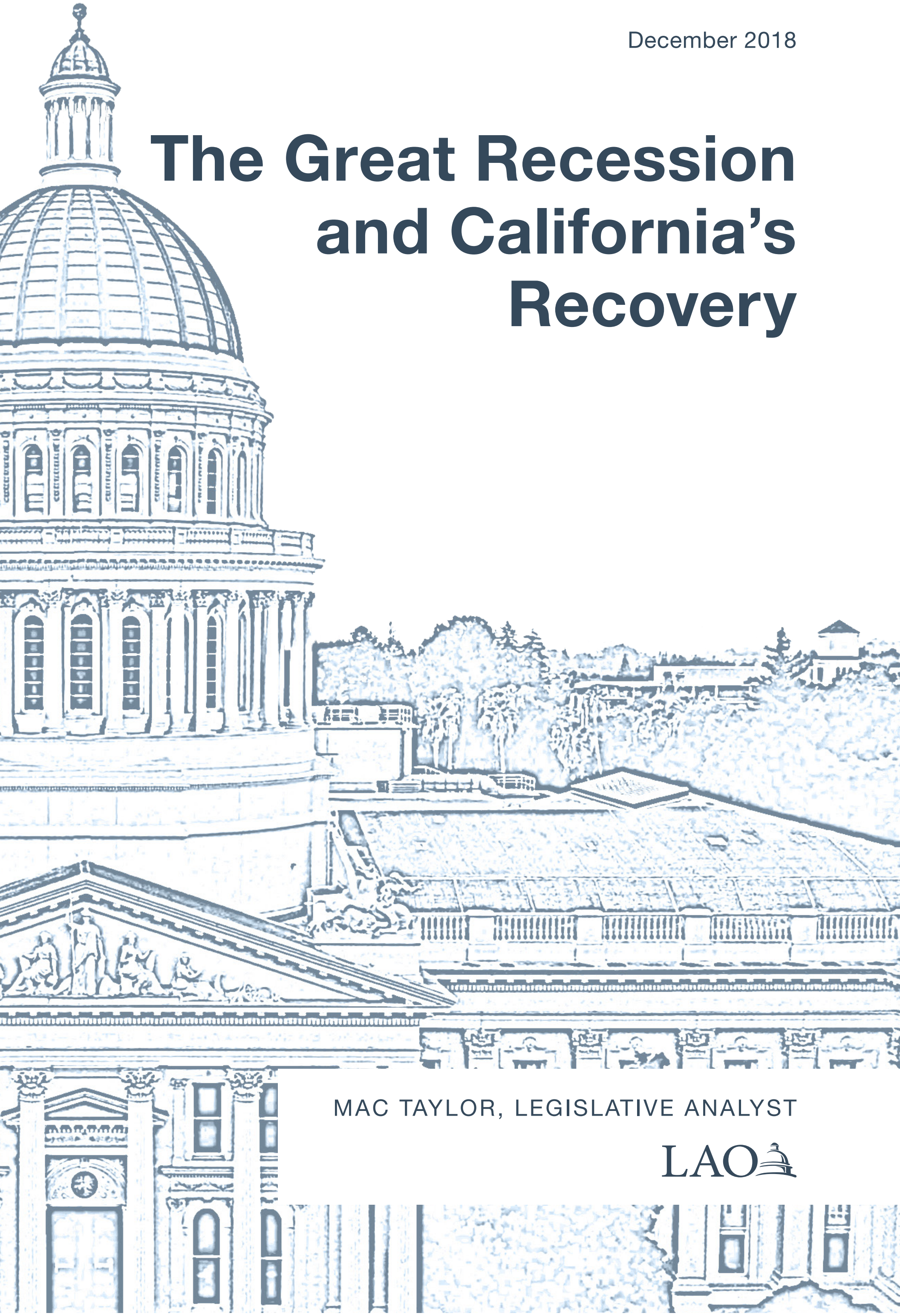
December 2018

# The Great Recession and California's Recovery



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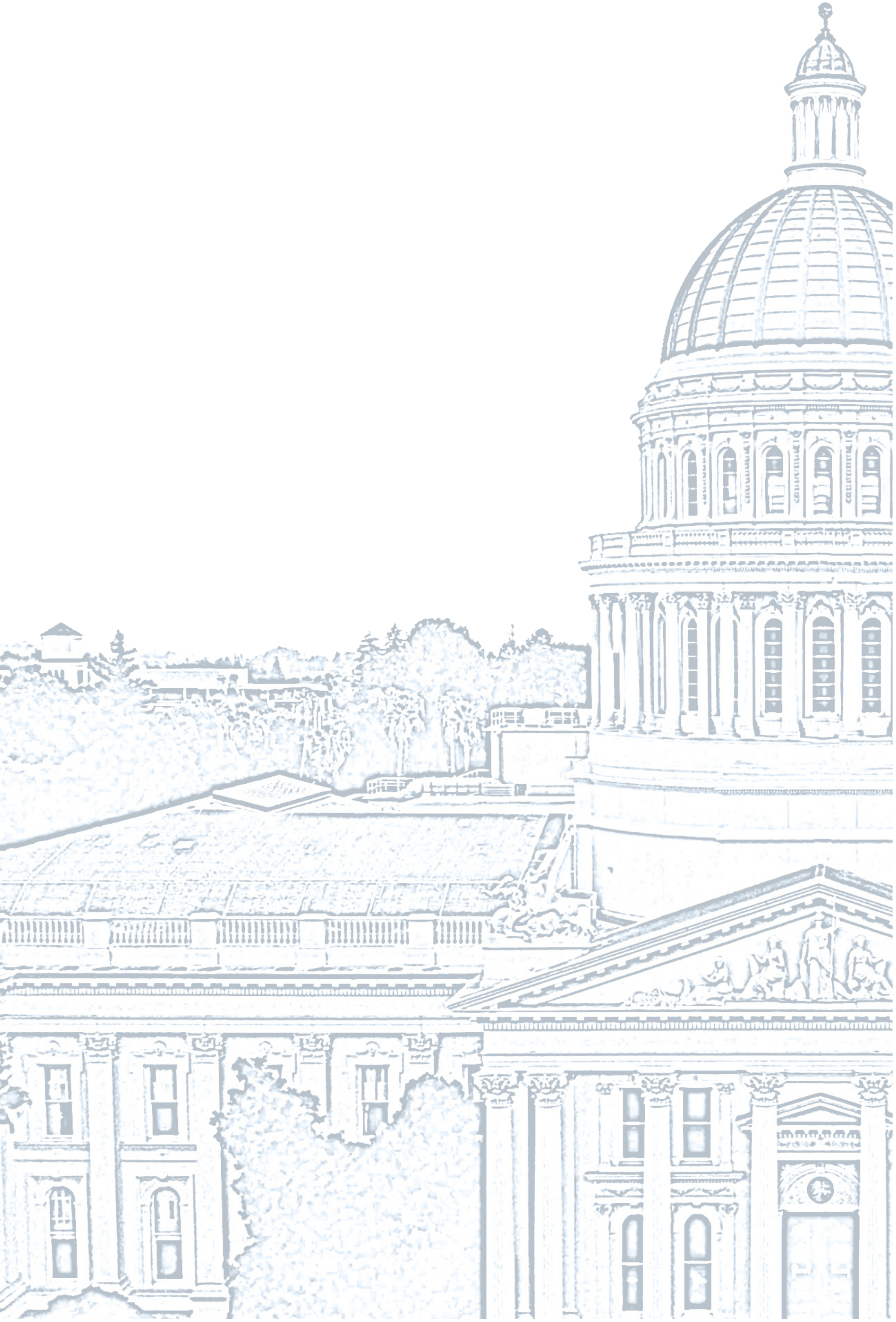


# Ten Years Ago…

On December 31, 2008, Governor Schwarzenegger's proposed budget projected a $42 billion deficit. This shortfall was stunning, but, in fact, it turned out to be optimistic. A few months later, the Governor's deficit projection was $15 billion larger. In the subsequent weeks, the Governor released two more revised budgets, each one addressing larger shortfalls. In the months that followed, California was called "ungovernable," "a wreck," and a "failed state."

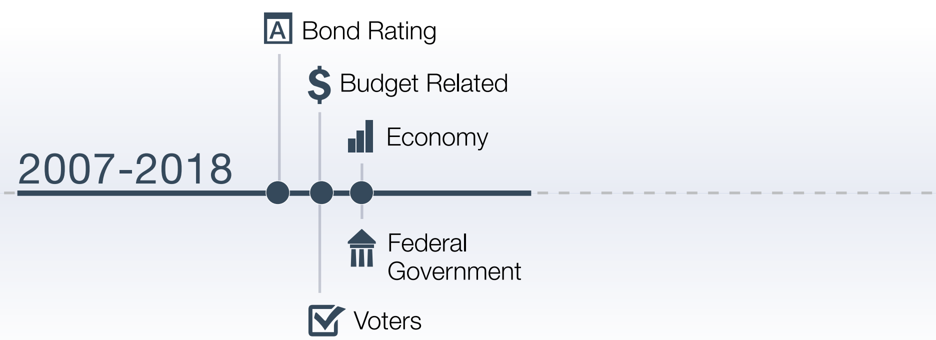
# Today…

California's fiscal position today is dramatically different. Last year's budget enacted a higher level of reserves than the state has seen in decades. In recent years, the Legislature and Governor have taken action to address many of the state's outstanding debts and have passed budgets that have consistently increased savings. While California's budget still faces challenges, the state has made undeniable progress. Few could have predicted this turnaround.

So how did the state achieve this feat? Here, we tell the story of the California budget over the last ten years.

## *How to Read This Report*

Timeline events in this report are categorized into the following five areas:








# California Enters the Great Recession With No Reserves

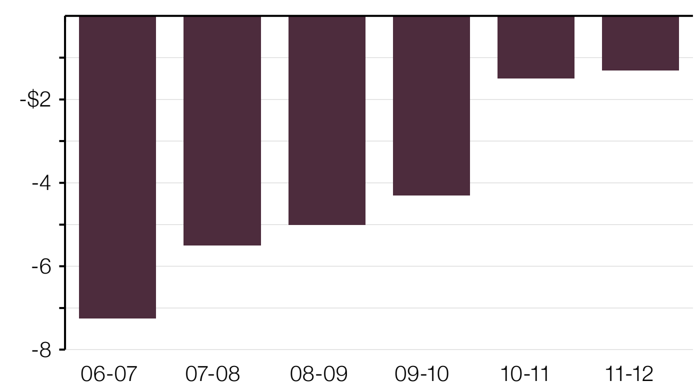
When California entered the Great Recession at the end of 2007, it faced a deteriorating revenue picture with effectively no reserves. The Legislature passed the 2007-08 budget in August of 2007, but by November, our office was already warning that the revenue situation was weakening due to slowing property tax collections and cash receipts that were falling short of projections.

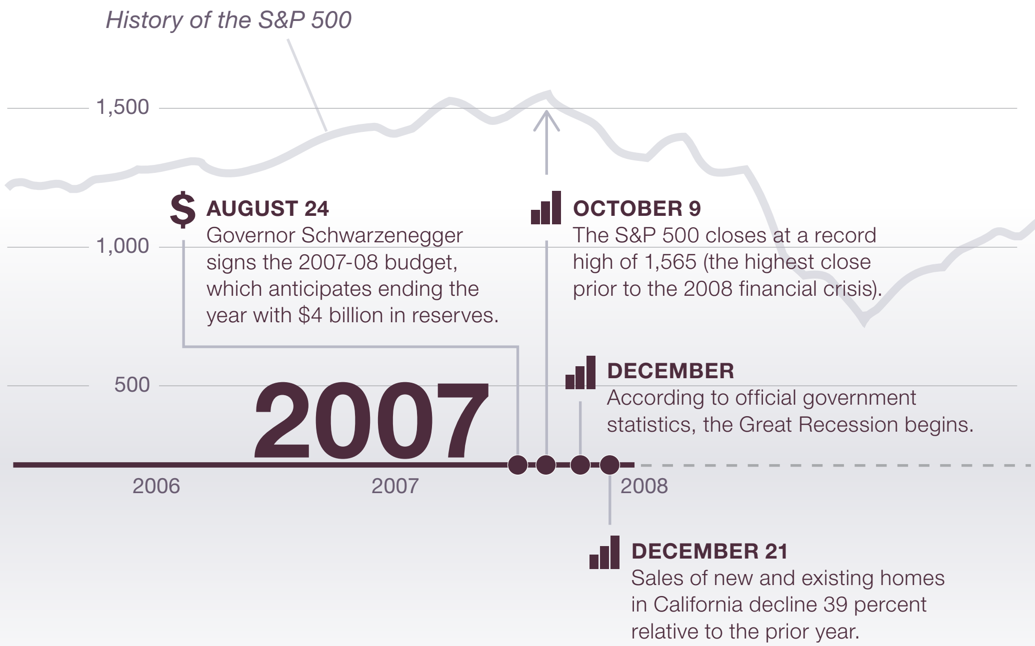
While the state believed it had a year-end surplus of $4 billion in August, by November, before the recession had even officially began, our office projected the state faced a $2 billion deficit. The coming recession would be the second largest in state history, resulting in formidable year-over-year revenue losses and budget shortfalls of tens of billions of dollars in each year.

The state also entered the Great Recession with its budget fundamentally misaligned. At the end of 2007 and in the years before, our office's projections indicated long-term spending exceeded projected revenues. This meant that, even though the state passed budgets that were balanced for the upcoming fiscal year, the budget faced projected "operating deficits" in future years.

### LAO Projected Operating Shortfalls in November 2006

*(In Billions)*










## *Lasting Effects of the Dot-Com Bust*

In part, the state entered the Great Recession without reserves because it never fully recovered from the last recession—the dot-com bust of the early 2000s. This recession was short-lived, but had an outsized impact on California's budget. This was primarily because the recession originated in the technology sector, which played (and continues to play) a large role in the state's economy and budget. The revenue declines were striking: year-over-year, revenues from California's tax on personal income—its largest revenue source—declined nearly 30 percent in 2001-02.

To address the sharp revenue shortfalls of the dot-com bust, the state relied heavily on borrowing and short-term solutions. For example, in 2004 the voters allowed the state to issue $15 billion in Economic Recovery Bonds, which carried debt service costs ranging from $1.5 billion to nearly $3 billion per year. The state also issued bonds for future tobacco settlement receipts and deferred education expenses.

Each of these actions addressed budget deficits in the short term, providing the state with a temporary infusion of money and allowing it to spend at higher levels than could be supported by current-year revenues. However, the state failed to pair these borrowing plans with ongoing changes to address the shortfalls. As a result, the imbalances persisted. A year before the Great Recession began, the state faced ongoing operating shortfalls of billions of dollars.

'07

**JULY 30**
President Bush signs the Housing and Economic Recovery Act of 2008.

**SEPTEMBER 15**
Lehman Brothers files for bankruptcy

**SEPTEMBER 15**
The Legislature passes (and the Governor later signs) the *2008-09 Budget Act* with $16 billion in budget solutions.

**FEBRUARY**
In a special session, the Legislature adopts mid-year revisions to the 2007-08 budget providing $7 billion in budget solutions.

**OCTOBER 3**
President Bush signs the Troubled Asset Relief Program into law.

**NOVEMBER 6**
The Governor calls a special session to address a major budget deterioration that occurred in the six weeks since the budget was passed. The administration projects the budget faces a year-end 2008-09 budget problem of $22.5 billion, nearly entirely due to a deteriorating revenue situation.

**2008**

**DECEMBER**
Fourth quarter gross domestic product decreases at an annual rate of 6.2 percent.

**DECEMBER 16**
The Federal Reserve reduces short-term interest rates to 0 percent for the first time in U.S. history.

**DECEMBER 18**
The Legislature passes a budget package addressing a portion of the shortfall. The Governor vetoes the package.





# Budget Shortfalls Keep Growing Larger

Throughout the Great Recession and years that followed, budget projections were repeatedly revised downward. Sometimes these revisions occurred only months, or even weeks, apart. On September 23, 2008, when Governor Schwarzenegger signed the *2008-09 Budget Act*, General Fund revenues were expected to total $102 billion. Two months later, our office warned these revenue estimates were off by $5 billion. A year later, the state had revised this estimate downward to $84 billion—$18 billion less than originally estimated.

These continual changes reflected the rapidly deteriorating economic conditions, and later, a relatively slow recovery. Moreover, budget problems occurred each year during this period because the state took numerous one-time or temporary actions to address what was an ongoing budget problem. As a result, the Legislature would pass a budget closing the deficit in one year, but the problem would reemerge in the next year when the actions expired and ongoing spending continued to exceed revenues.

### *What Is a Budget Solution?*

When the state's budget faces a shortfall or deficit (meaning that state expenditures exceed resources available) the state must adopt "solutions" to address the problem and bring the budget into alignment. These solutions can include revenue increases and expenditure reductions, as well as actions that allow the state to borrow or shift costs.

'08

# California's Cash Crisis

Throughout the course of a normal and healthy fiscal year, the state collects more money than it spends in some months and spends more money than it collects in others. (For example, the state collects much more money than it spends in April when income tax returns are due.) These normal, seasonal cash flows mean that the state often must borrow—either internally or externally—to ensure it can pay its bills on time. When the state has insufficient internal resources to cover these expenses, it sells short-term bonds to investors, providing an infusion of cash that the state repays by the end of the fiscal year.

In the fall of 2008, however, the state faced a cash crisis. The Legislature passed the 2008-09 budget on September 15, the same day Lehman Brothers filed for bankruptcy. In the following weeks, the state approached the bond market for cash flow borrowing and found the U.S. credit market had frozen, partly in response to the uncertainty following Lehman Brothers' collapse. On October 3, Governor Schwarzenegger wrote to the Secretary of the Treasury alerting him to the possibility that California might ask the federal government for short-term financing.

In the days that followed, the state underwent a campaign to encourage Californians to aid the state by purchasing short-term bonds through brokerages. This included radio advertisements, which featured Governor Schwarzenegger urging Californians to invest in their state. The campaign was unexpectedly successful and the state raised $5 billion—more than it initially planned. On October 9, the Governor again wrote to the Treasury Secretary, this time to express optimism that no federal loans would be required.

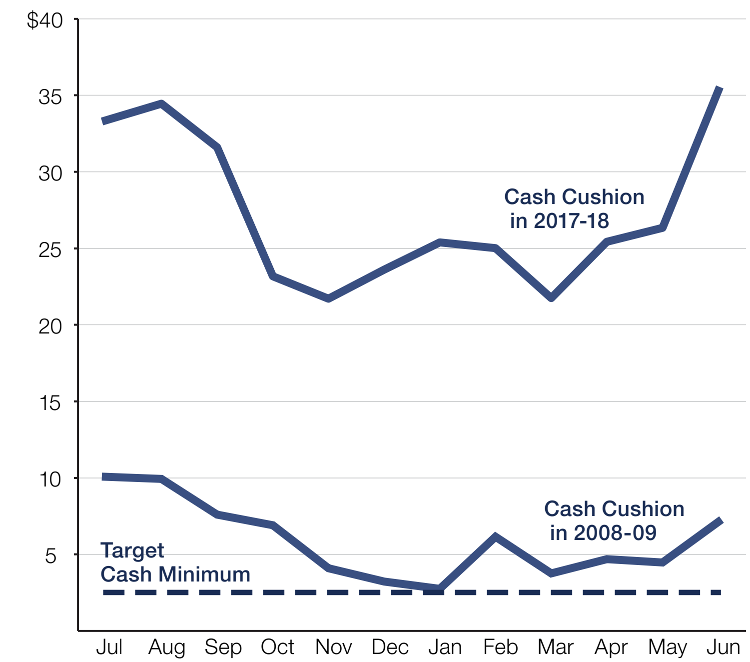
In the months and years that followed, the Governor, Legislature, and State Controller took extraordinary actions to address the state's cash crisis over the short and long term. These included issuing IOUs to cover state expenses, deferring payments to schools and local governments, and making state funds more accessible for internal borrowing. But the most important remedy to the cash crisis, over the long term, was to balance the state's budget.





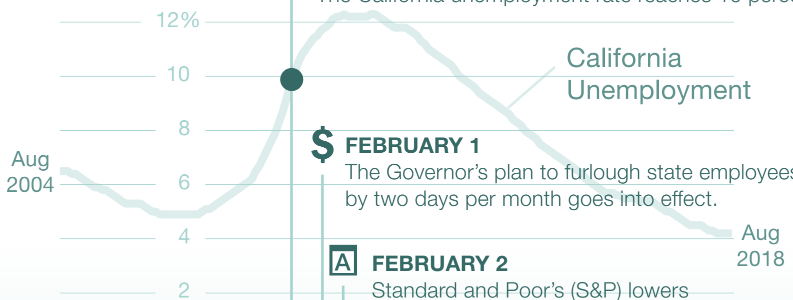
**State's Available Cash in 2008-09 Neared Minimum Levels**

*(In Billions)*



# 2009

**FEBRUARY**
The California unemployment rate reaches 10 percent.




**FEBRUARY 1**
The Governor's plan to furlough state employees by two days per month goes into effect.

**FEBRUARY 2**
Standard and Poor's (S&P) lowers California's bond rating from A+ to A.

**FEBRUARY 17**
President Obama signs the American Recovery and Reinvestment Act.

**FEBRUARY 19**
The Legislature passes (and the Governor later signs) the 2009-10 budget package a few months early. It includes $42 billion in budget solutions.

**FEBRUARY**
The State Controller delays over $3 billion in scheduled payments.

**MARCH 9**
The S&P 500 closes at 676, its lowest point during the financial crisis.

**MAY 14**
Governor Schwarzenegger releases a May Revision identifying a new $15.5 billion budget problem for the end of 2009-10. Most of this budget problem is related to projected drops in revenues.

**MAY 19**
Voters reject Propositions 1A through 1E, which would have made a variety of changes to help balance the budget, including raising revenues and allowing the state to borrow from the state lottery. To address the failure of these measures, the administration proposes an additional $7 billion in alternative budget solutions.

**MAY 26**
The Governor releases a second May Revision proposal to avoid using budgetary borrowing to address a portion of the shortfall.

**MAY 29**
The Governor releases a third May Revision proposal in response to our office's lower revenue estimates. Cumulatively, the Governor estimates the state's shortfall is $24 billion.

**JUNE**
According to government statistics, the Great Recession officially ends.

**JULY 24**
The Legislature adopts (and the Governor later signs) revisions to 2008-09 and 2009-10 budgets which include an additional $24 billion in solutions.

**OCTOBER**
The U.S. unemployment rate reaches 10 percent (the California unemployment rate is 11.8 percent).

'09

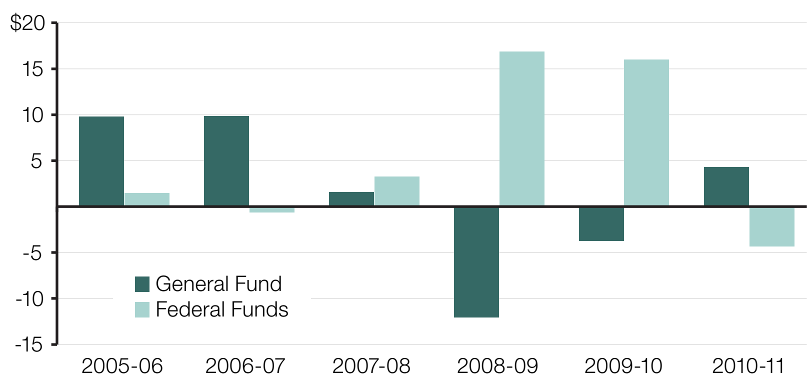
# Help From the Federal Government

Two key pieces of federal legislation helped California's budget and cash position during the Great Recession. First, the federal Troubled Asset Relief Program helped support some of the nation's largest lenders during the financial crisis. This created more liquidity in credit markets, easing California's cash crisis by indirectly contributing to the state's ability to borrow.

Second, the American Recovery and Reinvestment Act injected significant federal funding into California at the time of the state's worst budget situation. Between 2007-08 and 2009-10, while state spending dropped significantly, federal spending increased substantially, which helped the state maintain overall spending, even as state revenues experienced massive declines.

## Federal Funding Increased While General Fund Spending Declined

*(Year-Over-Year Change, in Billions)*




The federal government also initially considered taking the extraordinary action to help California directly with its fiscal situation (for example, with a loan). Eventually, the federal government decided against it. On June 16, 2009, the *Washington Post* reported that Obama administration officials had "decided that California could hold on a little longer and should get its budget in order rather than rely on a federal bailout."





**2010**

**JANUARY 8**
Governor Schwarzenegger releases a 2010-11 budget proposal identifying a $19 billion shortfall.

**JANUARY 13**
S&P lowers California's bond rating from A to A-.

**MARCH**
The Legislature passes (and the Governor later signs) several special session bills that reduce General Fund expenditures by $1.2 billion.

**MARCH 23**
President Obama signs the Patient Protection and Affordable Care Act into law.

**JULY 22**
President Obama signs a six-month extension of emergency jobless benefits for the long-term unemployed.

**OCTOBER 8**
The Legislature approves (and the Governor later signs) the 2010-11 budget. It is the latest budget in state history and includes $19.3 billion in solutions.

**NOVEMBER 2**
Voters approve Proposition 25, which changes the vote threshold for the budget from two-thirds to simple majority. Voters also approve Proposition 22, which restricts the state's authority to use or redirect state fuel tax and local property tax revenues.

## *Majority Vote Budgets*

Before 2010, the constitutional vote threshold for passing budgets and raising taxes was a two-third majority. Proposition 25 eliminated the two-thirds vote threshold for passing budgets. Since 2011, the Legislature can enact budgets by majority vote.

**2011**

**JANUARY**
The California unemployment rate begins to fall (from 12.2 percent to 12.1 percent).

**$ JANUARY 10**
Governor Brown releases his first budget (of his new term) shortly after assuming office. The budget estimates a problem of $25.4 billion for the end of 2011-12.

**$ MARCH**
The Legislature passes the first iteration of a budget bill for 2011-12 by majority vote under the new requirements of Proposition 25. (This budget bill is not signed.)

**$ JUNE 15**
The Legislature passes a second budget bill.

**$ JUNE 16**
The Governor vetoes the second budget bill.

**$ JUNE 28**
The Legislature passes (and the Governor later signs) the 2011-12 budget package, which includes $27 billion in budget solutions.

**A AUGUST 5**
S&P downgrades U.S. credit rating for the first time in history.





# Structural Changes to the Budget

Many of the actions the state took in response to budget shortfalls post-2008 were one time or short term in nature. However, the state also made some long-term changes that have lowered the growth rate of state spending (or increased the growth of state revenues), resulting in the state's better budgetary position today.

***Shifting Some Programs to Local Governments.*** In 2011, the state government shifted responsibility (and funding) for some criminal justice, behavioral health, and human services programs to local governments. This saved the state money by: (1) moving certain felons from high-cost prisons to less expensive jails at the county level, (2) requiring local governments to spend a portion of local revenues on these programs, and (3) creating incentives for counties to control programmatic costs. It also reduced the minimum funding requirement for schools and community colleges.

***Dissolving Redevelopment Agencies.*** Prior to 2012, cities and counties could create redevelopment agencies to address urban blight. Redevelopment agencies received property tax growth from all the local governments—city, county, special districts, and schools—within the designated areas of the agencies. Due to constitutional requirements for school funding, redevelopment agencies created state costs by increasing the amount of General Fund required to go to schools. In 2011, the Legislature passed a package of bills to limit redevelopment agencies. Due to subsequent litigation and a Supreme Court decision, however, redevelopment agencies ultimately were dissolved completely. As a result, property tax revenue that had gone to the redevelopment agencies increasingly is going to local governments. This reduced state costs for schools in 2017-18 by $1.5 billion.

***Increasing Personal Income Tax Rates at the Top.*** In 2012, voters approved Proposition 30, which temporarily increased the state sales tax rate for all taxpayers and the personal income tax rates for upper-income taxpayers. In the few years after voters passed it, Proposition 30 increased revenues by roughly $7 billion per year.

***Increasing Reserve and Debt Payment Requirements.*** In 2014, voters approved Proposition 2, which requires the state to set aside minimum amounts each year for reserves and debt payments. By taking money off the top and using it either for savings or paying off debt, the measure lowers ongoing spending.

## 2012

**JANUARY 5**
Governor Brown proposes a budget package for 2012-13, which estimates a $9 billion budget problem.

**FEBRUARY 1**
All redevelopment agencies in California are dissolved.

**MAY**
The administration revises its estimate of the budget problem upward to $16 billion.

**MAY 18**
The social networking company Facebook holds its Initial Public Offering. At the time, our office estimated this would give the state an additional $2.1 billion in revenues.

**JUNE 15**
The Legislature passes (and the Governor later signs) the *2012-13 Budget Act* with $16 billion in budget solutions.

**SEPTEMBER 12**
The Governor signs the Public Employees' Pension Reform Act into law, which made significant changes to California governmental employee pension benefits.

**SEPTEMBER 15**
Amazon.com begins collecting California sales tax.

**NOVEMBER**
Voters pass Proposition 30, which increased personal income tax rates for high-income taxpayers and sales tax rates.

**DECEMBER**
The California unemployment rate falls below 10 percent.

## 2013

**JANUARY 10**
Governor Brown proposes the 2013-14 budget. It is the first budget introduced in six years that does not require budget solutions to close a shortfall.

**JANUARY 31**
S&P raises California's credit rating from A- to A.

**MARCH 1**
Automatic budget cuts known as "sequestration" take effect.

**APRIL 10**
The S&P 500 hits a new all-time intraday record high of 1,589, surpassing the previous record on October 11, 2007.

**JUNE 14**
The Legislature passes (and the Governor later signs) the 2013-14 budget package, which enacts a reserve level of slightly more than $1 billion.

# 2014

**$ JANUARY 9**
Governor Brown releases a 2014-15 budget proposal, which includes a proposal to make the first deposit into the state's rainy day fund since 2007-08.

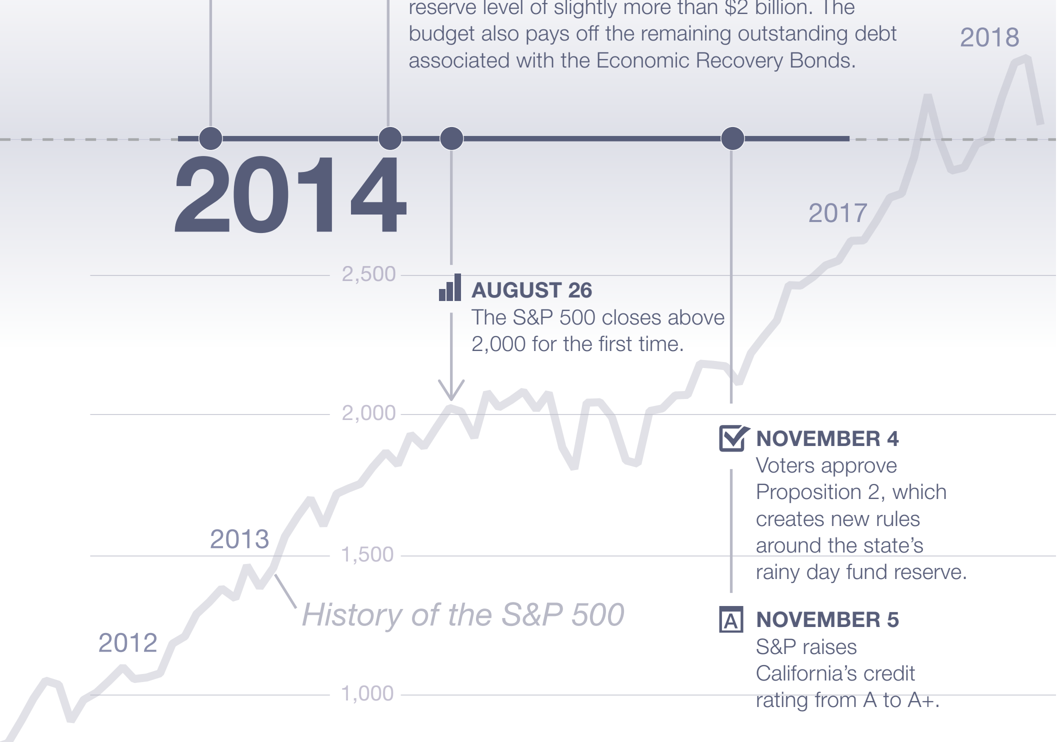
**$ JUNE 15**
The Legislature enacts a funding plan for the California State Teachers Retirement System. The plan aims to eliminate the system's $74 billion unfunded liability in 32 years by increasing contributions from the state, teachers, and school and community college districts.

**$ JUNE 15**
The Legislature passes (and the Governor later signs) the *2014-15 Budget Act*, which anticipates a year-end reserve level of slightly more than $2 billion. The budget also pays off the remaining outstanding debt associated with the Economic Recovery Bonds.

**AUGUST 26**
The S&P 500 closes above 2,000 for the first time.

**NOVEMBER 4**
Voters approve Proposition 2, which creates new rules around the state's rainy day fund reserve.

**NOVEMBER 5**
S&P raises California's credit rating from A to A+.







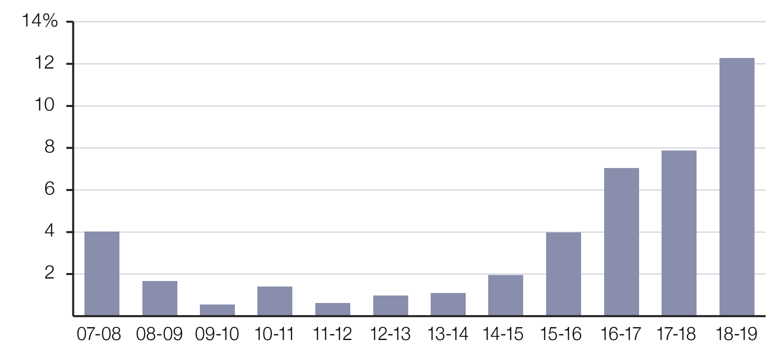

# New Rules for the State's Rainy Day Fund

On November 4, 2014, voters approved Proposition 2, which created new rules for the state's rainy day fund. Proposition 2 requires the state to deposit minimum amounts each year into reserves. In particular, Proposition 2 requires the state to set aside a share of capital gains revenues—a particularly volatile revenue source—that exceed a specific threshold. This means that the state sets aside the "spikes" in these revenues when they are peaking so that they can be used later when revenues fall short.

In addition to the required deposits under Proposition 2, in recent years, the state has put more money into reserves than is required. For example, in 2016-17 and 2018-19, the state made extra deposits of $2 billion and $2.6 billion, respectively. By the end of 2018-19, total reserves are projected to stand at an estimated $16 billion, far more than the budget had available in the years before the Great Recession.

## Recent Budgets Have Enacted Higher Levels of Reserves

*Total Enacted Reserves as a Percent of Revenues*




When the state makes deposits into its reserve accounts, there are two key benefits for the budget. First, using money to make a deposit, rather than increasing ongoing spending, lowers the budget's spending base, shrinking the size of a future budget deficit. Second, saving money means the budget has more funds available later to address a shortfall.

## 2015

**JANUARY 9**
The Governor releases a 2015-16 budget proposal.

**JUNE 19**
The Legislature passes (and the Governor later signs) the *2015-16 Budget Act*, which anticipates a year-end reserve level of nearly $5 billion.

**JULY 2**
S&P raises California's credit rating to AA-, its highest level in 14 years.

**DECEMBER 16**
The Federal Reserve raises interest rates for the first time since 2006.

## 2016

**JANUARY 9**
The Governor releases a 2016-17 budget proposal.

**FEBRUARY 5**
The U.S. unemployment rate falls below 5 percent for the first time in eight years.

**JUNE 19**
The Legislature passes (and the Governor later signs) the *2016-17 Budget Act*, which anticipates a year-end reserve level of $8.5 billion.

**NOVEMBER 16**
Voters approve Proposition 55 which extends the increases in personal income tax rates for high-income taxpayers until 2030 (under Proposition 30 these increases were to expire in 2018).

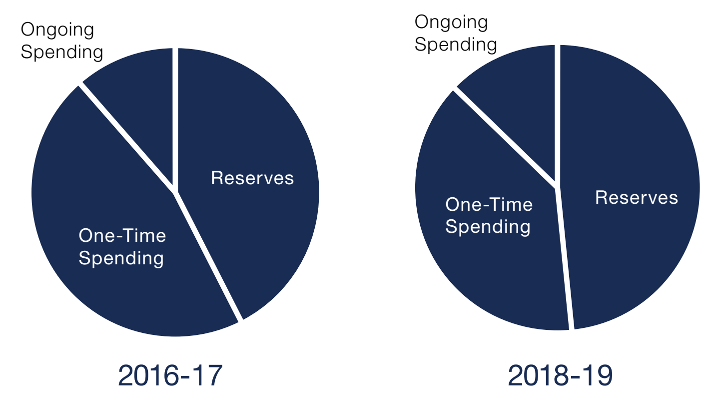




# Recent Budgets Have Focused on Reserves and One-Time Spending

Like reserves, one-time or temporary spending helps insulate the budget from future shortfalls. One-time or temporary spending—which is often devoted to infrastructure projects, repaying debts and other short-term purposes—does not increase the state's expenditure base. That is, the spending occurs in the budget year, but does not necessarily reoccur in future years. In contrast, ongoing spending often expands programs or services. Without action by the Legislature to reduce it, ongoing spending continues in future years, increasing the state's expenditure base.

## How Recent Budgets Allocated Discretionary Resources




In several recent budgets, the Legislature had additional discretionary resources available to allocate, typically because revenue growth has exceeded the underlying growth in state expenditure commitments. The Legislature mostly used these funds for one-time—rather than ongoing—budget commitments. For example, the 2016-17 and 2018-19 budget packages each allocated most available resources to building reserves. These budgets then focused remaining resources on one-time spending and allocated only 12 percent and 13 percent, respectively, of available resources to ongoing spending.

**2017**

**JANUARY 9**
The Governor releases a 2017-18 budget proposal.

**FEBRUARY 5**
The California unemployment rate falls below 5 percent for the first time in ten years.

**JUNE 19**
The Legislature passes (and the Governor later signs) the *2017-18 Budget Act*, which anticipates a year-end reserve level of $9.9 billion.

**SEPTEMBER 15**
S&P 500 closes above 2,500 for the first time.

**DECEMBER 22**
President Trump signs the Tax Cuts and Jobs Act into law.

**2018**

**JANUARY 9**
The Governor releases a 2018-19 budget proposal.

**JUNE 19**
The Legislature passes (and the Governor later signs) the *2018-19 Budget Act*, which anticipates a year-end reserve level of $15.9 billion.





# Key Takeaways

## The State Budget Situation Has Dramatically Improved Since 2008

***The Economy Has Played a Major Role in Improving the State's Financial Situation...*** The single most significant factor in the state's improved fiscal health is the long period of economic growth. Sustained growth in the economy and asset markets have resulted in many consecutive years of positive revenue growth.

***In the Early Years, the Federal Government Played an Important Role in Helping the State...*** In the early years of the Great Recession, the federal government played a role in assisting the state in its financial situation. Federal funding increases in 2009 and later cushioned sharp declines in state funding. This alleviated the state's worsening budget condition and blunted the worst of the economic and programmatic negative effects that would result from declines in state spending.

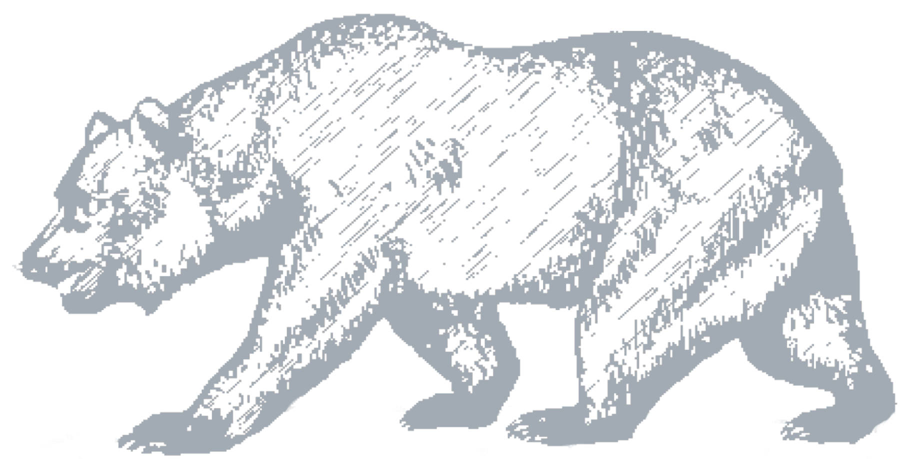
***...But Policy Decisions Also Were Important.*** Economic growth and federal assistance were both important factors for the state's financial turnaround to occur, but they would not have been sufficient alone. Steps taken by policymakers were critical, as well. In particular, in recent years, state policymakers have chosen to dedicate most available discretionary resources to building reserves and focused many new spending proposals on one-time, rather than ongoing, budget commitments. (That said, average annual spending growth over the period has not been low—in fact, from 2011-12 to 2018-19 General Fund spending grew 7 percent per year.)

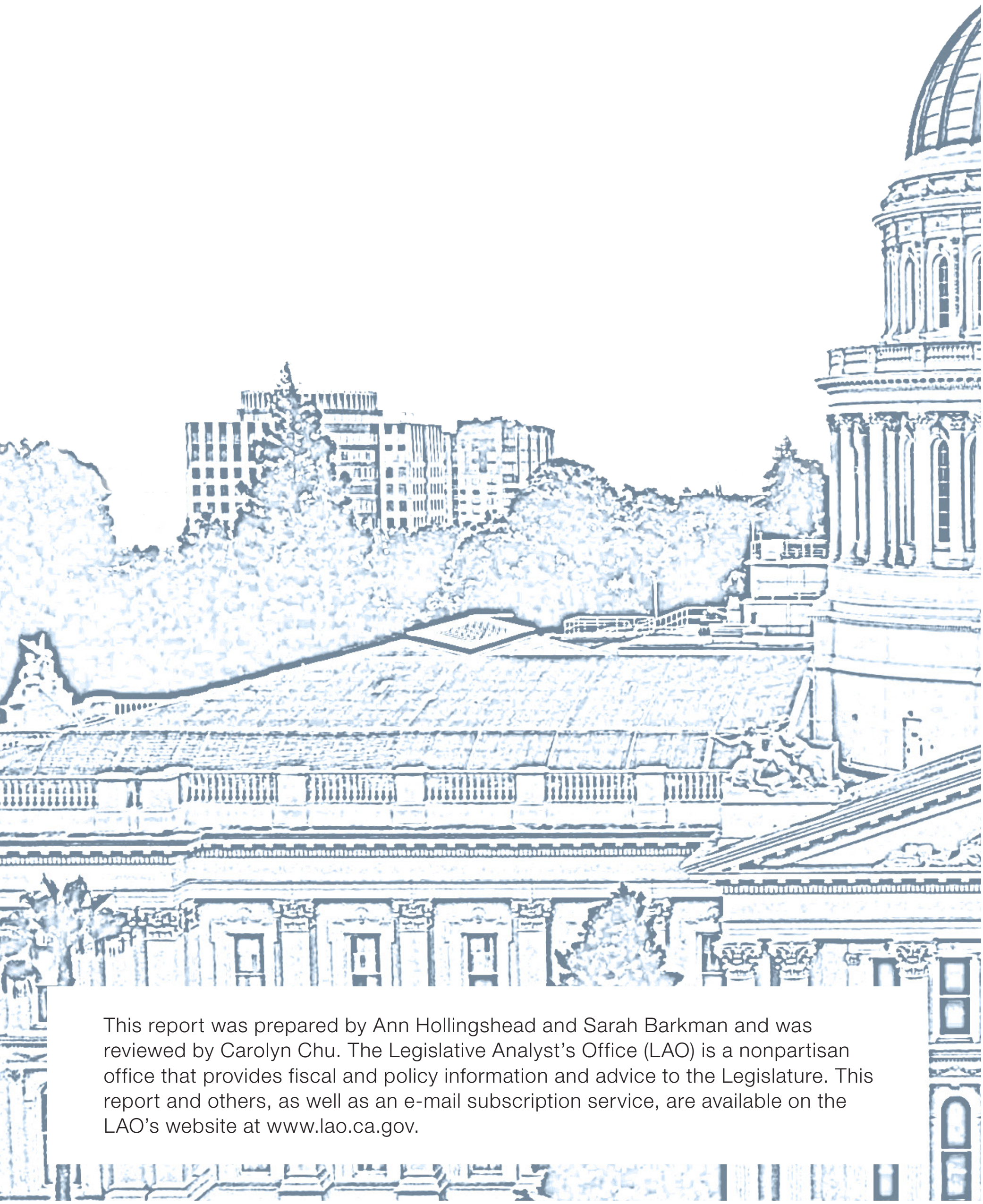
***California Is Much Better Prepared for a Recession Today Than It Was in 2007.*** As a result of these factors, the state is much better prepared for a recession today than it was when it entered the Great Recession ten years ago. When the state entered the Great Recession in 2007, the Legislature had recently enacted a budget with just over $4 billion in reserves. But by November of the 2007-08 fiscal year, our office was already warning that this reserve balance was actually a $2 billion deficit. By contrast, in June 2018, the Legislature enacted a reserve level of about $16 billion and our office's November estimates suggest the state's bottom line may be even better than the budget anticipated. The state's significant reserve balances also dramatically reduce the likelihood that the state will face another cash crisis.

## The State Budget Still Faces Challenges

***A Volatile Revenue Structure Yields Significant Growth.*** California's budget relies on volatile revenue sources—meaning the growth of revenues can fluctuate significantly from year to year based on economic conditions. On one hand, California's volatile tax system results in significant declines in revenues in years that the economy is weak. On the other hand, this tax system has underpinned the state's robust revenue growth in recent years. Revenues are volatile in part because high-income Californians (who see significant fluctuations in their incomes depending on the economy and financial markets) pay the highest marginal tax rates. High-income earners also have experienced the largest earnings growth since the Great Recession. Consequently, California revenues have surged as the economy has expanded.

***Other Challenges Also Loom.*** While its situation is undeniably better than it has been in decades, the state budget still faces challenges. Although reserve levels now are relatively high, they may not be enough to fully address a budget deficit in a future recession without significant spending cuts or revenue increases. In future years, the budget will need to confront cost pressures for infrastructure, health care, and pensions.





This report was prepared by Ann Hollingshead and Sarah Barkman and was reviewed by Carolyn Chu. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature. This report and others, as well as an e-mail subscription service, are available on the LAO's website at www.lao.ca.gov.