

# California: Recovery from the Recession and the Great Budget Head Fake

*Jerry Nickelsburg, Senior Economist  
UCLA Anderson Forecast  
December 2009*

The end of the current recession is turning out much as we predicted. California's unemployment rate continues to increase from the past year, local government employment continues its decline and has now been joined by state government contraction - and 2009 personal income, when it is reported, ought to be lower for the entire year. The current forecast differs from the previous one in as much as our U.S. forecast is slightly more optimistic than before and our California forecast overlays that with a larger than expected reduction in state government spending. The net effect is to lower our forecast for California for the coming year.

Overall, the outlook for the balance of the new year is for little to no growth. The economy will begin to pick up slightly in the beginning of 2011 and by the middle of 2011 begin to grow at more normal levels. The keys to California's recovery remain in exports of manufactured and agricultural goods. Factoring in a recovery in U.S. consumption which increases the demand for Asian imports and for products from California's factories, increased public works construction, and increased investment in business equipment and software.

**Recent Trends - Labor Markets on the Mend** In December of 2008, our forecast was for labor markets to improve in California by the fourth quarter of 2009. The carnage of the first quarter - when a third of a million jobs evaporated and the ranks of the unemployed swelled by over 400,000 - has now ended.

Importantly, the CES data, which is based on a larger sample than the household, or CPS survey, showed growth in non-farm payroll employment of 25,700 jobs for October 2009. This is the first growth in payroll jobs in California since April 2008 and the largest growth in payroll jobs since July 2007, five months before the recession began.<sup>1</sup> In the four months ending in October, job losses are considerably lower than the previous trimesters and four sectors, health care, wholesale trade, non-durable goods manufacturing and education are moving into net additions to employment.

However, the private sector employment industries-- construction, durable goods manufacturing and retail -- have yet to show encouraging signs. Total employment in the construction sector continues to decline due primarily to the dismal state of nonresidential construction and the fact that stimulus supported infrastructure construction has yet to begin in earnest. On the building side, new permits for residential construction reached record low levels seven months ago and have neither moved up nor down since then. With housing prices stabilizing according to one index (FHFA) and rising according to another (Case / Shiller S&P) and with inventories low in the coastal cities we still expect to see residential construction beginning a recovery in 2010.

## **The Public Sector and the Great Budget Head Fake**

With respect to the jobs market, one curious anomaly stood out. With all of the hue and cry about the California state government running out of money and a monstrous \$40 billion plus shortfall in the combined fiscal 2008 and fiscal 2009 state budgets<sup>2</sup>, employment in state government barely budged.<sup>3</sup> When there are ostensibly huge cuts

<sup>1</sup> <http://www.labormarketinfo.edd.ca.gov/?PAGEID=94>.

<sup>2</sup> "In Budget Deal, California Shuts \$41 Billion Gap," Jennifer Steinhauer, New York Times, February 19, 2009.

"Deal Reached to Close California's \$26 Billion Budget Deficit," Judy Lin, CNS News/Associated Press, July 21, 2009.

"California at the Brink of Financial Disaster," Michael Genest, California Department of Finance, 1/13/2009.

in spending and little response in the direct employment supported by that spending, one is led to the conclusion that those spending cuts are, at least in part, not there. This answer had been hinted at for some time and was succinctly called out in a November LAO Report.<sup>4</sup>

In sports, a head fake is a move which gets you to look in the wrong direction for a sufficient amount of time so that when you discover that you have looked the wrong way, it is too late to correct the error. In this case it is a July budget agreement which purported to include sources of revenue and spending reductions which were anything but guaranteed. In fact it would have been reasonable to assume that at least some of the budget solutions could not come to fruition. This head fake resulted in the budget shortfall being lobbed forward into the next 2010-2011 budget years. The LAO report predicts that the budget will have to be balanced through a combination of spending cuts and (possibly) new revenues to the tune of 20+ billion dollars. Our estimates are slightly more optimistic, but only slightly. Some of the estimated fiscal 2010 budget shortfall is being generated by mandated increases in spending which will have to be offset by new revenues or cuts elsewhere in the state budget, and others are being generated by the need to make up for the shortfall in fiscal 2009 revenues.

Pronouncements from Sacramento<sup>5</sup> to the contrary, this was a head fake. The gap was never closed. All of us, including the legislative and executive branches of government, took the fake with some relief that the worst was now behind us and we had survived a major fiscal crisis. The fake lasted a third of the fiscal year. In November, the LAO reported that at least \$2.1 billion dollars of revenue would never materialize and \$4.1B billion dollars of cuts would not be made.

More specifically, programs for health care and corrections are larger than the fiscal 2009 budget agreement, an event which occurred as a consequence of legal and political challenges and of court orders precluding certain cuts. Several revenue sources, notably the sale of the state's Compensation Insurance Fund and the allocation of money from transportation funds, turned out not to be possible. Federal stimulus funds directed at making up budget gaps for state and local governments will expire along with some of the one-time changes to expenditures. Prop 98 mandated increases in educational funding must also be added to the fiscal 2010 budget. All of these factors represent an estimated \$20B challenge for the legislature and governor.

Changes to state spending of this magnitude are always problematic for economic growth. The initial reaction to the news of the fake was that this is a disaster for California. Perhaps, it was and perhaps it was not. Essentially, what has happened is an inter-temporal shift in spending from fiscal years 2010- 2011 to fiscal year 2009. But, inter-temporal transfers of government spending are not always necessarily bad. It all depends on the timing and cost of the transfer.<sup>6</sup>

So, theory is the best guide we have for interpreting the impact of the head fake on California, and theory says this head fake, while slowing growth in 2010 and 2011, was not necessarily a bad event at all. To be sure, the recurrent budget crises and the systemic problems of government finance in California are a huge negative and they will require fundamental reform if such painful and costly episodes are to be avoided in the future. But the impact of this particular event does not, as one might think at first blush, engender another economic disaster for the state.

---

<sup>3</sup> <http://www.labormarketinfo.edd.ca.gov>, January 8, 2009.

<sup>4</sup> "The 2010-11 Budget: California's Fiscal Outlook," Mac Taylor, Legislative Analyst's Office, <http://www.lao.ca.gov>, 11/18/2909.

<sup>5</sup> "Closing the \$60 Billion Budget Gap," California State Budget: 2009-2010, California Department of Finance, <http://www.dof.ca.gov>, July 28, 2009.

<sup>6</sup> For a survey see "Back to Keynes?" Frederick van der Ploeg, CESifo Economic Studies, vol. 51, 2005, <http://CESifoOxfordJournals.org>.