Economic Analysis

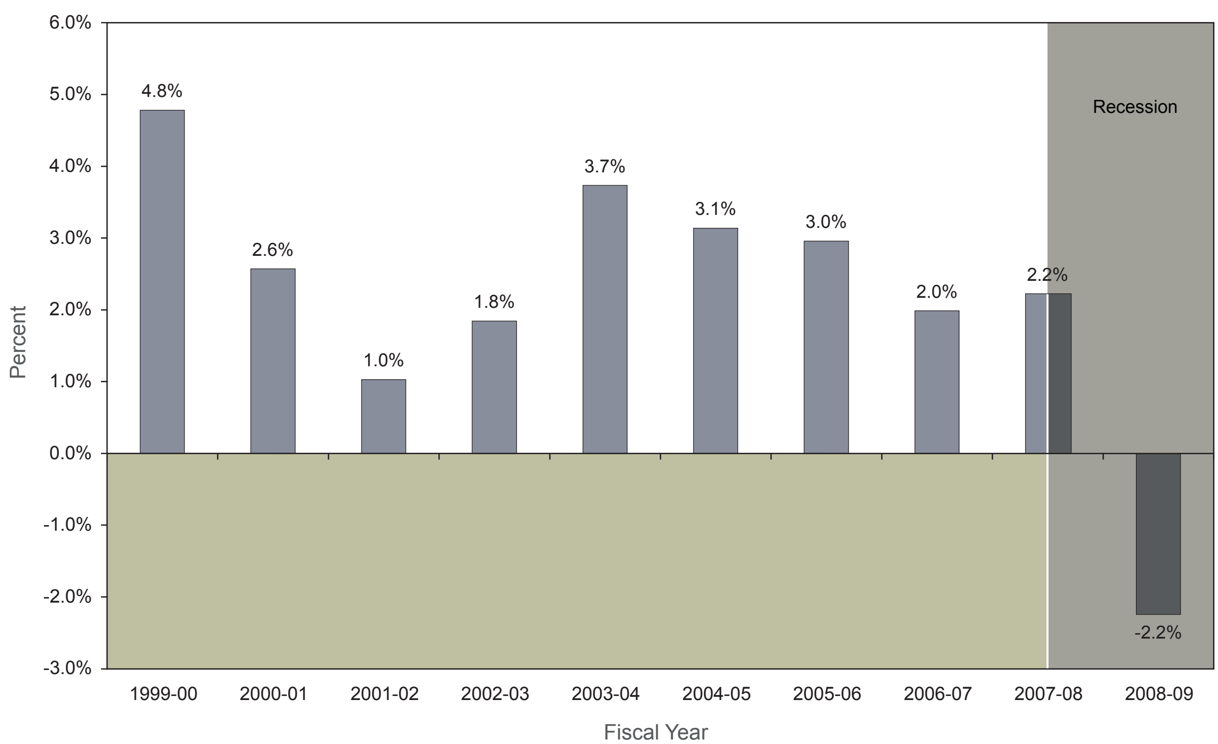
National Economy

In fiscal year 2008–09, the national economy experienced what many economists consider to be the worst recession in both duration and magnitude since the 1930s. A major financial meltdown was barely avoided in the fall of 2008 as the federal government and the Federal Reserve Board (Fed) took unprecedented steps to stabilize the economy and prevent what could have been a major depression according to many analysts. While centered in the United States, the recession was worldwide in scope. The U.S. economy was characterized by declines in real gross domestic product (GDP) and employment, a rising unemployment rate, and large declines in gasoline prices.

Financial Turmoil and Unprecedented Policy Responses

During the month of September 2008, a major credit crisis unfolded in financial markets. The September crisis began when two huge government-sponsored enterprises, Fannie Mae and Freddie Mac, were both placed into conservatorship on September 7. Following this action, several very large banks, insurance companies, and investment banks either became insolvent or very close to it. A review of the events of September by the Congressional Budget Office concluded that "…financial markets appeared to be on the verge of freezing up…"

Growth in Real GDP (Fiscal Years 1999-00 Through 2008-09)



Federal policymakers took unprecedented measures to stabilize the financial markets. In early October the Emergency Economic Stabilization Act (commonly referred to as a bailout of the U.S. financial system) became law. The Federal Reserve Board provided $900 billion in short-term loans to banks and made additional emergency loans of $1.3 trillion to other companies. In retrospect, these measures appeared to have been successful in averting what could have been a major financial crisis. In an effort to further stabilize the economy, a $787 billion economic stimulus package, the American Recovery and Reinvestment Act of 2009, was signed into law in early February 2009.

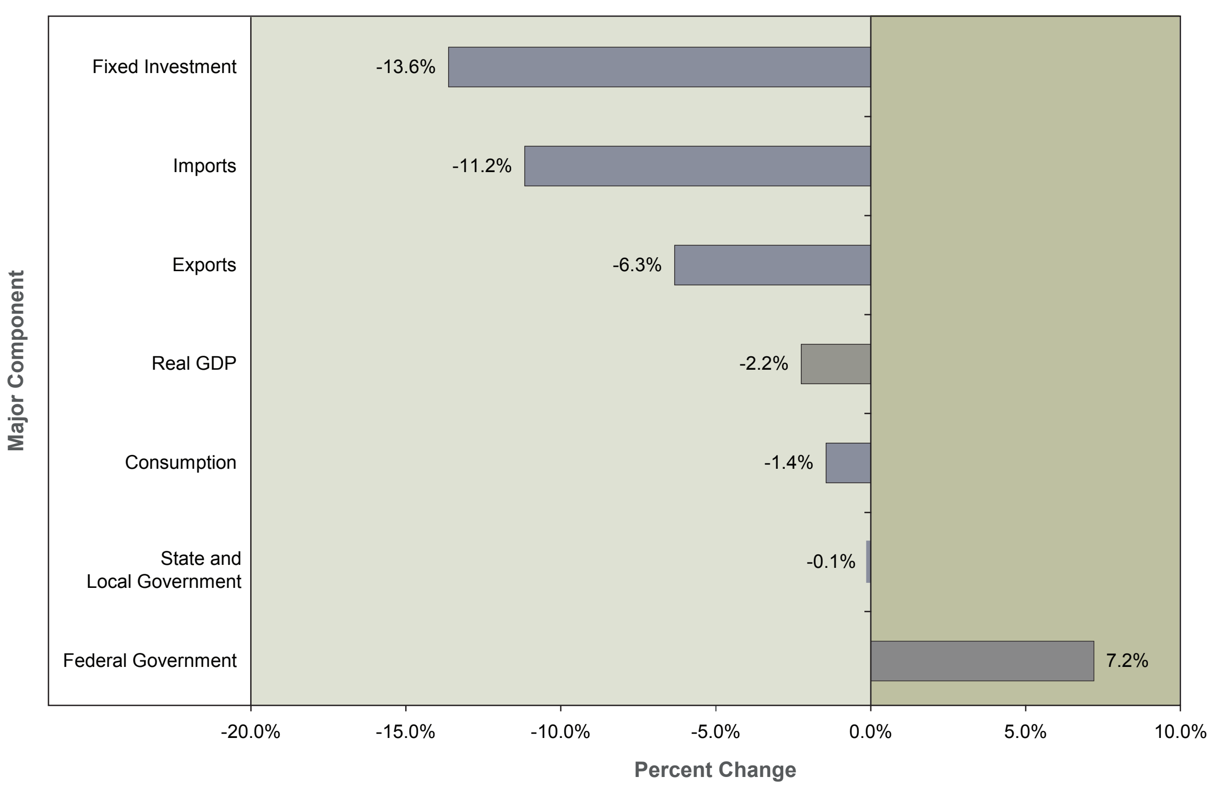
Gross Domestic Product

Real gross domestic product (GDP)—the broadest measure of the nation's output of goods and services—decreased 2.2 percent in fiscal year 2008-09. The last time real (alternatively called inflation-adjusted) GDP fell close to this magnitude was calendar year 1982, when it declined 1.9 percent. Nonagricultural employment decreased 2.3 percent, the largest decline since 1946.

Real GDP by Sector

All major sectors of the economy, except government, declined in fiscal year 2008-09. Real domestic fixed investment spending, which made up 15 percent of total real GDP, decreased the most, 13.6 percent. All major components of investment fell. A sharp drop in construction activity resulted in a 23.2 percent decline in real residential investment spending. Nonresidential investment held up better, falling 5.2 percent after adjusting for inflation. Spending on equipment and software, the largest investment component, was down 13.5 percent in real terms.

2008-09 Growth in Real GDP and Major Components



Real exports declined 6.3 percent. Exports are an important component of the economy, comprising about 13 percent of total GDP. The drop in exports largely reflects the extent to which the recession was worldwide and adversely affected the economies of our major trading partners. With the decreasing U.S. economy, real imports fell 11.2 percent. Since exports declined faster than imports, the nation's trade balance improved.

Real consumer spending fell by 1.4 percent. The last time consumer spending declined as much was in 1942. Consumer spending is very important to the economy, since it accounts for 71 percent of total GDP. Durable goods spending fell more than any other component, 8.8 percent in inflation-adjusted terms. Real nondurable goods spending decreased 2.1 percent. Real services spending was essentially unchanged, rising 0.1 percent. Car sales and travel spending posted particularly large declines, as is generally the case during recessions.

Government spending on goods and services increased by 2.6 percent after adjusting for inflation. Real federal government spending grew 7.2 percent, while real state and local government spending was essentially unchanged, falling 0.1 percent. Real federal government defense spending increased 7.9 percent, while federal government nondefense spending increased 5.6 percent after adjusting for inflation.

The Unemployment Rate

With the recession, a total of 3.8 million U.S. nonagricultural jobs were lost in fiscal year 2008-09. As a result, the average U.S. unemployment rate rose dramatically. The rate rose from 5.8 percent in July 2008 to 9.5 percent by June 2009. The rate has not been this high since 1983.

Corporate Profits and Housing Starts

As the economy deteriorated, corporate profits declined 15.5 percent in fiscal year 2008-09. The last time corporate profits declined by a similar percentage magnitude was fiscal year 1969-70, when they declined by 11.7 percent.

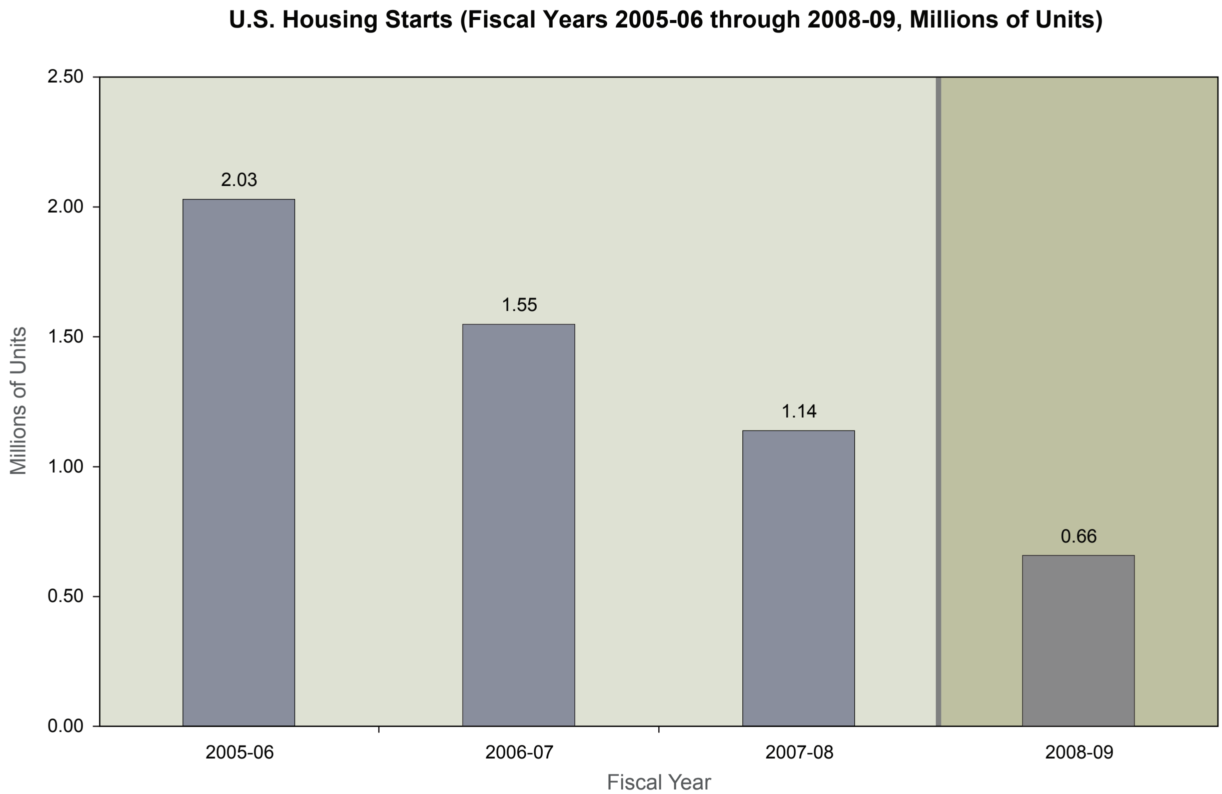
Housing starts declined dramatically, continuing a trend of the past two years. There were 0.66 million housing starts in fiscal year 2008-09, down from 1.14 million in 2007-08. The 2008-09 figure is down by about two-thirds from the fiscal year 2005-06 peak level of 2.03 million starts.

Consumer Prices

With falling energy prices through most of the year, inflation increased only modestly. U.S. gasoline prices declined about 18 percent in fiscal year 2008-09. The U.S. consumer price index rose 1.4 percent in fiscal year 2008-09, down from 3.7 percent in 2007-08.

Interest Rates

In response to deteriorating financial markets and a weakening economy, the Fed lowered interest rates dramatically in late 2008. The federal funds rate declined from 2 percent in July 2008 to near zero, about 0.2 percent, by December 2008. The Fed kept the federal funds rate at a target range of zero to 0.25 percent for the rest of the fiscal year. Long term interest rates also declined. Yields on conventional new home mortgages fell from 6.3 percent in July 2008 to 4.9 percent by June 2009.



Federal Budget Deficit

Federal responses to the late 2008 financial meltdown, additional stimulus responses to the recession in early 2009, and declining revenues all combined to increase the federal deficit exponentially. The deficit spiked from $455 billion in federal fiscal year 2008 to $1.417 trillion in federal fiscal year 2009 (federal fiscal years ending September 30 of each respective year). In terms of percentages of GDP, the deficit increased from 3.2 percent to 9.9 percent. This is the highest percentage since 1945, eclipsing the previous high of the past 50 years, 6 percent recorded in 1983.

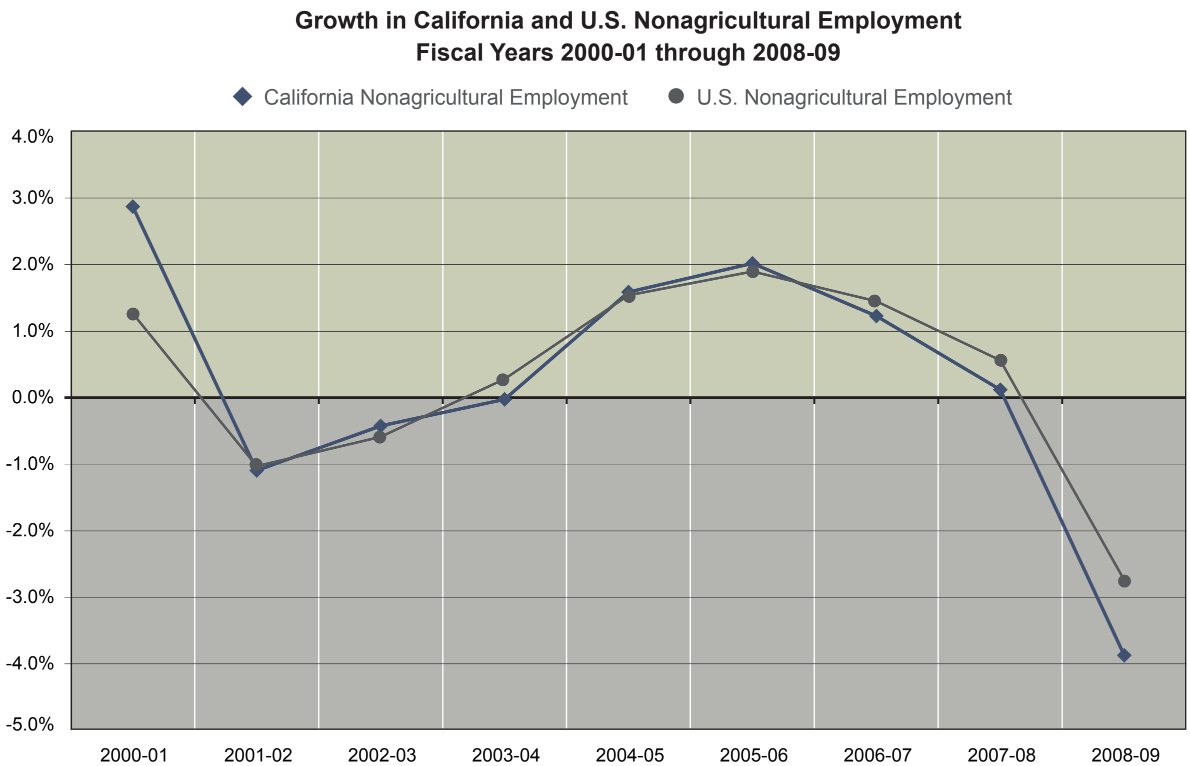
Both spending increases and revenue decreases contributed significantly to the federal deficit. Revenues declined 17 percent ($419 billion less than 2008), while spending rose 18 percent ($543 billion more than 2008).

California Economy

The California economy was in recession in fiscal year 2008-09 along with the rest of the U.S. economy. Entering the fiscal year the state was still suffering the impacts of the home lending crisis, as California has a disproportionately large share of the nation's subprime and adjustable mortgages. In addition, the California economy is highly dependent on high-technology goods and exports, sectors which have suffered more than average in the recession.

As a result of these factors, by most measures the California economy fared worse than the nation as a whole in fiscal year 2008-09. California nonagricultural employment fell 3.9 percent, while U.S. nonagricultural employment declined 2.7 percent. The California unemployment rate rose from 7.3 percent in

July 2008 to 11.6 percent by June 2009. For all of 2008-09, the California unemployment rate was 9.5 percent, 1.9 percent above the U.S. rate. California personal income (unadjusted for inflation) decreased 0.7 percent, while U.S. personal income rose just 0.1 percent.



Employment

California nonagricultural employment decreased 3.9 percent in fiscal year 2008-09, as payrolls declined by 587,000 jobs.

Employment Sectors

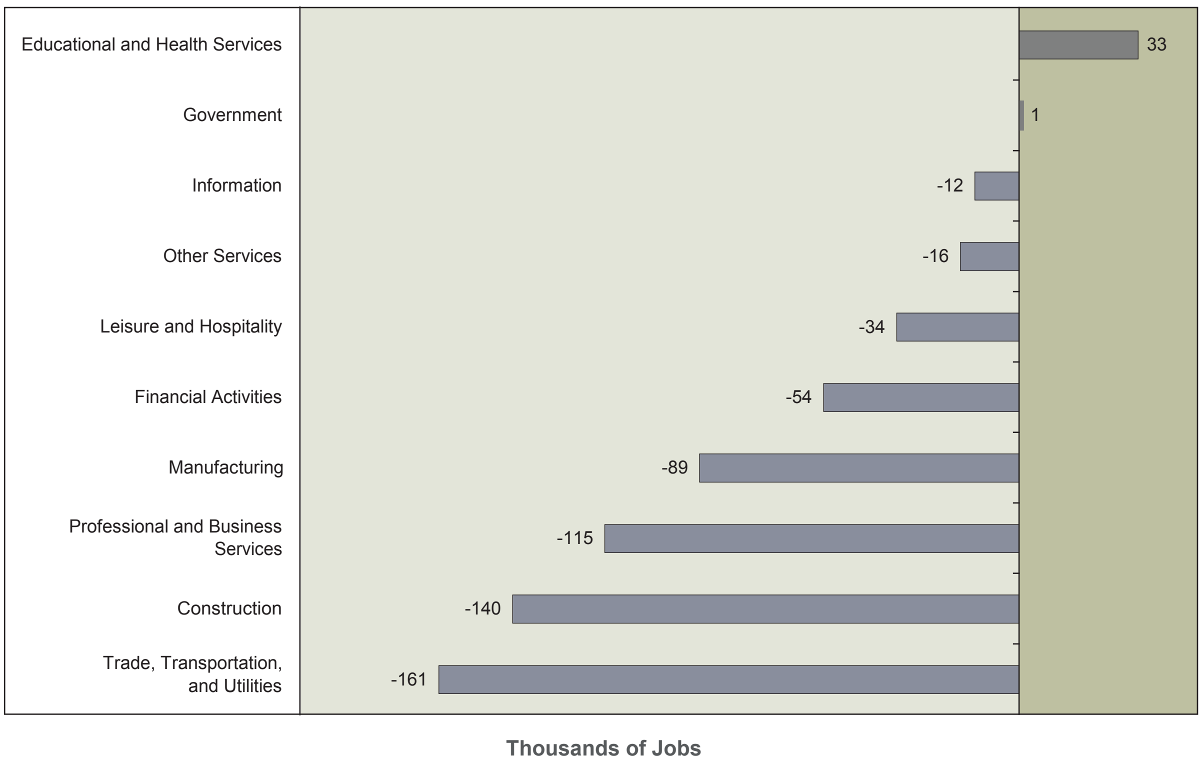
Trade, Transportation and Utilities. In 2008-09, trade, transportation and utilities lost 161,000 jobs, more than any other sector. This was a 5.5 percent decline. Car dealers and furniture stores had some of the sharpest declines in this sector. The trade, transportation, and utilities sector is the state's largest employment grouping, accounting for about 19 percent of all nonfarm jobs.

Construction. With the slowdown in housing activity in 2008-09, construction employment decreased by 140,000 jobs. This was a 16.6 percent decline. About 5 percent of all nonfarm jobs are in construction.

Professional and Business Services. Professional and business services lost 115,000 jobs, a 5.1 percent decrease. About 60 percent of the job losses in this sector were in employment services, which provide many temporary employees to firms. The professional and business services category is the state's third largest sector, employing 15 percent of Californian nonagricultural workers.

Manufacturing. The manufacturing sector lost about 89,000 jobs in 2008-09, a 6.1 percent reduction. Jobs losses were widespread among many durable goods and nondurable goods manufacturing industries. Manufacturing employs 9 percent of workers on nonagricultural payrolls.

2008-09 Changes in California Nonagricultural Employment



Financial Activities. Employment in financial activities—lenders, insurance agents, and real estate brokers—decreased by 54,000 jobs, or 6.2 percent. These industries are closely associated with residential real estate activity. Financial activities account for about 6 percent of nonfarm Californian jobs.

Leisure and Hospitality. Employment in leisure and hospitality industries, such as restaurants and hotels, decreased 2.2 percent in 2008-09, a loss of 34,000 jobs. Most of the job losses were in food services. Leisure and hospitality industries employ about 11 percent of nonfarm Californian workers.

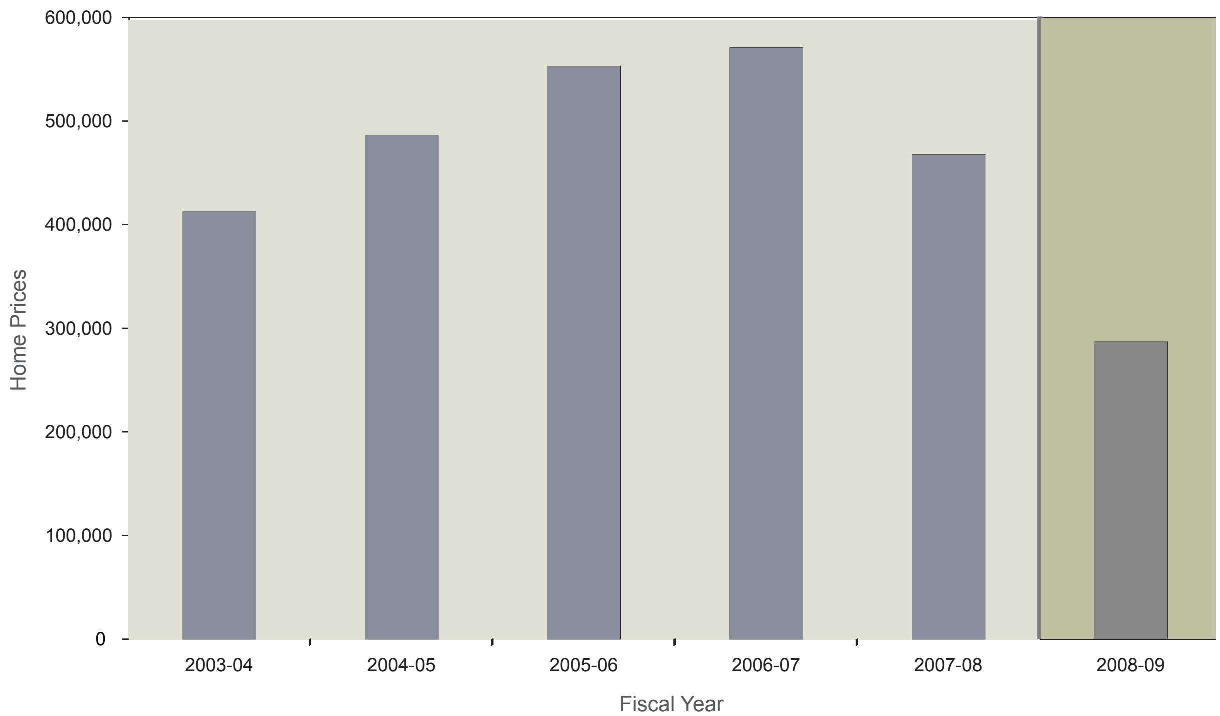
Other Sectors. The remaining private industry sectors (other services, mining and natural resources) provided employment for 3 percent of nonagricultural workers. Employment in this group decreased by 3.1 percent (16,000 jobs).

Information. Information providers—publishing, motion pictures, broadcasting, telecommunications and Internet services—lost about 12,000 jobs, a 2.6 percent decrease. Print publishing accounted for close to 50 percent of the lost jobs in this sector. Telecommunications jobs also fell sharply. Information jobs account for a relatively small share of state jobs, about 3 percent.

Government. Government employment was essentially unchanged in 2008-09, adding about 1,000 jobs. Federal payrolls increased, while state and local government hiring decreased in 2008-09. Government is California's second largest sector, with 17 percent of all California nonagricultural jobs.

Educational and Health Services. Private educational and health services was the only major private sector that increased jobs in 2008-09. Education and health gained 33,000 jobs, a 1.9 percent increase. This is a relatively large sector, accounting for about 12 percent of nonfarm employment. Over 90 percent of the jobs added in this sector were in health care.

Median Prices of Existing California Single Family Homes (Fiscal Years 2003-04 through 2008-09)



Building Construction and Home Prices

The value of all private building construction permits issued in California fell by 37 percent in fiscal year 2008-09, much greater than the back-to-back 17 percent declines of the previous two fiscal years. The value of both residential and nonresidential construction permits decreased by similar percentages. Only 46,000 home building permits were issued in 2008-09, a record low and down sharply from 85,000 in 2007-08, which was the previous record low. The 46,000 permits are less than one-third of the ten-year average of 151,000 permits.

With weak demand, home prices also dropped sharply until February 2009 before turning upward. For all of 2008-09, statewide median home prices declined 39 percent, as the median price of an existing single-family detached California home averaged $287,000. The percentage decline was the largest for any one-year period since 1975, when the California Association of Realtors started keeping records on home prices. With the drop in values, median California home prices in 2008-09 were below the average for fiscal year 2001-02.

A total of 534,000 existing single-family homes were sold in fiscal year 2008-09, close to the long-term average of 527,000. However, many of these sales were foreclosures and other distressed sales.

Vehicle Registrations

With the recession, new car and truck registrations combined were down 33 percent in 2008-09. New car registrations were down about 31 percent, while new truck registrations (mostly medium and heavy duty trucks) declined 44 percent. The last calendar year with a decline in new car registrations close to this magnitude was 1974 when they declined 29 percent.

Consumer Prices

California consumer prices for all urban consumers rose a modest 1.3 percent in 2008-09, down from 3.4 percent in 2007-08. Falling gas prices contributed disproportionately to the overall inflation rate, as California gasoline prices decreased over 16 percent in 2008-09. At the national level, the consumer price index increased similarly, by 1.4 percent in 2008-09, down from 3.7 percent in 2007-08.

California Budget Crises

As a result of the recession, California faced multiple budget crises in fiscal year 2008-09, largely brought about by the combination of the recession and various state laws. As with the federal government, revenues declined sharply. According to the Legislative Analyst's Office (LAO), General Fund and special fund revenues combined decreased by 18 percent in fiscal year 2008-09.

The budget was enacted in September 2008, more than two months after the fiscal year started. In November 2008, the Governor called a special session of the Legislature, primarily to deal with deteriorating revenues. On December 1, 2008, the first day of the 2009-10 Legislature, the Governor declared a fiscal emergency and called another special legislative session. As the Governor and the Legislature could not agree on a fiscal solution, on December 19, 2008 the Governor called yet another fiscal emergency and another special session. In February 2009, the 2009-10 Budget was enacted at the earliest time in the state's modern history, largely to deal with the fiscal year 2008-09 budget problems.

Temporary Sales and Use Tax Increase Enacted

A centerpiece of the February 2009 Budget package is a temporary increase in the state portion of the sales and use tax that took effect April 1, 2009. The state portion of the sales and use tax rose from 5 percent to 6 percent, and will be in effect until June 30, 2011.

Taxable Sales Activity

Transactions subject to the sales and use tax totaled $484.4 billion during the 2008-09 fiscal year. This was a decrease of $68.5 billion, or 12.4 percent, compared to 2007-08. With the recession, taxable sales declined in every quarter (see following table). After the financial crisis of September 2008, taxable sales declined at worsening double-digit rates each quarter during the rest of the fiscal year.

2008-09 Taxable Sales

Growth in Actual Dollars Compared to Growth in Constant-Value Dollars

	Taxable Transactions		Percent Change From Prior Year In		
Quarter	Amount *(thousands of dollars)*	Percent of Total	Actual Dollars	Constant Value Dollars	California Taxable Sales Deflator
July-September	$135,983,432	28.1	-2.7	-7.5	5.1
October-December	$127,904,743	26.4	-12.0	-11.1	-0.9
January-March	$107,174,862	22.1	-16.2	-13.1	-3.5
April-June	$113,361,318	23.4	-19.0	-15.5	-4.1
Fiscal Year	**$484,424,355**	**100.0**	**-12.4**	**-11.7**	**-0.8**

Taxable sales decreased by 11.7 percent over the previous fiscal year when measured in constant dollars. The California Taxable Sales Deflator—an index that tracks price changes only for commodities subject to the sales and use tax—showed annual inflation of -0.8 percent. Falling gas prices throughout much of the fiscal year were largely responsible for the decline in prices. By quarter, the Deflator fell more sharply as the fiscal year unfolded. The -0.8 percent inflation rate shown by the Deflator contrasted with the 1.3 percent rate indicated by the California Consumer Price Index, which also measures price increases for housing costs and services, which are not subject to the sales and use tax.

As with last year's annual report, we do not have comparable data available to calculate percentage changes of retail stores and other businesses from fiscal year 2007-08. In 2007 the BOE began a process of converting business codes of sales and use tax permit holders to North American Industry Classification System (NAICS) codes. This process is now complete; over one million permit holders were converted from the previous business coding system to the NAICS codes. As a result of the coding change process, industry data for fiscal year 2007-08 are not comparable with data for 2008-09. Therefore, we will not publish percentage changes by industry in this annual report.

Appendix Table 19, on page A-28, shows details on sales tax activity and the number of sales tax permittees by business type. The NAICS coding process has also caused us to change the format of this table from those of previous annual reports.

Revenue Growth

Tax programs administered by the BOE produced state and local revenues totaling $48,419,964 during fiscal year 2008-09. This was a decrease of $4.7 billion, or 8.9 percent, from 2007-08. The revenue decline was unprecedented since records have been kept, and it resulted from sharp decreases in economic activity resulting from the recession.

Revenues from each tax are presented in the text table on page 49. Additional detail and historical comparisons are found in Appendix Table 2, on page A-2.

Sales and Use Taxes

Sales and use taxes contribute 82 percent of the revenue from BOE-administered tax and fee programs. Combined revenue from all state and local sales and use taxes and fees totaled $39,924,935,000 in 2008-09, a decrease of 10.1 percent from 2007-08. The state's portion of the sales tax was $26,512,939,000 (including fees and the fiscal recovery fund.) This includes revenues from a temporary increase in the state rate from 5 percent to 6 percent that became effective April 1, 2009.[1] The portion allocated to other jurisdictions—cities, counties, and special districts—totaled $13,411,995,000, including allocations to the Local Revenue Fund and the Public Safety Fund. Sales and use tax details are provided in Appendix Tables 18 through 23B, beginning on page A-26.

By the end of the fiscal year, special district taxes were being levied by 113 jurisdictions in 41 counties (see "District Transactions (Sales) and Use Tax," on page 15.) These counties are the source of 97 percent of all taxable sales in the state. Some districts cover entire counties while others are restricted to city limits or other legal boundaries. Special district information is located in Appendix Table 21C, on page A-34. Appendix Table 23B, on page A-40, lists total sales and use tax rates by county.

Special Taxes

Fuel taxes. In 2008-09, the state's fuel tax revenues totaled $3,203,821,000, a 5.7 percent decrease from the previous fiscal year. Jet fuel and diesel fuel taxes, which tend to be more closely tied to economic activity than gasoline taxes, declined the most, 18.7 percent and 11.6 percent. Distribution of gasoline for highway use fell 3.6 percent to 14.8 billion gallons. Historical fuel tax data are presented in Appendix Tables 24-26, beginning on page A-41.

Cigarette and tobacco taxes and fees. Revenue from excise taxes on cigarettes and other tobacco products totaled $1,005,615,000 in 2008-09, falling 3.6 percent from the previous year. While such a drop reflects the trend of decreasing cigarette consumption, part of the reason for the decline resulted from an increase in the federal tax rate effective April 1, 2009. The federal tax increase of $0.62 per pack appears to have been passed on to consumers by major cigarette manufacturers, and likely resulted in fewer cigarettes consumed during this portion of the fiscal year.[2] For more information on these taxes, see Appendix Tables 30A and 30B, which begin on page A-53.

Insurance taxes. Insurance taxes were $1,937,269,000 in 2008-09, a 3.6 percent decrease. For more information on these taxes, see Appendix Tables 31-33, which begin on page A-56.

Alcoholic beverage tax. The state's excise tax revenues from alcoholic beverages decreased 1 percent from 2007-08 levels to total $323,954,000 for the fiscal year. Revenues from beer and wine increased 2.1 percent to $160,953,000, while revenues from distilled spirits decreased 3.9 percent to $163,001,000. Tax rates range from twenty cents a gallon for wine to $3.30 per gallon for distilled spirits. For historical data on taxes, total apparent consumption, and per capita apparent consumption by major type of beverage, see Appendix Tables 27-29, beginning on page A-48.

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[1] Under ABx3 3, (Statutes of 2009) the state portion of the sales and use tax rate rose from 5 percent to 6 percent, starting April 1, 2009. The higher rate will be in effect until June 30, 2011.

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[2] Under H.R. 2 (Statutes of 2009) the federal cigarette tax rate increased from $0.39 per pack to $1.01 per pack on April 1, 2009. Federal tax rates for tobacco products also increased substantially; the increases varied greatly depending on the type of product.

Electricity, telephone, and natural gas surcharges. The electrical energy surcharge, levied on the use of electricity in California, produced $57,049,000 in 2008-09, virtually unchanged from the previous year. The natural gas surcharge produced $448,137,000, an increase of 12 percent. The emergency telephone users surcharge, which funds the 911 statewide emergency number system, totaled $107,795,000, an increase of 3.9 percent. Additional detail and historical comparisons are provided in Appendix Tables 34 and 35, beginning on page A-61.

Hazardous substance taxes and other environmental fees. Revenues from hazardous substance taxes and other environmental fees totaled $567,936,000, a 3.4 percent decrease from 2007-08. These taxes and fees are used to fund specific environmental programs. Additional detail and historical comparisons are provided in Appendix Tables 36A and 36B, beginning on page A-63.

Property Taxes

Locally collected property taxes on state-assessed properties amounted to $830,536,000, an increase of 5.7 percent. The timber yield tax, which is levied when timber is harvested to substitute for an annual value-based property tax, totaled $6,872,000. This was a 46.4 percent decrease, reflecting the sharp declines in home construction discussed earlier. The private railroad car tax, levied on railroad cars owned by firms that do not operate railroads, produced $6,045,000, a decrease of 1.1 percent.

Comparison of Revenues 2007-08 and 2008-09

In thousands of dollars

Revenue Source	2007-08	2008-09	Percent change
Sales and Use Taxes			
State tax[1]	$27,771,845	$25,273,188	-9.0
Local revenue fund state sales tax (0.50%)	2,805,089	2,439,721	-13.0
Public safety fund sales tax (0.50%)	2,805,089	2,439,721	-13.0
Fiscal recovery fund sales tax (0.25%)	1,401,776	1,239,366	-11.6
City and county sales tax (0.75%)	4,228,650	3,734,285	-11.7
County transportation tax (0.25%)	1,429,075	1,246,361	-12.8
Special district taxes	3,974,548	3,551,907	-10.6
Other taxes and fees	405	385	-4.9
Totals	**44,416,478**	**39,924,935**	**-10.1**
Fuel Taxes and Fees			
Gasoline and jet fuel	2,807,199	2,680,495	-4.5
Diesel and use fuel[2]	589,395	523,326	-11.2
Totals	**3,396,594**	**3,203,821**	**-5.7**
Alcoholic Beverage Taxes	327,270	323,954	-1.0
Cigarette and Tobacco Products Taxes			
Cigarette tax	109,871	107,254	-2.4
Cigarette and tobacco products surtax	327,734	315,344	-3.8
Breast cancer research cigarette stamp tax	26,400	25,718	-2.6
California children and families first cigarette stamp tax	576,857	555,404	-3.7
Cigarette and tobacco products licensing fee	1,934	1,895	-2.0
Totals	**1,042,797**	**1,005,615**	**-3.6**
Insurance taxes	2,009,700	1,937,269	-3.6
Electrical energy surcharge	57,040	57,049	0.0
Natural gas surcharge	400,030	448,137	12.0
Emergency telephone users surcharge[3]	103,748	107,795	3.9
Hazardous substances taxes and other environmental fees[4]	587,646	567,936	-3.4
Local taxes on state assessed properties[5]	785,570	830,536	5.7
Timber yield tax	12,831	6,872	-46.4
Private railroad car tax	6,110	6,045	-1.1
Grand Totals	**$53,145,812**	**$48,419,964**	**-8.9**

1 State tax rate 5.0% through March 2009; 6.0% effective April 2009.

2 Includes diesel fuel taxes collected under the International Fuel Tax Agreement (IFTA) implemented on January 1, 1996.

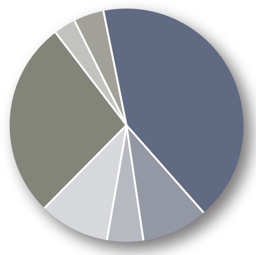
3 Effective January 2009, the surcharge is extended to Voice over Internet Protocol (VoIP) services that provide access to the 911 emergency system.

4 Includes revenues from the Hazardous Substances Tax, Integrated Waste Management Fee, Underground Storage Tank Maintenance Fee, Tire Recycling Fee, Oil Spill Prevention and Administration Fee, Oil Spill Response Fee, Childhood Lead Poisoning Prevention Fee, Occupational Lead Poisoning Prevention Fee, Marine Invasive Species Control Fee, Water Rights Fee, and Electronic Waste Recycle Fee.

5 Collected by county tax collectors.

Sources of State Revenue July 1, 2008–June 30, 2009

Percentage of Total State Revenue



Revenue Source	Revenue *(in thousands)*	Percent Change from 2007-08	Percentage of Total State Revenue
Board of Equalization			
Major Taxes and Licenses			
Sales and Use Tax[1]	$28,972,302	-9.4	27.3
Gasoline and Jet Fuel Tax	2,666,389	-5.8	2.5
Diesel and Use Fuel Taxes	513,739	-13.2	.5
Insurance Gross Premiums Tax	2,053,850	-5.5	1.9
Cigarette and Tobacco Products Tax	1,000,456	-3.6	.9
Alcoholic Beverage Tax	323,934	-1.0	.3
Totals, Major Taxes and Licenses	$35,530,670	-8.7	33.4
Totals, Minor Revenues[2]	1,186,961	2.8	1.1
Grand Total, Board of Equalization	**$36,717,631**	**-8.4**	**34.5**
Other Agencies			
Major Taxes and Licenses			
Personal Income Tax	$44,355,959	-20.4	41.7
Corporation Tax	9,535,679	-19.5	9.0
Motor Vehicle "in lieu" Tax	2,298,128	2.4	2.2
Trailer Coach Fees "in lieu" Tax	31,041	4.3	.0
Motor Vehicle Registration and Other Fees	3,237,473	10.1	3.0
Estate, Inheritance and Gift Tax	245	-96.1	.0
Horse Racing (Parimutuel) License Fees	30,737	-12.1	.0
Totals, Major Taxes and Licenses	$59,489,262	-18.3	56.0
Totals, Minor Revenues	10,104,599	-25.9	9.5
Grand Total, Other Agencies	**$69,593,861**	**-19.5**	**65.5**
TOTAL STATE REVENUE	**$106,311,492**	**-16.0**	**100.0**

Source: 2010-11 Governor's Budget

[1] Includes revenues from the state sales tax, the state disaster relief tax, the local revenue fund state sales tax, and the fiscal recovery fund sales tax.

[2] Includes private railroad car, electrical energy, natural gas, emergency telephone, and environmental taxes and fees.

Note: Percentage detail may not compute to totals due to rounding.