CHAPTER 1

A FORECAST FOR THE CALIFORNIA LABOR MARKET

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The condition of the California labor market, or, more properly, labor markets is in large part a reflection of the general health of the State's economy. In turn, the California economy is linked to the level of activity in the nation as a whole as well as to global markets for goods and financial assets. The outlook for the California labor market is good by almost any measure, but there are dangers primarily stemming from risks in the financial sector. Specifically, a major and sustained meltdown in the stock market could have adverse effects nationally and a disproportionate impact within California. In this chapter, we draw on evidence developed by the UCLA Anderson Forecast at its March and June 2000 quarterly conference as well as earlier, longer-term analysis assembled by the Forecast Project.

California's National Linkage: A History

Graph 1 shows the close association between economic conditions in California and the rest of the U.S. as reflected in annual percentage changes in employment (Mitchell 1998). Basically, if a California forecaster were allowed only one piece of information in projecting next year's labor market trends, he/she would want to know what was going to happen in the U.S. as a whole. From World War II to the mid-1990s, a second question would have been what was happening to defense spending. But after the mid-1990s, that second question became increasingly less important due to the decline of California's defense sector.

Although it is fashionable for state boosters to point to what a large economy California would be if it were an independent country, it is not in fact an economically independent entity, as graph 1 makes clear. There is no California central bank and no California currency or exchange rate to provide economic independence from the rest of the U.S. There were political and social movements within the state during the Great Depression that sought to revive the California economy in the face of national depression through creation of some form of California monetary independence (Mitchell 2000). But as a practical matter, no such options exist for a state within the U.S. Nor can California isolate itself from U.S. trends through protective tariffs or internal migration barriers, although the latter was also tried briefly and illegally by Los Angeles in the 1930s.[1] California's financial markets are also not separable from those outside its borders.

Since the end of World War II, California has achieved a faster rate of population, labor force, and employment growth than the U.S. as a whole. However, defense spending – especially as reflected in its aerospace industry – played an important role in the State's ongoing economic expansion. The end of the Cold War, therefore, left a scar on the state. Two gaps opened in the late 1980s and early 1990s which

have not yet been closed. California's share of the nation's population diverged from its share of employment, resulting in a softer labor market in California than in the U.S. And the State's employment growth – even after recovery from the recession of the early 1990s got underway – remains on a lower expansion path than previously. According to UCLA Anderson Forecast projections, the latter gap means a "loss" of about 2.5 million hypothetical jobs for the State by 2002, compared to what would have been expected on the old growth path.

For many years after World War II, California had a somewhat higher unemployment rate than the nation as a whole. The higher rate reflected in part the State's youthful age profile that had developed by the early 1950s. New migrants into the State, initially from the other states but to an increasing extent from other countries, tended to be young and mobile. Although California experienced the same deep recession in the early 1980s as the rest of the country, the Reagan administration's defense build up of that era closed the gap between the national and state unemployment rates. The post-Cold War decline of aerospace reopened the U.S./California unemployment rate gap, although a convergence began to develop in the post-recession period of the late 1990s.

Net in-migration to California (domestic + foreign) actually turned negative in the early 1990s due to falling job opportunities in the State. (graph 2) The outflow was a domestic matter; immigration to California remained positive throughout the period, sparking the State's anti-immigration Proposition 187 of 1994. But the delayed California recovery again began sucking in domestic migrants by the late 1990s. Still net in-migration to the State has not returned to the levels seen in the Reagan-era expansion.

Recent National Trends

By the late 1990s, the U.S. economy was in a boom unlike anything seen since the late 1960s when Vietnam War spending played a role (Dhawan 2000a). The national unemployment rate fell to levels not attained since that earlier era. In a sense, the 1990s were the mirror image of the 1970s. In the 1970s, everything that could go wrong seemed to do so. The Bretton Woods international exchange rate system collapsed in the early 1970s, leading to dollar depreciation and resultant inflation. A war in the Middle East crystallized the OPEC cartel, producing a dramatic increase in petroleum prices in 1973-74. The Iranian revolution at the end of the decade had a similar effect, a second "oil shock." Productivity growth, for reasons still unclear, slowed dramatically.

In the 1970s, everytime we flipped the economic coin, it came out tails – to the point where observers began to think that perhaps there was something wrong with the coin itself. That something was nicknamed "stagflation," a seeming tendency for inflation to accelerate even at comparatively high rates of unemployment. A popular explanation at the time was that it was all the fault of the baby boomers. Young people have higher unemployment rates, so some of the stubborn failure of the unemployment rate to decline was blamed on the boomers then entering the labor market. Moreover, their declining SAT scores were taken as a sign of educational failure and poor work attitudes, thus accounting in part for the productivity problem. Government commissions were set up to study the perceived productivity crisis.

The stagflation of the 1970s spooked the stock market, particularly as the Federal Reserve pushed up interest rates to halt inflation acceleration. But it is important to note that sometimes even a fair coin will produce a string of tails. And just as a fair coin can produce a string of tails on occasion, sometimes it will also produce a string of heads.

In the 1990s, we experienced such a string of heads. The dollar tended to appreciate, holding down inflation through import competition. Excess demand at home could spill over and tap slack international markets rather than raise domestic prices. This tendency was aided by bad fortune abroad. A soft Europe made up of countries trying to meet the criteria to join the Euro zone, a Japanese economy weakened by the bursting of a stock and real estate bubble, a slump in Mexico brought on by a currency crisis, and a later currency crisis in Asia all held down world prices and led to an international scramble to export to the U.S.

With inflation in check, the Federal Reserve could avoid slowing the surging U.S. economy (and thus the California economy) through anti-inflation interest rate hikes. Indeed, in 1998, interest rates were cut during the Asian crisis. And they have come back only gradually since. American consumers went on a

spending binge fueled by a dramatically rising stock market. Technology and Internet-related shares rose dramatically in value, producing a wealth effect that seemed to make ordinary saving superfluous. The nickname for the economic coin toss outcome in the 1990s was the "New Economy."

Just as explanations abounded for the string of tails in the 1970s, so, too, were there handy explanations for the string of heads in the 1990s. It was said that technology had so boosted productivity that core consumer price inflation (excluding food and energy) was being held in check. Measured productivity did indeed seem to accelerate, reversing the sluggishness that had set in the 1970s.

But there are questions about these interpretations. During the 1990s, there was considerable agitation to "fix" official price indexes, especially the Consumer Price Index (CPI). The official reasons were that the CPI did not adequately reflect quality improvements and did not allow for consumer substitution possibilities. In fact, a major motivating factor was to hold down CPI-linked cost-of-living adjustments in Social Security which appeared expensive in the light of the coming retirement of the baby boom. Related changes in statistical methodology also affected the national income accounts. By holding down officially recorded inflation, statisticians thus boosted "real" GDP growth and therefore measured productivity increases.

In particular, "hedonic" quality adjustments to computer prices have produced enormous measured gains in productivity in computer manufacturing itself (Mitchell 2000b). Thus, as graph 3 shows, the supposed productivity boom is heavily concentrated in durables manufacturing, the sector containing computers. In nondurables and non-manufacturing (including services), no productivity boom is apparent. Given problems that have become inherent in interpreting official data on GDP and inflation, the best indicators of the condition of the national economy are now those linked to the labor market: employment, unemployment, and wage change.

Pay increases have generally been moderate, despite widespread reports of labor shortages, although some acceleration can be seen (Mitchell 2000c). New economy advocates seek to explain this moderation by proposing that "everyone" now receives stock options – not measured in the official wage indexes – as part of their compensation package. But that isn't really true. Some people, mainly professionals and managers do receive stock options. However, when the wage data are confined to production and non-supervisory employees – folks who don't usually receive options – they have shown the same moderation as the broader occupational pay indexes. In fact, given other trends, such as price inflation, wages as measured by the ECI were more or less following an expected path after a pause in 1999. The tight labor market was leading to an acceleration in nominal pay increases, one of the factors leading the Federal Reserve to raise interest rates.

There is no doubt that the national economy boomed in the late 1990s and that the stock market played a role. There is no doubt that unemployment fell dramatically and that other labor market indicators – such as new claims for unemployment insurance – also suggested a very tight labor market. However, measurement changes make comparisons with past performance in terms of real GDP and productivity growth subject to question. What is clear is that the good times nationally - however measured, have helped California. And some of the good times – namely the rise in value of technology stocks – originated in California.

At the national level, the UCLA Anderson Forecast has projected an eventual slowdown – not a recession – as past and future Federal Reserve interest rate hikes take hold. This prognosis assumes that while there might be a stock market "correction" of some type, a more drastic financial meltdown will not occur. Such a meltdown, however, is the greatest risk to the national and state economies.

The Short-term California Labor-Market Outlook

Employment growth in California accelerated during 1999, reaching an annualized rate of 4 percent in the second half of that year and early 2000 (Lieser 2000a). As a result, the gap between California and U.S. unemployment rates continued to narrowed and is expected to disappear. (table 1) Exports from California expanded as the world economy generally improved. Growth in Mexico and relative sluggishness in Japan moved Mexico into the top-ranked destination for California goods in 1999. That pattern continued into early 2000. Exports to Mexico from California are four times as large as sales to

all the rest of Central and South America. Note that the category "industrial machinery" on table 2 includes computers. Thus, California's export goods have a definitely high-tech flavor.

Payroll employment data are annually "benchmarked" to a complete job count based on unemployment insurance tax records. Table 2 shows the regional distribution of employment and change in employment during 1999 within California. Central California remained a soft spot in the California economy with high unemployment. Northern California showed the impact of the Silicon Valley expansion with extremely low unemployment rates in San Jose and San Francisco. The former's rate of employment growth has been hindered by a severe labor shortage. In Southern California, the Orange metropolitan area has achieved an extremely low, Silicon Valley-style unemployment rate. Los Angeles remained something of a hole in the regional economic doughnut with relatively high unemployment and only a modest pace of employment increase. While the annual non-farm payroll employment count for California as a whole passed its 1990 (pre-recession) peak in 1996, the Los Angeles-Long Beach metropolitan area was just getting back to its prior peak in early 2000.[2]

Industries linked to real estate showed high rates of job growth in 1999 and early 2000. Both residential and nonresidential construction were exhibiting rising trends in 1999 and are projected to continue in that direction. Residential construction output, however, remained well below the peak rates of activity seen in the decades of the 1960s, 1970s, and 1980s, an issue taken up below. Areas of strength in 1999 and early 2000 included construction employment (graph 4) and jobs in lumber and wood manufacturing. Table 3 shows past and projected rates of employment growth in selected industries and sectors.

Aerospace employment resumed its decline in 1999 after a period of relative stability in 1997-98. The decline occurred despite projected and actual increases in real U.S. defense spending. Apparel, which had been an expanding sector until the late 1990s, remained a weak area in 1999, as it adjusted to competition from low-wage imports. Corporate restructuring in banking produced a notable employment decline in the mid-1990s and the financial sector remained stagnant in 1999. Electronic and computer manufacturing remained flat in 1999, but renewed exports demand should produce future improvements.

Strong areas in employment growth are found in private and public services. Motion picture employment has been expanding despite fears of "runaway" production to Canada. The business services sector has been increasing rapidly. Some of the growth is due to outsourcing of activities by manufacturing and other employers such as payroll accounting and office cleaning to specialized service firms. Temporary help supply agencies are also included in the business services sector. State and local government employment has been expanding, fueled in part by rising tax revenue and a growing need for school teachers due to policies emphasizing class-size reduction.

Public sector employment growth, of course, can only be sustained if tax revenue continues to fill up government coffers. California consumers have been following their national counterparts on a spending binge, thus producing strong sales tax receipts. Some of this exuberant spending undoubtedly reflects the wealth effect stemming from the stock market. But there are also direct state tax receipts from capital gains in the stock and real estate markets. California Department of Finance estimates provided to the UCLA Anderson Forecast suggest that over 8 percent of tax receipts to the State's general fund will have come from capital gains in 2000 – up from 2-4 percent in the mid-1990s. Initial Public Offerings (IPOs) have produced disproportionate wealth effects in California. One estimate, based on IPOs in California during 1997-99, suggests that the 134,000 employees in these firms who were eligible for equity stakes acquired equity interests of about $500,000 each! (Mattey 2000).

Clearly, a stock market reversal would have a significance adverse impact on state and local revenue, thus dampening the demand for government employees. It would also potentially affect other asset markets – notably real estate – which as indicated above has been a source of employment growth. In part supported by stock market gains, California single-family housing prices stood 50 percent above the national average in 1999. In the longer-term such a housing cost differential can discourage employment growth in the State by making housing unaffordable and hindering worker recruitment. But in the short-term, a decline of housing prices could aggravate an economic downturn through a negative wealth effect

and a loss of consumer confidence. Such a sequence was part of the California recession story of the early 1990s.

In short, just as there is a significant risk to the national economy posed by a stock market reversal, so – too – is there a major risk to California. Indeed, because California has a disproportionate interest in the high-tech and Internet firms that drove stock market increases through 1999, it is more vulnerable than other states to a prolonged market slump. As the experience in Japan over the past decade suggests, such financial slumps can produce a prolonged period of sluggish economic performance and chronic soft labor markets.

The Long-term California Labor Market Outlook

Over long periods of time, the year-to-year ups and downs of the business cycle cannot be projected (Lieser 1999). The UCLA Anderson Forecast anticipates that the State's population will rise about 1.6 percent per year through 2020 while the labor force is expected to rise at an annual rate of 1.9 percent. (table 4) Thus, a significant rise in gross labor force participation is expected. Obviously, such growth in population and workforce will pose many challenges including environmental, transportation, and housing. Housing poses a special challenge since there are many barriers to expanding the housing supply. A "Santa Barbara" policy of tightly restricting development ultimately will produce such high housing costs that employment and population growth will be restricted. Completely open development, on the other hand, raises issues of quality of life.

The UCLA Anderson Forecast projects a tilt in employment mix toward services and finance-insurance-real estate. These projections are based on the following assumptions:

- Aerospace employment will reach a critical mass and thereafter will be sustained, although growth of employment and production will be very limited. R&D activities in this sector will continue. California offers advantages to R&D that are not available to actual manufacturing of aerospace products.
- Despite competition for land and water, agricultural output in California will continue to increase. However, high productivity growth will continue to produce a decline in farm employment.
- Retail employment in finance and business services will increasingly shift to the Internet. However, there will be continued need for employees to deal with such functions as credit approval and regulatory compliance. There will also continue to be strong demand for information services employment.
- Construction in California seemingly has shown a decline in productivity, with substantial reductions in residential and non-residential construction and yet more employees. This anomaly makes employment projections uncertain. It is assumed that gains in construction jobs will be modest.
- The Internet could have a negative effect on employment in wholesale and retail trade. Some employment gains are nonetheless projected, but wholesale/retail trade employment will slip as a fraction of overall employment.

Although California has been a relatively youthful state compared with the overall U.S. (thanks to in-migration from domestic and foreign sources), it will share in the uncertainties posed by the retirement of the baby boom. Some of these uncertainties are showing themselves today in debates over how to "save" Social Security and Medicare. Issues relating to private pension plans, saving, and retiree medical benefits are also beginning to surface. Even if stock market gains of recent years are sustained, as the baby boom reaches retirement age, its members will want to cash out their holdings. They will have to sell their assets to someone.

In the past two decades, the U.S. has financed its consumption binge by borrowing from abroad, thereby becoming the world's largest debtor. But other developed countries have baby boom/baby bust demographics roughly similar to those of the U.S.; they, too, will want to cash out their claims on the U.S. as their populations age into retirement. Thus, the short-term financial uncertainties discussed in the

previous section have their counterpart in longer-term uncertainties in the interaction of demographics and finance. The longer-term projections for California do not explicitly assume a particular resolution of these issues. Readers should keep in mind that it is simply assumed that in the long run California's population will continue to grow relative to the nation as a whole and that jobs will be available for those of workforce age in the State.

California's employers depend on the continuing inflow of new entrants into the labor market. At present, there is much concern about the quality of K-12 education in the State. But other than class-size reduction, there seems to be little consensus on remedies for public education. A poor quality K-12 system can only aggravate the degree of income inequality that has particularly characterized California (Reed 1999). Poor basic education threatens the State's labor supply; resulting labor-market outcomes threaten social and political stability in California.

Summary

- The California economy suffered a more severe recession than the U.S. in the early 1990s, but since the mid-1990s has been experiencing a solid recovery.
- California's economy, although large, is not independent of national trends. It is vulnerable to the financial risks that face the overall economy. In certain respects, it is more vulnerable to a major stock market crash than the U.S. as a whole due to the presence of "New Economy" industries in the state.
- The long-term outlook for California is for more rapid population and employment growth than the nation. But questions remain about the supply of housing and the quality of education for the growing population. Income inequality remains a troubling issue for the state.

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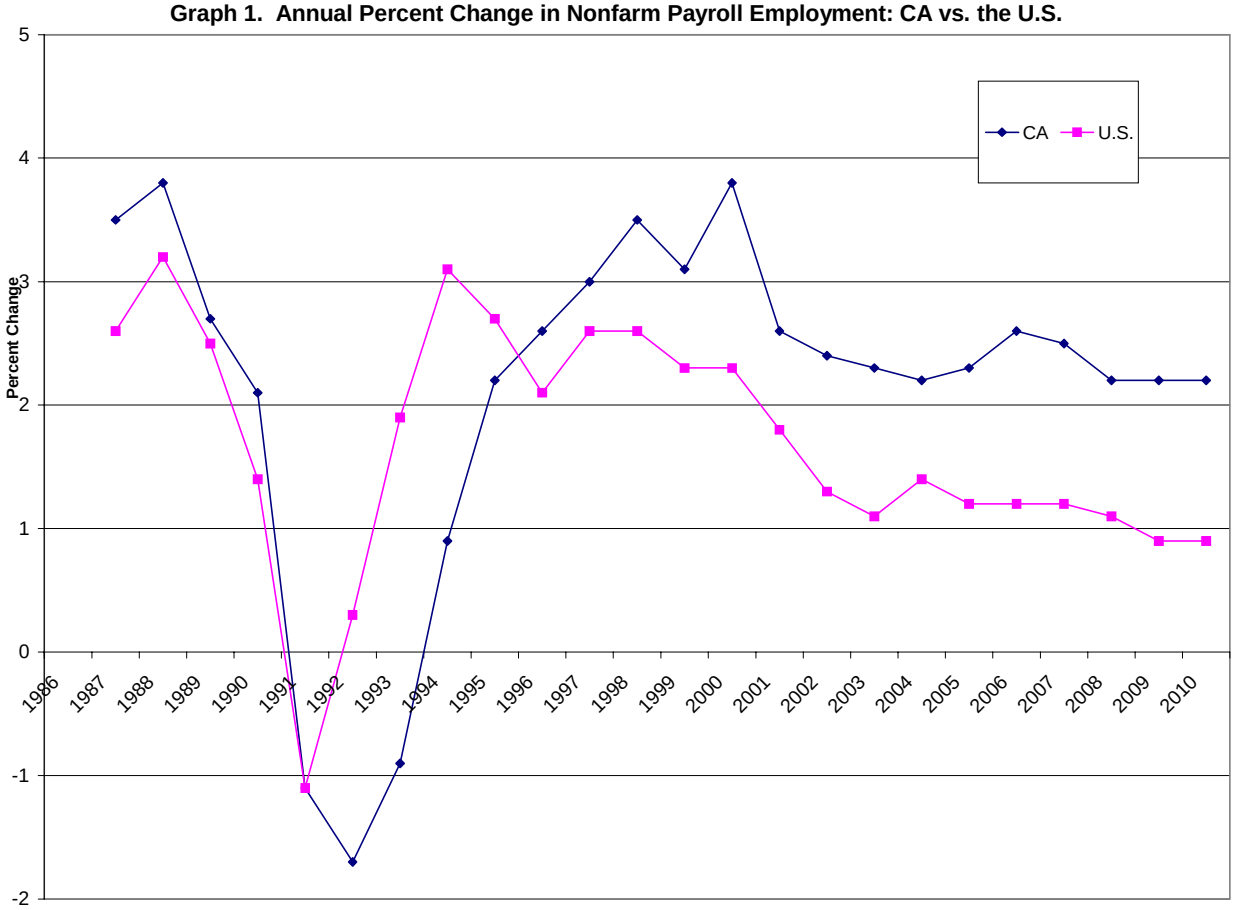
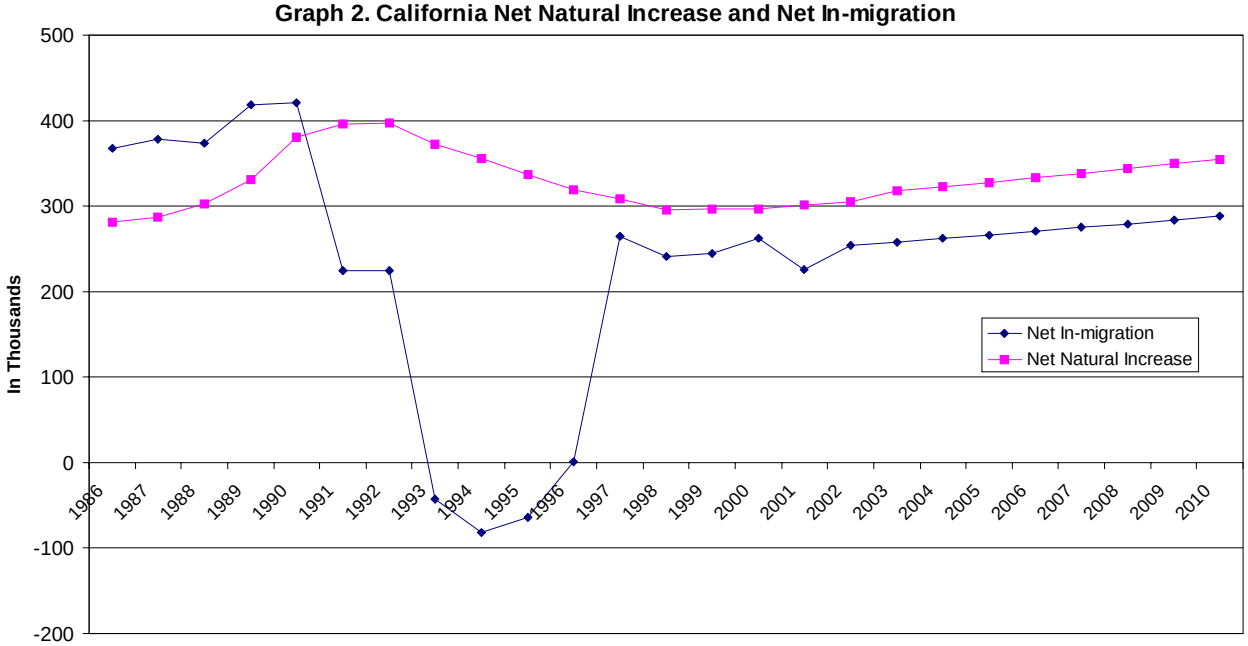
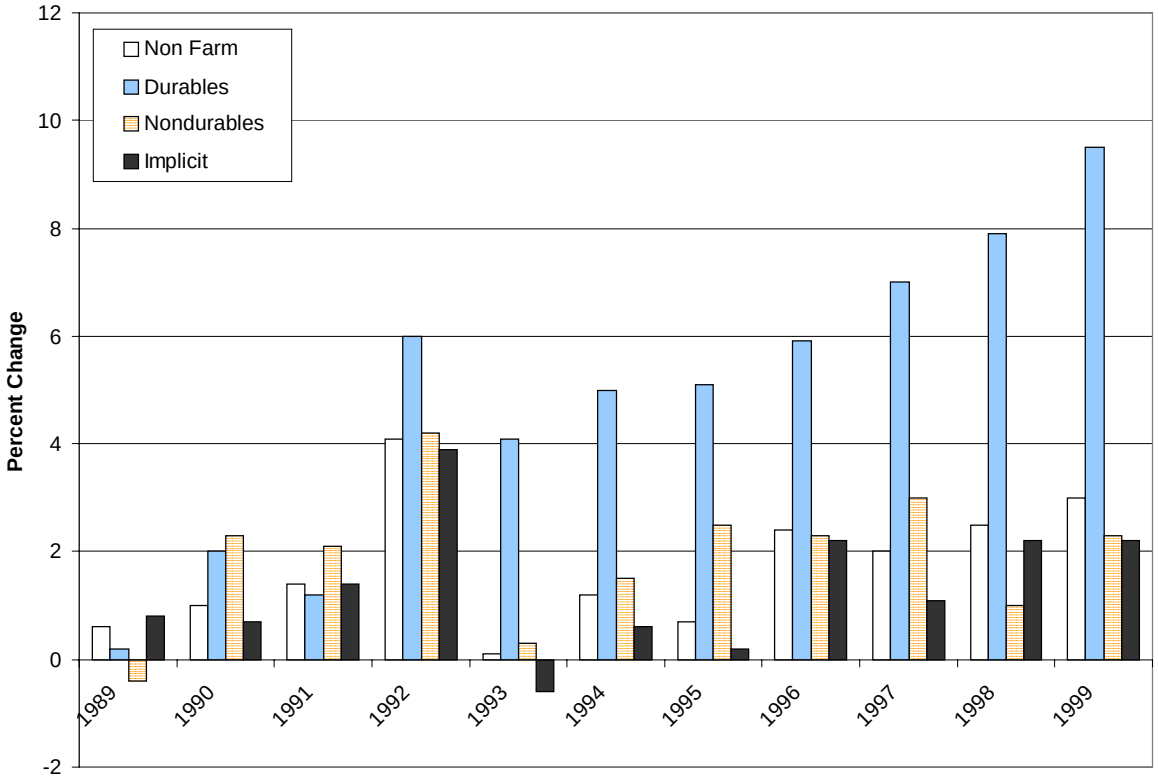
Graph 1. Annual Percent Change in Nonfarm Payroll Employment: CA vs. the U.S.



Graph 2. California Net Natural Increase and Net In-migration



Graph 3. Sectoral Productiviy Measures: Year-Over-Year Change



Graph 4. California Employment in Construction

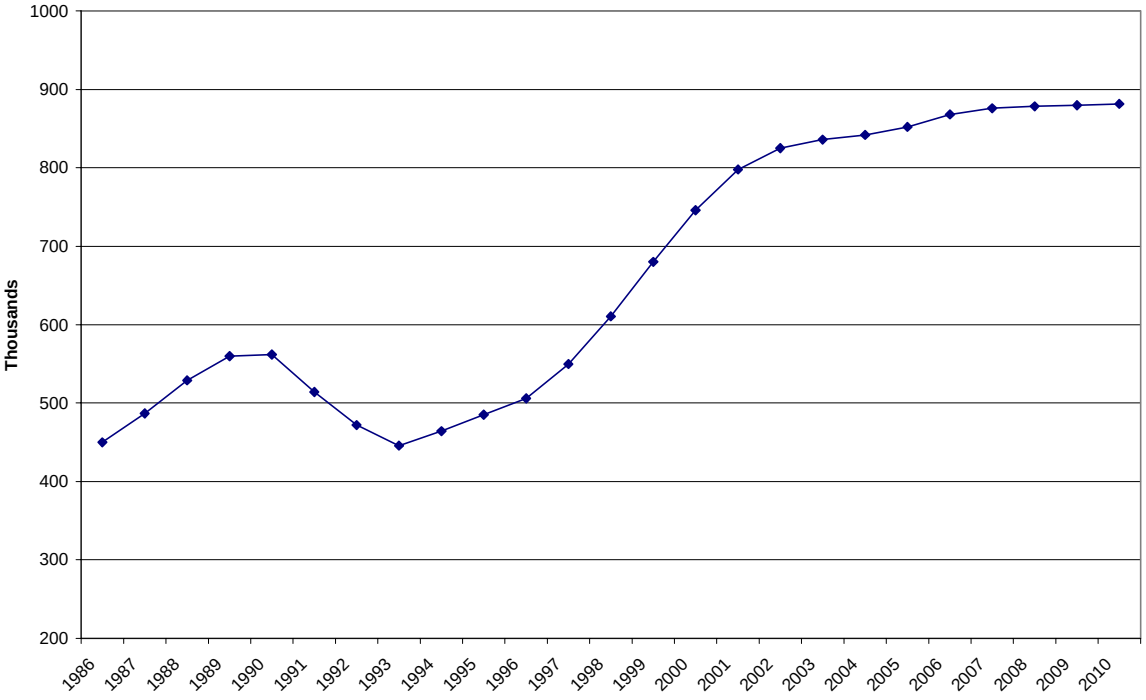


Table 1: UCLA Anderson Forecast as of June 2000: Unemployment and Payroll Employment

	1998	1999	2000	2001	2002
Unemployment Rate:					
U.S.	4.5	4.2	4.2	4.6	4.6
California	5.9	5.2	4.8	4.5	4.6
Non-farm Payroll Employment Growth:					
U.S.	2.6	2.2	1.9	1.1	1.2
California	3.6	3.1	3.8	2.6	2.5

Table 2: Recent Trends in Employment in Selected California Metropolitan Areas

	Non-farm Employment 1999 (000)	Employment Growth at Annual Rates (%) 1999	2000 YTD
SOUTHERN	7,856	2.9	3.0
Los Angeles	4,005	1.6	2.2
Orange	1,345	3.5	3.3
Riverside -S.B.	934	5.8	5.5
Ventura	263	4.2	4.1
Santa Barbara	159	2.5	2.4
San Diego	1,150	4.0	3.1
CENTRAL	971	2.9	3.4
Fresno MSA	288	3.2	3.6
Kern	189	2.3	2.9
Kings	29	3.3	3.2
Merced	52	0.8	2.7
Tulare	94	2.2	3.8
Modesto	141	3.1	4.0
Stockton MSA	178	3.9	3.2
NORTHERN	4,148	3.2	2.8
San Francisco	1,073	3.0	2.8
Oakland MSA	1,010	3.5	2.5
San Jose	969	1.3	2.1
Sacramento	687	5.3	3.8
Santa Cruz	95	2.9	1.3
Sant Rosa	179	3.7	3.4
Vallejo - Napa	165	5.3	4.8

*Year to Date through May

** Not seasonally adjusted

Table 3: California Employment (Levels)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
NONFARM						**Payroll Survey (Thousand)**						
	12,359	12,153	12,045	12,159	12,421	12,744	13,127	13,595	14,016	14,502	14,882	15,255
Mining	37	35	35	32	30	29	29	25	24	24	24	23
Construction	514	472	446	464	485	506	550	611	681	735	782	797
Manufacturing	1,971	1,891	1,805	1,777	1,794	1,852	1,914	1,951	1,922	1,936	1,936	1,952
Nondurable Goods	702	708	695	698	705	712	724	722	719	757	728	737
Durable Goods	1,269	1,182	1,110	1,079	1,090	1,139	1,190	1,229	1,203	1,209	1,209	1,216
High Technology	638	584	527	484	479	500	521	534	511	499	500	516
Electronics	330	310	302	294	310	334	353	362	352	349	348	362
Computers	101	95	92	83	85	90	95	95	98	96	100	105
Communications Equipment	29	30	31	31	35	38	38	39	40	40	40	41
Electronic Component	133	122	118	120	129	142	152	159	152	150	146	149
Measuring & Control	68	63	61	59	61	64	67	69	62	63	63	66
Aerospace	308	274	225	190	169	165	168	172	159	150	151	154
Aircraft & Parts	146	132	108	93	84	83	85	89	83	78	77	78
Missiles & Space	68	58	47	36	29	26	25	25	23	21	21	21
Aerospace Instrument	94	84	71	61	55	56	58	57	53	51	53	55
Trans., Public Utilities	613	607	611	619	630	642	664	695	718	735	751	764
Trade	2,922	2,835	2,812	2,845	2,915	2,974	3,048	3,123	3,206	3,299	3,362	3,432
Finance, Ins., R.E.	799	792	794	771	732	737	758	799	821	841	871	892
Services	3,411	3,426	3,462	3,558	3,728	3,891	4,025	4,224	4,410	4,642	4,821	5,016
Government	2,091	2,096	2,081	2,093	2,107	2,113	2,140	2,166	2,235	2,290	2,335	2,380
Federal	347	346	336	325	312	296	285	273	268	264	263	262
State & Local	1,743	1,750	1,744	1,768	1,795	1,818	1,856	1,894	1,967	2,026	2,072	2,118
FARM	342	351	364	379	373	407	413	406	411	433	436	435
						Household Survey (Thousands)						
Total Unemployment	13,996	13,961	13,895	14,065	14,141	14,384	14,942	15,355	15,722	16,180	16,608	17,043
Unemployed	1,172	1,430	1,439	1,322	1,204	1,119	1,004	968	864	779	809	852
Labor Force	15,169	15,391	15,334	15,388	15,345	15,504	15,947	16,324	16,586	16,959	17,417	17,895
Unemployment Rate (%)	7.7	9.3	9.4	8.6	7.8	7.2	6.3	5.9	5.2	4.6	4.6	4.8

Table 4: Long-term Projections for California from the UCLA Anderson Forecast (thousands)

	1999	2020	Annual Rate of change 1999-2020
Population	34,133	47,742	1.6%
Labor Force	16,586	24,826	1.9
Household Employment	15,722	23,500	1.9
Nonfarm Payroll Employment	14,016	21,052	2.0
Mining	24	20	-.1
Construction	681	796	.7
Manufacturing	1,922	2,181	.6
Transportation, public utilities	718	980	1.5
Trade	3,206	4,515	1.6
Finance, insurance, real estate	821	1,302	2.2
Services	4,410	8,229	3.0
Government	2,235	3,029	1.5
Farm wage employment	411	350	-.8

Endnotes

[1] For several months, the Los Angeles Police Department illegally halted migrants from other states at the California border who appeared to be heading for Los Angeles in the so-called "bum-blockade."

[2] However, the household survey, which includes farm workers, unpaid family workers, and self-employment reports that the 1990 peak for Los Angeles-Long Beach was surpassed in 1998. Household survey data are subject to whatever revisions are made in the light of the 2000 Census of Population.