



Economic Growth Diminishes the Prospect for a Long-term Budget Fix

First the good news. Economic growth continues in California. Not only that, the state is outperforming the rest of the nation in job growth. The housing market is less frothy, but looks like it is headed for a soft landing. The loud pop of a residential bubble bursting—anticipated by many analysts—has so far been absent.

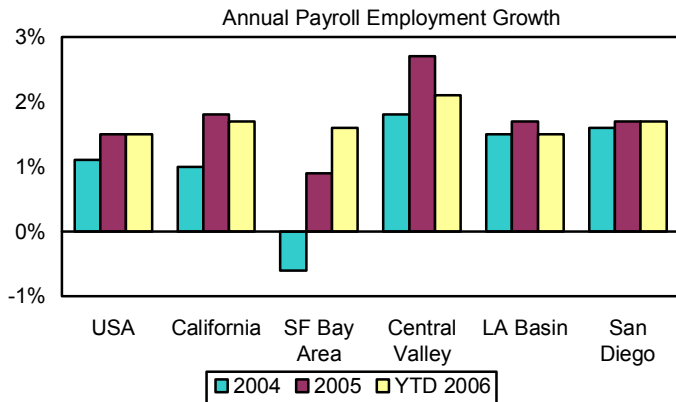
A healthy economy has substantially improved the financial conditions of the state government. Its 2005-2006 fiscal year ended on June 30 with a \$2.8 billion General Fund surplus. Even though this year's surplus was smaller than the \$5.9 billion reported during the fiscal year 2004-2005, it was the second consecutive annual surplus.

That's also good news, right? Well, maybe. Because, as economic growth has greatly increased the state's revenues, an opportunity to undertake serious financial reform might have been lost.

Growth continues across the state.

Before delving into the budget issue, let's examine what has been happening with the state's economy. The latest employment report paints a rather optimistic picture. California's seasonally adjusted unemployment rate was 4.9% in June. That rate was one of the lowest we've seen since 2001.

The state gained 11,000 payroll jobs in June, bringing the total net gain during the first half of this year to 56,300. That number translates to an average monthly gain of 9,400 jobs.



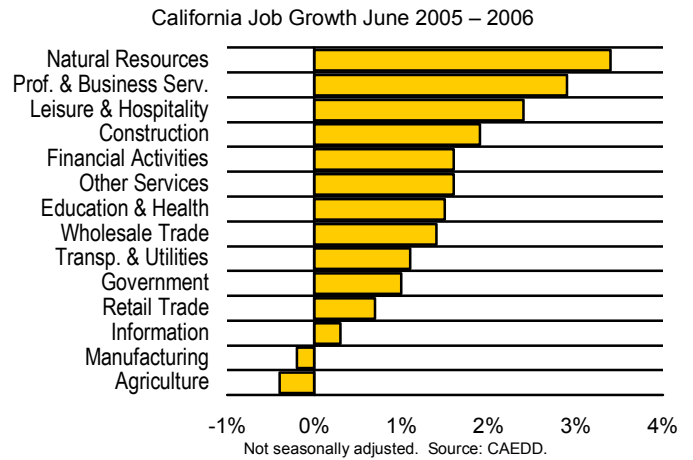
Not seasonally adjusted. The YTD 2006 data are for the first 6 months of the year, compared with the same period in 2005. Source: California Employment Development Dept. (CAEDD)

As the chart above shows, the rate of job growth during the first half of this year was similar to that of 2005 for both the United States and California. The national growth rate was 1.6%, identical with the 2005 annual growth rate. California enjoyed stronger growth than the national average at 1.7%

during the first six months of this year. This figure is slightly lower than the 1.8% growth registered in 2005.

The San Francisco Bay Area has gained momentum in recent months. Its January-to-June job growth was 1.6%, much higher than the 0.9% last year and almost on par with the state average. The Central Valley remains the fastest growing region in the state, but its growth moderated to 2.1%, from 2.7% in 2005.

In Southern California, the five-county Los Angeles Basin and San Diego County both enjoyed growth rates similar to or the same as last year's 1.7%. Within the region, a slowdown was most noticeable in the Inland Empire, where job growth was solid at 2.5% during the first half of 2006, but much lower than the 5.5% and 4.9% recorded in 2004 and 2005.



Job growth has been particularly strong in professional and business services (+2.9%) and leisure and hospitality (+2.4%). Construction employment expanded 6% in 2005, but its year-over-year growth slowed to 1.9% in June, reflecting a less active housing market. (See the above chart.)

On a numerical basis, professional and business services added the largest number of jobs with a gain of 61,500 jobs, followed by the leisure and hospitality segment (which includes food services) with 35,700 new jobs. Natural resource and mining was the fastest growing industry category (+3.4%) percentage-wise, but added only 800 jobs over the past twelve months.

Economic recovery improved the state's finances.

California depends very heavily on corporate and personal income taxes for its revenues. They account for 65% of the state's cash receipts. Sales and use taxes contribute about

30%, and other miscellaneous items, such as Insurance Companies Tax, account for the rest. (Property taxes do not appear in the state's General Fund statements, because they are levied and collected by counties.)

In the 2005–2006 fiscal year, personal income tax revenues increased by \$7.4 billion or 17.6%, compared with the 2004–2005 fiscal year. This large increase is due to the aforementioned employment growth, as well as capital gains from the stock market and property sales. Corporate tax revenues dropped by \$2.1 billion or 16.5%, but last year's receipt was inflated because of a one-time tax amnesty.

The sizable surpluses of the past two years present a stark contrast with the massive deficit the state was saddled with when Governor Schwarzenegger took office. Does this mean that the budget problem has been fixed?

Revenues may drop, but spending is expected to rise.

Because the state derives so much of its revenues from income taxes, its cash receipts can vary significantly from year to year, depending on economic conditions. A booming economy has boosted revenues in recent years, but an economic downturn can quickly reverse the trend. Income from capital gains is especially vulnerable to adverse economic conditions. Remember what happened in 2001 when the stock market tumbled and sharply reduced the state's revenues.

Disbursements, on the other hand, tend to be more constant. The state's main outlays are education, public health, social programs, correction and judicial systems. The cost of these items does not fluctuate much from one year to the next, though population growth steadily exerts upward pressure. Therefore, California has to perform a nearly impossible task of balancing volatile revenue streams with stable (but gradually rising) expenditures. This is the main structural problem with the state's budget.

In addition, the 2005–2006 General Fund statement shows that, excluding transfers among fund categories and other accounting tricks, revenues increased by 9.2%, while spending rose by 10.7%. In short, outlays kept on growing faster than revenues.

The governor signed the 2006–2007 budget into law on June 30. This \$131-billion budget assumes that a strong economy will again deliver a big increase in revenues to cover all the spending. But high costs of energy and the Fed's rate hikes are expected to cool the economy of the state and the nation. We cannot count on another windfall with any certainty. Further, the next recession (which, unfortunately, *will* come eventually) is likely to put the state in the same predicament it found itself in a few years ago.

The budget crisis in 2001 created an opportunity to overhaul the state's finances and build something more workable. Instead, the state muddled through the crisis by borrowing and also by moving the money around between programs (another form of borrowing), because it was politically more palatable. Now that deficits have disappeared, there is even less incentive for the governor and the state legislature to fix those fundamental shortcomings of the system.

This is troubling, because, in order to stay competitive in coming decades, California must improve its woefully deficient transportation system, troubled public schools, and unreliable power supply. The state also must ensure future availability of water, affordable housing, open space and parks. I don't know how California can do all that, while it hobbles from one financial crisis to the next.

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Economic Forecast – August 2006

UNITED STATES	2004	2005	2006	2007
Real GDP Growth (%)	3.9	3.2	3.5	3.0
Unemployment Rate (%)	5.5	5.1	4.6	4.6
Nonfarm Employment Growth (%)	1.1	1.5	1.4	1.0
Consumer Prices Change (%)	2.7	3.4	3.4	2.2
Federal Funds Rate (%)	1.3	3.2	5.0	5.2
CALIFORNIA				
Real GSP Growth (%)	5.2	4.4	4.4	3.3
Nonfarm Employment Growth (%)	1.0	1.8	1.4	0.9
Personal Income Growth (%)	6.6	6.0	6.0	5.5

Bold: Actual. GSP stands for Gross State Product.

The information in this report is based on data available as of August 1, 2006, and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied on as a sole source of information and opinion.