



REUTERS/STEPHEN LAM

# CALIFORNIA OR BUST

If the Golden State is to restore its former glory, it will have to reverse course quickly, becoming less socially progressive and more friendly to business.

BY NICHOLA GROOM  
LOS ANGELES, JAN 3

Er<sup>E</sup>rich Kwek's new office is awash in sunlight and impeccably ordered, with enough space for a desk, small sitting area

and a conference table. If you didn't know better, you might mistake it for a corner office at a successful corporation.

But the long whiteboard on the opposite wall is a reminder that this room was never meant to be an office at all.

A year ago, Kwek's office was a classroom filled with first graders. Today, the superintendent of South Whittier School District looks out of his windows into an empty schoolyard.

At the end of the last school year,



**PLUGGING THE HOLES:** South Whittier School District maintenance worker Kent Burrows repairs roof leaks at Carmela Elementary School in Los Angeles, California, December 6, 2010. **REUTERS/DAVID MCNEW**

## *"IT IS A LAND OF DREAMS AND OCCASIONAL NIGHTMARES."*

California state budget cuts forced Telechron Elementary School to go on summer vacation for the last time. Soon after, the district moved its administrative offices into the low, white brick building until it can decide what to do with the property.

Kwek's system is in a downward spiral: as state austerity forces cut after cut and jobs remain elusive, students and their families are leaving -- to areas that hardly seem to be competitors for the California good life. This year, the district lost 175 kids -- double the number it had planned for.

"People who were here for jobs moved out, whether it be back to Mexico or out of state, or whatever," Kwek said.

### **A NEW START**

THE PUBLIC SCHOOLS are a sign of the grim position the Golden State finds itself in as a new governor takes office -- self-proclaimed skinflint Jerry Brown, a Democrat with a long history in California politics.

Just a few decades ago, the state's public school system was the envy of the nation, and California -- with its sunny weather,

laid back lifestyle, stunning landscape and booming motion picture, technology and manufacturing industries -- was both an economic engine of U.S. prosperity and the ultimate symbol of The American Dream.

Today, the image of California is one of brokenness. Its \$1.7 trillion economy is clawing its way out of a recession that crippled its housing market, sent unemployment marching into the double digits and depleted its coffers.

The state also faces a budget shortfall over the next 18 months of more than \$25 billion. Efforts by California lawmakers to plug similarly-sized holes in the budget over the last few years have been unprecedented, epic and tortuous.

Californians' faith in government is in the dumps, and even insiders see the state's future as murky and unstable. "It is a land of dreams and occasional nightmares," California's state treasurer, Bill Lockyer, said.

True, California has seen busts before -- the dot-com implosion was just a decade ago, after all. But this time, projections are for a much slower recovery that will mire America's

most populous state in high unemployment and perpetuate \$20 billion budget shortfalls for years to come.

"We've avoided this discussion over the course of a generation because the boom and bust cycles in California are faster. We could expect economic recovery to save the day," said California Senate President pro tempore Darrell Steinberg, a Democrat. "That's not going to happen this time."

More so than ever before, California faces an identity crisis. If the world's eighth largest economy has any chance of restoring its former glory, it will have to reverse course drastically and quickly, becoming less socially progressive and more friendly to business. The Golden State doesn't just need to go on a diet -- it needs emergency bariatric surgery.

As the new governor takes office, many expect to see state government that is slimmer, with further cuts to education and social services and less generous pensions.

In addition, an unloading of many responsibilities onto local governments is on the horizon. The politics of the future may also be fought at the local level, as Brown

bows out of regulation but leaves mayors and city councils in the tough position of leading change -- and having to raise local revenue to do so.

Businesses, meanwhile, are wondering whether a better future is worth the wait.

### SPENDING WITHOUT SAVING

SINCE AS FAR BACK as the Gold Rush, California has enjoyed a disproportionate share of the nation's wealth. Though it is most famous as the home of Hollywood and high-tech leaders like Google Inc and Apple Inc, the state is also a critical hub of trade with Asia, boasts an agricultural industry that is "the nation's salad bowl" and is headquarters for explosive sectors such as solar energy and electric cars.

But California has been all too willing to spend its wealth rather than save it.

In 2006, for instance, Governor Arnold Schwarzenegger signed a budget that increased education spending to an all-time high and trumpeted the return of funding for art, music and the former Mr. Universe's personal favorite -- physical education.

"They had money they didn't know what to do with," said Dennis Smith, superintendent of Orange County's Placentia-Yorba Linda School District. "They gave us everything imaginable. As opposed to maybe saving the money."

Placentia-Yorba Linda has since laid off dozens of teachers and is scraping the bottom of the barrel just to pay for the basics.

California has been living beyond its means since the go-go days of the dot-com boom pushed state revenues to unsustainable levels. The man Schwarzenegger unseated as governor -- Gray Davis -- implemented hefty spending increases and tax cuts that the state could no longer afford once the Internet bubble burst and revenues settled down to more reasonable levels.

"Promised spending levels were woven into the law that were excessively expensive commitments," Lockyer said.

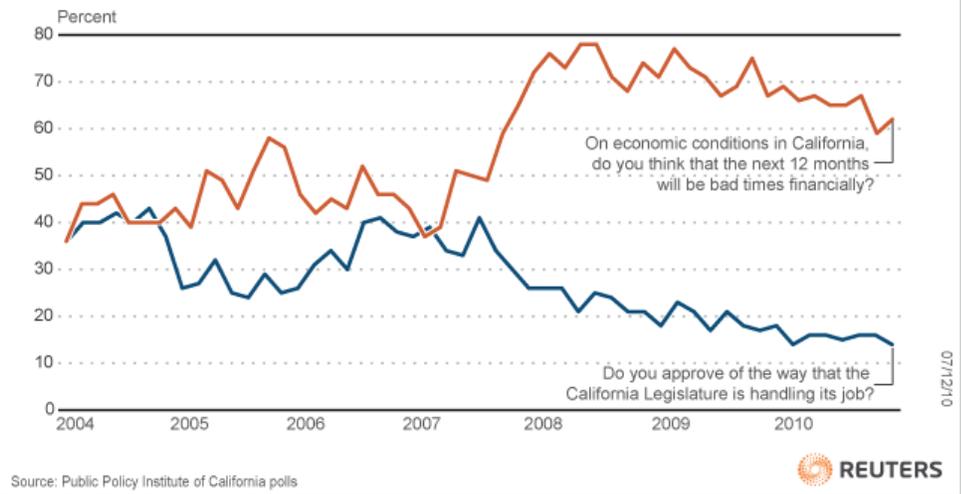
A 1999 law that gave generous pensions to state employees -- long-serving workers could retire at 50 with 90 percent of their salaries -- is widely criticized for ballooning California's unfunded pension obligation to as much as \$500 billion. Schwarzenegger rolled back some of those benefits this year, and Brown has vowed to raise retirement ages and demand more contributions from employees.

### THE JERRY BROWN DIET

THAT'S JUST ONE of many sacrifices Brown

## California poll

As pessimism on California's financial future settles in, the state legislature's approval rating bounces along the bottom.



is asking of Californians. The famously stingy 72-year-old, who served as governor once before from 1975 to 1983, rode a message of frugality to victory at the polls in November. He is preparing to unveil a budget in January that will make many Californians quake in their Birkenstocks.

"The day of reckoning is upon us," the no-nonsense Brown said at a forum with educators in December. "When you look at a budget of this magnitude you are looking at a lot of things that people care deeply about. And those are the things that are going to get cut back, because we have no choice."

With pledges to cut spending everywhere, reform pensions, give more authority to local governments and ease regulations that hamper economic growth, Brown's plans for the bluest of blue states sound straight out of the Republican playbook. Yet voters on the left think Brown will be able to cut back spending while still protecting those in need.

"With Jerry Brown we're finally going to get a governor who has got a brain, but has a heart as well," said Eliseo Medina, secretary-treasurer of the Service Employees International Union, which has 700,000 members in California.

Brown, Medina expects, will take what he called "a balanced approach" -- in other words, a combination of cuts and taxes -- to balancing the budget. "Not simply what Schwarzenegger has done, which is cut, cut and more cutting," Medina said.

Yet even Democrats said they are prepared for Brown to put the state on a strict diet. "Jerry Brown is a Democrat, but he's got

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his own rhythm and his own beat," said Charles Calderon, the Democratic leader in California's State Assembly. "People on Wall Street are saying 'Bite the bullet and let the chips fall where they may.' It's contrary to their world view for Democrats to want to do that, but we're arriving to a point where we are going to be asked to do a lot of that by our governor."

### PRISONS AND WELFARE

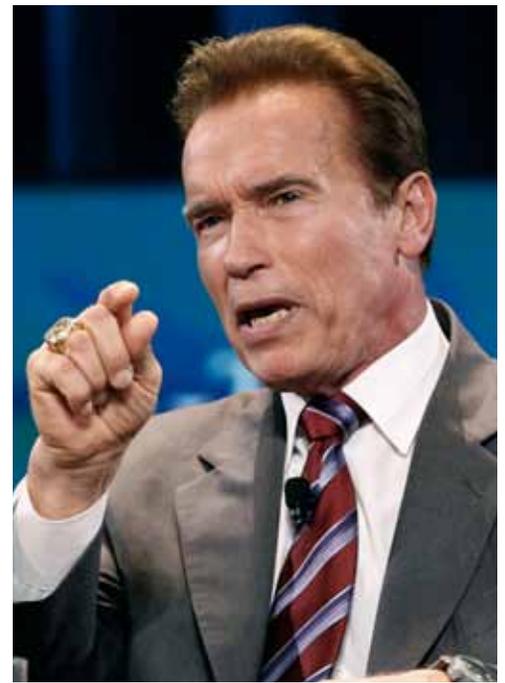
THE QUESTION IS where to cut, and there are not too many obvious targets. "It is a little bit of a misconception out there that the state's spending has been so profligate," said Standard & Poor's analyst Gabriel Petek.

Brown and others have picked out the massive prison system as ripe for savings. Like many states, California's spending on prisons has risen dramatically in recent years due to both tougher crime laws and more stringent requirements for inmate healthcare. What sets California apart is that it also spends a great deal on generous wage and benefit packages for its prison guards.

"You see a bunch of stories about officers making over \$100,000 a year because of overtime," said James Austin, president of corrections consulting firm JFA Institute.



**RIPE FOR CUTS:** A view of the California Medical Facility, a prison hospital, in Vacaville, California March 17, 2010. **REUTERS/ROBERT GALBRAITH**



**GUBERNATOR:** Outgoing California Governor Arnold Schwarzenegger gestures during an appearance at the Women's Conference 2010 in Long Beach, California, October 26, 2010. **REUTERS/MARIO ARZONI**

"And then they marry each other, and they have baby guards, and you got a family making half a million bucks."

California's prison guards union campaigned aggressively for the labor-friendly Brown. The union has been without a contract since 2006 after negotiations with Schwarzenegger reached a standstill, and its members are optimistic that Brown will offer them a better contract.

"Anything will be better than what Schwarzenegger put forth," union spokesman Ryan Sherman said, adding that prison guards "have been taking quite the monetary hit as of late."

But who in California hasn't?

"What we have is a very grumpy set of claimants," Brown said at the education forum in December, referring to, well -- everyone. To show his gratitude for their support, Brown showed up at the prison guards convention in Las Vegas in early December. His message to them? We must tighten the belt.

The incoming governor also proposed to cut corrections spending by reducing the number of inmates who spend 90 days or less in state prisons. Lawmakers including Steinberg, however, said weeding out some offenders from state prisons will "take a lot of political will."

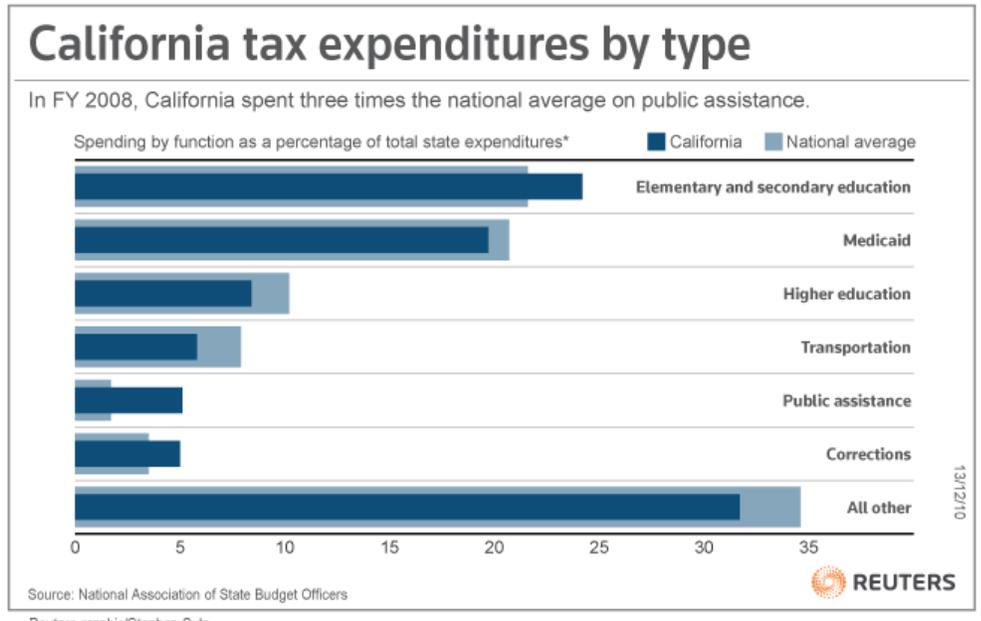
Welfare is another area that could see cuts, as California's spending on cash assistance far exceeds that of other states. At various

times, including his latest attempt to plug the current budget hole, Schwarzenegger has proposed eliminating California's welfare program altogether.

California has a higher percentage of people on welfare because it allows children to keep receiving cash assistance after their parents exceed their five-year time limit or fail to comply with the program's requirements. At the same time, the state spends more of its welfare dollars on cash payouts rather than programs like child care.

"California does end up looking like an outlier in the way it has run its welfare program," said Caroline Danielson, a research fellow at the Public Policy Institute of California.

And yet Californians, who are proud of living in a socially progressive state, have made it clear that cuts to welfare would be very unpopular. In October, a statewide uproar ensued when Schwarzenegger vetoed funding for a welfare-to-work child care program because he said lawmakers had not



*"THE FUNDING FOR SCHOOLS IS A POLITICAL PROCESS, AND EVERY YEAR THAT PROCESS IS STALLED."*



**CORNER OFFICE:** South Whittier School District Superintendent Erich Kwek, Ed. D., and consultant Eric Hall (R) talk to a reporter in Kwek's office in a former classroom at Telechron Elementary School, which became the administrative offices of the South Whittier School District after budget problems forced the school to close last year, in Los Angeles, California, December 6, 2010.

REUTERS/DAVID MCNEW

set aside enough money in the state's rainy day fund.

In some respects, Californians are still in denial about what it will mean for the state to live within its vastly depleted means. According to a USC/Los Angeles Times poll in November, just 24 percent of voters believe services such as health care and education will have to be cut.

"No one wants Grandma left out in the middle of the street in her wheelchair with no help," said Connie Conway, the new Republican leader in the state assembly.

### TAX BATTLE

CALIFORNIANS DON'T WANT the government taking more of their paychecks either. At the polls in November, they rejected a fee increase to fund state parks and

approved a measure that will make it harder for the legislature to raise taxes.

"The voters really spoke: 'Do not tax us anymore,'" Conway said.

But many in the state say taxes, rather than spending, are at the heart of California's troubles. For some, the Golden State hamstrung its finances when a 1978 ballot initiative, Proposition 13, capped property taxes at 1 percent. California became more dependent on personal income, sales and corporate taxes, which can fluctuate wildly from good times to bad.

"Where we draw our revenue from is equally as broken as what we spend our money on," said Assemblywoman Alyson Huber, a moderate Democrat. "If I were your investment adviser and you had \$25 billion to \$40 billion swings in your portfolio, what

would my advice be to you? Diversify."

Prop 13 also limited the ability of California's towns and cities to raise their own revenues by requiring a two-thirds vote to do so. The idea was to consolidate school funding at the state level to give districts an equal amount of money regardless of whether they served rich or poor communities.

But now, California has spent decades controlling the purse-strings of its cities and school boards without the benefit of stable and predictable revenues. "The funding for schools is a political process, and every year that process is stalled," Kwek said. "We need a more stable stream of money for schools that we can count on."

Schools would like their funding linked to property taxes, though it would be virtually impossible for Brown to do away with Prop

13. It has been called both the “sacred cow” and “third rail” of California politics, and many said any move to overhaul the tax base would be political World War III.

“The political problem you have is it means that the folks on the right have to have a conversation that involves the word ‘tax,’” Huber said. “And to my friends on the left, I criticize them just as much. They need to come to the table agreeing not to increase the size of the pot.”

A more doable solution -- and one that Brown has said he wants to pursue -- would be to give localities more control over their finances. That could be a euphemism for saddling them with more responsibility or a promise to help overturn part of Prop 13 and make it easier to raise taxes locally.

But that still doesn’t solve California’s dilemma over whether to hike its already lofty state taxes to help close the current budget chasm.

Brown has said that any tax increase would have to get voter approval, and many expect him to put the screws on voters with a harsh and miserly budget.

“Jerry Brown is going to early on inflict a lot of pain by putting a budget together that is living within the state’s means,” said Eric Hall, a consultant to several California schools districts. “Once the screaming gets loud enough he’ll put a measure on the ballot to increase revenues.”

**“THE WORST PLACE IN THE UNIVERSE”**

THE PROBLEM IS THAT many believe California simply can’t afford to raise taxes. That’s particularly true for the corporations the state needs to put its residents back to work. Recently, California came in 49th in a Tax Foundation ranking of the business-friendliness of U.S. states, partly because its corporate tax rate is the eighth highest in the nation.

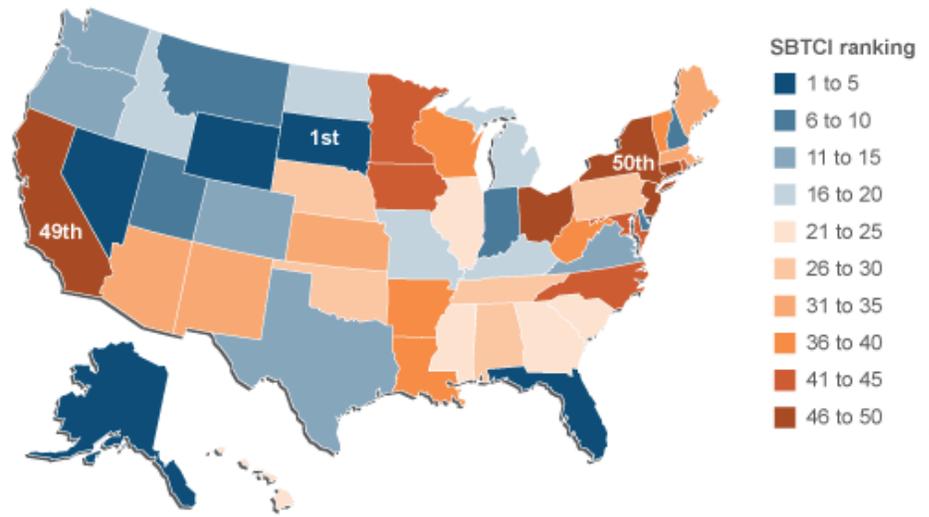
“The business community, they are a group that feels probably more oppressed than the schools,” Brown said last month. “They really feel like they are in the worst place in the universe and they all want to leave.”

California’s landmark climate change law, with plans for more renewable energy and a market to curb greenhouse gases, is another albatross around the neck of California businesses because it adds layers of regulation they don’t have elsewhere, said Bob Dutton, the Republican leader in the state senate.

“It doesn’t do you any good to chase your jobs over to China,” Dutton said. “They aren’t green.”

# California’s bad business climate

According to the 2011 State Business Tax Climate Index (SBTCI), California ranks as the second-worst state for businesses in the country.



Source: The Tax Foundation

Reuters graphic/Stephen Culp



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But others say the law, which survived an oil company-backed challenge at the polls in November, will go a long way toward solidifying California’s status as a leader in innovation and creating both high-technology and manufacturing jobs.

In Silicon Valley’s San Jose, green technology companies have grown despite the recession. But the city’s mayor said California needs to do a lot more to support other industries.

“Clean technology is not somehow going to transform the state,” Mayor Chuck Reed said.

If it can’t be cheaper, California will have to compete for corporate jobs by being more nimble, Reed added. As an example, he cited how San Jose prevented network equipment maker Brocade Communications Systems Inc from pulling up stakes by finding a site for its new headquarters, expediting building permits and offering a tax rebate.

“We put up \$2.5 million, but they will generate more than \$2.5 million a year of revenues to us forever,” Reed said.

To be fair, California has sent some recent signals that it is ready to help businesses expand. In November, voters killed a ballot measure that would have repealed certain corporate tax breaks, and earlier this year the state made purchases of green technology manufacturing equipment exempt from sales taxes. But the state has a lot further to go.

“We should be doing more tax credits, for things like manufacturing jobs coming to

California,” said Huber.

Luckily for California, the state still has one major advantage -- it is still the home of U.S. tech innovation.

“The fastest way to introduce innovation into a product is to have the production and development talking to each other constantly and not separated by significant distance,” said Elon Musk, whose electric car company, Tesla Motors Inc, and rocket company, Space Exploration Technologies Corp, both have manufacturing operations in California.

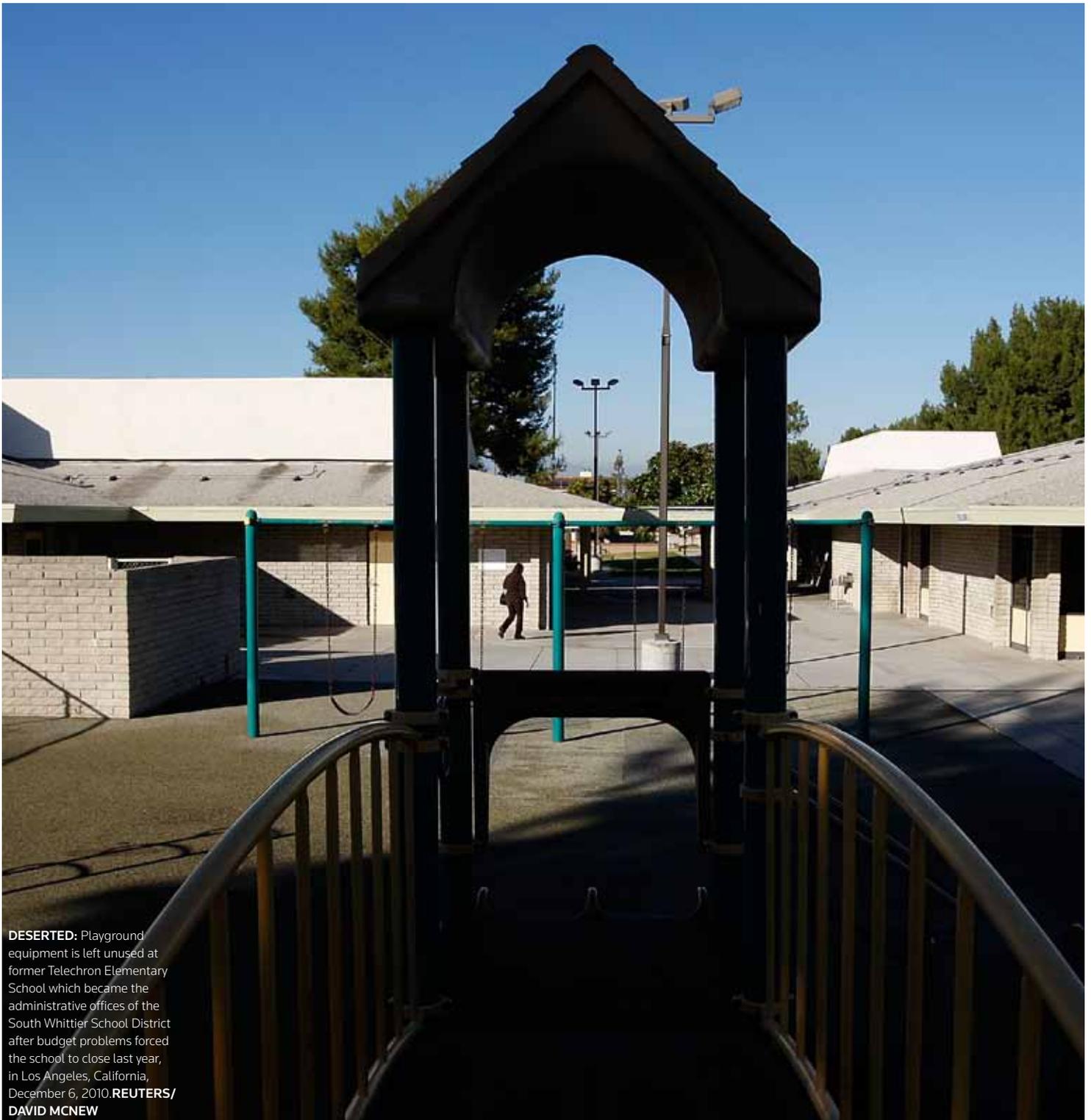
Musk warned, however, that California must be vigilant about making sure its tax code and labor laws don’t outweigh the benefits of its location.

In other words, California must be better about looking over its shoulder. “We’re always in danger,” Reed said. “It’s a global market that’s fierce. We have to worry about it all the time.”

Recently, for instance, Utah’s governor pitched California companies on expanding there after his state ranked No. 1 on the Forbes list of the best states for business. California, which ranked a dismal 39th on the list, has already seen several of its companies, including Adobe Systems Inc, Twitter and eBay Inc, establish themselves in Utah.

“There is no excuse for California to play second fiddle to any other state in the nation,” said Senator Dutton. “But right now we are.”

(Reporting by Nichola Groom; Editing by Claudia Parsons and Jim Impoco)



**DESERTED:** Playground equipment is left unused at former Telechron Elementary School which became the administrative offices of the South Whittier School District after budget problems forced the school to close last year, in Los Angeles, California, December 6, 2010. **REUTERS/DAVID MCNEW**

**COVER PHOTO:** Democratic candidate for California Governor Jerry Brown speaks to supporters as he celebrates his victory over Republican challenger Meg Whitman, at his election night rally in Oakland, California November 2, 2010. **REUTERS/STEPHEN LAM**

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