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County Executive Officer

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Executive Office, County of Riverside

April 28, 2010

Honorable Board of Supervisors
County of Riverside
Robert T. Andersen Administrative Center
4080 Lemon Street, 5th Floor
Riverside, CA 92501-3651

**REQUIRES
4/5 VOTE**

SUBJECT: FY 09/10 Third-Quarter Budget Report

Board members:

Attached is my report on the county's financial picture as of the third quarter. Overall, revenue is trending as projected and most departments expect to end the year on target. In this report, several important issues are addressed, including beginning fund balance, Prop. 172, budget planning and state mandates.

I asked departments to analyze their year-end positions in order to determine how our efforts to cut costs have affected the general fund. We anticipated ending the fiscal year with \$20 million and updated analyses indicate that we should meet that target but many factors affect fund balance. The actual number will not be derived until September, when the Auditor closes the books on FY 09/10. We trust our cost-cutting measures have taken hold and that additional savings may surface.

In building the recommended budget, we are presenting conservative estimates that will be updated, should conditions improve. While projections may be an inexact science, our budget modeling tries to use the most accurate and relevant information available. We are relying in part on projections from economists at California State University, Fullerton, and Beacon Economics. Reports from both are attached for your reference.

Our objective is to eliminate the structural deficit in two years, a plan the Board reviewed during the April 13 budget workshop. Department heads are doing an excellent job carrying out current-year reductions, keeping in mind the additional cuts that will be needed in FY 10/11 as well as in FY 11/12. I expect this approach will soften effects on the FY 11/12 budget, as departmental cost-cutting strategies continue to be implemented over the coming year. The degree of cuts to departments in FY 11/12 also will be determined as the Board hears testimony this afternoon on department-requested enhancements. The two-year objective to eliminate the structural deficit also will establish the essential elements of a two-year budget plan.

3.82

As discussed during the April 13 Board workshop, I have started reprogramming funds from various county projects in order to bolster the reserve for economic uncertainty. With the Board's approval, \$82 million of the \$103 million proposed will be shifted today into the reserve for economic uncertainty. My goal is to reprogram the balance by the end of this fiscal year.

Since Prop. 172 funds began to plummet, the Board has eased the effects on public safety by using about \$91 million in general-fund reserves. As discussed on April 13, I recommend identifying a distinct fund to retain and isolate any excess Prop. 172 receipts. In that way, retained funds can be used to stabilize department allocations year-over-year, when revenue falls. The Board could also allocate funds to support priority public safety needs. I will submit a formal policy to institutionalize these changes with the final adopted budget.

As the Board requested, I have attached an SB 90 update that reflects outstanding state obligations as well as a list of mandated services the county currently provides. To date, state deferrals total \$40 million. Payments from the state have been sporadic and unpredictable. We will examine the degree to which unfunded mandates can be discontinued.

A summary of current draws on contingency is on page 12. Budget adjustments are included to draw down contingency but only for critical and unavoidable costs. As I said in the mid-year report, all departments must use every means possible to meet budget targets before the Board considers allocating additional general-fund support. The net effect of recent and recommended activity on contingency is summarized below.

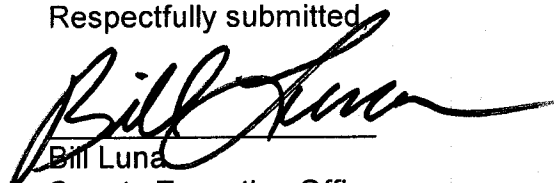
<u>Millions</u>	
\$14.3	Quarter's beginning balance
(14.3)	Third-quarter activity
<u>7.7</u>	Aggregate of actions recommended in this report
\$7.7	Interim balance

Included attachments:

- ATTACHMENT A Recommended budget adjustment summary
- ATTACHMENT B Human Resources' recruitment and vacancy report
- ATTACHMENT C Sales and use tax update
- ATTACHMENT D County SB 90 mandate update
- ATTACHMENT E Economic outlook from Cal State Fullerton
- ATTACHMENT F Economic outlook from Beacon Economics

IT IS RECOMMENDED that the Board of Supervisors approve the recommendations and associated budget adjustments in Attachment A; and receive and file this report and all its attachments (B through F).

Respectfully submitted

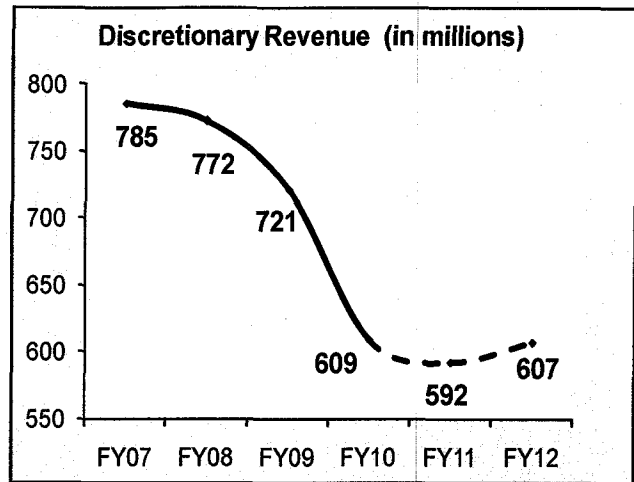

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COUNTY OF RIVERSIDE
EXECUTIVE OFFICE
FY 09/10
THIRD-QUARTER BUDGET REPORT
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A. EXECUTIVE HIGHLIGHTS

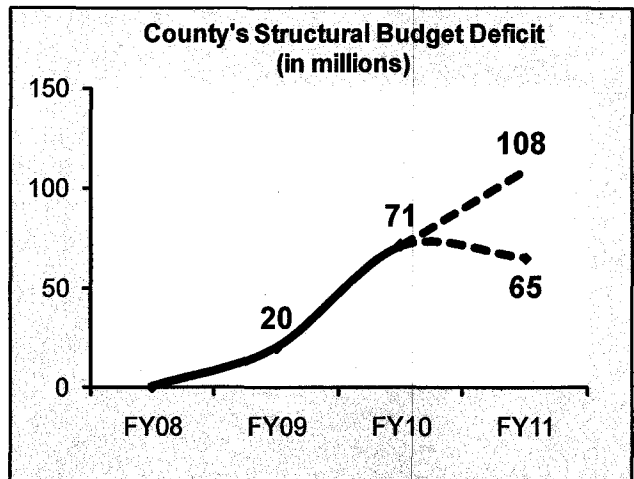
Discretionary general-fund revenue is currently estimated at \$609 million and there are no losses in discretionary revenue to report this quarter. Based on available data, revenue will likely decrease another \$17 million next fiscal year. In FY 11/12, revenue is expected to start a slow but steady recovery. If budget projections for FY 10/11 hold true, the ongoing yearly discretionary-revenue loss since FY 06/07 will reach \$193 million or about 25 percent.



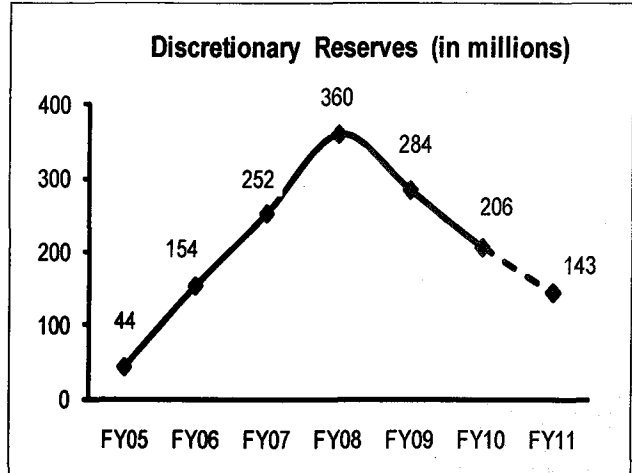
Public safety sales tax started declining in FY 07/08. The Board took action and has since mitigated impacts on public safety by using about \$91 million in general-fund reserves. Going forward, the Executive Office recommends modifying the mechanics of Prop. 172 by accumulating receipts that exceed departments' budgeted amounts in a restricted fund. Funds will be distributed to eligible public safety departments up to annual budgeted levels. Retained funds could be used for any public safety purpose as directed by the Board. This could include stabilizing department allocations year-over-year, when revenue falls, or using the funds to support other high-priority public safety needs.

General fund beginning fund balance: prior to the end of the fiscal year, the Executive Office forecasts department savings and unbudgeted discretionary revenue. That "ending balance" forecast becomes one building block on which the next year's budget is built. Reports received from departments this quarter indicate that the general-fund balance at year-end will be \$19-20 million. The Executive Office will report the actual balance in October, once FY 09/10 officially closes.

Budget deficit: During FY 08/09, the county used about \$20 million in reserves to cover ongoing costs. At the start of this year the county expected to use \$51 million; since then, the use of reserves increased to \$71 million to cover \$20 million in revenue losses reported in the first quarter. Unchecked, this deficit could grow to \$131 million next year, so eliminating this fast-growing deficit has been identified by the Board as a high priority. The EO suggested, and the Board sanctioned, a cost-cutting plan for FY 10/11 that will shrink the projected \$131 million deficit to \$65 million. The Board will consider funding \$42.5 million in program enhancements on May 4. If entirely funded, the county's deficit would rebound to about \$108 million.



The Board has endorsed a plan to eliminate the structural deficit within two years. That plan incorporates replenishing reserves and implementing a two-year budget plan that sets the foundation for budget cuts in FY 11/12. Recommendations in this report nearly double the size of the reserve for economic uncertainty (REU); upon approval, REU will total \$191 million. Discretionary reserves detailed in this report total \$206 million. Currently, the multiyear budget plan, which is based on Board actions taken through April 13, incorporates a \$65 million draw on REU in FY 10/11 to balance the general-fund budget.



To maintain high credit ratings and strong financial controls, the county must develop plans to restore reserve levels and maintain structural balance. Credit concerns may increase the cost of financing our ongoing need for working capital. The county's issuer ratings remain at AA levels: Moody's (Aa2), S&P (AA-) and Fitch (AA-).

Riverside County's Budget Health Benchmarks

	Target	06/07	07/08	08/09	Now
REU	15%	15%	15%	14%	31%
Contingency	4%	5%	4%	4%	1%
Deficit	0%	0%	0%	0%	12%
General Ratings	AA+	AA-	AA	AA	AA-

	Moody's	S&P	Fitch
Best Quality	Aaa	AAA	AAA
High Quality	Aa1	AA+	AA+
	Aa2	AA	AA
	Aa3	AA-	AA-
Upper Medium Grade	A1	A+	A+

B. GREATER ECONOMIC OUTLOOK

Treasury Secretary Timothy Geithner reported in mid-April that the national economy is growing faster than the administration expected. The Commerce Department reported recently that the economy grew at 5.7 percent in the fourth quarter of 2009, the fastest pace since 2003. This follows a modest third-quarter growth that ended four consecutive quarters of decline. Geithner added that the country was on the way to sustained job creation, that the private sector is growing, consumer spending is up and consumer confidence is expected to rebound.

The Dow Jones entered the rarified air of 11,000 in April for the first time in about two years. Both the Dow and NASDAQ have ended higher in eight of the nine weeks ending April 16. U.S. stock futures are on the rise as companies continue to report higher-than-expected profits during this first-quarter earnings report period. Results thus far have been positive and as of April 23, Bloomberg analysis shows that 81 percent of S&P 500 companies have reported first-quarter earnings above analyst estimates.

Despite these upswings plenty of troubling signs bear watching. The Senate's Goldman hearings highlight the uncertainty companies face as the government debates new regulations. The national jobless rate stubbornly remains close to 10 percent, with Riverside County facing a rate of 15.1 percent. Some economists contend higher unemployment rates are the new normal but the Obama administration calls the situation cyclical and temporary. However, with 6.1 million Americans unemployed for 27 weeks or more as of December 2009, it will take two years of above-average job growth just to bring the unemployment rate below 5 percent.

What many do not realize is that a second wave of mortgage defaults is set to begin this year. Looking strictly at the total amount of mortgage debt scheduled to reset over the next two to three years, it appears this second wave's effects, potentially, could be similar to the subprime defaults of 2007 and 2008.

Cautious optimism about the national economy is reasonable so long as we recognize what remains broken: massive debt both public and private, persistent nearly unprecedented unemployment and an American housing dream that could slip from the grasp of millions more.

C. STATE BUDGET UPDATE

State general-fund revenue continued to improve in March, compared to estimates contained in the governor's FY 10/11 state budget plan. The general fund's year-to-date revenue through March exceeded the governor's estimate by \$2.3 billion, an increase of 4.1 percent. Total general-fund revenue for March is \$356 million (5.9 percent) higher than initially projected. Personal income tax and corporate tax revenue came in above projections, while sales tax receipts were below the anticipated level. However, overall personal income and corporate tax revenue remain at levels significantly below last year.

Although there are no signs of a strong recovery, the economy appears to be in the nascent stages of a turnaround. The housing market's downward spiral and slow construction activity might finally have bottomed out. The unemployment rate has stayed steady. April will be a critical month for personal income tax revenue as final returns or extension

requests for the 2009 tax year are filed with the Franchise Tax Board. April revenue may give us a clearer picture whether a recovery is truly under way.

D. COUNTY OUTLOOK

1. LOCAL OPERATIONAL TRENDS

According to Fullerton economists Dr. Adrian Flessing and Dr. Mira Farka, Riverside County is beginning to recover from the 2008-2009 recession; however, this recovery is expected to lag behind those of the nation the state, and even the rest of the region. Factors expected to suppress local recovery include the high unemployment rate, which is now 15 percent, and the unusually large number of foreclosed homes. In short, positive growth in local manufacturing and transportation sectors will likely be insufficient to generate any consequential recovery over the next couple of years.

Data from the Assessor-County Clerk-Recorder indicate that foreclosure activity is down from last year. Although document recordings have declined about 6 percent during the third quarter of FY 09/10, the number of deeds recorded is about the same as last year. The Recorder now projects documentary transfer tax revenue for FY 09/10 to exceed budget expectations by \$1 million.

The Assessor has revised his estimated year-to-year decline in county assessed value for FY 10/11. The new range is a 4 to 4.5 percent drop. This half-a-percent adjustment could reduce projected property tax losses by \$2.5 million for the county next year. This decrease in assessed value results primarily from two factors: first, worsening declines in values of commercial and industrial properties, and additional declines in value for single family homes, vacant land, and other real property types; second, the inflationary factor annually applied to base-year values will reflect a decrease. The Assessor will confirm his projections during presentation of the recommended budget.

Building and Safety reports that through March the number of building permits issued (grading, remodel, plan check, multi-family, etc.) has declined less than 0.25 percent from the same nine-month period last fiscal year. This decline is significantly better than the 42 percent decline reported in last year's third-quarter report. This fiscal year, 922 single-family residential building permits have been issued, up 9 percent from last year but a 43 percent decline from two years ago. The county's peak for monthly building permits was in May 2005, when 5,423 total permits and 1,993 single-family residential permits were issued. For comparison, in March 2010, building permits totaled 1,161 and there were 99 single-family residential permits issued.

The Planning Department has received 35 percent fewer applications this year compared to the same period in FY 08/09. Major planning applications are down 30 percent for the same period. These declines are better than the 45 percent drop in total planning applications experienced last quarter and the 52 percent decline in total planning applications in the first quarter. Visitors to the two TLMA regional offices have declined 26 percent during the first nine months of FY 09/10 compared to the same period in FY 08/09; this is better than the 30 percent decline reported at the second quarter and the 40 percent decline reported at the first quarter.

2. FINANCING RESOURCES

a) Board Discretionary Reserves

Consolidating County Reserves for Economic Uncertainty

The Executive Office is taking action to increase the general fund's reserve for economic uncertainty based upon consensus of the Board at recent budget workshops. The recommended actions below move \$82 million immediately and begin the process of moving another \$21 million.

Several projects either are complete or can be delayed and the remaining allocated capital improvement plan (CIP) funds can be transferred to the general fund. Complete or nearly complete projects and their savings include: new DA building (\$1 million), Hemet Family Care (\$150,000) and Hemet fleet (\$109,000). Projects that can be delayed include: Community Health Agency administration building (\$2.4 million), Riverside downtown parking (\$7.5 million) and Indio county administrative center remodel (\$262,000). An additional \$800,000 can be moved from CIP cash while still leaving an adequate contingency balance to complete ongoing projects. The total available to transfer from CIP to the general fund is \$12.2 million.

The Board can reprogram and move several designations in the general fund into the reserve for economic uncertainty. These designations are for important Board priorities that will continue to be monitored and might require future funding. The higher priority at this time is to maximize funds in the Board's primary reserve. Designations to be reprogrammed and their balances include: public service (\$20,000), Probation (\$308,425), capital projects (\$3.2 million), Department of Public Social Services (\$6.9 million), CalWorks (\$8.2 million) and SB90 (\$3.6 million). The total available to reprogram from various designations to the reserve for economic uncertainty is \$22.2 million. We have programmed \$3.4 million for the community improvement designation next year for Board discretion. The Board should review this planned allocation in the recommended budget and determine equitable levels of funding for each district.

General-fund cash was moved into the tobacco securitization fund for the regional detention center's construction. Because it will be more than one year before construction can begin, \$47.5 million will be moved back to the general fund and into reserve. After the move, adequate cash will remain in the fund to complete planning and design efforts necessary before a construction bid is solicited.

Finally, cash is available in redevelopment pass-through funds that originated in Riverside, Moreno Valley and Palm Desert. Some conditions must be met before the cash can be moved so it will likely be another 60-90 days before this can be accomplished.

Recommended Motion: That the Board of Supervisors approve: 1) that the CIP projects listed above be delayed or completed as soon as possible; 2) \$12,223,000 cash be moved from the CIP fund (30700) to the general fund; and 3) approve and direct the Auditor-Controller to adjust appropriations and designations as follows:

Increase appropriations:		
30700-1104200000-551100	Contributions to county funds	\$12,223,000
Expected offset:		
30700-1104200000-309100	Reserve for construction	\$12,223,000
Increase estimated revenue:		
10000-1101000000-790600	Contributions from county funds	\$12,223,000
Increase designations:		
10000-1000100000-320110	DFB – economic uncertainty	\$12,223,000

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller adjust designations as follows:

Decrease designations:		
10000-2400100000-320104	DFB – public service	\$20,000
10000-1000100000-320107	DFB – probation	308,425
10000-1000100000-320109	DFB – capital projects	3,202,572
10000-1000100000-320129	DFB – DPSS realignment	6,867,822
10000-1000100000-320145	DFB – DPSS CalWorks	8,200,598
10000-1000100000-320133	DFB – SB90 deferral	<u>3,634,091</u>
	Total	\$22,233,508
Increase designations:		
10000-1000100000-320110	DFB – economic uncertainty	\$22,233,508

Recommended Motion: That the Board of Supervisors approve the transfer of \$47.5 million from the tobacco securitization fund (30121) to the general fund and direct the Auditor-Controller to adjust appropriations and designations as follows:

Increase appropriation:		
30120-1105100000-551100	Contributions to county funds	\$47,500,000
Expected offset:		
30121-1105100000-309100	Reserve for construction	\$47,500,000
Increase estimated revenue:		
10000-1101000000-790600	Contributions from county funds	\$47,500,000
Increase designations:		
10000-1000100000-320110	DFB – economic uncertainty	\$47,500,000

b) Estimated Beginning Fund Balance

When the Executive Office constructs the FY 10/11 recommended budget, it will include a beginning balance estimate of \$20 million. This balance measures how the county ended the previous year. Additional unexpected discretionary revenue, departmental budget savings and remaining unused contingency at year-end are available in the new budget as

beginning balance. Discretionary-revenue shortfalls and department overruns decrease this balance. Each year many factors are not final when the new budget is created.

The Executive Office requested and received quarterly reports from most departments. From that information, we can estimate general-fund departmental savings at about \$5 million. Also included in those reports are updated estimates of discretionary revenue. We are now able to estimate additional general-fund discretionary revenue at \$11 million. Finally, the estimate of year-end contingency (page 12) is \$3.4 million. Totaling these three sources yields our current beginning balance estimate of \$19.4 million.

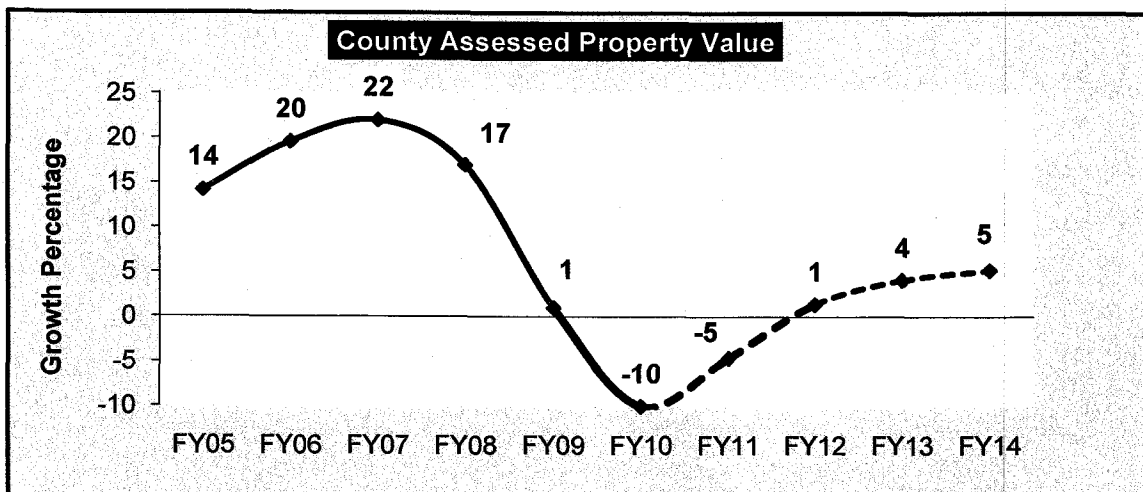
c) Property Taxes and Assessed Value

Nearly 80 percent of the county’s discretionary revenue comes, in one form or another, from property taxes. In FY 09/10, the county’s assessed value declined approximately 10.5 percent, creating most of the county’s \$78 million discretionary-revenue loss.

Property-related tax estimates for FY 09/10 continue to fluctuate as the county struggles to determine the “new normal” and adjusts to the unusual number of property reassessments and supplemental property tax refunds. Three-quarters of the way through the fiscal year, there are no additional property-related revenue losses to report.

The chart below shows the extraordinary growth in county assessed property values that began before FY 04/05 and the precipitous decline that started in FY 07/08. The Executive Office expects FY 09/10 to be the worst of the downturn and beginning in FY 10/11, fewer residential properties will require reassessment. The Assessor reports that values will decline next year between 4 and 4.5 percent. Current modeling assumes a decline of 4.6 percent. The actual decline will not be available until the roll closes at the end of June.

California State University Fullerton and the Institute for Environmental and Economic Studies (IEES) are developing forecasts for changes in county assessed values beyond FY 10/11. IEES projects moderate growth in FY 11/12. Previous estimates reflected no change that year. Projections for FY 12/13 and FY 13/14 have been updated to reflect 2 percent more growth in both years than previously projected.



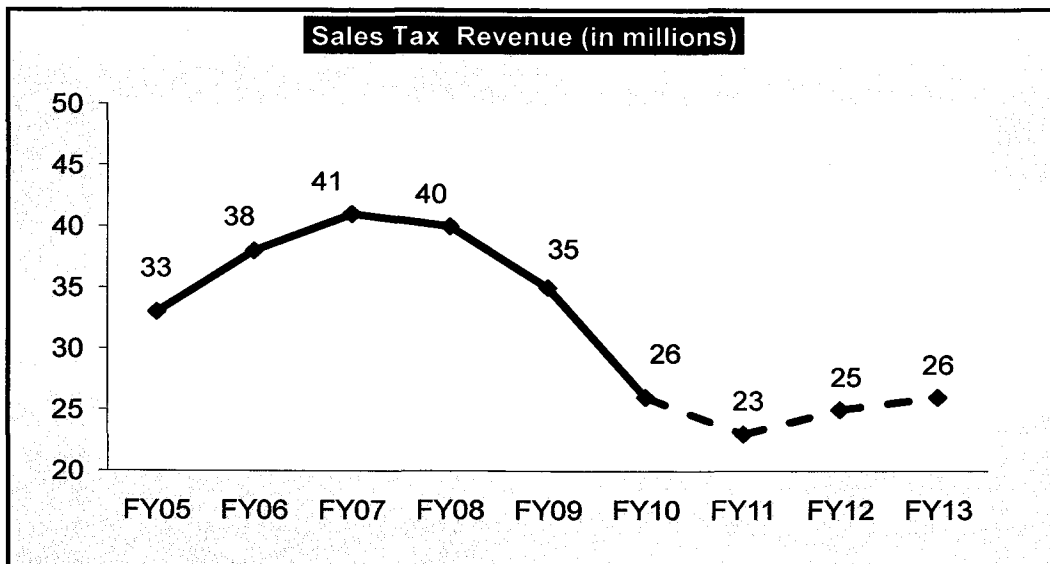
d) Sales and Use Taxes

Hinderliter de Llamas & Associates (HdL) is the county's sales tax consultant. HdL reports that from October through December 2009, receipts for sales and use taxes in all jurisdictions within Riverside County are down 5.8 percent from the same period a year ago. However, HdL reports that sales tax receipts from unincorporated areas fared worse, down 20.9 percent compared to the same quarter a year ago. HdL anticipates these double-digit declines in sales tax could slow to single digits and bottom out sometime this summer. HdL expects that the evaporation of easy consumer credit, prolonged foreclosure activity and continued weakening in the commercial real estate sector will reset sales long-term to a "new normal." HdL expects receipts will decrease in FY 10/11, with modest increases of 2-3 percent beginning sometime in FY 11/12. In the attached report, HdL concludes:

There is general agreement that the current recovery is fragile and that California will trail the nation. However, there is sharp disagreement on its durability. Most analysts believe that as long as the current demand for exports continues, the other previously cited factors will sustain a slow recovery. Others argue that a second dip in the recession is likely. They maintain that the current recovery is a "bubble" created by unsustainable tax cuts, federal stimulus spending, low interest loans and modification programs that mask and only delay inevitable foreclosures. Further, the pending resetting of large numbers of adjustable rate home mortgages and need to refinance \$500 billion in commercial loans is being ignored. Until we suffer the consequences from those losses they say, the end of federal bailouts will simply send us back into a recession. Both sides express concerns about the sufficiency of future job opportunities.

HdL projects that FY 09/10 receipts for sales and use taxes will likely total \$25.5 million, slightly below the current budgeted estimate. At this time, the Executive Office recommends leaving the budgeted estimate at its current level.

The following chart reflects the trend in sales tax revenue since FY 04/05 and budget estimates through FY 12/13.



e) Prop. 172 – Public Safety Sales Tax

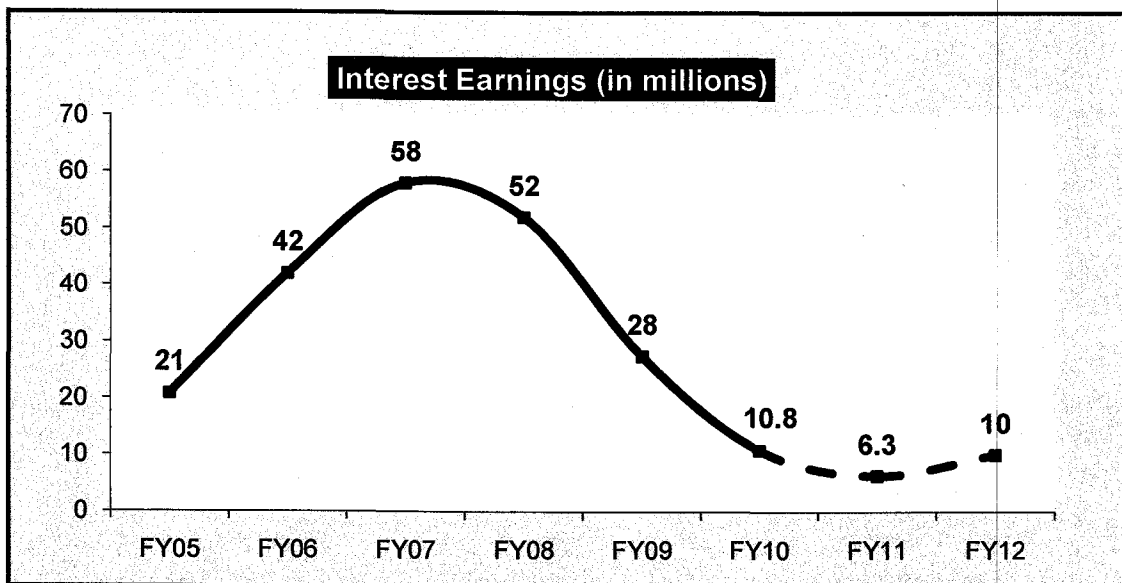
Prop. 172 public safety sales tax was estimated in the adopted FY 09/10 budget at \$125.8 million. Subsequently, that estimate was reduced by \$15.2 million to \$110.6 million. HdL estimates that FY 09/10 receipts could total \$111.4 million, just slightly higher than the current budgeted estimate. Given economic uncertainties, the Executive Office recommends leaving the budgeted estimate at its present level.

The Executive Office recommends modifying the mechanics of Prop. 172 revenue distribution, as discussed with the Board in the budget workshop on April 13. The recommendation includes identifying or establishing a restricted fund into which Prop. 172 receipts from the State Controller, above budgeted levels, will be retained. Interest earned would remain in this fund. In modifying the process, distributions to public safety departments would be made as funds are received from the state up to the amount budgeted in each public safety department budget. Revenue received above budgeted levels will be isolated in this special fund until allocated by the Board for public safety needs.

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to 1) cap annual distributions of public safety sales tax revenue received at the department budgeted level, 2) isolate and restrict for public safety any and all receipts in excess of what is budgeted by the public safety departments, 3) retain interest earned within the new fund; and, 4) initiate the process for the fiscal year beginning July 1, 2009.

f) Interest Earnings

The Treasurer-Tax Collector reports that as of the end of the third quarter, the FY 09/10 interest earnings target of \$8.5 million will be met. Due to certain investment opportunities and realized gains during the period, the treasurer now projects \$10.8 million for the year, an increase of \$2.3 million.



The Treasurer reports that as modest gains in the nation's leading economic indicators continue, there has been talk of potential Federal Reserve rate hikes beginning in the latter part of 2010 and into 2011. Further improvement in the job market is needed, however to

help sustain the economy's moderate recovery from the worst recession since the 1930s. The Fed recently stated "the economy expanded "somewhat" across most of the U.S. in March as consumer spending and manufacturing improved, signaling the recovery is broadening without gaining much speed."

At this juncture, due to historically low interest rates and the anticipation of continued pressures on general-fund balances for FY 10/11, the Treasurer's projection of \$6.5 million of interest revenue remains. Quarterly updates over the course of the next fiscal year will be provided to the Executive Officer and the Board.

3. MULTIPLE-YEAR BUDGET PLANNING

Workshops for the FY 10/11 budget began in November. The workshops included written and verbal testimony from departments and will culminate in formal board direction on net-county-cost (NCC) adjustments. Thus far the Board's intent has been to make significant cuts as needed in order to sustain general-fund reserves. The Board also has endorsed plans to eliminate the structural deficit within two years if feasible.

General Fund Multiple-year Projection (in millions)						
	Adopted Budget	PROJECTED ACTUAL				
	09/10	09/10	10/11	11/12	12/13	13/14
<u>RESOURCES:</u>						
Beginning fund balance	25	66	20	20	20	20
Ongoing discretionary revenue	629	609	592	608	626	639
Use of reserves (to balance budget)	50	71	65	16	0	0
Other one-time revenue and reserves	57	72	0	0	0	0
	761	818	677	644	646	659
<u>APPROPRIATIONS:</u>						
Ongoing GF Allocations (NCC)	853	910	744	690	646	646
Budget cuts and Labor Savings	(92)	(92)	(67)	(46)	0	0
Ongoing GF Allocation (net of cuts)	761	818	677	644	646	646
<u>Cost Details</u>						
Contingency funding	30	8	20	20	20	20
New jail staffing (Sheriff)	0	13	0	0	0	0
Public safety COLA's	10	10	0	0	0	0
800 MHz debt service	0	0	0	7	0	0
Added to reserves	4	45	3.4	3.4	3.4	3.4
Available for budget needs	0	0	0	0	0	13
Reserve for economic uncertainty	75	191	126	110	110	110
Other discretionary reserves	31	15	17	17	17	17

*Notes: Departments to absorb retirement benefit costs and cost-of-living allowances.
Retirement costs are expected to increase about 0.4% in each of FY 10/11 and FY 11/12.*

To prevent ratings downgrades, the Board showed support for a plan to rebuild reserves and implement a two-year budget plan that sets the foundation for budget cuts in FY 11/12.

NCC cuts pull money from existing programs and it is clear that the steps needed to balance the budget will reduce county services.

The Board also showed support not only \$67 million in budget cuts but doubling the size of the reserve for economic uncertainty to \$211.4 million. This can be accomplished when the Board authorizes shifting \$103 million from various accounts for future projects, including \$47.5 million that had been set aside for a proposed regional detention center in the Whitewater area.

The county's multiple-year budget plan incorporates projected expenditures and revenue four years ahead. The multiyear plan is based on Board actions taken through April 13 and incorporates direct cuts as well as a \$65 million draw on the emergency reserve fund to cover the expected FY 10/11 deficit.

E. THIRD-QUARTER ACTIVITY

1. QUARTERLY DISCRETIONARY REVENUE SUMMARY

There are no changes in discretionary revenue to report this quarter. The following chart reflects cumulative changes in county discretionary revenue over the past nine months.

Summary of FY 09/10 Discretionary Revenue (in millions)			
	Original Budget Estimate	Third- Quarter Update	Variance from Orig. Budget
Property Taxes	283.9	274.5	(9.4)
Motor Vehicle In Lieu	199.5	197.9	(1.6)
Tax Loss Reserve Fund-Overflow	46.0	46.0	0.0
Sales Tax *	34.8	25.6	(9.2)
Fines and Penalties	26.1	26.1	0.0
Documentary Transfer Tax	9.2	9.2	0.0
Interest	8.5	8.5	0.0
Franchise Tax	8.0	8.0	0.0
Misc. Federal and State	6.0	6.0	0.0
Other (Prior Year & Miscellaneous)	5.6	5.6	0.0
Transient Occupancy Tax	1.6	1.6	0.0
TOTALS	629.2	609.0	(20.2)

** Does not include public safety sales tax revenue*

2. GENERAL FUND DISCRETIONARY RESERVE SUMMARY

Upon approval of this report, the following table lists the \$206.5 million in Board-established, general-fund discretionary reserves. About \$191 million resides in the reserve for economic uncertainty (REU) to stabilize general-fund budgets. Over the next two years this fund will be drawn down as needed, allowing phased budget cuts as the county strives to balance expenditures and revenue.

	Discretionary Reserves (in millions)					Balance
	FY 08/09 Ending Balances	Draw Downs for Budget Use	FY 09/10 Beginning Balances	First- and Second qtr Adjustments	Third- quarter Adjustments	
Economic uncertainty	98.5	(23.0)	75.5	33.8	82.0	191.3
Capital projects	38.3	(38.3)	0.0	3.2	(3.2)	0.0
PSEC - 800 MHz	27.1	(27.1)	0.0			0.0
Property tax system	9.6		9.6	4.0		13.6
SB90 deferred state revenue	3.6		3.6		(3.6)	0.0
DPSS - CalWorks incentive	8.2		8.2		(8.2)	0.0
DPSS - realignment growth	6.9		6.9		(6.9)	0.0
Probation	2.6	(2.3)	0.3		(0.3)	0.0
Community improvement	0.0		3.4	(1.4)	(0.4)	1.6
CAC maintenance	1.2	(1.2)	0.0			0.0
TOTAL	196.0	(91.9)	107.5	39.6	59.4	206.5

3. APPROPRIATIONS FOR CONTINGENCY

Funds allocated into contingency are appropriated for unforeseeable events. These funds are at the Board’s discretion and historically have been used to backfill shortfalls in discretionary revenue, finance unforeseen expenditures and cover uncorrectable departmental budget overruns. The Board-approved contingency target is 4 percent of ongoing discretionary revenue, or about \$24 million.

Last quarter, the Department of Public Social Services returned \$10.3 million to the general fund, citing slow caseload growth, salary savings associated with furloughs and increased federal funding. That savings was appropriated within the contingency budget. This quarter, DPSS is returning another \$8.9 million, which will be appropriated in contingency, if the Board approves. DPSS finances are heavily influenced by the recession. As it faces growing demand for its services the state is making it harder for residents to qualify. State revenue is falling as more federal dollars are coming in. These opposing influences can wildly swing the need for general-fund support. The department’s early estimate is that it will need to reacquire \$18 million in general-fund support next year for legally mandated services. The department will update this estimate as more current information becomes available.

Departments’ requests to fund critical core services are included in this report. Those requests total about \$1.2 million and should be funded out of contingency. If the recommendations in this report are approved, contingency will total about \$7.7 million.

Each year county departments provide mandated state services for which they do not receive state reimbursement. The general fund finances those costs until state payment is received, usually several years later. An analysis reveals about \$4.2 million in expenditures needing coverage this year. In order to account for this impact, \$4.2 million has been earmarked within the contingency budget.

FY 09/10 USE OF CONTINGENCY

	Cost Adjustment	Revenue Adjustment	Total Adjustment	Contingency Status
Quarter's Beginning Balance:				\$14,305,029
Third-quarter adjustments:				
Item 2.1 on 1/12/10 Cash Overage	\$94	\$0	(\$94)	\$14,304,935
Item 3.64 on 02/09/10 Pro. 172 Shortfall	\$15,192,975	\$0	(\$15,192,975)	(\$888,040)
Item 3.12 on 03/16/10 Replenishing Contingency	\$0	\$888,040	\$888,040	\$0
Actions recommended in this report:				
Alternate Public Defender (page 16)	\$646,999	\$0	(\$646,999)	(\$646,999)
Animal Services (page 16)	\$250,000	\$0	(\$250,000)	(\$896,999)
RCRMC - Detention Health (page 20)	\$325,000	\$0	(\$325,000)	(\$1,221,999)
DPSS Administration (page 21)	\$0	\$4,993,000	\$4,993,000	\$3,771,001
DPSS IHSS (page 22)	\$0	\$2,400,000	\$2,400,000	\$6,171,001
DPSS Categorical Aid (page 23)	\$0	\$1,500,000	\$1,500,000	\$7,671,001
Contingency balance upon approval of this report =				\$7,671,001
Pending actions that could affect contingency:				
SB90 Mandates	\$4,300,000	\$0	(\$4,300,000)	\$3,371,001
Projected year-ending contingency =				\$3,371,001

F. FY 09/10 DEPARTMENTAL STATUS

1. GENERAL GOVERNMENT

a) Board and Clerk of the Board

A minor accounting change will allow the department to more accurately report actual expenditures and transfers. There are no new or unexpected expenses driving this request and total general-fund support will not change.

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor-Controller adjust appropriations and estimated revenue as follows:*

Decrease appropriations:

10000-1000100000-526410	Legally required notices	\$200,000
10000-1000100000-520820	Janitorial supplies	15,000
10000-1000100000-572800	Intra-misc	(95,000)
	Total	\$120,000

Decrease estimated revenue:

10000-1000100000-777520	Reimbursement for services	\$40,000
10000-1000100000-778280	Interfund – reimbursement for services	80,000
	Total	\$120,000

b) Economic Development and Facility Management Agency (EDA)

Facilities Management Administration

A budget adjustment is requested to increase appropriations for unplanned miscellaneous expenses, including consultant fees related to the energy efficiency and conservation block

grant. As appropriate, some charges will be applied to specific divisions and the balance will be spread to all FM divisions through distribution of the administrative expense.

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:*

Increase appropriations:		
10000-7200100000-524660	Consultants	\$43,000
10000-7200100000-526700	Rent – lease	64,000
10000-7200100000-524560	Auditing and accounting	4,000
10000-7200100000-537080	Interfund expense – miscellaneous	315,000
10000-7200100000-572400	Intrafund – internal charges	<u>(426,000)</u>
	Total	\$0

Energy Management

A budget adjustment is requested to allow additional spending authority associated with utilities rate increases.

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:*

Increase appropriations:		
10000-7200600000-529540	Utilities	\$1,728,237
10000-7200600000-573800	Intrafund – utilities	<u>(1,419,772)</u>
	Total	\$308,465
Increase estimated revenue:		
10000-7200600000-777610	Utilities	\$240,058
10000-7200600000-778350	Interfund utilities	<u>68,407</u>
	Total	\$308,465

Deferred Maintenance

EDA/FM requests permission to reprogram excess funding (\$150,000) set aside for the Third and Park streets parking lot, since that project is complete. It is requested that the savings be allocated to the following four projects:

- French Valley Business Center (\$25,000)
- UST Testing/Permitting (\$50,000)
- Various emergency maintenance efforts (\$75,000)

Recommended Motion: *That the Board of Supervisors approve the reprogramming of \$150,000 within deferred maintenance.*

c) Executive Office

The Executive Office requests budget adjustments to transfer funds (\$520,490) acquired through county Ordinance 810.2 to the Environmental Programs Department. The funds cover costs associated with the acquisition, survey and appraisal of the Wilhelm property to assist in meeting multiple species habitat and conservation program (MSHCP) requirements.

Recommended Motion: That the Board of Supervisors approve the purchase of land, and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Increase appropriations:		
10000-1100100000-536800	Interfund expense – distributions	\$520,490
Expected offset:		
11033-1100100000-308101	Restricted program money	\$520,490
Increase appropriations:		
20200-3100500000-525400	Title company services	\$2,000
20200-3100500000-540040	Land	<u>518,490</u>
	Total	\$520,490
Increase estimated revenue:		
20200-3100500000-778260	Interfund – property and assessment	\$520,490

The Executive Office requests a budget adjustment to salary payoffs in accordance with the implementation of the early retirement incentive for eligible employees approved by the Board on Feb. 9, 2010 (Item 3.33).

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Increase appropriations:		
10000-1100100000-510220	Payoff permanent – seasonal	\$306,826
Increase estimated revenue:		
10000-1100100000-777480	Reimb. of cost – admin overhead	\$120,000
10000-1100100000-777520	Reimbursement for services	142,000
10000-1100100000-781360	Other miscellaneous revenue	<u>54,826</u>
	Total	\$306,826

d) Registrar of Voters (ROV)

With the department's continued efforts to cut costs on supplies, overtime and temporary help, the Registrar anticipates actual expenditures to be below budget by more than \$340,000. The department requests approval to use \$100,000 of this savings to replace two aging affidavit scanners at an estimated cost of \$50,000, and to purchase two voting by mail (VBM) envelope scanners at an estimated cost of \$50,000. Replacing the affidavit scanners would reduce maintenance costs and avoid a backlog caused by equipment failure. Purchasing the VBM scanners would reduce the need for temporary personnel while preserving voter privacy, and allow voters to verify the receipt of the ballots sooner.

Recommended Motion: That the Board of Supervisors approve the purchase of two affidavit scanners and two envelope scanners; and approve and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations:		
10000-1700100000-546160	Equipment – other	\$100,000

Decrease appropriations:
 10000-1700100000-525340 Temporary help services \$100,000

2. PUBLIC PROTECTION

a) Alternate Public Defender

The Board of Supervisors approved the creation of an alternate public defender (APD) for death penalty cases on Feb. 28 (Item 3.57a). In order to be fully operation on July 1, the department requests \$650,000 in start-up funding to be spent this year.

This budget unit was created because capital cases that seek the death penalty are very expensive. Currently, when the Public Defender declares a conflict, cases are accepted either by the conflict panels or by private counsel recommended by the panels after conflict counsel reaches contractual limits. Cases could be sent first to an APD if the Public Defender declares a conflict. Only when the APD has reached capacity would cases be sent to the conflict panels. The Public Defender expects some savings on investigations and expert assistance, and significant savings later as the need for private counsel is greatly reduced.

Recommended Motion: *That the Board of Supervisors approve the purchase of two photocopy machines; and approve and direct the Auditor Controller to adjust appropriations as follows:*

Increase appropriations:		
10000-2401300000-520260	Computer lines	\$75,000
10000-2401300000-523640	Computer equip. – non-fixed asset	55,356
10000-2401300000-523620	Books and publications	10,000
10000-2401300000-523680	Office equip. – non-fixed asset	349,830
10000-2401300000-523700	Office supplies	17,892
10000-2401300000-525220	Pre-employment services	2,921
10000-2401300000-526700	Rent or lease of buildings	100,000
10000-2401300000-546160	Equipment – other	<u>36,000</u>
	Total	\$646,999
Decrease appropriations:		
10000-1109000000-581000	Appropriations for contingency	\$646,999

b) Animal Services – Community Health Agency

Projections indicate that departmental revenue will not meet budgeted targets. The department expects to miss its revenue target by \$300,000 and anticipates the need for additional general-fund support to balance its budget. To minimize the unbudgeted impact on the general fund, the department has implemented layoffs and continues to operate under a hiring freeze. The department also continues to seek donations and is looking for additional ways to reduce costs to offset revenue losses. Revenue estimates have been adjusted for FY 10/11.

In addition, the department expects to complete its move into the new western Riverside city/county animal shelter in early May. Costs associated with operating this new facility are expected to total \$250,000. Animal Services requests \$250,000 in general-fund support to cover this year's operational expenses.

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations:		
10000-4200600000-520820	Janitorial services	\$50,000
10000-4200600000-522310	Maintenance – buildings	100,000
10000-4200600000-529540	Utilities	<u>100,000</u>
	Total	\$250,000
Decrease appropriations:		
10000-1109000000-581000	Appropriations for contingency	\$250,000

c) District Attorney’s Office

The District Attorney’s Office has provided the following information:

“The District Attorney’s Office continues to maintain public safety effectiveness and successfully navigate the current difficult budget situation. At the 3rd Quarter after assessing the impact of the District Attorney’s cost reduction efforts significant budget savings have been achieved. However with the implementation of a new round of “Golden Handshake” early retirements, the District Attorney’s Office will experience additional unanticipated payouts of leave balances by the end of the fiscal year. The District Attorney’s Office has obtained another \$1 million in revenue from new grants sources since the 1st Quarter 2009-2010 report.”

The report from District Attorney was filed on April 26 and the Executive Office did not have ample time to verify the information before this report was submitted.

d) Fire Department

The Fire Department indicates greater-than-expected savings from cost containment measures. Despite shortfalls in tax revenue, cost controls will keep the department on track to meet budget targets.

e) Indigent Defense

The capital-case retrial against Jackson Daniels concluded on Jan. 28 when the defendant was sentenced to death for murdering two Riverside police officers in 1982. The Executive Office made the final payments to his private defense counsel this past quarter. Over the course of the second trial, eight private attorneys were involved in the defense. Costs were unprecedented. To date, the year-end projection is \$191,001 beyond the approved budget. No additional funds are requested at this time. The Executive Office is closely monitoring expenditures and will notify the Board if pending capital trials conclude and attorneys must be paid beyond budgeted amounts.

f) Public Defender

The Public Defender worked with the Executive Office to fill critical vacancies during the second quarter. Positions filled include four of the 17 attorney vacancies and six of the 13 investigator vacancies. The 10 individuals hired began working during the third quarter. At

midyear the Board added \$2 million to the department's budget for hiring, which keeps the Law Office of the Public Defender from declaring overload.

By strictly limiting expenditures, the Public Defender is within budget for services and supplies. Any funds saved will be needed to cover salaries and benefits, so that the office will not need any additional general-fund support by year-end.

The department continues to bill the state but revenue continues to lag because the Prison Legal Reimbursement fund was suspended. Payments related to sexually violent predators and other provisions of SB 90 are paid in arrears and the Public Defender has not been paid for two fiscal years.

The Indian Gaming Grant award for FY 08/09 was rolled over. The department requests the following adjustment to cover third-quarter related expenses.

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:*

Increase appropriations:		
10000-2400100000-510040	Regular salaries	\$16,561
10000-2400100000-518100	Budgeted benefits	<u>6,689</u>
	Total	\$23,250
Expected offset:		
11123-2400100000-308101	Restricted program money	\$23,250

g) Sheriff's Department

The Sheriff's Department projects a surplus of approximately \$647,000 by the close of this fiscal year. Executive Office review indicated a similar result.

As discussed in the midyear report, the department expected to close its initial \$21 million budget gap. The actions that make this possible include: getting \$10 million from general fund contingency to cover Prop. 172 losses, capitalizing on federal funding opportunities, participating in the early retirement programs for sworn and classified staff, and monitoring unreimbursed overtime costs.

Moving forward, the Sheriff's budget strategies will continue to focus on saving jobs. The Sheriff has directed his staff to defer costs, wherever possible, to future fiscal years in an effort to create savings to mitigate layoffs in other county departments.

The Sheriff's Department reports that the Board should be mindful of the long-term liabilities that come with current cost containment measures. Without funding and additional staff, the department's ability to meet crucial jail objectives and maintain a safe patrol ratio in unincorporated areas are at risk. In order to sustain public safety levels, the department expects overtime costs to rise. The Executive Office acknowledges the priority of public safety, while maintaining fiscal solvency.

The department also has increased the mileage requirements for fleet vehicles, reducing vehicle pool costs for a short time. This simultaneously creates an aging fleet and long-term

liability. Over the next several fiscal years a greater proportion of the fleet will need to be replaced at the same time, increasing costs substantially. The Executive Office recognizes the liability, while directing that efforts to reduce fleet management costs should continue.

Recent Board action allowed the Sheriff to continue jail staffing efforts for the Smith Correctional Facility. The department began the 182nd basic academy on April 29 and will incur two months of personnel costs for the new hires. The academy will begin to provide some offset to attrition next winter.

The Sheriff's Department notes that there is a current unfunded liability for the furniture and equipment costs at the new Thermal and Palm Desert stations. The Executive Office will work to complete these projects, including use of used furniture and other equipment as was recently installed in the in the downtown law building.

The Sheriff's Department requests budget adjustments to realign revenue to coincide with program expenditures for the "COPs Rehire" program. These adjustments have no impact on net county cost.

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor-Controller to adjust estimated revenue as follows:*

Increase estimated revenue:		
10000-2500300000-767430	Federal – ARRA prime recipient	\$428,842
10000-2500400000-767430	Federal – ARRA prime recipient	3,233,140
10000-2500500000-767430	Federal – ARRA prime recipient	<u>399,068</u>
	Total	\$4,061,050
Decrease estimated revenue:		
10000-2500300000-767220	Federal – other operating grants	\$4,061,050

The Sheriff's Department requests budget adjustments to the "Riverside Auto Theft Interdiction Detail" (RAID) program to reflect recent changes in allowable program reimbursement. These adjustments have no impact on net county cost.

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:*

Increase appropriations:		
10000-2500800000-525440	Professional services	\$119,000
Increase estimated revenue:		
10000-2500800000-755200	Vehicle theft SB 2130 (RAID)	\$119,000

h) Airport and Land Use Commission (ALUC) – TLMA

The department's contribution from the general fund was under budgeted. The department requests budget adjustments to appropriate and spend the additional funding.

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:*

Increase appropriations:		
22650-3130800000-510040	Regular salaries	\$5,562
22650-3130800000-518100	Budgeted benefits	<u>3,708</u>
	Total	\$9,270
Increase estimated revenue:		
22650-3130800000-790600	Contributions from other funds	\$9,270

3. PUBLIC WAYS AND FACILITIES

Nothing to report.

4. HEALTH AND SANITATION

a) Community Health Agency (CHA)

Public Health

Realignment revenue from the state – generated from sales tax and vehicle license fees – and clinic revenue for services continue to decline. However, the department anticipates meeting its net-county-cost budget targets due to significant salary savings tied to furloughs. Unfortunately, as staff costs fall, so does grant revenue for programs reimbursed based on actual costs.

California Children's Services (CCS)

Realignment revenue from the state continues to decline. Revenue from the state could be delayed due to sluggish processing of payments. CCS will continue to monitor and notify the Executive Office as information become available.

b) Detention Health Services (DHS) – RCRMC

The department reports savings in pharmaceuticals and private hospital care. However, the savings is insufficient to keep the department from exceeding its Board-approved budget target. The overrun is projected to be \$325,000. The department continues to explore other cost savings but does not expect significant results this fiscal year. If the department runs out of appropriation authority before year-end, it will not be able to buy supplies and provide critical medical services to inmates, forcing the Sheriff to seek medical services elsewhere. In order to avoid impacts on the department, the Sheriff requests additional spending authority and additional general-fund support.

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:*

Increase appropriations:		
10000-4300200000-525240	Prisoner hospital charges	\$325,000
Decrease appropriations:		
10000-1109000000-581000	Appropriations for contingency	\$325,000

c) Medically Indigent Services Program (MISP) – RCRMC

At midyear the department reported a significant increase in enrollment and an anticipated reduction in realignment revenue from the state. The result was the need for additional general-fund support totaling \$2.6 million. As of the third quarter the department has

lowered the estimated overrun by \$200,000. The department agreed to use realignment funds typically transferred to RCRMC to cover the expected \$2.4 million budget overrun.

5. PUBLIC ASSISTANCE

a) Department of Public Social Services (DPSS)

DPSS is one department buffeted more strongly than most by the recession. It faces a growing demand for its services at a time that a nearly bankrupt state is making it harder for residents to qualify. It faces falling revenues primarily from the state at the same time that more federal dollars are coming in than ever before. In a department with an \$800 million budget, these opposing influences can wildly swing the need for general-fund support.

This fiscal year and last, a combination of conservative budgeting, good management and unexpected federal support has allowed DPSS to return about \$60 million to the general fund. The future, however, is far from certain. Service needs are growing, federal funds might soon dry up and the state might not be able to pay its bills. The department's early estimate is that it will need \$18 million in new general-fund support next year for legally mandated services. The department will update this estimate as more current information becomes available. The first update to the Board will come within 30 days in the context of the governor's May revise budget.

The department's caseload continues to grow in assistance programs. The table below summarizes caseload growth from February 2009 to February 2010.

Programs	Feb-09	Feb-10	Change
CalWORKS Eligibility	27,593	31,415	13.85%
Child Care Placements	5,247	5,088	-3.03%
CalWORKS Welfare to Work	14,737	14,681	-0.38%
Food Stamps	54,887	76,822	39.96%
Medi-Cal	108,113	117,562	8.74%
Foster Care	3,405	3,033	-10.93%
Adoption Assistance	4,966	5,374	8.22%
In-Home Supportive Services	16,658	17,682	6.15%
CWS	9,649	9,047	-6.24%
APS	1,410	1,950	38.30%

The department has updated expenditure projections to reflect the most current trends and has adjusted for prior-year closeout revenue received in the current year. The net result is a savings to the general fund totaling \$4,993,000, which can be appropriated into contingency. The department requests the budget adjustment reflecting this savings.

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Decrease appropriations:

10000-5100100000-510040	Regular salaries	\$2,277,000
10000-5100100000-518100	Budgeted benefits	1,150,000
10000-5100100000-521640	Maintenance – software	1,675,000
10000-5100100000-523840	Computer equip. – software	1,171,000
10000-5100100000-524680	Consultants – computer program	712,000

10000-5100100000-529540	Utilities	443,000
10000-5100100000-524940	Instructors – trainers	252,000
10000-5100100000-527840	Training, education, tuition	355,000
10000-5100100000-523700	Office supplies	169,000
10000-5100100000-528920	Car pool expense	<u>454,000</u>
	Total	\$8,658,000
Increase estimated revenue:		
10000-5100100000-760000	Fed-public assistance admin	\$1,485,000
Decrease estimated revenue:		
10000-5100100000-750300	CA-public assistance admin	\$5,150,000
Increase appropriations:		
10000-1109000000-581000	Appropriations for contingency	\$4,993,000

CalWORKs

Growth in stage-one child care caseload is trending below budgeted levels. This program is part of the single allocation that requires a county maintenance-of-effort share of cost. Savings do not reduce net county cost. The department requests a budget adjustment to align revenue with expenses.

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Decrease appropriations:		
10000-5100100000-530420	Child care services	\$4,300,000
Decrease in estimated revenue:		
10000-5100100000-760000	Fed-public assistance admin	\$3,971,000
10000-5100100000-750300	CA-public assistance admin	<u>329,000</u>
	Total	\$4,303,000

In Home-Supportive Services (IHSS)

Caseload for individual provider hours is growing but a decrease is expected for the contracted service component. Overall, the slower growth rate is projected to result in net-county-cost savings. The department requests the following budget adjustment to reflect the anticipated general-fund savings and appropriate that savings in contingency.

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations:		
10000-1109000000-581000	Appropriations for contingency	\$2,400,000
Decrease appropriations:		
10000-5100200000-530440	Client services	\$2,400,000

Categorical Aid

Adoptions assistance is experiencing slower caseload growth than originally projected. The projected net county cost savings is about \$2 million. A recent federal district court ruling, however, provides for increased group-home rates, which is expected to offset the savings.

As reported in the first quarter, while developing the FY 09/10 budget, the federal medical assistance percentage (FMAP) increases for foster care and adoptions assistance were not confirmed. They are, therefore, not included in the budget. Because those increases have been formally extended, a \$1.5 million general-fund savings is now anticipated. The department requests budget adjustments to account for this new revenue and to move the savings into contingency.

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:*

Decrease appropriations:		
10000-5100300000-530480	Categorical assistance	\$3,414,000
Decrease estimated revenue:		
10000-5100300000-761000	Fed-public assistance admin	\$909,000
10000-5100300000-750700	CA-public assistance admin	<u>1,005,000</u>
	Total	\$1,914,000
Increase appropriations:		
10000-1109000000-581000	Appropriations for contingency	\$1,500,000

County Funded Programs

The department projects the need for an additional \$200,000 to cover expenses for county funded foster care. The cost can be covered with a transfer from Categorical Aid. The department requests a budget adjustment to transfer the funds.

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:*

Increase appropriations:		
10000-5100400000-530520	County funded assistance	\$200,000
Decrease appropriations:		
10000-5100300000-530480	Categorical assistance	\$200,000

6. EDUCATION, RECREATION, AND CULTURE

Nothing to report.

7. ENTERPRISE FUNDS

a) Riverside County Regional Medical Center (RCRMC)

The approved budget authorized \$64.4 million in reserve funds to cover hospital operating expenses. However, at this time, RCRMC expects expenses to be less than budgeted. Revenue also is trending higher than anticipated. Together, these reduce the need for reserves to about \$37.9 million. No budget adjustments are requested at this time.

RCRMC also reports that pending federal initiatives could significantly enhance hospital revenue. The hospital will update the Board as these initiatives develop.

b) Waste Management District

The Waste Management Department requests a budget adjustment to purchase an industrial tarp sewing machine and tarp to be used for alternative daily cover at the Badlands Landfill.

Recommended Motion: *That the Board of Supervisors approve the purchase of a tarp and an industrial sewing machine, and direct the Auditor-Controller to adjust appropriations as follows:*

Increase appropriations:		
40200-4500100000-526910	Field equipment – non-fixed asset	\$2,500
40200-4500100000-546160	Equipment – other	<u>12,500</u>
	Total	\$15,000
Expected offset:		
40200-4500100000-380100	Unrestricted net assets	\$15,000

8. INTERNAL SERVICE FUNDS (ISF)

a) Exclusive Care

The department expects that bi-weekly cash flow and changes to pharmacy supply will keep Exclusive Care within appropriation limits for the balance of the fiscal year. However, new drug ordering regulations forced the department to purchase a new drug ordering program for pharmaceuticals, costing \$4.6 million. The department will have to use substantial reserves to cover this cost.

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:*

Increase appropriations:		
45800-1132000000-534480	Physician care claims	\$587,100
45800-1132000000-534500	Hosp. care services claims	2,500,000
45800-1132000000-534520	EPO pharmacy claims	<u>1,500,000</u>
	Total	\$4,587,100
Expected offset:		
45800-1132000000-380100	Unrestricted net assets	\$4,587,100

b) Online Administrative Services Information System (OASIS)

In its third-quarter status report, OASIS reports estimated year-end expenses were less than budgeted, primarily in salaries and benefits. This savings is attributable to furloughs and vacancies. This will yield a higher than anticipated year-end balance of net assets.

OASIS requests approval and budget adjustments to acquire additional memory and CPU processor capacity for its production servers. This purchase is necessary to accommodate immediate production needs on the servers housing the county's Financials, HRMS/payroll, and budgeting systems.

Recommended Motion: That the Board of Supervisors approve the acquisition of 448 gigabytes of additional memory and 4 CPU processor cores for three OASIS production servers; and approve and direct the Auditor-Controller to adjust appropriations as follows:

Decrease appropriations:		
45420-1109200000-510040	Regular salaries	\$112,884
45420-1109300000-510040	Regular salaries	<u>41,505</u>
	Total	\$154,389
Increase appropriations:		
45420-1109200000-546080	Equipment – computer	\$112,884
45420-1109300000-546080	Equipment – computer	<u>41,505</u>
	Total	\$154,389

c) Supply Services

Systems furniture sales to other county departments are trending substantially below budgeted expectations. In FY 07/08 furniture sales exceeded \$11 million and last year, sales were close to \$7 million. Furniture sales this year are currently less than \$500,000. The department requests budget adjustments to better align sales and revenue based on current trends.

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Decrease appropriations:		
45700-7300400000-527600	Indirect cost – furniture	\$3,000,000
Decrease estimated revenue:		
45700-7300400000-781600	Systems furniture	\$3,000,000

d) Temporary Assistance Program (TAP)

On July 21, 2009, the Board implemented the Subsidized Time-Limited Employment Program (STEP), a subsidized work program that stimulates local employment and creates jobs. Currently, the program is administered by TAP and funded with American Recovery and Reinvestment Act funds, through the Department of Public Social Services. Projections anticipate a \$1.4 million increase in payroll costs this year. The department requests budget adjustments to account for the additional cost and the associated reimbursement.

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Increase appropriations:		
47000-1131800000-510320	Temporary salaries	\$1,400,000
Increase estimated revenue:		
47000-1131800000-777480	Reimbursement –admin overhead	\$200,000
47000-1131800000-777540	Reimbursement – salaries	<u>1,200,000</u>
	Total	\$1,400,000

9. SPECIAL DISTRICTS

a) Flood Control and Water Conservation District

A budget adjustment is required to reimburse construction costs pursuant to a cooperative funding agreement from the area drainage plan (ADP) fund.

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor Controller to adjust appropriations as follows:*

Increase appropriations:		
25140-947460-574200	Intra-zone special expense	(\$1,500,000)
25140-947460-527920	Equipment – other	1,000,000
25140-947460-524820	Engineering services	<u>500,000</u>
	Total	\$0

b) Regional Parks and Open Space District

Parks Resident Utility Trust

Several resident housing units in countywide parks need high-priority health and safety upgrades. There are sufficient reserves to correct these issues and Parks requests budget adjustments to complete the work.

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor Controller to adjust appropriations as follows:*

Increase appropriations:		
25510-931108-522310	Maintenance – buildings	\$25,000
Expected offset:		
25510-931108-320100	Designated fund balance	\$25,000

c) County Services Areas (CSA)

For various county service areas, actual operating expenses are expected to exceed budgeted estimates due to CSA restructuring, increased utilities costs and staff reassignments. Budget adjustments are necessary to provide sufficient appropriations to establish a CSA administrative operating fund, add personnel support in CSA 36 and cover increases in streetlight utilities and salaries and benefits. No general-fund impact results from these budget adjustments, which will be funded from reserves.

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:*

Increase appropriations:		
23525-905102-537180	Interfund exp. – salary reimb.	\$25,000
Expected offset:		
23525-905102-325100	Unreserved fund balance	\$25,000
Increase appropriations:		
40440-906203-510040	Regular salaries	\$15,000

Expected offset: 40440-906203-313300	Restricted net assets	\$15,000
Increase appropriations: 23825-908401-537180	Interfund exp. – salary reimb.	\$5,000
Expected offset: 23825-908401-325100	Unreserved fund balance	\$5,000
Increase appropriations: 23850-908501-537180	Interfund exp. – salary reimb.	\$5,000
Expected offset: 23850-908501-325100	Unreserved fund balance	\$5,000
Increase appropriations: 40400-912211-510040	Regular salaries	\$6,000
Expected offset: 40400-912211-380100	Unrestricted net assets	\$6,000
Increase appropriations: 24550-914301-510040	Regular salaries	\$40,000
24550-914301-537180	Interfund exp. – salary reimb	25,000
	Total	\$65,000
Expected offset: 24550-914301-325100	Unreserved fund balance	\$65,000
Increase appropriations: 24825-914901-537180	Interfund exp. – salary reimb.	\$1,500
Expected offset: 24825-914901-325100	Unreserved fund balance	\$1,500
Increase appropriations: 33200-915201-537180	Interfund exp. – salary reimb.	\$15,000
Expected offset: 33200-915201-325100	Unreserved fund balance	\$15,000
Increase appropriations: 24150-910801-537180	Interfund exp. – salary reimb.	\$5,000
Expected offset: 24150-910801-325100	Unreserved fund balance	\$5,000
Increase appropriations: 23950-909101-529530	Street lights	\$10,000

Expected offset:		
23950-909101-325100	Unreserved fund balance	\$10,000
Increase appropriations:		
24875-915210-510040	Regular salaries	\$5,000
Expected offset:		
24875-915210-325100	Unreserved fund balance	\$5,000
Increase appropriations:		
23375-903601-510040	Regular salaries	\$50,000
23375-903601-525080	Temp assist pool svcs	25,000
23375-903601-537180	Interfund exp. – salary reimb.	<u>10,000</u>
	Total	\$85,000
Expected offset:		
23375-903601-325100	Unreserved fund balance	\$85,000

ATTACHMENT A: RECOMMENDATION SUMMARY

For convenience, this section repeats the recommendations contained in the main document. There is no new information in Attachment A.

CEO Cover letter

IT IS RECOMMENDED that the Board of Supervisors receive and file this report and all its attachments, and approve the recommendations and associated budget adjustments in Attachment A.

Board Discretionary Reserves

Recommended Motion: *That the Board of Supervisors approve: 1) that the CIP projects listed above be delayed or completed as soon as possible; 2) \$12,223,000 cash be moved from the CIP fund (30700) to the general fund; and 3) approve and direct the Auditor-Controller to adjust appropriations, estand designations as follows:*

Increase appropriations:		
30700-1104200000-551100	Contributions to county funds	\$12,223,000
Expected offset:		
30700-1104200000-309100	Reserve for construction	\$12,223,000
Increase estimated revenue:		
10000-1101000000-790600	Contributions from county funds	\$12,223,000
Increase designations:		
10000-1000100000-320110	DFB – economic uncertainty	\$12,223,000

Recommended Motion: *That the Board of Supervisors approve and direct the Auditor-Controller adjust designations as follows:*

Decrease designations:		
10000-2400100000-320104	DFB – public service	\$20,000
10000-1000100000-320107	DFB – probation	308,425
10000-1000100000-320109	DFB – capital projects	3,202,572
10000-1000100000-320129	DFB – DPSS realignment	6,867,822
10000-1000100000-320145	DFB – DPSS CalWorks	8,200,598
10000-1000100000-320133	DFB – SB90 deferral	<u>3,634,091</u>
	Total	\$22,233,508
Increase designations:		
10000-1000100000-320110	DFB – economic uncertainty	\$22,233,508

Recommended Motion: *That the Board of Supervisors approve the transfer of \$47.5 million from the tobacco securitization fund (30121) to the general fund and direct the Auditor-Controller to adjust appropriations and designations as follows:*

Increase appropriation:		
30120-1105100000-551100	Contributions to county funds	\$47,500,000

Expected offset:		
30121-1105100000-309100	Reserve for construction	\$47,500,000
Increase estimated revenue:		
10000-1101000000-790600	Contributions from county funds	\$47,500,000
Increase designations:		
10000-1000100000-320110	DFB – economic uncertainty	\$47,500,000

Prop. 172 – Public Safety Sales Tax

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to 1) cap annual distributions of public safety sales tax revenue received at the department budgeted level, 2) isolate and restrict for public safety any and all receipts in excess of what is budgeted by the public safety departments, 3) retain interest earned within the new fund; and, 4) initiate the process for the fiscal year beginning July 1, 2009.

FY 09/10 DEPARTMENTAL STATUS

GENERAL GOVERNMENT

Board and Clerk of the Board

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller adjust appropriations and estimated revenue as follows:

Decrease appropriations:		
10000-1000100000-526410	Legally required notices	\$200,000
10000-1000100000-520820	Janitorial supplies	15,000
10000-1000100000-572800	Intra-misc	(95,000)
	Total	\$120,000
Decrease estimated revenue:		
10000-1000100000-777520	Reimbursement for services	\$40,000
10000-1000100000-778280	Interfund – reimbursement for services	80,000
	Total	\$120,000

Economic Development and Facility Management Agency (EDA)

Facilities Management Administration

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations:		
10000-7200100000-524660	Consultants	\$43,000
10000-7200100000-526700	Rent – lease	64,000
10000-7200100000-524560	Auditing and accounting	4,000
10000-7200100000-537080	Interfund expense – miscellaneous	315,000
10000-7200100000-572400	Intrafund – internal charges	(426,000)
	Total	\$0

Energy Management

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Increase appropriations:		
10000-7200600000-529540	Utilities	\$1,728,237
10000-7200600000-573800	Intrafund – utilities	<u>(1,419,772)</u>
	Total	\$308,465
Increase estimated revenue:		
10000-7200600000-777610	Utilities	\$240,058
10000-7200600000-778350	Interfund – utilities	<u>68,407</u>
	Total	\$308,465

Deferred Maintenance

Recommended Motion: That the Board of Supervisors approve the reprogramming of \$150,000 within deferred maintenance.

Executive Office

Recommended Motion: That the Board of Supervisors approve the purchase of land, and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Increase appropriations:		
10000-1100100000-536800	Interfund expense – distributions	\$520,490
Expected offset:		
11033-1100100000-308101	Restricted program money	\$520,490
Increase appropriations:		
20200-3100500000-525400	Title company services	\$2,000
20200-3100500000-540040	Land	<u>518,490</u>
	Total	\$520,490
Increase estimated revenue:		
20200-3100500000-778260	Interfund – property and assessment	\$520,490

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Increase appropriations:		
10000-1100100000-510220	Payoff permanent – seasonal	\$306,826
Increase estimated revenue:		
10000-1100100000-777480	Reimb. of cost – admin overhead	\$120,000
10000-1100100000-777520	Reimbursement for services	142,000
10000-1100100000-781360	Other misc revenue	<u>54,826</u>
	Total	\$306,826

Registrar of Voters (ROV)

Recommended Motion: That the Board of Supervisors approve the purchase of two affidavit scanners and two envelope scanners; and approve and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations:		
10000-1700100000-546160	Equipment – other	\$100,000

Decrease appropriations:		
10000-1700100000-525340	Temporary help services	\$100,000

PUBLIC PROTECTION

Alternate Public Defender

Recommended Motion: That the Board of Supervisors approve the purchase of two photocopy machines; and approve and direct the Auditor Controller to adjust appropriations as follows:

Increase appropriations:		
10000-2401300000-520260	Computer lines	\$75,000
10000-2401300000-523640	Computer equip. – non-fixed asset	55,356
10000-2401300000-523620	Books and publications	10,000
10000-2401300000-523680	Office equip. – non-fixed asset	349,830
10000-2401300000-523700	Office supplies	17,892
10000-2401300000-525220	Pre-employment services	2,921
10000-2401300000-526700	Rent or lease of buildings	100,000
10000-2401300000-546160	Equipment – other	<u>36,000</u>
	Total	\$646,999

Decrease appropriations:		
10000-1109000000-581000	Appropriations for contingency	\$646,999

Animal Services – Community Health Agency

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations:		
10000-4200600000-520820	Janitorial services	\$50,000
10000-4200600000-522310	Maintenance – buildings	100,000
10000-4200600000-529540	Utilities	<u>100,000</u>
	Total	\$250,000

Decrease appropriations:		
10000-1109000000-581000	Appropriations for contingency	\$250,000

Public Defender

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations:		
10000-2400100000-510040	Regular salaries	\$16,561
10000-2400100000-518100	Budgeted benefits	<u>6,689</u>
	Total	\$23,250

Expected offset:		
11123-2400100000-308101	Restricted program money	\$23,250

Sheriff's Department

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust estimated revenue as follows:

Increase estimated revenue:		
10000-2500300000-767430	Federal – ARRA prime recipient	\$428,842
10000-2500400000-767430	Federal – ARRA prime recipient	3,233,140
10000-2500500000-767430	Federal – ARRA prime recipient	<u>399,068</u>
	Total	\$4,061,050
Decrease estimated revenue:		
10000-2500300000-767220	Federal – other operating grants	\$4,061,050

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Increase appropriations:		
10000-2500800000-525440	Professional services	\$119,000
Increase estimated revenue:		
10000-2500800000-755200	Vehicle theft SB 2130 (RAID)	\$119,000

Airport and Land Use Commission (ALUC) – TLMA

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Increase appropriations:		
22650-3130800000-510040	Regular salaries	\$5,562
22650-3130800000-518100	Budgeted benefits	<u>3,708</u>
	Total	\$9,270
Increase estimated revenue:		
22650-3130800000-790600	Contributions from other funds	\$9,270

HEALTH and SANITATION

Detention Health Services (DHS) – RCRMC

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations:		
10000-4300200000-525240	Prisoner hospital charges	\$325,000
Decrease appropriations:		
10000-1109000000-581000	Appropriations for contingency	\$325,000

PUBLIC ASSISTANCE

Department of Public Social Services (DPSS)

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Decrease appropriations:		
10000-5100100000-510040	Regular salaries	\$2,277,000
10000-5100100000-518100	Budgeted benefits	1,150,000
10000-5100100000-521640	Maintenance – software	1,675,000
10000-5100100000-523840	Computer equip. – software	1,171,000

10000-5100100000-524680	Consultants – computer program	712,000
10000-5100100000-529540	Utilities	443,000
10000-5100100000-524940	Instructors – trainers	252,000
10000-5100100000-527840	Training, education, tuition	355,000
10000-5100100000-523700	Office supplies	169,000
10000-5100100000-528920	Car pool expense	<u>454,000</u>
	Total	\$8,658,000
Increase estimated revenue:		
10000-5100100000-760000	Fed-public assistance admin	\$1,485,000
Decrease estimated revenue:		
10000-5100100000-750300	CA-public assistance admin	\$5,150,000
Increase appropriations:		
10000-1109000000-581000	Appropriations for contingency	\$4,993,000

CalWORKs

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Decrease appropriations:		
10000-5100100000-530420	Child care services	\$4,300,000
Decrease in estimated revenue:		
10000-5100100000-760000	Fed-public assistance admin	\$3,971,000
10000-5100100000-750300	CA-public assistance admin	<u>329,000</u>
	Total	\$4,300,000

In Home-Supportive Services (IHSS)

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations:		
10000-1109000000-581000	Appropriations for contingency	\$2,400,000
Decrease appropriations:		
10000-5100200000-530440	Client services	\$2,400,000

Categorical Aid

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Decrease appropriations:		
10000-5100300000-530480	Categorical assistance	\$3,414,000
Decrease estimated revenue:		
10000-5100300000-761000	Fed-public assistance admin	\$909,000
10000-5100300000-750700	CA-public assistance admin	<u>1,005,000</u>
	Total	\$1,914,000

Increase appropriations:		
10000-1109000000-581000	Appropriations for contingency	\$1,500,000

County Funded Programs

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations:		
10000-5100400000-530520	County funded assistance	\$200,000

Decrease appropriations:		
10000-5100300000-530480	Categorical assistance	\$200,000

ENTERPRISE FUNDS

Waste Management District

Recommended Motion: That the Board of Supervisors approve the purchase of a tarp and an industrial sewing machine, and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations:		
40200-4500100000-526910	Field equipment – non-fixed asset	\$2,500
40200-4500100000-546160	Equipment – other	<u>12,500</u>
	Total	\$15,000

Expected offset:		
40200-4500100000-380100	Unrestricted net assets	\$15,000

INTERNAL SERVICE FUNDS (ISF)

Exclusive Care

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations:		
45800-1132000000-534480	Physician care claims	\$587,100
45800-1132000000-534500	Hosp. care services claims	2,500,000
45800-1132000000-534520	EPO pharmacy claims	<u>1,500,000</u>
	Total	\$4,587,100

Expected offset:		
45800-1132000000-380100	Unrestricted net assets	\$4,587,100

Online Administrative Services Information System (OASIS)

Recommended Motion: That the Board of Supervisors approve the acquisition of 448 gigabytes of additional memory and 4 CPU processor cores for three OASIS production servers; and approve and direct the Auditor-Controller to adjust appropriations as follows:

Decrease appropriations:		
45420-1109200000-510040	Regular salaries	\$112,884
45420-1109300000-510040	Regular salaries	<u>41,505</u>
	Total	\$154,389

Increase appropriations:		
45420-1109200000-546080	Equipment – computer	\$112,884
45420-1109300000-546080	Equipment – computer	<u>41,505</u>
	Total	\$154,389

Supply Services

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Decrease appropriations:		
45700-7300400000-527600	Indirect cost – furniture	\$3,000,000

Decrease estimated revenue:		
45700-7300400000-781600	Systems furniture	\$3,000,000

Temporary Assistance Program (TAP)

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations and estimated revenue as follows:

Increase appropriations:		
47000-1131800000-510320	Temporary salaries	\$1,400,000

Increase estimated revenue:		
47000-1131800000-777480	Reimbursement –admin overhead	\$200,000
47000-1131800000-777540	Reimbursement – salaries	<u>1,200,000</u>
	Total	\$1,400,000

SPECIAL DISTRICTS

Flood Control and Water Conservation District

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations:		
25140-947460-574200	Intra-zone special expense	(\$1,500,000)
25140-947460-527920	Equipment – other	1,000,000
25140-947460-524820	Engineering services	<u>500,000</u>
	Total	\$0

Regional Parks and Open Space District

Parks Resident Utility Trust

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations:		
25510-931108-522310	Maintenance – buildings	\$25,000

Expected offset:		
25510-931108-320100	Designated fund balance	\$25,000

County Services Areas (CSA)

Recommended Motion: That the Board of Supervisors approve and direct the Auditor-Controller to adjust appropriations as follows:

Increase appropriations: 23525-905102-537180	Interfund exp. – salary reimb.	\$25,000
Expected offset: 23525-905102-325100	Unreserved fund balance	\$25,000
Increase appropriations: 40440-906203-510040	Regular salaries	\$15,000
Expected offset: 40440-906203-313300	Restricted net assets	\$15,000
Increase appropriations: 23825-908401-537180	Interfund exp. – salary reimb.	\$5,000
Expected offset: 23825-908401-325100	Unreserved fund balance	\$5,000
Increase appropriations: 23850-908501-537180	Interfund exp. – salary reimb.	\$5,000
Expected offset: 23850-908501-325100	Unreserved fund balance	\$5,000
Increase appropriations: 40400-912211-510040	Regular salaries	\$6,000
Expected offset: 40400-912211-380100	Unrestricted net assets	\$6,000
Increase appropriations: 24550-914301-510040	Regular salaries	\$40,000
24550-914301-537180	Interfund exp. – salary reimb	<u>25,000</u>
	Total	\$65,000
Expected offset: 24550-914301-325100	Unreserved fund balance	\$65,000
Increase appropriations: 24825-914901-537180	Interfund exp. – salary reimb.	\$1,500
Expected offset: 24825-914901-325100	Unreserved fund balance	\$1,500
Increase appropriations: 33200-915201-537180	Interfund exp. – salary reimb.	\$15,000

Expected offset: 33200-915201-325100	Unreserved fund balance	\$15,000
Increase appropriations: 24150-910801-537180	Interfund exp. – salary reimb.	\$5,000
Expected offset: 24150-910801-325100	Unreserved fund balance	\$5,000
Increase appropriations: 23950-909101-529530	Street lights	\$10,000
Expected offset: 23950-909101-325100	Unreserved fund balance	\$10,000
Increase appropriations: 24875-915210-510040	Regular salaries	\$5,000
Expected offset: 24875-915210-325100	Unreserved fund balance	\$5,000
Increase appropriations: 23375-903601-510040	Regular salaries	\$50,000
23375-903601-525080	Temp assist pool svcs	25,000
23375-903601-537180	Interfund exp. – salary reimb.	<u>10,000</u>
	Total	\$85,000
Expected offset: 23375-903601-325100	Unreserved fund balance	\$85,000

**FY 2009 – 2010
3rd Quarter Budget Update
Vacancy Report**

The economic downturn continues to influence hiring activity in the County due to departments' requirements to stay within their required Maximum Fill Rate during the third quarter, and plan for further reductions for the next Fiscal Year.

While the countywide hiring freeze has been lifted, departments are continuing conservative approaches to hiring in most areas as a result of the continued economic downturn affecting our region. Most departments report that only key positions are being filled by shifting department staff and that hiring is to match attrition. The healthcare market remains competitive and RCRMC continues to have a steady stream of hiring activity to keep pace with attrition and increased census levels, while operating in an environment of mandated staffing ratios. RCRMC reports recruiting for 61 positions as we enter the fourth quarter. The Public Health Department also anticipates hiring 12 positions in healthcare, with four Nutritionists, one Physical Therapy Assistant, one Occupational Therapy Assistant, one Healthcare Social Worker, one Supervising Medical Records Technician, one Health Education Assistant, and three Assistant Nurse Managers. The Environmental Health Department is also anticipating hiring six Environmental Health Specialists in the fourth quarter.

The Riverside County Regional Park & Open-Space District anticipates the possibility of a limited amount of hiring in the fourth quarter, related to the projected completion of the Jurupa Valley Aquatic Center.

In the fourth quarter, growth in the Economic Development Agency will continue related to stimulus funding. Employment growth in the Economic Development Agency has been steady over Fiscal Year 2009/2010, and is likely to continue from stimulus-related funds.

At the Department of Public Social Services (DPSS), due to the still unknown funding from the State, the department continues to take a conservative approach to filling positions and adding any new positions to their budget. However, the current economic situation has caused a significant increase in the demand for services related to temporary financial assistance, which has also caused an increase in eligibility worker caseloads. Based on this, DPSS has decided to fill several Eligibility Technician I positions to provide more efficient customer services. In most other divisions of DPSS, they remain conservative in filling positions in order to absorb possible cuts in State funding.

As we enter the fourth quarter, the Sheriff's Department is planning for the completion of the Larry D. Smith Correctional Facility in Banning. Additional staff will be needed to allow inmate occupation in the new housing areas. An additional 142 sworn, corrections, and classified staff positions were approved to fully operate the addition to the facility. Recruiting for these and other critical positions is underway, with a deputy academy starting in late April.

The Human Resources Department is committed to working with each county department to meet their recruiting needs. The goal of the department is to provide the most efficient and effective recruiting services possible, so the county can meet its mission through its employees.



Q4

Riverside County In Brief

The allocation from the county's October through December sales declined 21% from the holiday quarter of 2008 after accounting adjustments and retroactive audit recoveries were factored out.

The previous incorporation of Menifee, business closeouts and a continuing decline in both pricing and sales of building/construction materials, business equipment, boats, RVs and motorcycles all contributed to the decrease. Onetime purchases related to a major energy project that temporarily inflated revenues from last year's comparable quarter were also a factor.

A reduction in revenues from the countywide use tax allocation pool further contributed to the decrease. The unincorporated area generated 12.7% of all taxable sales in the county for the quarter and therefore received a 12.7% share of the pool.

The losses were partially offset by a solid quarter for the Desert Hills factory outlet center, increased delivery of e-commerce orders from unincorporated area warehouses and retroactive correction of a previous mis-allocation of taxes from a new car dealership.

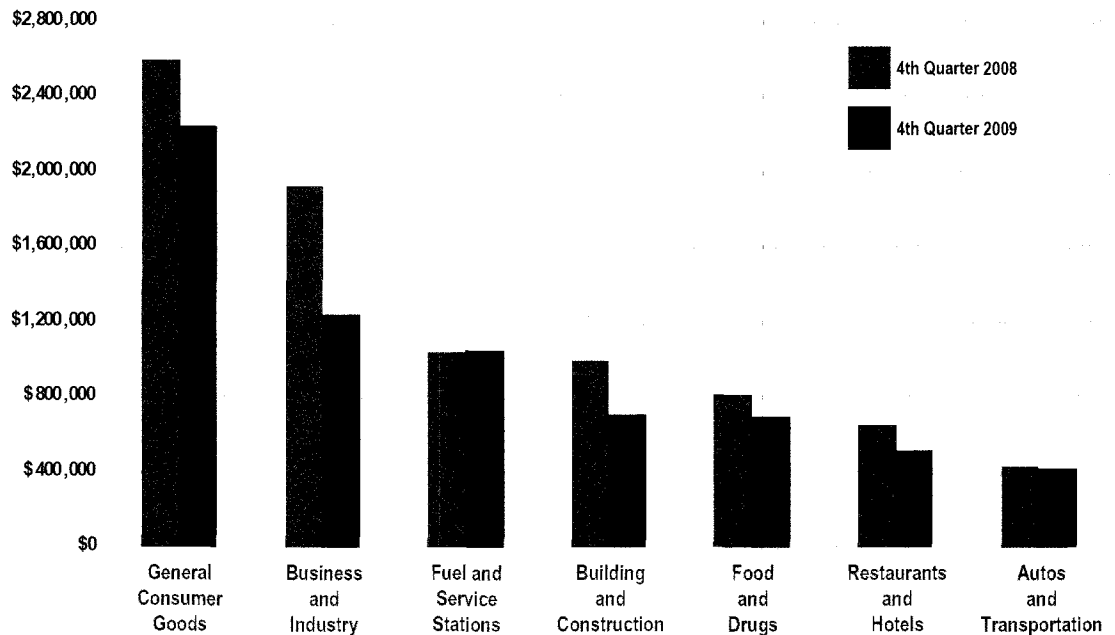
Adjusted for reporting aberrations, sales and use tax revenues for the county and its cities combined were 5.8% lower than the same quarter one year ago while southern California as whole was down 6.8%.



Riverside County Sales Tax Update

First Quarter Receipts for Fourth Quarter Sales (Oct-Dec 2009)

SALES TAX BY MAJOR BUSINESS GROUP



TOP 25 PRODUCERS

In Alphabetical Order

Albertsons	Mobile Modular Management
Arco Travel Zone Center	Morongo Shell
Best Buy	Orco Block
Burberrys Limited	Pedder Nissan
Circle K	Polo Ralph Lauren
Coach	Ralphs
Costco E-Commerce Sales	South Coast Winery
Edward Don & Company	Stater Bros
G & M Oil	Target
Gucci America	Vons
Home Depot	Wal Mart DVD Rentals
Joseph L Chiriaco	
Kohls	
Lowes	

REVENUE COMPARISON

Three Quarters – Fiscal Year To Date

	2008-09	2009-10
Point-of-Sale	\$25,516,742	\$19,133,857
County Pool	2,898,473	2,021,535
State Pool	10,790	18,454
Gross Receipts	\$28,426,006	\$21,173,846
Cty/Cnty Share	274	0
Net Receipts	\$28,426,280	\$21,173,846
Less Triple Flip*	\$(7,106,570)	\$(5,293,462)

*Reimbursed from county compensation fund

California Overall

Local allocations for sales occurring October through December were 6.7% lower than last year's holiday quarter after adjusting for accounting aberrations.

All regions experienced declines. The largest reductions were in building and construction materials and business equipment and supplies. Shoppers generally favored discount stores and value-oriented apparel to traditional department stores and specialty shops. However, a few high end chains also posted gains. A rise in new car sales was offset by declining revenues from auto leases and continuing drops in sales of RVs, boats and motorcycles. The quarter's largest statewide increases were from value oriented family apparel and from rising service station prices.

Short Term Recovery Projected

Most economists and trade analysts are cautiously optimistic that there will be recovery over the next two or three quarters. Stabilization of home prices and the recovering stock market have made the still employed more confident about making purchases that were avoided during the bottom of the recession. Lower prices have also stretched the discretionary income available to make those purchases.

They see banks beginning to lend again while the restocking of depleted inventories is stimulating industrial production. Other factors adding to the optimism are increased demands for American exports, renewed spending on technology and software and a recent uptick in California's entertainment industry.

The Budget Conundrum

There is general agreement that the current recovery is fragile and that California will trail the nation. However, there is sharp disagreement on its durability. Most analysts believe that as long as the current demand for exports continues, the other previously cited factors will sustain a slow recovery.

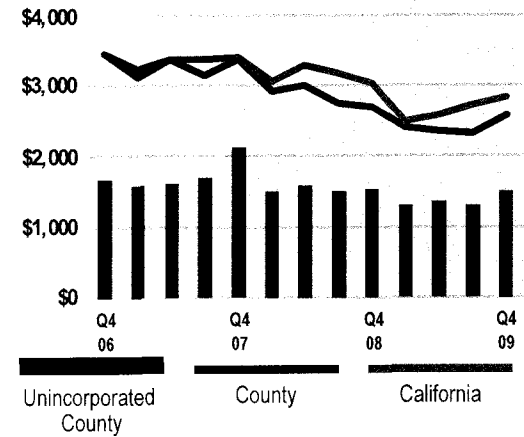
Others argue that a second dip in the recession is likely. They maintain that the current recovery is a "bubble" created by unsustainable tax cuts, federal stimulus spending, low interest loans and modification programs that mask and only delay inevitable foreclosures. Further, the pending resetting of large numbers of adjustable rate home mortgages and need to refinance \$500 billion in commercial loans is being ignored. Until we suffer the consequences from those losses they say, the end of federal bailouts will simply send us back into a recession. Both sides express concerns about the sufficiency of future job opportunities.

Recovery and Sales Tax

It will be slow, spotty and uncertain. Gains from value priced consumer goods, technology, medical focused industries and higher fuel prices are expected. The increase from incentive driven car sales should continue for another quarter or two.

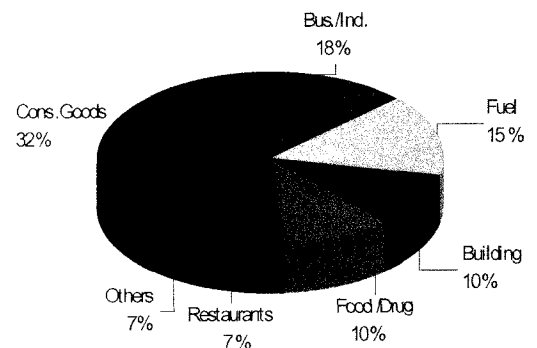
The outlook for a recovery from building and construction materials remains pessimistic while restaurants and other categories are expected to be flat or decline further.

SALES PER CAPITA



REVENUE BY BUSINESS GROUP

Riverside County This Quarter



RIVERSIDE COUNTY TOP 15 BUSINESS TYPES

Business Type	Unincorporated County		County	HdL State
	Q4 '09*	Change	Change	Change
Service Stations	\$1,043.1	1.2%	13.8%	7.0%
Family Apparel	792.9	-3.7%	10.8%	9.4%
Discount Dept Stores	445.5	-37.8%	0.1%	1.8%
Contractors	408.1	-22.2%	-26.8%	-23.0%
Restaurants No Alcohol	352.9	-21.5%	-1.9%	-2.3%
Grocery Stores Liquor	331.8	-17.5%	0.8%	2.1%
Specialty Stores	265.6	8.4%	-2.2%	-6.0%
Lumber/Building Materials	226.0	-40.5%	4.3%	-0.5%
Motion Pictures/Equipment	215.5	40.8%	40.3%	-21.4%
Wineries	180.2	33.8%	32.0%	2.0%
Women's Apparel	165.8	3.8%	5.5%	0.0%
Shoe Stores	144.1	19.9%	9.0%	-1.6%
New Motor Vehicle Dealers	—	CONFIDENTIAL	0.2%	1.0%
Grocery Stores Beer/Wine	120.8	-7.0%	-6.2%	-0.9%
Light Industrial/Printers	119.8	-6.2%	-18.5%	-24.3%
Total All Accounts	\$6,932.3	-17.9%	-3.0%	-5.9%
County & State Pool Allocation	729.9	-22.2%		
Gross Receipts	\$7,662.2	-18.3%		
City/County Share	0.0	-100.0%		
Net Receipts	\$7,662.2	-18.3%		

*In thousands

ATTACHMENT D

The Auditor-Controller provided the table on the following page. It gives a summary of the outstanding SB90 claims due to Riverside County. Programs that have been suspended during FY 09/10 are identified in the first column with an S. Although 43 budget units have outstanding claims totaling almost \$40M, approximately \$36M is attributable to nine budget units. Departments with outstanding claims in excess of \$500,000 are the Auditor/Controller, Registrar of Voters, District Attorney, Public Defender, Sheriff: Administration, Patrol and Corrections, Mental Health Treatment and Animal Services.

Outstanding claims owed to Riverside County by the state total \$39.9M. Of this total amount, \$28.6M dates back prior to July 1, 2004. We are owed \$2.0M total for FYs 05-07, \$4.4M for FY 07/08, and \$5.0M for FY 08/09. Payments from the state have been unreliable and sporadic.

- The state approved AB 138 in 2005 allowing it until 2021 to repay, without interest, the \$28.6M in old year claims.
- A total of \$6.4M was claimed for FY 07/08. As indicated in the FY 07/08 column approximately \$4.4M remains outstanding. The cumulative claim outstanding for FY 04/05 through FY 06/07 is about \$2M.
- The amounts listed in the FY 08/09 column are the claims filed in February 2010 and are payable by October 15 or sixty days after the date the appropriation becomes effective.

Seventeen mandates were suspended for FY 09/10 and a similar number have been proposed for suspension in FY 10/11. Based on claims submitted over the last three years, departments are not expecting additional support (either through new NCC or from state reimbursement) for any suspended programs. Some departments have indicated that they decided to continue providing suspended services by absorbing the cost within their existing Net County Cost. Insufficient data was received to confirm whether or not this is true in all departments.

After the state approves its FY 10/11 budget we will examine any changes to the mandate list and will report to the Board the degree to which unfunded mandates can be discontinued.

County of Riverside
Summary of Due from SB90 - Summarizing Pre 2004/05
Amounts in Dollars - as of March 31, 2010

<u>FY09/10</u> <u>Suspended</u>	<u>Mandates</u>	<u>Total</u>	<u>FY08/09</u>	<u>FY07/08</u>	<u>FY04/05- FY06/07</u>	<u>Claims Prior to July 1, 2004</u>
	Absentee Ballots	4,708,707	1,231,152	1,376,284		2,101,271
	Administrative License Suspension	5,755	3,878		1,877	
S	AIDS: Testing	4,395				4,395
	Allocation of Property Tax Revenue	37,965	13,006		3,648	21,311
	Animal Adoption	3,026,997	589,547	1,014,871	198,543	1,224,036
	Child Abduction and Recovery	5,673,339	1,537,668			4,135,671
S	Conservatorship: Developmentally Disabled Adults	10,476				10,476
S	County Treasury Oversight Committees	16,461				16,461
	Crime Victims' Domestic Violence Incident Reports	8,612	2,831		5,781	
	Crime Victims' Rights	977,783	315,184	268,923		393,676
	Developmentally Disabled Attorney Services	68,510	3,134	53,660		11,716
	DNA: Database	10,820	3,047	5,502	2,271	
	Domestic Violence Arrest Policies & Standards	188,720	47,143			141,577
	Domestic Violence Arrests and Victims Assistance	42,120	9,710	(6,157)	38,567	
	Domestic Violence Treatment Services	216,929	91,523			125,406
	Fire Safety Inspections of Care Facilities	9,254	5,957	3,297		
S	Grand Jury Proceedings	1,227,705				1,227,705
	Handicapped and Disabled Students II	125,116			125,116	
	Consolidation of HDS, HDS II and SED: Out of State Mental Health Services	416,940		574,924	(157,984)	
	Health Benefits for Survivors of Peace Officers and Firefighters	215,174	102,488			112,686
S	Investment Reports	41,141				41,141
	Local Government Employee Relations	80,039	80,039			
S	Mandate Reimbursement Process	487,125				487,125
	Medi-Cal Beneficiary Death Notices	21,474	10,834	4,029		6,611
	Mentally Disordered Offenders	728,226	187,394	297,149		243,683
	Mentally Disordered Sex Offenders	22,998	5,037	8,369		9,592
	Not Guilty By Reason of Insanity	115,877	14,211	47,503		54,163
S	Open Meetings Act/Brown Act Reform	667,471			(11,696)	679,167
S	Peace Officers' Cancer Presumption	410,414		82,695		327,719
	Peace Officers Personnel Record: Unfounded Complaints and Discovery	17,229	10,754	6,475		
	Peace Officers Procedural Bill of Rights	6,818,235	77,193	71,190	906,401	5,763,451
	Permanent Absent Voters	523,069		150,068		373,001
S	Prisoner Parental Rights	1,655,514			851,209	804,305
S	Racial Profiling: Law Enforcement Training	274,447		274,447		
	Rape Victim Counseling Center Notices	6,096	(1,647)			7,743
S	Redevelopment Agencies: Property Tax Disbursement Reporting	4,613			4,613	
S	Regional Housing Needs Determination	52,732				52,732

County of Riverside
Summary of Due from SB90 - Summarizing Pre 2004/05
Amounts in Dollars - as of March 31, 2010

FY09/10 Suspended	Mandates	Total	FY08/09	FY07/08	FY04/05- FY06/07	Claims Prior to July 1, 2004
	Search Warrant: AIDS	225,914	27,359	24,519		174,036
S	Senior Citizen Property Tax Postponement	16,737				16,737
S		768,184				768,184
	Services to Handicapped Students	7,491,958				7,491,958
S	Sex Offenders: Disclosure by Law Enforcement	77,821				77,821
	Sexually Violent Predators	2,082,323	447,820	33,291		1,601,212
S	SIDS: Autopsy Protocol	37,332				37,332
S	SIDS: Contact by Health Officers	55,000				55,000
	Stolen Vehicle Notification	9,944	3,948	4,108		1,888
	Unitary Countywide Tax Rate	50,381	41,738			8,643
	Voter Registration Procedures	161,033	89,920	71,113		
	Total	10,976,627	610,785	133,031	0	10,232,811

Note 1

FY2008/09 reimbursement claims were filed in February, 2010. Pursuant to GC17561 (d), reimbursement claims are paid by October 15 or sixty days after the date the appropriation for the claim is effective, whichever is later.

Note 2

FY 2007/08 the county filed a reimbursement claim of \$7.4 million, the county received a payment totaling \$2.0 million, 31% of the claims filed.

Note 3

Article 13B of the California Constitution establishes that mandated costs incurred prior to fiscal year 2004-05 and not paid prior to fiscal year 2005-06 fiscal year may be paid over a term of years, as prescribed by law. The budget bills have prescribed that term as 15 years payable by fiscal year 2020-2021.



CALIFORNIA STATE UNIVERSITY FULLERTON

Dr. Adrian R. Fleissig

Dr. Mira Farka

COUNTY OF RIVERSIDE

FORECASTS AND ECONOMIC OUTLOOK

for

COUNTY OF RIVERSIDE

Final Report
19 April 2010

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A. RIVERSIDE BUDGETARY VARIABLES

A1. Property Tax Revenue

The County of Riverside provided the *Institute for Environmental and Economic Studies* (IEES) with property tax data on 890,005 property parcels for FY 2009-2010. This data differs from the Riverside County Assessor's property tax records which had 943,527 parcels and include supplemental tax revenue. Both supplemental tax and teeter overflow revenue are excluded from our estimates. The ad valorem property tax revenue in FY 2009-2010 for the 890,005 parcels was \$2,015,444,793 compared to the county total tax amount of \$2,791,936,880 which includes all property taxes reported by the county. The parcels were classified into the following seven categories: Residential, Time Shares, Manufactured Homes, Vacant, Commercial, Agricultural and Unassigned Code (see Table 1 for more details).

During the FY 2009-2010, tax revenue from residential parcels (single and multifamily) totaled \$1,354,309,605, which accounts for 67.2% of all property taxes (Table 1). The next largest share in the amount of \$482,519,356 comes from commercial parcels, which account for 23.94% of property taxes. The remaining categories total \$178,615,513 or 8.6% of property taxes in Riverside County.

Table 1
Ad Valorem Property Taxes^a
Fiscal Year 2009-2010

Type of Parcel	Dollars	Share of Property Taxes
Residential ^b	1,354,309,605	67.20%
Time Shares ^c	11,307,583	0.56%
Manufactured Homes ^d	44,823,547	2.22%
Vacant ^e	63,192,292	3.14%
Commercial ^f	482,519,356	23.94%
Agricultural ^g	58,382,752	2.90%
Unassigned Code ^h	909,658	0.05%
Total	\$2,015,444,793	100.00%

^a Data provided by the County of Riverside
^b Single and multifamily
^c Timeshare estates in a timeshare project pursuant to Section 2188.9 of the Revenue and Taxation Code.
^d Factory built manufactured homes
^e Vacant according to residential parcel codes
^f Apartment buildings, commercial building on leased land, vacant commercial, special use and all other types of commercial property.
^g Parcels under and not under an agricultural preserve act
^h Unassigned code are parcels that were not assigned to residential, commercial or agricultural

The economic recession, the real estate crisis and financial issues of the last two years have had a devastating impact on the economy of Riverside County. County property values have declined significantly more than the national average and the broader Southern California region. Compared to FY 2008-2009, the assessment roll dropped by an unprecedented 10.51% in FY 2009-2010, a net decrease of over \$25 billion which is the largest county decline in the state of California.

The decrease in assessment roll was largely caused by a reduction in value of 384,289 parcels by the Riverside County Assessor's Office in line with Proposition 8. Proposition 8 requires the assessor to apply the lower value of either the property's Factored-Base-Year Value (established under Proposition 13) or its market value as of the lien date (January 1). For FY 2009-2010, the total reduction in

assessed value as per Proposition 8 was in excess of \$42 billion, far above the FY 2008-2009 levels when 200,190 parcels received a temporary assessment reduction in the amount of \$16 billion.

Despite some preliminary signs of price stabilization in the housing market, the Riverside County real estate sector will continue to experience further strain over the next six quarters. Foreclosures and distressed sales in the county are one of the highest in the nation. In addition, the slump in commercial real estate, which lagged the housing sector by around 18 months, is particularly pronounced in Riverside County and will place further pressure on property values. New construction in residential, commercial and industrial sectors is virtually nonexistent, reflecting weak demand and deteriorating fundamentals.

Given these adverse forces, further reductions in assessed valuation as per Proposition 8 are expected in FY 2010-2011. For commercial properties, relatively large downward revisions in assessed values (Prop 8) will spill over into FY 2011-2012. In addition, since the California Consumer Price has declined, the Revenue and Taxation Code (section 51) requires that the 2010 assessment roll be adjusted using an inflation factor of 0.99763 (a decrease of -0.237%).

As a result of declines in assessed valuation, ad valorem property tax revenues (from the parcel data provided by the County) decreased from \$2,280,294,989 (FY 2009-10) to \$2,015,444,793 (FY 2010-11). This represents a net decline of \$264,850,196 or -11.6% from FY 2008-2009.

In addition, 89,112 (10.01%) property owners were delinquent on paying their property taxes (at least one installment) for FY 2008-2009 (most recent data provided). The number of property owners who paid one installment but were delinquent on the other installment was 20,387 (2.29%) and the number of owners delinquent on both was 68,725 (7.72%). This is significantly higher than in the previous fiscal year.

Delinquencies on property tax payments are likely to continue to be a major problem for the county in FY 2010-2011 and beyond as the county's economy lags behind the national recovery. The county will continue to experience high unemployment rates, record-breaking foreclosures, and continued deterioration in commercial real estate, which should generate an increase in delinquencies on property tax payments over the next two years.

Commercial Property

Conditions in the commercial real estate market have deteriorated markedly over 2009 and are unlikely to improve in the current year. At the end of January 2010, \$4.9 billion of commercial property in the Inland Empire was either in default, foreclosure, bankruptcy or real estate owned (REO). As of March 2010, 371 commercial properties are in distress. The region has the highest hotel foreclosures in California; 17 hotel properties have foreclosed during this cycle and 51 properties are in default. Transaction volume has plummeted; it is down -52% from one year ago in the industrial sector and -45% in retail. Net absorption rates are negative and vacancy rates are the

highest on record at 12.6% for industrial properties and 23.7% for office space.

Against this backdrop, commercial property tax revenues are expected to decline in the near term. We analyzed 39,786 commercial parcels provided by the County which consist of apartment buildings, commercial building on leased land, vacant commercial, special use, and other types. A major concern is the significant increase in the number of properties defaulting on property taxes. Failure to pay property taxes on vacant commercial properties in FY 2008-2009 (latest available data) was \$6,475,459 (27.2%) of all commercial properties. A further \$4,109,881 (17.3%) of commercial property taxes was delinquent on special use parcels. Apartment buildings had \$1,606,445 (6.8%) of all commercial delinquent taxes. These amounts are well above last year's levels as delinquencies on commercial properties have increased steadily and will continue to rise between 2010-2012 given the deteriorating economic factors and financial strains in this sector.

For FY 2009-2010, only 802 commercial properties had a Proposition 8 reduction in assessed value for a total amount of \$442 million. This accounts for only 2% of total commercial parcels, far below the 51% residential properties which experienced the Prop 8 "decline-in-value." One reason for this discrepancy comes from the fact that the downturn in commercial real estate sector lagged the housing market recession by about 18 months. In addition, the process of reassessing commercial properties takes much longer than the

residential sector given the large number of parameters that need to be taken into account when assessing commercial properties.

Commercial real estate prices have declined by -46% from their peak, dramatically increasing the number of Proposition 8 property tax appeals which is now around 20%. We anticipate a significant rise in the number of commercial properties that will experience a reduction in assessed valuation (Proposition 8) in FY 2010-11 and FY 2011-12 reflecting the recent deterioration in market value. Beyond this horizon, assessed valuation for commercial properties is expected to stabilize rising at a modest rate.

Non-Commercial Property

The housing market in Riverside County appears to have bottomed out towards the end of the second quarter of 2009. From its trough in May 2009, housing prices have risen by 14% as of March 2010. Housing affordability in the county has improved significantly after the precipitous decline in home prices. The number of foreclosures declined in February 2010 compared to the previous year, likely reflecting the efforts of the federal government and lenders to prevent a new wave of foreclosures.

Despite these encouraging signs, Riverside County continues to post record-breaking foreclosures, the fourth highest in the nation. As of March 2010, the county has one foreclosure-related filing per 133 household. Mortgage delinquencies have continued to increase even with the declines in foreclosures; roughly 19% of homeowners are at least 90 days delinquent, up from the 13.6% recorded a year earlier.

This indicates that government programs and not market fundamentals are at the core of the decline in foreclosures seen in early 2010. An increase in the mortgage defaults is expected in the coming months caused by high unemployment and a reset in a large number of adjustable-rate loans to higher monthly payments. In addition, despite improvements in housing affordability, demand for property should remain relatively restrained in the short term due to high and rising unemployment, low confidence and falling rental rates.

For FY 2009-2010, 253,364 residential properties received a Proposition 8 reassessment, reducing the assessment roll by roughly \$36.5 billion. Assessed values were also reduced for condominiums (\$3 billion), vacant land (\$1 billion) and other property (\$1.5 billion).

Following these trends, property taxes fell significantly for non-commercial property in FY 2008-2009. We analyzed 850,219 parcels non-commercial property provided by the county, which include residential, agricultural and unassigned parcels.

Property tax delinquencies rose considerably in 2008-09 (latest available data) compared to the previous fiscal year. The largest share of delinquencies came from owners of residential parcels who failed to make either one or both property tax installments. Single-family and multi-family delinquencies accounted for \$116,179,506 (71.3%) of total delinquent non-commercial property taxes. Delinquencies for vacant land (residential, mountain, desert and manufacture homes) was \$18,576,025 (11.4%) of delinquent non-commercial property taxes. Delinquencies for agricultural were

\$14,928,865 (9.2%) and for condos or Planned Unit Developments were \$6,907,260 (4.2%).

While housing prices appear to have stabilized, high unemployment, lack of consumer confidence and issues in housing finance will restrain the pace of the housing recovery in Riverside County. Property tax delinquencies are expected to increase during FY 2010-2011 as the region takes longer to recover compared to the rest of Southern California. Non-commercial property assessed values, while declining modestly in the FY 2010-2011, will not be revalued at the rates of FY 2009-2010 when they were reduced by an unprecedented amount of -15.4%. We expect non-commercial property to add modestly to the assessment roll in FY 2011-2012, with the growth rates firming up in the longer-term as the recovery gains momentum in Riverside County and the temporary reductions from Prop 8 "decline-in-value" are reversed.

Property Tax Projections

Our projections for Riverside County property taxes are based on econometric models that use a number of variables for forecasting purposes: data by type of property, failure to pay property tax installments, and property tax data from neighboring counties. The forecasts are provided in Table 2. We project an overall decline of -4.2% in 2010-2011, below the drastic fall of the previous year. The projected decline in FY 2010-11 is attributed to the expected decreases in assessments from Prop 8 particularly as it applies to commercial properties, the downward adjustment of the inflation factor

as required by the Revenue and Taxation Code, financial issues in commercial real estate finance, record-high mortgage delinquencies and foreclosures, and higher unemployment rates. We project that property taxes will rise modestly in FY 2011-2012. In the long term, property taxes are expected to grow as house prices rise, triggering a reversal of Prop. 8 which will increase the assessment roll.

Fiscal Year	Commercial	Growth	Non-Commercial	Growth	Total	Growth
08-09	467,715,758	n/a	1,812,579,231	n/a	2,280,294,989	n/a
09-10	482,519,356	3.2%	1,532,925,437	-15.4%	2,015,444,793	-11.6%
Forecast						
10-11	421,490,927	-12.6%	1,509,931,556	-1.5%	1,931,422,482	-4.2%
11-12	397,934,853	-5.6%	1,561,269,228	3.4%	1,959,204,082	1.4%
12-13	403,505,941	1.4%	1,636,210,151	4.8%	2,039,716,093	4.1%
13-14	417,628,649	3.5%	1,727,837,920	5.6%	2,145,466,569	5.2%
14-15	434,751,424	4.1%	1,828,052,519	5.8%	2,262,803,943	5.5%
^a Data provided by the County of Riverside and <u>exclude</u> supplemental tax revenue. The decline of 11.6% exceeds the 10.51% of the County Assessor's because the data exclude supplemental tax revenue.						

The property tax projections in Table 2 represent a baseline forecast. However, if downside risks intensify such that the unemployment rate increases beyond projected levels, mortgage delinquency rates and foreclosures rise more than the forecast, conditions in commercial real estate deteriorate further, the recovery in the county turns out to be much weaker than expected trailing the U.S. with significant lags, another likely scenario shows a larger

reduction in property taxes. Under this "increased-risk-scenario", our forecasts, which exclude supplemental tax and teeter overflow revenue, are as follows: FY 2010-11 (-5.1%), FY 2011-12 (-0.3%), FY 2012-13 (3.1%), FY 2013-14 (4.0%) and FY 2014-15 (4.3%).

A2. Motor Vehicle Licensing Fee (in Lieu)

Motor Vehicle Licensing Fee revenue is based on assessed property values (Table 3). In FY 2005-06, the state converted MVLF revenue into property taxes in lieu of MVLF. This source of revenue is linked to assessed valuation. Nonetheless, there are significant deviations from the assessed valuation trend. For example, during FY 2005-06, there was an underestimate of MVLF for Riverside County. To correct for the underpayment, an additional payment was made in FY 2006-07, causing the MVLF revenue in FY 2006-07 to be higher than what the actual payment was. Thus while this source of revenue tends to grow and fall at a similar rate to assessed property taxes, the state adjustments for underpayments or overpayments distorts the underlying trend for MVLF revenue. In tandem with assessed valuation, we project a decline in this source of revenue in FY 2009-2010 and FY 2010-2011 followed by increases beyond this horizon as assessed values rise from depressed levels.

Table 3^a

Fiscal Year	Motor Vehicle Licensing Fees Dollars	Growth
Historical		
06-07	188,888,320	15.54%
07-08	218,658,730	15.76%
08-09	221,661,746	1.37%
Forecast		
09-10	196,613,969	-11.3%
10-11	187,766,340	-4.5%
11-12	190,958,368	1.7%
12-13	199,360,536	4.4%
13-14	209,926,644	5.3%
14-15	222,102,390	5.8%
^a Data provided by the County of Riverside		

A3. Taxable Sales Riverside County

The taxable sales data are from the County of Riverside which reports tax revenue derived from sales within the unincorporated area. Weak economic fundamentals (such as high unemployment and low confidence) should further depress taxable sale revenues in FY 2009-2010 as local residents and businesses further reduce their spending. Taxable sales are expected to decline by over 25% in FY 2009-2010 and to post additional decreases during fiscal year 2010-11. In the long-term taxable sales should post positive growth rates, exceeding 6% in FY 2014-2015.

Table 4^a

Fiscal Year	Taxable Sales (millions of dollars)	Growth
Historical		
06-07	40,606,561	8.19%
07-08	39,528,715	-2.65%
08-09	34,181,132	-13.53%
Forecast		
09-10	25,319,174	-25.93%
10-11	24,701,386	-2.44%
11-12	25,472,069	3.12%
12-13	26,651,426	4.63%
13-14	28,021,310	5.14%
14-15	29,848,299	6.52%
^a Data provided by the County of Riverside		

A4. Proposition 172 Public Safety Sales Tax Projections

Proposition 172, the "Local Public Safety Protection and Improvement Act of 1993," was enacted in November 1993 and allocates a half-cent sales tax to public safety in cities and counties. The total sales tax revenue is distributed to cities in Riverside County as well as to the County. The State distribution of Proposition 172 revenue to Riverside County depends on the amount of taxable sales in Riverside County and on the Riverside County's share of total tax revenue. Forecasts for the Public Safety Sales Tax are determined using regression techniques and estimates from these models are in Table 5. For Riverside County, the public safety sales tax

projections are forecasted to decline significantly for FY 2009-2010 and fall at a smaller rate for FY 2010-2011. In the longer term, there should be growth in this revenue for the county.

Table 5^a

Fiscal Year	Proposition 172 Public Safety Sales Tax (in thousands)	Growth
Historical		
06-07	143,520,591	4.85%
07-08	142,819,907	-0.49%
08-09	120,792,513	-15.42%
Forecast		
09-10	106,418,204	-11.90%
10-11	104,374,974	-1.92%
11-12	107,193,099	2.70%
12-13	111,373,630	3.90%
13-14	116,830,937	4.90%
14-15	124,191,287	6.30%
^a Data are from the Riverside County		

A5. Documentary Transfer Tax

Documentary transfer tax is typically from a transfer of the ownership of real property. Historical and projected values for this source of revenue are in Table 6. The tax rate for the City of Riverside is \$1.10 for every \$500 of net consideration or value conveyed; the tax rate for all other cities and the unincorporated

areas of the County of Riverside is \$.55 for every \$500 of net consideration or value conveyed (www.riversideacr.com). Documentary transfer tax is correlated with house sales, changes in interest rates which can trigger refinancing, changes in property values, changes in payroll employment, foreclosure rates, and other factors that cause a change in ownership. With the current decline in property values, issues in commercial real estate, and an uncertain recovery in the housing market, documentary transfer tax is likely to decline in 2009-2010 followed by relatively robust increases over time.

Table 6

Fiscal Year	Documentary Transfer Tax Dollars	Growth
	Historical	
06-07	22,836,219	-35.06%
07-08	13,477,571	-40.98%
08-09	10,624,354	-21.17%
Forecast		
09-10	9,114,633	-14.21%
10-11	10,082,607	10.62%
11-12	11,427,627	13.34%
12-13	13,061,778	14.30%
13-14	15,066,761	15.35%
14-15	17,507,576	16.20%
^a Data are from the Riverside County		

B. RIVERSIDE COUNTY OVERVIEW FORECAST AND REPORT

The economy of the Riverside County has slowly begun to emerge from the severe economic recession of 2008-2009. The county's economy is expected to take longer to recover than the Southern California region and the national economy due to continued high unemployment, lack of employment opportunities, record-breaking foreclosures, and problems in commercial real estate. Because the recovery will be slow and weak, the upturn will bear more similarities to a mild recession than to an expansion. The unemployment rate will continue to remain uncomfortably high for an extended period, the number of foreclosures is expected to rise further before it stabilizes, and budget issues will continue to remain problematic reflecting both statewide challenges and local revenue shortfalls prompted by sharp deteriorations in economic activity.

There is evidence of some positive economic factors emerging in the county. To begin with, the precipitous decline that plunged the county into the deepest recession in record has stopped. Housing prices increased during the second half of 2009 after dropping for almost three years. Housing affordability reached record-highs in 2009. World trade volume, which supports the region's manufacturing, trade, and transportation sectors, has improved significantly.

These factors should generate some economic growth but they are not sufficient to stage a meaningful recovery for the Riverside County in the near term. Commercial real estate is expected to deteriorate further in 2010 and 2011 as loans mature and refinancing remains difficult at depressed values. While housing is now more affordable

in Riverside County, foreclosures, distressed sales, and high unemployment levels are likely to restrain growth in this market. In addition, there will be little new construction in residential, commercial and industrial sectors in 2010. Thus the fundamentals for a strong recovery are lacking. With dim employment prospects, depressed consumer spending, and a fragile real estate sector, in the near-term, the recovery will depend largely on federal government support and increased international trade volumes.

To analyze short-term economic conditions, the *Institute for Economic and Environmental Studies (IEES)* at California State University Fullerton has developed a leading indicator which has proven to be a reliable predictor of economic activity for the region. Additionally, at the County level, employment data provide an important indicator of the overall regional economic conditions. The near and long term outlook for the Riverside County economy is discussed below using these measures, econometric models, and other data.

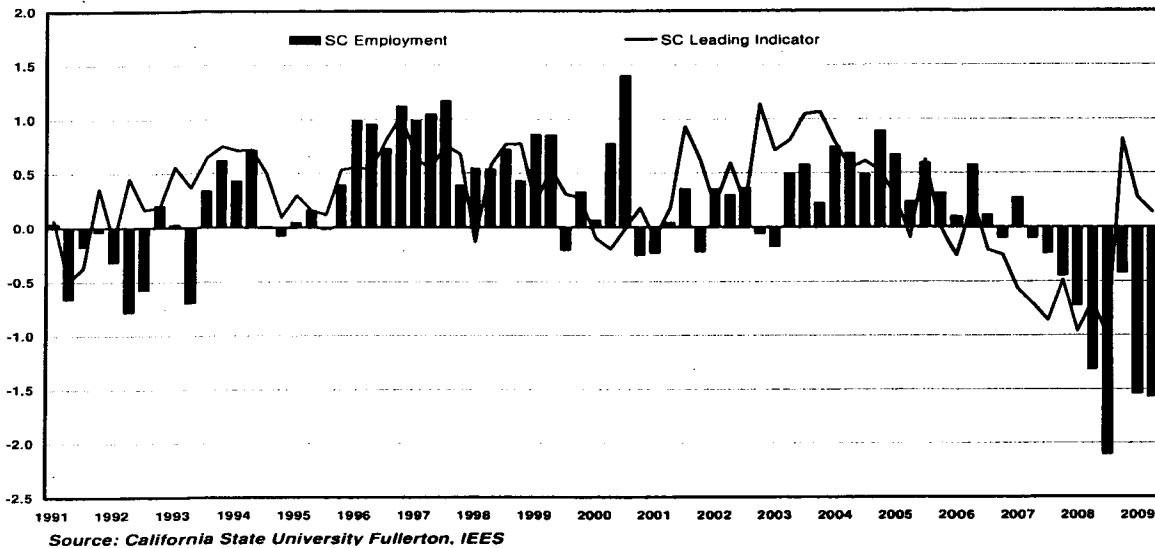
B1. NEAR TERM OUTLOOK AND FORECAST

The *IEES Southern California Leading Economic Indicator* is used to analyze the near term economic activity in Southern California, which includes Riverside County. The southern California region consists of Los Angeles County, Orange County, San Bernardino County, Riverside County, Ventura County and Imperial County. The *S.C. Leading Indicator* uses a combination of national and regional data to project economic activity in the region. At the national level,

macroeconomic indicators that are used in the index include the money supply adjusted for inflation, the interest rate spread and the Standard & Poor's S&P500 stock index. Regional variables include nonfarm employment changes, the unemployment rate, building permits and the Pacific Region consumer confidence index. An increase (decrease) in the SC Leading Indicator implies an increase (decrease) in economic activity in the Southern California region in the next 3 to 6 months. The indicator has been found to accurately predict turning points in economic activity for Southern California (Figure 1).

The *S.C. Leading Indicator* has risen modestly for the last three quarters after nine consecutive declines beginning with the first quarter of 2007. The relatively small increase suggests a modest improvement in economic activity in the Southern California region over the next 3 to 6 month horizon. The sustained uptrend bodes well for the regional economy, but the pace of improvement is weak indicating that the recovery has not yet gained a strong footing.

Figure 1
Southern California Leading Economic Indicator and SC Employment



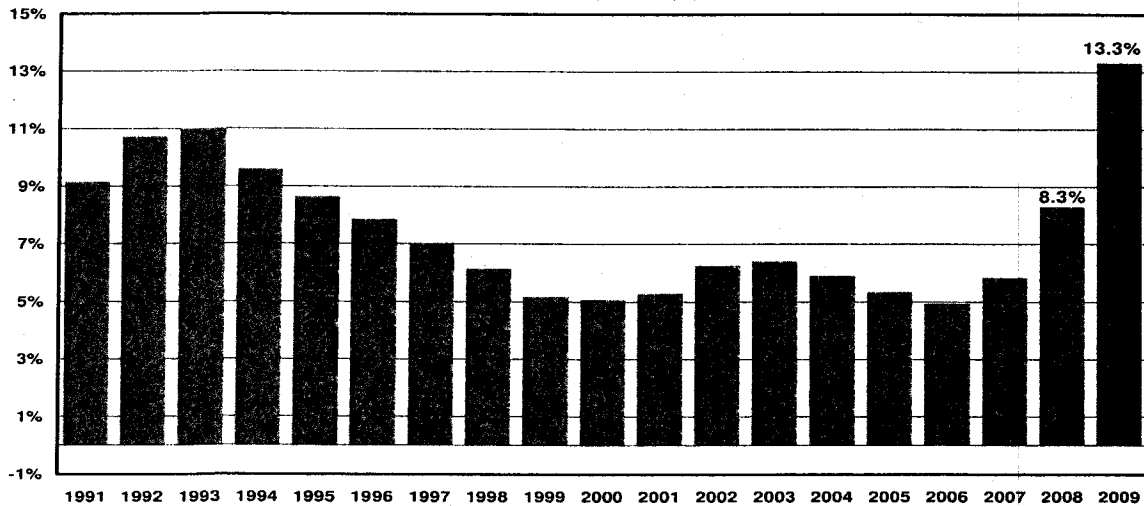
Unemployment

Among urban areas, Riverside County has the second highest unemployment rate. During 2008-2009, jobs in the county were cut at the fastest pace on record, resulting in an economic crisis that was deeper and more widespread than the national economy and the broader Southern California region. Since the start of the recession, the unemployment rate has risen by more than 10 percent from a low of 4.8% recorded early in 2006. Currently, the employment levels for the Inland Empire (Riverside and San Bernardino), stand at the same levels as in December 2002, which means that the crisis has destroyed all jobs created during the boom period of 2003-2007.

Going forward, a persistently high unemployment rate continues to remain the main concern for the county's economy, restraining growth and placing significant downward pressure on the pace of the recovery. The unemployment rate shot up from an already elevated level of 8.3%

in 2008 to an average of 13.3% in 2009 (Figure 2). The employment picture deteriorated further late in 2009 and early in 2010. In December 2009, the unemployment rate remained extremely high at 14.1%, the sixth consecutive month where the rate was over 14%. In January 2010 (the latest available data), the unemployment rate topped 15%. This is considerably above the peak unemployment rate of 12.4% recorded during the recession of early 1990s.

Figure 2
Civilian Unemployment Rate
Riverside-San Bernardino



Source: Employment Development Department

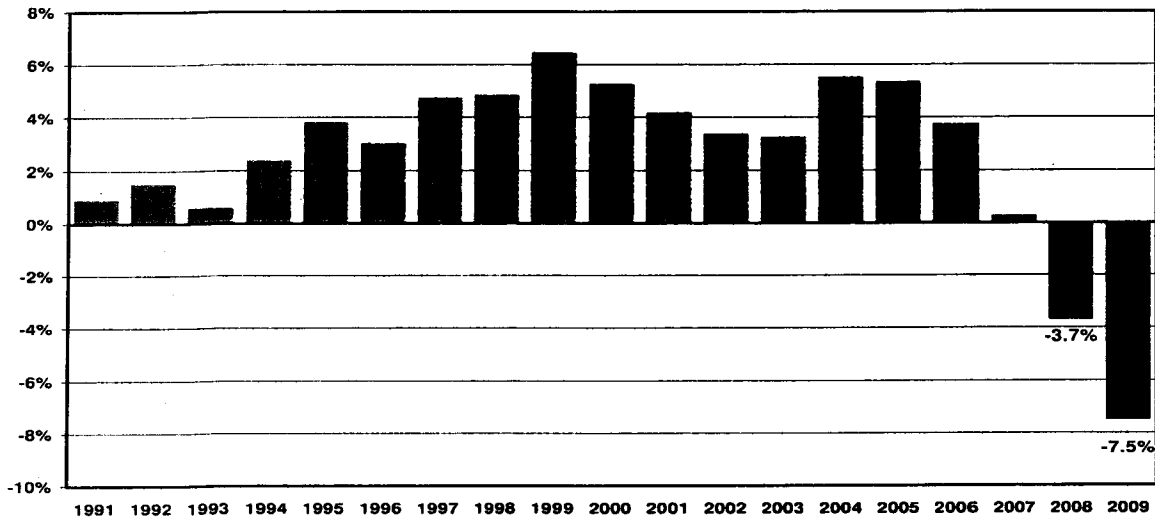
There are currently over 130,000 unemployed persons in Riverside County (excluding San Bernardino) and if we account for the underemployed and "discouraged workers" who have left the labor force, the unemployment rate is closer 30 percent. Overall, the labor market should remain in a "recessionary-mode" over the next six quarters, with an extremely high unemployment rate, which is expected to rise

above the 2009 annual average before stabilizing at high levels towards the end of the year.

Payroll Employment

In terms of nonfarm payroll employment (Figure 3), the Riverside-San Bernardino MSA lost 91,900 jobs during 2009, which represents a 7.5% overall decline. This is the second year in which nonfarm employment has fallen and the recorded 7.5% (91,900) decrease is almost twice as large as the 3.7% (47,100) decline in 2008.

**Figure 3
Nonfarm Payroll Employment**



Source: Employment Development Department

Virtually all sectors have suffered tremendously during the crisis, recording sizable job losses. The hardest hit industries were construction (23,300 jobs lost), Trade, Transportation and Utilities (23,200), manufacturing (18,400), and Professional and Business Services (10,100). The gain in federal government employment (500)

was more than offset by layoffs in local government (3,200) as the county grapples with budget issues due to a drastic fall in revenue at the state and local level. Educational and Health Services added a total of 1,100 jobs over this period.

The collapse of international trade during the recession had a devastating impact in the county's economy. Due to its geographic location, Riverside county serves as the main distribution center for roughly 75-80% of goods for the region's ports. As the global economy recovers faster than the U.S. (and much faster than Riverside county), the volume of trade has increased from the rock-bottom levels of early 2009. This should support the local economy, though logistics related to trade activity are projected to be far below the levels of 2005-2007 in the near-term.

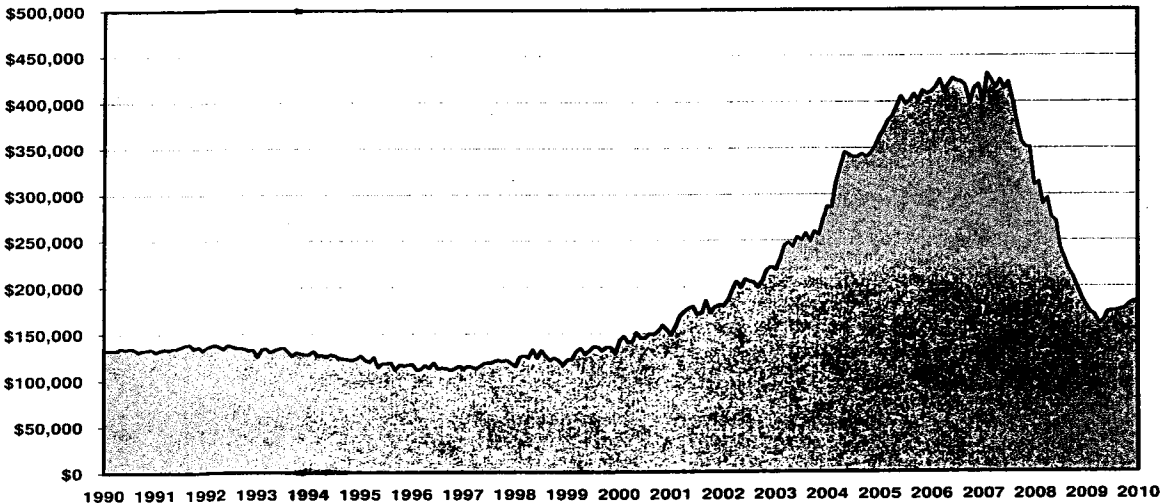
Health and Education sectors should continue to add jobs and although the pace of job creation in these sectors is expected to pick up during 2010, it will be far below the pre-crisis levels. Federal government employment is expected to grow, but this may be offset by losses in the local government sector. Funds from the American Recovery and Reinvestment Act (federal stimulus) should boost infrastructure projects which in turn will offer some support to the local construction industry. These positive trends, however, are still fragile and are unlikely to bring about a meaningful turnaround in the labor market over the near-term.

The Housing Sector

The housing market crisis was particularly severe in Riverside County given the boom in housing construction from 2003 through 2007. In effect, the housing sector was the primary driver of economic growth in the county during this period. Single family median house prices increased from \$132,459 in January 1990 to a record high of \$430,769 in February 2007. At their peak, housing prices and income in the county were grossly misaligned, bringing about the largest property price decline recorded in the area.

The collapse in house prices was fast, deep and widespread. In December 2009, the single family median home price stood at \$183,226, 57% below the \$430,769 peak of February 2007 (Figure 4). This sharp deterioration in house prices had a devastating impact in the county's economy and is continuing to restrain growth.

Figure 4
Median Price of Existing Detached Homes
Riverside County



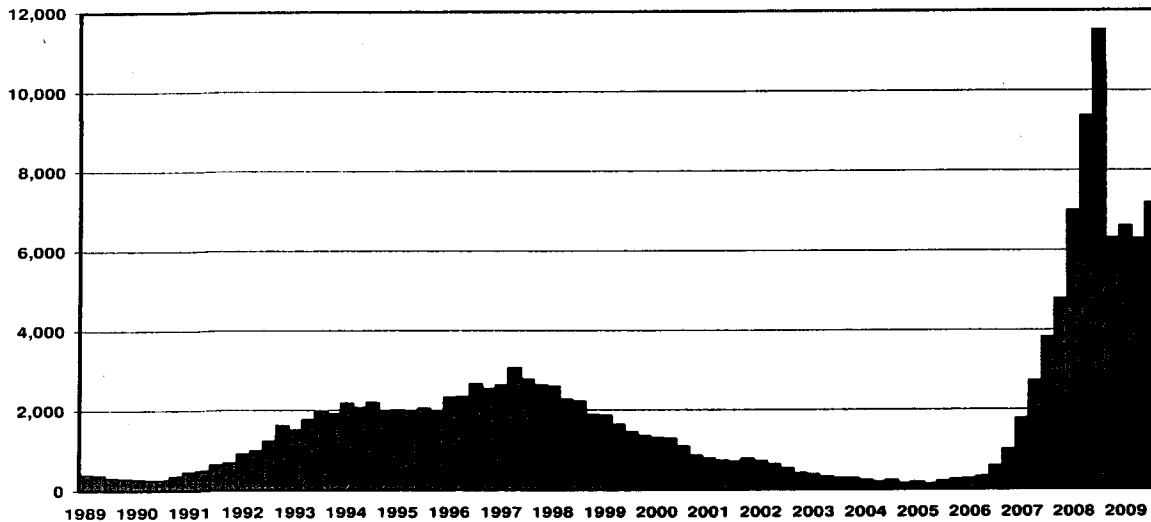
Source: California Association of Realtors

It appears that single family median house prices bottomed out at \$159,796 in April 2009. Since then, the market has shown a steady appreciation with the median price rebounding to \$183,226 in December 2009. This trend is expected to continue as this market emerges from the deep recession as the sector stabilizes at levels substantially below the 2007 peak.

A similar picture emerges for new and attached homes, where in 2009 the median house price declined below its 2008 levels. As of the fourth quarter of 2009, the median price for new attached homes was \$198,990 and for new unattached houses was \$309,000. Though higher than the trough of mid-2009, these levels are now only roughly equal to those recorded during the 2002-2003 period.

As the housing recession deepened in the county, foreclosures skyrocketed to record-levels. Riverside County has the fourth highest level of foreclosures in the entire nation. Foreclosures have risen steadily since the fourth quarter of 2006 and peaked at 11,523 in the third quarter of 2008 (Figure 5). The number of foreclosures remained relatively high throughout 2009 and it would have been much higher without the moratorium from banks and the federal government loan modification programs. The rate of foreclosures is expected to rise in 2010 due to high unemployment, increases in mortgage delinquencies (one fifth of borrowers are currently delinquent), the expiration of government support and an increase in mortgage resets. The resets alone are expected to trigger a second wave of foreclosures during 2010-2012 as many Alt-A and option-adjustable rate loans issued between 2005-2007 adjust to higher levels.

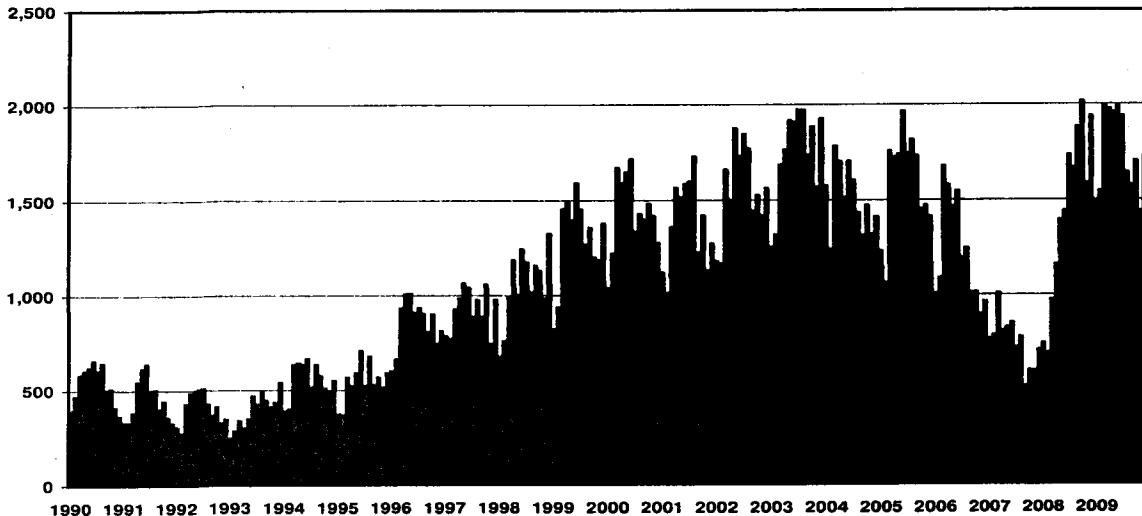
Figure 5
Foreclosures Riverside County



Source: Real Estate Research Council

Single family sales in the county rose by 21.7% in 2009 compared to 2008 (Figure 6). The first-time home buyers tax credit (\$8,000), tax credit for qualified repeat home buyers (\$6,500) and distressed sales contributed significantly to the observed increase in sales activity. At 21,026 units, single family sales in 2009 were close to

Figure 6
Single Family Sales (monthly units)
Riverside County

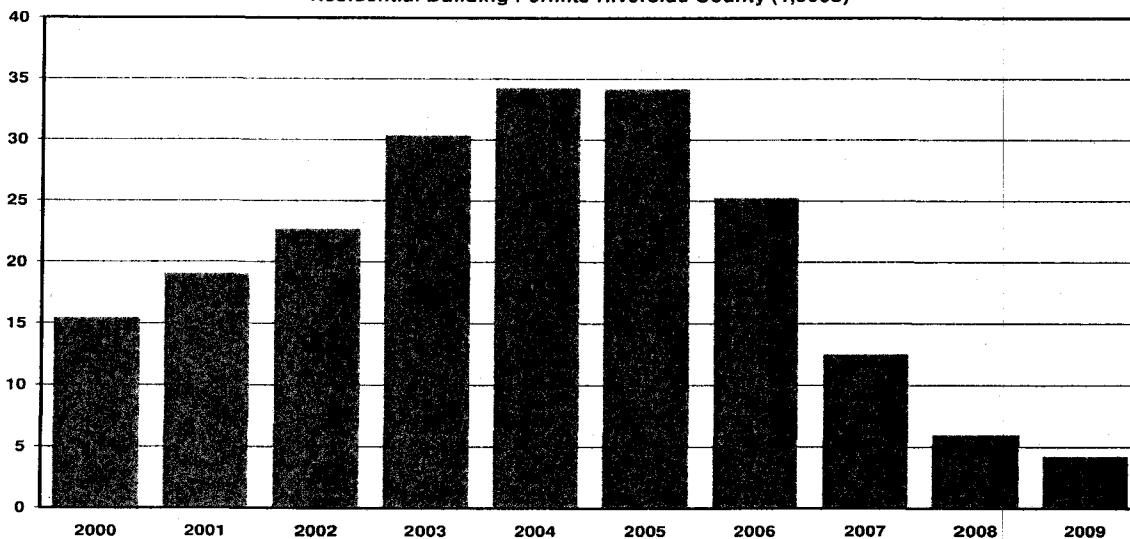


Source: California Association of Realtors

the peak of 21,199 units in 2003.

Activity in the construction sector has come to a virtual standstill during the crisis. New construction is practically non-existent. In 2009, only 4,188 annual new housing permits were issued (single and multi-family) representing a decrease of 29.2% (5,919 permits) from the already low level of 2008. This contrasts sharply to the 2004-2005 period when building permits averaged over 34,000 units per year. Residential building permits are expected to remain flat over the next few months and rise modestly in the second half of the year, reflecting developments in the housing sector.

Figure 7
Residential Building Permits Riverside County (1,000s)



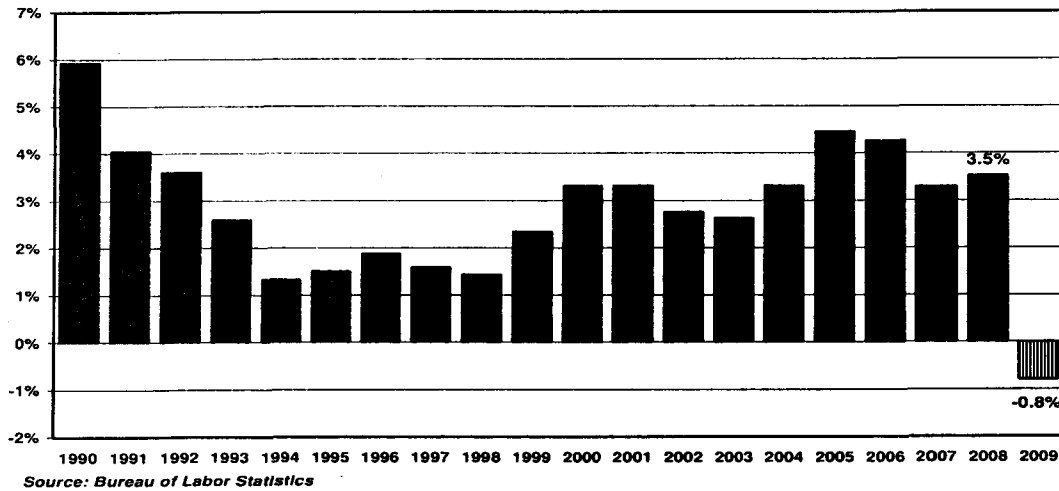
Source: Construction Industry Research Board

Inflation

Headline inflation (which includes food and energy prices) in Riverside County as measured by the consumer price index for Los Angeles-Riverside-Orange Counties, declined by -0.8% in 2009 (Figure 8). This is the first drop in consumer prices in record. In

contrast, from 2000-2008, inflation has risen steadily averaging between 2.6% and 4.5% per year. With slack labor demand, low consumer spending and weak economic activity, inflationary pressures are expected to remain relatively low in 2010.

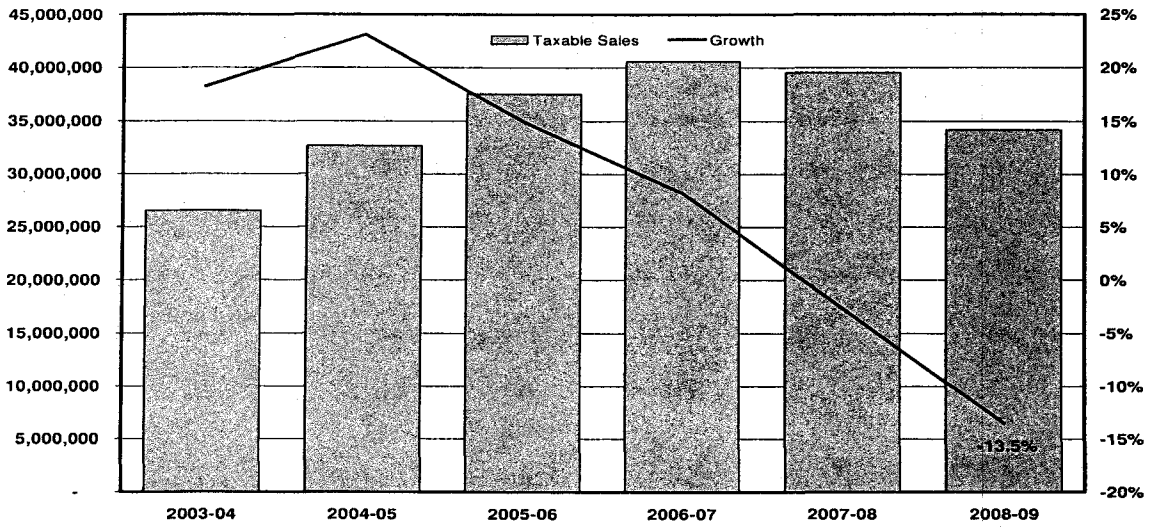
Figure 8
Los Angeles-Riverside-Orange County
Consumer Price Index



Taxable Sales

Taxable sales are from the Riverside County. The most recent data shows a -13.53% decline for 2008-2009 (Figure 9). The weak recovery, which will trail the nation's and Southern California's, will continue restrain consumer and business spending translating in further declines in taxable sales. With a rise in unemployment, a retrenchment in consumer and business spending and future projected budget cuts, taxable sales are projected to decline over the FY 2009-2010 and FY 2010-2011 (see Table 4) and grow modestly in the longer term.

Figure 9
Taxable Sales Riverside County



Source: Riverside County

In summary, the economy of Riverside County, while slowly emerging from the deep recession, will continue to face significant headwinds in the near term. The labor market will be the main drag on economic growth with small gains in employment and persistently high unemployment rates. Deep cuts in public and private consumption are likely to further reduce taxable sales, albeit at a significantly lower pace than in 2009. For the real estate sector, while house prices appear to have stabilized, commercial property values are expected to decline further and there is likely to be minimal increases in residential building permits. Inflation is expected to remain well-contained in the near term, reflecting low consumer demand.

B2. LONG TERM OUTLOOK AND FORECAST

The long term economic outlook for Riverside County will largely depend on the strength of the economic recovery in the U.S., Southern California region and trends in international trade. The county faces a unique set of challenges and opportunities that should support an eventual rebound in economic activity, although the convergence path will level off at a trajectory below the one recorded in the mid-2000. There are a few reasons for optimism in the long-run. The county has a significant pool of workers well-trained and specialized in areas such as logistics, construction and manufacturing. The availability of abundant land and the proximity to coastal areas should result in development projects that will support the regional economy. In addition, the county has an number of agencies ready to invest in infrastructure improvement, including \$162.7 million in funding approved from the California Transportation Commission.

Unlike the coastal economies which are already stable and built-up, Riverside County is more sensitive to shocks (both positive and negative), which create more dramatic boom-bust cycles. Over time, its economy should be more self-dependent and less reliant on neighboring regions. The path to less dependency, however, has been badly obstructed by the severe recession which has the impaired the self-sustaining forces of the local economy. Because of its severity, this recession will have a lasting impact on the county's economy with a structurally higher unemployment rate (at least for the foreseeable future) and lower standards of living. Much like the national picture, the local economy that will emerge from this recession will

not resemble that of the pre-crisis. Some construction and manufacturing jobs may never return even after a full recovery and economic growth is bound to trail below the pre-crisis expected growth-path for the forecast horizon.

Over the medium term, the county's economy will have to confront a number of issues. The commercial real estate sector will restrain growth over next few years. Weak consumer spending, high unemployment, and lower property values will result in low tax revenue. With a sluggish recovery, payroll employment will grow moderately but at a slower pace than recent historical trends. Budgetary problems at the state and local levels will likely result in the suspension or delays in transportation funding. Because of sharp declines in revenues, local agencies will be unable to make up for the lack of state funding to support infrastructure projects as has been the case in past downturns.

Beyond the forecast horizon, the overall prospects for Riverside County are positive. The county will continue to attract new businesses and workers because of its central location, proximity to the ports of Long Beach and Los Angeles, and its pivotal role in transportation and distribution of goods. The relatively low cost of living, affordable business rent and housing should provide further support. Thus there are strong fundamental forces that will support the county's growth in the long-run.

B3. PROJECTIONS OF RIVERSIDE COUNTY MAIN ECONOMIC VARIABLES

Table 7 (continued on next page)
Riverside County Forecasts¹

Historical			
Year	Payroll Employment ¹	Unemployment ¹	Single Family Median House Prices ²
2007	0.3%	5.8%	\$397,290
2008	-3.7%	8.3%	\$238,984
2009	-7.5%	13.3%	\$172,714
Forecast			
2010	-2.7%	14.2%	\$188,221
2011	0.4%	12.7%	\$195,520
2012	1.1%	10.9%	\$206,315
2013	1.6%	9.8%	\$216,443
2014	2.7%	8.7%	\$229,564
2015	3.3%	7.6%	\$242,641
1. Source: Employment Development Department 2. Source: California Association of Realtors			

Table 7 (continued)

Year	California Consumer Price Index ¹	Consumer Price Index Los Angeles-Riverside-Orange Counties ²	Building Permits (in 1,000s) ³
Historical			
2007	3.3%	3.3%	12.5
2008	3.4%	3.5%	5.9
2009	-0.3%	-0.8%	4.2
Forecast			
2010	1.9%	1.6%	4.3
2011	2.3%	2.4%	4.8
2012	3.2%	3.3%	6.0
2013	3.5%	3.4%	9.3
2014	3.1%	2.9%	10.0
2015	2.9%	2.6%	12.3
1. All items with base period 1982-84=100, Source: California Department of Finance 2. All items with base period 1982-84=100. Source: Bureau of Labor Statistics 3. Source: Construction Industry Research Board			

C. U.S. MACROECONOMIC OVERVIEW FORECAST AND REPORT

The fundamentals of the U.S. economy have improved considerably compared to a year ago. After a deep and prolonged fall marked by significant job losses, implosion of global demand, relentless eroding of consumer and business confidence and non-functioning financial markets, the U.S. is finally on a long and arduous path to recovery. The "Great Recession" - as the recent recession is commonly referred - appears to have ended in the summer of 2009 with some expansionary forces taking hold late in 2009 and continuing in the current year. As the U.S. economy emerges from the longest post-war recession, the question now is about the sustainability, strength and quality of the recovery.

In the postwar era, sharp economic downturns are usually followed by years of above-average growth rates and rapid economic expansions. We do not think that this will be the case in the current recovery cycle, which is expected to be moderate (at best), graduate and sluggish, stretching over 8-10 quarters with below-trend growth and high unemployment. The forces that have supported the recovery so far are inherently non-fundamental and transitory: expansionary fiscal and monetary policies, a turnaround in the inventory cycle, and a more robust global economy. Over the near-term horizon, the economic recovery is likely to be restrained by continued consumer deleveraging, weak household spending, anemic labor markets, fragile financial markets, tight credit, and concerns about the commercial real estate sector.

The outlook for the U.S. economy, while improved, is still cautious. The recovery will be more uneven than previously anticipated, as the economy converges to a "new normal" where not all changes are reversible and not everything that was lost during the recession will be fully recovered. Two years after the recession, the level of output is projected to be 10% below what it could have been had the crisis never happened. Consumer spending and labor markets will remain sluggish over the next eight quarters and may not return to their full potential for a few years, as banks and households repair their damaged balance sheets - a process that takes years to complete.

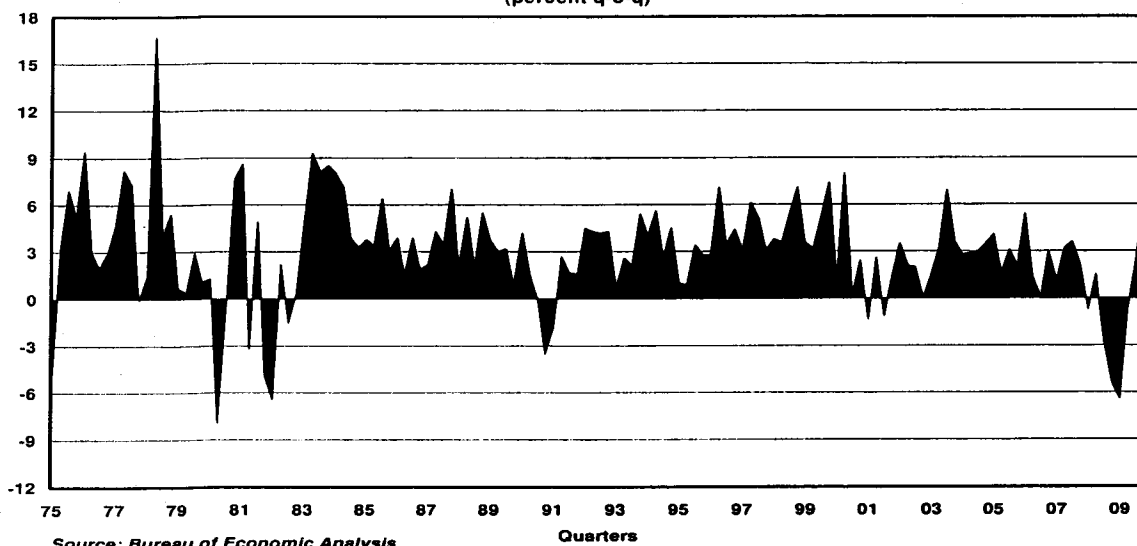
Below we provide an analysis of the U.S. economy and discuss our outlook and forecasts as they relate to some of the main components of the economy: (A) real economic activity, (B) inflation, (C) financial and government sectors, (D) global environment and (E) projections of key national economic variables.

C1. Real Economic Activity

Real economic activity, measured by real gross domestic product (RGDP), fell by -3.8% during the recent crisis - the largest decline of any postwar recession. The economy contracted for four consecutive quarters from 2008Q3 -2009Q4, an unprecedented back-to-back decline since the introduction of quarterly GDP data in 1947. At 21 months, the recent recession is the longest postwar recession surpassing the previous record-holders of 1973-75 and 1981-82 both lasting 16 months.

Economic growth picked up significantly in the second half of 2009 as signs of recovery began to emerge (Figure 1). The economy grew by 2.2 percent in the third quarter of 2009 and by a robust 5.9% in the fourth quarter. The lift in GDP was primarily due to the fiscal stimulus and a sharp turnaround in inventories which was initially expected to boost RGDP through early 2010. Though other factors such as consumption spending and investments appear to have stabilized, they are still well below their pre-crisis growth levels.

Figure 1
U.S. Real GDP Growth
(percent q-o-q)



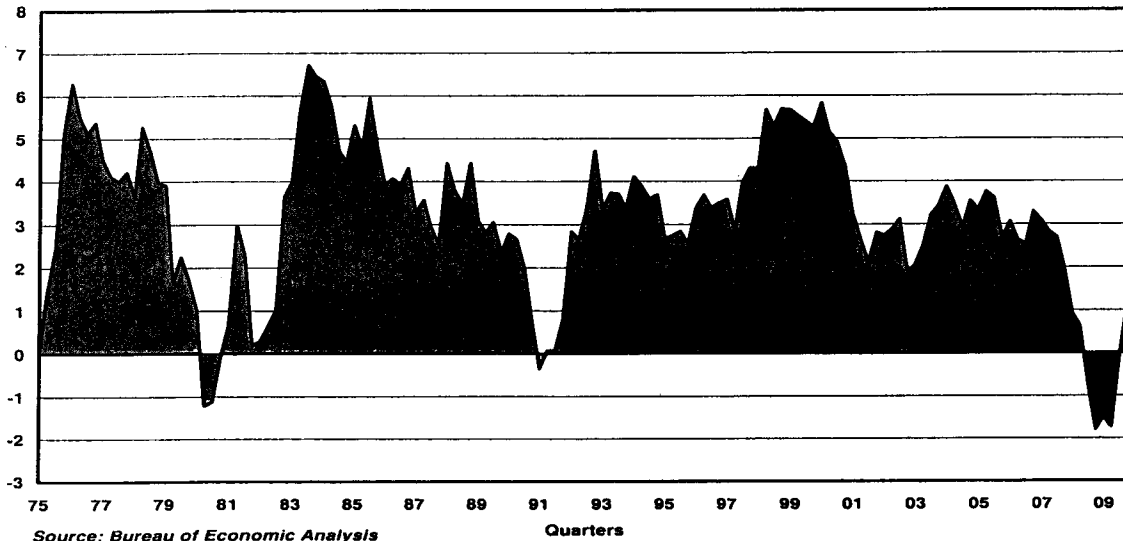
Over the near-term, our forecast for the U.S. economy is more bearish than the consensus. U.S. real GDP is expected to grow by a modest 2.7 percent in 2010 and 2.9 percent in 2011, well below the "average" post-recession levels. Based on a number of macroeconomic trends which are discussed in detail below, we expect the recovery to be long and protracted and will likely stretch over 2011 and 2012 with real output expanding below capacity-level. In the long-run, based on

historical cyclical trends, our overall assessment of the U.S. economy is positive with long-run growth at roughly 3 percent.

Consumption Spending

At 71% of real GDP, consumption spending is the engine of the U.S. economy. As such, a sustained recovery would require robust spending from U.S. consumers, which has not been uncommon in the post-recession cycles. The current recovery however, is far from normal precisely because it is characterized by dramatic structural changes in consumer behavior. Attempting to repair their balance sheets, households began to deleverage in the third quarter of 2008, at the height of the financial crisis, and have continued to pay down debt and boost savings throughout 2009. The erosion of housing and financial sector wealth, combined with continued job losses have severely strained the U.S. consumer during the recent crisis. From the third quarter of 2008 to the third quarter of 2009, consumer demand imploded declining over five quarters on a year-over-year basis, posting the largest consecutive drop since 1951 (Figure 2).

Figure 2
U.S. Consumption Expenditures
(percent y-o-y)

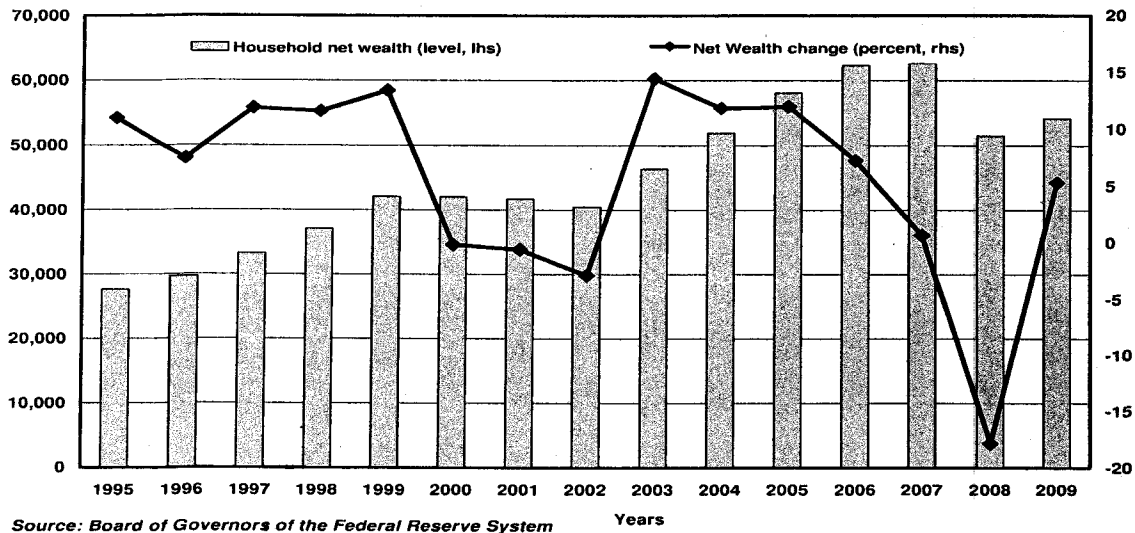


Consumption spending has stabilized during the second half of 2009, rising by 2.8 percent in the third quarter and 1.7 percent in the fourth quarter. Though welcomed, this bounce in consumption spending is well below pre-recession levels and sub-par when compared to other recovery cycles. Moreover, most of this increase is due to the overly supportive monetary and fiscal policies: the widely popular "cash-for-clunkers" program and stimulus-related tax cuts added a sizable chunk to spending.

Household wealth rose considerably during the last three quarters, posting an overall increase of \$5.7 trillion (Figure 3). The improvement is due to a combination of factors: an increase in equity prices, stabilization in the housing sector and provisions in the fiscal stimulus package. At the current level of \$54.2 trillion, household wealth is still 21 percent below the pre-recession peak. While current gains in wealth are certainly supportive of spending, a

stronger, continued and prolonged increase in wealth is needed before consumers boost spending.

Figure 3
Household Net Wealth
(billions of dollars and percent changes)



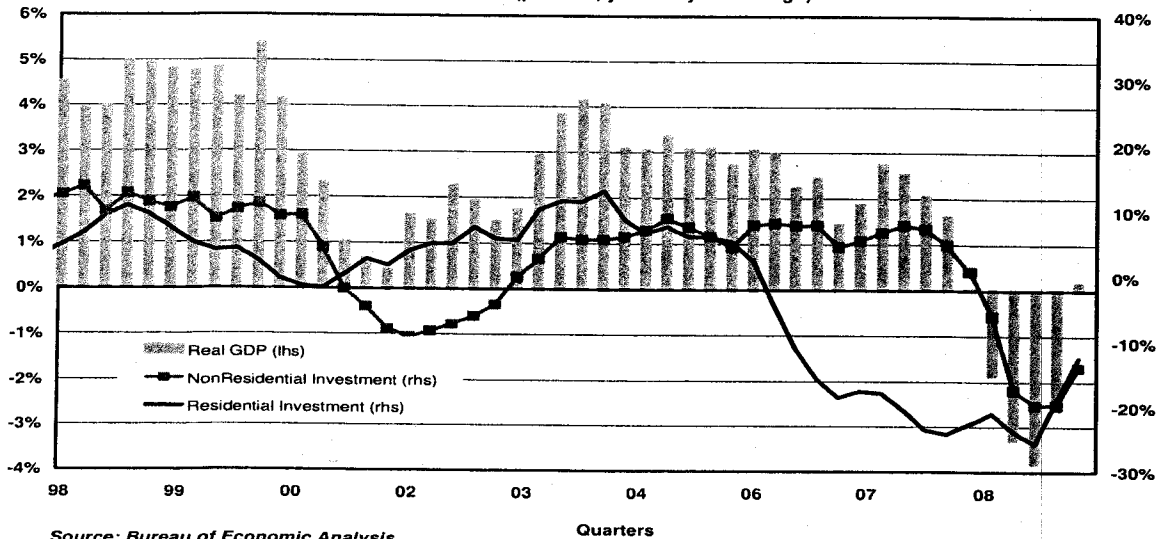
In the near-term, high unemployment rates and continued deleveraging will continue to restrain any meaningful upswing in household spending, particularly in early-to-mid 2010 as some consumer-friendly fiscal programs come to an end. We anticipate that the process of consumer deleverage will continue throughout 2010 as households increase saving rates to make up for some of the lost wealth. Consumption spending should continue to stabilize at a moderate pace, lagging the overall recovery cycle. For the recovery to be self-sustained, however, consumer spending is needed and we project that this is likely to be more robust (albeit below historical levels) in late 2011 or early 2012 after the labor market has stabilized and consumer balance sheets look healthier.

Investment Spending and Inventories

After declining at a precipitous rate for seven straight quarters, private investments have turned around and posted solid gains during the second half of 2009. Residential investments recovered from a decline of 30.7% in the first half of 2009, to a quarter-on-quarter gain of 18.9% (2009Q3) and 5.0% (2009Q4). The latest data suggest that this trend is expected to continue in 2010 as this sector rebounds from very low levels. Residential construction should reach the levels of early 2008 by the third quarter of 2011. This projection would still be 38% below the peak levels of late 2005 and early 2006 and is consistent with housing starts of around one million per year.

Non-residential investments, which comprises the larger portion of private investments and includes expenditures on structures (commercial buildings, retail stores, industrial plants, warehouses) and durable equipments (computers, information processing industrial and other equipments), also improved in the fourth quarter of 2009, albeit at a smaller pace. Non-residential investments are a good leading indicator of future economic performance with improvement in this sector generally boding well for the larger economy (Figure 4).

Figure 4
Real GDP, NonResidential and Residential Investments
(percent, year-on-year change)

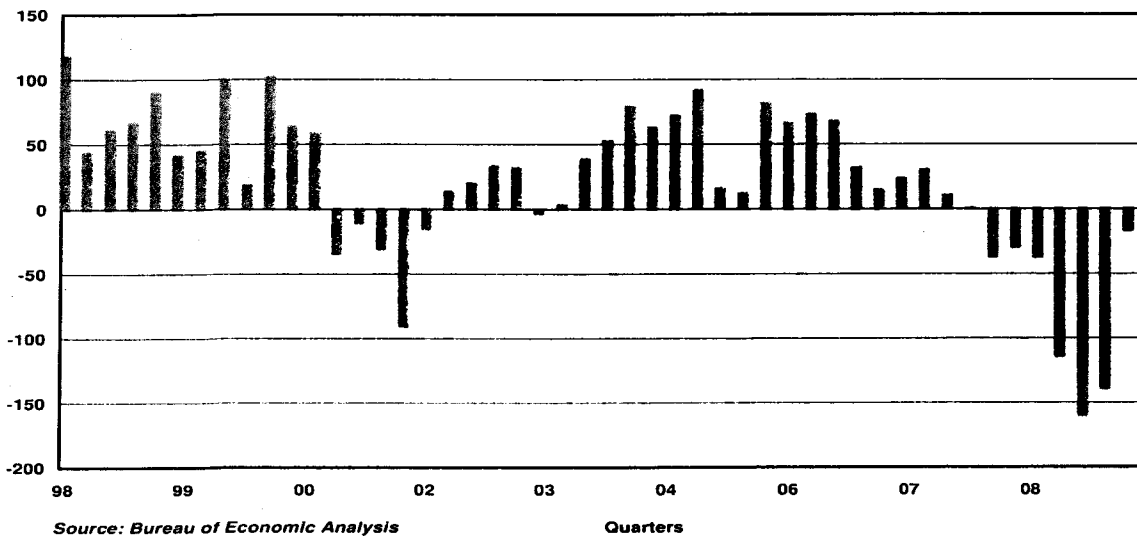


Business spending on Equipment and Software should expand moving forward as corporate profits recover, demand picks up and financial strains on many businesses ease up. Investment in equipments is projected to grow at a similar pace as in the post-2001 recession, posting on average a growth rate of about 4-5% over the next 3 years. This forecast is a bit conservative given that at the onset of this recession cycle there was no CAPEX excess, unlike the post-90s tech boom. In contrast, non-residential structures are likely to be a drag on economic activity given the increased strain in the commercial real estate market.

The largest boost from the business sector came from a sharp reduction in the pace of inventory liquidation (Figure 5). After shaving off on average about 1.8 percentage points (pp) in economic growth during the first two quarters, inventories added 3.8 pp to the fourth quarter RGDP. The drawdown in inventory cycle appears to have

run out of steam; recent data from the manufacturing sector report that firms' inventories are relatively lean, which could lead to some restocking and a continued pick-up in industrial production over the coming months.

Figure 5
Change in Private Inventories
 (billions, chained dollars)



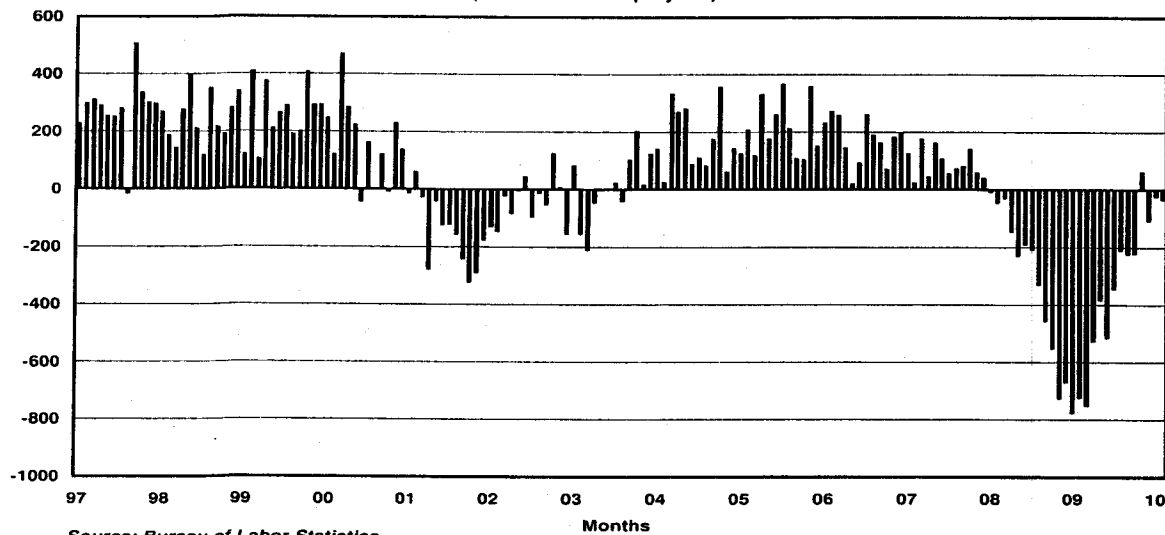
Labor Market

The financial crisis has had a devastating impact on the labor market. Since its onset in December 2007, the recession has destroyed a total of 8.4 million jobs pushing the number of unemployed to 14.9 million and doubling the unemployment rate to 9.7%. As of February 2010, the number of persons working part time for "economic reasons" has risen to 8.8 million, the maximum recorded since the Bureau of Labor Statistics began tracking this information. The broadest measure of unemployment, which includes marginally attached workers, discouraged workers, and involuntary part-time workers now stands at

17.9%, higher than in any period during the post war era. Some states have fared even worse: in California, the "real" unemployment rate currently stands at 20.3%.

On the plus side, the pace of job losses has declined. From January to April 2009, nonfarm payrolls fell on average by 725,000 jobs per month; from May through June, jobs cuts averaged 475,000 per month; from June through September they slowed to 260,000 per month, and from December 2009 through February 2010 the average job loss was around 60,000 per month (Figure 6). The slowing in net employment losses reflects primarily a reduction in layoffs rather than an improvement in hiring. Job losses are widespread across all sectors and the only large sectors currently adding jobs are health care and the federal government. Construction and manufacturing jobs have fared particularly badly during this recession: since December 2007, employment has fallen by 1.9 million in construction and by 2.1

Figure 6
Nonfarm Payroll
(thousand of employees)



million in manufacturing.

Recent data seems to indicate that conditions in the labor markets are improving and labor demand may be firming. Employment in the temporary help industry, which is typically a leading indicator, has been steadily increasing since October 2009. In addition, after steep declines in the first half of 2009, the average workweek hours have picked up indicating that firms increased demand for existing labor which should eventually translate in new hiring.

Despite these encouraging signs, we anticipate that labor market conditions will remain weak over the near-term horizon and would improve very gradually in the next several years. The unemployment rate will likely remain uncomfortably high over the next two years, averaging 9.6 percent in 2010 and 9.2 percent in 2011. Much like the previous two recessions of 1990-1991 and early 2000s, the current recovery will be jobless, with some modest job gains occurring towards the end of the third quarter of 2010.

In the long-term, the recent financial crisis is likely to be an inflection point for the U.S. economy, with permanently higher unemployment rates (at least for the foreseeable future) and lower standards of living. Some jobs, such as manufacturing, may never return as the new economy that emerges from this recession will not fully resemble that of the pre-recession. A reallocation of workers is likely in the construction sector, at least over the medium-term horizon.

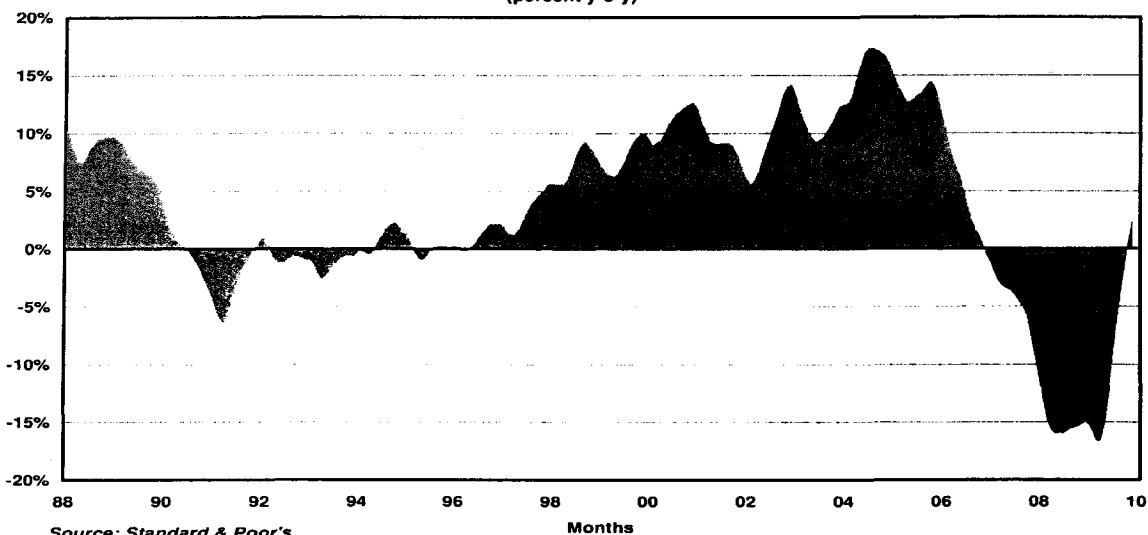
Real Estate Market

The housing market was hit particularly hard in the recent recession. From the first quarter of 2006 to the first quarter of 2009, new home sales plunged 70%, single-family starts plummeted 79% and the Case-Shiller home price index dropped by 32% - the largest declines since World War II.

Housing began to stabilize in spring 2009, but the pace of improvement slowed during the second half of the year. After seven consecutive months of increase, existing home sales fell sharply in December and January. Similarly, new home sales retraced more than half of the nearly 30 percent gain posted through mid-2009, indicating that some of the earlier strength reflected demand that was pulled forward in anticipation of the expiration of the homebuyer tax credit. The recovery in construction activity in single-family homes also declined in the second half of 2009; after a significant rise from extremely depressed levels, housing starts remained relatively flat at around 0.56 million from June to December.

Housing prices have been more encouraging as they have stabilized through the second half of 2009, albeit at a very low level. In the last two months of 2010, the Case-Shiller 10-city price index rose for the first time in 35 months (Figure 7). According to the University of Michigan Survey Of Consumers, the number of respondents who expect house prices to increase over the next 12 months now slightly exceeds those that expect prices to decrease.

Figure 7
National House Prices: Case-Shiller Index
(percent y-o-y)



The outlook for housing market is mixed. We anticipate the stabilization in house prices to continue during this year. Sales should also improve modestly but not enough to eliminate the inventory overhang. The number of foreclosures will remain at exceptionally high levels with 2.8 million homes receiving foreclosure notices in 2009 and an estimated 3 million in 2010. A staggering 15 percent of borrowers are delinquent in their mortgage payments or have entered foreclosure procedures, which is unlikely to improve against a backdrop of high unemployment and high loan-to-value ratio. Mortgage resets are expected to increase during the 2010-2012 period placing additional strain in the housing sector and resulting in a second wave of foreclosures.

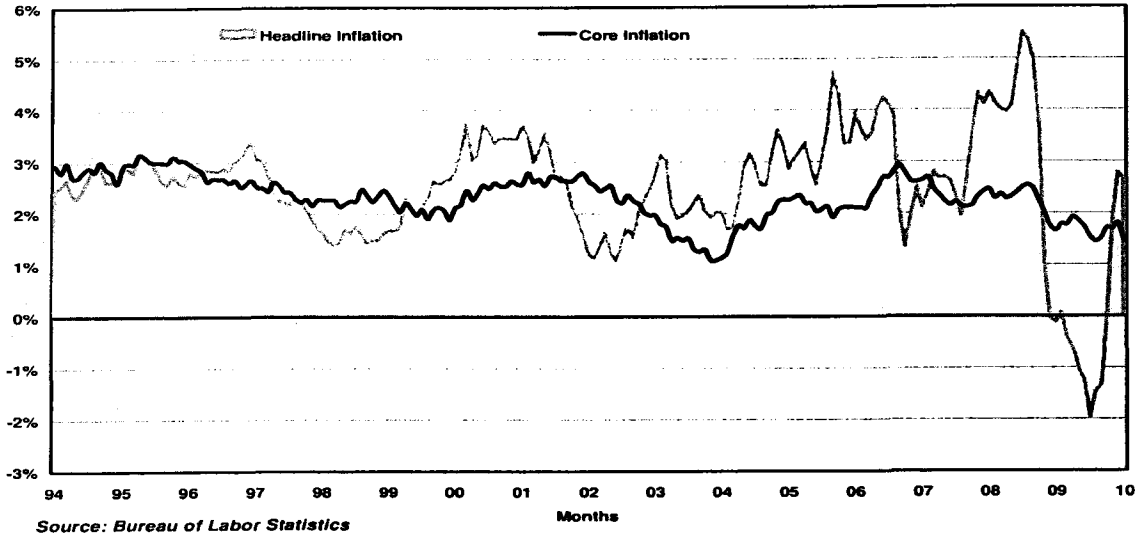
The commercial real estate market presents an even gloomier picture. According to FDIC, one sixth of all construction loans were close to being delinquent during 2009, placing additional strains on

regional and local banks which are the major lenders to small businesses. An overwhelming majority (90 percent) of the survey respondents from the Commercial Real Estate Index expect new commercial development to remain nonexistent in their market areas and rent concessions to increase. Although some indicators show that the sharp decline in commercial property values has begun to flatten, 86 percent of respondents report prices are below replacement costs. In addition, the current transaction volume is the lowest since 2001. Conditions in the commercial market are likely to get worse before they get better because during the current year office vacancies are expected to rise to 18%, industrial vacancies to increase up to 14.9%, and retail vacancies to edge up to around 13%.

C2. INFLATION

Inflationary expectations seem to be well contained over the near term. The consumer price index (CPI), which includes both food and energy prices picked up late in 2009 and continued to rise in January 2010 as sharp increases in energy prices offset deceleration in food and other prices (Figure 8). In contrast, core inflation, which excludes volatile prices such as food and energy, remained in the 1.5%-1.8% range during 2009, well below the 2.3% rate that prevailed in 2008. Recession-induced deflationary forces were more apparent in the labor market. Despite large productivity gains, hourly compensation in the nonfarm business sector - a measure for wage income - rose by 2% in 2009, below the 3% level recorded in 2008.

Figure 8
U.S. Headline vs Core Inflation
(percent, year-on-year change)



Risks are elevated both for future deflation and inflation. A weak recovery characterized by a large output gap, high unemployment and low utilization capacity, indicates that pricing power will be limited and deflation may still be a risk. Nonetheless, the massive amount of liquidity injected by the government to avoid a headlong financial collapse has placed upward pressure on prices and a potential surge in inflation is possible.

It is unlikely that either extreme materializes over the next two years. Inflation expectations seem to be balanced given that the excess money supply is still pushing against slack capacity and resource utilization is well below normal levels. While inflation expectations have recently increased, survey-based measures of near-term inflation expectations are well within the comfort zone of the Federal Reserve. Long-term inflation expectations have been

relatively stable over the past year, with 5- and 10-year inflation expectation remaining at around 2.9%.

Oil prices rose strongly during 2009 spurred by a buoyant recovery in emerging markets. Crude oil is expected to increase further in the current year supported by the strength of global demand. However, this upward pressure should be relatively small given the above-average inventories and substantial spare capacity.

We expect headline inflation to remain subdued over the next two years, rising by 1.8 percent in 2010 and by 2.6 percent in 2011. While consumer prices appear to be stable over the near term, the risks of a surge in inflation over the longer-term horizon are elevated. Whether an escalation in prices is ultimately avoided will depend on the ability of the Federal Reserve to reduce excess liquidity when the economic recovery has gained more traction.

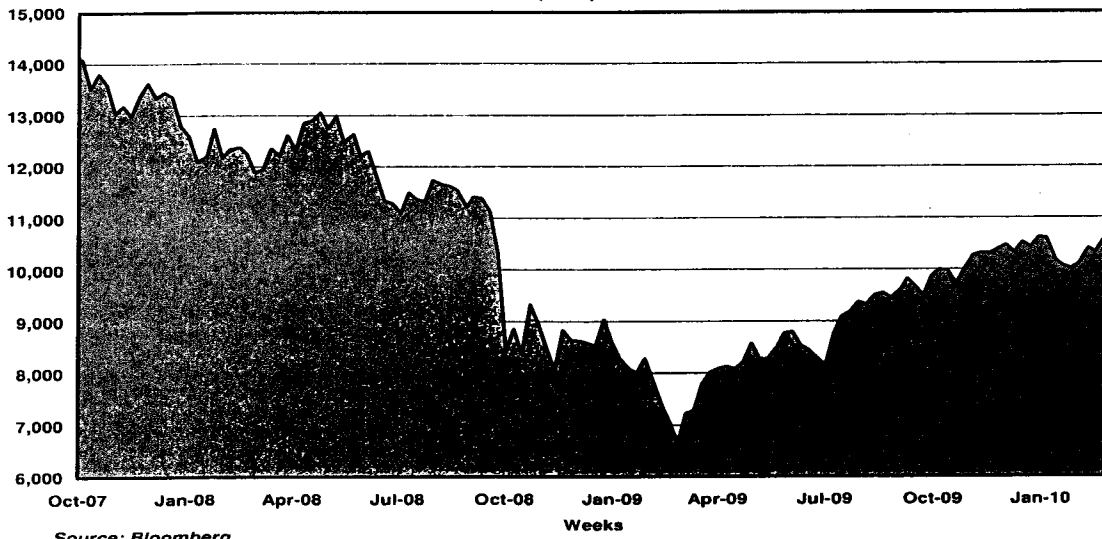
C3. FINANCIAL AND GOVERNMENT SECTORS

Financial Markets

The recovery in the financial sector began in the second quarter of 2009 and continued through the second half of the year and into 2010, as investor concerns about the health of the financial system subsided. Many of the largest banks were able to raise capital by issuing new stock and repurchase preferred shares that had been issued to the Treasury under the TARP program. Results from the 19-bank "stress test" conducted by the Treasury Department revealed a capital shortfall of just \$75 billion. Eight of those stress-tested banks felt confident enough to pay back \$63 billion of capital the government had

provided them last year. The spread between banks' overnight borrowing costs and the federal funds rate has dipped down to below 0.25%, indicating that trust between banks has returned and credit markets have eased up back to normal. With an improved outlook, banks have increased their exposure to risk, expanded their balance sheets (which are now 40% bigger than in 2005), and have become larger entities than before the crisis. As of March 2010, the stock market soared 60% from a 12-year low of one year ago, as the deepest recession since the Great Depression waned (Figure 9).

Figure 9
Dow Jones Industrial Index
(level)



Despite these significant improvements, the recovery in the financial sector is far from complete, financial stability is still fragile and the system as the whole faces a number of headwinds in the current year. The profitability of commercial banks continues to remain low as elevated loan losses restrain bank earnings. Bank lending is likely to remain sluggish against a backdrop of weak loan

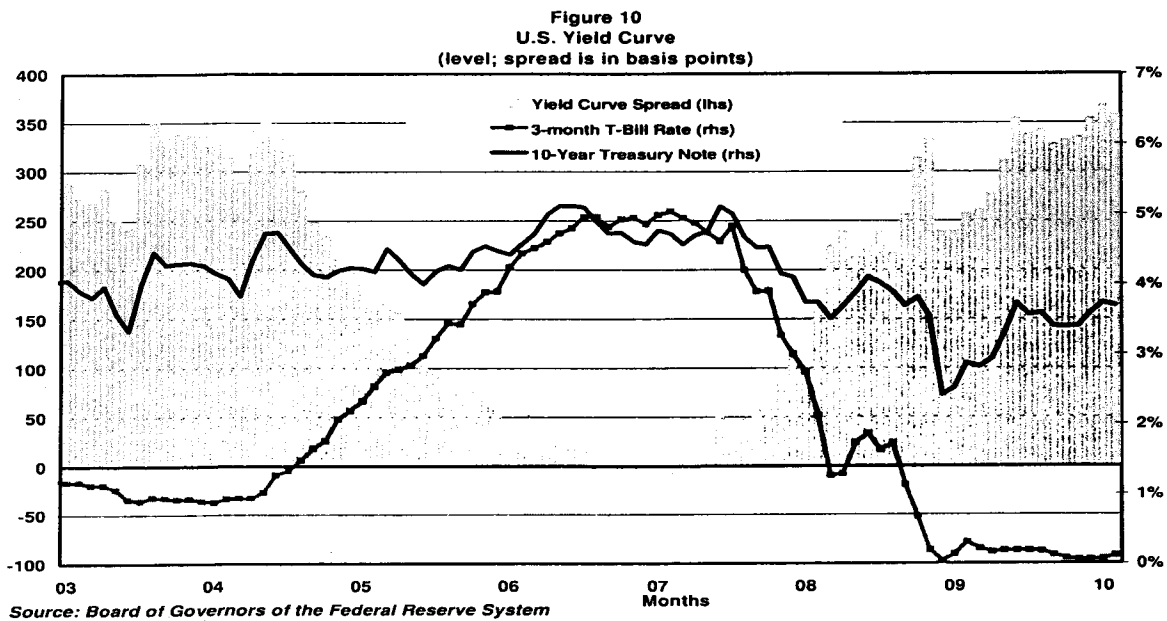
demands, tighter credit policies, the possibility of further loan write-downs, and the withdrawal of central bank liquidity facilities and government guarantees. Moreover, those sectors with limited access to capital markets, in particular consumers and small to medium-size enterprises, will continue to face credit constraints.

Though estimated losses from "toxic assets" have fallen from \$4 trillion to around \$3 trillion, a large portion of these losses has yet to be absorbed. The number of delinquent loans is expected to increase as unemployment remains high and tight credit market makes it difficult for households to refinance existing homes into more affordable mortgages. As a result, U.S. banks are expected to incur a total of \$1 trillion in losses of which only \$628 billion has been recognized. Globally, the numbers are even more worrisome: commercial banks have recognized \$1.3 trillion through the first half of 2009 but face another \$1.5 trillion of potential write-downs ahead. And although bank earnings are recovering they are still too weak to offset the anticipated write-downs over the next 18-months.

Given the sluggish pace of the recovery, the Fed is unlikely to change the federal funds target rate from its current record-low rate of 0-0.25% in the first half of 2010. We expect some liquidity withdrawal in the third quarter of this year, but the pace of the tightening should be slow and gradual.

Yields on shorter maturity bonds have edged lower compared to last summer reflecting the projected trajectory of policy rates. However, yields on longer-maturity Treasury bonds have increased slightly, most likely reflecting an overall improvement in economic

outlook (Figure 10). The spread between the 10-year and 3-month rates has continued to remain relatively elevated, indicating renewed optimism about growth prospects. Short rates are expected to increase in tandem with policy rates, reaching 0.8% towards the end of 2010. Long term bond yields should also rise as recovery gains some momentum and inflationary pressures begin to emerge.



The Government Sector

The deepest recession did not turn into a second Great Depression in large part because of an unprecedented government support. The total amount of government support that has been injected into the system so far through various programs such as direct loans, guarantees, share purchases, tax cuts, spending stimulus, and balance-sheet rebuilding, is in excess of \$4 trillion. This amounts to a

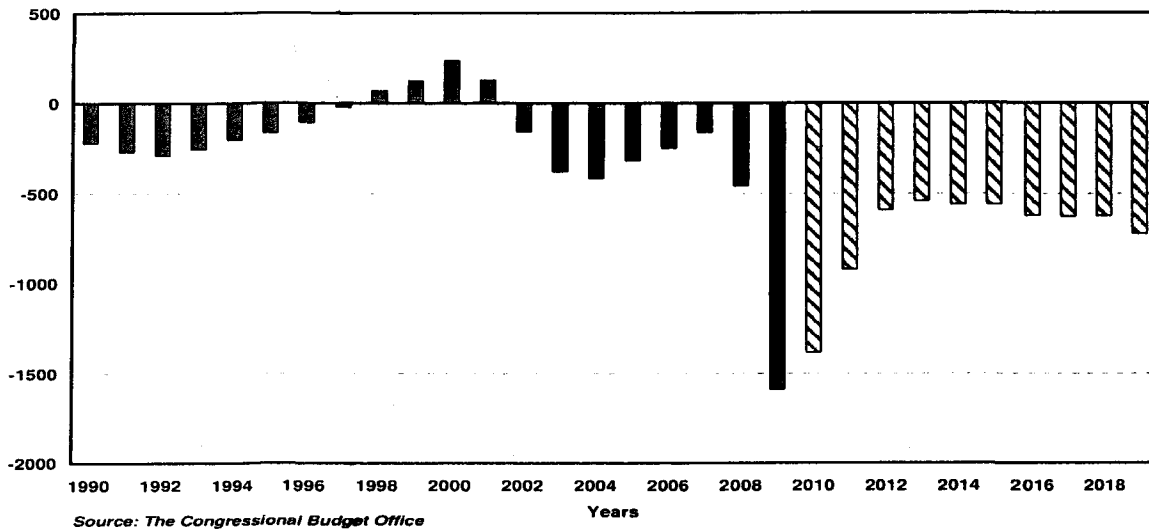
little more than one third of the entire U.S. real economic output produced in one year.

At \$787 billion, the American Recovery and Reinvestment Act, is the largest countercyclical fiscal stimulus in history. With an estimated positive GDP impact of 2.5% in both 2009 and 2010, it rivals the New Deal of the 1930s which provided a GDP boost of only around 1.25%. The stimulus plan was relatively back-loaded with roughly 30% spent in 2009 and the rest in the current year. This should provide a substantial boost in economic activity throughout 2010 but have less of an impact in 2011 as programs come to an end. Nonetheless, the fiscal stimulus is an important part of the recovery process since it extends the window of opportunity for the stability of financial sector, for the job market to turn around, and for consumers to repair their balance sheets.

The government stimulus has provided a temporary boost in demand over the short-term horizon. The widely popular "cash-for-clunkers" program appears to have brought forward the demand for automobiles. Also, the \$8,000 first-time homebuyer credit may have temporarily boosted the demand for homes. According to NAR, around 350,000 of the 1.8 million buyers who will claim the credit this year would have not purchased a home without it. The program was extended until April 2010 with its base broadened to include existing home buyers in addition to first-time buyers. Early this year, Congress passed a \$15 billion "jobs-bill" which provides companies with tax incentives to increase hiring. In addition, Congress has enacted extensions for unemployment benefits and other tax cuts for businesses.

As a result of these policies, the fiscal deficit has risen to unprecedented levels estimated to reach \$1.5 trillion (10.3% of GDP) in 2010 and \$1.3 trillion (8.9% of GDP) in 2011. The deficit is not expected to improve in the longer term: according to the Congressional Budget Office debt held by the public sector would grow from \$7.5 trillion (53% of GDP) at the end of 2009 to \$20.3 trillion (90% of GDP) by the end of 2020 (Figure 11). By all measures the US-debt trajectory, if it remains in its current path, is unsustainable. While a fiscal crisis is not imminent over the foreseeable future, there are considerable risks that mounting debts will have a large negative impact on economic growth given the size of the U.S. economy, the volume of debt markets and the dollar's role as reserve currency. Once the recovery is more robust, the focus of fiscal policy should be on lowering the deficit to a more sustainable level, including addressing a host of entitlement programs.

Figure 11
US Budget Deficit: Historical and Projected
 (level, billions)



The Federal Reserve

During the crisis, the Federal Reserve Bank (Fed) established and expanded a number of liquidity programs to support the functioning of financial markets. As a result of these actions, the Federal Reserve's balance sheets increased from \$870 billion before October 2008 to upwards \$2.3 trillion. With improvements in the financial sector and the broader economy, the Fed needs to carefully recalibrate its policy to simultaneously maintain a stable inflation rate without stifling the recovery.

Some of the most recent actions from the Fed indicate that the overly accommodative bias is being slowly withdrawn from the market. Many of the special liquidity lending facilities are now closed and the temporary swap arrangements with other central banks have ended. The discount lending rate charged to banks was raised from 0.25% to 0.75% and the maturity of the loans was reduced from 90 days to 28 days. Other restrictive measures are expected over the next six quarters as economic activity gathers pace such as outright sales of accumulated assets, increasing the rate of interest on reserve balances, executing reverse repurchase agreements and tightening rates.

C4. GLOBAL ENVIRONMENT

The world economy also emerged from the deep recession in the second half of 2009, but the pace of recovery is highly uneven across the globe. While the strength of the rebound is weak and sluggish in advanced economies, developing nations have picked up speed and are

growing again at rates near their pre-crisis peaks. China's economy has proven very resilient even in absence of strong export demand from developed nations, growing by an astounding 8.7% in 2009. India's economy, which was more insulated from the global economic slump due to less reliance in exports, also expanded by around 6.5%. Brazil was also less effected by the recession due to its limited exposure to world trade, a stable financial system and rising commodity prices.

In contrast, growth in advanced economies has trailed developed nations as the recovery has shown to be tentative, sluggish, and fragile. Japan's export-dependent economy was hit hard by the global recession which will stifle its short-term recovery. The Eurozone suffered its largest recession since World War II. Economic activity slumped by -5% in Germany early in 2009 as the collapse of world trade volumes shrank its export-driven economy. By the end of 2009, China surpassed Germany as the world's largest exporter. The German economy rebounded in the second half of 2009 supported by sizeable fiscal and monetary policies and a substantial pick up in trade activity. The French economy was impacted less by the recession due to a smaller reliance on exports and a sizable public sector which is relatively insulated from financial shocks. The recovery in the U.K. is trailing that of the U.S. and Eurozone because British consumers and banks are, in many respects, more indebted than their U.S. and European counterparts and will take longer to deleverage. Economic activity in Eurozone is further restrained by fiscal woes in some of its peripheral economies (Greece, Portugal, Spain and Ireland), which has

raised significant concerns about the sustainability of the region's recovery in the near term.

The global economic recovery is expected to continue in the near-term with emerging market economies bouncing back faster than developed nations and providing the bulk of global growth. This requires that the world economy recovers without the push from U.S. consumers. Several arguments support this scenario: (1) consumers in developing nations do not face the massive deleveraging issues of the U.S. consumers, (2) emerging market economies entered this recession with far healthier government finances, external balances and international reserves than advanced countries, and (3) infrastructure investment needs are still relatively high in most of the developing nations.

A few emerging economies (notably developing Asia) should post sizable positive growth rates in the neighborhood of 6-9 percent. A cause for concern going forward for these economies are inflationary pressures and potential real estate and asset price bubbles, which can be addressed with appropriate fiscal and monetary policies. Advanced economies, while recovering, will lag behind emerging economies growing between 1.1 - 3.2 percent. Despite the lift from emerging economies, the volatile recovery of developed nations will restrain the global economy over the next couple of years, causing world economic growth to settle at around 4%, below the pace of the boom years.

Trade volume collapsed in 2009 as consumer demand around the globe plummeted. U.S. exports dropped by -9.6 percent and imports

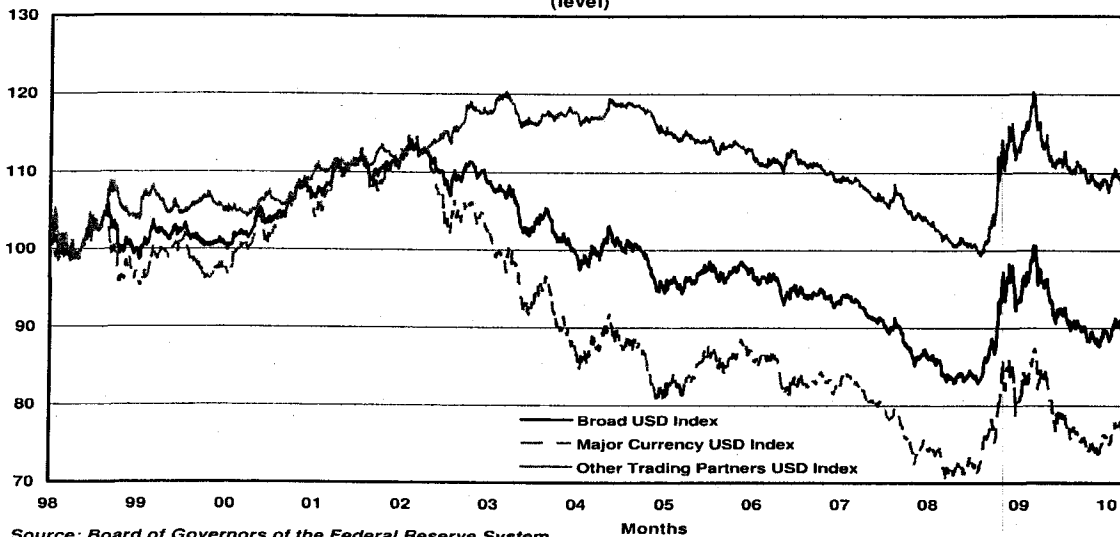
fell by -13.9 percent. These trends were reversed in the second half of the year with exports rising by 22.8% and imports by 15.8% in the fourth quarter of 2009. Export growth is expected to exceed the rate of imports over the forecast horizon as the U.S. economy grows at a slower pace than its emerging market counterparts (China and the rest of emerging Asia in particular). Nonetheless, our models forecast short-term trend reversals (such as the decline in trade volumes in 2013 and 2014, Table 1), reflecting trends in the global economy, changing patterns in terms of trade, and exchange rate adjustments.

These structural changes have a positive impact on the U.S. current account deficit, which has declined from a high of \$825 billion (6.23% of GDP) in the third quarter of 2006 to \$475 billion (3.3% of GDP) in the fourth quarter of 2009. Our forecasts indicate that while the U.S. current account will remain negative over the next 5 years, the deficit should continue to decrease.

For the duration of the crisis (October 2008-March 2009), the dollar appreciated steadily against all trading partners as investors sought the relative safety of U.S. Treasury securities. Since March 2009, the dollar has depreciated gradually as the global financial crisis subsides and investors become less risk averse (Figure 12).

As the economic recovery gains strength, the biggest threat to the dollar is the shift from unsustainable consumer spending in the pre-crisis era to unprecedented levels of government spending. Large external imbalances, the reluctance of export-driven emerging economies to abandon the dollar peg, and a weaker recovery in the U.S.

Figure 12
US Dollar Indices
(level)



relative to the global economy place further downward pressure on the dollar. China has recently voiced concerns about the potential inflationary impact of the U.S. fiscal stimulus on the value of its \$1.5 trillion investment in U.S. government securities. On a more worrisome note, Chinese officials have also called for an alternative currency reserve system that would offer more stability for its foreign exchange reserves.

In the foreseeable future however, the dollar is likely to remain the dominant reserve currency because the U.S. economy and financial markets are much larger than Europe's and China's banking system is still fragile. The dollar faces a steady depreciation over the next few years, but a dollar crisis can ultimately be avoided if fiscal excesses are eliminated, and China shifts gradually from an export nation to a consumer-driven economy.

C5. Projections of Key National Economic Variables

Table 8a
National Economic Variables
Real Gross Domestic Product
(percent)

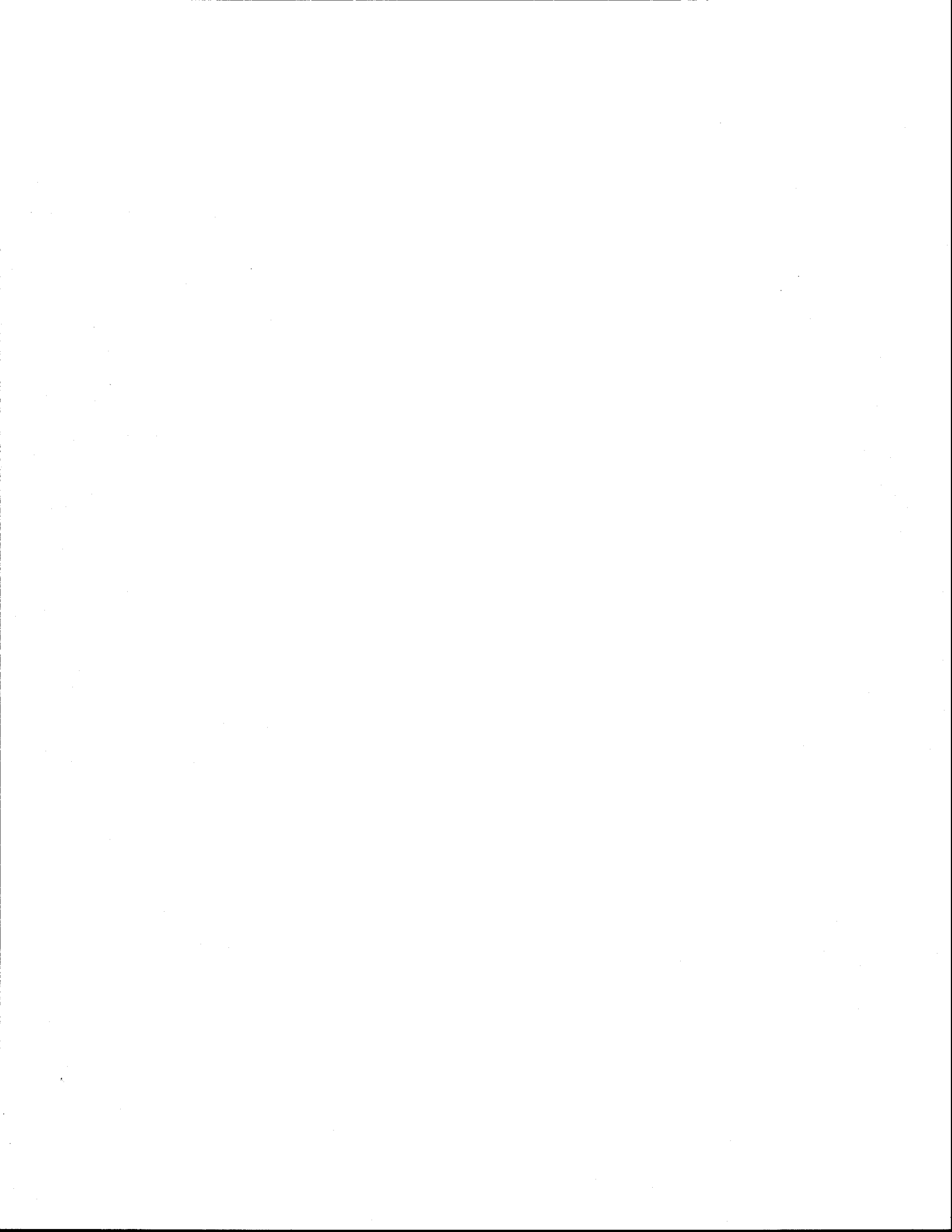
Year	RGDP	Consumption	Residential Investment	Non Residential Investment	Exports	Imports
Historical						
2007	2.1	2.6	-18.5	6.2	8.7	2.0
2008	0.4	-0.2	-22.9	1.6	5.4	-3.2
2009	-2.4	-0.6	-20.4	-17.7	-9.6	-13.9
Forecast						
2010	2.7	1.3	8.3	4.3	7.4	3.2
2011	2.9	2.2	7.5	9.6	8.2	4.3
2012	3.6	2.9	5.2	6.5	8.8	4.7
2013	3.3	3.0	4.7	5.8	6.5	3.2
2014	2.8	2.7	6.4	6.0	4.8	3.5
2015	2.9	2.8	4.2	6.4	5.6	3.9

Table 8b
National Economic Variables
Inflation and Labor Market
(percent)

Year	Headline CPI	Core CPI	Wage/Costs Labor Compensation	Unemployment	Payroll Employment	Labor Productivity
Historical						
2007	2.9	2.3	4.2	4.6	1.1	1.8
2008	3.8	2.3	3.0	5.8	-0.6	3.0
2009	-0.3	1.7	2.0	9.3	-4.3	3.8
Forecast						
2010	1.7	1.5	2.2	9.6	0.1	4.0
2011	2.6	2.1	3.4	9.2	0.8	3.6
2012	3.6	2.4	4.2	8.2	1.2	2.7
2013	3.8	2.8	4.0	7.5	1.5	2.8
2014	3.3	2.5	3.6	6.3	1.1	2.5
2015	3.0	2.3	3.8	6.0	1.2	2.2

Table 8c
National Economic Variables
Financial Assets, Current Account, Exchange Rate
(percent)

Year	Federal Funds	3 Month T-bill	10-Year Note	30-year Mortgage	Current Account % of GDP	US Dollar Index percent change
Historical						
2007	5.02	4.36	4.63	6.34	-5.1	-4.8
2008	1.92	1.37	3.66	6.04	-4.9	-3.5
2009	0.16	0.15	3.26	5.04	-3.0	6.1
Forecast						
2010	0.51	0.43	3.95	5.12	-2.8	-0.4
2011	2.31	2.22	4.48	5.67	-2.2	-3.6
2012	3.54	3.31	4.86	5.93	-1.8	-3.8
2013	3.95	3.82	5.18	6.20	-1.5	-2.7
2014	4.42	4.28	5.53	6.75	-1.3	-2.6
2015	4.58	4.37	5.62	6.83	-1.0	-2.5



**2010
Riverside
Economic
Forecast**



BEACONECONOMICS

Presented by Beacon Economics

Commissioned by the Riverside County Executive Office



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National Forecast

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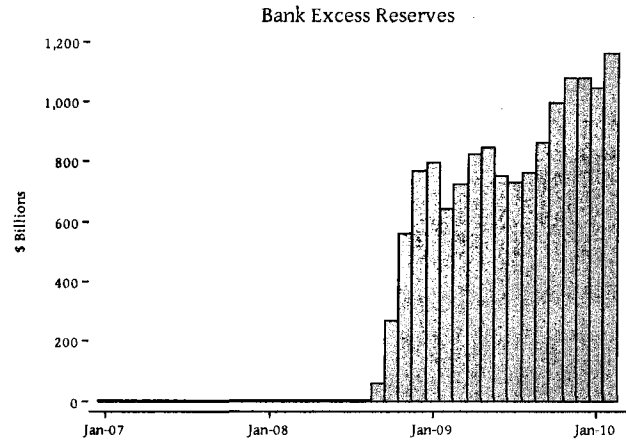
The Big Picture: Not out of the Woods Just Yet

Any discussion of the 2008-2009 recession will necessarily include a litany of “worst since the Second World War” caveats. The decline in real economic output, the decline in international trade flows, the proportionate and total losses of jobs and real income, the rise in the unemployment rate, and the decline in business spending all were at record levels. The best that can be said is that the more bearish predictions of a complete global economic meltdown did not come true. Whether this is due to the massive bailout of Wall Street banks (and bankers) as has been stated countless times by those behind the bailout plans or simply because the risk of such an event was overstated will never be known.

More important, the recession has come to an end. All signs point to it, from housing prices to labor markets, economic output, and, of course, the financial markets, which have been positively giddy over the past 12 months. And banks are starting to loosen their purse strings – recent figures from the Federal Reserve Lender Survey show banks loosening their credit standards and reducing the rate premiums they charge borrowers. The big question now is, how sustainable will the recovery be?

Our view on this has been changing in recent months. We are becoming more “optimistic” in the short run. Recovery is already underway, and much of the stimulus has yet to hit the economy. For example, the Federal Reserve has injected unprecedented amounts of liquidity into the economy, but much of this boost never made it to Main Street – in fact most has been absorbed by the banking sector in the form of excess reserves. With bank lending starting to flow again some of that \$1.2 trillion could hit the economy this year. Let us not forget to mention all that stimulus spending that is still trying to find a project to fund. According to the website Propublica, less than half the

stimulus money has been spent – \$151 billion is in process right now, and another \$321 billion will be spent this year. With this kind of boost, 2010 could end up being a very strong year.



Of course we used the word ‘optimistic’ in quotes, because a solid 2010 does not necessarily mean a good 2011 or 2012. Indeed, we are also becoming more pessimistic in the medium run. Although having growth return in the short run is clearly a good thing, it has not occurred because the U.S. economy has moved beyond the issues that plagued it at the start of the recession two years ago. Rather it is due primarily to fiscal and monetary policy.

The nation seems to be trading in its private bubble for a public one, swapping one set of unsustainable economic drivers for another.

While these actions have done what they were intended to do – namely, stabilize the economy – they come with a cost. First, the interventions are creating their own set of potential imbalances – an out-of-control Federal deficit and the potential for massive inflation. Second, these programs have slowed the closing of the imbalances in the economy that pushed us into the recession in the first place, and in some cases the problems are actually getting worse.

In short, the nation seems to be trading in its private bubble for a public one, swapping one set of unsustainable economic drivers for another. And as with all bubbles, the pop, when it occurs, will likely prove painful.

What are these ongoing imbalances? They include consumer spending, which is currently at an all-time high percentage of personal income. The recent rise in savings rates is an illusion created by the record tax cuts that were part of the stimulus package. The banks aren't out of the woods yet, either. The collapse in asset values has left banks with many underwater loans. This has been covered up by changes in the accounting rules — but the losses will still need to be accounted for eventually. Rising home prices mask the fact that over 6 million mortgages are currently non-performing in the United States — a supply that will eventually need to be addressed.

Right now the economy is a forecaster's nightmare: it is in a place it has never been, with challenges ahead it has never seen before.

The rally in the equity markets seems to be occurring despite the fact that overall asset prices still seem too high given our long-run potential for growth. And the bounce in the asset markets overlooks the fact that overall the national deleveraging that needs to occur to shed off record levels of debt has yet to really get underway. It's clear that the economy is far from being on stable footing.

But if you are reading this report hoping for some clearer sense of what comes next, we apologize up front for not being able to deliver a clearer picture of the U.S. economy. Forecasting in normal times is a difficult challenge, true to the cliché that it is as much of an art as a science. And right now the economy is a forecaster's nightmare: it is in a place it has never been, with challenges ahead it has never seen before.

Forecasters who think they have a clear vision of how it is all going to play out are either fools or frauds.

The best-case scenario is that the Federal Reserve and the Obama administration manage to draw down the public bubble slowly, a possibility that private bubbles typically don't share. In this situation, they manage to pull back on the stimulus slowly (The Fed gradually withdraws the excess liquidity, the Federal Government is able to close the budget deficit slowly, the FDIC manages bank failures on a gradual basis, etc) as the economy heals and meets the ongoing challenges. But this will require a delicate touch, to say the least — one unfortunately not normally associated with congressional politics. In such a scenario, the 2010 boom will be followed by a period of slow growth, perhaps for two years or more.

The worst-case scenario is that the bubble pops rapidly, putting the economy squarely back into another recession — the double dip. The potential sources of such a scenario come from many directions.

- The Federal Reserve might not be able to contain the beast it has unleashed, and the new liquidity-driven financial bubble could continue to grow despite efforts to slow it down, until it painfully pops of its own accord.
- Inflation could change from cold to hot quickly, forcing the Fed's hand. Rates could spike as a result, the dollar could drop in value, and the real cost of borrowing could hit very high levels.
- The global sovereign debt worries could affect the United States, causing the cost of borrowing to rise sharply and forcing the U.S. government to adopt some degree of rapid fiscal austerity.
- The financial markets could get hit by one or two large defaults — perhaps caused by a public debt default in Europe (read Greece) or from some other direction yet to be revealed. Or the stock market could crash and this time the Federal Reserve —

largely out of bullets — could do little about the consequences.

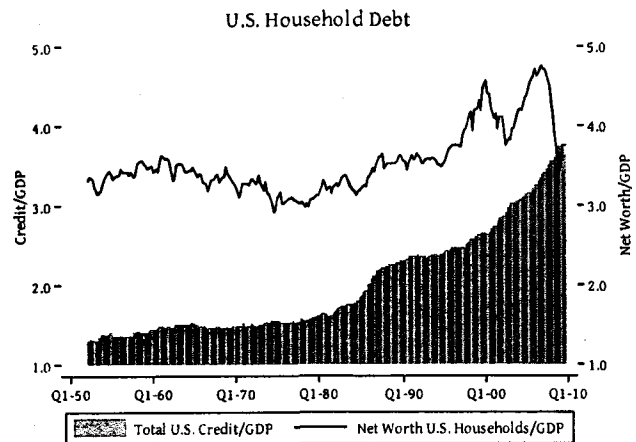
So enjoy 2010 — it should be a good year. But don't overextend. The one thing you can count on is that economic volatility will be the watchword for the next few years. The U.S. economy is surely in a better place than it was two years ago, but we are not yet in a position to enjoy another extended expansion. And this shouldn't be a surprise. The problems that put us here built up over more than a decade. It is going to take time to work our way out of them.

In the meantime, count your blessings — because even an unstable U.S. economy offers its citizens one of the highest standards of living in the world, something that Americans too often forget in uncertain times.

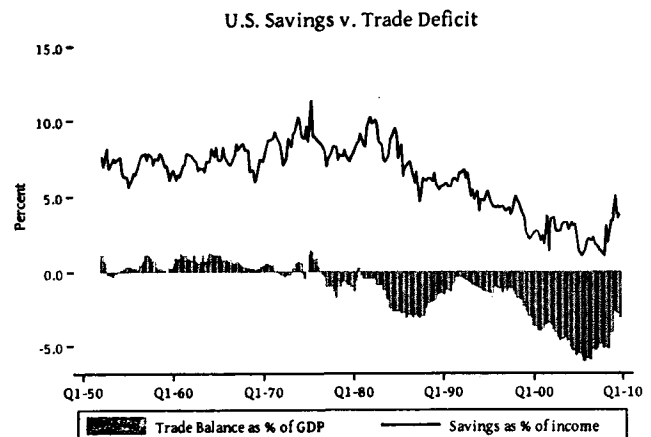
The 2010 Economic Rebound

To understand where the economy is today, we have to first understand how we ended up in this particular position in the first place. The roots of the recession began not with the failure of Lehman Brothers, but back in the mid-1990s. It was then that the great financial bubble began to form in the U.S. economy. Over the next 13 years, U.S. asset prices, for stocks, bonds, homes, commercial real estate, and so on, rose to levels that simply made no sense, given long-run productivity growth in our economy.

One way of seeing this is by considering the basic relationship between the net value of the U.S. economy (U.S. household net wealth) relative to U.S. GDP — our national P/E ratio. Given that the U.S. economy grows at a fairly stable rate (roughly 3% per year in real terms) the value of assets in our economy should be proportional to overall economic output over time.

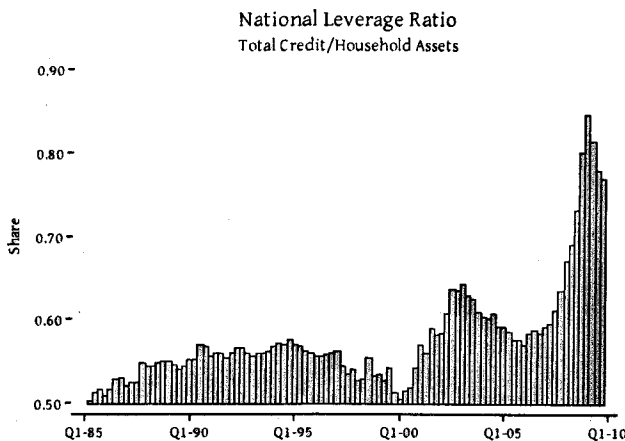


The P/E ratio for the U.S. economy, which had ranged between 3 and 3.5 since the statistic first started being measured after World War II, for whatever reason shot up to 4.7 between the mid-1990s and the start of the last recession. In other words, the market value of the U.S. economy was far too high given our true ability to meet those future claims. Indeed, it could be argued that the U.S. economy was “overvalued” by something on the order of \$15 trillion to \$20 trillion.



Along with this increase in asset values came an increased use of credit by banks, consumers, businesses, and everyone else. Overall, the gross amount of debt in the U.S. economy grew at twice the pace of the overall economy between 1995 and 2008, leaving the nation with record levels of debt. Indeed, this debt is still a large issue for the U.S. economy. Even though asset

price collapses have pushed the P/E ratio down to a figure with a closer resemblance to normalcy (though still high from a long-term perspective), overall debt levels remain quite high relative to GDP even now – consider the following graph that shows the total value of credit in the U.S. economy to the growth value of all assets held by consumers. This leverage ratio has come down some, but still has a ways to go. The process of deleveraging has yet to fully work its way through the system.



The problems haven't only been on the financial side of the ledger. American consumers, convinced that they were rich and getting richer at a record pace, began to save less and less of their income, and as a direct result the U.S. economy began to run a record large trade deficit. In other words, the U.S. economy developed a structural problem to go along with the accounting problems. Too many resources (capital and labor) were being devoted to real industries supporting consumer spending, home building, finance, and imports, which in turn were growing excessively due to the bubble. Too few resources were being devoted to exports and business investment.

What is perhaps most amazing about this past economic downturn isn't that it happened. The downturn was inevitable, and when the bubble popped, the financial havoc was going to be intense. It was inevitable that the U.S. economy (and therefore the

world economy) was going to go through a painful period of recalibration as resources were reallocated to sustainable long-run uses. What is truly shocking is how many economists argued that the economy was fine even as late as the middle of 2008, even as things had already started to implode.

Now there are clear signs of growth in the economy. GDP growth in the fourth quarter hit nearly 6% in real terms. Admittedly, much of this growth was the end of the inventory runoff, but aggregate demand growth was still well into positive territory (albeit below its long-run average). Consumer spending has been on the rise, as is business spending on equipment. Furthermore, real exports rose faster than imports in the fourth quarter. This is one of the reasons that the industrial part of the economy is also doing well. Industrial production has increased and capacity utilization is rising sharply.

Contributions to Real GDP Growth by Sector (SAAR)

	87 to 07 Avg.	Recess. Avg.	2009-1V
Gross domestic product	3.05	-2.40	5.90
Personal consumption	2.18	-0.86	1.23
Durable goods	0.47	-0.66	0.02
Nondurable goods	0.42	-0.31	0.64
Services	1.29	0.11	0.57
Gross private investment	0.66	-3.32	4.63
Structures	0.04	-0.41	-0.47
Equipment/software	0.51	-1.10	1.09
Residential	0.03	-0.87	0.13
Change in inventories	0.07	-0.94	3.88
Net exports	-0.12	1.23	0.30
Exports	0.67	-1.02	2.32
Imports	-0.80	2.24	-2.02
Government	0.34	0.54	-0.23
National Defense	0.02	0.38	-0.19
Nondefense	0.05	0.13	0.21
State and local	0.27	0.03	-0.25

Source: Bureau of Economic Analysis

Housing construction and the labor markets have not shown much of a rebound as yet, but even here the

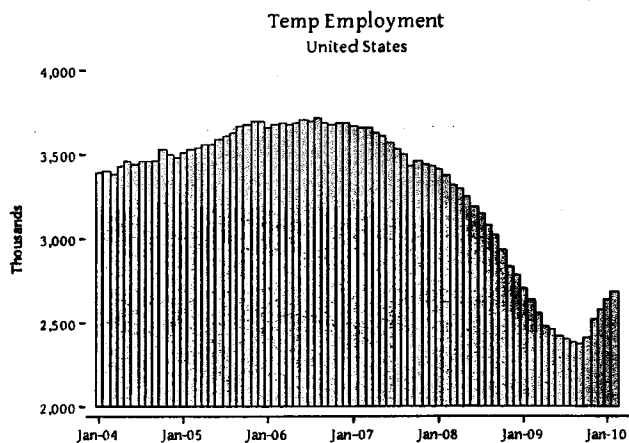
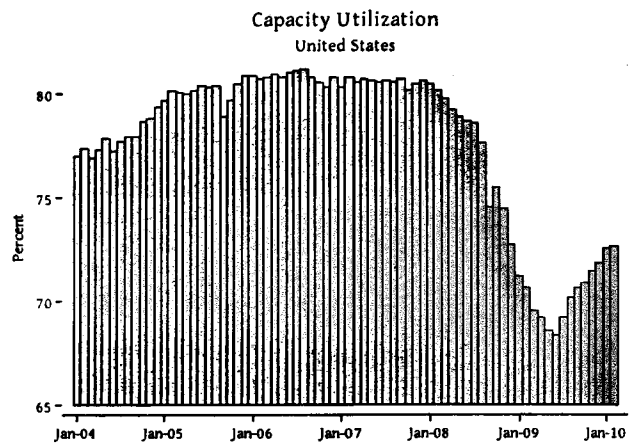
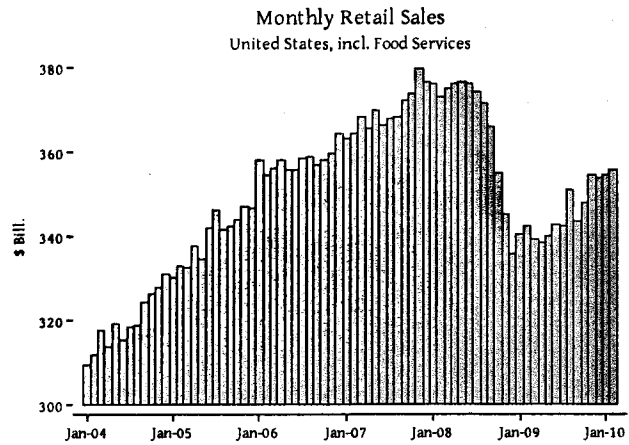
news is better. The labor markets have at least stabilized, and unemployment rates have fallen slightly. There are a number of signs that recovery in employment will be starting in the next few months. Weekly hours worked has been rising among employed workers, and temporary employment has seen sharp increases. Similarly, even though housing starts and permits continue to sit on the bottom, home prices have been rising as sales in some markets have been looking solid.

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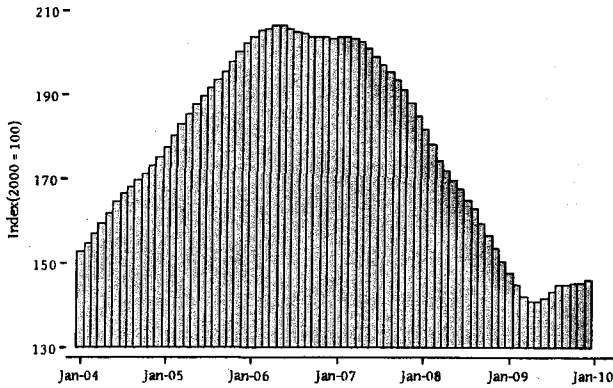
Perhaps most impressive is the rebound in the financial markets. Of course, the equity markets are way up from last year at this time, as has been widely reported in the press. But the bounce is deeper than seen in the major indexes. After hitting record high levels in the midst of the crisis in late 2008, risk premiums have come way down. The so-called TED spread¹ has dropped to almost nothing, as has the record spread between seasoned Baa and Aaa corporate bonds.

Companies in need of refinancing outstanding debt are finding the process easier than they thought. In the middle of 2009, as the economy swooned, many bond experts predicted that 2010 was going to be one of the worst years ever for corporate bond defaults. Instead, given the data on loan problems to date, this year may end up being a below-average year for defaults.

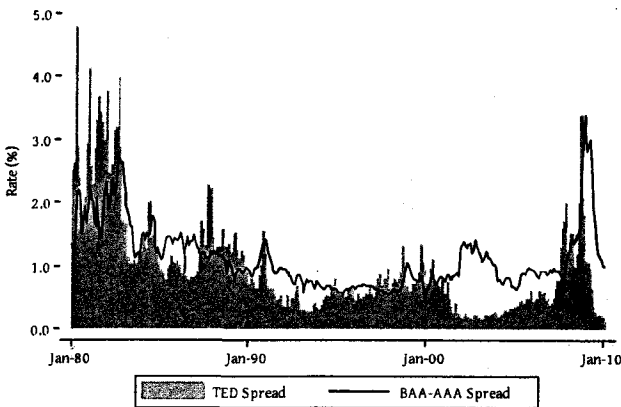
¹The difference between the 3-month T-bill interest rate and the 3-month LIBOR interest rate.



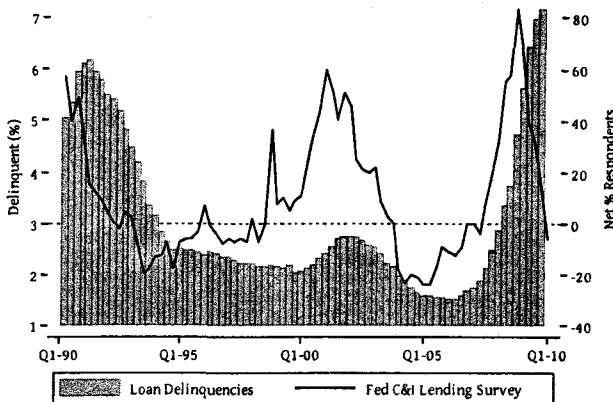
Case Shiller 20 City Index
United States



Risk Spreads



Mortgage Lending



The banking sector has also been a surprise. While Federal Reserve data shows that loan delinquencies continue to rise, the recently released data from the Senior Loan Officer Opinion Survey on Bank Lending Practices shows that lending terms on many sorts of loans have actually begun to ease. This is completely out of sync with past data that shows lending terms only loosening with a substantial decline in the rate of delinquency.

As noted, this rebound in the economy owes more to government policy than strong fundamentals. While we have all heard bits of information about the interventions, it may be worthwhile to put them into one place.

- The Federal Reserve has reduced short-run rates to near zero. The Fed has also embarked upon an aggressive plan to lower long-run rates through quantitative easing — a fancy term for printing money. The Fed has added almost \$1.3 trillion to the monetary base — one of the most aggressive expansions on record.
- The Treasury has been involved in many direct support programs — from bailing out AIG and the GSEs (government-sponsored entities) to managing the spectacularly underperforming PPIP (the Legacy Securities Public-Private Investment Program) and of course TARP. It has also been running the HAMP programs that are designed to encourage the modification of mortgages for delinquent homeowners.
- Congress and the Obama administration have also been involved, with a nearly \$1 trillion stimulus program that does everything from cut taxes to backfill state welfare systems, direct spending on various infrastructure projects, and provide a tax credit for home purchases. A controversial change in the FASB rules has also been passed, addressing how banks and other financial institutions value loans.
- The FHA, which after years of being more or less pushed out of the home lending market, has come

back with a vengeance, insuring home purchase mortgages at a record pace.

The potential consequences of these interventions are clear. Federal debt levels will rise to 70% of GDP within 5 years according to current estimates. It will likely get there more quickly, given that much of the bailout tab has yet to be fully recognized on the public books. In addition, there is the issue of the monetary base expanding by 150%. If the velocity is held constant, this implies that prices in the U.S. economy should also rise by 150% within the next five years — a rate of inflation that makes the 1970s look tame.

Of course, the challenges raised by these interventions are worth it if these actions get the economy moving again. But there's the rub. Even though the economy is currently expanding, the problems in our economy are still profound. As the stimulus is unwound, it remains to be seen whether the momentum of current growth will allow us to take these problems in stride. If not, the economy will quickly tumble back into a recession.

To illustrate the problems still entrenched in the economy we will first take a deeper look at two sectors: real estate and consumer spending. In each case, the positive signs on the surface mask problems underneath. Next, we will take a closer look at Federal Reserve policy and what it may mean for inflation.

Real Estate

Home prices started to bounce back in 2009 as sales began to heat up. While the national numbers are modest, some markets are positively hot. Cleveland, Memphis, the San Francisco Bay Area, Denver, and St. Louis all saw double-digit increases in median prices in 2009 according to the National Association of Realtors. The number of bank owned "REO" units has also been in decline.

Policy, not fundamentals, is driving the real estate market — a telling analogy for the force behind the U.S. economy overall.

The Case-Shiller Home Price Index offers additional evidence of price growth, with more accurate data broken down by market. The following table lays out the Case-Shiller estimates of price growth from June to December by tier of housing. While a few of the markets still lag, others have shown significant price gains — particularly at the low end of the market.

Case-Shiller Home Price Index
Price Growth by Tier, Jun-09 to Dec-09, (% SA)

	Low	Middle	High
Las Vegas	-2.7	-4.3	-3.0
Tampa	0.0	-1.5	-2.3
New York	0.1	-0.1	-0.8
Seattle	1.1	-0.6	0.1
Miami	1.9	-1.2	3.2
Chicago	7.8	1.3	1.1
Denver	5.7	1.1	0.9
Portland	0.4	2.5	1.7
Atlanta	7.0	3.1	1.4
Boston	4.2	2.2	2.4
Washington, D.C.	7.4	5.5	3.6
Los Angeles	7.5	7.2	4.2
Phoenix	19.6	5.7	2.3
Minneapolis	22.4	6.5	5.1
San Diego	11.7	7.2	3.4
San Francisco	11.5	7.6	4.5

Policy, not fundamentals, is driving the real estate market — a telling analogy for the force behind the U.S. economy overall. In the real estate sector, policy has created a big demand push even as it has restricted supply. Buyers are enjoying record low interest rates due to the Fed's policy of "quantitative easing," where money is printed and used to buy debt being issued by Fannie Mae and Freddie Mac. Similarly, the FHA has vastly expanded its presence in the market over

the past two years, guaranteeing a record number of mortgages. And, of course, there is the homebuyer tax credit program (scheduled to end at the end of April). The original deadline for the program, November 30, 2009, drove a number of people into the market, leading to an uptick in sales; it remains to be seen if the new deadline will lift sales in March and April.

All of these programs have a limited lifespan. Fed Chairman Ben Bernanke has to worry about the inflationary pressures created by the expansion of the money supply. The FHA's portfolio is seeing record increases in delinquencies. In the very near future, the government will be reaching into its wallet to bail out this institution (as well as its banking counterpart, the FDIC) to the tune of hundreds of billions of dollars.

And even though the housing industry strongly pushed for and received an extension of the tax benefit, it is only the last two or three months of such programs that really create the desired result of expanding sales. It is the end of such programs that makes them work in the first place, as it forces people to get into the market before the program ends as opposed to sitting on the sidelines waiting for prices to fall further. Note how sales have been falling for the last three months after the initial deadline. The new deadline is already showing less of an impact. To extend them indefinitely takes away their very purpose.

The largest issue, however, is that of foreclosures. Although much has been made of the various homeowner rescue plans, they have had little to no impact on the pace of foreclosures, or on the eventuality that these problem mortgages will ultimately have to be taken over by the banks. Instead, they have only slowed the process down.

According to the Mortgage Bankers Association, almost 13% of all mortgages (on properties with 1 to 4 residential units) were nonperforming at the end of 2009 — this includes those that are seriously delinquent or somewhere in the foreclosure process (but not yet REO). For the MBA this implies that there are

5 million nonperforming loans out there. Of course, they only cover 80% of the market; hence we can estimate that nationally this number hits 6.2 million.

As with many policies, the HAMP loan modification plan is a policy designed to fight the last war, when it was interest rate resets that caused foreclosures. Today, the problem is that an enormous number of homes are underwater — the mortgage value is greater than the value of the home. Modifying loan payments will not solve this problem. To date, the HAMP program has only permanently modified 160,000 loans, with another 90,000 modifications close to being completed. This is a proverbial drop in the bucket relative to the scale of the problem.

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It might be hoped that rising prices would help the situation. But bear in mind that overall prices have fallen by 33% in the 20 metropolitan areas tracked by the Case-Shiller Home Price Index. In the areas hardest hit by mortgage problems, home price declines are closer to 45%, and for the big four (Nevada, Florida, California, and Arizona) the number is 55%. Home prices fell because they had reached unsustainably high levels during the course of the bubble. They will not reach these levels again under normal circumstances (read — normal inflation rates) for many, many years. Indeed in many markets prices have not even gotten back to 2000 levels relative to incomes — a time when prices seemed close to their long-run sustainable levels.

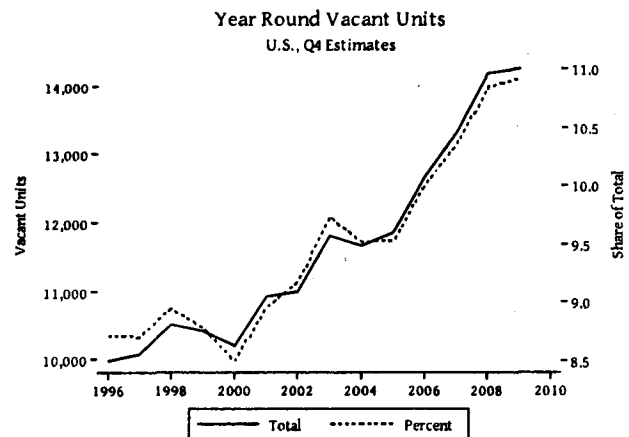
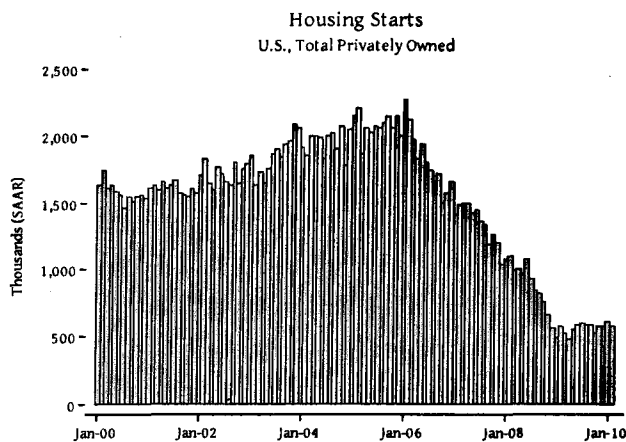
Nor can we expect much in the way of a recovery in housing construction. The last few years saw annual housing completions top 2 million units in a nation that needs perhaps half as many units to meet the demand of population expansion. The cumulative number of housing completions outstripped the number of

Mortgages 60+ Days Delinquent or in Foreclosure

	Q4-06		Q4-08		Q4-09	
	Share	Number	Share	Number	Share	Number
West North Central	3.05	83,550	5.59	158,294	7.35	203,228
West South Central	4.39	176,442	6.21	269,178	8.00	343,164
East South Central	4.49	90,383	7.01	151,487	9.25	197,198
New England	2.47	45,455	6.47	123,868	9.54	179,384
Mid Atlantic	3.11	146,819	6.76	330,800	10.14	490,646
Mountain	2.17	81,290	7.75	307,310	11.74	452,954
East North Central	5.11	306,374	8.88	555,175	12.08	723,905
Pacific	1.59	121,097	8.56	684,908	12.34	969,141
South Atlantic	2.83	272,027	9.74	998,105	14.00	1,401,471
Total		1,323,438		3,579,125		4,961,091

new households by more than 3 million over the past decade. The second quarter housing vacancy report from the census shows that the share of year-round empty units stands at 10.7%, or 1.7% above the rate it was at in 2002. This implies that there are still 2.5 million too many units in the system. Thus, while some areas will need quicker recoveries, many will not see substantial building for years.

pecially specialized structures such as schools, hospitals, and manufacturing plants)—has largely offset the declines. Further, the great wave of commercial delinquencies has yet to emerge, contrary to predictions and despite rising vacancy rates and falling rents. This is surprising, given that even optimistic experts in the industry recognize that prices have fallen at least 30% in the hardest-hit markets.



The nonresidential construction market has been the one positive surprise in the system. Construction tanked in the first quarter of 2009 but started to stabilize in the second quarter. While spending on retail, office, and warehouse space, as well as on hotels, has dropped, spending elsewhere—on infrastructure (es-

Once again, there is a worrisome backdrop to the story. Lenders have little incentive to be aggressive toward commercial property investors who are unable to meet balloon payments or fall short on loan covenants. Banks are already under substantial duress and the change in the Financial Accounting Standards Board (FASB) rules gives great leeway on how poten-

tially problematic loans are valued. Extend (the terms of the loan) and pretend (the loan is healthy) has become the rule of the day for banks' survival, despite the fact that this formula relies on deceiving investors about the true state of their loan portfolios. Combine this with low short-run rates that take some of the pressure off the borrowers with adjustable-rate loans, and we can see that the wave of commercial delinquencies is still in the offing, it has just been temporarily frozen in its path.

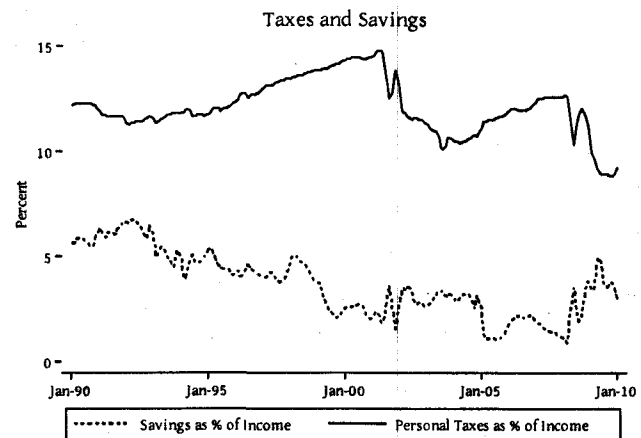
Consumer Spending and Public Deficits

As noted, consumer spending was clearly too high at the onset of the recession. With savings rates at near zero and debt levels at a record high of 120% of annual income (at the start of the decade this figure was roughly 80%) spending had to come down some. And it did, with the expected results for the economy. Now, personal savings rates are running slightly over 3% of income — still too low from a long-run perspective, but moving in the right direction. More important, consumer spending is on the rise as well, which is clearly good news for the economy in the short run.

But, the fact that it is rising should be raising warning flags. After all, real income was battered by the loss of jobs and has yet to recover at all. How can Americans be spending and saving more even as they earn the same amount? That good trick came via the record cut in taxes Americans received in 2009 as part of the stimulus program, as well as from the progressive nature of our tax system. Americans had been paying roughly 12% of their income in taxes at the start of the downturn. Last year that number was down to a record low 8.8%.

...the wave of commercial delinquencies is still in the offing, it has just been temporarily frozen in its path.

It may be the case that savings is larger than it appears — after all, as we saw in the last section, millions of households are enjoying housing services without bothering to pay the mortgage. Unfortunately, this income transfer does not appear in the BEA income statistics. But it can't be that much. If each of the 6 million nonperforming mortgages in the nation cost on average \$1,500 per month and was not paid for a full year, this still would only add roughly 1% to consumer incomes. It simply isn't large enough to swing the statistics one way or the other. So what this means is that consumer spending as a share of income is currently at a record high — and rising. The consumer part of the problem has not been solved.



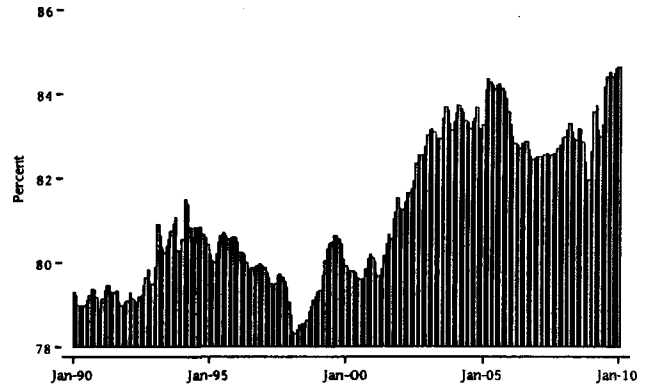
Of course, if the government makes the tax cuts permanent, this would solve the problem. Unfortunately, this is not a valid option. The U.S. government had serious debts coming into the recession. The Bush administration chose to fund its Middle East adventures not through tax increases but through borrowing. For a while the public sector needed to borrow an amount roughly equivalent to 6% of GDP — roughly the level of borrowing through much of the Reagan and George H.W. Bush administrations. But the bailout plans took this to a level not seen since World War II, with the current pace of borrowing reaching 11% of GDP — \$170 million per hour, or \$4 billion per day.

This puts us close to the Greek level of fiscal deficits. Fortunately, the world's lending community doesn't put us in the same category of risk — hence our government still pays relatively low rates on its debt. But how long we can continue on such a path is unclear, particularly if inflation starts to set in at any level. And is such an action ethical? Should the next generation of Americans be held financially responsible for this generation's inability to spend at a reasonable level?

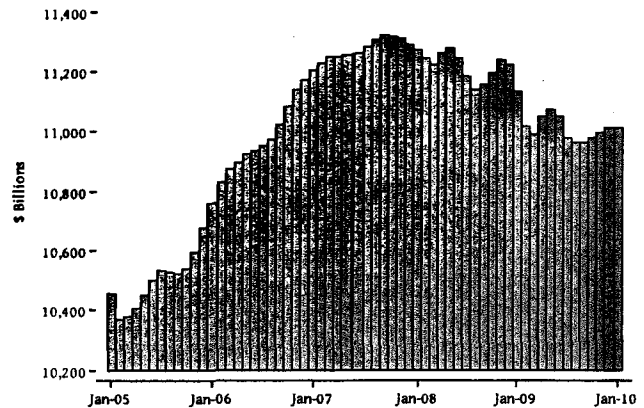
Taxes will necessarily increase in the next two years, although the speed at which they will rise is yet to be determined. The current budget proposal on the part of the Obama administration includes some extensions of middle class tax cuts but allows tax rates to go up on higher-income households. This will clearly put consumers in the difficult position of having to reduce spending or savings. The first is bad for the short-term health of the U.S. economy, the second is bad for long-term health.

The only real hope for the administration is that income growth will return with enough speed to allow Americans to pay higher taxes without cutting back elsewhere. At this point in time, it seems unlikely to occur. The labor markets remain weak, and the last few recessions seem to indicate that the jobless recovery is a standard part of a modern recession. It may be even worse this time around. Because of the shift in economic drivers, away from housing and consumer spending, many laid off workers will need to be retrained in new fields before they become employable. This may be why job creation is such a top policy priority.

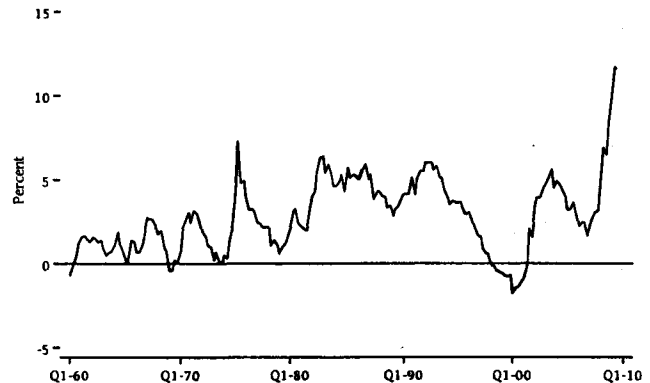
U.S. Consumption
As a Share of Income



Real Income (SAAR)

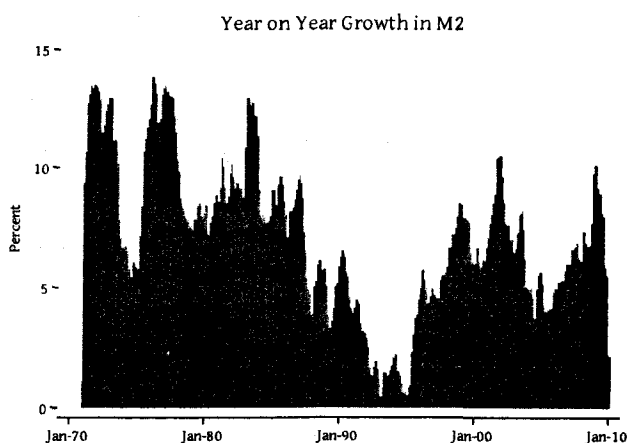


Net Government Borrowing
As a Share of GDP



Inflation and the Federal Reserve

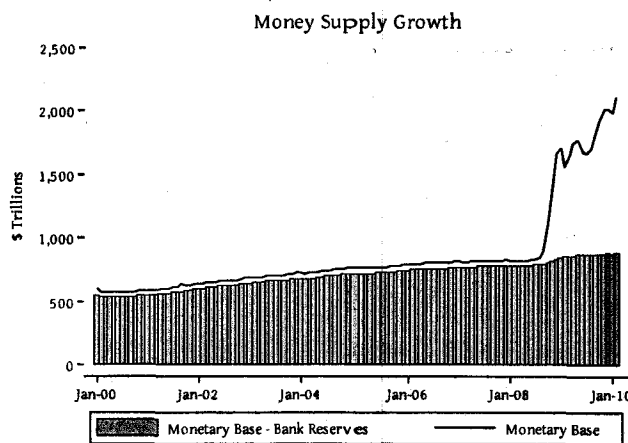
What about inflation? We have already noted that the Federal Reserve has been printing money in order to push down long-term interest rates. To date, they have expanded the monetary base by nearly \$1.3 trillion dollars. Much of this has gone to purchasing Fannie Mae and Freddie Mac debt — but some has also been used to buy longer-term treasuries and some private label asset-backed securities. As noted, this has expanded the base money supply by 150%, which implies that there is the potential for 150% inflation in the next five years. With this level of risk, it seems astonishing that the bond markets have been so willing to continue to lend.



One reason for the continuation in lending is that there is no immediate risk of inflation. Much of the stimulus has landed in the banks in the form of excess reserves. Indeed, taking the growth of excess reserves out of the equation, the monetary base has grown by only 12.5%. And even here we are not seeing inflationary pressures. The increase in savings and lack of confidence has slowed the velocity down substantially. M2 — the best measure of broad money that corresponds to serious inflation — has actually decelerated in recent months. When the Fed states that it is willing to hold rates low for the foreseeable future, it has the confidence of knowing that it has 18 months before inflation can become an issue.

Still, the Fed has to begin to slow the expansion eventually — and to date they are planning to by the end of April. One might have expected to already see the impact on the debt markets — but not yet. The problems in Greece and the European Union have likely pushed a flight to security. Plus, with rates on high-risk debt coming down, there isn't much for the liquidity already in the market to do.

The real risk for the Federal Reserve starts not when they stop printing money, but when they need to mop up the liquidity. Much of the liquidity they injected into the economy has been sitting in the banks. Once the banks begin to lend again, excess reserves will start to fall. This hasn't happened yet, but with indications of loosening credit at banks and with firms starting to invest again in capital equipment and inventories, it will only be a matter of time. When excess reserves begin to fall, the Fed will have to start selling off assets to control inflation — or, in an equivalent move, they will have to raise the rate they are paying the banks on those excess reserves. In either case, rates will begin to rise and will pull some of the stimulative effects out of the economy.



Bear in mind that one of the largest failures of the Federal Reserve during the Great Depression was that it allowed the money supply to collapse, adding to the overall painful recession the nation was in as a result of the collapse of that asset bubble. Fed Chairman

Bernanke was not going to let that happen. Currently, price levels are nearly flat despite the massive injection of liquidity. We might argue not that the Fed overdid it — but that they did just enough.

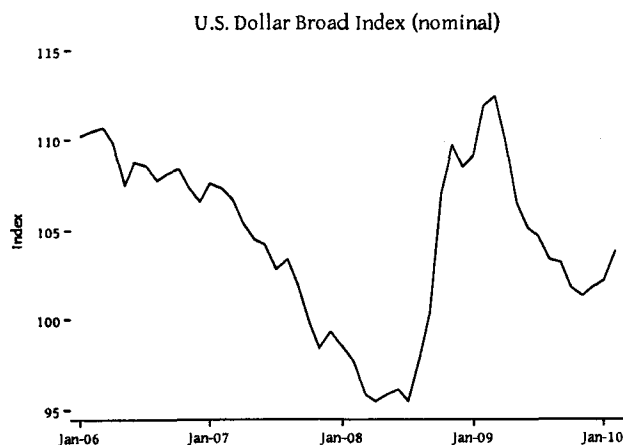
Of course, this assumes that the Fed is actually planning on fighting off inflation. As already discussed, the financial system is not out of the woods yet. The FDIC continues to take over banks at a record pace. But inflation poses a cheaper, simpler solution for the Federal Reserve — inflate the value of the assets above the value of the debt. While this is bad for the debt holders, it can go a long way to reducing the painful deleveraging process the nation is still working its way through. Inflation is now a realistic political option rather than a bad economic decision.

Are There Any Bright Spots?

With all the risks on the horizon, one might wonder if there are any bright spots. The answer, as always, is yes. In the short-to-medium run the export market may continue to shine. With the world economy starting to expand again (particularly the developing world), and with a weaker dollar, firms who sell products to these parts of the world may find themselves doing quite well. Of course troubles in Europe have put some upward pressure on the value of the dollar in the short run, but it still remains at a relatively low level. The one worry is that a deepening sovereign debt crisis could cause a worldwide flight to safety again. This would not be unlike what happened in the second half of 2008 when the export surge that occurred at the start of the year — and that somewhat offset the decline in domestic demand — was put to a quick end.

Another bright spot in the short term will continue to be business spending. Real net investment dropped to a near all-time low level during the downturn. The catch-up effect should keep growth in the sector decent if not spectacular. Similarly, a state and national

policy push for alternative energy should create possibilities there.



In the longer term, the U.S. economy, once it works through its current issues, will be back on a solid growth path. Today's problems do not take away from the fact that the U.S. is still the center of the technological and financial world. While many worry that the U.S. economy is being undermined by trade with Asia (primarily China), in fact there is little direct competition between the two economies. Prior to this downturn industrial production in the U.S. economy was at a record high level. Incomes were rising at a solid pace for Americans — faster than in most of the developed world. These trends will return.

All of this does lead to one longer run worry having to do with the employment markets. An ongoing problem in the United States has been the widening gap between the skilled and the unskilled. This has to do fundamentally with changes that have allowed businesses to use information technology to replace many low skilled positions in the U.S. economy. The boom in housing and retail that was fueled by the massive financial bubble had masked the problem. As the economy returns to normal, these issues will reemerge. And they show how badly the nation needs to embark on a long run program of enhancing the educational opportunities available to the next generation — something at which we are clearly failing.

National Historical Table

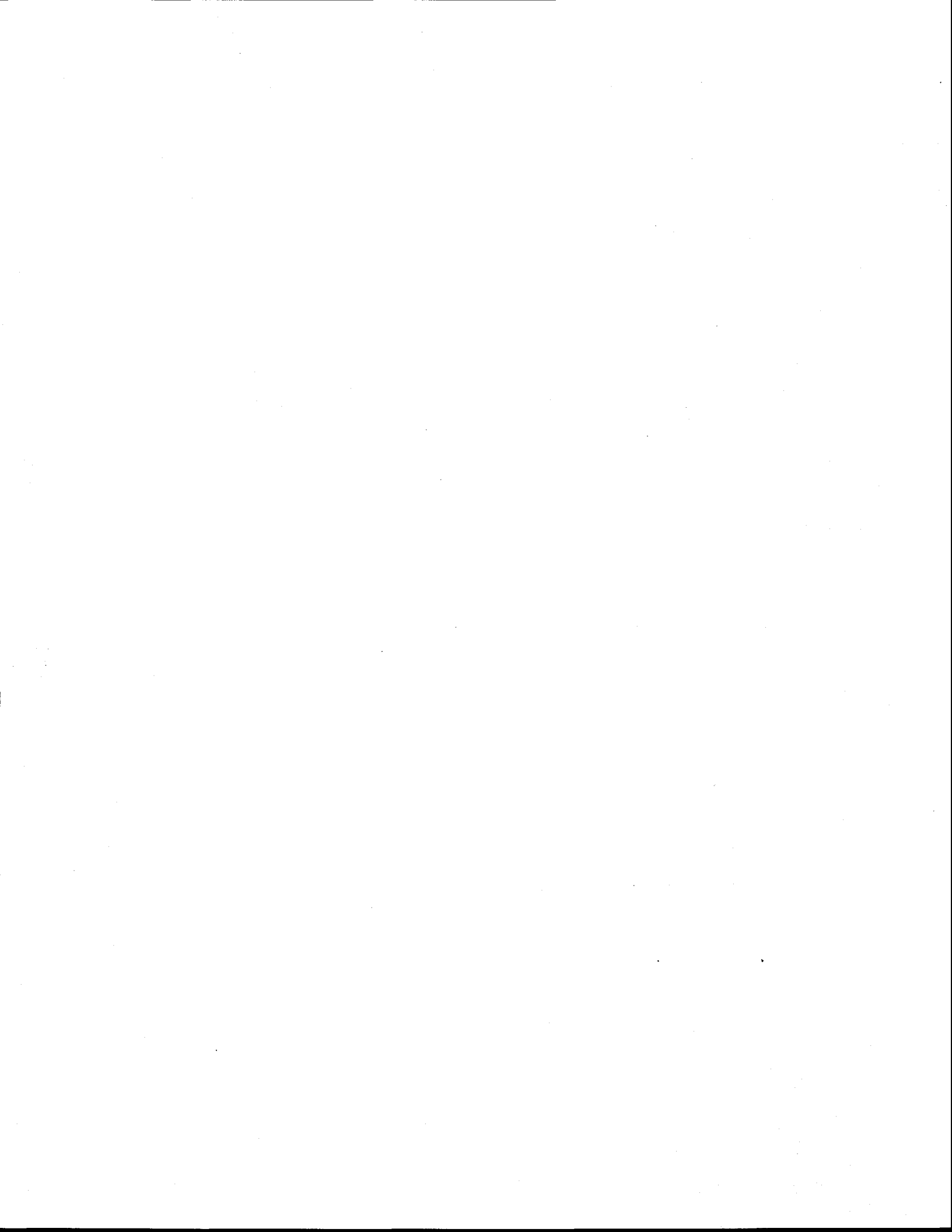
United States	Q3-2007	Q4-2007	Q1-2008	Q2-2008	Q3-2008	Q4-2008	Q1-2009	Q2-2009	Q3-2009	Q4-2009
National Real GDP (\$ Bill.,SAAR)	13,318.90	13,389.50	13,357.10	13,398.00	13,300.70	13,114.50	12,902.60	12,877.90	12,958.40	13,150.40
Growth (%SAAR)	3.60	2.10	-0.70	1.50	-2.70	-5.40	-6.40	-0.70	2.20	5.90
Real Personal Consumption (\$ Bill.,SAAR)	9,335.60	9,363.60	9,349.60	9,351.00	9,267.70	9,195.30	9,209.20	9,189.00	9,252.60	9,291.70
Real Investment (\$ Bill.,SAAR)	2,166.50	2,123.40	2,082.90	2,026.50	1,990.70	1,857.70	1,558.50	1,456.70	1,474.40	1,628.70
Real Government Expend. (\$ Bill.,SAAR)	2,458.90	2,468.70	2,484.70	2,506.90	2,536.60	2,544.00	2,527.20	2,568.60	2,585.50	2,577.90
Real Net Exports (\$ Bill.,SAAR)	-638.40	-564.00	-550.90	-476.00	-479.20	-470.90	-386.50	-330.40	-357.40	-347.10
Total Nonfarm Empl. (Mill, SA)	137.66	137.86	137.90	137.49	136.70	135.02	132.81	131.09	130.08	129.63
Growth (%SAAR)	0.11	0.60	0.10	-1.17	-2.28	-4.83	-6.38	-5.10	-3.05	-1.38
Unemployment Rate (%SA)	4.63	4.80	4.97	5.30	6.03	6.97	8.17	9.27	9.63	10.03
Personal Income (\$ Trill.)	11.95	12.10	12.14	12.29	12.29	12.23	11.95	12.05	12.01	12.11
Growth (%SAAR)	4.20	5.28	1.39	5.06	-0.20	-1.72	-8.87	3.25	-1.44	3.68
Savings Rate (%)	1.42	1.27	1.04	3.05	1.92	3.34	3.37	4.94	3.59	3.76
Tax Rate (%)	12.56	12.58	12.62	10.79	11.70	11.72	9.93	8.99	8.92	8.79

Forecasts by Beacon Economics

National Forecast Table

United States	Q1-2010	Q2-2010	Q3-2010	Q4-2010	Q1-2011	Q2-2011	Q3-2011	Q4-2011	Q1-2012	Q2-2012
National Real GDP (\$ Bill.,SAAR)	13,264.47	13,389.67	13,452.28	13,517.19	13,546.28	13,548.72	13,562.15	13,567.99	13,545.80	13,605.01
Growth (%SAAR)	3.52	3.83	1.88	1.94	0.86	0.07	0.40	0.17	-0.65	1.76
Real Personal Consumption (\$ Bill.,SAAR)	9,330.60	9,394.97	9,429.39	9,482.31	9,492.67	9,488.12	9,489.52	9,477.80	9,443.24	9,442.17
Real Investment (\$ Bill.,SAAR)	1,677.84	1,723.65	1,754.64	1,774.07	1,793.53	1,805.46	1,819.80	1,836.67	1,844.55	1,896.79
Real Government Expend. (\$ Bill.,SAAR)	2,602.93	2,620.60	2,624.14	2,619.82	2,611.14	2,595.34	2,582.75	2,571.96	2,563.42	2,560.99
Real Net Exports (\$ Bill.,SAAR)	-346.90	-349.55	-355.88	-359.01	-351.06	-340.20	-329.94	-318.44	-305.41	-294.93
Total Nonfarm Empl. (Mill, SA)	129.64	129.89	130.20	130.60	131.05	131.42	131.75	132.06	132.32	132.62
Growth (%SAAR)	0.05	0.76	0.97	1.24	1.38	1.13	1.00	0.96	0.77	0.90
Unemployment Rate (%SA)	9.80	9.66	9.57	9.47	9.36	9.31	9.28	9.25	9.25	9.21
Personal Income (\$ Trill.)	12.19	12.32	12.42	12.55	12.67	12.80	12.91	13.04	13.16	13.27
Growth (%SAAR)	2.47	4.45	3.23	4.19	3.97	4.21	3.51	3.98	3.70	3.40
Savings Rate (%)	3.25	3.40	3.48	3.28	2.53	2.42	2.63	2.82	3.13	3.15
Tax Rate (%)	9.28	9.31	9.28	9.50	10.54	11.14	11.18	11.50	11.85	12.18

Forecasts by Beacon Economics





BEACONECONOMICS

California Forecast

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State Overview

Despite the considerable pain being caused by the current cyclical fluctuation in the economy, California remains poised for long-term success once the imbalances that caused this downturn work their way through the system. In addition to great weather, scenic natural beauty in the form of oceans, mountains, and deserts, and just about all of the man made attractions a human being could possibly want, California is home to some of the finest universities in America, attracting the best students and researchers from across the nation and the world. Nearly 19% of the state's residents have bachelor's degrees compared with 17.5% in the United States overall, and 11% have graduate degrees compared with 10% nationwide. As a result, California remains an attractive place to locate a business—especially among the high-tech industries that now call the state home including information technology, biotech, and renewable energy. Unlike low-skilled manufacturing industries like textiles and apparel, these industries rely more on the quality and skills of their labor force than they do on the cheap price tag and relative abundance of low-skilled workers. If California can maintain this trend going forward, it will be well-positioned to continue attracting industries that will carry us into tomorrow.

This isn't to say that California does not face challenges in maintaining this position. Education, for example, is a critical issue. Because of the sheer magnitude of both K-12 and university education relative to the rest of California's General Fund revenue, it is often a prime target for spending cuts in times of fiscal turmoil. Although we have a greater concentration of highly educated residents compared with the country overall, we also have a larger concentration of residents who lack even a high school diploma. In 2008, it was estimated that nearly 20% of Californians over the age of 25 had less than a 12th grade education. Despite our skilled labor force and ability to attract high-tech businesses, adequately funding education is vital if we

hope to maintain our position as a leader into the future.

California also serves as a hub for goods, services, and people coming into and going out of the United States. In terms of goods trade, roughly 13% of U.S. exports come from California's ports though this number has fallen slightly since the onset of the recession. In other words, California provides a crucial gateway for U.S. businesses to access overseas markets. The majority of what we export is emblematic of our high-tech businesses. In 2009, over 50% of the state's exports were in electrical machinery, industrial equipment and computers, optic, photo, and medical equipment, and aircraft. California is also a large exporter of services to the rest of the world. Predominantly, California provides professional and business services to foreign firms that include management and operational consulting. California also exports our intellectual property such as patents and trademarks, as well as entertainment licensing of movies and music. Tourism is also one of the state's strongest exports. And, as the value of the dollar declines, California is uniquely positioned to exploit the increased competitiveness of U.S. goods and services abroad.

California remains an attractive place to locate a business—especially among the high-tech industries that now call the state home including information technology, biotech, and renewable energy.

Just as critically, California is an important point of entry into the U.S. for foreign immigrants who come to study, work, and live. Nationwide, just over 12% of our residents were born overseas versus nearly 30% in California. This has brought vast diversity of cultures and ideas to the state and has made it a melting pot of peoples from all over the world. Indeed, California has much more racial diversity than the United States overall, with larger shares of black, His-

panic, and Asian residents and smaller shares of non-Hispanic whites.

These characteristics of the state's economy and demography have been a boon to our success, which is borne out in the statistics. At \$61,000, median household income is almost \$10,000 higher in California than it is nationwide where median household income was only \$52,000 in 2008. In addition, nearly 19% of California's households earn at least \$125,000, while only 13% of U.S. households earn as much.

The private equity markets seem to agree that California is still a good place to start and grow a business. Although venture capital investment across the country has taken a severe knock since the economic downturn began, California still receives a disproportionate share of these dollars. It is estimated that over 50% of the venture capital dollars invested nationwide in 2009 came to California.

Since the onset of the recession, California has seen turbulence across virtually all aspects of its economy.

This is not to say that California does not face real and significant challenges. Labor markets remain weak, and we have yet to see a rebound in employment across the state. New business formation, as measured by venture capital money, is down substantially from its 2007 peak, and remains well below the levels seen during the tech boom of the late 1990s. We have real policy challenges ahead as well. California's regulatory structure is unfriendly to businesses, and mandates such as pensions are in real trouble following the CalPERS fiasco. Budget problems abound in Sacramento, and little has been done to change a tax system that leaves the state vulnerable to the boom and bust revenue cycles that have plagued California for years—the state continues to levy relatively high taxes on relatively small tax bases. However, these challenges have yet to slow California down, and can be

fixed if policymakers in Sacramento find the political will to do so.

Since the onset of the recession, California has seen turbulence across virtually all aspects of its economy. The consumer pulled back sharply in 2008 and 2009, and taxable sales in California fell dramatically. This was the result of a huge imbalance in consumer spending behavior, where savings had fallen to near-zero over the past 25 years, and debt levels steadily rose as credit became easier to access. The recession forced consumers to deal with this imbalance, and we have seen savings rates climb back up into the 5% territory. Although it has been painful for businesses and households, consumption levels have now fallen back to a level that is proportionate to incomes, where they are much more sustainable.

The housing market fell victim to some of the same trends, and has since taken a beating as well. Home prices began coming down precipitously in 2007, and there was a subsequent surge in defaults and foreclosures. As option-ARM (adjustable rate mortgages) reset to higher interest rates many people were unable to make their monthly payment and were forced into foreclosure. Others saw their property values decline so much that they entered into a negative equity situation where they owed far more on their mortgage than their home was worth. Many of these underwater homeowners made a decision to walk away from their home rather than make payments on an asset that was worth half of its original purchase price. Now that prices have fallen so dramatically, homes are returning to affordable levels across the state. Ultimately, it is a good thing for California to have home prices that are supported by incomes, and more households and families can consider investing in their first home.

While the residential real estate market appears to be leveling off and returning to fundamentals, the commercial real estate markets continue to be an area of concern. Across California, vacancy rates on commercial property continue to rise. Asking rents have con-

tinued to fall as well, and fewer units are being occupied each quarter than were vacated. California's hotels have also seen sustained reductions in both room occupancy and revenue per available room. Until these trends turn around, the nonresidential construction market will continue to be a drag on California's recovery.

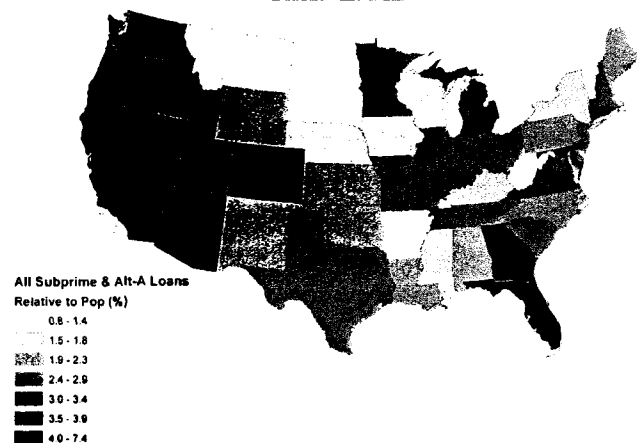
...federal stimulus dollars are beginning to make their way into actual projects, and California should gain from this as well.

Encouragingly, recent evidence suggests that the economy is beginning to slowly turn around. The country saw strong economic growth in the second half of 2009. This was driven by consumer spending, which itself was the beneficiary of massive government intervention through federal incentive programs to buy homes and cars. Although these were temporary programs, which have since expired, they did appear to help the American consumer find some sort of a level footing. The strong growth in real GDP also came from one of the largest inventory burn-offs in recent history. During the recession, many firms shifted into a mode of depleting their shelves rather than making new orders, and industrial production stalled as a result. Now, we have seen inventories bottom-out in recent quarters and both production and new orders have seen a small uptick. This should be a positive indicator for the labor markets, which should benefit as plants across the country begin to switch back on. In addition, federal stimulus dollars are beginning to make their way into actual projects, and California should gain from this as well.

Down, but Not Out

Looking back as we begin a new year, it is hard to deny 2009 was one of the worst years for California's economy in more than two decades. This cyclical fluctuation has hit California hard. Indeed, the state played a major role in the downturn we see nationwide. California was subject to the primary imbalances that drove the country into recession. For example, California took on a disproportionate share of the subprime and Alt-A loans relative to most other states. These loans were often structured as adjustable rate mortgages with an option for a lower payment for an initial period of 5 or 7 years.

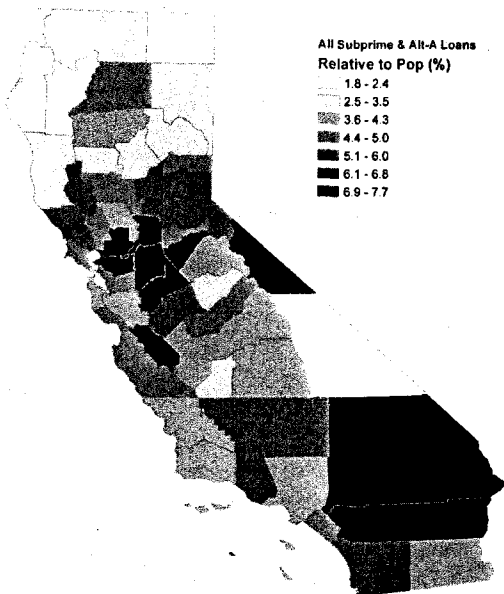
National Subprime & Alt-A Loans Outstanding
December 2005



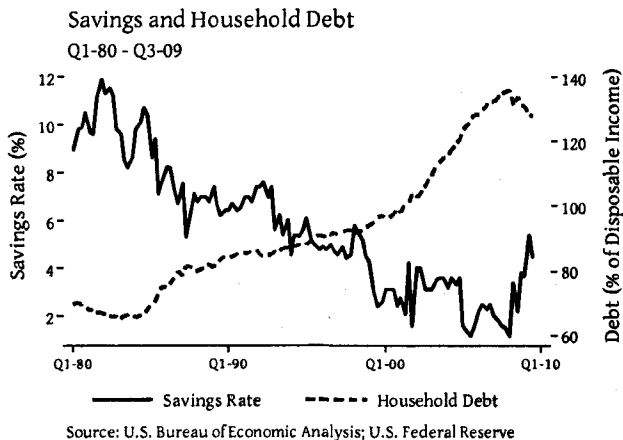
Unfortunately, many buyers did not realize that their loans would reset to higher interest rates (and thus higher payments) long before they reached their 5-year option period. In many cases, buyers lacked the sophistication to fully understand the structure of their mortgages and failed to realize that their introductory payment amount would not cover all of the interest being amortized during those years. Typically, banks have a cap on the amount of negative amortization that can be accumulated before an adjustable rate mortgage recasts, so many people saw their payments rise dramatically well in advance of their introductory period actually ending. Others were speculating on continued price increases, and some were pro-

viding false information in order to secure a loan for a home they couldn't afford.

California Subprime & Alt-A Loans Outstanding
December 2005



As a result of all of these factors, we were more vulnerable to the inevitable housing collapse that began in late 2006. Specifically, in December 2005, it is estimated California had roughly 19.5% of the outstanding subprime and Alt-A loans in the nation.

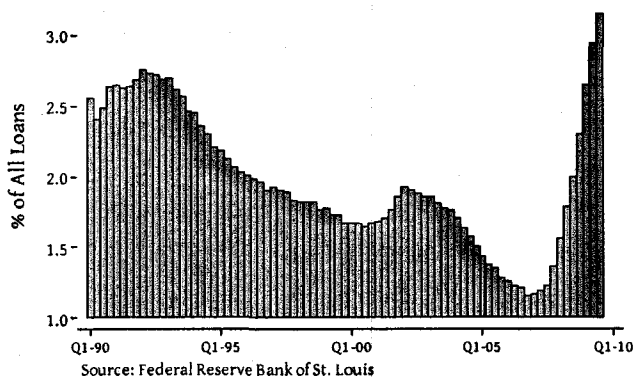


This is much higher than the state's share of the U.S. population, which averages roughly 12%. This shows that California had more than its fair share of these risky loans, and is one reason that we are feeling a large degree of the pain.

The unbalanced levels of savings and debt were not only the prime suspect in the widening U.S. trade deficit and national debt, they were clearly unsustainable.

Across California's counties, the subprime and Alt-A loans were highly concentrated in specific areas. Areas exposed to the largest number of risky lending practices relative to their population bases were both the Inland Empire, consisting of Riverside and San Bernardino Counties, and the East Bay region of the San Francisco Bay Area, including Contra Costa and Alameda Counties. Both regions—Inland Empire and East Bay—saw some of the largest run-ups in home prices as the subprime bubble grew. Subsequently, both regions have seen some of the largest declines in prices and the largest increases in defaults and foreclosures.

U.S. Loan-Loss Reserves
Q1-90 - Q3-09



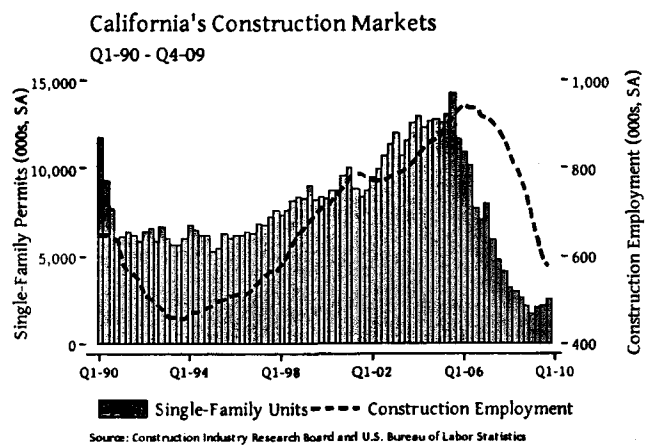
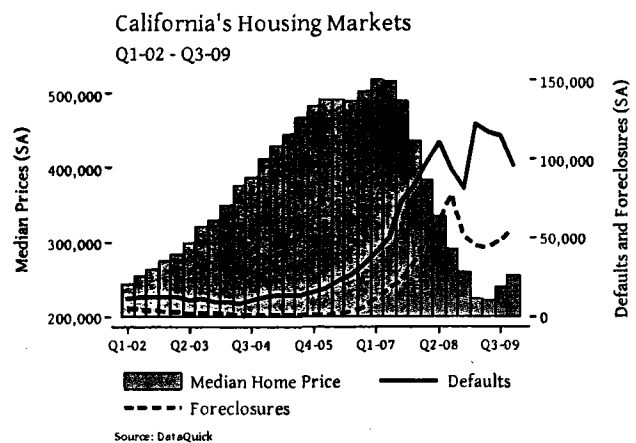
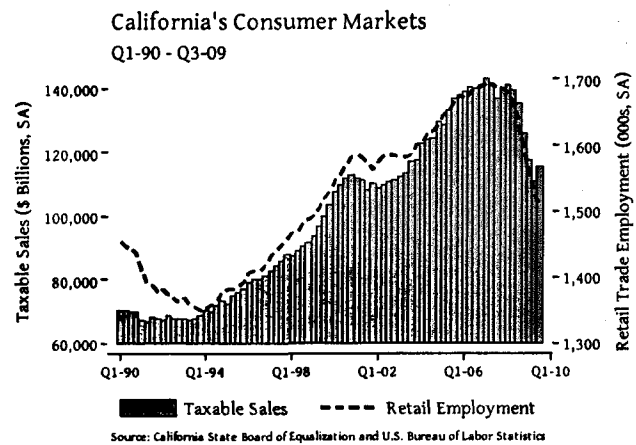
Additionally, the spending imbalances that built up over 20 years made the economy susceptible to a major consumer downturn. Savings rates, which historically have averaged over 7% of disposable income, be-

gan a downward trend in the early 1980s. By the first quarter of 2008, savings fell to just over 1% of income. At the same time, household debt as a percentage of disposable income went through the roof—rising from 69.7% of income in 1980 to 136% by the first quarter of 2008. This trend, coupled with a large share of consumption compared to the overall economy, created the perfect storm for a recession. The unbalanced levels of savings and debt were not only the prime suspect in the widening U.S. trade deficit and national debt, they were clearly unsustainable.

These bad habits eventually caught up with us. As banks started to suffer with under-performing loans and non-performing loans and asset prices appeared to be peaking in 2006, the spigot was essentially shut off. The easy credit driving this bubble evaporated. Indeed, we can see in the national numbers that once the real estate markets sustained losses and labor markets began to shed jobs in late 2007, the banks began reducing credit availability and pumping up their loan loss reserves. These reserves, which tend to go up in times of turmoil, rose from 1.16% of all loans in late 2006 to more than 3.15% of all loans by the third quarter of 2009.

Taking Stock

Since the collapse, California has been feeling pain across all aspects of its economy. The state's labor markets have been especially hard hit. In January 2010, the unemployment rate reached 12.5% on a seasonally adjusted basis and over 1.39 million total non-farm jobs were shed by December 2009 from peak employment in July 2007. When asset prices fell and the labor market started losing jobs, consumers began to dramatically pull back. By the second quarter of 2009, taxable sales were off their peak levels by 22.9% and retail trade continued to trim workers—with over 212 thousand jobs lost from its peak level by December of 2009.

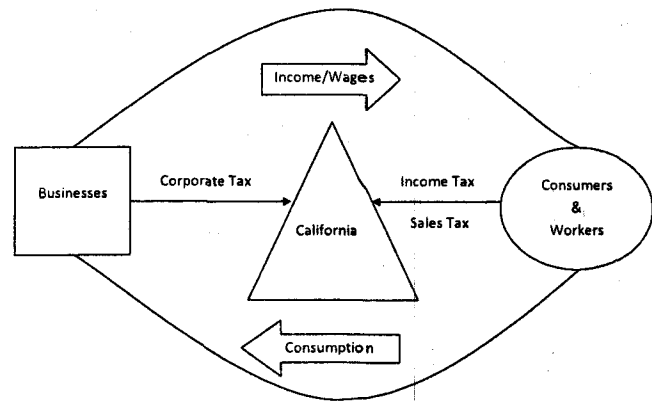


The real estate and housing markets have also taken a beating. After posting record gains between 2003 and 2006 home prices peaked. They began falling sharply in 2007, 2008, and 2009. At the same time defaults and foreclosures surged to decade highs. Residential building permits began to decline in late 2005 and by January 2009, with only 2,500 permits issued, they had fallen by 89% from their peak of more than 20,000 per month. Construction employment followed shortly after permits, and shed more than 379 thousand jobs, or 40% of its workforce by the end of 2009.

Commercial real estate came later to the game. In both the retail and office segments, vacancy rates did not begin to rise by any significant amount until late 2007 and early 2008. The slowdown in commercial real estate lagged the housing market and consumer pull-back and highlights the extent to which businesses follow the consumer. Looking out at the commercial market, there are many ominous signs. In every type of property (office, retail, or industrial), and in every region across the state, the same trends hold true: cap rates are up, rents are down, and net absorption remains negative while vacancy rates keep climbing higher.

The economic turmoil borne by the state has created an enormous amount of stress on our fiscal position as well. Between 90% and 95% of the state's General Fund Revenues are derived from three major sources—the so-called “Big 3”—personal income tax, corporate tax, and sales and use tax. Unfortunately, these revenues are almost entirely determined by California's economic health. For example, higher unemployment leads to lower incomes, which in turn drives lower consumer spending, which then drives corporate profits down. Then, the whole process starts over

again. These linkages create a vicious cycle for California's budget in times of economic downturn.



During the run-up in home prices, the decline in savings, and the increase in consumer spending, California began experiencing large increases in its General Fund Revenue. The state's revenue grew from roughly \$70 billion in the 1999-2000 fiscal year to more than \$95 billion by the 2006-07 fiscal year. This growth—which ranged from 6% to more than 13% per year (with the exception of the 2000-01 fiscal year which was hurt by the 2001 recession)—was very strong and could have been leveraged to get our fiscal house in order or to save for a rainy day. Unfortunately, it was not.

California General Fund Revenues (\$000s)

Source	2006-07	2001-02	1999-00
PIT	52,353,056	33,295,428	39,272,755
CORP	10,767,189	5,088,175	6,575,403
SALES	27,515,361	21,368,831	20,825,007
Big 3	90,635,606	59,752,434	66,673,165
TOTAL	95,665,223	64,341,833	70,771,088

Source: California State Controller's Office

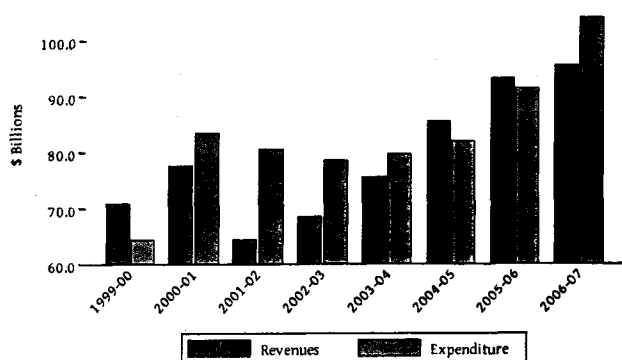
Then, in 2009 it poured with the Big 3 revenues declining dramatically. But rather than putting the increased revenues into a war chest to use to smooth out the state's finances during an economic downturn, expenditures were steadily increased each year. Because of this, the state's went from a \$2.7 billion budget surplus in June of 2006 to a year-to-date deficit of \$12.9 billion as of December 31, 2009.

In January 2010, the unemployment rate reached 12.5% on a seasonally adjusted basis...

The economic turmoil borne by the state has created an enormous amount of stress on our fiscal position as well.

Now California policy makers are forced to make choices about which programs to cut, and which to trim, how to create new, better ways to increase revenues. We have already seen cuts to K-12 education, furloughs of State employees, and increases in sales tax and personal income tax rates as temporary fixes. However, a true recovery in California's fiscal position relies most importantly on a recovery in the State's economy. Additionally, while California does have more than \$20 billion in outstanding debt (both internal and external borrowing), it represents only a small percentage of our gross state product. As consumer spending and employment return to growth, so will the state's three major sources of revenue.

General Fund Revenues and Expenditures
1999-00 - 2006-07



Source: California State Controller's Office

A Bird's-Eye View

Looking at the nation from a bird's eye view, California clearly has been hard hit. With nearly 1.4 million jobs lost since employment peaked in July 2007, California has shed the largest number of jobs of any state. However, in other ways, this recession has affected some states even harder. For example, in terms of employment decline as a percentage of peak em-

ployment, California ranks 6th with a decline of 9.2%. Michigan ranks 1st, having shed 18% of its jobs from its peak, followed by Ohio and the states with subprime and Alt-A woes—Nevada, Florida, and Arizona, with declines of 13.8%, 11.5%, and 11.1%, respectively. Indeed, the number of jobs lost in the combined five states of Michigan, Ohio, Arizona, Nevada, and Florida are roughly twice as large as the number of jobs lost in California.

Similarly, California's labor markets began heading into decline relatively early in this recession, with employment peaking in July 2007. Of the 50 states and the District of Columbia, 16 did not begin to see employment contract until the second quarter of 2008. Yet, 10 states including Michigan, Florida, Nevada, and Ohio began eliminating nonfarm payroll positions before California, and another five including Arizona, saw employment peak by the end of 2007. The Golden State has the 5th highest unemployment rate in the nation with 12.5%, trailing Michigan (14.3%), Nevada (13.0%), Rhode Island (12.7%), and South Carolina (12.6%). In sum, while California is feeling the sting of this downturn more than most, there are a few places in the country that are struggling even more.

The Golden State has the 5th highest unemployment rate in the nation with 12.5%, trailing Michigan (14.3%), Nevada (13.0%), Rhode Island (12.7%), and South Carolina (12.6%).

The same is true for California's housing markets. A disproportionate share of subprime and Alt-A loans went to California before the market peaked, making it susceptible to a housing downturn. Since the bubble has collapsed, we have seen a wave of foreclosures

Comparative Labor Market Statistics

State	Peak Employment	Decline (000s)	Decline (%)	Unemp. Rate
California	Jul-07	-1,393.0	-9.2	12.5
Florida	Mar-07	-926.1	-11.5	11.9
Michigan	Jun-00	-845.9	-18.0	14.3
Ohio	May-00	-652.5	-11.6	10.8
Illinois	Jan-08	-437.1	-7.3	11.3
Texas	Aug-08	-431.3	-4.1	8.2
New York	Apr-08	-367.4	-4.2	8.8
Georgia	Feb-08	-341.3	-8.2	10.4
North Carolina	Feb-08	-305.0	-7.3	11.1
Arizona	Aug-07	-298.0	-11.1	9.2
Pennsylvania	Apr-08	-269.9	-4.6	8.8
New Jersey	Jan-08	-242.9	-5.9	9.9
Indiana	Jun-07	-235.1	-7.9	9.7
Tennessee	Feb-08	-221.2	-7.9	10.7
Washington	Mar-08	-199.7	-6.7	9.3
Wisconsin	Jun-07	-198.0	-6.8	8.7
Nevada	Feb-07	-179.4	-13.8	13.0
Virginia	Feb-08	-177.2	-4.7	6.9
Massachusetts	Mar-08	-166.7	-5.0	9.5
Alabama	Jan-08	-162.2	-8.1	11.1
Minnesota	Jun-07	-159.6	-5.8	7.3
Colorado	May-08	-156.5	-6.6	7.4
Missouri	Feb-08	-153.7	-5.5	9.5
Oregon	Feb-08	-148.6	-8.5	10.7
South Carolina	Sep-07	-145.7	-7.5	12.6
Maryland	Feb-08	-125.3	-4.8	7.5
Kentucky	Jun-07	-117.2	-6.3	10.7
Connecticut	Mar-08	-103.4	-6.0	9.0
Utah	Dec-07	-85.5	-6.8	6.8
Oklahoma	May-08	-79.0	-4.9	6.7
Mississippi	Feb-08	-76.0	-6.6	10.9
Kansas	Apr-08	-74.6	-5.3	6.4
Iowa	May-08	-71.2	-4.7	6.6
Louisiana	Aug-08	-69.4	-3.6	7.4
Idaho	Nov-07	-55.2	-8.4	9.3
Arkansas	Feb-08	-54.6	-4.5	7.6
New Mexico	Apr-08	-46.2	-5.4	8.5
Rhode Island	Jan-07	-44.6	-9.0	12.7
Hawaii	Dec-07	-43.0	-6.8	6.9
Maine	Jan-08	-33.6	-5.4	8.2
Nebraska	Oct-08	-32.9	-3.4	4.6
West Virginia	Oct-08	-32.8	-4.3	9.3
New Hampshire	Jan-08	-31.1	-4.8	7.0
Delaware	Feb-08	-30.9	-7.0	9.0
Montana	Mar-08	-26.4	-5.9	6.8
Wyoming	Oct-08	-21.2	-7.0	7.6
Vermont	Jun-07	-15.8	-5.1	6.7
South Dakota	Aug-08	-12.5	-3.0	4.8
District of Columbia	Aug-08	-9.4	-1.3	12.0
North Dakota	Nov-08	-5.7	-1.5	4.2
Alaska	Dec-08	-1.9	-0.6	8.5

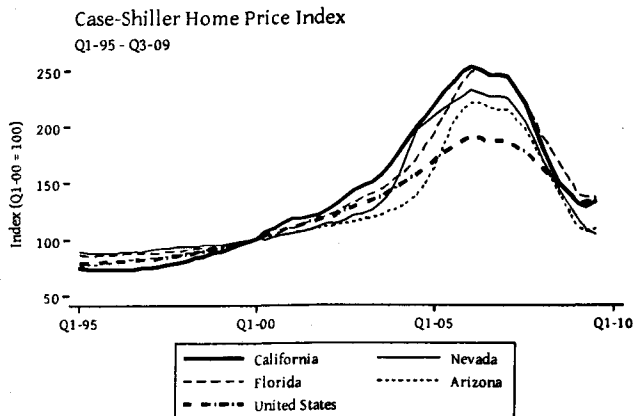
Source: U.S. Bureau of Labor Statistics

Mortgage Delinquencies and Foreclosures (% of All Loans)

State	30 Days Past Due	60 Days Past Due	90 Days Past Due	In Foreclosure
Florida	3.80	2.05	6.31	12.98
Nevada	3.69	2.27	8.16	9.78
Arizona	3.58	2.05	6.19	6.37
California	2.84	1.67	6.12	5.94
New Jersey	3.40	1.58	3.98	5.48
Illinois	3.66	1.76	4.75	5.28
Ohio	4.13	1.79	4.44	4.67
Michigan	4.29	2.10	5.90	4.52
Hawaii	2.33	1.20	3.23	4.31
Maine	3.73	1.64	3.38	4.22
Indiana	4.52	1.85	4.97	4.06
Rhode Island	3.78	1.81	4.47	4.04
New York	3.30	1.45	3.92	3.94
Maryland	3.62	1.73	4.46	3.79
Wisconsin	2.85	1.32	3.15	3.69
Connecticut	3.35	1.56	3.53	3.59
Idaho	3.06	1.46	3.32	3.54
Georgia	5.05	2.30	5.11	3.51
Minnesota	2.60	1.24	3.06	3.47
Massachusetts	3.43	1.47	4.14	3.41
South Carolina	4.19	1.72	3.72	3.31
Delaware	3.75	1.42	3.32	3.19
Utah	3.35	1.55	3.33	3.11
Kentucky	4.17	1.71	3.42	3.11
Louisiana	4.39	1.84	4.12	2.91
Dist. of Columbia	2.91	1.31	3.11	2.91
Mississippi	5.84	2.50	5.47	2.90
New Mexico	3.46	1.39	2.71	2.89
Oregon	2.44	1.16	2.99	2.87
Colorado	2.65	1.20	2.70	2.87
Pennsylvania	3.88	1.63	3.42	2.73
Iowa	2.96	1.20	2.50	2.71
Oklahoma	3.81	1.44	2.80	2.70
New Hampshire	3.54	1.54	3.36	2.38
Vermont	2.58	0.98	1.96	2.37
Washington	2.42	1.19	3.26	2.30
Tennessee	4.63	1.92	4.22	2.30
Virginia	3.07	1.36	3.12	2.27
Kansas	3.27	1.32	2.72	2.24
West Virginia	4.84	1.88	3.33	2.19
North Carolina	4.07	1.70	3.57	2.09
Alabama	4.69	1.88	4.14	2.08
Missouri	3.90	1.68	3.57	2.08
Texas	4.25	1.78	3.44	2.00
Arkansas	4.07	1.49	3.07	1.93
Nebraska	2.85	1.12	2.22	1.91
South Dakota	2.00	0.78	1.55	1.65
Montana	2.35	0.96	1.85	1.60
Wyoming	2.52	1.01	1.77	1.49
Alaska	2.42	0.98	1.54	1.38
North Dakota	1.99	0.69	1.18	1.13

Source: Mortgage Banker's Association

and nonperforming mortgages. By the third quarter of 2009, 5.8% of all mortgages were in foreclosure in California, which is the highest in at least 30 years. Even more troubling are the number of loans that are nonperforming, but have yet to hit the foreclosure process. According to the Mortgage Bankers Association, an additional 10.5% of all mortgages in California are at least 30 days past due. Combine these, and 16.3% of California's mortgages are distressed – and will play a role in moderating the recent growth we have seen in home prices as the economy begins to recover. We also see a large percentage of California's homeowners who remain current on their mortgage, but who face the daunting prospect of being severely underwater. First American Corelogic currently estimates that 35% of all mortgages in California are in negative equity situations, and another 4% are within 5% of being underwater.



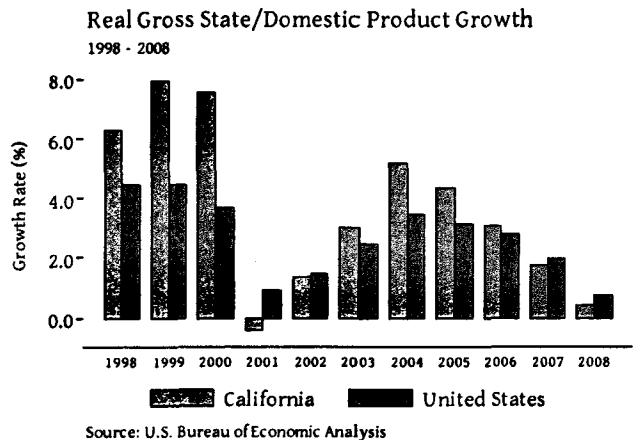
As bad as things are in California, other states were wrapped up in the housing bubble as well. Along with those in California, home prices in Florida, Arizona, and Nevada grew at an unsustainable rate during the first part of the decade. This growth surpassed that of the nation overall, and was completely out of line with income growth—which should be the primary driver of home values. Now, Florida, Nevada, and Arizona all have larger proportions of their existing mortgages in foreclosure relative to California at 13.0%, 9.8%, and 6.4%, respectively.

These states also have large shares of distressed mortgages that have yet to hit the foreclosure process. By the third quarter of last year, Nevada had the largest stock of 30-, 60-, and 90-day delinquencies at 14.1% of all loans. This was followed by Florida with 12.2% of all loans in delinquency. Arizona had slightly less delinquent mortgages with 11.8% of all loans at least 30 days past due. Thus, although California has battled with beleaguered housing markets, it has not been the hardest hit.

California is still a major growth engine in the U.S. economy. For the past 10 years, real economic growth in California has exceeded that in the United States overall.

These Boots Were Made for Walkin'

Despite the problems in California's housing, consumer and labor markets, it is important to keep the state's underlying economy in perspective in any economic outlook. When we zoom out from the cyclical volatility the state is currently facing and focus on long-run trends, it becomes clear that the future is bright for the Golden State.



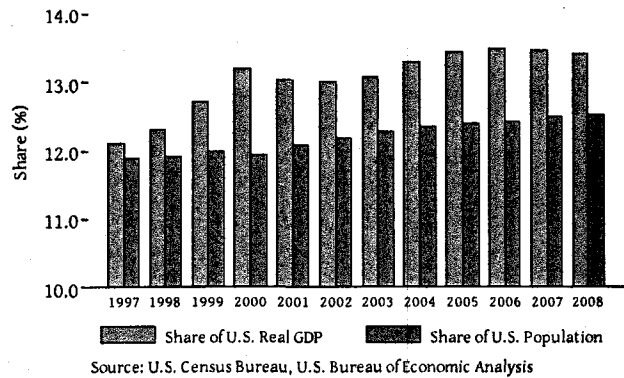
California is still a major growth engine in the U.S. economy. For the past 10 years, real economic growth

in California has exceeded that in the United States overall. During the past 10 years California has averaged an annual growth rate of 3.7% in its real gross state product, while the United States achieved average economic growth of only 2.7%. The exceptions to this trend are the 2001 downturn when growth was slower than that of the nation overall, and the current recession. This is unsurprising given that the pullback in California led the nation in this recession and illustrates the economic impact of California on the country. During growth periods California grows faster than the nation, but pulls back harder in times of recession.

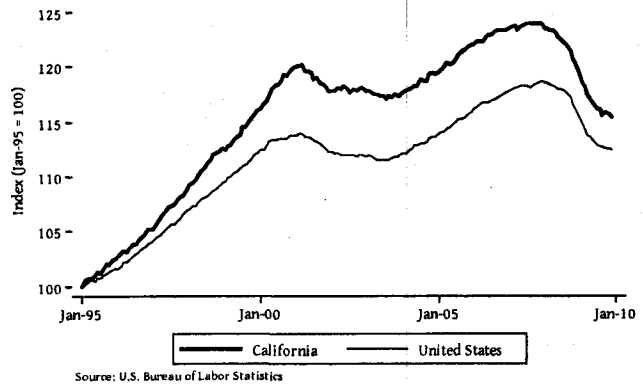
The long-term strength in California's economy is also illustrated by comparing California's share of U.S. economic output relative to its share of the population. Since 1997, California has maintained between 11.9% and 12.5% of the nation's total population. Over the same period, the state had a larger share of the country's economic output, which ranged from 12.1% to 13.5%. This shows that California has had a significant influence on the national economy. Californians are adding more than their fair share to the nation's economy.

Other economic indicators point to a bright future for the Golden State as the recovery begins. For example, employment growth has outstripped that of the United States in the majority of the last 15 years. To illustrate, between January 1995 and peak employment in 2007, California's total nonfarm payrolls grew by almost 24%. During that same time the United States expanded its employment base by only 18.3%. So again, it is clear the state has been one of the key regions driving employment growth in the nation, in addition to driving its economic growth.

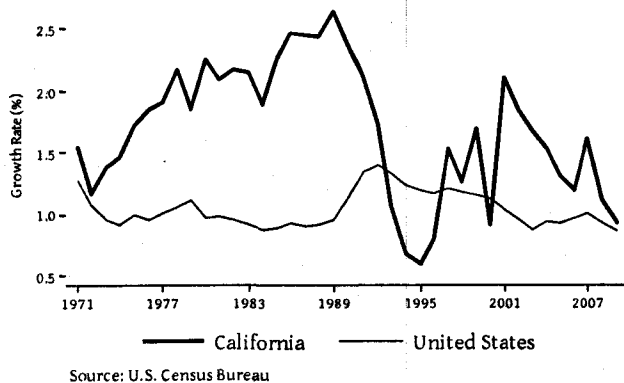
California's Economy and Population
1997 - 2008



Total Nonfarm Employment Index
Jan-95 - Nov-09



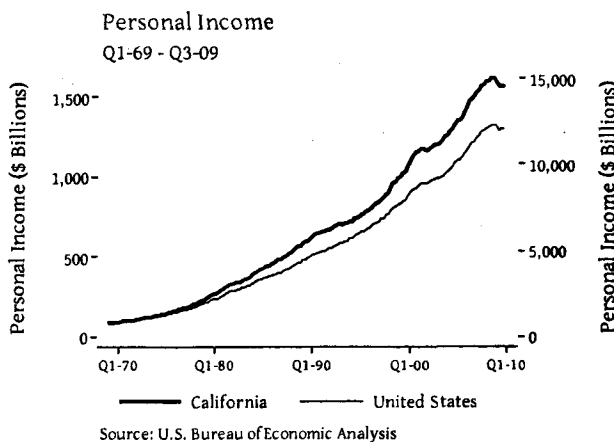
Population Growth
1971 - 2009



The state's demographic trends are a sunny spot for the future as well. With the exception of the mid-1990s, California's population has been growing faster than the nation overall. Part of this population growth is due to natural increase with more births than deaths occurring each year. However, another part of this population growth is from net migration of new residents from the rest of the U.S. and all over the world.

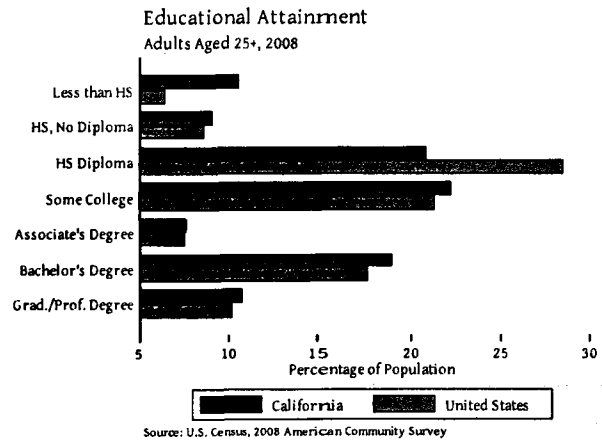
While our outlook for California's income is partly based on an expected increase in population growth, it is also founded on other demographic assets within the State

While population growth also presents challenges for the state, California's income growth, which has consistently outpaced the United States overall, is partly due to this strong population growth over the past 30 years. Although personal income in the state has contracted more sharply than the nation since the onset of this recession, it has also had its labor markets hit harder. As employment begins to increase, we expect a return to healthy income growth in both California and the United States.



While our outlook for California's income is partly based on an expected increase in population growth, it is also founded on other demographic assets within

the state. The primary advantage California has moving forward is its highly educated population. In addition to being home to many top-tier public and private universities—including among others U.C. Berkeley, U.C.L.A., University of Southern California, and Stanford University—California has many highly educated residents.

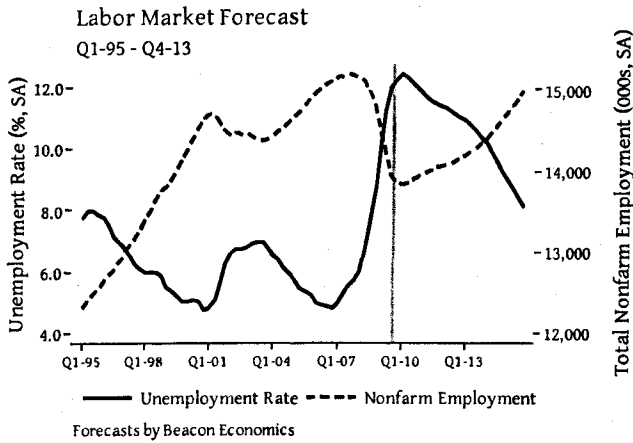


Compared to the United States overall, a larger share of California's residents have associate's degrees, bachelor's degree's, and graduate and professional degrees. This increases the ability for California to attract high-skilled businesses that need skilled workers to fill their jobs. Higher education levels also add to worker productivity, which will ultimately lead to higher wages and incomes for the state's population.

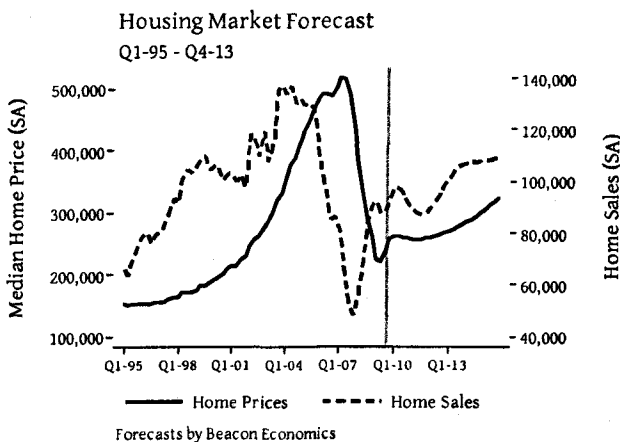
Forecasts

Based upon this analysis of California's economy, we forecast California's labor markets to begin turning around over the next few quarters. The state's unemployment rate was at or near its peak of 12.5% in the first quarter of 2010. Growth in nonfarm payrolls will resume in the first half of 2010, but the growth will be muted as housing and consumer markets struggle to regain a solid footing in 2010 and 2011 due to uncertainty about future growth. There is also uncertainty as to whether several key tax cuts at the state and na-

tional level will be allowed to expire or whether they will be extended or made permanent.

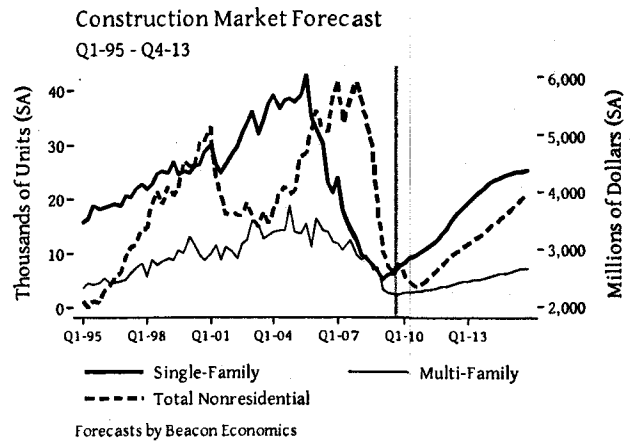


The housing market, which has taken a beating over the past three years, is also feeling for a bottom. While home prices in California have risen in recent quarters, there still exist a large number of nonperforming loans and mortgages in foreclosure that will make the rebound in home prices less steep than many expect. Also, as the tax credits for first-time home buyers expire, home prices rise, and the pool of eligible first-time buyers is absorbed, we expect to see home sales come down slightly in 2010, though they will remain above 80,000 per quarter over the next two years.



However, the pent-up demand for homes and the growing population—along with a real estate market nearing its bottom—should benefit the construction

market. We have seen an uptick in residential building permits issued over the past six months in California, and we expect to see this trend continue over the next few years, though activity will not reach the peak levels seen in 2005 and 2006 for many years to come. Nonresidential construction, which has fallen to levels not seen since the mid-1990s, still has problems to work out. Nonresidential building permits will not return to growth until later in 2010 and will stay well below 2007 levels of permitting through 2015.



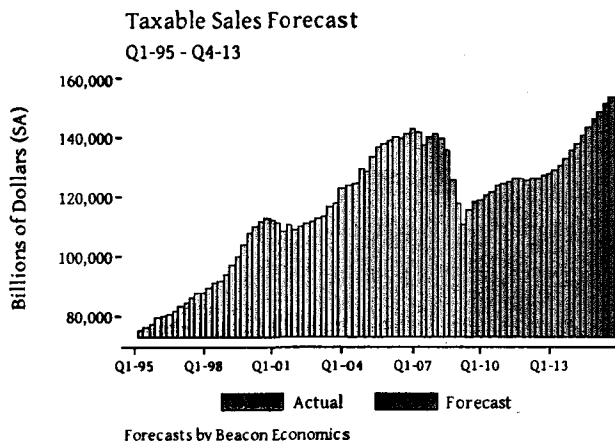
Unfortunately, the picture for commercial real estate is grimmer. In all of California's 8 major regions, cap rates are increasing—traditionally a positive sign. But, when we dig deeper into these numbers a different story emerges: cap rates are rising despite falling prices because rents are falling faster than prices. These trends do not point to a return to growth in nonresidential construction any time soon. In addition, as long as net absorption remains negative and vacancy rates rise, the commercial real estate market will be a drag on California's recovery.

...pent-up demand for homes and the growing population—along with a real estate market nearing its bottom—should benefit the construction market.

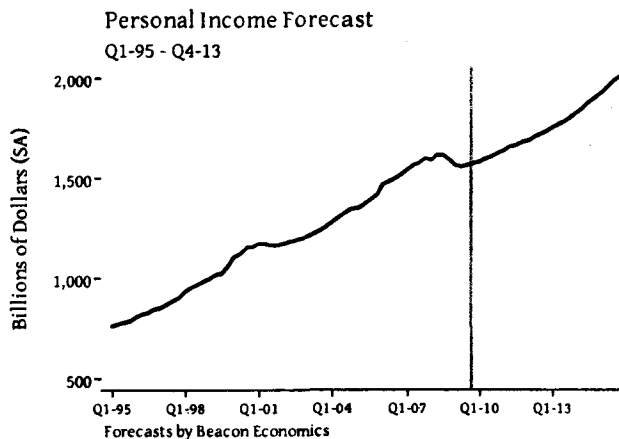
Taxable sales, which saw a strong bump in the third quarter of 2009 due to the Cash for Clunkers program and the first-time homebuyer tax credit, are expected to remain weak through 2010. They will likely rise above 2009 levels by roughly 1.3%. Part of this is due to slow projected growth in employment and part is due to the uncertainty over the expiration of the tax cuts and incentives discussed earlier. Consumer spending will also be affected by the increase in savings rates, as people shift toward replenishing their savings or become first time savers.

As the labor markets have been slowing their decline, we have seen personal income level off as well. We currently predict that 2010 will see a return to growth in personal income in the Golden State. As the labor markets continue to heal, we expect to see income trend upwards at a slower, but more healthy and sustainable pace of growth than we have seen over this past decade we expect to see income trend back upward at a slower, but more healthy and sustainable pace of growth than we have seen over this past decade.

Despite today's turmoil and the hard times we face in the immediate future, California's long term outlook is bright. While we need to address political challenges in order to overcome our troubled regulatory structure and fiscal situation, the state's fundamentals are sound. Among other things, we have a highly skilled labor force, continue to attract high-tech businesses and new investment, and our ports and airports remain a vital gateway for goods, services, and people into and out of the United States. We may be down, but the Golden State is surely not out.



we expect to see income trend back upward at a slower, but more healthy and sustainable pace of growth than we have seen over this past decade



State Historical Table

California	Q3-2007	Q4-2007	Q1-2008	Q2-2008	Q3-2008	Q4-2008	Q1-2009	Q2-2009	Q3-2009	Q4-2009
Total Nonfarm Empl. (Mill, SA)	15.19	15.18	15.14	15.09	14.96	14.75	14.45	14.18	13.93	13.85
Growth (%SAAR)	0.81	-0.31	-0.91	-1.45	-3.32	-5.45	-8.07	-7.26	-6.71	-2.40
Unemployment Rate (%SA)	5.47	5.70	6.00	6.67	7.53	8.70	10.17	11.30	11.97	12.27
Personal Income (\$ Bill)	1,577.54	1,600.47	1,591.69	1,613.95	1,615.23	1,595.58	1,566.08	1,562.65	1,566.09	1,576.42
Growth (%SAAR)	3.36	5.94	-2.18	5.71	0.32	-4.78	-7.19	-0.87	0.88	2.66
Taxable Sales (\$ Bill, SA)	136.99	139.96	140.85	139.28	135.33	125.70	117.63	110.61	115.45	118.17
Growth (%SAAR)	-11.91	8.96	2.55	-4.38	-10.86	-25.57	-23.33	-21.82	18.70	9.78
Single-Family Home Prices (\$ 000s, SA)	488.49	435.74	383.58	334.00	289.44	259.00	224.81	221.81	238.50	255.99
Growth (%SAAR)	-19.81	-36.69	-39.95	-42.51	-43.60	-35.89	-43.24	-5.22	33.67	32.72
Single-Family Home Sales (000s, SA)	54.03	48.18	54.13	66.98	81.86	90.86	92.25	87.90	88.31	93.45
Growth (%SAAR)	-55.89	-36.77	59.29	134.45	123.15	51.79	6.25	-17.57	1.89	25.39
Single-Family Permits (000s, SA)	14.44	12.43	9.54	9.00	7.72	6.56	5.12	6.14	6.46	7.59
Growth (%SAAR)	-56.35	-45.18	-65.33	-20.67	-46.01	-47.72	-62.93	107.45	22.35	90.67
Multi-Family Permits (000s, SA)	12.51	9.68	8.62	9.73	7.09	7.59	3.36	2.61	2.53	2.43
Growth (%SAAR)	88.75	-64.19	-37.05	61.84	-71.83	31.39	-96.16	-63.26	-12.81	-14.90
Nonresidential Permits (\$ Bill, SA)	5.59	5.91	5.56	5.17	4.78	3.67	2.93	2.67	2.57	2.73
Growth (%SAAR)	35.77	24.52	-21.29	-25.16	-27.40	-64.97	-59.65	-31.43	-13.30	26.69
Population (Mill)	37.79	37.91	38.02	38.13	38.24	38.33	38.42	38.49	38.55	38.60
Growth (%SAAR)	1.24	1.24	1.23	1.18	1.10	1.00	0.88	0.72	0.62	0.53
Net Migration (000s)	32.22	33.51	32.51	29.20	23.58	15.67	5.45	-7.07	-15.23	-22.65
Natural Increase (000s)	83.67	83.54	83.09	82.35	81.29	79.93	78.26	76.29	74.87	73.76

Forecasts by Beacon Economics

State Forecast Table

California	Q1-2010	Q2-2010	Q3-2010	Q4-2010	Q1-2011	Q2-2011	Q3-2011	Q4-2011	Q1-2012	Q2-2012
Total Nonfarm Empl. (Mill, SA)	13.84	13.85	13.89	13.92	13.96	14.00	14.03	14.05	14.07	14.09
Growth (%SAAR)	-0.28	0.48	0.89	1.10	1.17	0.95	0.81	0.72	0.55	0.62
Unemployment Rate (%SA)	12.40	12.28	12.12	11.93	11.74	11.60	11.48	11.39	11.33	11.25
Personal Income (\$ Bill)	1,583.41	1,598.66	1,610.04	1,625.21	1,639.93	1,655.20	1,667.82	1,682.32	1,695.69	1,708.13
Growth (%SAAR)	1.79	3.91	2.88	3.82	3.67	3.78	3.08	3.52	3.22	2.97
Taxable Sales (\$ Bill, SA)	118.82	120.36	121.68	123.59	124.60	125.10	125.94	125.94	125.50	125.87
Growth (%SAAR)	2.21	5.28	4.45	6.44	3.31	1.61	2.21	0.50	-1.41	1.20
Single-Family Home Prices (\$ 000s, SA)	261.53	261.94	260.50	259.08	258.05	257.47	257.55	258.36	259.79	261.73
Growth (%SAAR)	8.93	0.63	-2.17	-2.16	-1.58	-0.90	0.13	1.25	2.24	3.02
Single-Family Home Sales (000s, SA)	97.58	97.34	95.33	92.52	89.67	87.69	87.01	87.66	89.48	92.12
Growth (%SAAR)	18.86	-0.97	-8.02	-11.26	-11.77	-8.53	-3.10	3.03	8.57	12.32
Single-Family Permits (000s, SA)	8.20	8.94	9.66	10.24	10.83	11.59	12.50	13.48	14.57	15.88
Growth (%SAAR)	35.87	41.57	35.94	26.24	25.31	31.33	35.17	35.43	36.14	41.35
Multi-Family Permits (000s, SA)	2.58	2.65	2.86	3.02	3.19	3.39	3.61	3.81	4.01	4.24
Growth (%SAAR)	26.97	12.30	36.36	23.82	24.46	27.04	28.67	24.33	22.05	25.33
Nonresidential Permits (\$ Bill, SA)	2.54	2.41	2.33	2.35	2.43	2.52	2.61	2.70	2.79	2.87
Growth (%SAAR)	-24.76	-19.29	-12.35	3.95	13.65	15.42	15.77	14.64	13.47	11.49
Population (Mill)	38.64	38.68	38.72	38.75	38.78	38.81	38.84	38.87	38.90	38.93
Growth (%SAAR)	0.46	0.41	0.36	0.33	0.31	0.30	0.30	0.31	0.32	0.34
Net Migration (000s)	-28.36	-33.32	-37.26	-40.27	-42.30	-43.43	-43.77	-43.41	-42.53	-41.19
Natural Increase (000s)	72.97	72.45	72.16	72.08	72.17	72.42	72.79	73.27	73.84	74.48

Forecasts by Beacon Economics



BEACONECONOMICS

Riverside County Forecast

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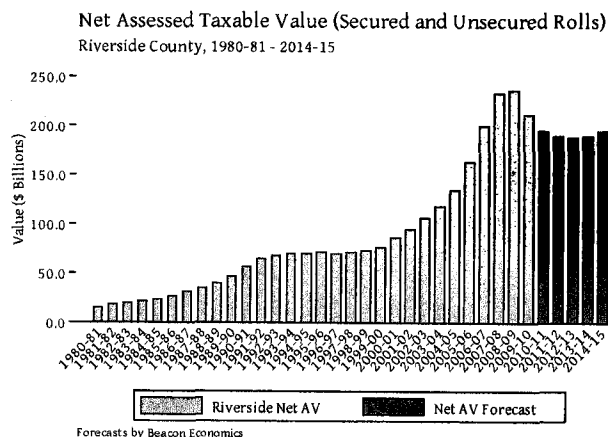
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Property Tax Rolls

There is no doubt that Riverside County was heavily involved in the housing mess that sent the market into collapse in late 2006 and early 2007. We saw above the the region took on a disproportionate share of risky mortgages relative to the rest of the state, and the Inland Empire has since seen some of the most precipitous declines in home values and increases in defaults and foreclosures since the market fell apart.

This is most certainly having an adverse impact on Riverside County's tax revenues. Indeed, in the property tax rolls for Riverside County, we can already see that the net assessed taxable value of real property has declined. According to the County Assessor's Office, the value of real property in Riverside fell from \$236.8 billion in the 2008-09 fiscal year \$211.3 last fiscal year. This represents a decline of more than 10% over one year. This is by far the largest decline in the property tax rolls in over 30 years.



Unfortunately, we are currently forecasting that things will get worse before they get better. Given the substantial declines in property values, we expect to see the Riverside County roll shrink more in the coming years. Assessed valuations usually follows declines in property values with a substantial lag. For example, home prices in Riverside County peaked at \$415 thousand in the first calendar quarter of 2007, which

Property Tax Roll Riverside County

Fiscal Year	Countywide Net Assessed Valuation (\$ Millions)
1980-81	14,918.0
1981-82	17,573.0
1982-83	19,979.4
1983-84	21,533.9
1984-85	24,047.2
1985-86	27,321.6
1986-87	31,063.0
1987-88	35,810.9
1988-89	40,558.8
1989-90	47,358.5
1990-91	57,065.7
1991-92	64,213.3
1992-93	68,448.0
1993-94	70,661.8
1994-95	70,616.9
1995-96	70,799.7
1996-97	70,213.5
1997-98	71,049.1
1998-99	72,603.6
1999-00	77,374.0
2000-01	85,912.5
2001-02	95,281.5
2002-03	106,195.2
2003-04	118,479.1
2004-05	135,490.7
2005-06	162,610.8
2006-07	200,411.2
2007-08	233,978.7
2008-09	236,846.7
2009-10	211,285.2
2010-11	195,444.1
2011-12	190,204.3
2012-13	188,447.6
2013-14	190,134.7
2014-15	195,336.3

Source: State Controller's Office and County Assessor's Office

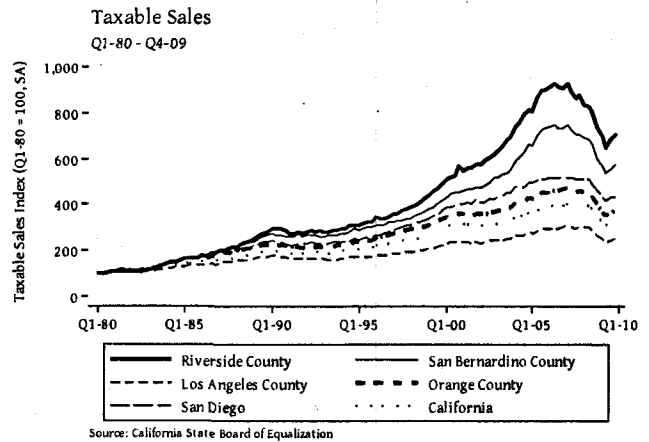
was the 2006-07 fiscal year for Riverside. However, it took until 2009-10—three fiscal years later—for these

declines in home values to create a decline in the property tax roll. We expect the rolls to decline by 20.4% in total by its trough, and these losses will continue through the 2012-13 fiscal year due to this lag-effect.

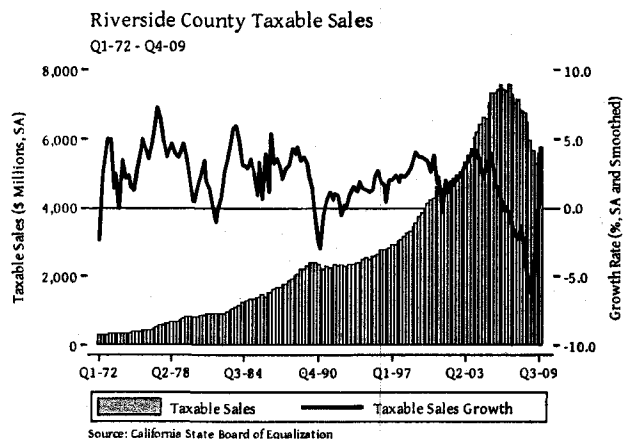
Specifically, the property tax rolls in Riverside County are expected to reach just under \$190 billion by fiscal year 2012-13. Because this is such a vital component of the local budget, this will undoubtedly put continued pressure on Riverside's fiscal position. It is also interesting to note that while we do forecast a return to growth in the coming years, Riverside's property tax rolls will not reach its 2008-09 bubble-levels by 2014-15.

Taxable Sales

Sales tax revenues are also a major source of revenues for Riverside. These too have taken a severe knock since the onset of this recession. Again, Riverside County was not a spectator in the huge reductions in savings and increases in household debt noted earlier. Indeed, since 1980 Riverside has seen the largest increase in taxable sales in all of Southern California and most of the rest of the State. From the first quarter of 1980 to the first quarter of 2007, taxable sales in Riverside County grew from just over \$800 million per quarter to more than \$7.5 billion per quarter—growth of more than 800%. Some of this was driven by strong population growth over this period, but the acceleration in growth we have seen over the past decade was also the result of the dangerous consumption patterns detailed above.



Total county-wide taxable sales began falling sharply after the first quarter of 2007. After peaking at over \$7.5 billion per quarter, the value of all taxable transactions fell to less than \$5.3 billion by the second quarter of 2009. This represents a decline from peak of more than 30%. However, unlike the County's property tax rolls we expect that most of the pain in the consumer market is behind Riverside. The region saw taxable sales grow by 5% in the third quarter of 2009, propelled in most part by federal government intervention aimed at boosting car sales (*Cash for Clunkers*) and home sales (*First-Time Homebuyer Tax Credit*). Although these programs were temporary and taxable sales dropped slightly in the final quarter of last year, consumer spending should begin to pick up in Riverside County in 2010.



Taxable Sales by City

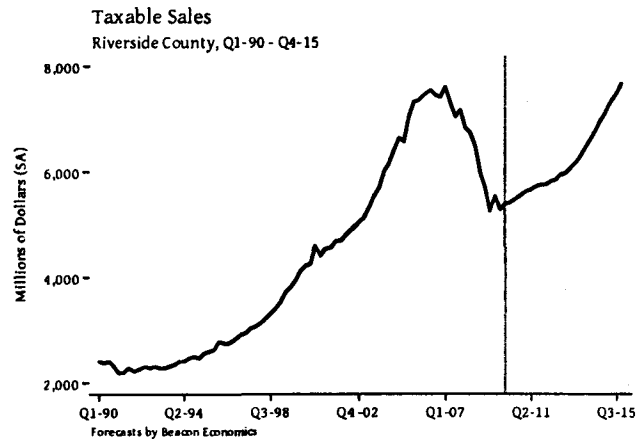
City	2008 Taxable Sales (\$ Millions)	2009 Taxable Sales (\$ Millions)	Share of County (%)	Growth (%)
Riverside	4,202.5	3,845.9	17.3	-8.5
Unincorporated	5,429.3	3,479.1	15.6	-35.9
Corona	3,009.6	2,515.9	11.3	-16.4
Temecula	2,370.1	2,284.5	10.3	-3.6
Palm Desert	1,484.1	1,349.7	6.1	-9.1
Moreno Valley	1,163.7	1,043.3	4.7	-10.3
Murrieta	1,004.7	977.2	4.4	-2.7
Palm Springs	850.2	841.0	3.8	-1.1
Hemet	858.0	797.9	3.6	-7.0
La Quinta	749.6	698.3	3.1	-6.8
Lake Elsinore	663.7	619.5	2.8	-6.7
Indio	701.5	612.8	2.8	-12.6
Cathedral City	658.9	608.1	2.7	-7.7
Perris	559.0	481.0	2.2	-14.0
Rancho Mirage	449.7	397.0	1.8	-11.7
Norco	449.3	375.8	1.7	-16.3
Beaumont	277.7	298.6	1.3	7.5
Coachella	312.4	265.4	1.2	-15.1
San Jacinto	200.3	194.1	0.9	-3.1
Banning	197.5	173.7	0.8	-12.0
Blythe	160.9	147.5	0.7	-8.3
Indian Wells	92.4	86.5	0.4	-6.4
Desert Hot Springs	94.1	85.0	0.4	-9.7
Calimesa	55.4	53.2	0.2	-3.9
Canyon Lake	12.3	13.7	0.1	11.4
Total	26,006.8	22,244.7	100.0	-14.5

Source: California State Board of Equalization

Note: Unincorporated includes Wildomar and Menifee

Drilling down below the county level, it is clear that not all cities were created equal in Riverside, but one trend was almost universal: consumer spending was down in 2009. Nearly one-third of the County's taxable sales happen in the City of Riverside and the unincorporated areas (including Menifee and Wildomar). Last year, taxable sales in the City of Riverside exceeded the unincorporated areas, which has not been the case in recent years. This partly due to the fact that taxable sales in the County's unincorporated areas have fell more dramatically. In 2009 they dropped by over 35% in the unincorporated areas versus falling by 8.5% in the City of Riverside. Corona and Moreno Valley are also large consumer areas that posted more than 10% declines in 2009. Only Beaumont and Canyon Lake saw taxable sales actually increase in 2009, but unfortunately they are small enough in magnitude that this did not offset declines in the larger shopping areas.

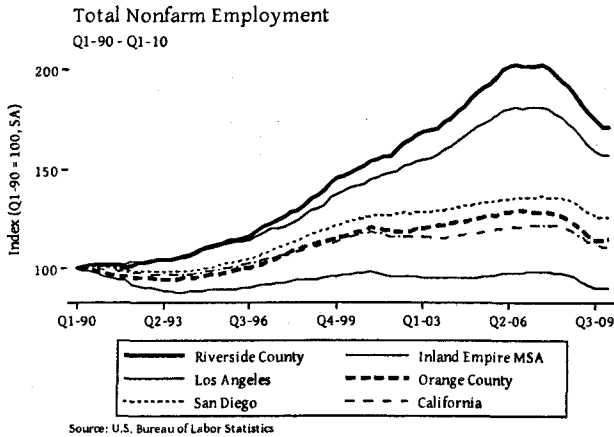
It is also interesting to note that some of the cities located in the southwest area of the county, such as Murrieta and Temecula saw only minor losses in 2009. Although these were some of the areas that saw the largest abuse in mortgage lending and borrowing, this is a testament to the strong influx of population that occurred over the past decade.



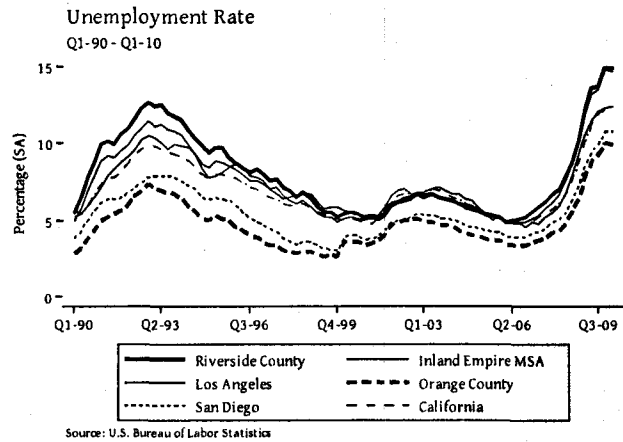
After such substantial and painful declines in this vital source of revenues, we do expect that taxable sales will begin to rise slowly in the coming quarters. Indeed, we see taxable sales rising by roughly 1.5% per quarter in 2010. However, there are some caution signs out there that the County should keep in mind when budgeting for the next few years. Several key federal tax cuts are currently slated to expire at the end of 2010 and early 2011. These include the Bush tax cuts for wealthy Americans, as well as the Obama payroll tax cuts enacted as part of the federal stimulus program. If these programs are allowed to expire, the adverse impact on disposable income is expected to have an effect on consumer spending in Riverside County. Look for growth in taxable sales to fall below 1% per quarter in 2011 and the first two quarters of 2012, before resuming a more normal (and sustainable) growth path of between 2% and 2.5%.

Labor Markets

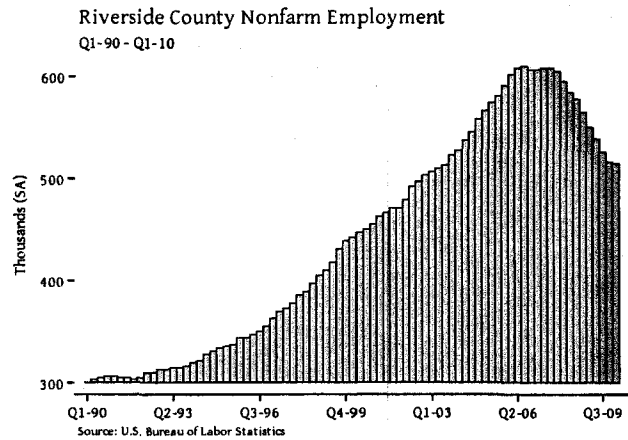
Since 1990, Riverside County has seen some of the strongest growth in employment in the State. Job growth in Riverside outstripped the Inland Empire MSA overall, and far exceeded job growth in Los Angeles, Orange County, or San Diego. And, while employment has dropped off, the region has held on to many of the job gains achieved over the past two decades, and employment is still more than 60% higher than it was in 1990. This contrasts with many other parts of Southern California, which saw less explosive employment growth and are not above their 1990 employment levels by any more than 40%.



This is not to say that Riverside's labor markets are in a good state of health. In addition to seeing vital sources of revenue drop off, Riverside County's labor markets have been hit hard. In many cases, this has created serious hardships for residents in the region. We currently estimate that Riverside's unemployment rate is at 14.9%, which makes it roughly equivalent to the Inland Empire overall. It also gives Riverside one of the highest rates or unemployed residents in all of Southern California.

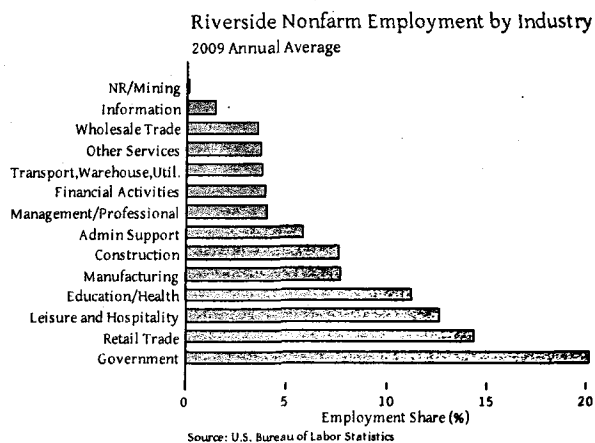


Total nonfarm employment has also seen marked reductions. Current nonfarm employment in Riverside County is estimated at roughly 515,000. This corresponds to a reduction in jobs of more than 15% or nearly 95,000 from its peak of 609,000 in the third quarter of 2007. This gives it one of the largest declines as a share of total employment relative to neighboring regions.

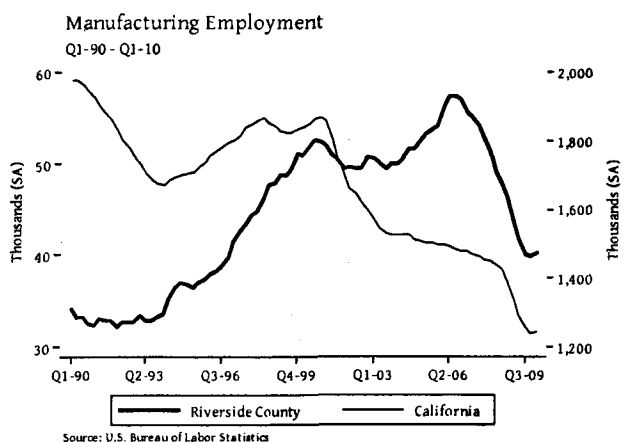


Part of the reason for the collapse in employment in Riverside is due to the structure of their economy. When we look at how jobs are distributed across industries within Riverside County, we see how the region was exposed to a consumer-led downturn such as the one the economy is currently trying to recover from. Outside of government employment, which is itself heavily reliant on consumer spending and prop-

erty values, the County's next largest employment categories are retail trade and leisure and hospitality.



Both retail and leisure and hospitality are nearly entirely determined by the level of consumer spending. As home prices fell off a cliff and taxable sales started falling, retailers, restaurants, and entertainment venues began shedding jobs. And, because of their dominant size in the County, this dragged total employment down substantially. Construction employment was also impacted dramatically as the housing bubble collapsed and builders virtually halted any new construction, and this drew total employment down sharply as well.



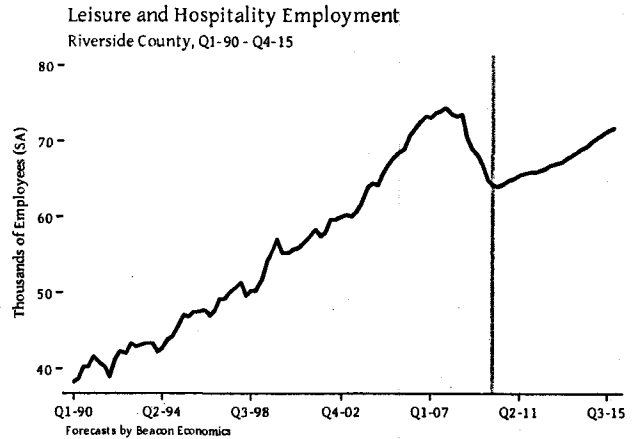
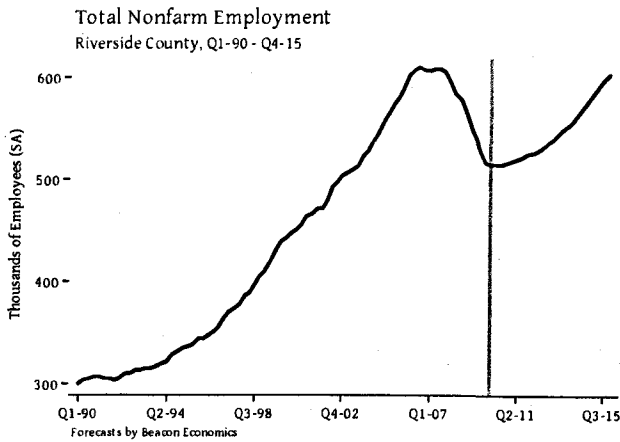
Riverside was doing quite well prior to this recession. Indeed, since 1990 this sector grew from roughly 33,000 jobs to nearly 60,000 by 2006. We do estimate that manufacturing employment has fallen since the onset of this downturn, but recent evidence shows that it is beginning to increase slowly.

Taking into consideration the recent trends in national economic growth, the rebound in consumer spending, and the structure of Riverside's economy we are forecasting that the County's labor markets have worked through the majority of their adjustment and should return to growth in the first half of 2010. Our forecast of unemployment is that Riverside was at its peak unemployment rate of 14.9% in the first quarter of 2010 and that it will begin to come down gradually. We do see the decline slowing in 2011 and 2012 as the aforementioned tax credits expire and put a drag on consumer spending.



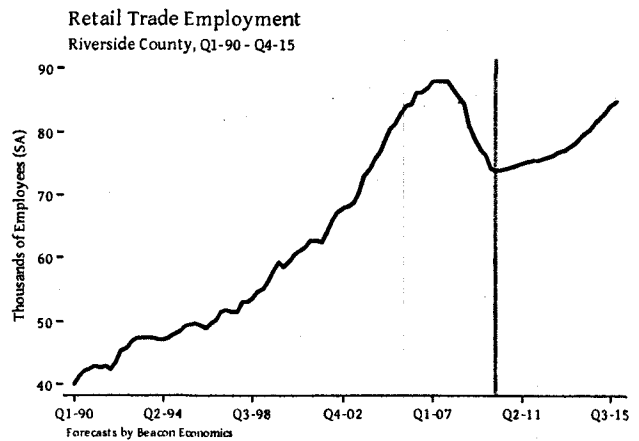
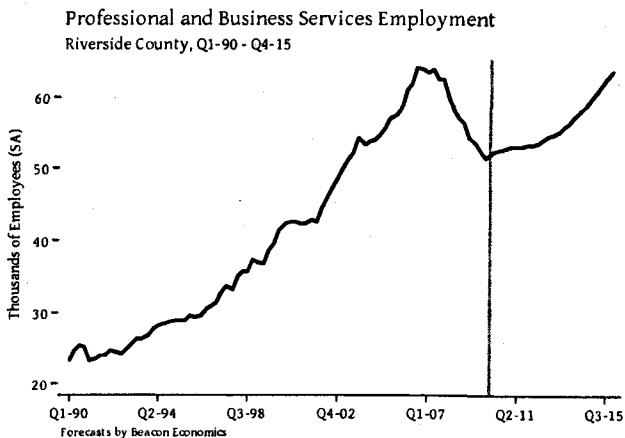
We are also forecasting that total nonfarm employment will begin to increase in the first part of this year, albeit slowly. This will come on the back of a rebound in both professional and business services, and leisure and hospitality employment. The region does have a strong pull for tourists given both the Palm Springs and Coachella Valley areas, which are destinations for both retirees and young professionals alike. These should benefit from increased consumer spending in coming quarters, as well as a trend of

Interestingly, while the remainder of California's manufacturing industries have been on a long-term trend of declining employment, manufacturing in



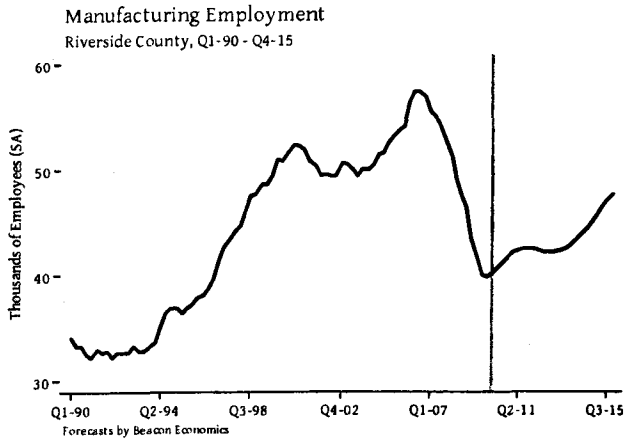
Americans substituting domestic for international travel. And, with great educational institutions like the University of California, Riverside, the County is creating a base of skilled workers to fill both management and professional, and administrative jobs. Indeed, we estimate the Riverside County has already seen a small uptick in employment from the administrative and waste services subsector and we expect this to continue, though we do expect to see growth slow in 2011.

Other sectors are forecasted to see more tepid growth coming out of this recession. Although we do expect taxable sales and consumer spending in general to pick up this year in Riverside, retailers will wait for sustained increases in activity before making the decision to significantly expand their payrolls. And, with expiring tax cuts on the horizon that will adversely impact consumption in the County, growth retail trade employment is likely to remain modest through 2011 as the American consumer struggles to get onto a level footing.

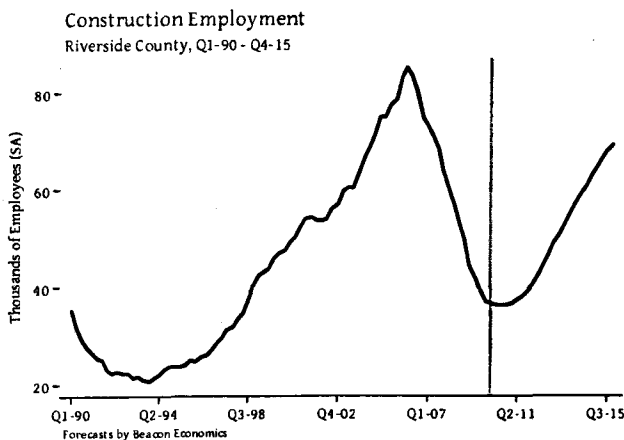


While manufacturing employment will return to growth in the County, it will be some time before it reaches its peak level of employment. We also expect to see manufacturing employment flatline in 2011 and 2012 as consumers pull back in the face of rising tax

rates at the federal level. This will certainly affect the demand for manufactured goods, and we expect to see growth in manufacturing stumble as a result.

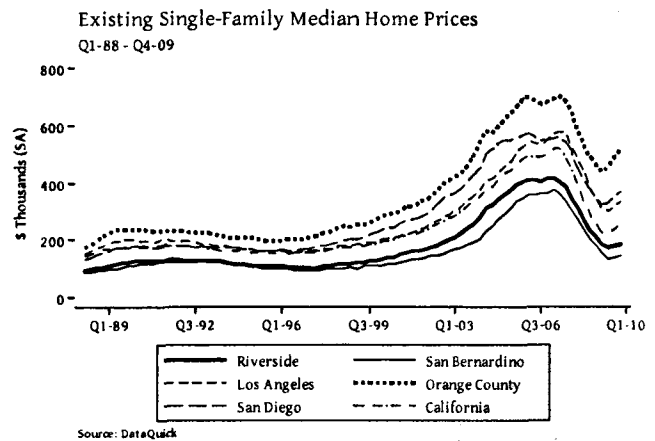


Similarly with construction employment: housing permits are beginning to increase in Riverside County, and this should begin to increase demand for construction employment. However, the growth in permits will not be strong enough to drive construction employment up to peak levels throughout the end of our forecast, which ends in 2015. It will unfortunately take time for the commercial market turn around, which is a necessary prerequisite to see jobs in the construction industry come back to full force.

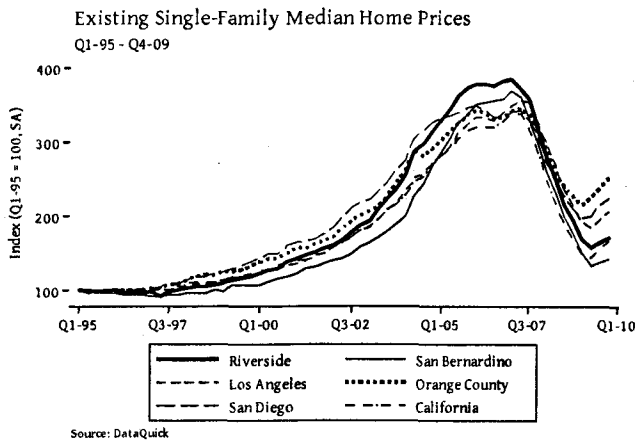


Real Estate

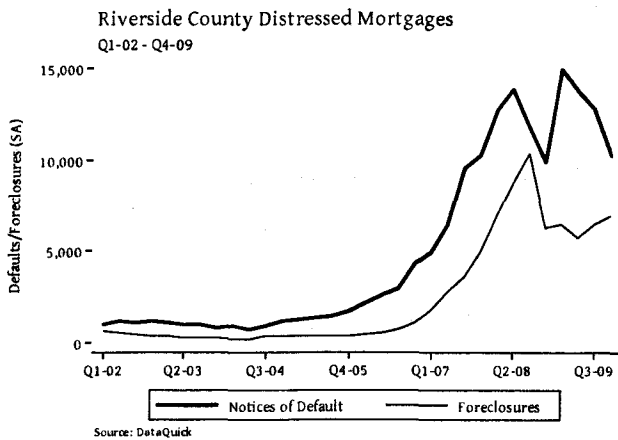
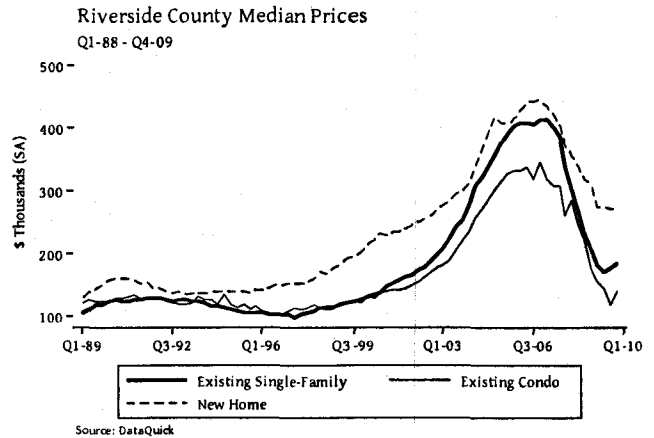
It has been noted herein that Riverside County was ground-zero in the housing bubble that collapsed in late 2006. We saw the disproportionate share of risky mortgages that ended up here, and this is certainly a large driver of the home-price increases experienced in the County. Indeed, between 2000 and the first quarter of 2007, the median price of an existing single-family home in Riverside County rose from \$132,000 to nearly \$415,000—an increase of nearly 215%.



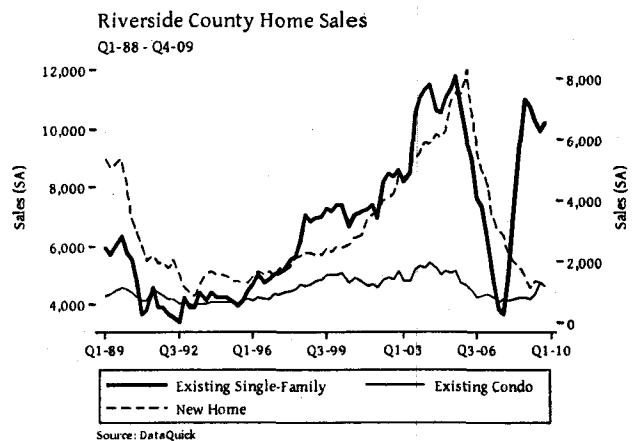
This was the largest rise in home prices anywhere in Southern California, and home price inflation here outstripped the increase in prices in San Bernardino, Los Angeles, Orange County, or San Diego. Since then, Riverside has seen some of the most precipitous declines in home values as well. At the end of 2009, home prices had dropped by 58.7%, wiping out most of the gains over the past decade with a median home price of only \$171,000.



also come down substantially. In contrast, the prices of new homes in Riverside County have yet to see prices fall on the same order of magnitude as the existing home or condo market.



As a result, sales of new homes have not seen the resurgence experienced by the other residential market segments. As existing-home prices fell substantially, sales of these homes began ramping up in a significant way. Between the end of 2008 and the end of 2009, existing single-family home sales averaged nearly 10,500 per quarter. Conversely, sales of new homes continued their decline throughout 2008 and 2009, suggesting that buyers are being incentivized by affordability, which has yet to return to the new-home segment.

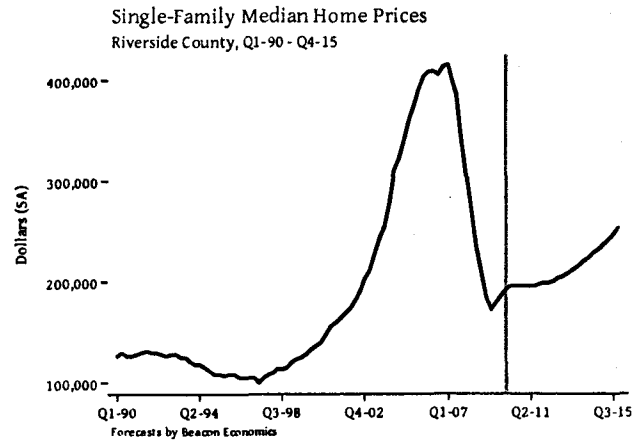
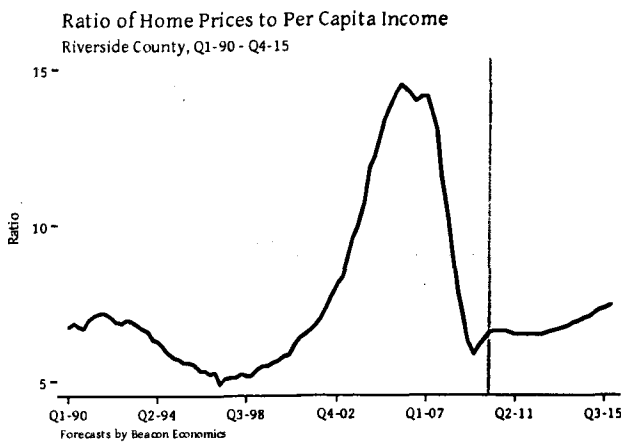


In the wake of these precipitous declines in home values, Riverside County has seen a surge in distressed and nonperforming mortgages. Reaching nearly 15,000 in a single quarter in late 2008 and early 2009, mortgage defaults were at their highest levels on record according to DataQuick. Similarly, Riverside saw a surge in foreclosures as well. Although these began to drop off in mid-2008, this was due to government intervention aimed at modifying home loans and instituting a moratorium on foreclosures. Yet notices of default remained high and these distressed properties have played a role in pushing home prices down even further in the County.

Looking across market segments, it is clear that the existing single-family homes segment has been hardest hit by price declines. Existing condo prices have

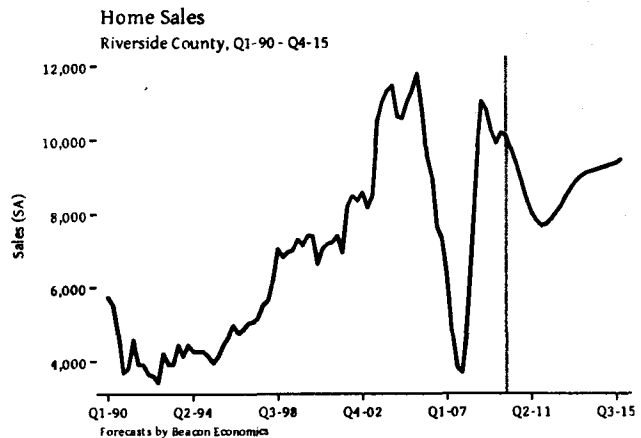
Although painful for Riverside County and the rest of the State, these declines in home prices we unfortunately necessary. During the home price bubble, the value of homes in Riverside and throughout the State were totally out of line with incomes. Before the bubble, home prices ran at roughly 6-times per capita income. At the height of the bubble, this reached as high as 14.5-times per capita income—a level that was clearly unsustainable as borne out by the statistics. Following the dramatic declines in prices, home prices are beginning to make sense again. Indeed, we can see in the statistics that home prices in Riverside county have fallen back to a level that are consistent with residents' incomes at roughly 6.4-times per capita income.

income. Take these away, which the government will eventually have to do, and the outlook for home prices becomes less bullish than it initially appears.



Home prices are currently forecasted to remain fairly flat over the next two years, with some very modest growth. It will be close to 2012 before the median price of an existing single-family home in Riverside County climbs above \$200,000. Sales will remain strong, though they will not see the 10,000 per quarter Riverside has seen in recent quarters. Yet they will hover above 8,000 per quarter as the regions affordability relative to surrounding employment centers (L.A., O.C., and S.D.) has increased, and should spur migration into the region once again.

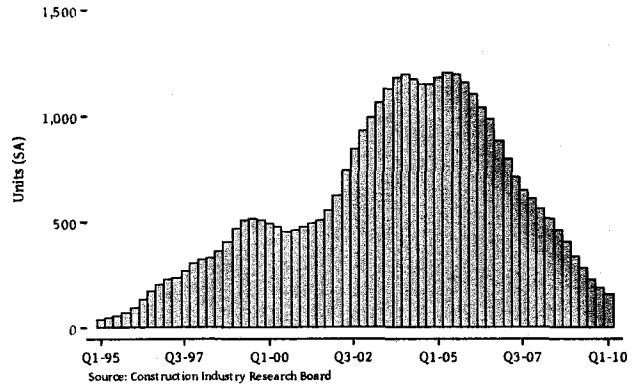
Thus, we expect that most of the pain that will be borne by Riverside's housing market is already behind it. Home prices have already increased in Riverside, from \$171,000 to nearly \$190,000 by the end of 2009. However, the return to growth will be modest at best in the near term. The bump in home prices recently a function of massive government intervention into the housing market in particular. The first-time homebuyer tax credit bolstered demand for homes. The Federal Reserve continues to keep interest rates at near-zero which has injected life into the mortgage lending market. In addition, the FHA's has become the subprime lender of sorts, making low down-payment loans to borrowers with less than exemplary credit or



Construction

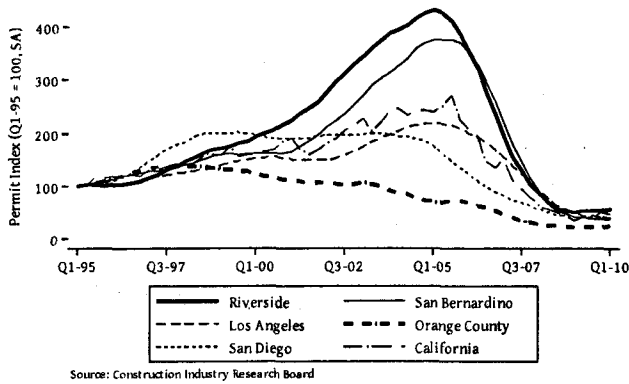
On the construction side, Riverside also saw one of the largest expansions in residential building in all of California. The construction of new single-family homes in Riverside County surpassed the growth in all other major Southern California markets, including San Bernardino. As noted, the region did see some of the strongest population growth over this period as well. However, much of this construction was on the part of builders who wanted to capitalize on the rising prices and favorable cap rates. As housing prices collapsed, so too did the issuance of new building permits.

Riverside County Multi-Family Building Permits
Q1-95 - Q1-10



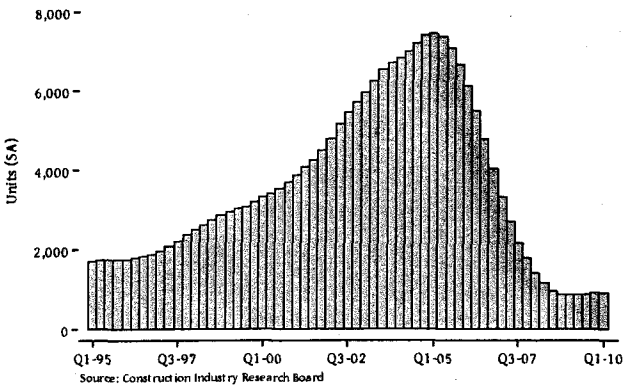
This was not merely confined to single-family residences. Riverside saw a surge in multi-family structures as well. After peaking at nearly 9,000 new residential units per quarter in late 2005, permits fell to just 1,000 per quarter in the first part of 2009. Since then, residential construction has seen a small uptick. We expect this to continue as the region's relative affordability has increased in the wake of these price declines since home prices have fallen faster in Riverside than elsewhere in Southern California. As a result, this should draw residents into the County in the coming years which should stimulate demand for new housing.

Single-Family Building Permits
Q1-95 - Q1-10



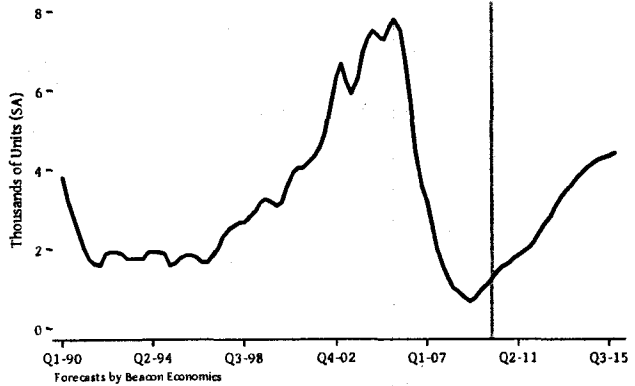
Source: Construction Industry Research Board

Riverside County Single-Family Building Permits
Q1-95 - Q1-10

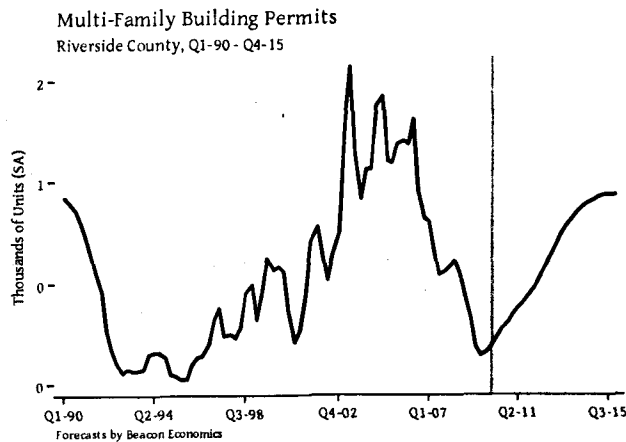


Source: Construction Industry Research Board

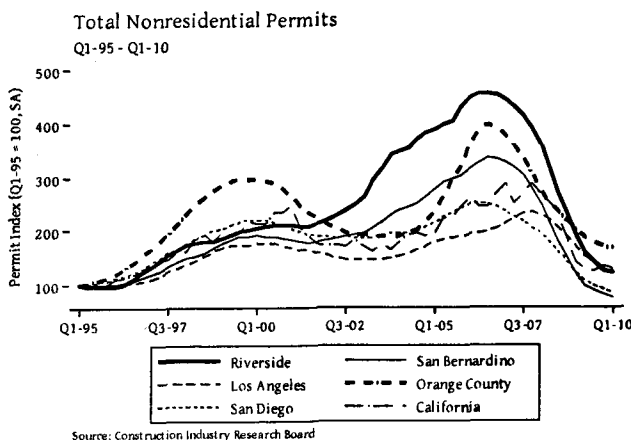
Single-Family Building Permits
Riverside County, Q1-90 - Q4-15



Forecasts by Beacon Economics

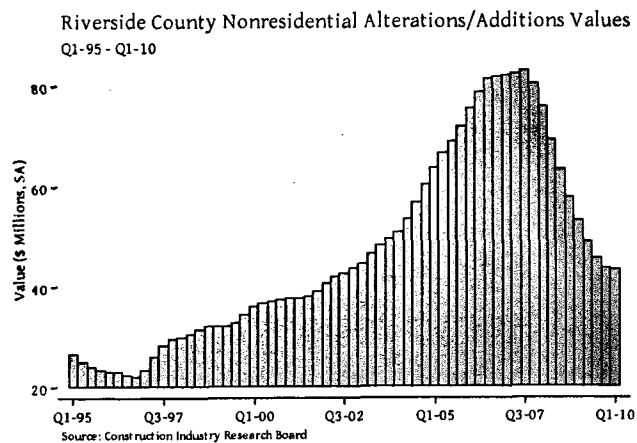
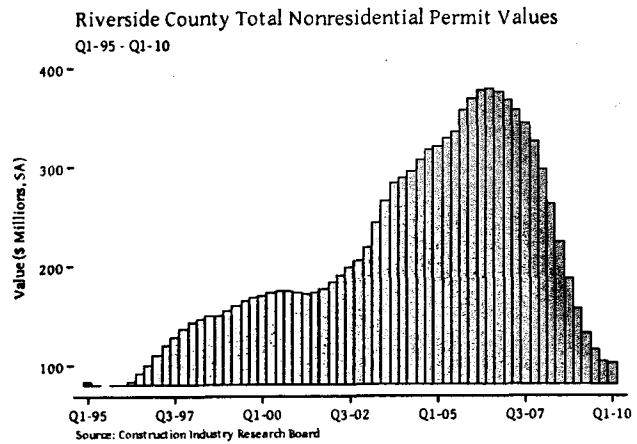


This boom in construction was not purely residential either. In fact, Riverside County saw tremendous growth in nonresidential construction over the past 15 years. In fact, since 1995 Riverside County has seen more growth in nonresidential construction than elsewhere in Southern California—similar to its residential statistics. Only Orange County saw grown in nonresidential construction grow by anything close to the order of magnitude experienced in Riverside.

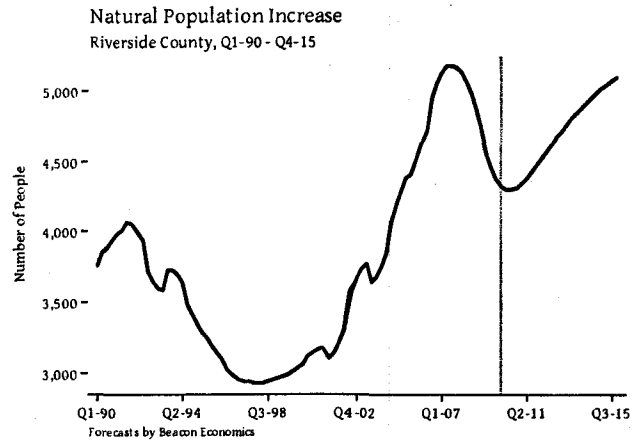
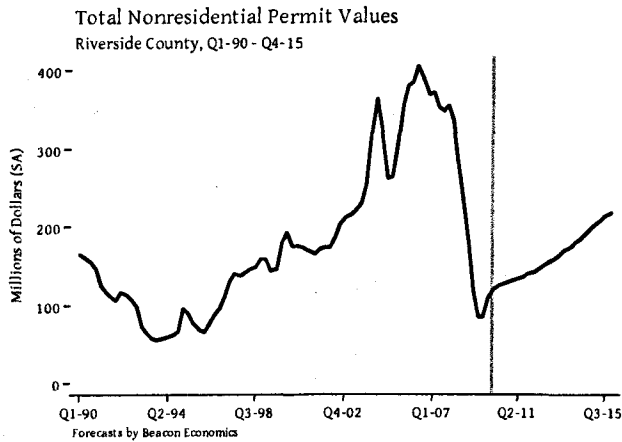


However, since 2006 nonresidential building permits have fallen off sharply. After reaching a peak of more than \$400 million in mid-2006, nonresidential building permit values have fallen to roughly \$100 million per quarter. And, unlike the housing market which has most of its pain behind it, Riverside's commercial market still has some issues to work out. We have yet

to see an uptick in nonresidential construction, and rents are still down, vacancy rates are still up, and net absorption remains negative.



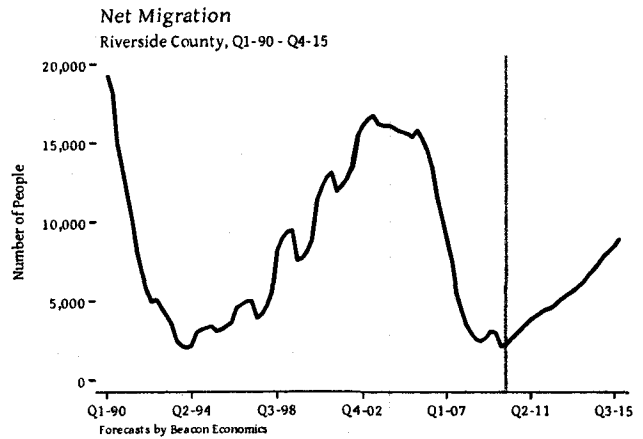
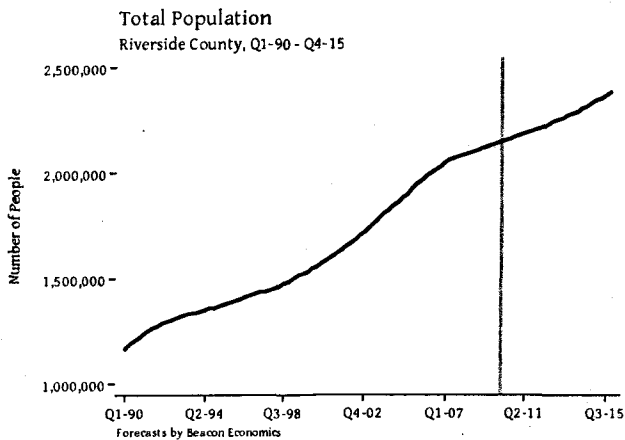
Thus, we are currently forecasting that the growth path of nonresidential construction permits will be much flatter than the recovery in residential construction. 2010 and 2011 will continue to be tough years for the commercial markets, and it will take time before nonresidential permits pick up steam. Indeed, our current forecast is that the value of nonresidential building permits will reach just over \$200 million per quarter by 2015—just half of its peak levels of activity under the bubble.



Income and Demographics

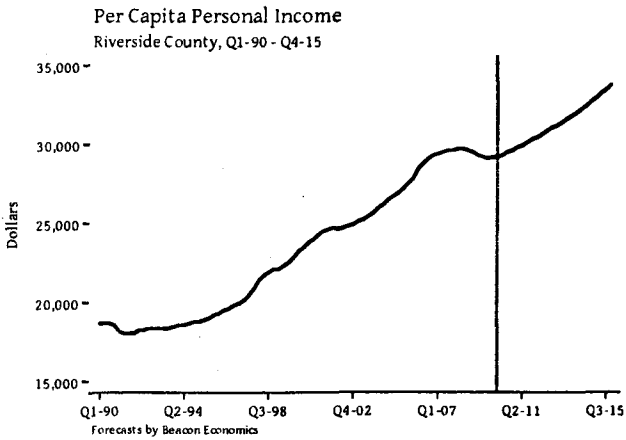
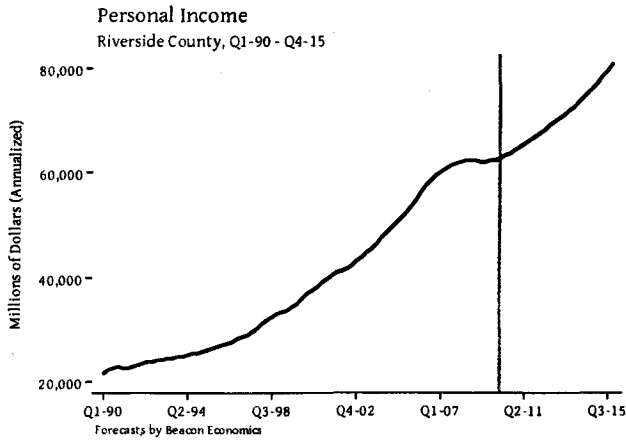
There is no doubt that between 1995 and the collapse of the housing market that Riverside County experience phenomenal population growth. Over this period, the County added more than 650,000 new residents. Part of this growth was due to a surge in natural increase (the number of births minus the number of deaths) in the County. However, much of this growth was due to net migration into Riverside, which reached as high as 17,000 per quarter in 2003. Many of these new residents flocked to Riverside County in search of affordable housing, despite the fact that they worked in nearby employment centers such as Los Angeles, Orange County, and San Diego.

Now that the price of housing in Riverside has fallen faster than in nearby employment centers, the County's relative affordability is on the rise again. This should stimulate the migration of new families into the region in search of a balance between homes they can afford and commutes they can tolerate. Although Riverside won't see the huge waves of people pouring in quarter after quarter as it did, it is still expected to see healthy net migration of between 5,000 and 9,000 per quarter over the next several years.



The dismal labor markets and high unemployment rates had definitely had an impact on personal income in the County. It is estimated that personal incomes in Riverside flatlined at roughly \$62 billion during the last two years. As the population has increased over this period, albeit at a slow rate, Riverside County has

actually seen per capita income decrease slightly to less than \$30,000.



However, as the region's population continues to expand and labor markets recover, income will continue to see strong growth in Riverside County. We estimate that personal income has already begun to rise in Riverside County. As residents continue to get back to work, look for per capita income to begin to rise in the first half of this year, which should benefit the consumer market as well. Although things have been tough for the County, many of the painful adjustments have been worked through and the return to slow growth is around the corner. The key for Riverside policy makers will be to remain patient in these uncertain times as the economy struggles to climb out of the cellar.

Data Sources

California Department of Education

The creation of this report would not have been possible without numerous public and private sources of data. We would like to acknowledge those sources here.

Business Activity

California State Board of Equalization

U.S. Bureau of Economic Analysis

California Employment Development Department

U.S. Census Bureau, American Community Survey

U.S. Department of Labor, Bureau of Labor Statistics

U.S. Department of Commerce, Bureau of Economic Analysis

Real Estate

DataQuick Information Systems

Construction Industry Research Board

California Association of Realtors

Mortgage Banker Association

S&P Case Shiller

Social & Demographics

California Department of Finance

U.S. Census Bureau

California Department of Finance

California State Board of Equalization

California Department of Justice

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