tax rate. Californians pay the highest rates on income and sales, and have the fifth highest corporate tax rate. On the margin, this creates a tremendous incentive for individuals and corporations to leave the state or to locate in other states that are more tax friendly. Raising taxes from this level could be counterproductive if it pushes more business out of the state.

TABLE 1: STATE TAX RANKING

	Combined Tax Rate	Top Marginal Income Tax Rate	Sales Tax Rate	Corporate Tax Rate
Highest Tax States*				
California	27.40%	10.30%	8.25%	8.84%
Iowa	26.90%	8.98%	6.00%	12.00%
Rhode Island	25.90%	9.90%	7.00%	9.00%
New Jersey	24.90%	8.97%	7.00%	9.00%
Minnesota	24.15%	7.85%	6.50%	9.80%
Lowest Tax States				
Wyoming	4.00%	0.00%	4.00%	0.00%
Texas	6.25%	0.00%	6.25%	0.00%
Washington	6.50%	0.00%	6.50%	0.00%
Nevada	6.50%	0.00%	6.50%	0.00%
Florida	11.50%	0.00%	6.00%	5.50%

*California 2009 data, all other states 2007

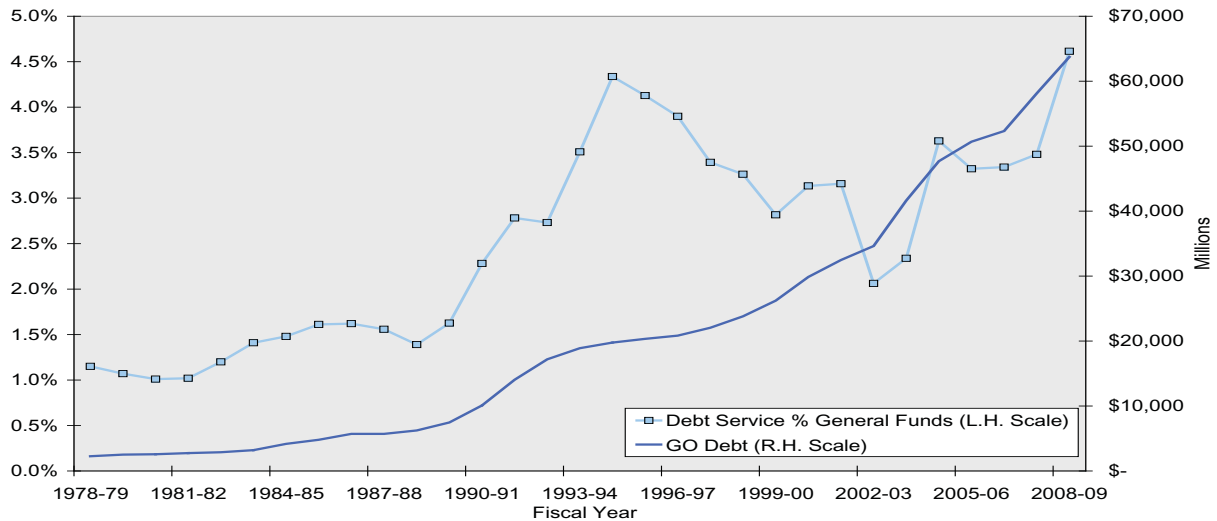
Sources: Bailard Research, California State Board of Equalization, California Franchise Tax Board, Tax Foundation, California Department of Finance

Is California going bankrupt?

No. The state is currently facing a cyclical budget shortfall primarily due to a sharp contraction in revenues caused by a severe recession. Just as a family faced with a reduction in income must cut back on their spending, elected officials must make the difficult choices of where to cut. From a longer term perspective, the lack of budget discipline has allowed expenditures to rise at an excessive pace (greater than the growth in population plus inflation) during the good times, causing the budget to lurch from feast to famine during periods of adversity. The question for investors is will the state be able to continue paying its debts. Chart 9 (on page 8) shows the expansion of general obligation bond issuance since 1978 and the debt servicing cost of that debt as a percent of general revenues. General

obligation debt of the state has risen from \$2.3 billion to \$63.7 billion or at an 11.75% annualized rate of growth. Debt service has risen from 1.15% of revenues to 4.62%. The ability to service debt has fallen even as interest rates have declined. If interest rates start to rise, the ability to service debt would deteriorate further. While the trend is not a healthy one, debt service is still a small part of the overall budget and the state is unlikely to default on its debt. However, defaults and bankruptcies of local governments could put a taint on all municipal debt (including state G.O.'s).

CHART 9: G.O. DEBT AND DEBT SERVICE



Sources: Bailard Research, California's Legislative Analysts Office, California Department of Finance

Summary

California is facing a severe budget crunch not only due to a huge cyclical decline in tax revenues but also due to a long-term lack of budget discipline. An economic recovery and an expansion in the tax base should go a long way toward fixing the current revenue shortfall. However, restoring discipline to expenditures is critical to getting off the budget deficit roller coaster. One way to do that is to return to the discipline of capping expenditure growth to population growth plus the CPI. Even if such a rule were

implemented, California still faces some major problems. It is the highest taxed state in the union, which is driving businesses and productive individuals out of the state, California has the lowest credit rating in the union, which is driving up borrowing costs. The state has also witnessed a significant deterioration in government employee productivity and sharply rising labor costs. Even with all these problems, California is unlikely to default on its general obligation debt and investors should eventually be repaid. The question is how rocky will the road be.

Sources: California Department of Finance, California State Board of Equalization, California Franchise Tax Board, California Legislative Analysts Office, Tax Foundation, Bailard Research.

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