Economic Analysis

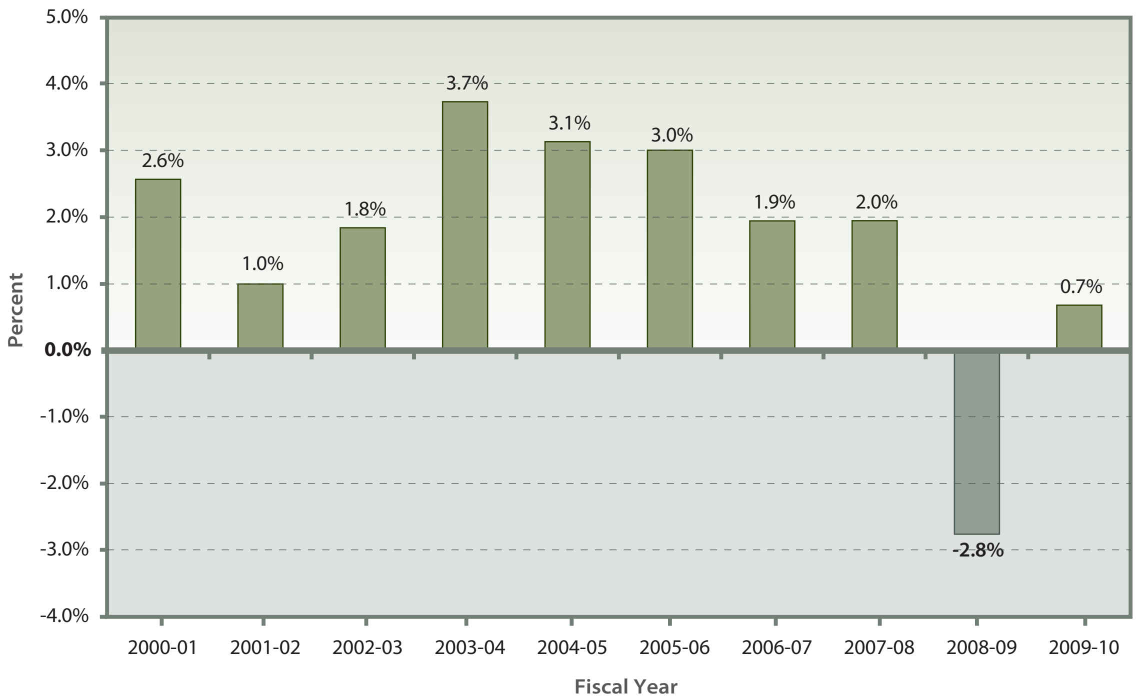
National Economy

In fiscal year 2009-10 the national economy was very weak, as it slowly emerged from what many economists consider to be the worst recession in both duration and magnitude since the 1930s. The U.S. economy was characterized by a modest increase in real Gross Domestic Product (GDP), sharply declining employment, high unemployment rates, very low interest rates and inflation rates, rising productivity and corporate profits, and a relatively high federal government deficit. What is commonly called the "Great Recession" left in its aftermath a 9.8 percent average unemployment rate for fiscal year 2009-10, more than twice as high as the 4.5 percent unemployment rate in fiscal year 2006-07, the last fiscal year before the recession started.

Gross Domestic Product

Real GDP—the broadest measure of the nation's output of goods and services—edged up 0.7 percent in fiscal year 2009-10. While growth was positive, it was extremely weak compared to typical pre-recession annual growth rates.

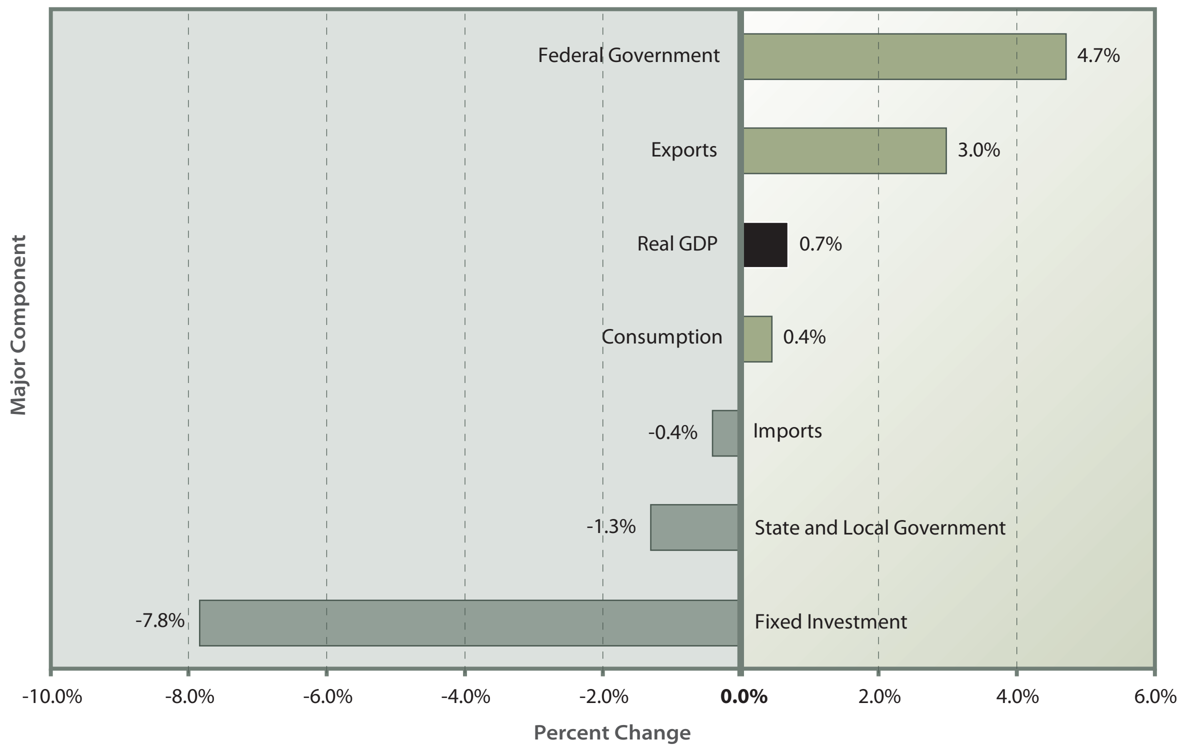
Growth in Real GDP
(Fiscal Years 2000-01 through 2009-10)



Real GDP by Sector

Federal government spending was the strongest growing sector, boosted by the domestic economic stimulus package and increased defense costs. Federal government expenditures rose 4.7 percent in fiscal year 2009-10. Real nondefense federal spending increased 5.4 percent, while defense spending rose 4.4 percent.

2009-10 Growth in Real GDP and Major Components



In contrast to the increase at the federal level, state and local government spending fell 1.3 percent, a consequence of continued weakness in most major revenue sources. With declining revenues related to slower economic activity, state and local government investment in structures declined 3.9 percent, pulling down overall state and local government spending.

Real export spending was the fastest growing private-sector component of GDP, rising 3.0 percent. Exports rose as many trading partners pulled out of the recession faster than the U.S. did. With the U.S. economy still weak, real imports changed little, falling 0.4 percent. Since exports rose while imports fell, the nation's trade balance improved.

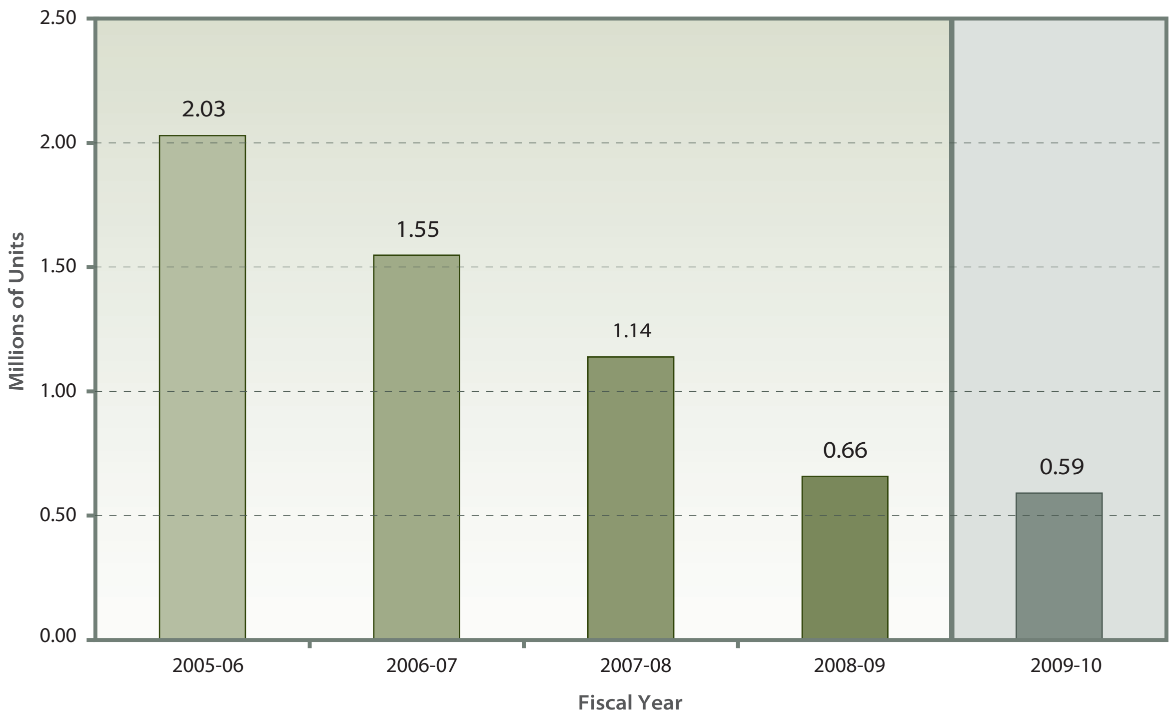
Real consumer spending edged up 0.4 percent. Consumer spending is very important to the economy, since it accounts for 71 percent of total GDP. Consumer spending has three major components, durable goods, nondurable goods, and services. Durable goods spending increased 4.3 percent in inflation-adjusted terms, while nondurable goods spending rose 1.2 percent. However, real services spending fell 0.4 percent, pulling down overall consumer spending. Within the services category spending on travel, restaurant meals, recreation, financial services, and insurance were all particularly weak.

Real domestic fixed investment spending, which made up 12 percent of total real GDP, decreased the most of any major sector of GDP, by 7.8 percent. As for components of fixed investment, spending on both residential and nonresidential structures declined at double-digit rates. Residential structures spending fell 10.0 percent, while nonresidential structures spending dropped 21.3 percent. The decline in real nonresidential structures spending was the sharpest since 1943. Spending on equipment and software (the third component of fixed investment spending) was essentially flat, rising 0.2 percent.

Housing Starts

Though the recession was over, housing starts continued to decline in fiscal year 2009-10. There were 0.59 million housing starts in fiscal year 2009-10, down from 0.66 million in 2008-09. The 2009-10 figure fell by more than two-thirds from the fiscal year 2005-06 peak level of 2.03 million starts, and is the lowest number in more than 50 years. Housing starts are well below numbers required to satisfy normal demographic demand. According to the U.S. Congressional Budget Office, annual construction of about 1.5 million units per year are necessary to keep up with growth of the population and to replace obsolete units.

U.S. Housing Starts
(Fiscal Years 2005-06 through 2009-10 Millions of Units)



Interest Rates

The U.S. Federal Reserve Board (Fed) maintained extremely low interest rates in 2009-10, continuing its monetary policy instituted in the prior fiscal year. The Fed kept the federal funds rate within a target range of zero to 0.25 percent. Three-month U.S. Treasury bill rates averaged 0.12 percent in fiscal year 2009-10, while ten-year U.S. Treasury bond yields averaged 3.55 percent.

Consumer Prices

In the aftermath of the recession, demand was generally weak, and there was little upward pressure on prices. Consequently, consumer prices hardly rose at all. The U.S. consumer price index increased only 1.0 percent in fiscal year 2009-10, matching the smallest rise in prices in nearly half a century. U.S. consumer prices for housing, clothing, recreation, and communications all declined from June 2009 to June 2010, pulling down the overall index. Compared to recent years, U.S. gasoline prices were reasonably stable, rising 3.9 percent from June 2009 to June 2010.

The Unemployment Rate

After peaking at 10.1 percent in October 2009, the seasonally adjusted U.S. unemployment rate came down slowly and leveled off at rates just below 10 percent for most of the second half of the fiscal year as the economy gradually improved. By June 2010, the U.S. unemployment rate was 9.5 percent, identical to the June 2009 unemployment rate. For the fiscal year as a whole the U.S. unemployment rate averaged 9.8 percent, the highest rate since 1983-84.

Corporate Profits

After firms sharply cut production, costs, and employment during the recession, many were well positioned to see increased profits when economic growth resumed in mid-2009. U.S. corporate profits before taxes jumped 26.5 percent in fiscal year 2009-10, the largest gain since fiscal year 1983-84. The surge in profits was in sharp contrast to the prior two fiscal years, when profits declined 10.4 percent and 17.7 percent. Low inflation, low borrowing costs, and increased productivity contributed to boost profits in 2009-10. Business output per hour rose 5.5 percent in 2009-10, nearly double the ten-year average growth rate of 2.8 percent per year. Business productivity has not increased so rapidly since 1962.

Federal Budget Deficit

During the recession federal stimulus responses and declining revenues combined to increase the federal deficit, leaving it at $1.416 trillion in federal fiscal year 2008-09 (federal fiscal years ending September 30 of each respective year). In terms of percentages of GDP, the 2008-09 deficit was 10.0 percent of GDP, the highest percentage since 1945.

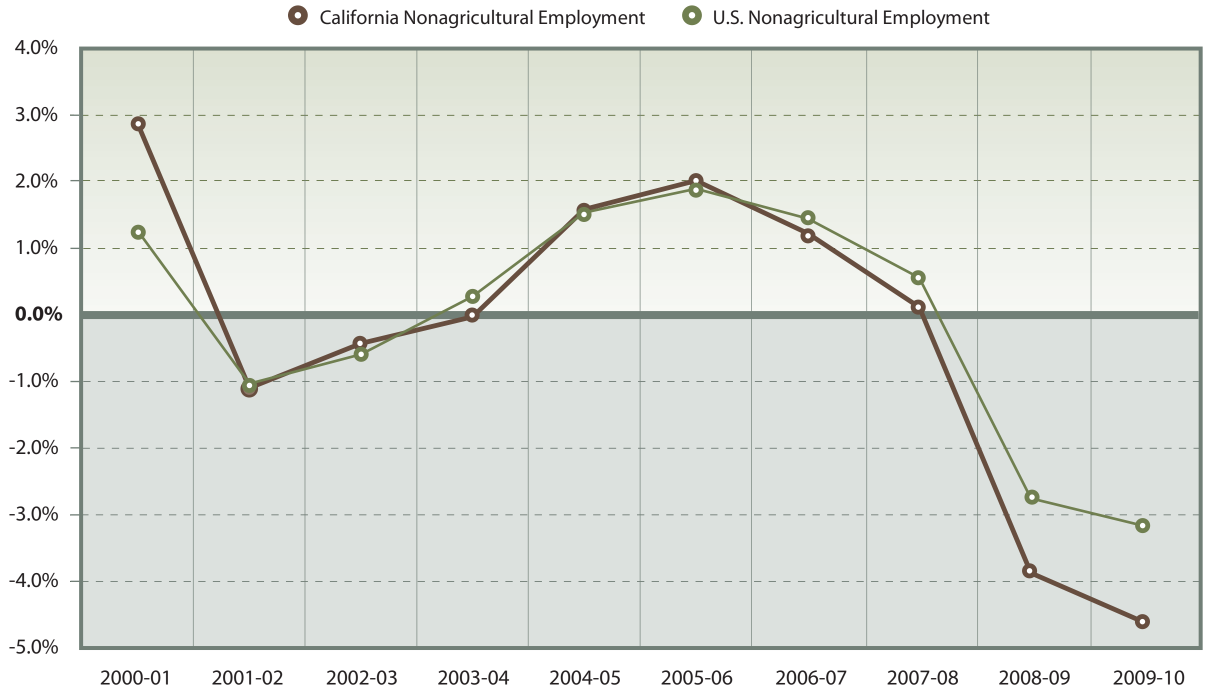
In federal fiscal year 2009-10 revenues edged up and outlays declined slightly, leaving the budget deficit only somewhat lower than in 2008-09. The federal budget deficit was $1.294 trillion in 2009-10, 8.9 percent of GDP. In terms of percentages of GDP, the 2009-10 budget was the second largest shortfall in the last 65 years, exceeded only by the 2008-09 budget.

California Economy

California economic growth was extremely weak in fiscal year 2009-10, similar to the rest of the U.S. economy. Entering the recession the state was suffering from the impacts of the home lending crisis of 2007, as California has a disproportionately large share of the nation's subprime and adjustable mortgages. In addition to causing employment and income losses, the recession exacerbated problems with such mortgages.

As a result of these factors, by most measures the California economy fared worse than the nation as a whole in fiscal year 2009-10. California nonagricultural employment fell 4.6 percent, while U.S. nonagricultural employment declined 3.2 percent. The seasonally adjusted California unemployment rate rose from 11.8 percent in July 2009 to a peak of 12.6 percent in March 2010, before declining slightly to 12.3 percent by June. For all of 2009-10 the California unemployment rate was 12.3 percent, 2.5 percentage points above the U.S. rate. The 12.3 percent California unemployment rate is the highest it has been for any twelve-month period since 1940. The only other fiscal year that the California unemployment rate was in double digits since World War II was in 1982-83, when it averaged 10.7 percent.

Growth in California and U.S. Nonagricultural Employment
Fiscal Years 2000-01 through 2009-10



Personal Income

Total personal income hardly changed in both California and the U.S. California personal income (unadjusted for inflation) decreased 0.2 percent, while U.S. personal income inched up 0.3 percent.

Employment

California nonagricultural employment decreased 4.6 percent in fiscal year 2009-10, as payrolls declined by 671,000 jobs.

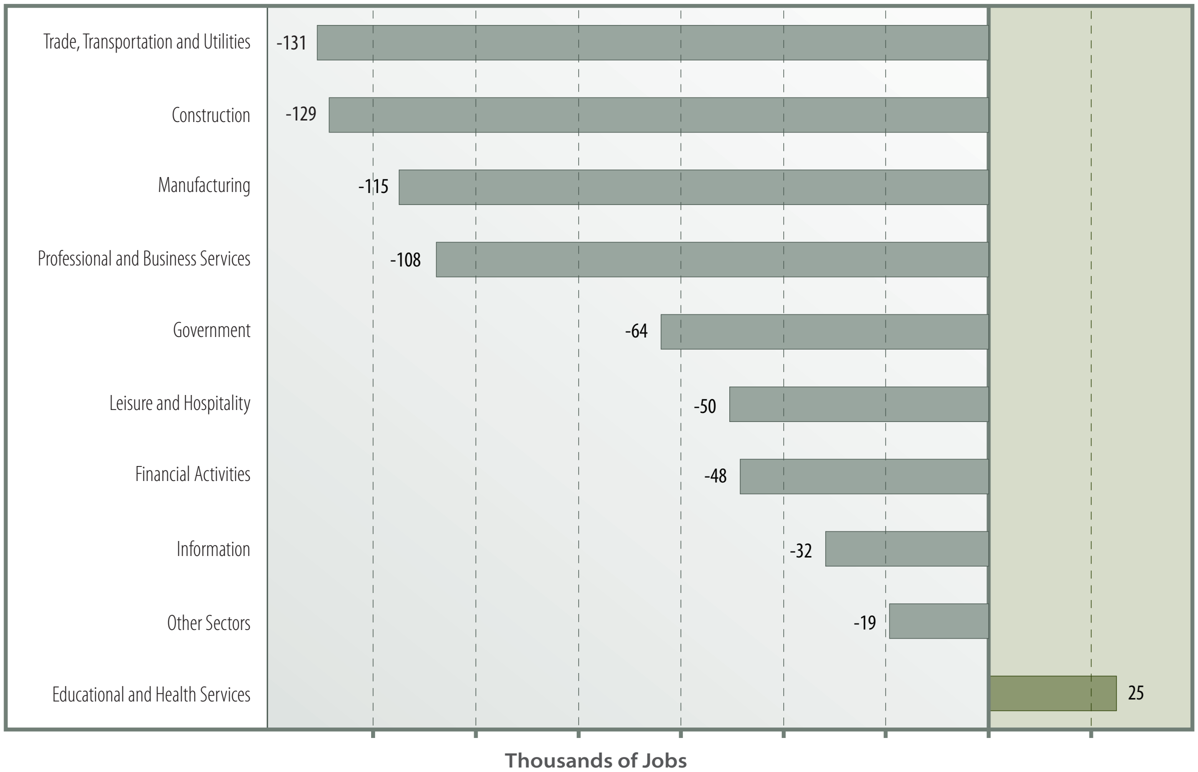
Employment Sectors

Trade, Transportation and Utilities. In 2009-10, trade, transportation and utilities lost 131,000 jobs, more than any other sector. This was a 4.8 percent decline. Car dealers and electronics 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 nonagricultural jobs.

Construction. With the continued slowdown in building activity in 2009-10, construction employment decreased by 129,000 jobs. This was an 18.2 percent decline. Much of the decline was associated with a sharp drop in nonresidential construction spending. About 4 percent of all nonagricultural jobs are in construction.

Manufacturing. The manufacturing sector lost about 115,000 jobs in 2009-10, an 8.4 percent reduction. Jobs losses were widespread among many durable goods and nondurable goods manufacturing industries. Manufacturing employs 9 percent of workers on nonagricultural payrolls.

2009-10 Changes in California Nonagricultural Employment



Professional and Business Services. Professional and business services lost 108,000 jobs, a 5.0 percent decrease. Professional services jobs related to nonresidential construction—such as architectural, engineering, and design services—had large losses. The professional and business services category is the state's third largest sector, employing 15 percent of Californian nonagricultural workers.

Government. Government employment decreased by about 64,000 jobs, a 2.5 percent decline. Federal government payrolls increased by 5.2 percent, but the much larger state and local sector saw a 3.4 percent decline in employment. Government is California's second largest sector, with 18 percent of all California nonagricultural jobs.

Leisure and Hospitality. Employment in leisure and hospitality industries, such as restaurants and hotels, decreased 3.3 percent in 2009-10, a loss of 50,000 jobs. The majority of the jobs lost were in food services. Leisure and hospitality industries employ about 11 percent of nonfarm Californian workers.

Financial Activities. Employment in financial activities—lenders, insurance agents, and real estate brokers—decreased by 48,000 jobs, or 6.0 percent. These industries are closely associated with real estate activity. Financial activities account for about 6 percent of nonfarm Californian jobs.

Information. Information providers—publishing, motion pictures, broadcasting, telecommunications and Internet services—lost about 32,000 jobs, a 6.9 percent decrease. Telecommunications accounted for over 40 percent of the lost jobs in this sector. Print publishing jobs also fell sharply. Information jobs account for a relatively small share of state jobs, about 3 percent.

Other Sectors. The remaining private industry sectors (other services, mining and natural resources) provided employment for 4 percent of nonagricultural workers. Employment in this group decreased by 3.7 percent (19,000 jobs).

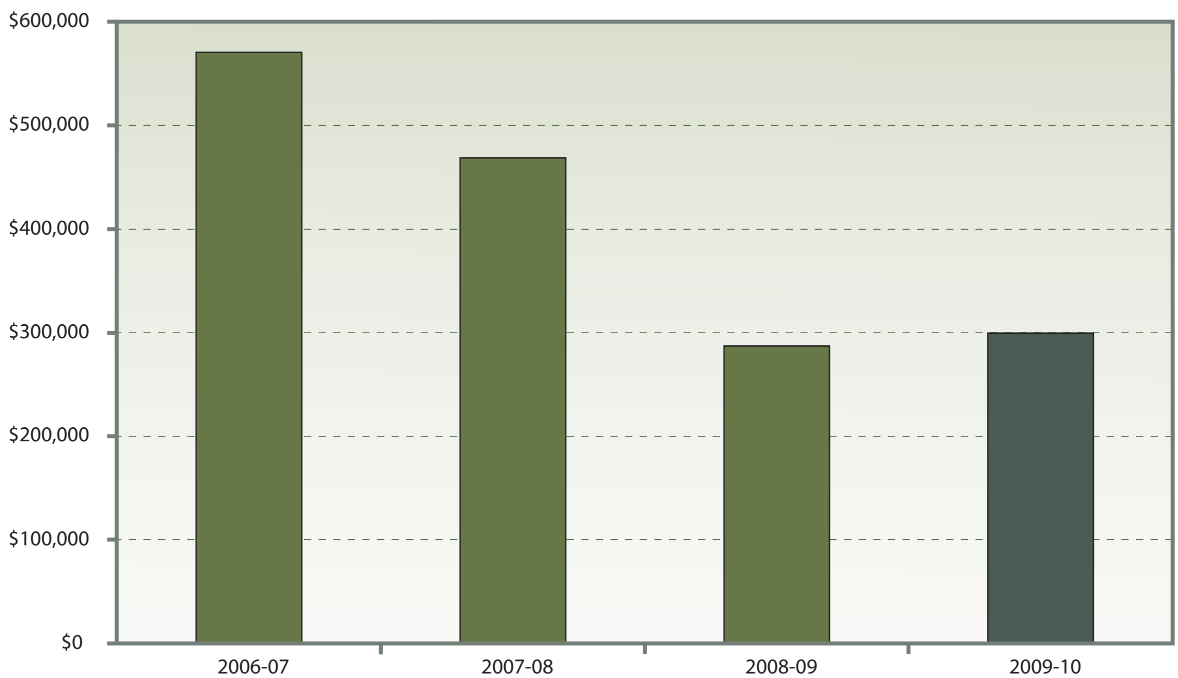
Educational and Health Services. Private educational and health services was the only major sector that increased jobs in 2009-10. Education and health gained 25,000 jobs, a 1.4 percent increase. This is a relatively large sector, accounting for about 13 percent of nonfarm employment. Close to 90 percent of the jobs added in this sector were in health care and social services.

Building Construction and Home Prices

The value of all private building construction permits issued in California fell by 15 percent in fiscal year 2009-10. While much less than the 37 percent decline of the previous year, this is the fourth straight year of double-digit decreases. The value of residential building permits fell by 7 percent, while nonresidential construction dropped 24 percent. In 2009-10, nonresidential construction spending was less than half of what it was only two fiscal years earlier. Only 40,000 home building permits were issued in 2009-10, a record low and down from 46,000 in 2008-09, which was the previous record low. The 40,000 permits are less than one-third of the ten-year average of 141,000 permits.

Median home prices were up modestly, rising 4.3 percent to average close to $300,000 in fiscal year 2009-10. Many of these sales were foreclosures and other distressed sales. Some reports indicate that more than one-third of California home sales in 2009 and 2010 were foreclosures or other distressed sales such as short sales. Median California home prices in 2009-10 were 48 percent below their peak in fiscal year 2006-07, and are below the average for calendar year 2002.

Median Prices of Existing California Single Family Homes
(Fiscal Years 2006-07 through 2009-10)



A total of 532,000 existing single-family homes were sold in fiscal year 2009-10, close to the long-term average of 528,000.

Vehicle Registrations

California new car and truck registrations edged up slightly in fiscal year 2009-10, similar to a modest increase in national car and truck sales. California new car and truck registrations rose 2.6 percent to 1.1 million vehicles. New vehicle registrations in California in fiscal year 2009-10 were about 60 percent of the 2005-06 peak of 1.8 million units.

Consumer Prices

California consumer prices for all urban consumers rose a modest 0.7 percent in 2009-10, down slightly from 1.3 percent in 2008-09. At the national level, the consumer price index increased similarly, by 1.0 percent in 2009-10.

California Budget Crises

In recent years California has faced multiple budget crises brought about by the combination of the recession, the tepid recovery, and various state laws. According to the Legislative Analyst's Office (LAO), the budget enacted for fiscal year 2009-10 had General Fund and special fund spending combined that was projected to be 15 percent less than in fiscal year 2007-08. However, even this greatly reduced budget could not be met by revenues and transfers as the fiscal year unfolded. In April 2010, as fiscal year 2009-10 was coming to a close, the LAO estimated that the state had lost about 20 percent of the revenue base it had before the recession started.

Temporary Sales and Use Tax Increase Remains in Effect

In the prior fiscal year (2008-09), a centerpiece of responding to the shortfall in revenues was enactment of 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 remained in effect until June 30, 2011.

Taxable Sales Activity

Transactions subject to the sales and use tax totaled $463.1 billion during the 2009-10 fiscal year. This was a decrease of $21.4 billion, or 4.4 percent, compared to 2008-09. With the recession ending in June 2009, taxable sales growth improved every quarter as the fiscal year unfolded (see table, below).

2009-10 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	$115,541,195	25.0	-15.0	-11.7	-3.8
October-December	$120,415,570	26.0	-5.9	-7.5	-1.7
January-March	$108,558,411	23.4	1.3	-2.5	3.9
April-June	$118,549,393	25.6	4.6	2.5	2.0
Fiscal Year	**$463,064,569**	**100.0**	**-4.4**	**-5.1**	**0.7**

Taxable sales decreased by 5.1 percent over the previous fiscal year when measured in constant dollars. The California Taxable Sales Deflator (Deflator)—an index that tracks price changes only for commodities subject to the sales and use tax—showed annual inflation of 0.7 percent. The Deflator fell during the first half of the fiscal year, but rose during the latter half. Much of the swing in direction of price changes in the Deflator was from gasoline prices, which fell sharply during most of the first half of the fiscal year, but rose even more during the latter half. The inflation rate shown by the Deflator was identical to the 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.

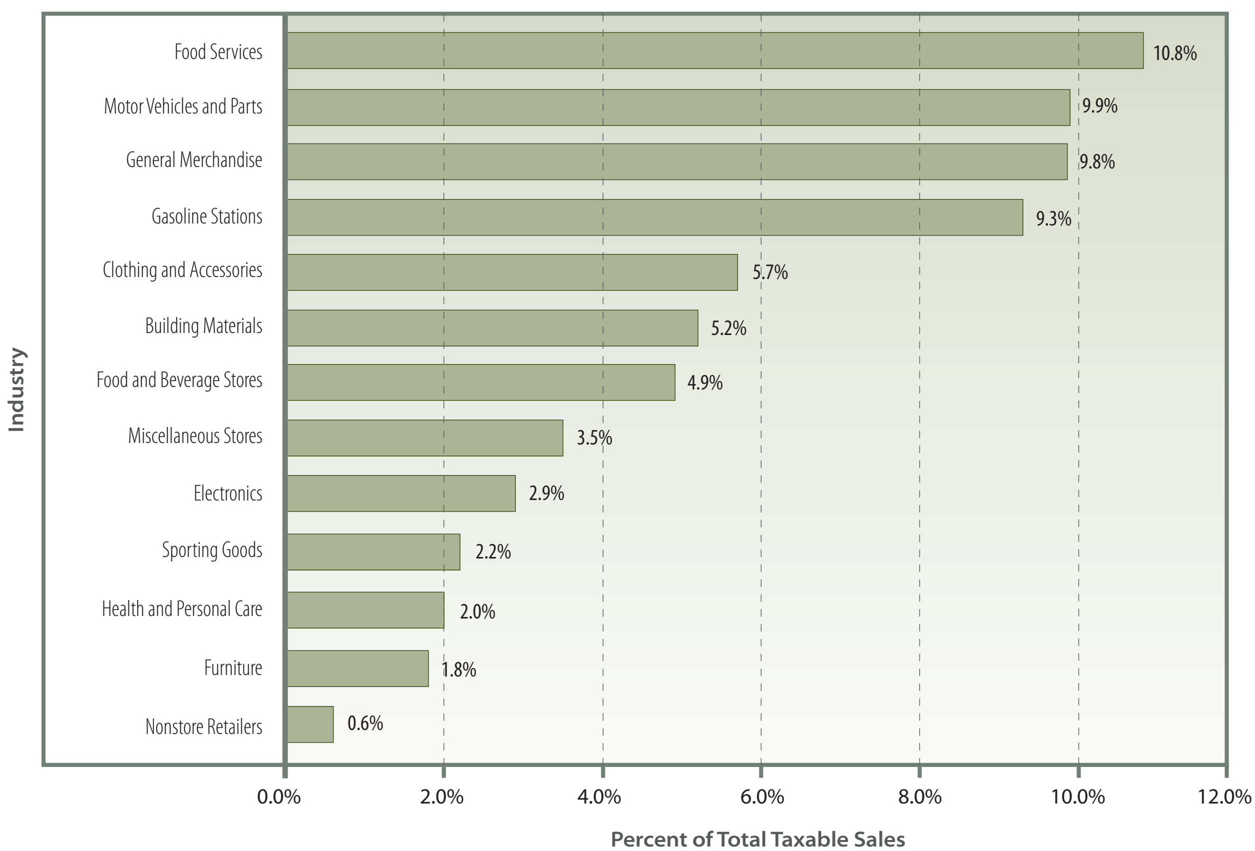
Taxable Sales by Industry

Taxable sales consist of sales made by two major groups of sellers: (1) retail and food services industries and (2) all other outlets. Taxable sales of all other outlets are mostly business equipment and construction goods. In fiscal year 2009-10 taxable retail and food services sales accounted for about 69 percent of total taxable sales, with the remaining 31 percent from all other outlets.

Taxable sales made by retail and food services industries decreased 1.6 percent in fiscal year 2009-10. The much more variable taxable sales from all other outlets declined 10.1 percent, as they were greatly influenced by the lingering effects of the recession.

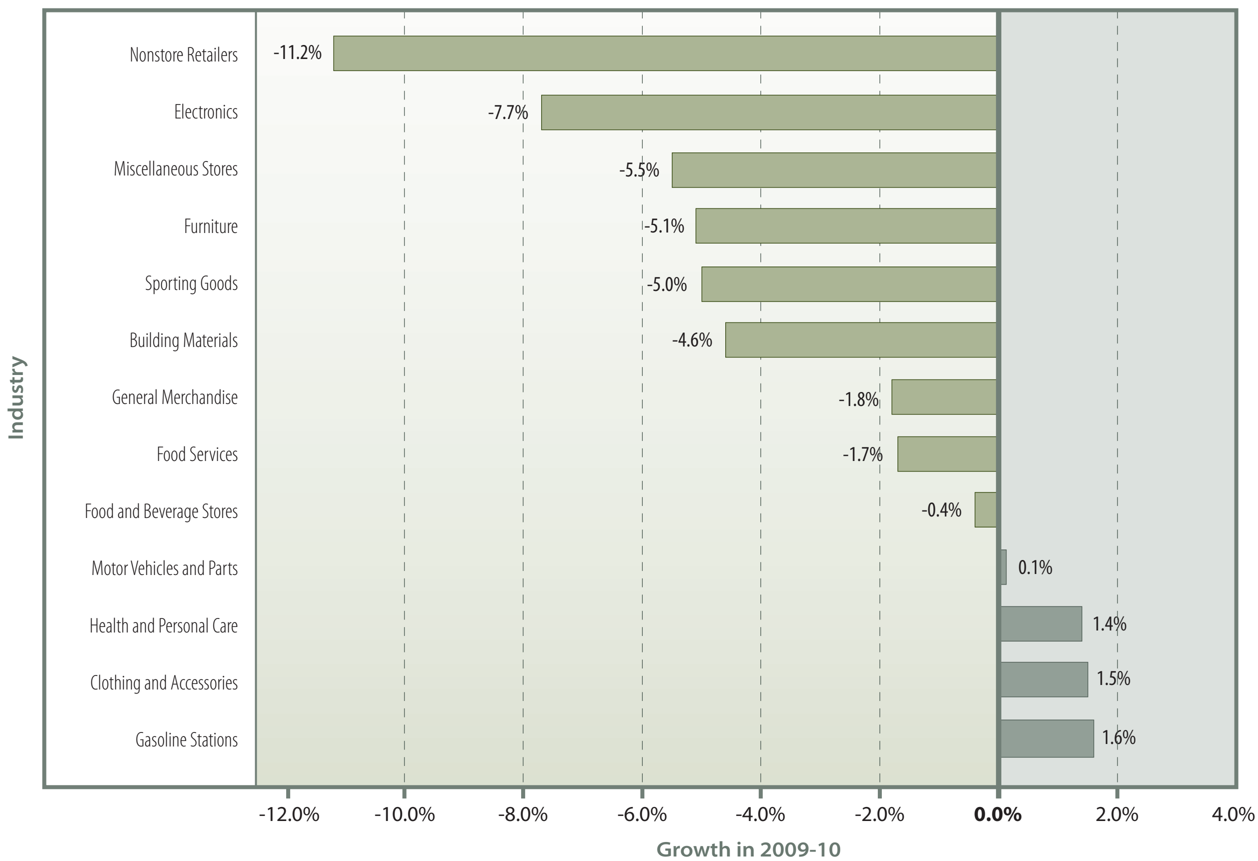
Retail taxable sales made by food services, motor vehicle dealers, general merchandise stores, and gasoline stations were the four largest retail industries, each comprising close to 10 percent of total taxable sales in fiscal year 2009-10. Taxable sales were widely dispersed among other industries, ranging from 0.6 percent to 5.7 percent of the total.

Industry Components of 2009-10 Taxable Sales



Changes in taxable sales by retail industry in 2009-10 ranged from a decline of 11.2 percent for nonstore retailers to a high of a gain of 1.6 percent for gasoline stations. Most retail industries had taxable sales declines in 2009-10. Motor vehicle and parts sales were essentially flat, rising just 0.1 percent. However, growth rates for different types of vehicles within this sector varied greatly. Sales made by used car dealers were up 3.7 percent and new car dealer sales were up 1.1 percent, but other motor vehicle sales were down 18.3 percent. Other vehicles include recreational vehicles, which had large sales declines mostly caused by the recession. The only retail industries with significant increases in taxable sales were those selling items consumers consider to be necessary: health and personal care items, clothing, and gasoline.

Growth in Taxable Sales by Industry in 2009-10



Appendix Table 19 on page A-28 shows details on taxable sales activity and the number of sales tax permittees by business type.

Revenue Growth

Tax programs administered by the BOE produced state and local revenues totaling $50,678,783,000 during fiscal year 2009-10. This was an increase of $2.3 billion, or 4.7 percent, from 2008-09. An overwhelming majority of the revenue gain resulted from a temporary increase in the state General Fund sales and use tax rate.

Revenues from each tax are presented in the text table on page 55. Additional detail and historical comparisons are found in Appendix Table 2, on page A-2.

Sales and Use Taxes

Sales and use taxes contribute 83 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 $42,165,819,000 in 2009-10, an increase of 5.6 percent from 2008-09. The state's portion of the sales tax was $28,834,896,000 (including fees and the fiscal recovery fund). This includes revenues from a temporary increase in the state rate from 5.0% to 6.0% that became effective April 1, 2009.[5] The portion allocated to other jurisdictions—cities, counties and special districts—totaled $13,330,923,000, 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-27.

By the end of the fiscal year, special district taxes were being levied by 113 jurisdictions in 42 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 2009-10, the state's fuel tax revenues totaled $3,168,797,000, a 1.1 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, 9.7 percent and 4.9 percent. Distribution of gasoline for highway use was 14.8 billion gallons, unchanged from fiscal year 2008-09. Historical fuel tax data are presented in Appendix Tables 24-26, beginning on page A-41.

Cigarette and Tobacco Products Taxes. Revenue from excise taxes on cigarettes and other tobacco products totaled $928,007,000 in 2009-10, falling 7.7 percent from the previous year. While such a drop reflects the trend of decreasing cigarette consumption, a major 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.[6] For more information on these taxes, see Appendix Tables 30A and 30B, which begin on page A-53.

Insurance Taxes. Insurance taxes were $1,884,992,000 in 2009-10, a 2.7 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 3.9 percent from 2008-09 levels to total $311,253,000 for the fiscal year. Revenues from beer and wine fell 6.7 percent to $150,171,000. Revenues from distilled spirits declined 1.2 percent to $161,083,000. 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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Under AB x3 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.

6

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 $53,300,000 in 2009-10, a 6.6 percent decrease from the previous year. The natural gas surcharge produced $532,303,000, jumping 18.8 percent. Increases in rates accounted for much of the gain. The emergency telephone users surcharge, which funds the 911 statewide emergency number system, totaled $90,349,000, a decrease of 16.2 percent. Additional detail and historical comparisons are provided in Appendix Tables 34 and 35, beginning on page A-61.

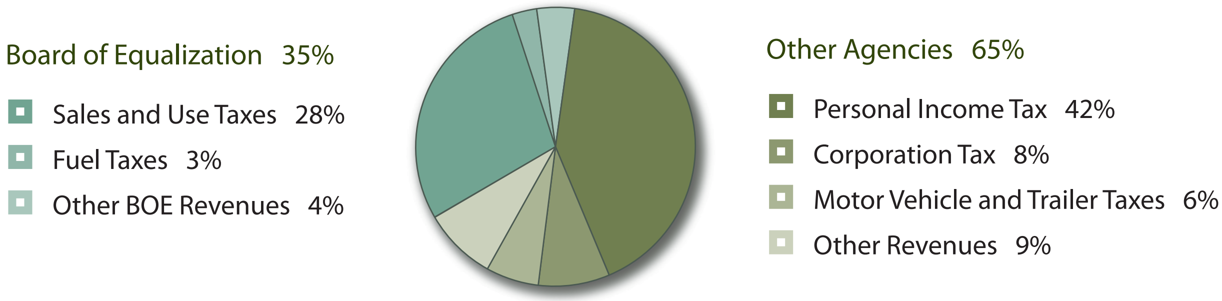
Hazardous substance programs and other environmental fees. Revenues from hazardous substance programs taxes and fees, and other environmental fees totaled $696,453,000, a 22.6 percent increase from 2008-09. Much of the gain resulted from rate increases in underground storage tank fees and electronic waste fees. 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 $838,728,000, an increase of 1.0 percent. The timber yield tax, which is levied when timber is harvested to substitute for an annual value-based property tax, totaled $2,967,000. This was a 56.8 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 $5,816,000, a decrease of 3.8 percent.

Sources of State Revenue, 2009-10

Percentage of Total State Revenue



Revenue Source	Revenue *(in thousands)*	Percent Change from 2008-09	Percentage of Total State Revenue
Board of Equalization			
Major Taxes and Licenses			
Sales and Use Tax	$31,197,154	7.68	28.36
Gasoline and Jet Fuel Tax	2,667,520	0.04	2.43
Diesel and Use Fuel Taxes	496,174	-3.42	0.45
Insurance Gross Premium Tax	2,180,786	6.18	1.98
Cigarette and Tobacco Products Tax	922,986	-7.74	0.84
Alcoholic Beverage Tax	311,242	-3.92	0.28
Totals, Major Taxes and Licenses	37,775,862	6.32	34.34
Totals, Minor Revenues	1,378,221	16.11	1.25
Grand Total	**39,154,083**	**6.64**	**35.60**
Other Agencies			
Major Taxes and Licenses			
Personal Income Tax	$45,646,436	2.91	41.50
Corporation Tax	9,114,589	-4.42	8.29
Motor Vehicle "in lieu" Tax	3,306,561	43.88	3.01
Trailer Coach Fees "in lieu" Tax	41,220	32.79	0.04
Motor Vehicle Registration and Other Fees	3,379,300	4.38	3.07
Estate, Inheritance and Gift Tax	0	—	0
Horse Racing (Parimutuel) License Fees	15,541	-49.44	0.01
Totals, Major Taxes and Licenses	61,503,647	3.39	55.91
Totals, Minor Revenues	9,338,132	-7.59	8.49
Grand Total	**70,841,779**	**1.79**	**64.40**
TOTAL STATE REVENUE	**109,995,862**	**3.47**	**100.00**