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# **California, Pivot of the Great Recession**

by

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The financial crisis that struck in 2008 marked the onset of the worst economic downturn since the Great Depression of the 1930s. The newly dubbed 'Great Recession' is a worldwide phenomenon, which some have called the first true crisis of the era of globalization. It crippled banks around the world, from Iceland to Hong Kong. It hit global trade hard in early 2009, with severe fall-offs from Korea to Germany. It crashed housing markets from Spain to South Africa. And it left millions unemployed, from Sheffield to Shenzhen (Krugman 2008, Henwood 2009, Stiglitz 2010).

The intensity of the downturn was bound to be felt unevenly across the globe, no matter how well-integrated world markets have become. Places dependent on housing construction, large capital goods manufacturing, exports, and speculative finance have suffered the most. The United States is generally acknowledged to be the pivotal country in the drama of the crisis. Not only is the U.S. economy the largest in the world, its exaggerated household debt, rampant financial speculation, and ballooning trade deficits were critical elements of the financial collapse that triggered the general downturn.

But the geography of the crisis has yet to be explored more precisely at the subnational level. Much has been written about Wall Street, of course; as the world's financial routing center, backed by the dollar as the global reserve currency and government credit markets of last resort, the Wall Street financial virus ended up infecting the entire global system (Shiller 2008, Read 2009, Sorkin 2009). Yet if Wall Street was the eye of the financial hurricane of the last decade, then California was the equivalent of the tropical oceans that provide the heat to feed such raging storms. More than any other place, California was the source of mass mortgage lending, ballooning home values, and dubious subprime operations. And behind that was California's leading role in U.S. urban, industrial and fiscal developments that underlay the stresses and strains on the financial system.

California needs to be recognized as a pivotal site of the bubble of the 2000s, the bursting of the financial markets, and the Great Recession that followed. Four propositions, each corresponding to a particular facet of the crisis, support the idea that California has been one of the wellsprings of the false boom and that the state is bearing a disproportionate brunt of the fallout.

First, California has long been the biggest player in U.S. mortgage markets, and its banks engaged in some of the worst excesses of the housing bubble. Second, California boasts the largest housing sector among the fifty states and its housing is the most unaffordable – making borrowers more vulnerable and susceptible to mortgage overreach. Third, the state is the country's largest sub-economy, accounting for roughly 13% of national output, and has long been at the forefront of industrial change, technological innovation, and globalization, but it also manifests some of the most troubling elements of industrial decline of the United States. Fourth, it has the largest state and local government budgets in the country and has suffered the worst fiscal crisis of any state.

The goal of this paper is to demonstrate the validity of these four propositions by showing how California displayed both early symptoms of, and causal connections to, the

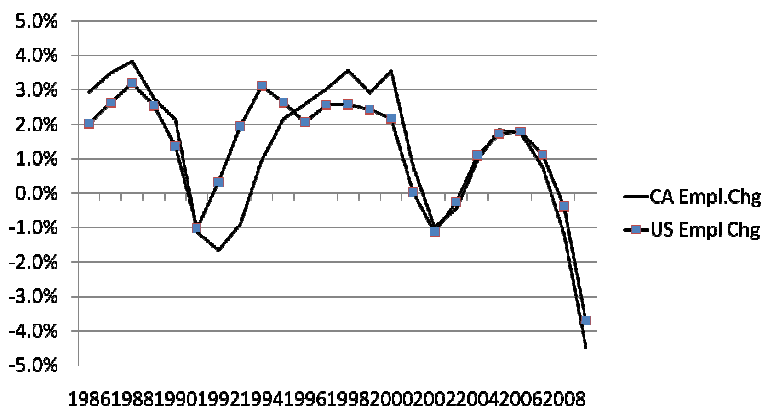
nationwide –indeed, global – crisis. To do so, we start with a snapshot of the economic disaster in California and an argument for the power of the local in a globalized economy. We then provide a breakdown of the U.S. national crisis for context and comparison, before returning to a detailed analysis of what took place in the Golden State and why.

## I. California in Free Fall

California has fallen hard since the financial crisis struck with full fury in 2008. It has taken a bigger hit than almost any other part of the country, by several indicators, and is in the worst shape since the Great Depression. As Steven Levy of the Center for the Continuing Study of the California Economy, has put it, “We were at the epicenter of the housing bubble, and we are at the epicenter of the fallout” (Steinhauer 2009).

The state lost over 1 million jobs from the peak of employment in July 2007 to the end of 2009, the largest absolute drop of any state. Over half of those losses came from construction, real estate and mortgage finance-related firms. Employment in the much vaunted high-tech sectors was significantly down from its peak, as well. Unemployment hit 12.4% in December 2009 – the 4th worst rate of any state and well above the national average of 10%. Adding part-time and discouraged workers (who have stopped looking for work), the underemployment rate jumps to a staggering 18%. [Figures 1 & 2]

Figure 1  
US and California: Annual Employment Change

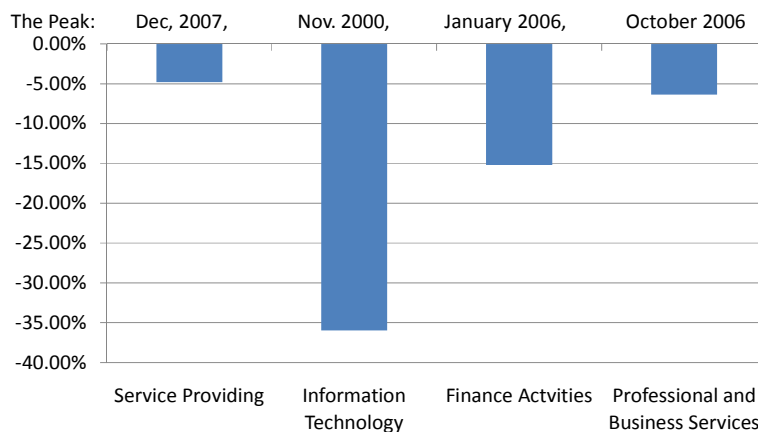


Source: BLS, EDD

California's state exports of \$76.1 billion were down from \$98.9 billion through the first eight months of 2008, a fall of 23%. Personal and business bankruptcies, a good indicator of general distress, were up by 58% in 2009 (3d behind Wyoming and Nevada), compared to a national jump of 32% (Baker 2010).

Figure 2

### Employment in Major California Sectors, December 2009: Down from Peak

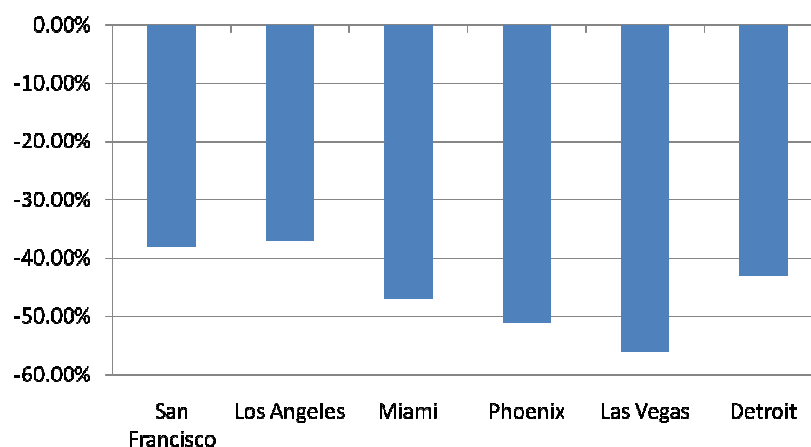


Source: BLS, EDD

California's property markets, which had been among the most pumped up in the nation, were stricken (Kroll 2009). Home prices fell off a cliff. The state's cities were among those with the largest declines in housing prices [Figures 3 & 4]. Hundreds of thousands of home owners could no longer meet their payments, and the Golden State soon led the nation in number of foreclosures. Thousands of houses lay empty, while residential construction was slashed by three-quarters from its peak in 2005 (Levy 2009).

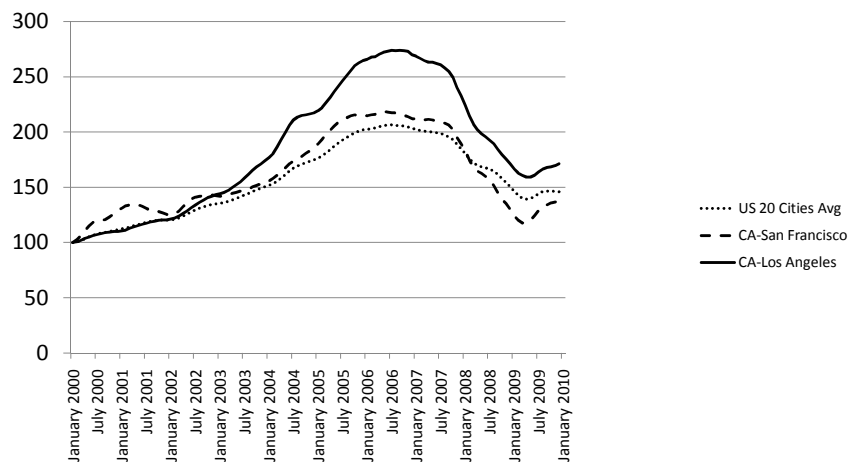
Figure 3

### Large Metro Areas with Greatest Downturn in Home Prices: From Peak to December 2009



Source: S&P Case Shiller

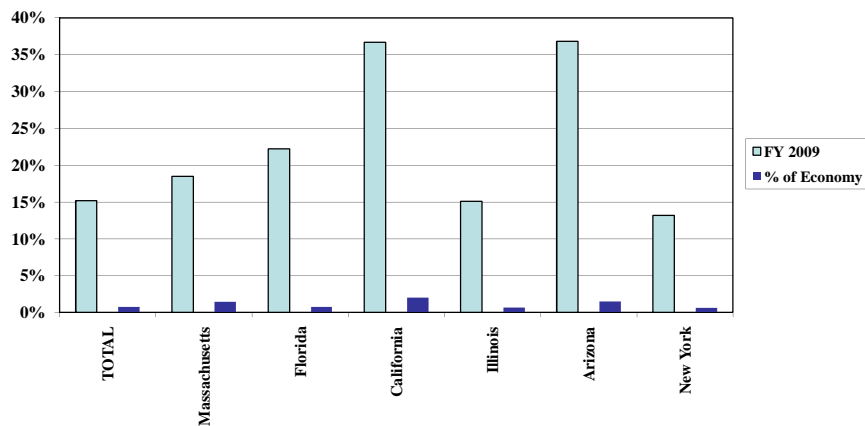
Figure 4  
Housing Prices:  
California Cities vs. US Cities



Source: Case Shiller Index; January 2000 =100

Finally, California's government deficits are among the worst in the country, not just in absolute terms, but relative to the size of the general fund and the state's economy. The budget gap was well over one-third of the fiscal year 2009 general fund and 2% of the gross state product. [Figure 5] The state's shortfall that year accounted for more than one-half of the total deficits, \$63 billion, of all 50 states (McNichol & Johnson 2009).

Figure 5  
States with 2009 Budget Gaps  
Size of Gap as Percent of 2009 General Fund



Source: Center on Budget and Policy Priorities; <http://www.cbpp.org/cms/index.cfm?fa=view&id=711>

There are other indications of how California's preeminent status within the US has been weakened, be it the decline in funding for education, where the reputation of the finest public university system in the world is threatened; immigration, where a slowdown indicates a dimming of the state's global allure; and innovation, where the increasing offshoring of high-end research and innovative activity to emerging technopoles in Asia has caused disquiet in Silicon Valley.

These indications of economic pain might not mean anything more than California has some features that have left it more vulnerable to the general downturn. That would be the usual approach to geography in mainstream economics: variations on a global theme and local effects of general processes (cf. Shiller 2008). Above all, it is usually nation-states that feature in economists' descriptions of geographic differences and development. No one doubts the pivotal role of the United States or China in the world economy today. But when it comes to smaller, subnational regions, we are more reluctant to assign them causal powers in the way the global economic organism operates.

Economic geography has a more complex anatomy than this, with localities and regions playing dynamic roles in an uneven and combined global economy. There are several useful geographic and economic theories that capture facets of the local and global dialectic: spatial division of labor (Massey 1984), globalization and regional clusters (Scott & Storper 1986), the spatial fix (Harvey 2006), place competition (Harvey 1985), long-distance commodity chains (Gereffi and Korzeniewicz 1994), global cities (Sassen 2001), urban agglomerations (Helsley and Strange 2007) and global city-regions (Scott 1998), among others. Yet none quite captures the dynamic interaction of places and scales, of the local and the global.<sup>1</sup>

Our view is that particular places -- in this case, the state of California -- are like the many gears and pulleys in the machinery of the world market, without which it would not operate in the same way. More than that, some places are crucial to the operation of the system; indeed, they can be thought of as the motors of capital accumulation (Scott 1988, Storper & Walker 1989). Of course, this is too mechanical a metaphor, with the whole process being more organic, like parts of a living body or ecosystem.

If all politics is local, as Speaker of the House Tip O'Neill famously proclaimed, then all economics is local, too – despite globalization. Local places matter – cities, subnational regions, federal states - they are not just sites to study as component cases of larger economic processes. Local developments can propel or change national and global economies. Chicago developed the derivatives markets that were at the heart of the financial innovations and turbulence of the last 30 years. Guangdong's Special Economic

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<sup>1</sup> Nor are abstract theories of capitalist geography especially helpful, such as the loose concepts of 'uneven development' (Smith 1984), 'glocalization' (Cox 1997), or 'scaling' (Herod & Wright 2002) . While these acknowledge the interweaving of local and global, they have little to say about the power of locality to upset the global applecart.



Zones launched the industrial reforms in China in the 1980s. Bangalore is largely responsible for offshoring in services and white collar jobs.

It has often been said that California is a beacon of the future, setting trends ahead of the nation, and even the world. This trailblazing effect might be thought of in terms of culture: Hollywood, hippies and Harvey Milk, the Azuza Street Revival, or West Coast rock. Or it might be cast in terms of politics: Richard Nixon carrying the banner of the Cold War out of Southern California; Ronald Reagan as the standard bearer for Neo-Liberalism; Proposition 13 and Howard Jarvis as the grandfather of the tax revolt (Davis 1990, Walker 1995, Phillips-Fein 2009).

California has been an economic and technological path-breaker, as well, with the impact of the Gold Rush, hydroelectricity, single-wing aircraft, computers and biotechnology, among others (Walker 2008). But along with the high-flying, high tech brilliance has come its antithesis -- wild economic excess. California is the consummate conveyor of hyped-up happiness and easy money, from the mining stocks of the 1870s to the oil bubble of the 1920s, from the land boom of the 1880s to the dot.com bubble of the 1990s (Dumke 1944, McWilliams 1946, Tygiel 1994).

Pushing this point farther, California has a legitimate claim to being considered the keystone in the broad arch of contemporary American capitalism. It is well known that Hollywood has long been the world's premier generator of moving images of enormous profit and social power (Scott 2005); that Silicon Valley is the greatest hub of high-tech electronics and the internet (Saxenian 1994); that Southern California long dominated military equipment and weapons development (Scott 1994); and that the Central Valley was the world's most advanced center of agribusiness in the 20th century (Walker 2004).

Similarly, California can make a fair claim to being the pivot of the Great Recession, as we shall attempt to demonstrate here. But before we can make a case for California's causal powers in the present crisis, we need to lay down a foundation requiring a broader analysis of the boom and the bust at the national level. That is the task of the next section. The third section will bring us back to California's fateful role.

## II. Four Horsemen of the Apocalypse

The Great Recession rode in on the backs of four horsemen of crisis: financial, urban, industrial, and fiscal. Too often these elements are treated independently, but they need to be seen as deeply intertwined -- and all are necessary to a satisfactory explanation of the boom and the bust in the United States.

### *a. The U.S. Financial Crisis*

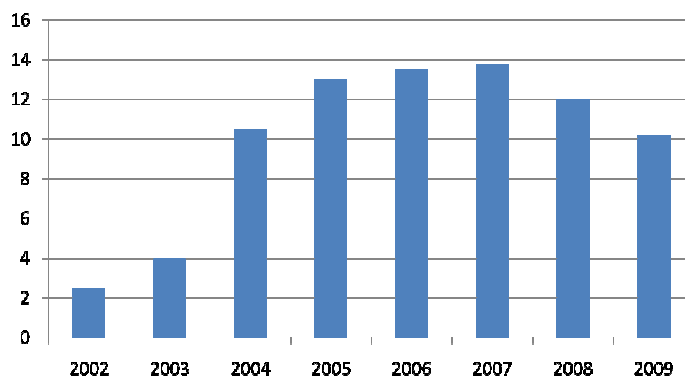
In 2008 the United States experienced a financial meltdown of extraordinary proportions, of a kind not seen since 1929. At the heart of the financial crisis was the accumulation of an unsustainable load of mortgage debt. As house prices rose dramatically through the late 1990s and 2000s, over 14 million new mortgage loans were issued and the total amount of home mortgages outstanding crossed \$10 trillion by 2006, doubling in a little over five years (up five-fold since 1996) (Shiller 2008, Phillips 2008).

Housing lenders then turned around and sold their mortgages in secondary markets in order to raise more capital for further lending. This kind of securitization has the virtue of providing liquidity in place of lumpy, fixed assets. As far-off investors snapped up mortgage-backed securities, it allowed local banks to lend again without the burden of holding long-term loans on their books.

The downside of securitization is that it distances mortgage originators from the ultimate investors in mortgage securities, allowing them to pass on dodgy loans to someone far away who is not in a position to verify underlying asset values. This led to heightened risk in wider mortgage markets and increasingly loose lending practices by mortgage originators. Subprime mortgages – made in non-transparent circumstances and with insufficient attention to ability to repay, as well as loans with initial teaser rates – rose from 6% of mortgage originations in 2002 to 20% in 2006 (Bardhan et al. 2009); the subprime share of mortgages outstanding quintupled over half a decade. **[Figure 6]**

Figure 6

### Share of Subprimes in Total Mortgages



Source: FED

Even more disturbing, mortgages were securitized not just once, but twice and thrice. Mortgage-backed securities were re-pooled, repackaged, sliced and diced to generate yet another batch of exotic securities (or derivatives), such as collateralized debt obligations (CDOs), structured securities backed by mortgages and other assets. CDO issuance shot up from \$20 billion in 2004 to \$180 billion in late 2006. The central players in this game were the big New York investment banks, like Lehman Brothers and Bear Stearns, but they were complemented by pension funds and the fast-growing array of hedge funds specializing in investment in derivatives (Phillips 2008, Gowan 2009, Stiglitz 2010).

The big banks made things worse. They began holding large amounts of exotic securities themselves, usually 'off-book', in Structured Investment Vehicles. Then, to guard against the increased risk, they bought Credit Default Swaps (CDS) – a kind of insurance contract on mortgage backed securities and bonds– from companies like AIG. The notional amount of outstanding CDSs reached a breath-taking \$69 *trillion* by 2008. Most of these new-fangled products were given high marks (low-risk) by rating agencies, such as Moody's and others, who had distorted incentives to do so, being paid by the issuer/seller of these securities (Shiller 2008, Barbera 2009, Sorkin 2009).

Needless to say, these practices were subject to growing speculative activity, and as securities values rose investments were leveraged with borrowed money -- often from the same banks wheeling and dealing in mortgage markets. In the end, risky investments mounted, debt ratios ("gearing") grew astronomically, and the whole thing became unsustainable – a credit bubble comparable to the 1920s, 1870s and others in capitalist history (Kindleberger 2000, Fraser 2005, Reinhart & Rogoff 2009).<sup>2</sup> [Figure 7]

All this was underwritten by a wink and a nod from regulators and government authorities. Deregulation allowed greater scope for bank lending, creation of derivatives, and the rise of "a shadow banking system". Meanwhile, the Federal Reserve Bank (The Fed) kept interest rates low, enabling Wall Street to operate with high leverage – further stimulating speculation in asset values.<sup>3</sup> In the end, all this financial “risk-taking” was guaranteed by the most comprehensive hedge of all – a government bailout.<sup>4</sup>

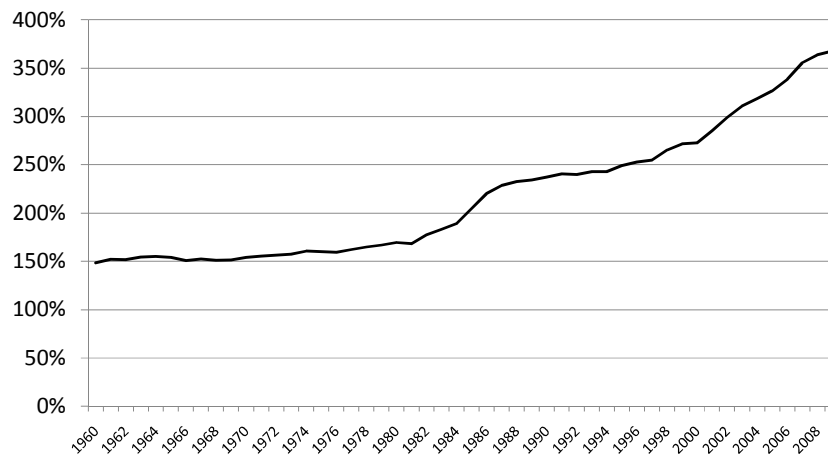
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<sup>2</sup> On the capitalist logic of financial crises, see Harvey (1982), Kindleberger (2000). On the crowd psychology of bubbles, see Galbraith (1988), Shiller (2005). Everyone was lulled by the idea that financial markets are always efficient, prices always correct since they reflect all available information, and risk everywhere adequately assessed in the ratings (LiPuma & Lee 2004, Fox 2009).

<sup>3</sup> The recycling of US dollars back into US treasuries and mortgage backed securities by China, Japan and oil producing countries also served to keep interest rates low.

<sup>4</sup> Indeed, Johnson (2009) argues, a financial oligarchy has effectively captured the government and its policy making apparatus, with the system evolving from the objective of allocating capital to efficient uses and distributing risk, to showering subsidies on the investor class (Sorkin 2009, Johnson & Kwak 2010).

Figure 7  
Total Credit Market Debt as Percentage of GDP

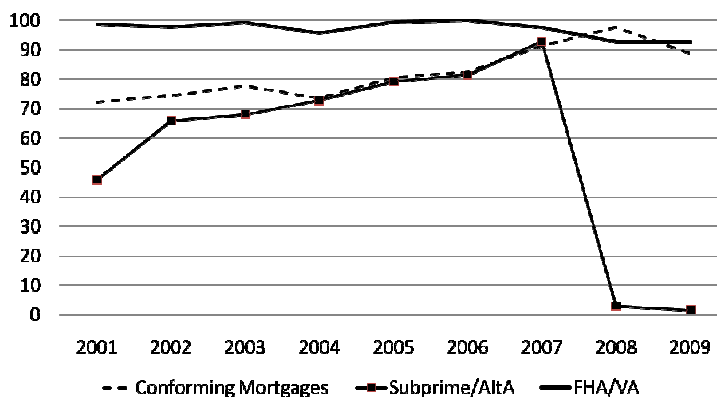


Source: Federal Reserve, BEA

The downfall of the financial bubble came because the frantic pace of asset price increases could not be sustained indefinitely. Yet the entire house of cards had that presumption built into its foundation. When prices began to slip, the financial feedback loops worked in reverse. By the end of 2006 housing sales had weakened, prices were declining, and mortgage payments began to fall behind. Early 2007 saw a rash of foreclosure filings and soon cold winds of doubt swept through the corridors of finance. Everyone demanded hard cash now in place of future high returns. Severe credit and liquidity shortages appeared and financial markets stalled by late summer.

Mounting losses continued in 2008, with investment bank Bear Stearns an early victim. By Autumn, the fallen giants of Wall Street included Lehman Brothers, Merrill Lynch, and AIG, and the icy breezes spread across Europe and beyond. The federal government ran a fire-sale on the wreckage of Bear Stearns and Merrill Lynch, took over AIG, and re-nationalized Fannie Mae & Freddie Mac (dealers in over half of all secondary mortgages) (Sorkin 2009). Non-bank lenders and investors, such as hedge funds, pension funds and securitization vehicles, suffered massive losses, as well (Gowan 2009, O'Connor & Guerrero 2009), and subprime securitization plummeted. **[Figure 8]**

Figure 8  
Securitization Rates for Home Mortgages



Source: Inside MBS & ABS; Note: Conforming mortgages are those below a limit set by Fannie and Freddie; FHA/VA are mortgage programs administered by FHA/VA

What were the underlying causes of the mortgage mania, subprime spread, and financial meltdown? To answer this, we need to look at developments in housing markets and urban centers of the country.

### ***b. U.S. Housing & the Urban Crisis***

The housing sector's size and linkages make it a vital part of the American economy – beyond just the financial effects of mortgage credit. The housing sector played a particularly striking role in U.S. economic activity over the last twenty years. As home sales climbed higher and higher during the upswing of the 2000s, construction contributed about one-fourth of growth of GDP – more than health care or military spending (Brenner 2009) -- and rose to over 6% of GDP (*The Economist* 2009, p. 8). Still, as fast as housing could be added, prices mounted skywards, with the national median house price more than doubling over the course of the 1990s and 2000s. Something strange, indeed, was happening, as shown by the way house prices outran comparable rentals or how the housing sector roared right through the stock-market meltdown in 2000 and recession of 2001-02.

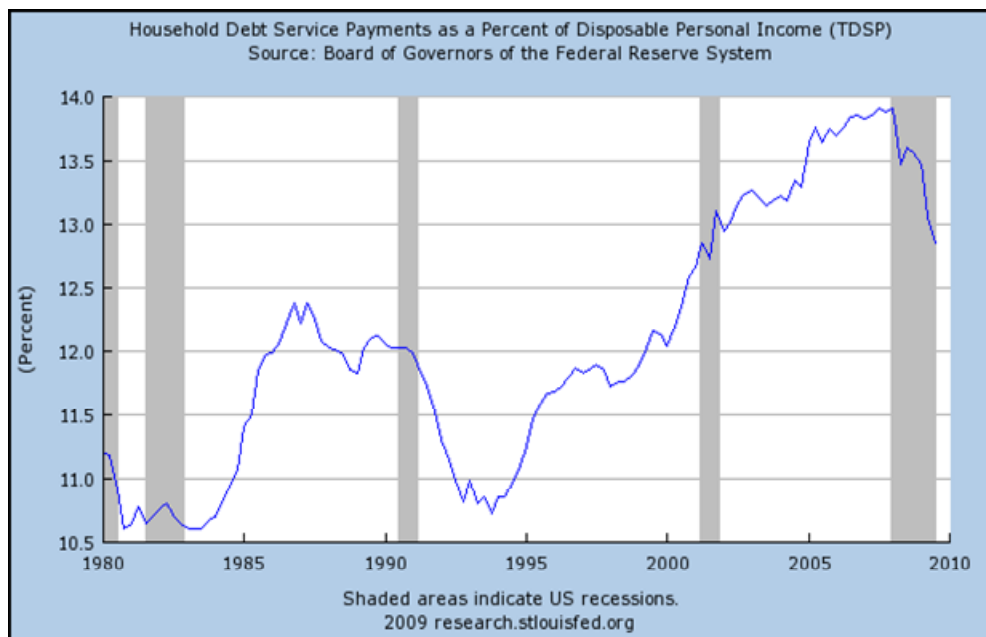
What lay behind the explosion in housing – and the subsequent debacle? This was a classic real estate bubble, of a kind experienced at many times and places in American history (Sakolski 1932, Hoyt 1933). The first cause was cheap, abundant credit. Mortgage loans were readily available thanks to the hyperactive secondary market. In addition, mortgages became cheaper as the Fed dropped interest rates from 2000 to 2003 to stave off recession. Prime rates fell to the lowest level in 50 years and mortgages followed them down to settle around 5-6%; low interest meant lower monthly payments,

which is the key price signal for most buyers. Abundant credit, “innovative” mortgages and low interest rates allowed buyers to bid up home prices across the board.

Second, with rising prices an asset bubble was set in train. As house prices soared, larger loans and higher monthly payments seemed justified by the prospects of rising prices and eventual sale (the wealth effect). The prevalent ethos that “home prices never go down” provided additional lubricant to the whole process, along with the kind of collective hubris and social psychology that sometimes overwhelm rational decision-making (Akerlof & Shiller 2009). This was abetted by the propagation of an asset-ownership based model of compensation (rather than salary or wage earnings); the boom in housing created illusory wealth to the tune of trillions of dollars and nurtured widespread delusional thinking about easy wealth (e.g., Lereah 2006).<sup>5</sup>

A third cause of the bubble and its aftermath was stagnant incomes among the majority of working families. This led households to stretch their finances to the breaking point to buy homes and rendered them vulnerable to dodgy lending practices. The result was that American households accumulated mountains of mortgage debt over the last decade (by far the biggest share of total household debt).<sup>6</sup> [Figure 9]

*Figure 9*

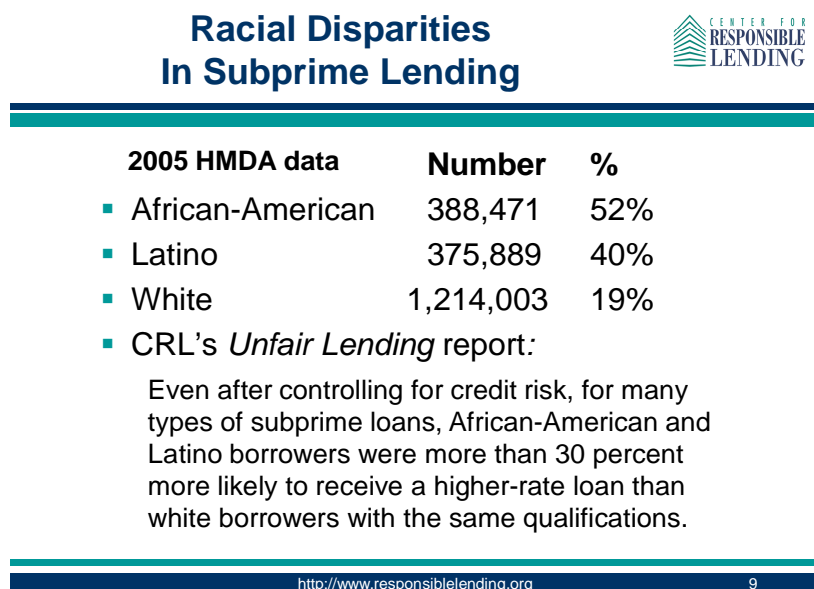


<sup>5</sup> Fed Chairman Ben Bernanke has argued that the wealth effect and the explosion of new mortgage products were more important in propelling the bubble than low interest rates (quoted in Aversa 2010).

<sup>6</sup> This phenomenon was by no means confined to the United States, although it was among the worst offenders (Glick & Lansing 2010).

Those with the least to begin with were the most overstretched, as housing prices in the lower segments of the market were the most inflated (Shiller 2008, p. 36). African Americans and Latinos had twice the exposure to subprime loans as Whites (CSI 2009). [Figure 10]

Figure 10



Inequality, which grew worse through the 1990s and 2000s, was a fourth force that impacted housing prices through its effect on affordability. Two-thirds of the income gains between 2002 and 2007 went to the top 1% of U.S. households (Piketty & Saez 2009). It allowed the rich to bid up houses at the top of the market to astronomical heights and steered house-builders toward upper-end buyers (making for a surfeit of large houses and a shortage of modest homes) (Tully 2008, DeLara 2009, Hong 2009).

A fifth cause of the housing bubble was geographic. The wealthier households began moving to city centers along the coasts in droves by the 1990s. This pushed up prices and squeezed out families with modest incomes (Fulbright 2007, Lees *et al.* 2008). Even in medium-sized cities, surging gentrification spread from well-known enclaves to new unexpected neighborhoods. Low-income and first-time buyers sought refuge in the far exurbs, where new housing was being added rapidly and prices appeared to be a bargain by comparison with urban centers; many of these poorer and younger first time buyers were targeted by subprime marketers.

Millions of home buyers were, in the end, unable to afford their mortgage payments. As mortgage debt soared, household debt service payments as a proportion of disposable income peaked in the first quarter of 2008. When teaser rates on subprime and adjustable rate loans ran their course, mortgages became unaffordable. This led to a huge wave of foreclosures by banks – over 3 million filings and 860,000 homes lost in 2008 alone (Christie 2009). To compound matters, the resulting fall in prices led to large numbers of houses being worth less than the amount owed on them, causing further foreclosures. Rising unemployment drove the final nail into the coffin of the housing market.

By mid-2009, almost 19 million houses stood empty (Levy 2009). New construction fell by over half from its peak (Kroll 2009). Banks dumped foreclosed homes on the market (roughly, 22% of sales in mid-2009), knocking the bottom out of the market in many areas. Median home prices fell by about 30% from 2006 to 2009 (Kroll, 2009). The number of houses valued at less than their mortgages ("underwater") mounted to over 10 million, or 23% of the market at that point (Levy 2009). People often just walked away from their homes and their debts (Temple 2008). The total loss of household wealth has been a staggering \$16 trillion.

### *c. U.S. Industrial Woes*

Beneath the financial and urban crises in the United States lay a weakening of the underlying economy. Signs of trouble go back to the 1970s, but became particularly acute in the 2000s. America's weakened economic base shows up in ways that are crucial to our story of how the financial and urban crises unfolded.

Overall, U.S. growth has been quite modest over the last four decades, as compared with the robust expansion of the postwar "Golden Age" – on average, about half the rate of increase in GDP, productivity, and personal income. Cyclic downturns have struck with depressing regularity every decade. The recession of the early 1970s saw a dramatic fall in the rate of profit and in the U.S. dollar, along with large bank failures (Brenner 2006). The downturn of the early 1980s was especially costly in terms of jobs, with unemployment peaking at over 10% – the highest rate since the 1930s (Bluestone & Harrison 1982). The restructuring of the US industrial landscape, the offshoring of manufacturing, and the emergence of the East Asian manufacturing behemoth all took off with dramatic speed.

The downturn of the early 1990s was less traumatic, but job losses were still significant, and, in what seemed to have started a trend, job recovery after the recession was over was slower than after previous recessions. Then, the revival of the mid 1990s had pundits touting the "New Economy" of high-tech and the Great American Jobs machine. But that turned out to be a mixed blessing; while large numbers of software jobs were created, the brief economic boom also resulted in one of greatest stock bubbles in history, which collapsed in stunning fashion in 2000 (the NASDAQ index bloated up five-fold, before falling back to its pre-bubble level) (Brenner 2002, Walker 2006).



The recession of 2000-02 was surprisingly mild, thanks to forceful intervention by the Fed to drop interest rates to the lowest level in fifty years. Yet the upswing that followed was the weakest of the last century, especially for employment. From 2001 to 2008, U.S. GDP grew by a feeble average of 2.2% and zero net jobs were created. With 8 million jobs lost in the Great Recession, private sector employment at the end of 2009 was at the same level (108 million) as a decade earlier (Bardhan 2010). What the Fed got for its money was a housing boom, but not much else (Brenner 2009).

The reason we speak of an 'industrial' crisis is because of clear signs of deterioration in the manufacturing base. Total employment in U.S. manufacturing shrank from around 18 million in 1990 to about 11.5 million in 2009. One reason is that many U.S. industries have become uncompetitive in world markets. This has contributed to a monstrous U.S. trade deficit, which started expanding in the 1980s and peaked at \$760 billion in 2006. Rapid expansion of "offshoring" by US multinationals (the transfer of production abroad with a view to importing the goods back into the United States) has further weakened employment prospects. On-shore manufacturing lines that remain viable have done so through productivity increases that yield no net jobs or by serving domestic sectors that have been hit hard in the current recession -- especially housing and automobiles.

Nor is the crisis confined to manufacturing. Over the last quarter century, the U.S. economy created seven jobs in the so-called services sectors for every job lost in manufacturing. While the growth of services is a worldwide phenomenon for developed countries, no other has seen as dramatic a fall in manufacturing employment as the United States. There seemed to be little cause for worry as long as only low skill, standardized jobs were moving offshore, high-skill sectors like software and business services were still growing, and cutting edge innovative activity was still anchored in the U.S.<sup>7</sup> Unfortunately, due to technological and institutional developments off-shoring came to embrace a range of white-collar occupations and services activities, threatening a whole new set of jobs (Bardhan & Kroll 2003). Now there is mounting evidence that R&D is being off-shored, due to the sheer numbers of engineers and scientists and the growth of innovation clusters in India, China, Russia and other countries. If the "next big thing" in technology originates abroad, it could seriously challenge U.S. leadership in high-tech (Bardhan & Jaffee 2010).

The eroding foundation of production has undermined wages for the American worker. Wages for the bottom half of the workforce have been stagnant for over 30 years, opening up an unprecedented gap between productivity and wage increases (Brenner 2006). Some of this is due to competition from cheaper labor, whether globally or domestically through immigration, and some to technological change putting a premium on skilled labor (Reich 1991, Rodrik 1996, Feenstra & Hanson 2001). But a major cause

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<sup>7</sup> Moreover, it was hoped that the export of services could be a saving grace. Although the US has a positive balance of trade in services, several features of services render them unable to compensate for the decline of manufacturing: lack of productivity gains and economies of scale and scope; winner-take-all nature of many occupations (such as lawyers, film stars); and conflation of production and consumption in the mode of delivery. Furthermore, exports are often followed by direct investment to provide the services on the ground with local talent.

is the reduced bargaining position of workers owing to weakened labor laws, the decline (and defeat) of unions, and bouts of high unemployment (Greenhouse 2008).

There has been a long-standing failure of American capital to invest in domestic industry. Financiers and multi-national corporations have preferred to invest abroad, delinking production, which generates jobs and wages, from domestic consumption. By contrast, Germany and Japan have done a much better job of maintaining their manufacturing bases despite the same global competitive pressures (cites?). An idea that has gained popularity in recent years is that personal consumption has become the principal motor of economic growth, as the consumption share of national spending rose from 62% in the 1960s to over 70% of GDP in the 2000s. This is nothing more than a smoke-screen over a failing industrial base: a high consumption share is simply the inverse of weak savings and a low investment share (given a constant government share) (Keynes 1936).

But to maintain high, and rising levels of consumption, given stagnant wages and incomes, many households had to go deep in debt (Silvers 2008). **[See again Figure 9]** This foolishness was encouraged by U.S. policy-makers. After the Asian crisis of 1997 threw a scare into the world financial markets, the United States was required to pull the world out of recession – by consuming more. Meanwhile, working Americans might have become restive over global labor competition and stagnant, even declining real wages, without the balm of rising debt and cheap imports. So policymakers let household debt pile up to keep the wheels of global commerce spinning.<sup>8</sup>

The clear result of stagnant wages, coupled with tax cuts on businesses and the rich during the Reagan-Bush years, has been a dramatic increase in inequality. One sign is the expanding gap in personal incomes (Piketty & Saez 2006). **[Figure 11]**. Another is the rising share of corporate profits in GDP, which hit an 80-year high of 14% in 2006. **[Figure 12]** A third is the vast enrichment of owners of capital assets – especially the top 5% (Wolff 1996, Keister 2000). Conversely, no other wealthy country has seen the impoverishment of such a large segment of the working class (Abranskey 2009, McGreal 2009).<sup>9</sup>

The build-up of wealth by corporations, individuals, pension funds, and banks did not translate into greater investment, however. On the contrary, discouraged by humdrum returns on routine assets and disinterested in the decline of domestic industry, given higher returns available in emerging economies, U.S. investors shifted their focus domestically to speculative assets. All this extra money pushing into the financial sphere exacerbated profit-seeking on paper assets and undue risk-taking.<sup>10</sup>

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<sup>8</sup> The "wealth effect" of the housing bubble helped sustain consumption, as many people borrowed against the rising value of their homes – about a quarter of all mortgages during the 2000s were for this purpose.

<sup>9</sup> Wealth inequality in the US would be even higher were it not for the significant level of home ownership; for the lower 80% of households, home equity is the primary asset (Zweig 2000). But even housing contributed to growing inequality in the 2000s (Zhu 2007).

<sup>10</sup> This appears to be a classic crisis of overaccumulation of capital – too much surplus chasing too few investment outlets (Harvey 2006, Brenner 2006).

Figure 11

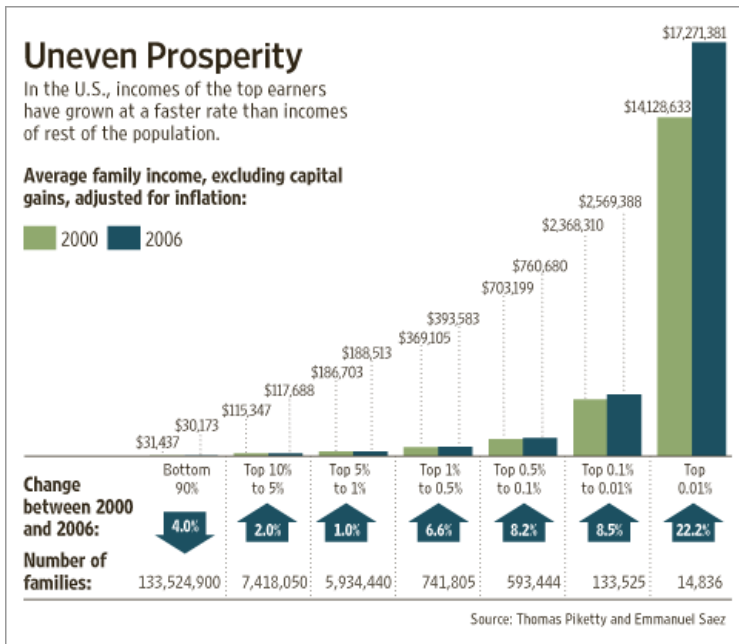
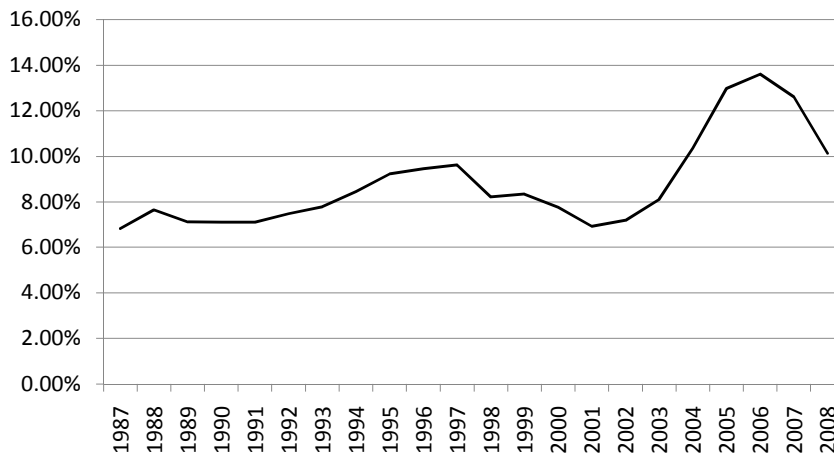


Figure 12

### Share of Corporate Profits before Tax in GDP



Source: BEA

#### d. The Fiscal Crisis

To add a bitter dessert to this lean economic meal, governments across the United States have faced slow-growing revenues for some time, and the bottom dropped out of the fiscal bucket with the Great Recession. A portion of the shortfalls is due to beneficent tax cuts for the rich and the corporations, thanks to the neo-liberal triumph of the Reagan-Bush-Clinton administrations (Harvey 2005). But weak economic performance made tax cutting more popular, whether among shareholders or workers whose incomes were going nowhere fast (Frank 2000).

An easy way out for the political class has been to compensate for slack government revenue by debt-financing, based on easy credit from booming financial markets. Government indebtedness, both federal and state/local, has thus grown rapidly over the last 30 years, shooting up in the 2000s – albeit at times compensated by rising real estate and stock values (Sbragia 1996). **[Figure 13]**

When the crisis hit in 2008, governments across the nation saw their revenues plunge and budget deficits soar. State and local governments have had to slash spending and lay off thousands of public workers, making the recession worse by lowering public and private demand for goods and services. The Federal government, on the other hand, has continued to spend, first with the Bush bank bailouts and then the Obama stimulus package (ARRA), running up bigger deficits and piling up more debt. The national debt is now the highest in peacetime history – although as a percentage of GDP it is still below that of the UK, France and Italy, and well below Japan – or even the United States at the end of World War II.<sup>11</sup>

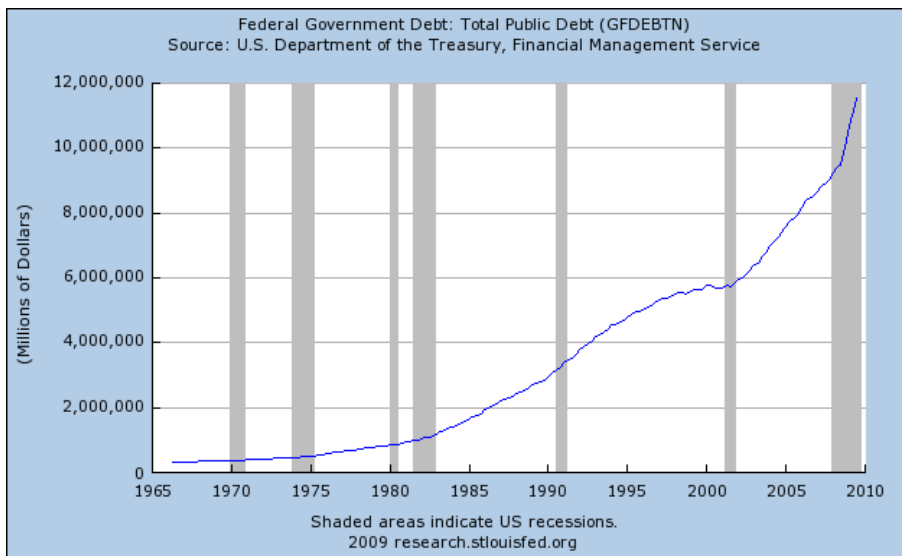
Deficit spending serves the larger purpose of creating a fiscal stimulus to counteract the Great Recession. Government intervention is wholly justified in a context where deficits and debt have yet to stoke either higher interest rates or inflation (Keynes 1936, Skidelsky 2009, Krugman 2009). But state and local governments are required to balance their budgets by law. While federal programs have provided some relief at the local level, a critical part of the stimulus package for revenue-sharing was cut out of ARRA by Republicans in Congress. Hence, the lower orders of government have been adding their deflationary cuts to the general downturn, working against the stimulus effort coming out of Washington (McNichol & Johnson 2009).

In sum, financial bloat, the housing bubble, industrial decline and fiscal crisis have worked together to make this the most severe economic recession the United States has experienced since the 1930s. Clearly, the four horsemen of the apocalypse rode together into the heart of the American economy. The result is what has come to be known as The Great Recession.

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<sup>11</sup> For comparative figures, see *Left Business Observer*, #123, November 25, p 7. Also, the growth of federal debt has only just compensated for the precipitous fall in household debt (Economist 2009, p. 12).

Figure 13



### III. California: Four Strikes, You're Out

In this section, we make the case that California has not just suffered along with the rest of the United States, or even more than other parts of the country. It has, more than any place other than Wall Street, been responsible for the bubble economy of the 2000s and the economic crisis that followed.<sup>12</sup> This can be seen in each of the four domains previously charted. Since it is California, with its notorious law and order regime, we like to refer to these as the four "strikes" against the state.

#### *a. California's Financial Frenzy*

While much of the financial alchemy in secondary mortgage markets, over-the-counter derivatives, and structured investment vehicles had an East Coast address, a disproportionate amount of mortgage issuance, housing speculation and subprime lending took place in California. When the bubble burst, the state ended up with more bad loans and foreclosures than anywhere else, and its eager lenders were among the first to go belly up.

California has long specialized in hyperactive finance. In the 1980s, it featured Michael Milken and his junk bond mania, which emboldened the Corporate Raiders of that

<sup>12</sup> Indeed, there is good reason to think that this has been true for the last three decennial booms and downturns. In the expansion of the 1980s and the crisis of 1989-92, Southern California led the way, thanks to the Reagan Second Cold War military build-up and the Savings and Loan-led real estate fiasco (Davis 1990, Soja 1991). In the 1990s high-tech/dot-com boom, which came down hard in 2000-03, Silicon Valley and the Bay Area took the lead in the greatest stock market bubble in history (Walker 2006).

decade, brought down New York investment house Drexel Burnham, and landed Milken in jail (Bruck 1989, Bailey 1992). Junk bonds and giant certificates of deposit fed the real-estate lending craze by the savings and loans, which ultimately destroyed a segment of the banking system that had always been intimately associated with housing. California was home to, among others, Lincoln Savings (under Charles Keating, who ended up in prison) and to American Savings, briefly the biggest S&L in the country (Binstein & Bowden 1993, Robinson 1990).

In the 1990s, California was home to the tech stock bubble, triggered by the instant riches generated in the Netscape IPO of 1995 (Lewis 2000, Barbera 2009). The Bay Area was not only the leading region for venture capital investment and initial public offerings, it was home to firms accounting for close to an astounding one-third of the market capitalization in the inflated stock exchanges, led by the NASDAQ (Walker 2006).

So it is not surprising that California led the way in the mortgage madness of the 2000s. Countrywide Savings, headquartered in Los Angeles county (Calabasas), became the largest mortgage lender in the country, issuing 20% of all mortgages; its loan portfolio (assets) was worth roughly \$94 billion at its peak.<sup>13</sup> IndyMac Bank of Pasadena, spun off from Countrywide in 1996, grew to \$32 billion in assets in a decade.

At the same time, Washington Mutual, based in Seattle, entered the Southern California market with a vengeance with seven acquisitions from 1996 to 2006, starting with American Savings, which alone equaled all Pacific Northwest holdings of WaMu. Great Western Savings followed, then Home Savings in 1998, and Long Beach Mortgage in 1999, making WaMu California's #2 bank at the time. WaMu rose to be the largest U.S. savings and loan company, then reorganized as the 6th largest bank, with over \$300 billion in assets.<sup>14</sup>

WaMu's purchases left Golden West/World Savings of Oakland as the largest independent S&L in California and the largest originator of adjustable rate mortgages (ARMs) in the country. Golden West had \$122 billion of loans in its portfolio when it was sold to Wachovia Bank in 2006, helping the latter rise to the 4th largest banking corporation in the country in 2008.<sup>15</sup>

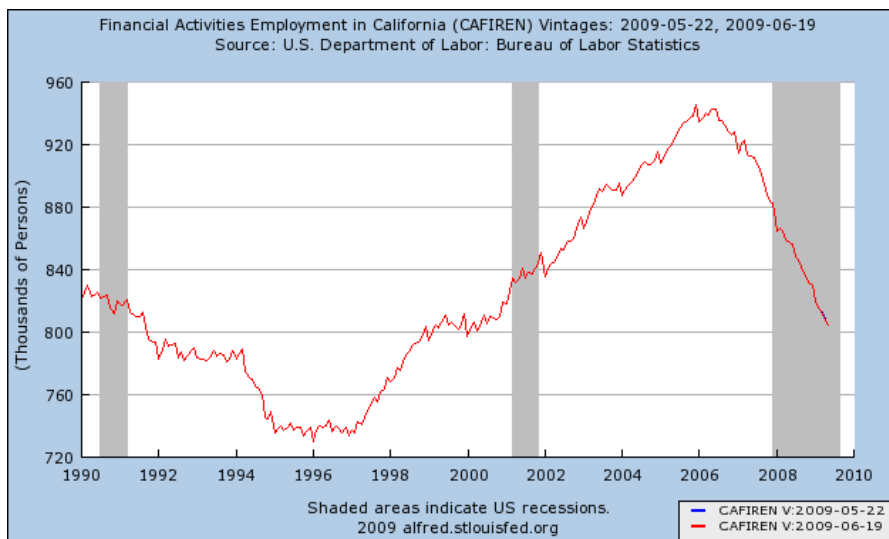
While it is difficult to gauge the magnitude of California-based lending as a whole, due to the geographical fungibility of financial flows, one indicator is the growth of financial employment. Although information technology and the business services both had a good run in the 1990s, neither of them recovered in the aftermath of the dot-com bust, whereas the financial industry went from strength to strength. Employment in FIRE (finance, insurance and real estate) skyrocketed between 1996 and 2006 to almost one million jobs, increasing by a remarkable 27%. **[Figure 14]**

<sup>13</sup> "Top Originators in Q108", [www.nationalmortgagenews.com/freedata/?what=orig](http://www.nationalmortgagenews.com/freedata/?what=orig)

<sup>14</sup> "Government Seizes WaMu and Sells Some Assets", *New York Times*, Sept. 26, 2008, p. A1. WaMu also bought Dime Bank of New York and others around the country, and Provident, a San Francisco issuer of credit cards.

<sup>15</sup> [http://en.wikipedia.org/wiki/Golden\\_West\\_Financial](http://en.wikipedia.org/wiki/Golden_West_Financial), accessed 8/14/09.

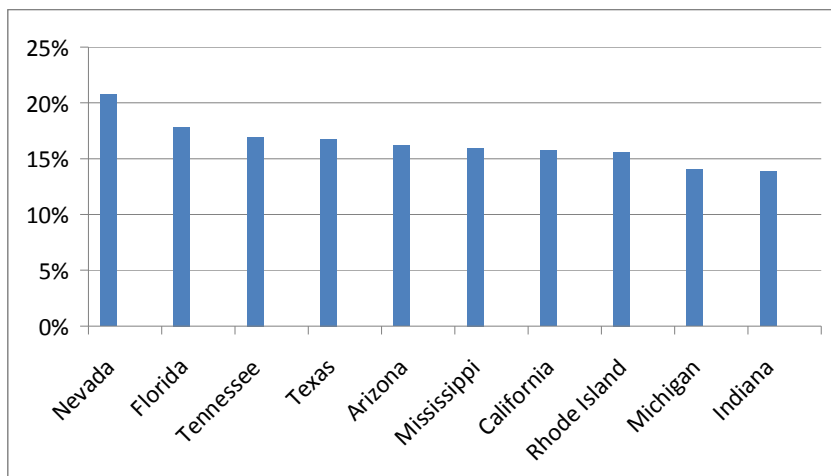
Figure 14



California was the center of the vortex of subprime loans. The enormous size of the state overwhelms all other contenders; California lenders were responsible for a stunning 56% of the \$1.38 trillion in subprimes issued from 2005 to 2007 (Temple 2009). The top five subprime lenders were located here: Countrywide Financial, Ameriquest Mortgage, New Century Financial, First Franklin, and Long Beach Mortgage (a division of WaMu). So were 9 of the top 10, including Wells Fargo Bank (Abate 2009). Over 15% of all mortgages outstanding in the state in 2007 were subprimes, putting it among the worst offenders among the states. [Figure 15]

Figure 15

### Share of Subprime in Total Mortgages Outstanding: Top Ten States, 2007 Q2



When the crisis finally hit, California mortgage banks were the first to fall and made up most of the top 10 bank failures of the Great Recession. In March 2007, New Century Financial declared bankruptcy and in September a failing Ameriquest was sold off to Citicorp. Merrill Lynch, which had bought First Franklin in 2006, shut it down in February 2008. A month earlier, IndyMac Bank was seized by the Federal Deposit Insurance Corporation. Countrywide followed six months later, closed by the FDIC and handed over to Bank of America. WaMu closed Long Beach Mortgage in May 2008.

Bigger things were yet to come. WaMu's collapse in September 2008 was by far the largest bank failure in American history up to that time (exceeded only by Lehman Brothers a month later). Its corpse was shortly thereafter fed to the lions at JP Morgan-Chase Bank.<sup>16</sup> By October, the carnage in Golden West's ARMs overwhelmed Wachovia, which was absorbed by Wells Fargo Bank (Reed 2008). Less spectacular, but telling, was the continued forced closures of California banks in 2009, such as Pacific National Bank and United Commercial Bank, mostly over commercial property loans gone sour (Selna 2009), and the largest failure to date in 2010, the La Jolla Bank.

During the financial frenzy, regulations regarding prudential lending, transparency and full-disclosure took a back seat, at both the federal and at the state level. While the main burden of regulatory policy in this arena lay with Federal authorities, the policies regulating the issuance, origination and disbursement of residential mortgages, as well as the entire institutional structure involved in the process, are also governed by state-level authorities. Any response of state agencies was late in coming and did little to rein in predatory and subprime lending, which was a key factor in the subsequent housing market crash (Bardhan, Edelstein, Kroll, 2009).

### ***b. California's Bloated Housing and Cities***

California led the way in inflating the housing bubble and in irresponsible urbanization, pushing beyond national trends in several respects. It saw an extremely rapid increase in home sales and prices, especially the latter. Combined with sluggish income growth for the average Californian, high prices made for extreme unaffordability of housing. And, finally, California's big cities exploded across the landscape with a decided class skew.

A number of factors set California apart. First, California's home prices have eclipsed the rest of the country since 1970. The state's "housing premium" only got higher in the 2000s, when the median home price hit a peak of \$594,000 in 2006, more than double the national peak of \$221,000.<sup>17</sup> The San Francisco Bay Area "enjoyed" the highest prices of any metropolitan area in the United States – nearly quadruple the national average.

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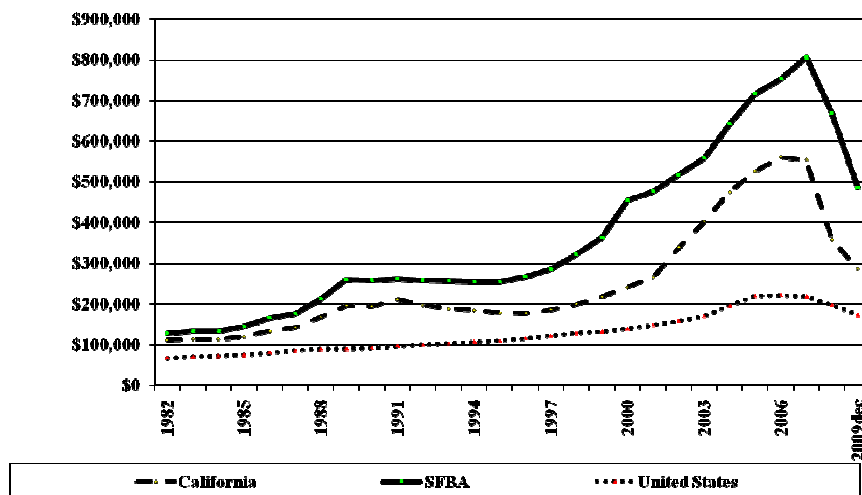
<sup>16</sup> WaMu took \$7 billion of TPG Equity Groups' capital with it; TPG is headquartered in San Francisco and Fort Worth, TX.

<sup>17</sup> Hawaii is the only state with higher average home prices. California moved out of the middle of the pack in the late 1960s and passed #3 Connecticut in the 1970s. (US Census data) On the history of real estate bubbles in California, see (McWilliams 1946).



[Figure 16] Overall, total property values in California more than doubled, from \$2 to \$4.4 trillion, 1998-2008.<sup>18</sup>

Figure 16  
Median Home Prices:  
The Bay Area, California and US



Source: California Association of Realtors; National Association of Realtors data

Second, nowhere else has housing been so unaffordable.<sup>19</sup> One might think this is because California has a higher average household income than most other states of the Union, but that is only part of the story. The Bay Area, on the other hand, does have among the highest average household incomes of any metropolitan area in the nation, or for that matter, the world; yet, for thirty years the San Francisco region has had the most unaffordable housing relative to income -- the income needed to afford the median price house is double the median income (Walker et al. 1990, California Budget Project 2008).

Moreover, the low affordability of California housing created fertile ground for subprime loans, as working people stretched their incomes to buy vastly overpriced homes.<sup>20</sup> Californians by the hundreds of thousands took on mortgages with no down-payment, teaser rates, and paltry documentation on household income. No state had more adjustable rate mortgages (Said 2009). Mortgage salesmen sprang up like weeds on a landslide: some 60,000 real estate agents, brokers and mortgage salesmen in early 2008.

<sup>18</sup> Figures from the State Board of Equalization (from *Los Angeles Times* graphic, on file)

<sup>19</sup> Again, with the exception of Hawaii.

<sup>20</sup> Unaffordable housing means low rates of home ownership in California, reversing a long history as a paradise of the single-family home and the suburban bungalow (McWilliams 1946).

Third, the urban geography of California exaggerated the worst features of the housing bubble. Its mega-cities sprawl over millions of acres of the fading beauty of the Golden State.<sup>21</sup> Greater Los Angeles, some 20 million strong, continued to surge across the Inland Empire of Riverside and San Bernardino counties, which doubled in population 1990-2009 (DeLara 2009). The Bay Area streamed north, south and east, developing its own Inland Empire in the Central Valley; there it collides with the spread of Sacramento and Stockton in one Northern California megapolis of over 10 million people (Metcalf & Terplan 2007). The vast majority of new construction during the bubble took place in the Inland Empires (DeLara 2009).<sup>22</sup>

Economic expansion, job creation, and immigration have triggered gigantic waves of home construction with every upswing. In 2006, new home sales peaked at a rate of over 200,000 per year, or roughly 16% of the national total (versus California's 12% of population and 13% of GDP). High prices have meant robust profits for homebuilders, giving California one of the largest and most powerful construction industries in the country, featuring local companies like KB (formerly Kaufman & Broad), Shappell, Standard Pacific and Shea Homes and making it a major field of operation for the nation's largest builders, such as Lennar, Pulte, Centex and D.R. Horton.<sup>23</sup>

The class and race geography of California's cities has been remade in the process. The upper classes, mostly white, have rushed to the coast. Places like Silicon Valley, San Francisco and Santa Monica are today virtually unaffordable for working families. San Francisco, in particular, has become dramatically older and less racially diverse (Fulbright 2007).

Meanwhile, the new working class of California, chiefly immigrants and the children of immigrants, have had to flee to the urban fringes to find jobs and affordable housing (DeLara 2009). Limited by poor wages in sectors such as warehousing and retailing, they still had to overreach to buy their suburban dream (Bonacich & DeLara 2009). Nowhere were more people more in need of loose credit terms in order to stretch their incomes to cover inflated house prices, and many became easy marks for subprime loan peddlers.

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<sup>21</sup> Sprawl is shaped by automobility and single-family homes -- all of which California helped to forge as a model of city-building -- but the key drivers are urban economic growth and the decentralization of jobs (Lewis 2004, DeLara 2009).

<sup>22</sup> On a regional scale, Arizona and Nevada are also, to a large degree, extensions of California, in terms of migration, investment and trade, and their behavior in the bubble was an exaggerated movement up and down, much like the Inland Empires.

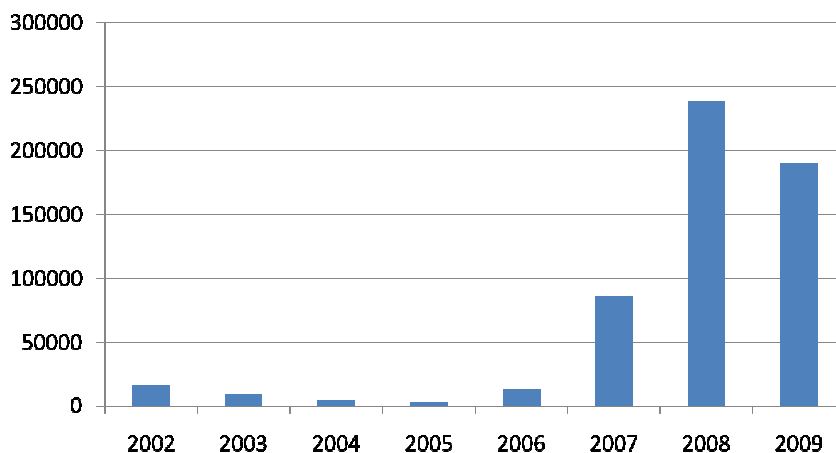
<sup>23</sup> Data from [www.hanleywood.com](http://www.hanleywood.com). Developers and financiers worked hand-in-glove, as in the way Countrywide financed almost all KB homes during the boom. California's percentage of national building was even higher in the 1980s, when its economy was stronger (see IIIc below).

This is, essentially, the geographical manifestation of the state's growing class divide. From the 1980s to the 2000s, California led the nation in the proliferation of millionaires and in a widening gulf between the rich and the rest (Walker *et al.* 1990). It was among the top five states in income inequality (and worsening inequality) by the turn of the century (Bernstein *et al.* 2002). Meanwhile, its employers have been successful at holding down wages among common workers, using the leverage of mass immigration to good effect (Waldinger & Bozorgmehr 1996, Milkman 2006).

When the bubble burst, California's housing market imploded. California was among the leading states in foreclosure rates and by far the largest in absolute numbers, with close to 250,000 repossessed homes. The state was among those with the largest declines in housing values. Housing overstretch was most exaggerated in the Inland Empires, where foreclosure rates above 50 per 1000 households were common.<sup>24</sup> [Figures 17, 18, 19]

Figure 17

## Number of California Foreclosures



Source: RAND

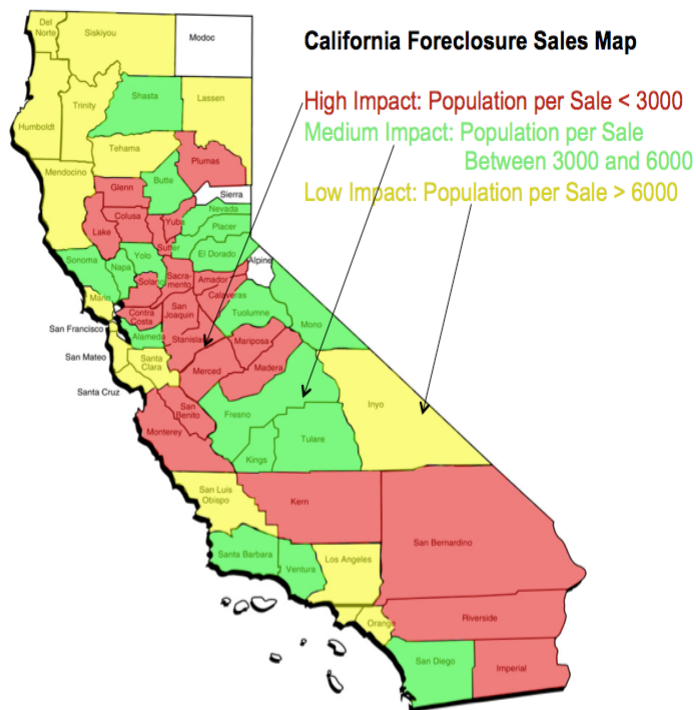
<sup>24</sup> The leading states for foreclosures were Florida, Nevada, Arizona, Michigan and California. The leading cities were Las Vegas, Phoenix, and Miami, plus California's Stockton, Merced, Riverside-Ontario-San Bernardino, Modesto, Bakersfield, and Vallejo-Fairfield. The exact orders changed with every passing quarter. Note that RealtyTrac, the largest dealer in foreclosures and main data source on foreclosures, is based in Irvine, California.

Figure 18  
 States with Largest Loss in Home Value from Peak to Q4 2009



Source: FHFA.

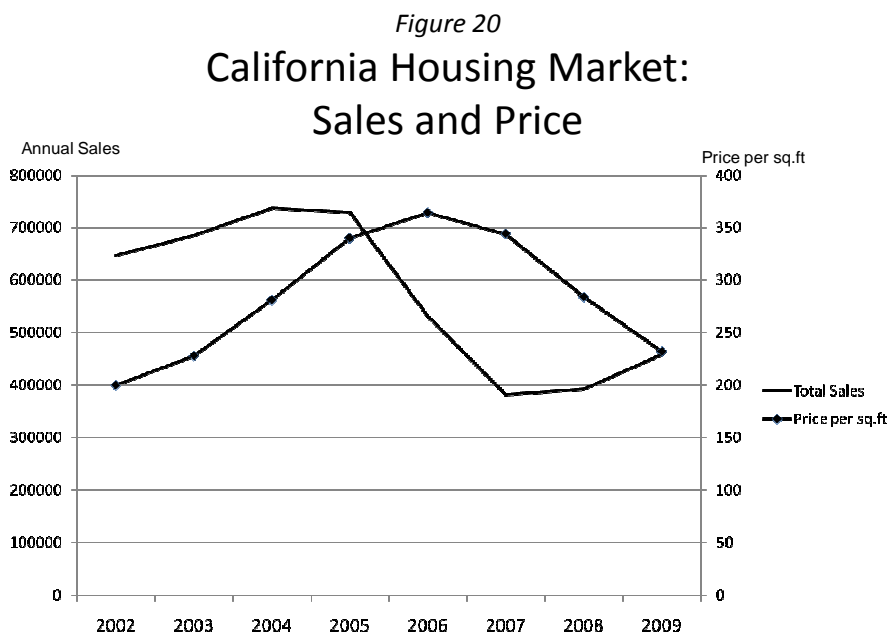
Figure 19



Source: Foreclosure Radar

The median house price at the end of 2009 was down 35-40% from its peak value at the height of the bubble (depending on the data source). [Figure 20] Only Nevada edged out California for the worse plunge in home values (and the two state economies are closely linked). Home values at the coasts and in the city centers held up much better than in the interior, where several urban areas had cumulative price declines over 50% by the end of 2008 – the worst in the nation. California had 2.4 million underwater mortgages by the end of 2009, around 35% of mortgage-holders, compared to 14% nationally by that time (Levy 2009).<sup>25</sup>

Working families concentrated in the inland areas of California were the hardest hit by the Great Recession. They suffered a double blow of home loss and job loss, with unemployment rates hitting 20% or more in some places, because the chief sources of employment in the interior, such as construction, warehousing, and agriculture, were badly hurt by the crisis. Forbes.com has repeatedly judged interior California towns such as Stockton, Bakersfield, Modesto, and Riverside as among the worst off in the country (Zumbrun 2008, 2009).



Source: RAND

<sup>25</sup> Home price and mortgage data from Zillow.com. E.g., <http://zillow.mediaroom.com/index.php?s=159&item=103>

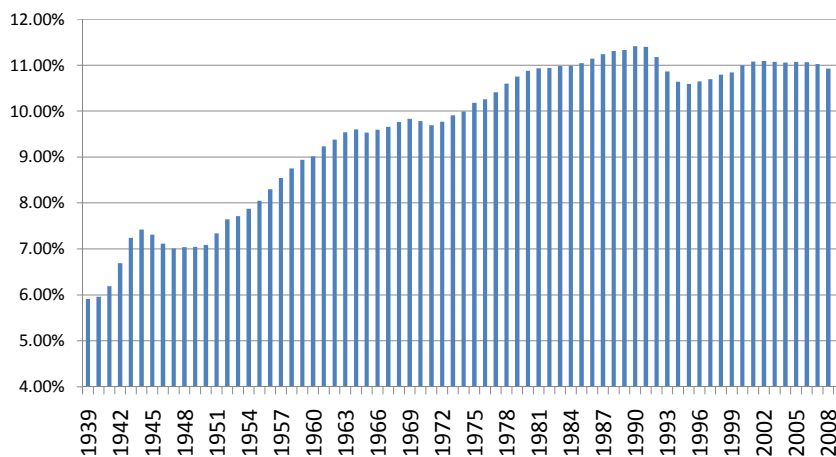
### c. California's Industrial Woes

California has been in the vanguard of American industry since World War II, thanks to its leadership in electronics, aerospace, entertainment, medical technology, and food production (Scott 1988, 1993, 2005, Saxenian 1994, Walker 2004). Overall, the state grew smartly from 1975 to 2000, climbing to fifth largest economy in the world by the end of the century (if it were a country; it has since fallen to eighth). It exceeded the national average in job growth for decades and was especially robust in the 1980s (Walker 2008). **[Figure 21]**

California has been the largest manufacturing state in the union for over 40 years and still employs 1.3 million people in manufacturing (Soja *et al.* 1983, Milkman 2006). In the 1980s, California bucked the trend of deindustrialization, felt so dramatically in the Rust Belt of the Northeast, thanks to the growth of high tech and aerospace (Bluestone & Harrison 1982, Walker 1995).<sup>26</sup> In the 1990s, it became the model for U.S. economic revival and job creation under the herald of The New Economy (Walker 2006, Florida 2002). California was America's last best hope in the face of global competition and industrial decline.

Figure 21

### California Employment as Percentage of US



Source: BLS, EDD

<sup>26</sup> Relative to population size, several rust-belt states still have a larger share of manufacturing.

Yet despite its standing as the industrial powerhouse of America, there are troubling weaknesses in California's economy – like that of the United States as a whole. What are the sources of this apparent contradiction?

First, job growth in California has stopped outrunning the country. Southern California suffered a massive and permanent decline in aerospace jobs in the early 1990s (Walker 1995). The high-tech Bay Area lost hundreds of thousands of jobs after the NASDAQ bubble burst (Walker 2006). California barely matched the sluggish national average of job growth in the 2000s.<sup>27</sup> **[Figure 21, again]**

Second, California has not grown only on the basis of high-tech and "creative labor", as some observers believe (Florida 2002). While upper end employment has been stronger than the national average, so has low-end job growth (Milkman & Dwyer 2002, Dube 2005). Over the last decade, the greatest employment gains have occurred in education, health care and social assistance services, and in accommodation and food services – not just professional and technical jobs. Southern California, in particular, has thrived on a bulging low-wage, immigrant labor force (Milkman 2006). This has helped drag down incomes among blue collar workers. As a result, California's average income grew at only half the rate of the rest of the country, 1980-2000 (Carroll & Ross 2003, p. 6).

Third, despite the hopes for high tech as the state's job generator, electronics has been a leader in shipping jobs abroad (Bardhan 2008). Silicon Valley's employment shrank in the 2000s, even as its wages rose, because mid-level white collar and blue-collar work was being shipped out to India, China and elsewhere (Abate 2009a). Hollywood has been leaking jobs to Canada and other growth peripheries of the entertainment industry (Scott 2005).

Fourth, Southern California's strongest growth sector has been the export/import carrying trade through the ports of Los Angeles and Long Beach. LA-Long Beach is far and away the biggest shipping center in North America and it feeds an enormous warehousing, transport and logistics corridor right out through the Inland Empire (DeLara 2009). This means California has prospered in part on the import trade that undermines local manufacturing and U.S. industry in general. The port of Oakland has played a similar, if more modest, role in Northern California.<sup>28</sup>

Fifth, bubble-driven construction and real estate were California's biggest job generators in the 2000s, making up over 20% of employment growth (Dube 2005), and reaching a peak of 5.6% of total employment in the state. Employment in FIRE rose to reach approximately 950,000 jobs, again just about 5.6% of the state total. When the housing bubble collapsed, the impact was devastating: home-building fell by 75% and about one-half million jobs were lost in construction, real estate, finance and building supplies (Steinhauer 2009).

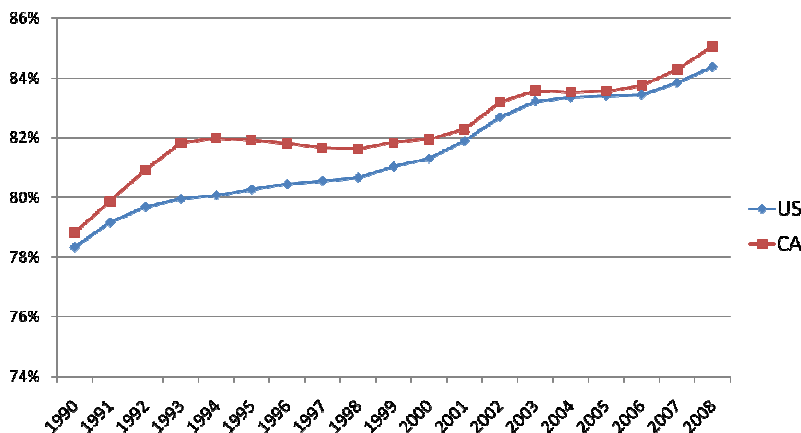
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<sup>27</sup> Center for the Continuing Study of the California Economy, *Numbers in the News*, December 2007 @ [www.ccsce.com/pdf/Numbers-dec2007-job-growth.pdf](http://www.ccsce.com/pdf/Numbers-dec2007-job-growth.pdf), accessed August 14, 2009.

<sup>28</sup> On the other hand, the state gains from the pass-through export trade.

Sixth, California's share of employment in manufacturing has fallen along with the rest of the country. Los Angeles suffered a radical fall from more than one million manufacturing jobs in the 1980s to just over one-half million today (Milkman 2006). Meanwhile, the share of services in California has risen faster than the U.S. average, with a marked bump accompanying the crisis of the early 1990s. [Figure 22] The dominance of services in the state's economy fuels further concern. In addition to the low productivity growth of services, mentioned earlier, the prospects for California's service exports and their capacity to generate jobs are relatively small (Bardhan & Kroll, 2007).<sup>29</sup>

Figure 22  
CA vs US: Services as Share of Total  
Employment



Source: BLS, EDD

Nonetheless, investors continued to pour money into California in the 2000s, as they had in the last two booms and bubbles (Walker 1995, 2005). However, with increased global competition, a global labor market and the willingness of multinational firms to arbitrage labor cost differences, the sustainability of profits and job creation in the state is questionable. If the offshoring of low-paying tradable jobs is a continuing threat, then the best possible scenario for the state is on-going innovation and the generation of high value-added jobs in Silicon Valley, Hollywood and elsewhere.

<sup>29</sup> As mentioned earlier, services exports are characterized by customer input as a necessary requirement in final service delivery; institutional and cultural specificity; the heavy arm of local regulation; and the fact that the only "medium" of delivery, apart from the Internet and goods embedded with services, are people embedded with services knowledge. All of this implies that services exports are more likely to create jobs in countries importing them, than at home.



#### *d. California's Crumbling Finances*

California has been at the forefront of the national fiscal crisis. It has the largest budget after the federal government, about \$100 billion per annum in the 2000s, and also the largest budget deficit of any state today. That deficit stood at over \$35 billion in fiscal year 2009 and is heading for \$20-25 billion in fiscal year 2010 (McNichol & Johnson 2009). [see again Figure 5]

California's fiscal woes are not new. They were brought on by the tax revolt that started in 1978 with Proposition 13, which capped local property taxes and requires a 2/3 vote of the legislature or the citizenry to increase taxes. Proposition 13 was the brainchild of Howard Jarvis, a long-time rightwing political organizer in Southern California and head of the Apartment Owners Association. But Prop 13 appealed to a majority of voters, who were being squeezed by soaring housing costs (and hence property taxes) in the 1970s (Lo 1990, Schrag 1998).

The fiscal result of Proposition 13 was immediate: local governments went into deep fiscal crisis in the recession of 1980-82 and the state had to bail them out by transferring money from the general fund (Schrag 1998). To make matters worse, the Reagan administration in Washington cut federal revenue sharing and aid to cities (Davis 1993), and the Deukmejian administration in Sacramento put its money into the greatest prison-building splurge in U.S. history (Gilmore 2007). To keep things running on reduced tax revenues, the government began to issue more bonds, putting the state further and further in debt.

In the downturn of 1990-93, the state took a \$11 billion nosedive into the red on a \$50 billion budget (Walker 1995). Governor Pete Wilson's poll numbers fell precipitously and to save his skin he seized upon "illegal immigrants" as the cause of the problem. Xenophobia salvaged Wilson's career and he won a second term in 1994, but he poisoned the Republican Party for Latinos and, as their numbers rose, Democrat Gray Davis was swept into the governor's mansion in 1998.

The Democrats tried to reboot social spending using the flood of revenues coming in with the bubble of the late 1990s, raising capital gains taxes to recover some of the riches flowing out of Silicon Valley. Alas, that bubble burst in 2000 and revenues fell off a cliff. This left the state with an even larger deficit of \$24 billion out of \$100 billion budget in 2002-03 and showed that the state's combination of harsh economic downturns and a patched-up tax system was dysfunctional (Walker 2006).<sup>30</sup>

The Republicans blamed Gray Davis for the cataclysm and succeeded in recalling the governor in 2003, electing Arnold Schwarzenegger in his stead. Schwarzenegger promised to solve the budget problems of the state, but could not – since he opposed all further tax increases or questioning of Proposition 13 (Schrag 2006).

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<sup>30</sup> For a full analysis of California tax effort, see <http://caltaxreform.org/>.

Consequently, the red ink began to flow again in fiscal year 2008 as the Great Recession began and the bottom fell out of revenues. The result has been horrendous slashing of budgets for schools, higher education, health and welfare, and local government functions (Schrag 2009). In the process, California's overall budget has shrunk 20% to around \$80 billion annually. And, to add injury to insult, it now has the worst bond rating of any state in the nation.

California is in a state of permanent crisis (Lustig 2010). Other states suffer in downturns, but none has a budget tied up in knots like this one, because none has an inflexible supermajority budget rule (Schrag 2009). The Democrats have proven powerless to reverse the situation. They are stymied by a 2/3 rule for passing budgets in the legislature, which Republicans have used to block any new revenues. In effect, California government has been seized by a Republican *coup d'état*.

### Conclusion

California has had a leading role in the national -- and even global -- crisis of the Great Recession. It was by far the largest stage on which the U.S. housing bubble and subprime madness played out. Sky-high housing prices combined with stagnant incomes to leave more households with unsustainable debt than in any other part of the country. At its foundation, California's industrial might -- and position as the Great Hope of American technology -- has become shakier, making it unable to underwrite sustainable urban expansion and middle class ambition for home ownership. And its massive fiscal crisis is a huge drag on the country's recovery from the Great Recession.

So here we are again in the 2000s, living with the unvarnished truth: the quicker they rise, the harder they fall. It should give pause to all those who think that this downturn is but a mere bump in the continued journey of American economic dominance. Policy responses to the housing foreclosure crisis have nibbled at the problem but have left large issues unresolved. The lessons of the financial crisis have not led to any meaningful reform.

Recovery here, and in much of the country, is likely to be slow and prolonged, as is typically the case after a major financial debacle (Reinhart & Rogoff 2009). Bankruptcies of households, businesses and banks will continue to flourish in 2010; bankrupts will not be spending much. Consumers with income will be paying down debt, suppressing aggregate consumption. Unemployment should remain high, with a largely jobless recovery. GDP growth is likely to be of the sputtering sort experienced by Japan since the 1990s. And the industrial base will continue to shrink in the face of global competition and domestic failure of investment and vision. It's not a pretty picture.

By contrast, the Asian economies are pulling out of the global crisis much more smartly than the United States. Their success proves, once again, certain truisms of economic policy if not of academic economics: the virtues of industrialization over financialization; rising income broadly distributed and development of the home market; savings and domestic investment; keeping a rein on aggregate debt; the role of the state and the public

sector in economic affairs over pure free market ideology; and, above all else, the importance of strategic economic vision and effective policy.

The usefulness of massive stimulus spending by government in a major downturn and the return of Keynesian economics to the center-stage is a welcome lesson; indeed, what signs of life there are in the American economy circa 2009 are due mostly to governmental intervention to save the financial system and public funds being expended to pump up spending. Alas, California's imploding fisc is a dead weight around the neck of the Obama administration in its effort to stimulate a recovery (McNichol & Johnson 2009). And in its straitened circumstances, state government will likely never return to the kind of generous and far-sighted social investment it provided in the past.

Ultimately, what sets California apart from other states is that it is more open to international trade and capital flows, being on the coast and boasting a large immigrant diaspora; it has a greater share of services; and it has a larger share of the “innovation pie”. All these make its economy more prone to booms and busts. Given the fourfold nature of the crisis and the state’s pivotal role in it, effective policy has to be equally multifaceted to cope with future economic volatility.

While certain policies can only be enacted at the national level, California is not helpless. Some potential policy solutions are obvious, if indirect, such as restoring the higher education system in the state to its previous luster. Nonetheless, education, by itself, is not enough to create jobs. At the least, there is an emerging need for an industrial policy and R&D policy in order to fortify key sectors and generate well-paying jobs. And there is a clear need to use tax and spending policies to make a dent in inequality, which is at the root of so many of the state’s problems.

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