June 3, 2010

(Revised)

Overview of the Economy, Revenues, and Spending

L E G I S L A T I V E   A N A L Y S T ' S   O F F I C E

Presented to:

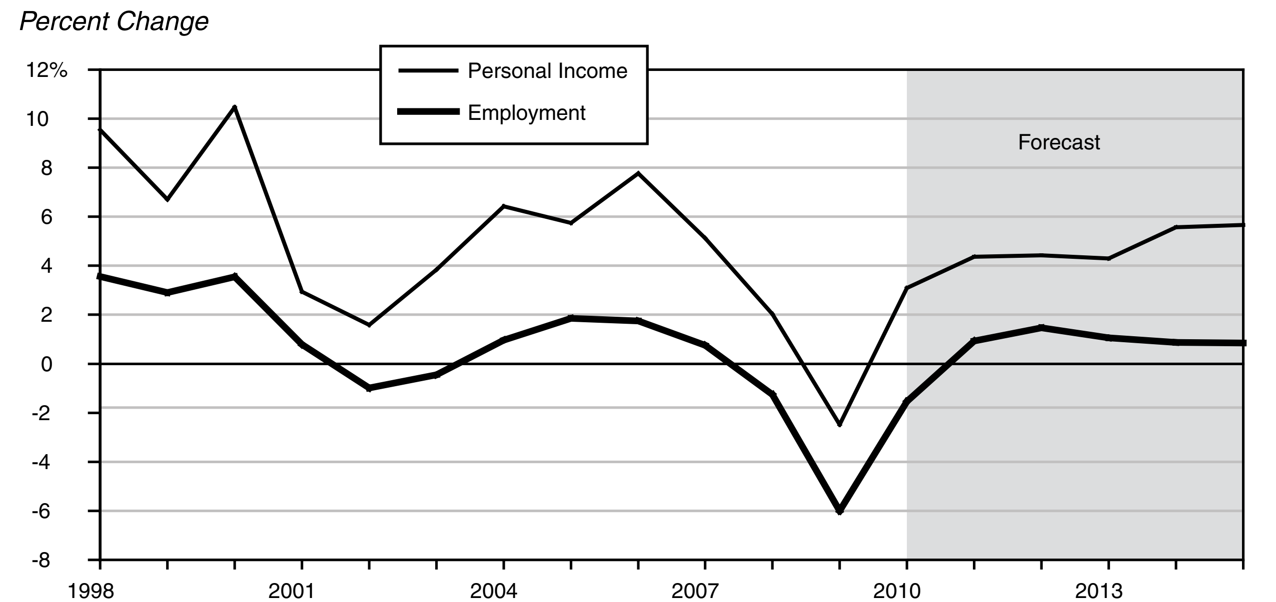
The Conference Committee on the Budget

LAO

65 YEARS OF SERVICE

Recession Pulled Income and Employment Negative

Recession Took Its Toll on California's Economy

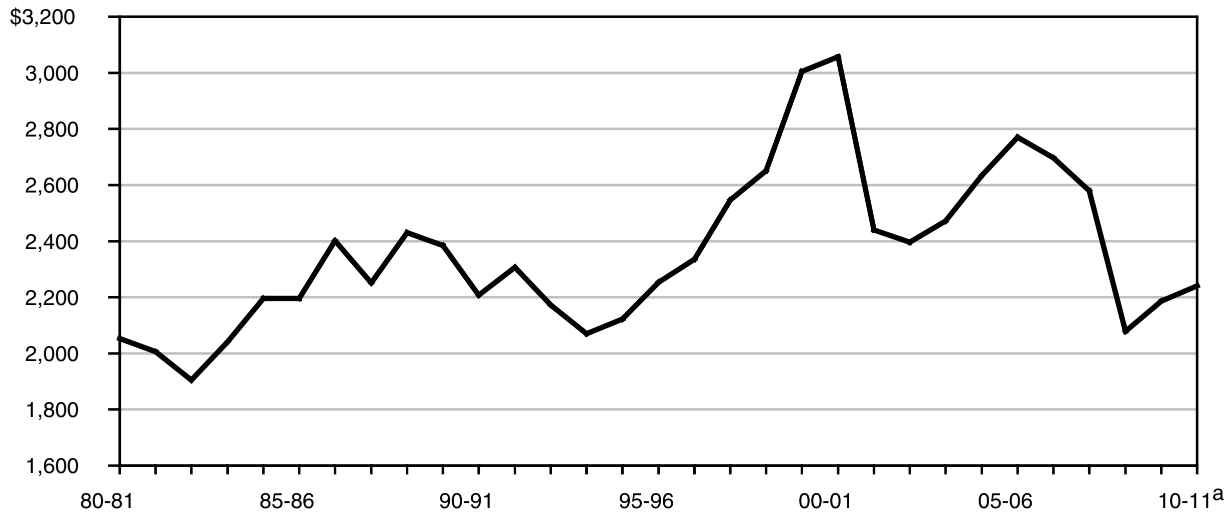


- Both personal income and employment are starting to rebound from the recession. The consensus view, however, is that the recovery will be modest.
- In 2009, personal income shrunk for the first time in the post-World War II era.
- Wage and salary employment is expected to stay negative for three straight years through 2010. We expect that unemployment will remain in the double-digits for the next few years.

Historical Look at State Revenues

Inflation-Adjusted Per Capita Major General Fund Revenues

2009-10 Base Year, State and Local Government Deflator



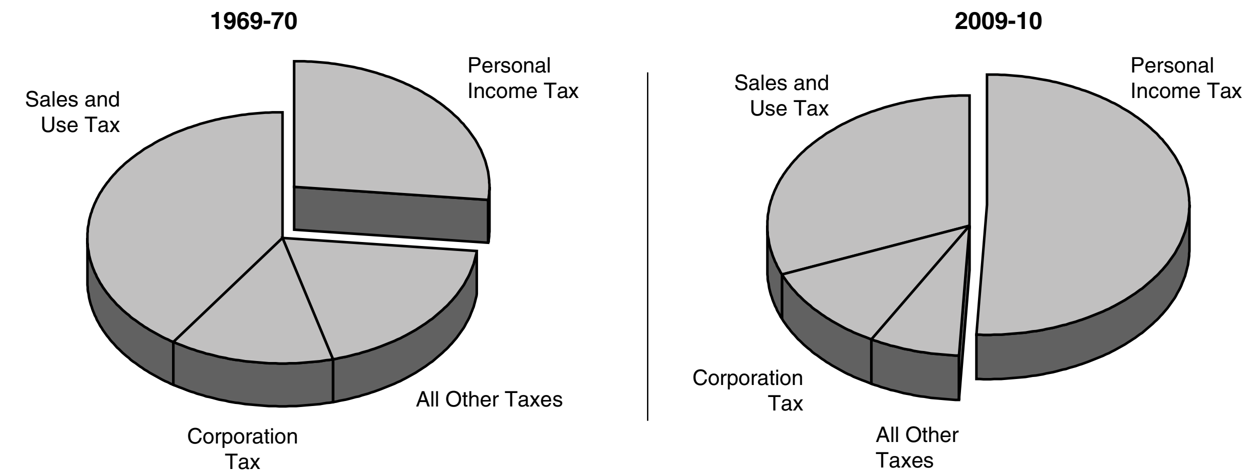
[a] 2009-10 and 2010-11 reflect LAO estimate.

- ☑ The dot-com boom pushed tax revenues to unprecedented levels. Since then, the bursting of that bubble and the housing bubble have returned revenues to the levels of the mid-1980s to mid-1990s (on a real, per capita basis).

- ☑ The 2009-10 and 2010-11 amounts would be about 10 percent lower if not for the temporary tax increases passed in the February 2009 budget package.

Budget Now More Reliant on Personal Income Tax

The Composition of General Fund Revenues Has Changed Over Time



- ☑ Over the past four decades, personal income tax revenues have increased dramatically—rising from 28 percent to 52 percent of General Fund revenues. This growth is due to increases in real incomes, the state's progressive tax structure, and increased capital gains.

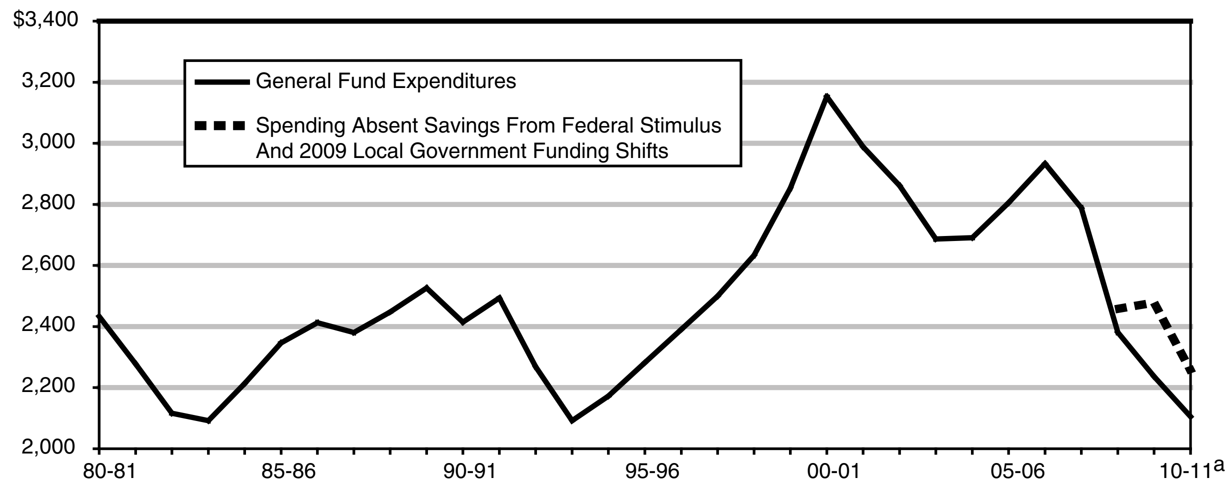
- ☑ The reduced share for the sales tax reflects in part the increase in spending on services, which generally are not taxed.

- ☑ In 1969-70, the state relied more heavily on a variety of smaller taxes, such as the alcohol, cigarette, horse racing, and inheritance taxes.

Historical Look at State Spending

Inflation-Adjusted Per Capita General Fund Spending

2009-10 Base Year, State and Local Government Deflator



[a] Reflects Governor's May Revision proposed spending levels for 2009-10 and 2010-11.

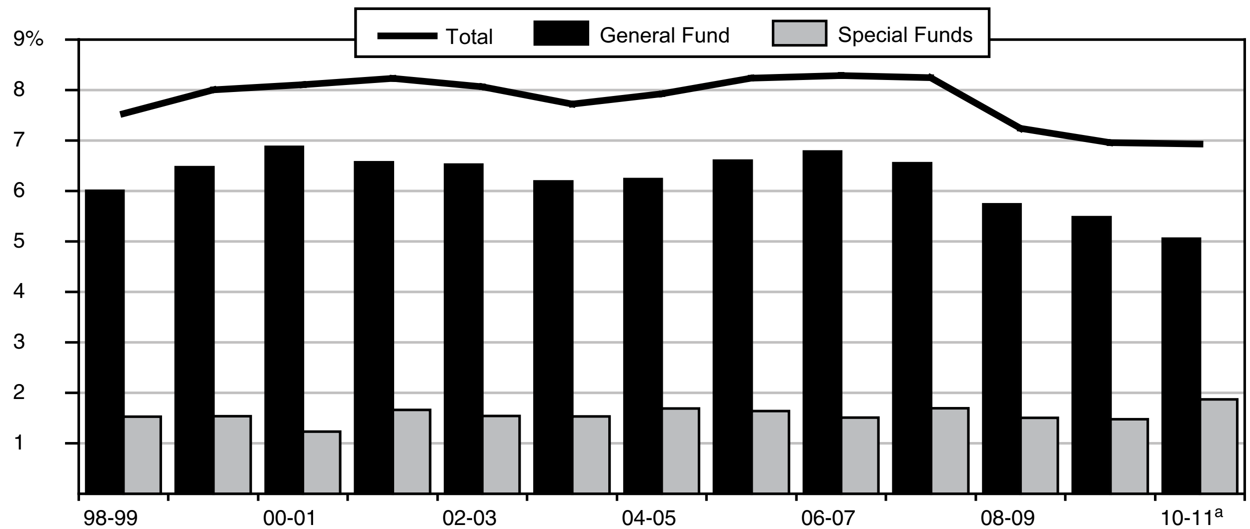
- ☑ Under the May Revision, 2010-11 inflation-adjusted per capita spending would be similar to that of 1993-94—also a low point due to a recession.

- ☑ Since 2008-09, large temporary boosts in federal stimulus funds and shifts of local property taxes (lowering General Fund spending) have helped the state balance its budget. Even accounting for these factors, adjusted General Fund spending under the Governor's May Revision proposals would be at its lowest level since 1995-96.

Spending, Including Special Funds, Declining as Share of Economy

State Spending as a Percent of Personal Income

1998-99 Through 2010-11



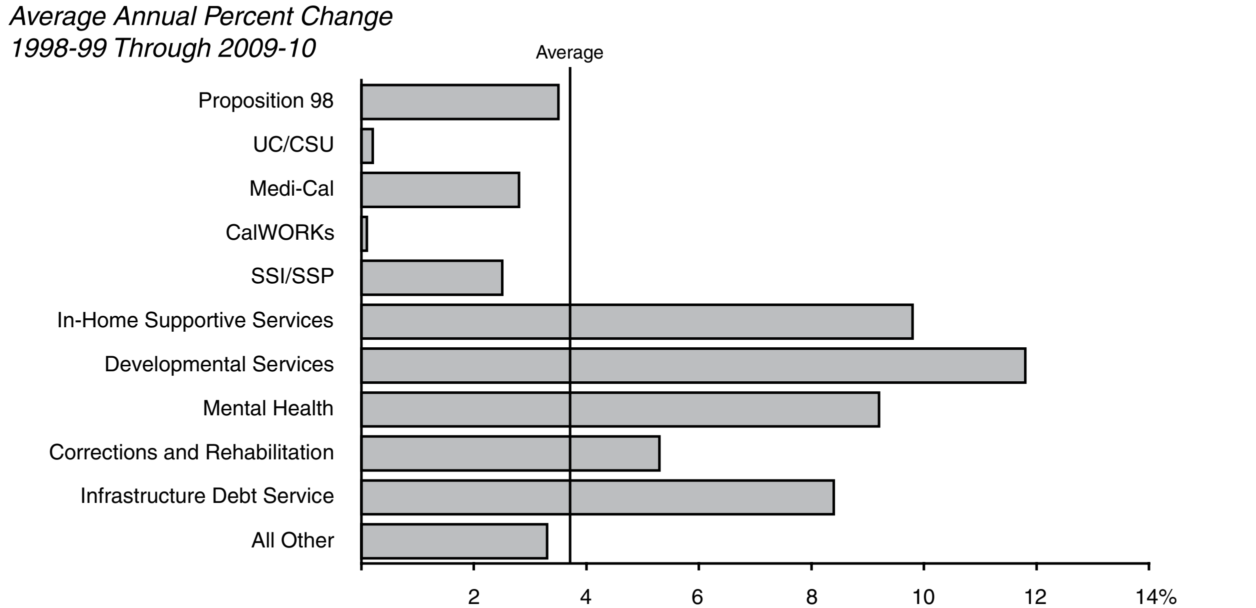
[a] May Revision proposed levels.

- ☑ Since 1998-99, state spending has varied between 7 percent and 8.3 percent of personal income. Special fund spending is fairly stable. The variation is caused by General Fund spending changes that reflect the state's fiscal condition.

- ☑ Spending reductions—combined with the federal stimulus funds—brought 2008-09 and 2009-10 spending by this measure to their lowest level over the period. The May Revision proposals would further drop spending below 7 percent of personal income.

Some General Fund Programs Have Grown Faster Than Others

Growth in General Fund Spending by Program Area



- ☑ Since 1998-99, state spending has grown by 3.7 percent on average each year. This is less than the rate of inflation and population growth, which has averaged 5.3 percent.

- ☑ Each program area has unique circumstances which makes these types of comparisons somewhat difficult. For instance, higher education's slow General Fund growth reflects a greater reliance on student fees. The Medi-Cal and California Work Opportunity and Responsibility to Kids (CalWORKs) growth percentages reflect the short-term federal stimulus assistance available in 2009-10.

How the State Budget Affects the Economy

☑ The state budget has three basic types of spending:

- Investment—education and infrastructure.
- Transfer payments—many health and social service programs.
- Direct services—such as state parks and fire protection.

☑ Unlike the federal government, the state cannot borrow huge sums of money and must balance the budget each year. For the state, therefore, there are minimal ways to stimulate economy directly in the *short term*.

- Infrastructure spending is one key way.

☑ In our view, the best approach over the *long term* to stimulate the economy is to:

- Keep tax bases broad (which keeps rates as low as possible).
- Maintain an appropriate regulatory environment.
- Have spending programs that make the state a desirable place to live and work, but ensure they are operated effectively and efficiently.

Effect of Balancing the Budget on the Economy

- Virtually any budget-balancing solution—either cutting spending or raising taxes—will have negative consequences on the economy.

- The relative effects of various solutions is extremely difficult to measure. There is not perfect information as to taxpayer or program recipient behavior. When there is reasonably good empirical evidence regarding behavior, we include such factors in our fiscal analysis.

- However, revenue and spending estimates provided by the LAO and the Department of Finance are not "dynamic" in measuring broad, large-scale feedback and multiplier impacts on the economy and state revenues. Previous efforts in this area resulted in considerable uncertainty in the reliability of estimates.

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Key Factors When Considering Budget Solutions

☑ Are there ways to minimize the programmatic effect? For instance, are fees or other alternative revenues potentially available?

☑ What is the impact on the receipt of federal funds? Is the program heavily matched with federal funds (temporarily or permanently)?

☑ Are core services being prioritized for the neediest populations?

☑ Are savings estimates realistic? Are there legal or implementation hurdles?

☑ Are there potential costs shifts to other state programs or other levels of governments? Are they being accounted for?

☑ What is the out-year impact of the solution?