

Economic and Proposition 98 Update

Association of
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Business
Officials

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Presented by


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Overview

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- National and State Economies
 - State Revenue Outlook
 - 2009-10 State Budget Revision
 - Proposition 98
 - What's Ahead
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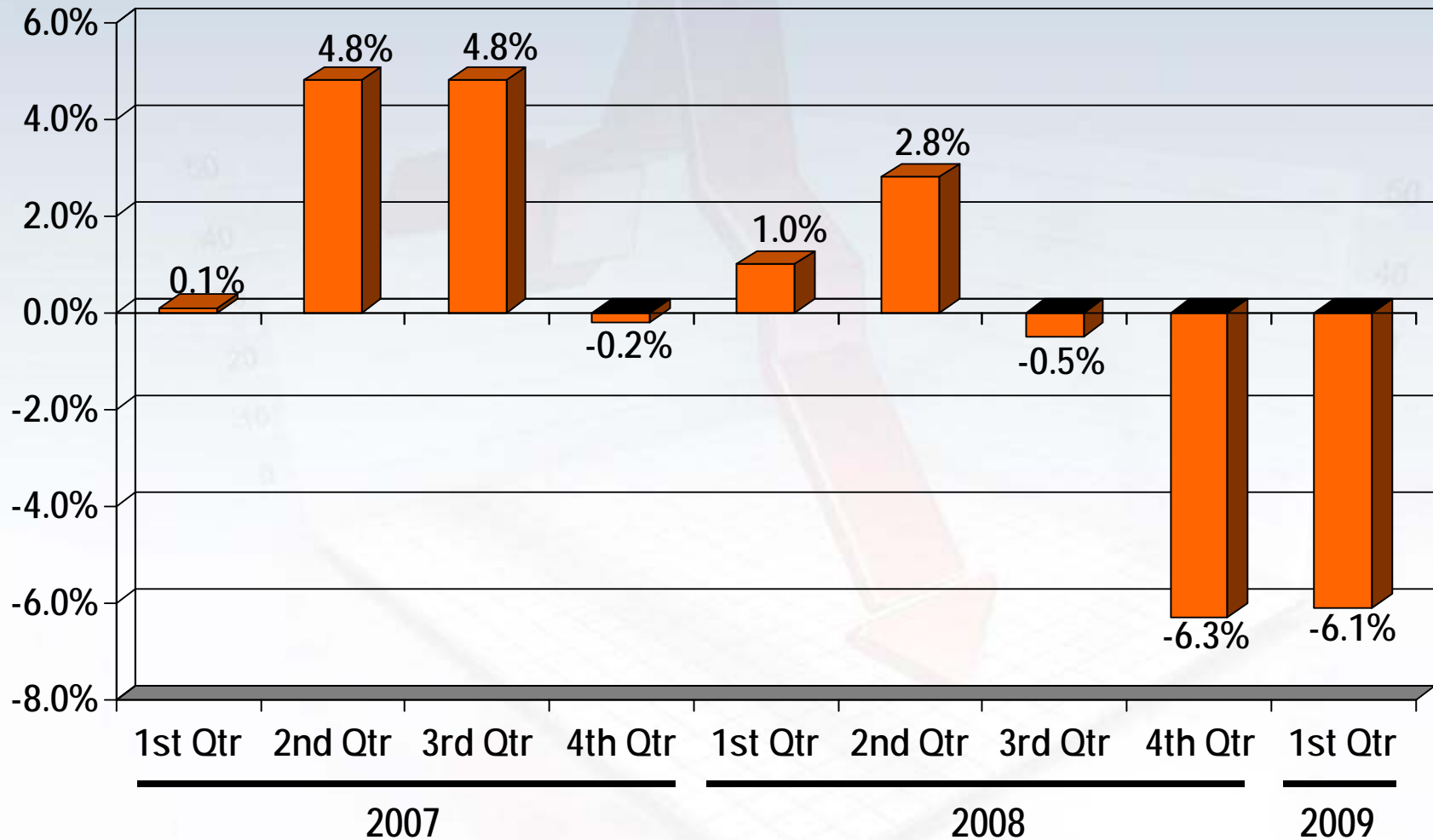
National Economy

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- The current recession is the deepest since the Great Depression
 - The recession began in December 2007 and is now 17 months old
 - The U.S. unemployment rate is 8.9%, up from 5.8% in 2008
 - The U.S. Gross Domestic Product (GDP) shrank 6.3% in the last quarter of 2008 and 6.1% in the first quarter of 2009, the biggest drop since 1958

National GDP

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Source: Governor's 2009 May Revision

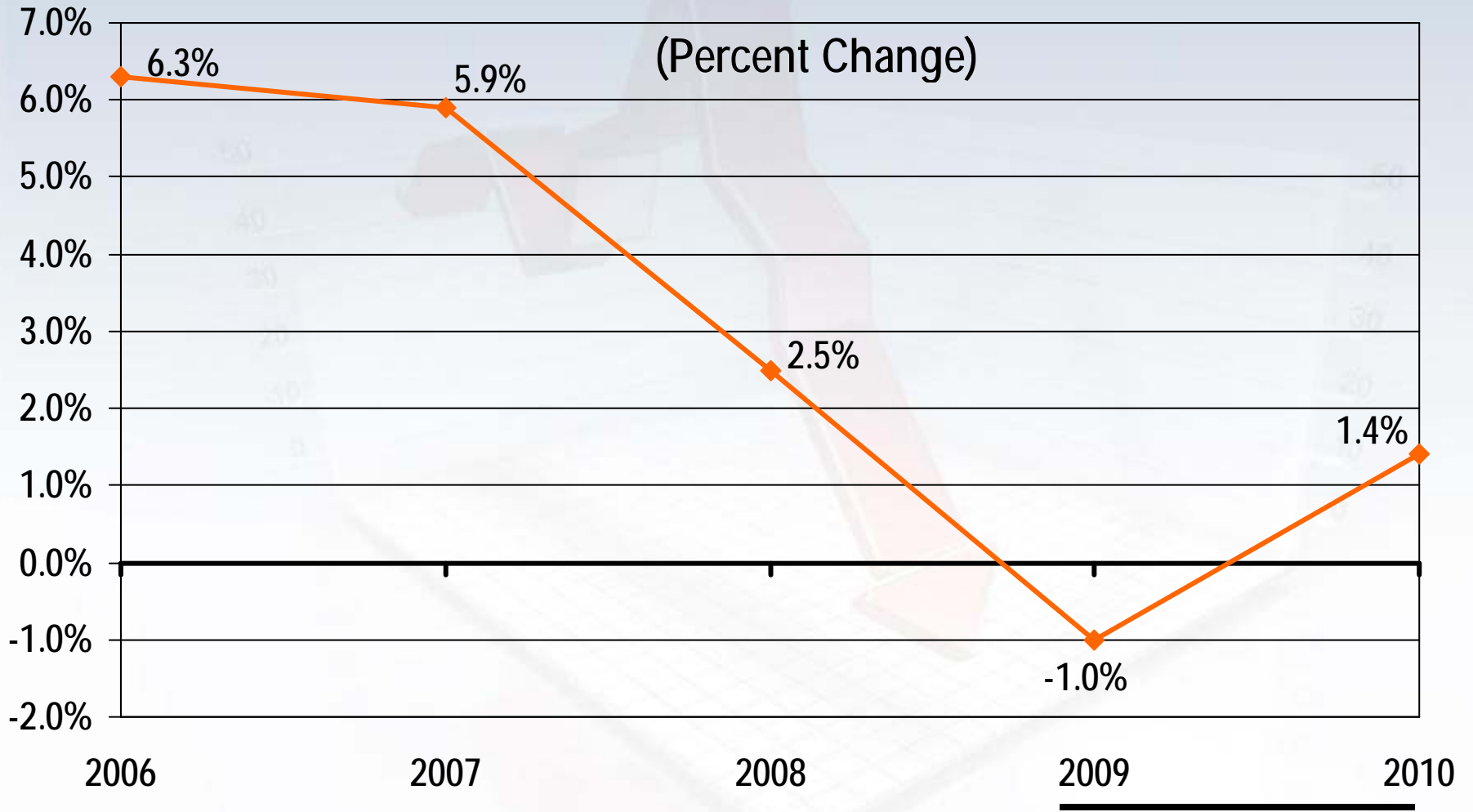
Recession

California's Economy

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- California's economy is suffering even more than the nation as a whole
 - The state was at the epicenter of the subprime mortgage collapse
 - Homebuilding fell for the fourth consecutive year in 2008, with housing starts expected to be down 24% in 2009
 - The state's unemployment rate is among the highest in the nation at 11.2% in March 2009, up from 6.4% one year earlier
 - Personal income is projected to decline 1.0% in 2009, the first time it has fallen since 1938

California Personal Income

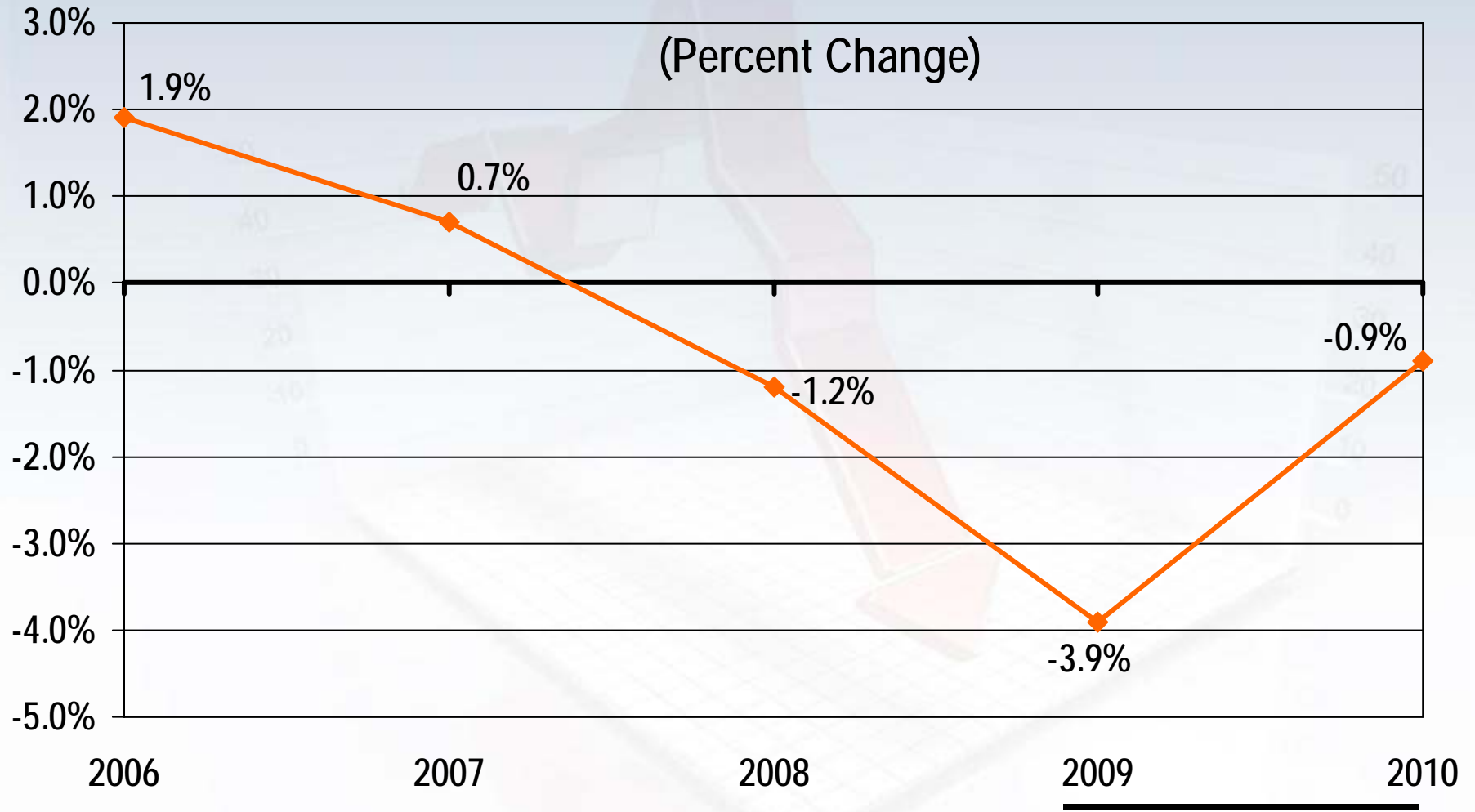


Source: 2007, 2008, and 2009 May Revisions

Projection

California Wage and Salary Employment

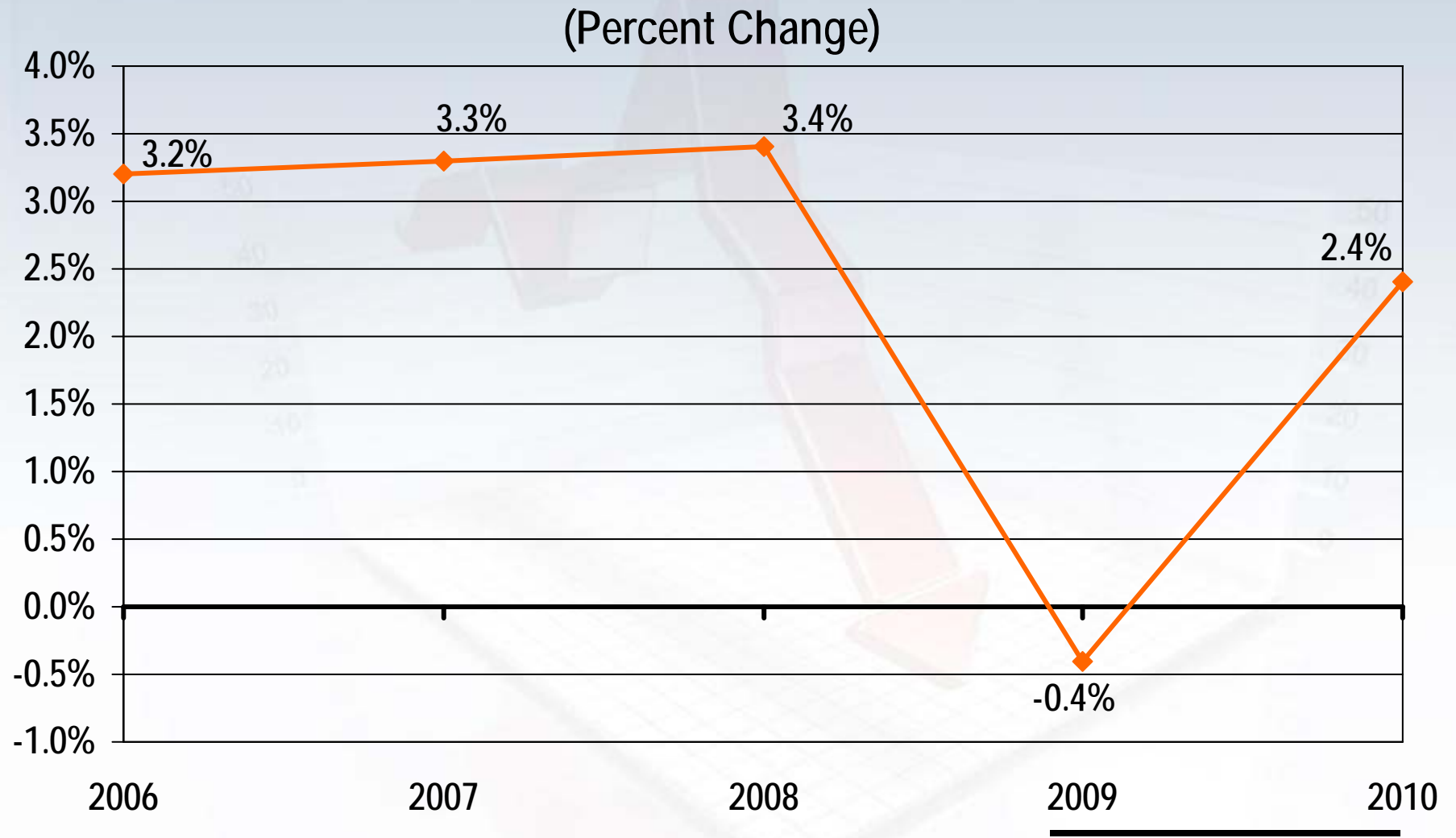
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Source: 2007, 2008, and 2009 May Revisions

Projection

California Consumer Price Index



Source: 2007, 2008, and 2009 May Revisions

Projection

The Administration's Forecast

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- The Administration is forecasting a turnaround in 2010
 - Its reasons for optimism:
 - Homes are more affordable
 - Consumers are beginning to spend
 - Financial markets are improving

National Indicators	Declining in 2009	Turn Positive in 2010
Real GDP	-3.5%	1.4%
Corporate Profits Before Taxes	-16.5%	19.5%
Housing Starts	-39.0%	53.9%
New Car and Light Truck Sales	-27.4%	19.1%
Consumer Price Index	-0.7%	2.0%

Source: 2009 May Revision

General Fund Revenues

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- The state economy drives General Fund revenues through three major taxes: personal income tax, sales and use tax, and corporation tax
- The collapse of the state and national economies has driven state tax revenues down
 - Since enactment of the 2009-10 Budget Act on February 20, 2009, baseline revenues (i.e., revenues absent new policy proposals) have dropped further:
 - -\$3.4 billion in 2008-09, a 3.8% shortfall
 - -\$8.9 billion in 2009-10, a 9.1% shortfall
- The May Revision proposes to make up this shortfall with more program cuts, fee hikes, revenue accelerations, and borrowing

Major May Revision Proposals

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- The projected deficit is now \$21.3 billion with the failure of yesterday's special election ballot measures
- Major Budget-balancing proposals:
 - \$9.8 billion in cuts and savings, with \$5.4 billion from Proposition 98
 - \$5.5 billion in borrowing from a revenue anticipation warrant (RAW)
 - \$2.8 billion from revenue accelerations and fees
 - \$2 billion from local government borrowing
 - \$1.2 billion from program consolidations, fund shifts, and other changes

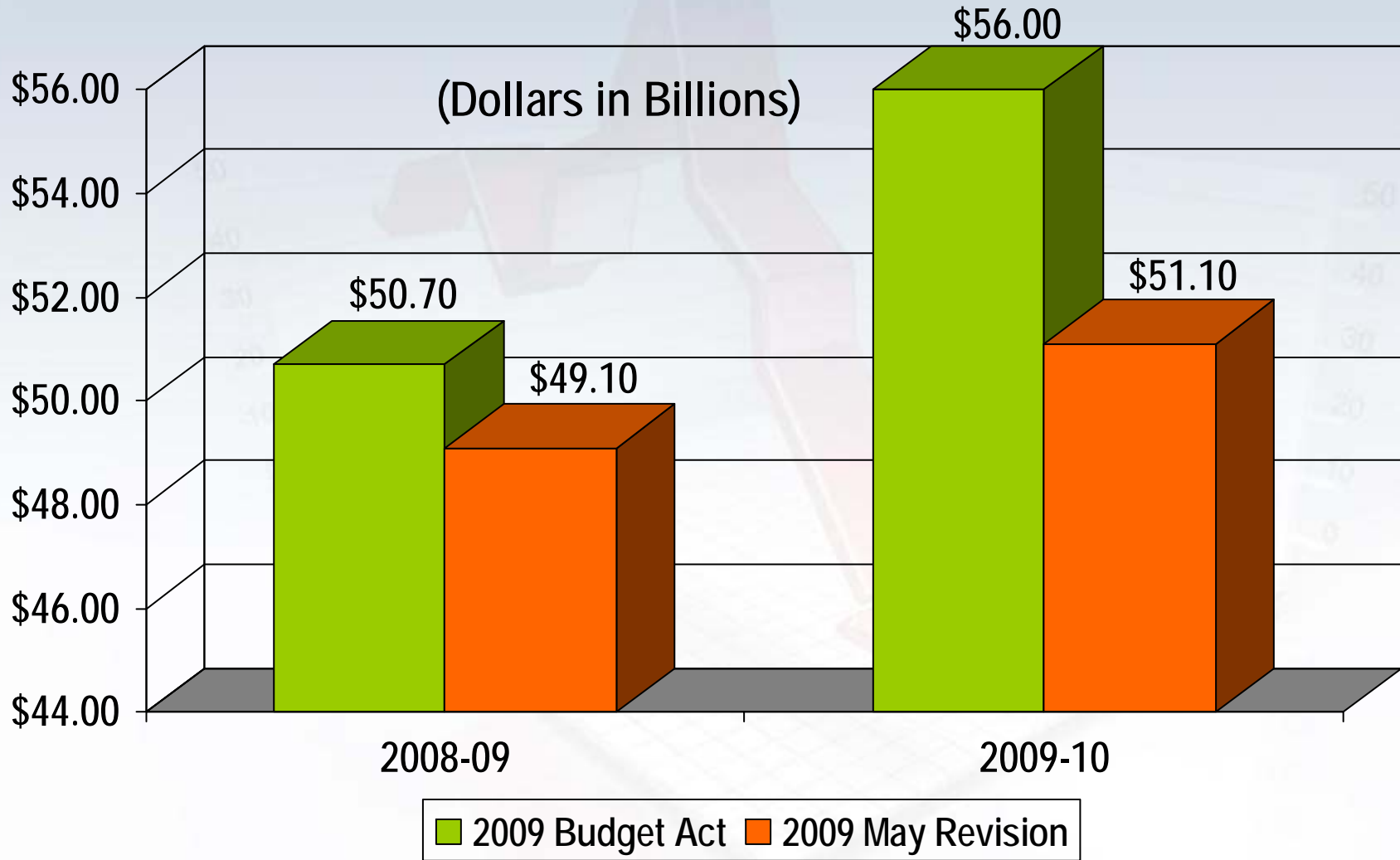
Proposition 98 Changes

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- Proposition 98 determines the minimum funding level for K-12 education and the California Community Colleges (CCC), based on one of three “tests”
 - For both 2008-09 and 2009-10, the operative formula is “Test 1,” with K-14 education to receive 41% of General Fund revenues
 - The drop in revenues has lowered the guarantee in both the current year and 2009-10
 - 2008-09 drops \$1.6 billion
 - 2009-10 drops \$4.8 billion
 - However, the drop in the Proposition 98 guarantee does not tell the full story

May Revision Proposition 98

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Funding Reductions and Adjustments

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- The 2008-09 drop in the minimum guarantee is made through:
 - \$1.3 billion in K-12 revenue limit cuts
 - \$85 million CCC categorical cut
 - \$115 million CCC apportionment deferral
 - \$114 million from elimination of the K-12 High Priority Schools Program
- The 2009-10 Proposition 98 cut is made through:
 - \$1.6 billion in K-12 apportionment deferrals
 - \$1.4 billion in K-12 revenue limit cut
 - \$334 million in CCC categorical cuts
 - \$127 million in CCC enrollment funding cut
 - \$120 million in CCC credit courses to non-credit
 - \$966 million reduction because of the failure of Proposition 1C (Lottery), which is revenue neutral to K-14 education

Proposition 98 Maintenance Factor

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- The May Revision is silent on the Maintenance Factor controversy
 - The Department of Finance has asserted that under Test 1 no Maintenance Factor is created and any prior amount is eliminated
 - At stake is more than \$9.3 billion owed to K-14 education
 - Voters rejected Proposition 1B, which would have resolved this issue
- Expect this issue to wind up in the courts
 - Ultimately, the Administration may want to settle this case rather than have a court order a multibillion dollar payment to education

Risks to the Budget

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- The state and national economies may continue to deteriorate through 2009 and into 2010, rather than turn around at the end of the year
 - Billions of dollars are at risk if the economy does not begin to recover
- The Budget relies on \$5.5 billion in borrowing from a RAW that may violate Proposition 58, which prohibits borrowing to balance the Budget
- More than \$23 billion is needed early in the new fiscal year to meet the state's cash flow requirements
 - California has the lowest credit rating of any state in the nation
 - Capitol markets are still very weak

Key Issues for the Legislature

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- Will the Legislature act to amend an already enacted 2009-10 Budget Act?
 - Amending the Budget will require a two-thirds vote
 - The Republican leaders of both houses have been removed for supporting tax increases in the 2009-10 Budget
- Will the Governor invoke his powers under Proposition 58 and declare a state of fiscal emergency?
 - If he does, the Legislature has 45 days to act, otherwise it cannot work on any other measures
- Will the Legislature replace a portion of the Governor's proposed cuts and borrowing with majority vote measures to raise revenues?
 - The Governor rejected this approach four months ago

Key Issues for the Legislature

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- Will the federal government guarantee California's debt?
- Will the federal government provide another round of stimulus funding to the states?
 - The federal government's deficit is projected at \$1.8 trillion
- Will the Legislature support the Governor's attempt to amend California's 2005-06 baseline funding level for purposes of meeting the Maintenance of Effort (MOE) condition for the federal American Recovery and Reinvestment Act (ARRA)?
 - The May Revision, if adopted, would violate the 2005-06 MOE level, as defined in California's application

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Thank you for attending!