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An Economic Backdrop for Fiscal Reform in California

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An Economic Backdrop for Fiscal Reform in California

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Executive Summary

Governor Schwarzenegger has called a special session of the legislature to convene immediately after the election in order to deal with a budget that is coming unwound literally weeks after it was put into place. While the revenue assumptions in the budget were certainly not high from an historical standard, they ignored the fact that California - and the entire nation - are rapidly tipping deeper into the economic downturn that began at the start of the year. The news is grim:

- Labor markets are showing increased signs of stress
- There is little sign of a recovery in housing and foreclosures are getting worse by the day
- Consumer markets have fallen off a cliff
- Corporate profits have been taking a beating

These add up to a downturn in revenues for the state that will take not months, but years, for California to work its way out of. We predict that the state's three major revenue sources - sales taxes, income taxes, and corporate taxes, will fall by over 11 percent over the course of the next two years. It will take an additional two years before revenues climb back above the peak they hit in fiscal year 2007-08. Given that the state is already dealing with a structural gap between its current revenue base and its expenditures implies that we are quite literally on the edge of a fiscal cliff.

Its time for California's leaders to deal with the fact that the state's massive budget problems cannot be fixed with temporary revenues or temporary expenditure cuts. A comprehensive effort needs to be made to find a solution... before we all fall off that cliff.

The Big Picture: It's going to get worse before it gets better

Hope for the best but prepare for the worst is a valuable old adage. While we all hope that tomorrow will

be better than today, we are well-advised to be prepared in the event that things take a turn for the worse. At the moment, California's budget strategy seems to adhere to a slightly different logic, one that might be summed up as: Hope for the best and ignore the obvious. Given the state of the economy today the underlying assumptions on which the state budget hangs are categorically off-mark.

The assumptions used to predict revenue flows for the next few years are based on the idea that this will be a temporary slowing of revenue growth followed by a strong recovery. Unfortunately, this is unlikely to be the case, and as a result the current budget does little more than delay the problem.

This report provides an overview of the current economic situation California is facing by looking at trends in employment, income, consumer spending, and housing. It then forecasts how these economic conditions will affect the states major sources of revenue: income, business, property, and sales taxes.

The economic news, perhaps unsurprisingly, is grim. All indications are that the worst is yet to come. The economy, already battered and bruised by collapsing housing markets, will now face an even tougher test - the pull back in consumer spending as the last vestiges of the phantom wealth created by the credit led real estate bubble disappear. This will be an economic downturn in California on par with that of the early 1990s.

Consequently, the fiscal landscape is equally bleak. The state created a structural budget gap in the late 1990s as permanent spending was ramped up based on a temporary surge in revenue generated from the dot-com boom. When the dot-com bubble collapsed, the budget gap that opened up was never truly fixed. Rather, temporary measures such as pilfering reserves and borrowing cash were used to fill the gap until the next great bubble - this one driven by the housing market and credit boom - fueled a second wave of temporary tax revenues. With the unwinding

of the housing bubble the structural gap will reemerge and this time triage won't work – we need to head straight into surgery.

From Credit Crisis to Recession

The credit crisis that began this past August has captured headlines and caused a dramatic shift in the attitudes of policymakers and economists who previously had been bullish on the economy and denied the possibility of a recession. Now the conversation has shifted: Find a solution to the financial crisis before Wall Street drags Main Street down with it. While stabilizing the banking sector is an important step towards ultimate recovery, the causality has been completely reversed. The state of California is not threatened with recession because of what's happening on Wall Street. Indeed, the state has been in a recession for a number of quarters, and this is what is putting the pressure on Wall Street.

To paraphrase Tolstoy, all expansions look alike, but each recession is painful in its own way. This downturn has had a very slow start due to the fact that the various components of spending – housing, consumer spending, business spending, and the external accounts – have not been cycling together as they normally do. The initial weakness in the state was due primarily to problems in the housing market and slowing of residential construction. The rest of the economy continued forward.

More recently, however, the situation has shifted. The problems that began in housing have spread to the rest of the economy. Mortgage problems have led to a broader financial crisis. The drop in net wealth due to declining home prices and the battering financial markets have taken are now taking a toll on consumer spending. Corporate profits are suffering and business spending is starting to move into freefall. The last bastion of strength in the economy – the external accounts – will start to take a turn for the worse as the

U.S. dollar has surged in recent weeks to levels not seen since 2006. In short, the U.S. and California are moving from a housing recession into a full blown recession.

Employment and Incomes

It is indeed a unique recession. Consider the most basic indicator of an economic downturn – the unemployment rate. Typically this is considered to be a concurrent indicator – that is to say it starts to rise around when the economy is starting to suffer, and only declines again after the downturn has ended and the economy is moving forward again. For example unemployment in California started rising in May of 1981 and the recession 'officially' started in July, two months later. During this recession however, the unemployment rate started rising way back in 2006 and is now 2.9 percentage points above the trough. This is worse than the trough-to-peak increase during the 1980 and 2001 recessions, and rapidly approaching that seen in the 1981 recession when it increased by a total of four percentage points. That there was little discussion about what was happening in the labor markets is owed to the fact that one, GDP was still growing; two, the state was still adding payroll jobs albeit at a slowing pace; and three, the pace of increase was (initially) unusually slow, a situation that changed early this year when the increase started to accelerate. Still, many forecasters in the state continued to preach that there would be no recession despite the fact that it looked as if we were already in one.

This September was actually the first month for some time in which unemployment did not increase by a substantial amount – only one-tenth of one percent. Unfortunately this respite will be short lived. A leading indicator of the unemployment rate is initial claims for unemployment insurance. Claims have risen from a seasonally adjusted weekly average of 50,000 in May, to 61,500 in August, to 63,500 in the first two weeks of October. And these do not include

those layoffs that have been announced but not yet enacted by a number of important employers in the state as corporate profits have swooned. We forecast that unemployment in California will rise to close to 10 percent, for a total increase of 5 percentage points, greater than during the 1990 downturn.

California Unemployment Rate (%)

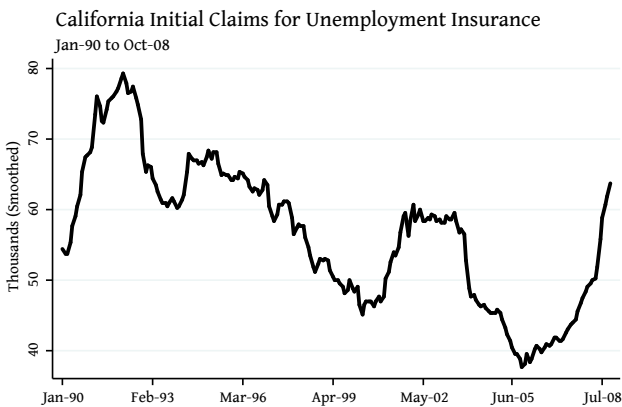
Trough		Peak		Change
Dec-79	6.17	Sep-80	7.23	1.07
Jul-81	7.03	Dec-82	10.97	3.93
Jul-90	5.13	Nov-92	9.87	4.73
Mar-01	4.73	May-02	6.73	2.00
NA		Sep-08*	7.70	2.87

*Current Estimate by Beacon Economics

Source: California Employment Development Department (EDD)



Source: California Employment Development Department

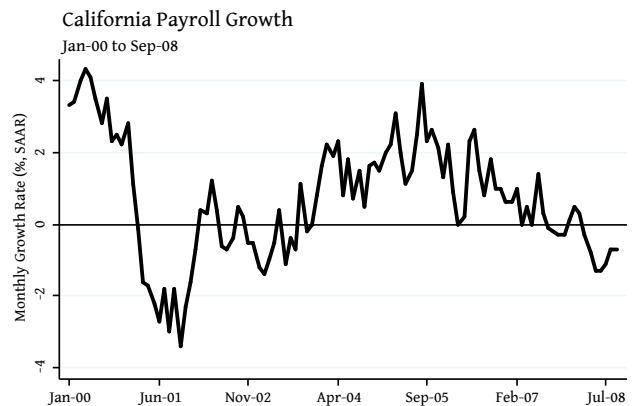


Source: California Employment Development Department

The payroll side looks less dire—at least at the moment. Overall, non-farm jobs have been shrinking by a one percent (annualized) pace for most of the year. But we can take little solace in this. There is a known bias in the payroll numbers that causes them to over-

estimate job growth as the economy slides into a recession, and underestimate them after the economy starts to recover. This bias is corrected when the new benchmark is put into place at the start of the year. We can expect a substantial downward revision in the employment data in a few months — making 2008 look much worse than the current estimates.

Despite this problem we can still look at the pattern of job changes across sectors to get a sense of how the recession is spreading. Job growth averaged 256,000 in 2004 and 2005 with solid growth in almost every sector. There was a marked slowing in job growth in 2006 and 2007 as a result of the slowing housing markets — the pace fell to a paltry 116,000 jobs per year, less than half the rate of the previous two years. Construction went from adding 56,000 jobs per year to losing 50,000 jobs. Durable good manufacturing also saw an increase in their ongoing job losses, finance and real estate tipped into negative territory, and retail experienced substantive slowing. Other sectors of the economy maintained their strength. It is worth noting that despite ample evidence of a slowing economy state and local government went on a hiring spree, adding close to 100,000 new employees to the rolls up from 32,000 in the previous two years.



Source: California Employment Development Department

Annualized Changes in Employment by Sector

Sector	04-05	06-07	08
Non-Farm	256.8	116.3	-125.7
Construction	56.3	-47.8	-61.0
Durables	-4.8	-20.0	-23.6
Non-Durables	-8.7	-7.9	-7.1
Wholesale	20.9	16.0	-5.9
Transport	6.4	8.8	-0.4
Retail	33.3	8.7	-27.9
Information	-9.5	-7.6	24.5
Finance	15.8	-23.0	-25.2
Real Estate	7.9	-2.9	-6.5
Professional	49.0	40.0	13.4
Mgmt of Enter.	-8.1	-3.3	-6.3
Administrative	25.7	15.1	-40.8
Education / Health	23.1	45.9	42.9
Leisure	35.3	36.1	-6.7
Other	-0.6	7.7	-6.1
Federal Govt	-2.8	-0.4	0.7
State Govt	-1.4	14.3	-3.8
Local Govt	18.5	35.8	10.1

Source: California Employment Development Department (EDD)

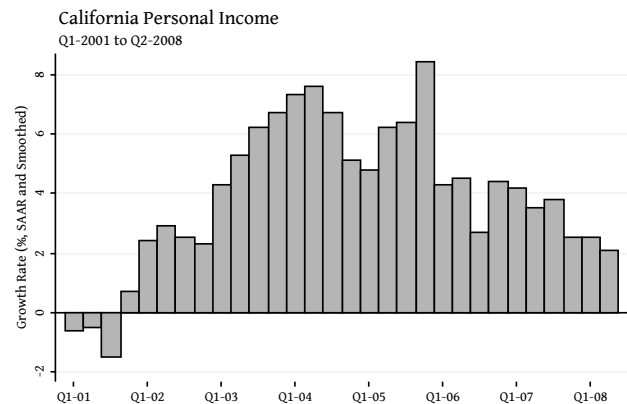
In 2008 the situation has shifted to an annualized loss of 125,000 per year, although again this will likely be revised for the worse in January. The weakness in the economy has spread to most every sector with the exception of Education and Health. The only sector of the economy doing well is information as the drop in the dollar has pulled movie production back into the state and the successful conclusion of the writer's strike has put projects back into the pipeline.

State Income

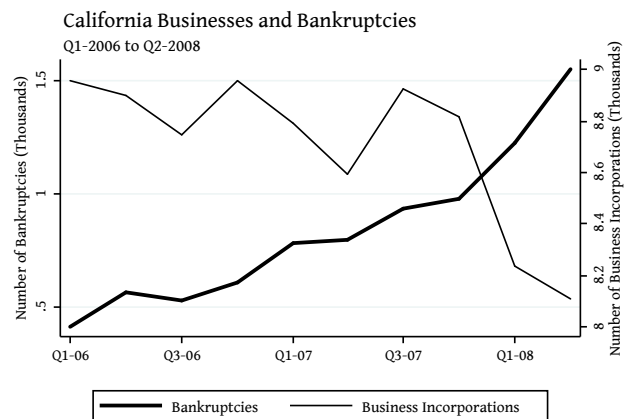
Not surprisingly, by current estimates income growth has been slowing in the state. Although overall income grew by a strong six percent in the second quarter, driven in large part by the arrival of the federal rebate checks that many families received, wage and salary growth was roughly two percent (smoothed), down from the already weak pace of growth seen in 2007.

There are three key issues to bear in mind when evaluating these personal income numbers and thinking about where they will head. First, current income is based on estimates derived from tax withholdings and quarterly payments from private business. These estimates will change over time, and potentially for the

worse. Second, the current turmoil and the decline in the equity markets in the third quarter will have substantial implications for income tax receipts. Capital losses will be written off on gross income — a process that had substantial implications for the budget in 2001 and 2002. Finally we have to remember that layoffs are starting to pick up pace — implying that more people will be losing their jobs and their incomes in the coming months. We predict that incomes will continue to shrink for some time.



Source: Bureau of Economic Analysis



Source: U.S. Bankruptcy Courts, California DOF

We are also starting to see signs of weakness on the business side of the economy. Business incorporations have fallen from 9000 to 8000 per year. Moreover, business bankruptcies surged to over 1500 in the second quarter, up from 500 per quarter in 2006. While the third quarter numbers are not yet in, national statistics show total taxes on corporate profits falling

10 percent from the third quarter of 2007 to the second quarter of this year. The third quarter is likely to be worse, but the fourth quarter will see a dramatic decline as the equity losses filter through the system. In short, business taxes are unlikely to make up for losses in personal income taxes.

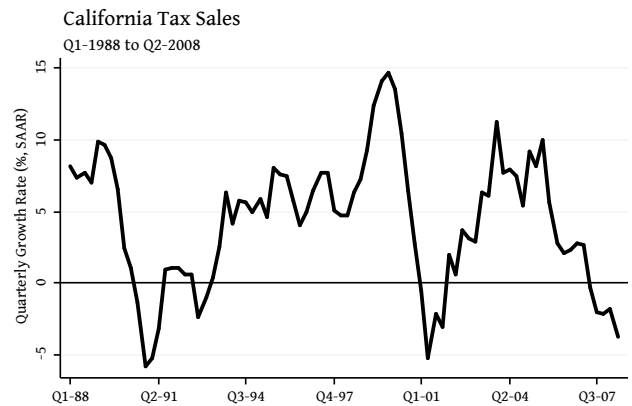
Consumer Spending

State and local governments in California rely heavily on sales taxes as a portion of their revenue base. Indeed, one of the current discussions is a ‘temporary’ increase in the state rate in order to help deal with the current budget gap. Unfortunately such an effort is not likely to accomplish much in terms of increasing revenues. As noted above, the last shoe to drop in this recession is the pullback of consumer spending. With home equity rapidly disappearing and consumers holding record levels of debt, households have had to pull back on their discretionary spending.

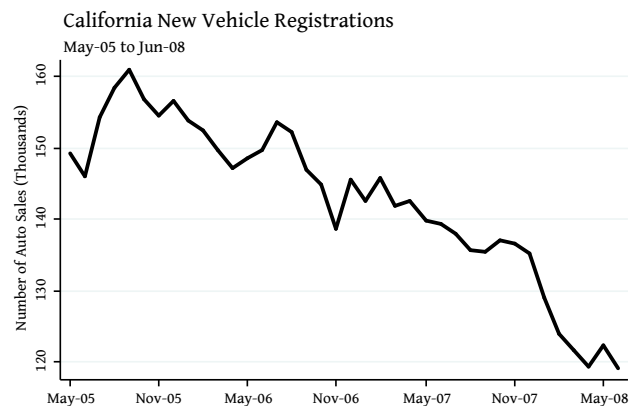
Taxable sales had been growing at a substantial ten percent pace between 2003 and 2005, along with a strong increase in overall home values. This is an unusually high pace, as they typically increase at roughly the same rate as income growth, and indicative of the home equity effect on spending. But as sales and home prices started to decline through 2006, taxable sales growth also cooled, falling from its previously lofty level down to the two percent range before finally tipping into negative territory in 2007. The latest reading is the worst: Current estimates show sales falling at nearly a four percent annualized pace in the second quarter of the year. Similarly, new vehicle registrations fell from 160,000 in 2005 to 140,000 in 2007 to 120,000 in the first half of this year.

The big question is where we head from here. While we don’t have third quarter numbers yet, they promise to be much worse. The second quarter was when the federal rebate checks reached consumers. And despite the cash infusion, on a national basis consumer spend-

ing growth was a mediocre 1.2 percent. Third quarter numbers for national consumer spending recently arrived with the third quarter GDP figure and they show spending falling by three percent in annualized terms, one of the sharpest consumer pull backs seen in decades. Auto sales also plummeted in the third quarter from the second quarter. In short, the trends are strongly negative at the national level and those trends will likely look worse here in California since we were ground zero in the housing bubble.



Source: California Board of Equalization



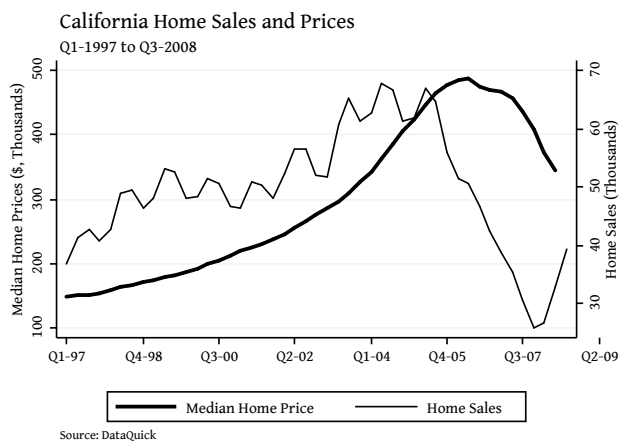
Source: California Department of Finance

Housing Markets

Finally, there is the housing market. While the problems in the economy started here, we now know that housing is not the sole problem. Rather it was the canary in the credit coalmine. The general asset bub-

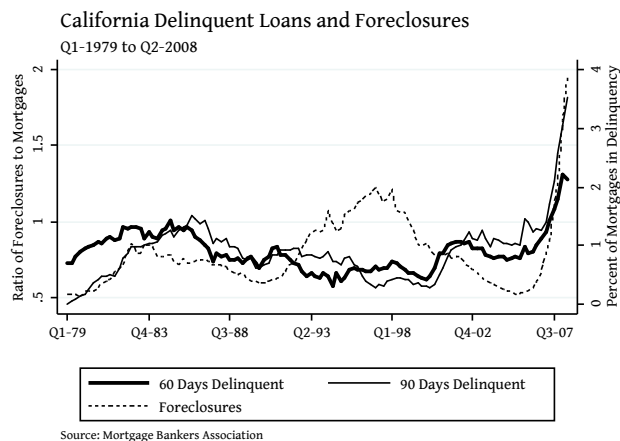
ble that is in the process of unwinding began with housing but has spread across the financial system's many parts. Corporate debt and other personal debt are all showing the same type of stress — rising delinquencies and heightened write-offs by banks. Even as home prices have been falling at a record pace, so too have the equity markets turned. The major indexes are down 35 to 45 percent from the start of the year. Given this, it's worth looking at the housing market to see if recovery is starting to occur — as this may also predict that the broader measures may be getting close to the bottom.

One recent sign that may seem encouraging has come from the sales markets. According to Dataquick, home sales in Southern California were up 65 percent in September from last year at this time. In the Bay Area sales were up by 45 percent. Sales activity is a strong leading indicator of the direction of the market under normal circumstances — possibly implying that prices will begin to firm up.



Unfortunately this sign of recovery is largely a red herring. Sales in the state are being driven more by foreclosures than true strength in the market. And this isn't much of a surprise — according to data from Realtytrac, approximately 3.5 percent of all housing units in the state, around 400,000 units, are currently in the foreclosure process or already REO (owned by the foreclosing bank). With such a heavy stock banks

are needing to rid themselves of inventory and prices are actually falling with the sales of these units rather than firming up as is typically seen when sales activity ticks up. Indeed, well over half of all sales in the state at the moment are foreclosed property and another quarter is distressed sales.



More importantly, while an increase in sales will eventually help by drawing down the existing inventory of foreclosed units, it will have to increase much more in order to make real headway against the still rising tide of foreclosures. Of all current outstanding mortgages in the state 3.2 percent are 60 to 90 days behind on payments according to figures from the Mortgage Banker Association. Short of some radical change in federal policy, most of these will end up in foreclosure at some point in the next six months. The state passed a rule delaying the actual serving of papers — but this only pushed the problem out two months.

Building permits also point to continuing problems as they continue to fall in the state. Indeed, they are down 50 percent in the third quarter compared to the third quarter of last year.

There are also long run problems that have yet to be addressed. Quite a few recent homebuyers used exotic mortgages that have low initial payments. Many of these products do not reset (jump to a higher payment base) until 2010 and 2011. Most of these properties will likely go into foreclosure when this reset occurs,

since the payments will reflect some of the outrageous prices that were being paid for homes at the peak of the bubble. Even if foreclosure rates have peaked, they will remain substantially higher than their long run average and will continue to put downward pressure on prices.

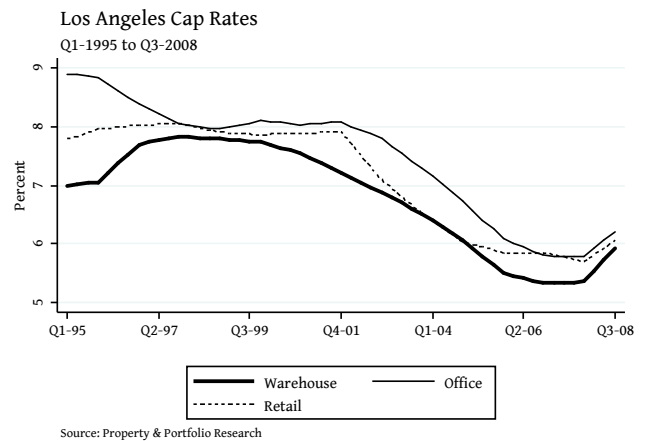


What this implies is that home prices will continue to fall for some time. The central problem with the housing market has always been prices. While the policy debate has centered on the terms of these mortgages, the problem was the amount being paid rather than the structure of the debt. Prices nearly tripled between 1999 and 2007 before they started to fall. A reasonable estimate is that home prices in the state will have to fall 40 to 45 percent to fall back in line with income levels. We also have to account for the fact that prices tend to overshoot on the way down due to the overall weakness of the economy. With this in mind prices will likely drop 50 to 60 percent by the time things bottom out. The good news is that prices have already fallen over 30 percent from their peak. But bear in mind that there will be no rapid recovery. Home prices, once they find bottom tend to stay there.

There is yet another land crisis unfolding. The bubble was not just in residential real estate, but also in commercial real estate. There the problem was in falling cap rates — the relationship between the prices paid for the buildings and their revenue streams. The same

issue — too much credit driving wild speculation — is now unwinding. Cap rates are rising as a result, even as rents are starting to succumb to the economic pressures and are starting to fall. Commercial property prices — which also add significantly to California’s property tax base — will likely fall 30 to 35 percent before this portion of the cycle is ended.

The net result will be a big impact on property taxes. This year’s property tax roll may have escaped the worst of the downturn. Next year’s will not.



Capitalization Rates (%)

Region	Apartment		Office		Retail		Warehouse	
	2007Q3	2008Q3	2007Q3	2008Q3	2007Q3	2008Q3	2007Q3	2008Q3
East Bay	5.12	5.78	6.81	7.23	5.79	6.30	6.07	6.48
Inland Empire	5.12	6.00	6.67	7.06	6.06	7.15	5.25	5.99
Los Angeles	4.96	5.46	5.78	6.20	5.73	6.05	5.34	5.92
Orange County	5.08	5.74	6.07	6.63	5.82	6.16	5.46	6.21
Sacramento	5.84	6.35	7.03	7.51	6.49	7.01	7.05	7.55
San Diego	4.89	5.82	6.20	6.55	5.58	6.04	5.62	6.14
San Francisco	5.03	5.35	5.74	6.22	5.71	6.02	6.08	6.33
San Jose	5.05	5.47	6.64	7.02	5.88	6.32	6.01	6.51

Source: Property and Portfolio Research (PPR)

Revenue Crunch A Comin'...

Given all the dire economic news that has come to light in recent weeks, it should be of little surprise that the state budget is already in a precarious position just a few months into the start of the fiscal year. The Department of Finance’s monthly bulletin (an abbreviated version of which is shown in the table below) for September shows that revenues are already coming in

well below expectation, with actual receipts at 4.7 percent below the official forecast. September alone came in at almost nine percent below expectations. Corporate tax revenues were off by the largest proportion, coming in at 19 percent below expectations. Sales and use taxes were off by the most in absolute terms – half of a billion below expectations.

2008-09 Comparison of Actual and Forecast Agency General Fund Revenue

Revenue Source (\$ in millions)	Sep-09			2008-09 Year-to-Date		
	Forecast	Actual	% Diff	Forecast	Actual	% Diff
Personal Income	5,836	5,547	-5.0	11,491	11,393	-0.9
Sales & Use	2,249	2,037	-9.4	6,827	6,312	-7.5
Corporation	2,238	1,812	-19.0	2,659	2,231	-16.1
Total	10,667	9,744	-8.7	22,580	21,520	-4.7

Source: California Department of Finance, Monthly Financial Bulletin

State Revenue Forecast

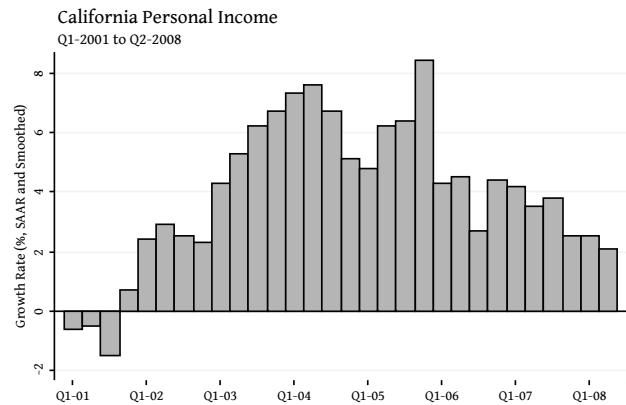
	Total	Corporate	Income	Retail
2006-07	3.10%	8.20%	4.10%	-0.50%
2007-08	2.70%	6.90%	4.60%	-2.30%
2008-09 Forecast	2.80%	9.60%	2.50%	1.10%
Average	6.40%	5.10%	8.50%	5.10%

Forecast by Beacon Economics

The state did not use highly optimistic estimates in its forecast. Overall they predicted that revenues would rise by 2.8 percent in the current fiscal year, equal to last year’s growth rate and well below the 6.4 percent the state has averaged over the past 20 years. This average was largely driven by corporate taxes and retail, which picked up the slack created elsewhere. Given that these two are off the farthest from what was forecast, there is little wonder that a revenue shortage is on the way and that the Governor has ordered a special session of the state legislature to convene after the election.

So what can California expect over the next two years? To determine this we have developed a forecast of the three major state revenue sources – sales and use taxes, income taxes, and corporate taxes. The forecast is based upon Beacon Economics’ forecast for California. This forecast calls for unemployment in the state to rise to 10 percent by the end of 2009 as a result of a severe consumer led recession in the United States as a whole – a downturn on par with what was experienced in the mid 1970s or early 1980s. This forecast may have seemed overly bearish one year ago, but as

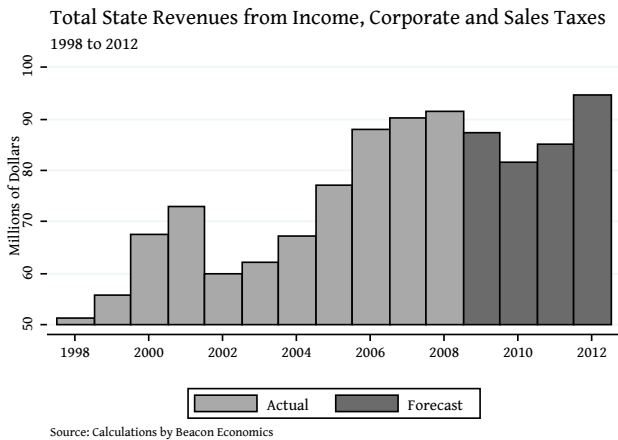
the recent data show it looks to be well in line with the current direction of the economy.



Source: Bureau of Economic Analysis

The results are indeed grim. We predict that total revenues received from the state’s three major sources this fiscal year will decline by a difficult 4.4 percent, with declines in revenues from sales and corporate taxes offset by a milder decline in income taxes. This is due to the lagging nature of income taxes. So beware: As even larger decline will strike in the next fiscal year (2009-10) when incomes will be jolted severely downward. Overall, we expect the total revenue from these three sources to drop to just over \$80 billion. Recovery will not occur until 2012 when revenues will surge to above the peak hit in 2007-08 fiscal year. The implications of this forecast are clear. The current short-term measures being used to close the budget gap are lining up to make the problem next year worse.

If this outlook seems improbable, keep in mind that there is precedent. The income flows to the state from these three sources declined by 18 percent from fiscal year 2000-01 to 2001-02 and did not recover again until 2005. Proportionally speaking, our forecast is mild given that we predict a much worse overall recession than what occurred in the early 2000s.



The system needs to be fixed. This includes mending the budget process, stabilizing revenue sources, lengthening the time horizon the state plans for, and addressing the system under which crises, which inevitably happen, are handled. One theory of long run change is that the best opportunity to overhaul a system is during a time of crisis when bureaucratic forces that might stifle change are reduced. This is certainly a time of crisis. We just have to make very sure that the change we enact is the right change.

California can continue to expect these dramatic swings in revenues largely because of its reliance on a tax base that is very cyclical. Consider income taxes, which are highly progressive. Incomes at the top end of the earnings scale fluctuate dramatically between good times and bad – and hence, the state suffers the same fate in terms of what it collects in income taxes. Similarly, sales taxes in California are limited to goods – and big-ticket items such as autos and furniture are highly cyclical, a volatility that is again passed on to the state. These extreme ups and downs will continue until the state’s revenue base is widened to include less cyclical portions of the economy.

Of course the fiscal problem has less to do with cyclical revenues than it does with cyclical expenditures. The state’s elected officials find it politically easy to spend every bit of cash that is available to them, but much harder to cut back when that cash disappears. The whipsaw effect of this has many critical implications for the state’s long-term prosperity. The boom-bust nature of spending in California tends to penalize one-time expenditures that can be put off (such as investing in roads and bridges); it ruins the state’s credit rating; it hurts California’s educational system by building instability into public education’s revenue streams; and in the long run it makes the state more reliant on debt to pay its bills, passing the strain on to the next generation.

Introducing Beacon Economics

Beacon Economics is a research and consulting firm specializing in analyses of real estate markets, local economic development, public and private policy issues. Beacon Economics organizes economic outlook conferences and advises city governments, financial institutions, real estate firms, and other businesses. We are available for public speaking and litigation support.

With offices in both Northern and Southern California, we are well positioned to cover local and regional markets throughout the western United States.

What is Beacon Economics?

- Regional Economic Forecasting
- Public Speaking
- Contract Research
- Litigation Support

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Jon Havenman is a founding partner of Beacon Economics. Dr. Havenman is an expert in goods movement, international trade policy, and labor issues. Prior to launching Beacon, he was the Director of the Economy Program at the Public Policy Institute of California. He received his Ph.D and M.S. in Economics from The University of Michigan, 1992. he has been a senior economist with the President's Council of Economic Advisors, a has held a faculty position in the business school at Purdue University.

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