Too Big to Fail

Despite California's massive fiscal problems, observers think the state's future is still golden.

BY DANIEL WEINTRAUB

The letter was a plea for help.

"A fiscal meltdown by California… would surely destabilize the U.S., if not worldwide, financial markets," state Treasurer Bill Lockyer wrote last spring to U.S. Treasury Secretary Timothy Geithner.

The appeal came after California raised taxes, cut spending, prepared to pay its bills with IOUs, sent employees home on furloughs and still faced a multi-billion cash shortage. In his letter, Lockyer, a former Senate leader, asked if the federal government would co-sign on a loan, allowing the state to improve its cash flow and pay its bills on time.

The reaction was a swift "no." And not only from the federal government. Even though the assistance would not have been a true bailout because no cash would have changed hands from the feds to the state treasury, at least in the short term, plenty of observers saw the request as the first step on what could be a very slippery slope. If the federal government gave special assistance to California, why not New York, or Florida, or any of the other states hard-hit by the deepest recession since the Great Depression?

But the exercise did serve one useful purpose. It placed in the public sphere a question many people had been discussing in private whispers: Is California too big to fail?

That is an issue as relevant now as it was then. Even though the state adopted a budget over the summer and climbed back from the edge of the fiscal abyss, its troubles have not ended. The state still faces a multi-billion structural shortfall between spending and revenues, and that's assuming the economy has hit bottom and will rebound in 2010.

The question arises because California is different, in so many ways. Its population of 38 million is, of course, the largest in the nation. Its general fund budget of $91 billion is nearly twice as big as New York's, the next biggest state. Its gross state product of $1.8 trillion makes its economy, even in its weakened condition, the eighth largest in the world.

Then there's politics. California has 55 electoral votes, and they all went for Barack Obama in 2008. The state is home to U.S. House Speaker Nancy Pelosi of San Francisco and Dianne Feinstein, a key player in the U.S. Senate. More than most places in the United States, California has an image of its own around the world: home of Hollywood stars, beautiful beaches, majestic mountains, Central Valley farms that feed millions, and the Silicon Valley, birthplace of the information revolution. It is, in short, one of the richest places on the planet. If California fails, would anyplace be safe from financial ruin?

A HUGE HOLE

The state is certainly in deep trouble. Its unemployment rate of 12.2 percent as of August is higher than all but three states—Michigan, Nevada and Rhode Island. Exports, once a major source of economic growth, have cratered. The state has had more foreclosures than anywhere in America, and California's foreclosure rate of about one in every 200 homes is twice the national average.

In the past year alone, California has lost 190,000 jobs in the construction and finance industries, which had been a major job creator in a state rapidly losing its manufacturing workforce. The latest bad news was a decision by General Motors and Toyota to close the state's last remaining automobile manufacturing plant, in Fremont in the San

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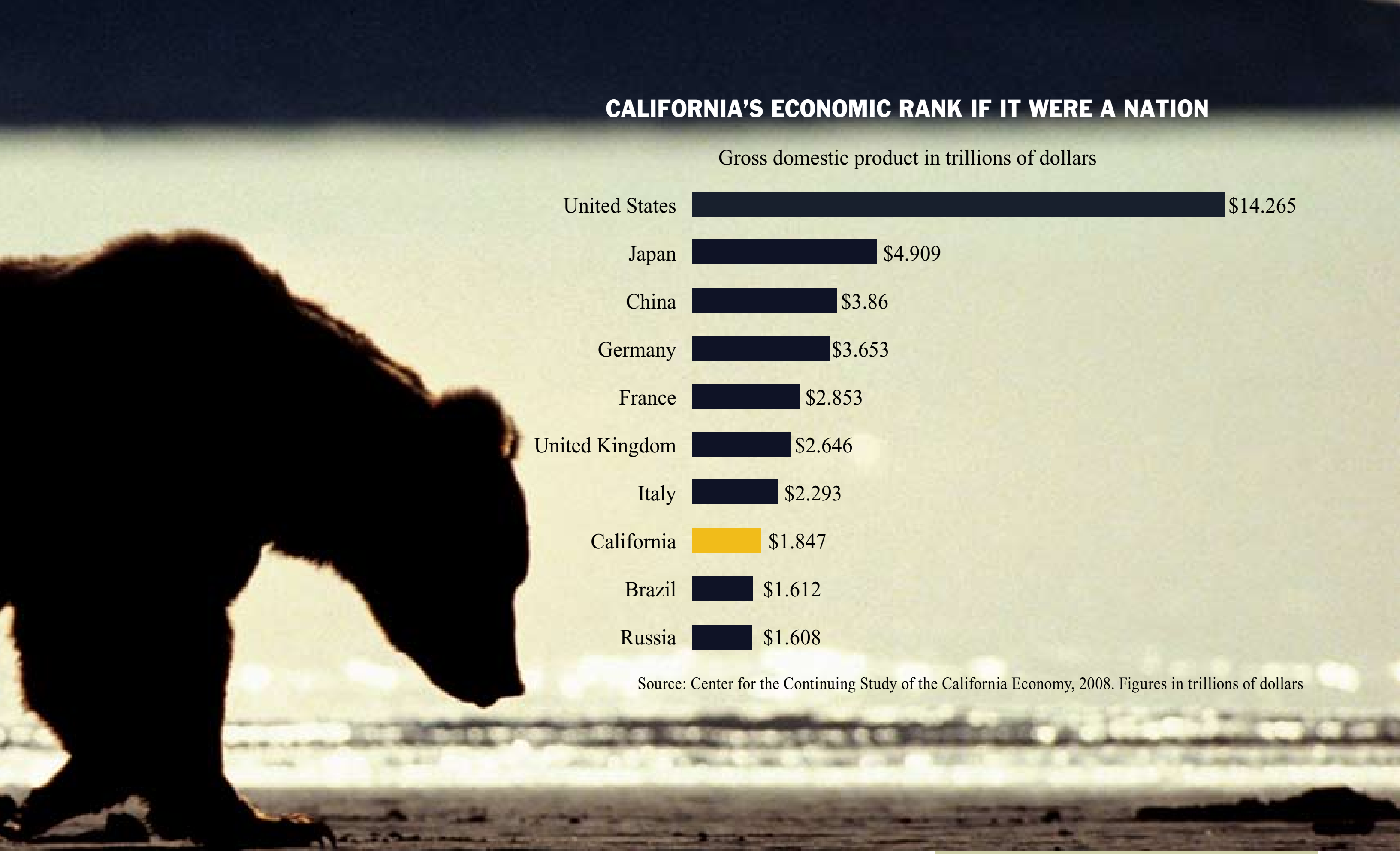

Francisco Bay Area.

The effect on the state's fiscal condition has been swift and certain. Although California had several years of strong economic growth, it never managed to erase the structural deficit that emerged after the dot-com crash. The latest recession dealt a blow that even a well-managed government would have found difficult to weather. Revenues dropped by about $16 billion over two years, despite a $10 billion tax increase that included higher levies on personal income, sales and cars. The state has cut employee pay the equivalent of 14 percent with three unpaid furlough days a month; cut aid to the aged, blind and disabled; reduced spending on schools and universities; and is trying to cut $1.2 billion from its prison system. And there is more to come.

But the question remains: Is there anything the federal government can or should do for California that it's not doing for the rest of the country? Do the people in the other 49 states have a stake in California's success?

At least some experts on the California economy say the simple answer is probably not. California's fortunes are so intertwined with those of the rest of the country, and the world, that the best way for this state to get better is for everyplace else to get better, too.

"The things that will make California grow rapidly as an economy will, at the same time, help the nation," says Stephen Levy, director of the Center for the Continuing Study of the California Economy. "Those things—expanding world trade and successes in alternative energy, medical records technology, the application of technology to our problems—are all things California excels at."

JOBS WILL RETURN

So far, at least, California's downturn, while ugly, has been a cyclical recession. Unlike 1991, when its aerospace industry disappeared, or 2001, when the tech bubble burst and computer industry jobs vanished, the biggest damage in this recession has been to housing and related industries. But other than some finance companies that served people in other states, these are mostly local jobs that will return once the housing market bottoms out and people start buying again.

It's not as if California's houses can be built by outsourcing the work to India. The state's population is still growing by about 500,000 people a year. People will buy houses again, some day. And when they do, those houses will be built, marketed and sold by Californians. Many, if not all, of those lost jobs will come back.

Do people in the other 49 states have a stake in California's success?

"California is going to come out of this just fine," says economist Christopher Thornberg. "Sure, we have a rough couple of years ahead of us. But we're going to be OK."

Thornberg, a principal in Beacon Economics, notes that California's deficit, while seemingly massive, represents only about 1 percent of the state's economy.

"The federal government would love to have that deficit," he says. "This is a political

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issue, not an economic issue. We could raise the money we need if we had the political will to do it, and it wouldn't be that damaging to the economy. We have to sort this out ourselves."

STIMULUS BOOST

It's not as if the rest of the country has not already been helping. Thanks to its size, California received a bigger share of the economic stimulus package than any other state. By the time the entire stimulus is spent, California expects to receive a whopping $85 billion. More than a third of that, or about $30 billion, will be in tax relief to California individuals and companies. Another $20 billion will go to health and welfare programs, and $11 billion to education. The rest will be divided mostly among transportation, energy, housing and environmental programs.

But there is still more the federal government could do to help without singling out California. It could increase aid to states with high poverty rates. California's rate of 12.7 percent is higher than many long-suffering Rust Belt states. The federal government could pay a larger share of the states' costs of dealing with illegal immigration. California spends more than $5 billion on that expense. And if the federal government did more to help the housing market, that would certainly help California, because the state has the most beleaguered housing market in the country.

New federal policies on housing, education and health care would probably do more to help the state than direct cash payments, says Senator Lois Wolk. She sees both sides of the issue of whether other states have a stake in California's future.

"On the one hand, the collapse of the eighth largest economy in the world would be felt everywhere," Wolk says. "The increasing globalization of our world economy gives each and every country a stake in the economic stability of the others. The rapid decline of the economy and how quickly it spread worldwide starting in November truly surprised me. However, the feds should demand that we get our own house in order, which we are reluctant to do."

SENATOR
LOIS WOLK
CALIFORNIA

Although the recession appears to be easing, even in California, no one knows if the recent glimmers of hope are sustainable. In the worst-case scenario, California's economy would worsen, retail sales would slow further, profits would drop more and incomes would decline for a third straight year, leading to an unprecedented drop in tax receipts. The state would be unable to pay its bills and might even default on its bonds. The courts would be buried in litigation as creditors and lawyers for the poor, the schools and local governments fought over whatever cash remained in the till. Although there is no provision for a state bankruptcy, at that point, either the federal courts or the executive branch might have to step in to bring order to the chaos, if nothing else.

Jed Kolko, an economist with the Public Policy Institute of California, said such fears about the state's economy imploding are overdone. On the other hand, he said, if California's economy really did collapse, there is probably nothing the federal government could do to help it.

"If California were to fail," Kolko says, "that would be because the whole nation or the whole world were failing. If California were really on the verge of failure then probably neither the federal government nor anyone else would be bailing us out."

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