

Danger of Guaranteeing California Debt

In the next two months, the State of California is looking to sell \$15 billion in Tax & Revenue Anticipation Notes (TRANS) in the public marketplace. The recent multiple downgrades of the State's credit rating and declining economic fundamentals, the State fears there may be no appetite to purchase new California debt. The stated purpose of this financing is to bridge the cash flow needs of the State beyond July 2009. To enhance the offering's credit worthiness, the State is asking the US Congress to take the unprecedented step of backing the sovereign debt of the State of California with the Full Faith & Credit of the United States.

External Economic Environment

The United States is in the midst of a severe recession, which began in the 4th quarter of 2006 and is expected to run through the end of 2009. From peak to trough, the net contraction will amount to approximately 3% of GDP. The sectors of the economy most severely impacted by the recession continue to be real estate and finance. Considering California was at the National forefront of both sectors for the last decade, it is logical that the current contraction will have a disproportionately negative impact on the State.

The large monetary and fiscal intervention by the US Federal Government has cushioned the initial shock of the contraction and created a favorable basis for a moderate recovery of GDP next year. Nonetheless, it will probably be at least another 5 years for the real estate and financial sector to become positive generators of growth. Absent any structural change to the California economy, the State should anticipate a slower recovery than the US in general.

Internal Economic Environment

For 35 years California has led the United States in GDP growth, job creation and standard of living. During these golden years, the State taxed, borrowed and spent itself into an increasingly uncompetitive economic position. Today California has highest tax rates, second highest unemployment rate, highest total unemployed, lowest credit rating, highest fiscal deficit and least attractive business environment.

Although California leads the nation in net migration out of the State, it continues to enact new anti-business laws and environmental mandates. The increasingly negative business climate and punitive consumer tax structure contributes to the State's increasing deficits. Because the State has historically been able to borrow its way out cash flow shortfalls, there has been no pressure to change this broken model.

Proposition 13

The State of California has historically relied on real property and income taxes to fund its operations. In 1978, a taxpayer revolt resulted in the passage of Proposition 13, which limited the increase on assessed valuations of existing properties to 2% annually. Consequently, the State increasingly relied on income tax, especially capital gains taxes, to fund budget growth.

The broad decline in real estate prices from 1990-97 predictably resulted in a significant drop in revenue for California. One of the biggest victims of the recession was the County of Orange. The County maintained its spending levels, even as revenue contracted, by increasing its reliance on speculative short-term investment earnings. Although the investments helped cover costs in the short run, the scheme ultimately proved to be a disaster and the County was forced into bankruptcy. When the County's efforts to raise sales taxes were rebuffed by voters, operations were restructured to be more efficient. In spite of a 20% revenue reduction, services continued largely uninterrupted and at a level which met all legal requirements.

Capital Gains from Stocks and Real Estate

From 1997-2001 Silicon Valley was the center of the universe. Capital gains taxes, a byproduct of soaring internet stock prices, filled California's coffers. The newly created wealth resulted in higher consumer spending, increased auto sales and record revenues for California. It also fueled a dramatic expansion of government programs.

When revenues fell off a cliff in fiscal year 2001-2002, the Governor and California Legislature sought to enact new taxes to fill the budget short fall. Working together, they increased the marginal tax rates on high-income earners and tripled the vehicle license fee (VLF) for all car owners. The combination of progressive and regressive taxes, were wildly unpopular and led to another taxpayer revolt. The Governor was recalled, the VLF tax was rescinded and legislation was passed that permitted \$10 billion of long term borrowing to plug a current year deficit.

For the next 5 years, consumer spending and car sales accelerated, while real estate capital gains exploded. The spike in tax revenue allowed the State Legislature to increase spending at twice the compounded growth of the State GDP.

Capital Gains End

Spurring the growth of the California budget was the State's phenomenally large capital gains tax base. The top one percent of earners generates 40% of the states revenues; 250,000 people have been doing the heavy lifting for a state with a population around 32 million. From 1994 to 2007, this top-heavy tax system flourished as virtually every class of investment vehicle, including growth stocks, residential real estate, commercial real estate, commodities, art, collectibles, oil, gold and US Government bonds participated in a bull market. During this period of economic expansion, the state was collecting roughly \$25 billion in capital gains driven taxes.

Since the middle of 2008, most market prices have declined precipitously. The losses associated with all investments have created tax-loss carry forwards that will offset about 80% of any capital gains tax liabilities for the next 5 years.

Tax and Spend

In late 2008 the California State Controller's and Treasurer's offices began warning that there was going to be a serious decline in revenues, due to the worsening economy. The Legislature responded to this grim outlook by increasing regressive State taxes, expanding State employee head-count and passing new business restrictions. In order for the Legislature's budgetary house of cards to stand, voters must approve a series of new taxes when they go to the polls May 19. The Legislature's tax, borrow and spend initiatives will fail, according to all recent polling data.

State Revenue Cash Flow

The State of California's cash flow balances rise and fall on an cyclical basis annually. Consumer sales and new model car sales generate very large sales tax and VLF revenue at the end of the calendar year. Tax revenues are paid to schools and other beneficiaries in January and reserves thus hit a low point in February.

Income and property tax collections begin in March and the State's reserves hit their annual high point in April. Reserves then decrease each month until they hit their annual low point in September. To smooth cash flow availability, the State is permitted by Federal Law to sell of TRANS maturities up to 210 days or until sufficient revenue is collected to match spending activity. If the State does not have the resources to pay beneficiaries of State spending on a timely basis, the Legislature may delay the distribution of apportionments.

Warrants and RAWs

If the State is unable to borrow money to meet their obligations, the State Controller can issue unsecured warrants to vendors. The State can also sell Registered Anticipation Warrants (RAWs), which are promises to pay on a daily priority basis as cash flow is available. It is a felony for the State Controller to fail to pay RAWs or warrants as cash becomes available. RAWs would be extraordinarily attractive to investors, because their criminal protection against the non-payment, default is not an option.

The RAWs that were issued in the last 30 years were met with strong ratings and exceptionally strong investor demand in the past. The State has tried to avoid issuing RAWs in the past, because RAWs require fiscal discipline; as revenue is collected cash must be immediately paid out to creditors.

Moody's and S&P have both assigned an A rating to State of California. Given that TRANS are sold to money market funds that require a minimum rating of AA, there currently is no market for California TRANS.

Orange County Treasurer Bridge Loan to Schools

Starting in August of 2008, the Orange County Treasurer's Office recognized the State was going to have a cash flow challenge in February 2009. Some California K-14 schools, with insufficient reserves, were at risk of not being able to meet their obligations as they came due. Considering all California school districts offer each teacher an individual employment contract by March 15 for the following Fiscal Year through June 30th, some schools would have to shorten the school year or renegotiate every individual teacher's contract (impractical).

Working in concert with the other County Treasurers, Orange County was able to structure a \$3.5 billion Bridge Loan, to be secured with School Warrants. This likely would have been enough cash for most California schools to complete their full school year, in the absence of a State budget.

Compromise Tax Increase

In late February 2009, the California State Legislature signed a "compromise" State Budget that substantially increased taxes, and placed tax and borrowing measures on the May 19th ballot. Although the State is required to annually pass a balanced budget with a \$2 billion reserve, most State financial officers estimate the budget will be \$10 billion in the red, even if all the initiatives passed. Furthermore, the current budget is curiously assumes that property taxes will increase 5%, while most County Treasurers forecast their collections to be flat or negative this year and down an additional 5% next year. The California Legislative Analyst March 2009 forecast is enclosed.

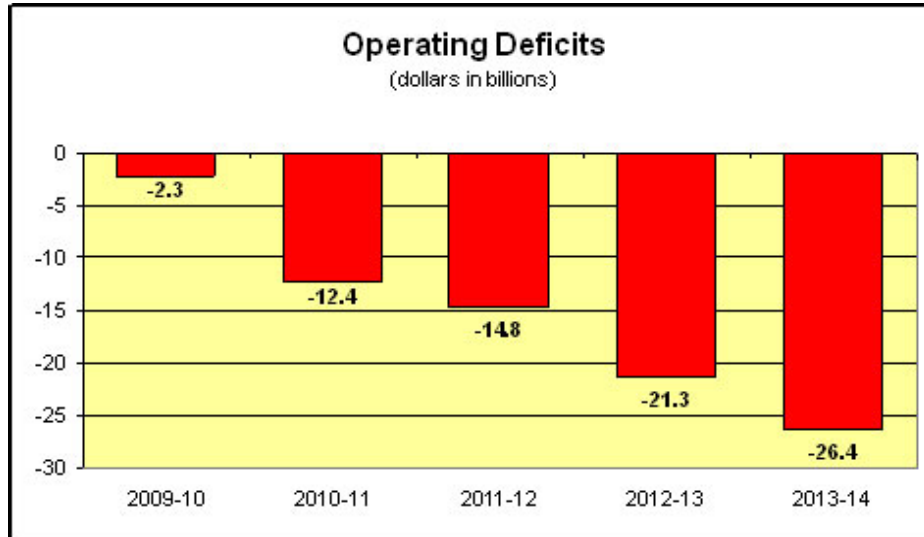
California State Debt Issuance

The Treasurer of the State of California has sold \$10 billion of bonds so far this year. Bonds issued at the beginning of the year yielded 4%, but this most recent offering saw rates with yields up to 6%; a 200 basis point increase in just a couple months!

California now has approximately \$60 billion of debt outstanding. The financial impact resulting from the 2% increase in cost associated with the most recent borrowings is equal to the requirement to terminate 107 school teachers per day on each of the 187 State mandated school days. The vast majority of the bond sales have been to individuals. Each sale of bonds included financial projections regarding the State budget that appear to have been incorrect at the time of issuance

Further borrowing by the State of California, absent any realistic adherence to budget revenues, will result in the need for higher taxes, lower spending or default in the future. The March 2009 pro forma published by the California State Legislative Analysts Office (LAO) estimates that the

State of California would face a new \$8 billion operating shortfall for Fiscal 2009-10 and a \$76 billion of annual deficits over the next 5 years (exhibit below).



These projections may be extraordinarily optimistic. The LOA is assuming that all the revenue generating in initiatives on the May 19th ballot pass, even though they are substantially behind in the polls. Furthermore, the LAO assumed that assessed secured property values would rise by 5% next year

Additional Budget Risks

No commercial bank or insurance company is currently willing to provide credit enhancement to increase the rating of the State of California. The common response from lenders is that California appears to be heading for further downgrades and lenders are concerned that this would drag down their own credit rating.

Issuance of RAWs

There is a substantial pool of buyers for California State Revenue Anticipation Warrants. The interest rate cost to issue RAWs would be more favorable than that of recent debt issuance. The only impediment to issuing RAWs is that the State Legislature fully understands that this debt issuance would legally require fiscal discipline.

Do No Harm

Orange County is the only municipality in the State of California to initiate layoffs (250 out of 18,000 employees) of the State funded Social Services and Health Care programs. Although

there were thousands of “pink slips” issued to teachers last March 15th across the State of California, most were rehired before the school year began. Over the last twelve months, the State has actually increased head count.

California counties, schools and other municipal entities are required to maintain reserves by law. Those reserves will cushion the “failure to fund” California State mandated services for at least six months. The Orange County Treasurer’s office believes that the \$7 billion investment pool that they manage, would allow the County of Orange to continue to operate for over nine months, if the State of California is unable to borrow any more.

K-14 schools also have the right under California Law to borrow from their County Treasurer under certain conditions. In September 2008, the Orange County Treasurer’s office negotiated terms and conditions and established a framework for lending to local schools. Most K-14 school districts in the State of California are utilizing similar language to seek authority to borrow from their County Treasurer.

US Government Guarantee of California Debt

Providing US Federal guarantees for the State of California substantially increases the RISK of the United States losing its AAA Sovereign Debt rating. Furthermore, US guarantees of California debt would have a material adverse effect on the ability of all other municipality and state borrowers to fund, due to a “crowding out” effect. As interest rates soar for non-Federal-guaranteed debt, the United States government will inevitably become the lender of “last resort” for all government entities.

If the US government decides to aid California, it should buy RAWs, not guarantee the State’s debt. RAWs will insure that all investors get paid on time. Purchasing RAWs give the US government an avenue to aid California, without establishing a precedent that could destroy the US government’s credit worthiness.