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Wealth Management Research **22 September 2010**

Municipal Bonds

State of California

- We believe the State of California will honor its full faith and credit obligation to pay debt service in full and on a timely basis. Debt service does not yet represent a significant burden on the annual budget. The State constitution places GO debt ahead of all other current expenditures with the exception of primary and secondary (K-14) education.
- A reduction or delay in state-shared revenue presents a much bigger challenge for California's local governments. County governments, in particular, are highly reliant upon transfer payments from the State Treasury and are more susceptible to cash flow difficulties.
- The State is highly dependent upon very volatile revenue sources to fund General Fund operations. Expenditure requirements often are imposed by law and are less susceptible to adjustment. The result is a boom-and-bust cycle in which California's powerful economy periodically generates a dramatic increase in revenue which, in turn, is promptly consumed by expenditures deferred during economic recessions but required by law.

Please note that this report has been republished to correct an error in the second paragraph on page 10 where the phrase "with participation" has been changed to "without participation".

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California has received a great deal of media attention regarding its structural budget deficit and its demonstrable inability to adopt a balanced budget on a timely basis. Current deficits are large enough now to generate disturbing headlines in the general press. As a result, many investors have expressed increased concern about the implications of budget imbalances on the payment of general obligation debt service.

We begin with an abbreviated history of California's political dynamics and recent history of engaging in direct democracy through citizen initiative. We offer a review of the pledged security on California debt and conclude with a review of the state's current financial challenges.

The Roots of Political Dysfunction
In this report, we begin with an abbreviated history of California's political dynamics and recent history of engaging in direct democracy through citizen initiative.

Term Limits
California voters imposed strict term limits upon the California Legislature in 1990 when they voted in favor of Proposition 140 by a relatively narrow margin. The Proposition restricts state senators from serving more than two four-year terms in office. Restrictions imposed on the State Assembly are even more severe; members in that chamber may only serve for six years. Subsequent attempts to roll back the voter initiative thus far have failed.

In the wake of Proposition 140, inexperienced legislators are entrusted with significant responsibility very early in their tenure. Assembly Speakers and Minority Leaders are elected with fewer than four years of state legislative experience and now only rarely survive more than two years as leader of their party's caucus. Rank-and-file legislators are reluctant to alienate their base of political support given the need to seek subsequent political office or otherwise find new employment; loyalty to the legislature as an institution therefore suffers.

Moreover, one unanticipated result of Proposition 140 is an increasing reliance on entrenched political interests in the capital for advice and guidance on complex legislation. Inexperienced legislators are necessarily more reliant upon industry lobbyists and single issue advocates for their technical expertise than veteran legislators, in a prior era who were given time by their constituents to become experts in their own right.

Gerrymandered Districts
Each political party perceives some benefit from the delineation of legislative districts that overwhelmingly favor their own electoral prospects. Each decade, the governor and legislature have redrawn the boundaries of legislative districts to favor the majority party. As a result, fewer districts are genuinely competitive and party primaries often determine the identity of each district's legislative representative well in advance of the general election. Moderate candidates, better able to attract crossover voters in a competitive general election, offer little advantage to the party faithful because the outcome of the election is generally a foregone conclusion in any event. Candidates with more rigid political views, in contrast, are supported by each party's most zealous activists and tend to be more successful in party primaries.

Closed Primaries
Closed primaries, where only those individuals with a stated party affiliation may vote in that political party's primary, are common to many states. In California, closed primaries exacerbate the problem presented by gerrymandered districts. Moderate candidates, with a predisposition to compromise for the sake of a timely budget, are less likely to gain support from the bleeding edge of their own party and are more reliant upon independent voters who are ineligible to vote in the party primary.

The Initiative Process

The initiative process, whereby statutory and constitutional amendments are enacted by popular petition, is common to many states. However, very few appear to have used it with as much regularity as California. The number of ballot measures circulated, qualified, and adopted in the Golden State has increased markedly during the past 40 years.[1] Only 22 such initiatives appeared in the entire decade of the 1970s but 46 qualified for a vote in the 1980s. Since 1990, there have been more than 120.

The widespread use of paid signature gatherers may be in part to blame for the increased use of the citizen initiative. California requires proponents to collect enough valid signatures to equal 8% of those voting in the preceding gubernatorial election.[2] In light of the time-restricted window of 150 days in which to gather sufficient signatures to qualify for inclusion on the next ballot, it is no surprise that a signature collection industry has developed. According to the National Council of State Legislatures, it now costs more than USD 1million to obtain enough signatures to ensure a place on the ballot.[3] The median cost per signature during the 1980s was reported as USD 1.41.[4]

One might reasonably argue that an emerging culture of direct democracy is gradually transforming the electorate into an independent branch of state government. The State of California does not require a formal review of the text of ballot initiatives prior to signature circulation. Proponents can draft an initiative, circulate it, place it on the ballot, and launch a media campaign without much legislative oversight. Over time, then, the state legislature plays a less significant role as issues of governmental taxation are ceded to the electorate on an annual basis. In November, for example, California voters will be asked to vote on nine separate ballot measures, five of which would further amend the State Constitution.

Supermajority Votes for Budget Adoption

Only three states require more than a simple majority to pass all appropriation bills.[5] In California, the constitution requires a two-thirds vote for general fund appropriations for purposes other than public schools (Art. IV, Sec. 12). However, as the Legislature typically passes only one budget bill, the requirement has effectively applied to the whole budget. This requirement has proven to be a high hurdle. Since 1980, the Legislature has met the June 15 constitutional deadline for sending a budget to the governor on only five occasions. Unless legislative leaders agree on a budget and obtain the governors signature by September 23, the state will have established a new and unenviable record.

At the beginning of each legislative session, then, a relatively inexperienced group of legislators convene in Sacramento with relatively rigid political views, little incentive to compromise with their colleagues

1 California Research Bureau, California State Library, 1997 and California Health Care Foundation, 2010

2 Constitutional amendments require 8%; statutory amendments require only 5%.

3 National Council of State Legislatures, 2010

4 Charles Price, California Journal, volume 19, no 11, page 484

5 Six other states require more than a simple majority only in certain instances.

across the aisle, and a short-term perspective on their career in Sacramento. It is little wonder that there is so little incentive for either party to make the compromises necessary and provide the votes required to pass a budget with the necessary plurality.

Government by Initiative

The passage of Proposition 13 in 1978 and its impact on statewide property tax collections heralded a new era for state and local finance in California. As we have discussed, its passage triggered renewed interest in the circulation of citizen petitions. The measure also established a new regime for financing state and local government expenditures that persists to this day.

Before we review the Initiative's unintended consequences, some historical context is useful. Proposition 13 enjoyed popular support for a variety of reasons but its passage was given additional impetus by two developments. First, the California Supreme Court ruled in 1976 that the State's system of financing public education was unconstitutional (Serrano v Priest). The system, largely funded through local property taxes, was deemed unconstitutional because wealthier school districts were capable of spending more per pupil than less affluent ones.

The state legislature responded by limiting the amount of local revenue that an individual school district could receive. Amounts in excess of the limitation were redistributed to other school districts around the State. Not surprisingly, homeowners in affluent communities were discouraged by the legislature's response to the court ruling and concluded that higher taxes were no longer justified if their local schools were not the recipients of higher funding.

Second, the economic stagnation and home price inflation prevalent in the 1970s was profoundly disorienting to Californians who had grown accustomed to rapid economic growth in the post-war years. Escalating property values triggered widespread reassessments of single-family homes at precisely the moment when voters were most concerned about their household budgets. These reassessments were followed by increased property taxation. Aggregate statewide property tax revenue increased from USD 6.7bn in 1972 to USD 11.0bn in 1978.[6]

Proponents of the initiative argued that Proposition 13 would reduce the rate of growth in local property taxation by stipulating that the maximum amount of any ad valorem tax on real property shall not exceed one percent (1%) of the full cash value of such property. The 1% tax would be collected by county governments but apportioned by law to the various taxing districts within the counties. Assessed valuations were rolled back to levels prevalent in 1975 and allowed to increase by a maximum of just 2% per year.[7] A more substantial change

6 U.S. Bureau of the Census, State and Local Governmental Finances, as cited by the Cato Institute in "Proposition 13 and State Budget Limitations, 2003.

7 The law requires assessments to increase at the lesser of the rate of inflation using the California Consumer Price Index (CCPI) or 2%. For the first time since the passage of Proposition 13 the CCPI actually declined between October 2008 and October 2009 and is attributable to economic recession. The Napa County Assessor has announced that all properties in his county that are assessed at their base year value will see a decline of 0.237 percent.

in valuation was permissible only upon a sale or transfer of the property to a new owner. Henceforth, any tax increase at the state level would require approval of two-thirds of the legislature; local taxes would require a similar majority at the polls.[8] By restraining the growth in assessed valuations and requiring a supermajority for any tax increase, proponents aimed to restrain the size of government and restrict its ability to raise revenue via the property tax.

Proposition 13 was successful in its primary objective of restraining the growth in property taxation. Property taxes declined substantially from a ratio of 6% of state personal income in 1972 to less than 2.5% in 1980.[9] The initiative was less successful in constraining the growth of governmental spending.

Ten years after the passage of Proposition 13, voters approved another initiative to amend the state constitution and mandate a minimum funding level for primary and secondary education.[10] Proposition 98, promulgated by the California Teachers Association, established a complex funding formula designed to ensure that at least 40% of the State General Fund budget is devoted to education. The initiative also sought to ensure that education funding would grow at least as fast as the state's economy and used 'per capita income' growth as a primary measurement to ensure this goal is achieved.

As a direct result of Proposition 98 and subsequent initiatives, the state legislature's ability to exercise discretion over education spending is now quite limited. To the extent economic recession makes the minimum funding formula untenable, the state legislature may suspend certain education funding with a two-thirds vote but must repay the difference in succeeding years and must do so using a higher "floor" for spending.

California's initiative process has created an environment in which tax limitations are imposed by law without the requisite constraints on public expenditures. Proposition 13 and Proposition 98 enjoy widespread popular support, but the unintended consequences of these measures and others like them are now being felt as California struggles with anemic economic growth.

Unintended Consequences

The structure of state and local government finance in California has changed markedly in the last 30 years. Three of the most important changes are described here. *First* and foremost, property taxes no longer function as a means by which local governments finance their own operations. Instead, the 1% tax rate is established by law and is allocated among all taxing jurisdictions. The amount of tax due to any particular taxing authority was based upon its relative share of the tax bill prior to the enactment of the constitutional amendment. Government agencies with the highest tax rates, and whose rates presumably

8 Proposition 39 later modified the two-thirds requirement for school district bonds in certain instances.

9 Michael J. New, "Proposition 13 and State Budget Limitations", 2003.

10 Prop 98 addresses state funding from kindergarten through the community college level with K-12 receiving approximately 88 percent of the dedicated allocation.

contributed the most to popular discontent, were effectively rewarded with a larger allocation of the new uniform tax rate.

And while Proposition 13 undoubtedly succeeded in restraining the growth in property taxes overall, there is some basis to believe that homeowners are actually bearing a larger share of this smaller burden. County assessors are able to identify the sale of single family homes relatively easily and mark the property's new assessed valuation to its sales price. Conversely, the sale of commercial property is more difficult to monitor due to more complex ownership structures. Commercial properties are often held in trust, as limited partnerships, or as part of a larger corporate entity. As the law defines a change of ownership as one that entails a property interest in excess of 50%, commercial properties with multiple owners may escape reassessment if the change of control happens over time.

A recent report by the California Tax Reform Association highlights the shift that has gradually occurred. Residential property in San Bernardino County constituted 50.74% of the County's aggregate assessed valuation in 1975. By 2008, residential property comprised 72.48% of the aggregate assessed valuation.[11] Although some of this growth can be attributed to rapid suburbanization over the course of a generation and an overheated market for residential real estate, similar results can be found for most counties in California.

Second, Proposition 13 also shifted more of the financial burden for health, education and welfare funding to the State. The property tax "rollback" provision of Proposition 13 resulted in an immediate loss of USD 6bn in taxes to local governments. Rather than allow expenditure reductions to occur as a direct consequence of Proposition 13's passage, the state legislature stepped into the breach and awarded block grants to cities and counties to compensate them for the loss of revenue. A portion of the property taxes that otherwise would have gone to schools was redirected to general-purpose governments; school budgets then were backfilled by the distribution of more state aid.

In later years, as school budgets became more constrained, the State reversed its position and mandated a shift of property taxes away from cities and counties back to the schools, creating an annual tug-of-war between school administrators and city and county managers that persists to this day. In retrospect, the State's decision to use its accumulated surplus to hold local governments harmless in 1979-80 was a strategic error. An immediate reduction in expenditures would have forced the State and its citizens to consider whether the public services to which they had grown accustomed were desirable or necessary. Instead, the level of government service was not reduced to any significant degree and the public remained unaware of the degree to which it was now more dependent than ever on new real estate development to pay for these services. Subsequent economic expansion masked the degree to which state and local government were dependent on the economic cycle and allowed elected officials to grant increased pension benefits to public employees.

Not surprisingly, the state government assumed a greater share of the

11 Lenny Goldberg and David Kersten, "System Failure: California's Loophole-Ridden Commercial Property Tax", May 2010.

health and welfare costs borne by local government through the distribution of state shared revenue. County governments, in particular, have become highly reliant upon state funding. In addition to the assumption of certain costs immediately following the enactment of Proposition 13, the State's realignment of responsibilities for trial court operations and social welfare payments during the recession of the early 1990s increased county government responsibilities without the establishment of a permanent and reliable source of funding.

Third, the proliferation of more esoteric techniques to finance capital programs have become commonplace as property taxes diminish in importance. The three most important types of securities are described below; each one is reliant to one degree or another on economic growth to ensure sufficient revenue is available for debt service – and each one came to greater prominence after 1980.

Community facilities districts, or CFDs, were authorized by the Mello-Roos Community Facilities Act of 1982. Mello-Roos districts are established to finance the infrastructure necessary for new residential and commercial development through the levy of a special tax within a defined geographic area. The special taxes levied within these districts initially are paid by developers, but ultimately are borne by subsequent purchasers of homes or businesses within those districts.

CFDs vary widely in credit quality with the establishment date of some districts coinciding with a period of economic expansion. Properties in these districts are supported by a diverse mix of residential and commercial taxpayers with little incentive to default on their special taxes. Other districts were established more recently and are unable to support the bonded indebtedness because residential and commercial construction ground to a halt in conjunction with the economic recession. These districts, less seasoned and more reliant on developers unable to sell subdivided parcels, have experienced widespread defaults.

Tax allocation districts were permissible under California law before Proposition 13, but became ubiquitous after its enactment. These districts are established by redevelopment agencies to capture future increases in assessed valuation within a specific geographic area and to redirect the resulting property tax receipts to economic development projects. Cities initially used tax increment districts as a means of capturing a larger share of aggregate property tax receipts and applying the proceeds to infrastructure projects without the need for a popular vote.

The increased use of tax-sharing agreements in recent years has reduced the ability of redevelopment agencies to capture all such incremental tax revenue but they remain a popular financing tool. The performance of tax allocation districts generally has been better than for community facilities districts through this recession (at least thus far), due in part to the ample debt service coverage built into the debt service structure.

Lease revenue bonds and certificates of participation are used frequently at all levels of government within California. These securities finance capital improvements without the need for a popular vote and without the need to identify a new source of revenue with which to make the requisite lease payments. In the case of county governments, these annual lease obligations often represent substantial liabilities. Investors historically have taken great comfort in the provisions found in state law that require the timely payment of lease obligations as long as the governmental body has beneficial use and access to the encumbered facility. There is significantly less appreciation for the degree to which county governments indirectly rely upon the timely payment of state shared revenue for the liquidity necessary to make these payments as they are due.

Evolutionary Changes to the State General Fund Budget

The State of California General Fund has become ever more dependent upon the personal income tax as its dominant source of revenue to support General Fund operations. Figure 1 illustrates the degree to which the highly progressive personal income tax dominates the state's total tax collections and Figure 2 demonstrates the extent to which the same revenue source drives the state's general fund operating statement. In the 1963-64 fiscal year, the personal income tax comprised only 18% of General Fund revenue. Today, more than half of California's General Fund revenues are derived from this one revenue source[12].

Even more striking is its rate of growth over time. During the last 30 years, personal income taxes have increased by over 900% while the next two largest sources have increased by less than half that rate. The faster growth in income tax is attributable to increases in real income and higher capital gains recognition. Sales taxes now comprise a proportionately lower share of revenue because society spends more on services – which generally are not taxed – than ever before.

The shift away from a more balanced revenue stream exacerbates a fundamental problem to which the State is exposed. When one considers the combination of personal income tax and state sales tax, the tax burden imposed on California residents is among the highest in the nation. The maximum personal income tax rate for individuals with incomes in excess of USD 46,350 is 9.55% with the highest rate of 10.55% applied to incomes in excess of USD 1mn.[13] The high tax rate is a principal factor in maintaining steady retail investor demand for California's municipal bonds.

The personal income tax is subject to substantial volatility. As the economy expands and investors recognize gains on investments (i.e., equity, fixed income securities, and real estate), the State often collects much more in taxes than originally estimated. Of course, the reverse is also true. Changes in the reported income of a relatively small group of taxpayers will have a significant impact upon the revenue available to fund state services. This state's current situation is not unprecedented. The situation was very similar only eight years ago when California reported a dramatic reduction in income tax revenue following the dot.com bust.

Figure 1: Relative Reliance by State upon Personal Income Tax Revenue

	Personal Income Tax Revenue as a Percent of Total State Tax Revenue (FY 2008)
Oregon	68.50%
Massachusetts	57.20%
New York	55.90%
Virginia	54.90%
Colorado	52.70%
Connecticut	52.40%
Georgia	48.60%
North Carolina	48.30%
California	47.50%
Maryland	47.20%
United States	35.90%

Source: NCSL based on data from BLS.

Fig. 2: General Fund Receipts 1 July – 31 August 2010

Numbers in millions of USD

Revenue Source	Actual Receipts to Date	2010-11 May Revisions	Actual Over (Under) Estimate
Corporate Taxes	293	358	(65)
Personal Income Taxes	6,032	6,123	(91)
Retail Sales and Uses Taxes	4,492	4,298	194
Other Revenue	867	732	135
Total General Fund Revenue	**11,684**	**11,511**	**173**
Non Revenue	187	49	138
Total General Fund Receipts	**11,871**	**11,560**	**311**

Source: California State Controller

12 For further detail on the manner in which the state's primary general fund revenue sources have changed over time, see Table I in the appendix to this report

13 The incremental 1% is defined as a mental health surcharge and applies to residents with USD1million of earned income

As the Legislative Analysts Office described it afterwards:
Tax revenues peaked at USD 17bn in 2000-01, but fell abruptly following the stock market decline - to under USD 6bn in 2001-02. This unprecedented 66% decline is the key factor behind the USD 10bn plus annual mismatch between revenues and expenditures.

Volatility is inherent in a highly progressive personal income tax, but it can be accommodated through the proper application of expenditure constraints and the use of rainy day reserves. Although state spending since 1998-99 has actually grown at a rate less than the combined rate of inflation and population growth, the state has not been able to accumulate sufficiently large fiscal reserves in anticipation of the inevitable drop in revenue. Rather, per capita General Fund spending reacts almost immediately to the availability of revenue. According to a presentation by the LAO to the legislative conference committee on the budget, expenditures rose sharply coincident with the technology boom, retreated temporarily, and rose again sharply from 2004-2007. Figures 3 and 4 provide a breakdown of the state's general fund cash balance position as of 31 August and the state's overall general fund disbursements for FY10.

Fig. 3: General Fund Cash Balance: 31 Aug. 2010

Numbers in millions of USD

	Actual Cash Balance	May 2010-11 Revision Estimate	Actual Over (Under) Estimate
Beginning Cash Balance August 1, 2010	(9,922)	(11,700)	1,778
Receipts Over (Under) Disbursements to Date	(3,926)	(5,428)	1,502
Cash Balance on August 31, 2010	(13,848)	(17,128)	3,280

Source: California State Controller

Fig. 4: General Fund Disbursements 1 July – 31 August, 2010

Numbers in millions of USD

	Actual Disbursements to Date	2010-11 May Revision	Actual Over (Under) Estimate
Local Assistance	10,793	13,876	(3,083)
State Operations	3,807	3,248	559
Other Payments	1,197	(136)	1,333
Total Payments	15,797	16,988	(1,191)

Source: California State Controller

Fiscal and Economic Update
When Governor Schwarzenegger declared a state of emergency on 28 July, he cited the state's weak economic performance and resulting revenue shortfalls as motivation for his action. He ordered additional furloughs for state workers in an attempt to preserve cash and to avoid the use of registered warrants. Six weeks later, the legislature remains deadlocked with opposing parties promulgating either further expenditure reductions or higher taxes and fees for service. The budget deficit, estimated at approximately USD 19bn, is a breathtaking sum of money and is unlikely to be solved by a single approach.

There is little doubt that the California housing market remains distressed. The controller's office reports that 13% of all home mortgages in the State are either seriously delinquent (60+ days) or in foreclosure. The state unemployment rate also remains elevated at 12.3% and is probably understated as a result of a low labor force participation rate. And to provide a further illustration of the severity of the recession, as if any were really needed, the Board of Equalization estimates that taxable sales dropped by 20.8% state-wide from second quarter of 2007 to the second quarter of 2009.

<u>The Outlook: Cautious Optimism</u>
Data compiled by the Nelson A Rockefeller Institute of Government reinforce the notion that California's tax collections are likely to move more quickly and more abruptly than other states. According to the Rockefeller Institute, tax revenue collections declined in the first quarter of 2010 in 34 of the 49 states for which comparable data are available. California, however, reported an increase in personal income tax collections and in sales tax collection in the first quarter of 2010 when contrasted with a year earlier. A tax increase may have been a contributing factor to the state's above average performance.

This data was subsequently reinforced by the state Controller's most recent monthly report for August. In it, Controller Chiang reports that General Fund revenue was USD 265mn higher than forecast in the May revision. The principal driver, as you would expect, were higher than anticipated collections of personal income taxes and sales taxes, as illustrated in Figure 2. In examining the data included in this table, keep in mind that these results include collections in August and in the preceding month of July, which was relatively weak. If we compare collection year-over-year by first examining collections in 2009, the results are more favorable. Compared with the first two months of fiscal year 2010 (July-August 2009), general revenue receipts were up by almost USD 500mn. The California Department of Finance reports a state-wide increase in total private payroll jobs of 13,700 in July. The number was insufficient to offset the reduction in government employment, but the bump in private sector hiring was a positive development nonetheless.

As the Controller recently conceded in his September report, a return to robust economic growth is unlikely in the near term. Corporate income tax receipts are still showing some decline and the housing market is moribund. The real challenge for California is facing up to the reality that its entire system of government finance is tied to the expectation of future economic growth. We are convinced that the powerful engine of the California economy will eventually succeed in providing such growth. There can be no meaningful national recovery without participation by California; the state's gross state product accounts for 13.4% of national GDP. That said, it may take longer than in the past to generate sufficient revenue to erase the accumulated deficit and address spending pressures that were deferred during the recession.

No discussion of the State's financial position would be complete without at least a cursory review of its pension liabilities. And while a detailed discussion of California's unfunded accrued actuarial liability must await a subsequent report on national public pension trends, it is worth discussing a few points here. At the end of the most recent fiscal year, the State had funded approximately 83% of its aggregate estimated pension liabilities. While this percentage is reduced from prior years, and bears little resemblance to the tradition of nearly full funding prior to 2000, the existence of an unfunded pension liability is not unique.

There is little immediate budget impact to the State by reducing its funding contribution in times of fiscal stress. States and their subdivisions amortize their liabilities over a much longer period than do private sector enterprises. And, contrary to the inferences made in may popular media articles, a failure to make a full payment in any one year will not trigger insolvency. Of course, the liability must be addressed over time and the longer one waits, the more difficult proper funding becomes. Many governments in California floated pension obligation bonds to finance their contribution to the pension system under the assumption that earnings would exceed the interest cost on the debt. This assumption has not yet proven out as subsequent investment losses and benefit increases undermined the strategy.

We expect California and all other states to gradually move in the direction of defined contribution plans. The transition will take at least a generation to complete but there appears to be few alternatives. New employees are unlikely to receive the same benefits of employees already enrolled in the system and all participants are likely to be asked to contribute more. Retirement benefits are generous and public sector compensation levels are no longer divergent from those found in the private sector; popular dissatisfaction with the level of benefits may just be the impetus necessary to convince state and local governments in California and elsewhere that renegotiation of benefit packages is inevitable and may as well be undertaken sooner rather than later.

Debt Commentary

We turn our attention now to several of the State of California securities most actively traded in the municipal market, including its general obligation and state public works board bonds as well as its revenue anticipation notes.

California General Obligation Bonds

The State of California is the single largest issuer of general obligation bonds in the United States and must rely upon its continued access to the capital markets for the cash necessary to finance myriad capital projects. Approximately 85% of the State's outstanding debt is categorized as general obligation. The California Constitution authorizes the sale of general obligation bonds with maturities up to 50 years, provided the bonds have received the approval of a simple majority of voters at a state-wide election. In practice, bond market dynamics usually will dictate a shorter term of 20 to 30 years. The state's debt ratios are manageable with debt service per capita at USD 128. Total State General Fund debt outstanding represents approximately 4.4% of the State's GDP and annual debt service represents a mere 0.33% of statewide personal income. The state's current GO credit ratings are A1 by Moody's and A- by S&P and Fitch. For the history of California's GO credit ratings, see Table II in the appendix to this report.

California's G.O. Bonds are secured by a pledge of its "full faith and credit" for repayment. In other words, the State pledges to collect annually the revenue necessary to pay principal of and interest on its outstanding debt. While the constitution does not set forth a specific priority of payment for general obligation debt service, investors typically have concluded that it ranks second among all types of expenditures. Since 1916, the California constitution has compelled the state to provide financial support for primary and secondary education.[14] In the absence of any such specificity for other types of obligations, the full faith and credit pledge for the repayment of debt is interpreted by the State to be next in order of priority. The payment of debt service on State general obligation bonds is further secured by a continuing appropriation from California's General Fund, thereby reducing the risk that budget delays will trigger a default on the debt

Of course, this interpretation raises the question: what happens if voters were to establish a compulsory expenditure with a higher priority through the initiative process? Such an action would undoubtedly trigger litigation but there is no established precedent upon which the courts might rely. Proposition 98 simply established the minimum funding level for a type of expenditure that already enjoyed primacy in terms of state obligations. Given the degree to which California has disclosed its interpretation of the priority of payments in Official Statements, we believe investors could make a reasonable argument that any change would represent impairment of the contract between Cali-

14 Generally interpreted to mean Kindergarten through community college.

The following description is found in the disclosure document prepared in conjunction with its Revenue and Anticipation Notes, Series 2008-09 A1:

The State of California has set forth its interpretation of the Priority of Payments for creditors in Official Statements.

(i) support the public school system and public institutions of higher education;

(ii) pay principal of and interest on general obligation bonds and general obligation commercial paper notes of the State,

(iii) provide reimbursement from the General Fund to any Special Fund of account of the State, to the extent required by law for moneys advanced …from Special Funds to the General Fund; and

(iv) pay State employees' wages and benefits, State payments to pension and other State employee benefit trust funds, State Medi-Cal claims, lease payments to support lease revenue bonds, and any amounts determined by a court of competent jurisdiction to be required to be paid pursuant to federal law or the State Constitution with State warrants that can be cashed immediately

Note: There is reason to believe that prior year obligations, those representing costs already incurred but for which payment has not been made, represent the highest priority. One example would be vendor payments for services provided to the State prior to the close of the previous fiscal year. The precise legal status of such payments, relative to the priority of payments set forth above, is undefined. However, as they represent a manageable liability, payment in those instances should not interfere with G.O. debt service.

The State Controller retains broad authority to decide which payments are made, to whom they are made, and when invoices will be honored. Until such time as either a state court or the Controller specify a different priority of payments (and we view this as very unlikely), the current interpretation provides some comfort for California general obligation bonds investors.

fornia as the borrower and its investors as the lender.

California spreads biased somewhat wider

Despite volatility, yield spreads between tax-exempt California GO debt and national benchmark 'AAA' high grade paper have improved from the wide levels attained during the state's cash crisis in June/July 2009. The yield difference at the 10-year maturity point stands at +96bps, nearly 100bps narrower than spreads prevailing last summer. In the 30-year area of the curve, where the issuance of taxable Build America Bonds and demand patterns of institutional investors have more of an impact, spread compression has not been as significant. There, the spread on California GOs compared to high grade munis is 132bps, down roughly 40bps from as high as 172bps in December 2009 (see Figure 5). That said, negative headlines regarding the continued budget impasse and the prospect of IOU issuance have caused modest spread widening in recent weeks. For historic information on California GO bond credit spreads at the 5, 10 and 30-year maturity since January 2001, see Chart I in the appendix to this report.

Comparing California GO bonds to single A rated general market benchmark data shows current yield premiums of 18bps and 68bps on 10-year and 30-year bonds, respectively. Yields on CA GO's at the front part of the curve are close to A rated national levels, while the longest dated CA bonds nearly match BBB yields as can be seen in Figure 6. Since 2001, which includes the period when California carried 'Baa1/BBB' ratings in 2003/2004 and again in July 2009, CA bond yields in the 10-year spot fluctuated from -48bps to a high of 79bps in March 2010 versus single 'A' levels. Relative to 'BBB' benchmarks, the state's 10-year debt traded at yields ranging from -9bps to -222bps over the same time frame and currently stands at -85bps.

Note that several factors complicate the comparison of current California spreads to historical levels. First, credit spreads and term spreads across the municipal market remain elevated. A second consideration is that California's debt levels have risen steadily and substantially over the past decade. Third, taxable Build America Bond issuance has reduced long-dated tax-exempt supply and finally rating recalibration processes that took place earlier this year introduced some measurement issues for credit quality spreads.

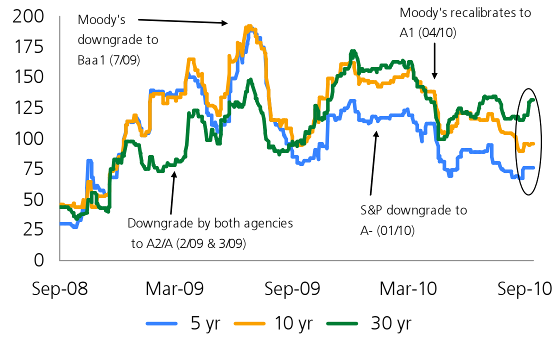
As mentioned, negative headlines regarding the continued budget impasse and the prospect of IOU issuance has caused modest spread widening in recent weeks. In the near term, some pressure on spreads could continue as higher new issue supply and increased headline risks bring more focus on the state's weak fiscal condition. The degree of further spread widening will depend in large part on whether the state is compelled to issue IOUs, in our view.

State Public Works Board Bonds

The State Public Works Board (SPWB) was created by the Legislature to manage the financial contracts associated with the acquisition of real estate and construction of capital facilities for state agencies. Voting members include the Directors of Finance, Transportation, and General Services. When the Board issues bonds, the voting membership is expanded to include the State Controller and the State Treasurer.

Fig. 5: CA GO vs. AAA general market spreads (bps)

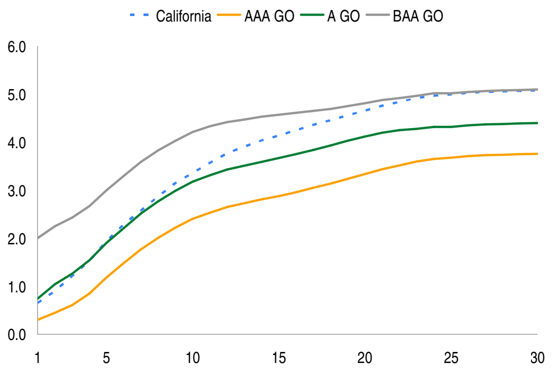
Recent spread widening has occurred on budget woes.



Source: MMD Interactive, WMR as of 17 September 2010

Fig. 6: CA GO vs. general market yield curves (%)

CA GO yields match 'A' rated general market levels at the front of the curve and 'Baa' levels at the long end.



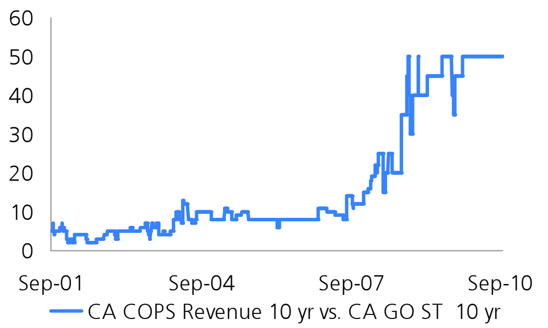
Source: MMD Interactive, WMR as of 17 September 2010

The SPWB also issues lease-revenue bonds; these bonds are secured by lease payments made by the State on behalf of its operating departments. The bonds are subject to abatement in the event the State, through its department, does not have beneficial use and possession of the leased assets.

The SPWB lease revenue bonds typically pay a higher rate of interest to investors than do the State's general obligation bonds. Given the widespread use of lease revenue bonds by the State and its operating departments, the risk of abatement is small but the distinction is important. The accompanying chart illustrates the spread between the yields of California G.O. bonds and the Public Works Board lease revenue securities over time. Since the broad credit crisis began in late 2007, spreads between the state's GO debt and its lease revenue bonds steadily widened before moderating in the 50bps range in 2010. Figure 7 shows the spread between 10-year California lease revenue bonds versus comparably maturing state GO debt. Spreads are much wider now, up from just 15bps pre-crisis levels.

Fig. 7: CA lease revenue vs. CA GO spreads (bps)

Spreads on lease debt have steadily widened before moderating at 50bps.



Source: MMD Interactive, WMR as of 17 September 2010

Short-term Borrowing: Revenue Anticipation Notes

As we have discussed, the personal income tax is an essential source of revenue for government operations. The personal income tax, however, is not collected in equal installments during the year. In some months, particularly during the last quarter of each fiscal year, the state government is awash with cash as taxpayers file their state income tax returns. In other months, it must engage in a substantial amount of internal borrowing to have the cash necessary to pay salaries and invoices, among other items. Disbursements often are made from the General Fund according to regulatory and statutory requirements without regard for the state's own cash flow cycle. According to the Legislative Analyst's Office (LAO), nearly 60% of these disbursements were made during the first half of the fiscal year.

Internal borrowing to accommodate this fundamental mismatch is a generally-accepted practice. The State Controller borrows money from hundreds of periodically dormant special accounts with accessible cash balances and repays those accounts as taxes and fees are received. The LAO estimates the state has access to as much as USD 15bn through this established procedure. In and of itself, internal borrowing is not a cause for concern.

To supplement this type of internal borrowing, the State also sells Revenue Anticipation Notes, or RANs. RANs are issued by California in almost every year to supplement its internal borrowing and provide the cash necessary to carry it through those months of the year when its principal sources of revenue are not collected in large enough amounts. Each RAN is a promise by the State to repay the amount of money it borrowed (the principal) with interest. They do not represent general obligations of the State. The State pledges to repay RANs from all available money by the last day of the fiscal year in which it borrows the cash. By repaying the RANs in the same year in which the money is borrowed, the State complies with the constitutional prohibition against the creation of a multi-year debt without a popular vote. The sale of RANs, like incidental internal borrowing for the purpose of accommodating uneven revenue flow, does not by itself indicate the existence of financial difficulties.

Fig. 8: Historical RAN pricing

Sale date	Maturity	Pricing coupon /yield (%)	MMD bench-mark[1]	Spread
9/24/2001	Jun-02	3.25/ 2.22	2.13	0.09
10/28/2002	Jun-03	2.75/ 1.60	1.70	-0.10
10/20/2003	Jun-04	2.00/ 1.03	1.03	0.00
10/31/2005	Jun-06	4.50/ 3.00	3.00	0.00
9/25/2006	Jun-07	4.50/ 3.35	3.53	-0.18
10/22/2007	Jun-08	4.00/ 3.37	3.40	-0.03
10/13/2008	May-09	5.50/ 3.75	2.20	1.55
10/13/2008	Jun-09	5.50/ 4.25	2.25	2.00
9/21/2009	May-10	3.00/ 1.25	0.38	0.87
9/21/2009	Jun-10	3.00/ 1.50	0.40	1.10

[1]MMD MIG 19-month and 8-month spots.

Source: MMD, Bloomberg, UBS WMR

Until recently, the State of California's RANs were prized among investors for their relative safety. As Figure 8 indicates, California historically sold its short-term notes at rates that were equivalent to a broader market index for short-term obligations. However, as investor concern with the State's structural budget deficit increased, the rates demanded for these short-term instruments increased markedly.

Given the strong demand for short-term munis, we would expect this year's RANs (once a budget is enacted) to price at tighter spreads than last year's note sale, but still at a noteworthy yield pick-up to high grade benchmarks.

Revenue Anticipation Warrants and IOUs

There is more discussion than ever about the prospects for the State of California to issue either Revenue Anticipation Warrants ("RAWs") or IOUs (also called registered warrants). The distinction between these two instruments is subtle but important. Unlike RANs, RAWs can be issued without a budget in place and can mature beyond the fiscal year in which they are issued. The longest maturity for a series of RAWs thus far has been 21 months. Their sale requires the active participation of the governor who must approve the sale and authorize their use as part of a reimbursement procedure in the State General Fund. Technically, the RAWs are a tool by which the state government reimburses itself for expenditures made from its General Fund. Practically, the sale of RAWs in lieu of conventional RANs is an unwelcome development and indicative of fiscal stress.

A registered warrant is a security that represents an "IOU" from the state government. Registered warrants are similar to checks which cannot be cashed by the recipient until the state government has the requisite cash to honor their presentation. The warrants accrue interest while they are held by the creditor. When the state was obliged to issue IOUs in the past, the maturity date was established after the close of the current fiscal year and a day or two after a long-term G.O. bond was scheduled to mature. The establishment of the later date was purposeful as state officials wished to publicly reaffirm the importance of G.O. bonds; the warrants fell in line behind that month's G.O. bond debt service.

So how do the warrants bypass restrictions governing the creation of long-term debt? The California courts have validated temporary external borrowing that meets the "appropriation doctrine". Under this doctrine, an obligation is not considered a debt or liability within the State Constitutional limitation on indebtedness if an appropriation is made from existing funds or funds which are reasonably anticipated to arrive shortly. The registered warrant represents actual payment to the creditor; the recipient of the warrant knows the date on which payment will be made with interest. Meantime, the warrant is a negotiable instrument which can be sold to third parties. Of course, investors properly view the sale of registered warrants as evidence of fiscal distress; their use may be necessary but does not represent a solution to more intractable problems.

Concluding Observations

- We expect the State of California to take all necessary steps to pay for G.O. debt service in full and on time.

- The State Public Works Board lease revenue bonds currently offer investors an incremental 45-50bps of yield, according to Municipal Market Data (MMD), in compensation for the lower priority of payment and abatement risk. We believe this is justified and the bonds offer reasonable value (on a relative basis) at these levels. Any spread compression between the G.O. and the Lease Revenue Bonds would lead us to favor the G.O. Bonds. Note that actual spreads vary depending on coupon structure, callability and lot size.

- Most county governments are very well managed and accustomed to periodic delays in the receipt of state-shared revenue. Even so, we believe county governments in California are the units of government most susceptible to fiscal stress during economic recession. Investors deserve to be paid a significantly higher yield – at least relative to the State's own obligations – for these securities. City governments, in contrast, have a broader array of revenue options at their disposal than do counties.

- In general, we favor essential service utility revenue bonds as among the safest alternatives for investors. Water and sewer revenue bonds and municipal electric revenue bonds from established issuers should provide greater comfort to investors concerned with long-term credit risk following this most recent economic recession.

Table I: General Fund Revenues

Category	Source	1978-79	1988-89	1998-99	2008-09	Percent Change 1978-2008
	Alcoholic Bev. Taxes & Fees	140,059	128,264	273,113	323,934	
	Corporation Tax	2,381,223	5,137,995	5,724,002	9,535,679	400%
	Cigarette Tax	189,780	162,221	150,190	107,250	
	Pari-mutual License Fees	98,543	102,584	23,619	2,768	
	Estate, Inheritance & Gift Tax	416,955	335,092	890,488	245	
	Insurance Gross Premium Tax	420,184	1,317,630	1,253,972	2,053,850	489%
	Trailer Coach License (In-Lieu) Fees	0	0	34,284	28,653	
	Retail Sales and Use Tax	5,779,234	12,577,297	18,957,484	23,753,364	411%
	Personal Income Tax	4,761,571	15,885,651	30,891,480	43,375,959	911%
Major Revenues		14,187,549	35,646,734	58,198,632	79,397,874	
	California State University Fees	0	304,605	0	0	
	Pooled Money Investments	446,352	441,153	308,573	109,289	
	Surplus Money Investments	0	16,763	6,578	5,259	
	State Lands Royalties	6,617	25,718	9,646	328,263	
	Abandoned Property	0	65,599	176,455	272,286	
	Settlements & Judgments	0	0	0	56,762	
	All Other Minor Revenue	259,939	281,389	229,361	1,575,887	
Minor Revenues		712,908	1,135,227	730,613	2,347,746	
SCO Adjustments	Adjustments to Reconcile	0	0	4,967	0	
Transfers and Loans		318,047	170,938	-318,921	1,026,492	
Grand Total		15,218,503	36,952,899	58,615,291	82,772,112	

Numbers in 000s
Source: California Legislative Analysts Office

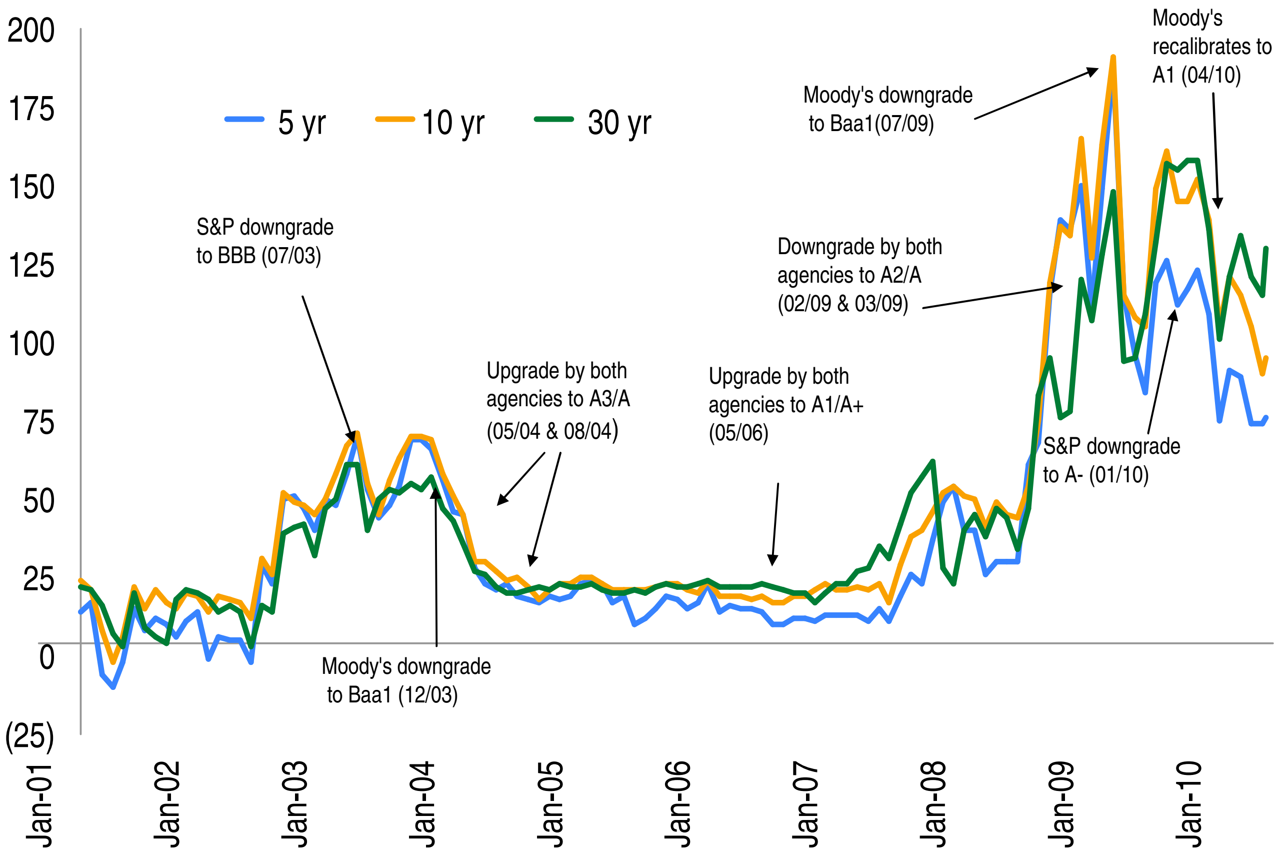
Table II: History of California's General Obligation Credit Ratings

	Fitch		Moody's		S&P
Apr-10	A-	Apr-10	A1	Jan-10	A-
Jul-09	BBB	Jul-09	Baa1	Feb-09	A
Jun-09	A-	Mar-09	A2	May-06	A+
Mar-09	A	May-06	A1	Aug-04	A
Jun-06	A+	Jul-05	A2	Jul-03	BBB
Jul-05	A	May-05	A3	Dec-02	A
Sep-04	A-	Dec-03	Baa1	Apr-01	A+
Dec-03	BBB	Aug-03	A3	Sep-00	AA
Dec-02	A	Feb-03	A2	Aug-99	AA-
Feb-00	AA	Nov-01	A1	Jul-96	A+
Oct-97	AA-	May-01	Aa3	Jul-94	A
Feb-96	A+	Sep-00	Aa2	Jul-92	A+
Jul-94	A	Oct-98	Aa3	Dec-91	AA
Sep-92	AA	Jul-94	A1	Jul-86	AAA
Feb-92	AA+	Jul-92	Aa	Feb-85	AA+
Jul-86	AAA	Feb-92	Aa1	Jan-83	AA
Oct-82	AA	Oct-89	Aaa	Jan-80	AA+
Jan-80	A	Apr-80	Aa	May-68	AAA

Source: California State Treasurer

Chart 1: 5, 10 and 30-year California GO versus AAA general market spreads (bps)

Spreads have been volatile since the onset of the credit crisis in late 2007.



Source: MMD Interactive, Rating agency reports, WMR as of 17 September 2010

Appendix

Statement of Risk

Municipal bonds: Although historical default rates are very low, all municipal bonds carry credit risk, with the degree of risk largely following the particular bond's sector. Additionally, all municipal bonds feature valuation, return, and liquidity risk. Valuation tends to follow internal and external factors, including the level of interest rates, bond ratings, supply factors, and media reporting. These can be difficult or impossible to project accurately. Also, most municipal bonds are callable and/or subject to earlier than expected redemption, which can reduce an investor's total return. Because of the large number of municipal issuers and credit structures, not all bonds can be easily or quickly sold on the open market.

Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
GO	General Obligation Bond	TEY	Taxable Equivalent Yield (tax free yield divided by 100 minus the marginal tax rate)
MMD	Municipal Market Data		

	Rating Agencies			Credit Ratings
	S&P	Moody's	Fitch/IBCA	Definition
Investment Grade	AAA	Aaa	AAA	Issuers have exceptionally strong credit quality. AAA is the best credit quality.
	AA+	Aa1	AA+	Issuers have very strong credit quality.
	AA	Aa2	AA	
	AA-	Aa3	AA-	
	A+	A1	A+	Issuers have high credit quality.
	A	A2	A	
	A-	A3	A-	
	BBB+	Baa1	BBB+	Issuers have adequate credit quality. This is the lowest Investment Grade category.
	BBB	Baa2	BBB	
	BBB-	Baa3	BBB-	
Non-Investment Grade	BB+	Ba1	BB+	Issuers have weak credit quality. This is the highest Speculative Grade category.
	BB	Ba2	BB	
	BB-	Ba3	BB-	
	B+	B1	B+	Issuers have very weak credit quality.
	B	B2	B	
	B-	B3	B-	
	CCC+	Caa1	CCC+	Issuers have extremely weak credit quality.
	CCC	Caa2	CCC	
	CCC-	Caa3	CCC-	
	CC	Ca	CC+	Issuers have very high risk of default.
	C		CC	
			CC-	
	D	C	DDD	Obligor failed to make payment on one or more of its financial commitments. this is the lowest quality of the Speculative Grade category.

UBS FS and/or its affiliates trade as principal in the fixed income securities discussed in this report.

Appendix

Disclaimer