**Title**
California's Economic Outlook: Short-term Recovery But Longer-term Uncertainties



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# CALIFORNIA'S ECONOMIC OUTLOOK: SHORT-TERM RECOVERY BUT LONGER-TERM UNCERTAINTIES

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California's short-term outlook remains one of expansion, albeit at a modest pace, after the recession of the early 2000s.[1] The longer-term outlook calls for a rate of population growth that continues to exceed the national rate, thanks to in-migration (foreign and domestic) and natural increase (birth rates > death rates). However, as California's population density continues to increase, the gap between U.S. population and employment growth and the state's growth rates will narrow. Whether that convergence comes about through a gradual adjustment, or an unpleasant sequence of events, will depend in part on a variety of public policy decisions.

Of course, the longer the projection period, the less certain the outcome. Migration patterns depend in part on the growth of job opportunities within California relative to those of other regions. A variety of external events at the national and world levels will be important determinants of California's economic trends. However, at present, California is not addressing a variety of important infrastructure issues such as water supply and transportation. Its education system at the K-12 level needs improvement. And there are many uncertainties about its financing of higher education. While other states have faced similar challenges in recent years, California has been postponing its responses.

## The Short-Term Outlook

Generally, the UCLA Anderson Forecast sees expansion in jobs, personal income, international trade, and taxable sales for the state in the short run. The Bay Area has stopped losing jobs and appears to be at least stabilizing. That bottoming out reflects the onset of a recovery in information services. Professional and business services, construction, private educational and health services, and retail trade all are on an upward path. Manufacturing has stabilized but seems unlikely to be a major growth sector for employment in the future. State and local government employment is on a downward trend, a reflection of California's fiscal crisis.

## Demographics and Decision Making in the Longer Term

The UCLA Anderson forecast projects a California population of almost 50 million by 2030, up from around 36½ million at this writing. Chart 1 summarizes the long-term trend of relative growth compared with the nation. A noteworthy element on the chart is the comparative leveling off by the 2030s. If the state does not address its infrastructure and educational needs, if housing supply remains tight and continues to rise in cost, there will be adverse consequences compared to the Forecast's projections. Either population and employment growth will fall short of current projections, as workers seek opportunities elsewhere, or there will be a notable diminution in the state's quality of life.

Much has been made of the tendency for immigrants in California to be relatively optimistic about the state's outlook, while long-term natives are pessimistic.[2] But such an attitudinal outcome should not be a surprise. Immigrants go from where things are worse to where they are better, even if "better" may not be especially good on an absolute criterion. If the natives are restless, it is likely to be because they are aware of long-term deteriorating trends in such phenomena as traffic congestion or school performance. In short, both groups – long-time natives and newcomers - can be right!

What is clear, as Chart 2 illustrates, is that California's demographics are shifting. Projections of the California Department of Finance show an estimated decline in the White-Anglo population over 2000-2030, with dramatic growth among Latinos and Asians, the two groups most associated with immigration. Although citizenship requirements and voting propensities make the current demographic composition of voters reflect the past, by 2030, these ethnic shifts will be well reflected in state politics. Less clear is how the change in demographics, mediated through the political process, will reflect itself in decisions on schools, transportation, water, and other important components of state policy.

At present, the demographic shifts play themselves out in divisive battles over such matters as bilingual education, rather than school improvement. Incumbent homeowners resist increased density of residential areas. But when density initiatives are blocked – inhibiting building up or within existing neighborhoods – the resulting tendency to build out is then blocked by environmental concerns. If we can't build up, in, or out, where do we build?

Similar battles occur over transportation. When a proposal was made to widen the Ventura Freeway in the San Fernando Valley, affected homeowners stopped the initiative, thereby limiting private automobile transportation. Yet when the Los Angeles County Metropolitan Transportation Authority began constructing a dedicated busway that paralleled the Freeway, other residents went to court to block the alternative of public transit. If we are not going to use private transportation or public transportation to move about, just how will we travel?

**California's Regional Markets**

Because of its large population and geographic size, the private sector in California is in fact composed of regional markets and sub-economies. This division was clearly seen in the last two recessions. In the late 1980s, the Cold War ended and military spending was accordingly reduced. The impact was especially felt in Southern California – the home of the bulk of the state's aerospace industry. As a result, the recession of the early 1990s was concentrated in Southern California and the Los Angeles area. A notable decline in home prices reflected the area's economic distress. Los Angeles County employment did not regain its earlier pre-recession (1990) peak until 1998.

Many view the LA Riots of 1992 – despite the proximate trigger of the trial of police officers in the Rodney King case – as essentially economic social unrest. On the other hand, the film/TV/entertainment sector – also concentrated in Southern California – eventually provided a partial offset to the Cold War job losses. Because that sector derives most of its revenue from outside the Southern California area, it is not particularly sensitive to local recession. However, the kinds of jobs provided by entertainment did not necessarily match the skills of those workers displaced from aerospace. Aircraft assembly workers do not inherently make good computer animators.

The Bay Area, while not immune to the effects of the national recession in the early 1990s, was increasingly enmeshed in the Silicon Valley's dot-com/tech boom. While it lasted, the boom generated wealth and employment, and made commercial office space scarce. By 2000, the office vacancy rate in San Jose was down below 3%, an astonishingly low level essentially meaning there was no space available.

On the other hand, the recession of the early 2000s was intimately connected with the dot-com/tech bust, and that bust was also centered in the Bay Area. Thus, the recession at that time was something of a reverse mirror image of the earlier recession, with the north suffering relative to the south. By 2003, the office vacancy rate was over 25% in San Jose and rents for office space had fallen in half.

Apart from both the Bay Area and the urbanized part of Southern California, the state has a host of rural counties whose economies are linked to agriculture and markets for primary products. These regions have tended to exhibit relatively high unemployment and lower-than-average per capita incomes compared with the rest of the state. Depending on location, some rural areas are influenced by a growing push of urbanization – often described pejoratively as "sprawl" – as housing costs push population toward localities where land prices are comparatively low.

Despite its size and diversity, however, California has one component that tends to draw its separate markets and sub-economies together and that is its public sector. The state government has a statewide tax base. Much of what the state does with its revenue is to pass it along to local governments such as school districts and counties. A boom in tax revenue in one area – as the dot-coms created in the Silicon Valley during late 1990s – tends to spill over into other areas as state expenditures and related local government expenditures rise. The reverse is also true. A slump in economic activity in any region cuts into the state's tax base and pinches state and local government spending – as occurred dramatically during the dot-com bust.

The story of the dot-coms' boom and bust is by now well known. A significant proportion of state government revenue by the late 1990s was being derived from capital gains taxation which in turn was linked to a rising stock market, particularly of tech stocks, and to realized stock options. State spending expanded as if the gains were permanent. When the gains vanished, the state's spending commitments did not, putting the squeeze on the public sector, state and local. While hopes spring eternal for a renewed tech boom – triggered in part by a public offering of Google stock in 2004 – California cannot realistically aspire to anything like a repeat of the 1990s experience in the foreseeable future. The state will have to live within its means, an adjustment that has yet to occur.

Despite its rising dot-com/tech revenue base in the 1990s, the Legislature and the Governor were not necessarily enabled to make wise decisions. A plan for electricity deregulation was approved in the latter days of the Pete Wilson administration. In theory, a market for power would be created, fostering competition, and bringing new supplies from the private sector on line. However, the details of how deregulation is accomplished matter.

As it turned out, there was inadequate incentive under the new regime for maintaining delivery reliability, as rolling blackouts – particularly in Northern California – eventually demonstrated. In addition, the rules of the new marketplace enabled price manipulation by energy providers. The upshot was higher power prices, an odd mix of the old and new regulatory systems in place, ongoing litigation against energy providers, and warnings that electricity shortages may reoccur in the future as the California economy expands.

Both the electricity crisis and the state budget crisis were key elements in the 2003 gubernatorial recall and the replacement of Governor Gray Davis by Arnold Schwarzenegger. In that sense, the political system responded to public concerns about California's economic outlook and the way state officials were managing the state's economic policy. But the political system needs now to produce decisions that resolve such issues rather than simply punish the incumbents.

Wall Street responded favorably to California in 2004 by raising the state's bond ratings – although the absolute ratings remained low compared with other states. Yet Wall Street's concerns are primarily centered on the likelihood of a default on state bonds, a probability that was never very high. Even during the Great Depression, California didn't default on its bonds, although other bills were not paid on time. Unlike Wall Street, California's residents, voters, and taxpayers must be concerned about much more than just bond default risk. They need the state to manage its affairs, such as designing a rational regime and appropriate incentives for electricity markets.

**California and the U.S.**

State boosters and California politicians are entranced with the idea that if California were a country, it would have a GDP ranking of 5th or 6th or 7th in the world. But the fact is that California's economy is not independent of national business cycles. Booms and recessions at the national level are quickly reflected in California's economy, since the state's biggest trading partner by far is the rest of the United States.

Historically, California's unemployment rate has tended to exceed the national level. Perhaps the unemployment gap results because it is more pleasant to be unemployed – if you have to be unemployed – in the sunshine. More likely it has to do with the state's demographics. California is a relatively young state – reflecting the fact that in-migration tends to be concentrated among the mobile young. Young people – who often do not have extensive family responsibilities – are less pressed to find work fast and more likely to shift among jobs if they don't find the right job match.

For much of the period during and after World War II, California's economy was significantly affected by national military expenditures, largely through what came to be called the aerospace industry. As Chart 3 shows, real military expenditures as a share of GDP declined steadily after the late 1980s. But even during the defense build-up of the late 1970s and early 1980s, however, California – while benefiting from increased military spending – was losing its relative share of such spending to other states.

Some of this slippage reflected political influence of other regions in attracting defense dollars. But some of the share erosion also reflected the difficulty of undertaking heavy manufacturing in Southern California. Such manufacturing becomes progressively difficult in the face of growing concerns and regulations relating to environmental pollution and the region's increasing congestion and costs.

Because of the dramatic shrinkage of Southern California aerospace, the projected post-9/11 growth in federal military expenditures will have only a modest positive effect on the state's economic expansion. In a sense, as Chart 4 illustrates, California has never really recovered fully from the aerospace-related recession of the early 1990s. The state was knocked off its historic annual employment growth trend of about 3% per annum by that recession. Its more modest 2.5% growth trend thereafter means that by 2010, the state's non-farm employment will be almost 4 million jobs below what would have occurred under the old growth path.

**California and the World**

California is linked to the world economy in two ways. It directly exports and imports tangible products. The state's goods exports are diverse and range from high-tech electronics to agriculture. During 2002-2003, California-made exports declined, especially in the high-tech electronics area. But by 2004, all major product categories were showing an uptick in state exports. Apart from tangibles, California also exports "intellectual" property in the form of films, TV shows, and other cultural products. Not surprisingly, when the U.S. negotiates international trade deals, California is particularly concerned about the protection of intellectual property from piracy.

Another linkage between California and the international economy is the state's role as an entrepot. The Ports of Los Angeles and Long Beach combined represent the nation's largest seaport. Other California ports, such as Oakland, also provide avenues for shipment of exports and imports. Particularly for high-value/low-weight products such as electronic components, airports are also major facilities for international trade. And, of course, airports also provide facilities for travelers and support the state's considerable tourism sector. But both airports and seaports represent considerable infrastructure investments. And both are now faced with issues related to funding homeland security as well as their primary missions.

During 2004, the Los Angeles-area seaports became backlogged with ships waiting to unload. Connections to the ports are by truck or rail. Truck connections, in turn, put burdens on area freeways. Although rail connections were improved by the construction of the Alameda Corridor in the 1990s, there still appears to be a problem in linking ship transportation to land transportation. As in other cases of infrastructure planning, the decision process appears to be hindered by a multiplicity of governmental entities that must coordinate diverse agenda and personalities.

Similar problems arose with regard to a plan to revamp LAX. The LAX plan has led to battles between the Los Angeles mayor, the city council, and the County Board of Supervisors. The airport capacity problem is aggravated by the decision of Orange County voters not to build a new airport at a closed military base and by limitations placed on the expansion of flights in and out of Long Beach Airport – which is controlled by a different entity than LAX. Longstanding plans to rejuvenate the recently-reopened Palmdale Airport cannot succeed unless some form of transportation is provided to and from that airport to population centers.

**California by the Numbers: Will the Forecast Pan Out?**

Chart 5 summarizes trends in non-farm payroll employment by major sector and in real per capita income projected to 2030. The only sector exhibiting an absolute decline is natural resources/mining, a relatively small component of total state employment, currently providing about 22,000 jobs. Its declining trend primarily reflects depletion of oil resources in the state. State and local government employment shows some growth acceleration only in later years when – presumably – California will resolve its fiscal dilemma. Manufacturing, once a powerhouse of the state's economy, especially in the Cold War/aerospace era, grows in the forecast but very modestly. The UCLA Anderson Forecast on per capita real personal income growth, running at a rate of over 2% per annum, is relatively optimistic and, again, assumes that California will overcome its political problems regarding fiscal policy, infrastructure, and development.

There are, of course, less optimistic scenarios that could play out. California's business community often complains about "job killer" legislation – typically such things as minimum wage increases, employer mandates for benefits, and living wage laws. Business spokespersons argue that such legislation, by raising costs, will chase businesses out of the state and to friendlier climes. But there are those in the California polity who are not keen on economic growth if it means more immigration and population density.

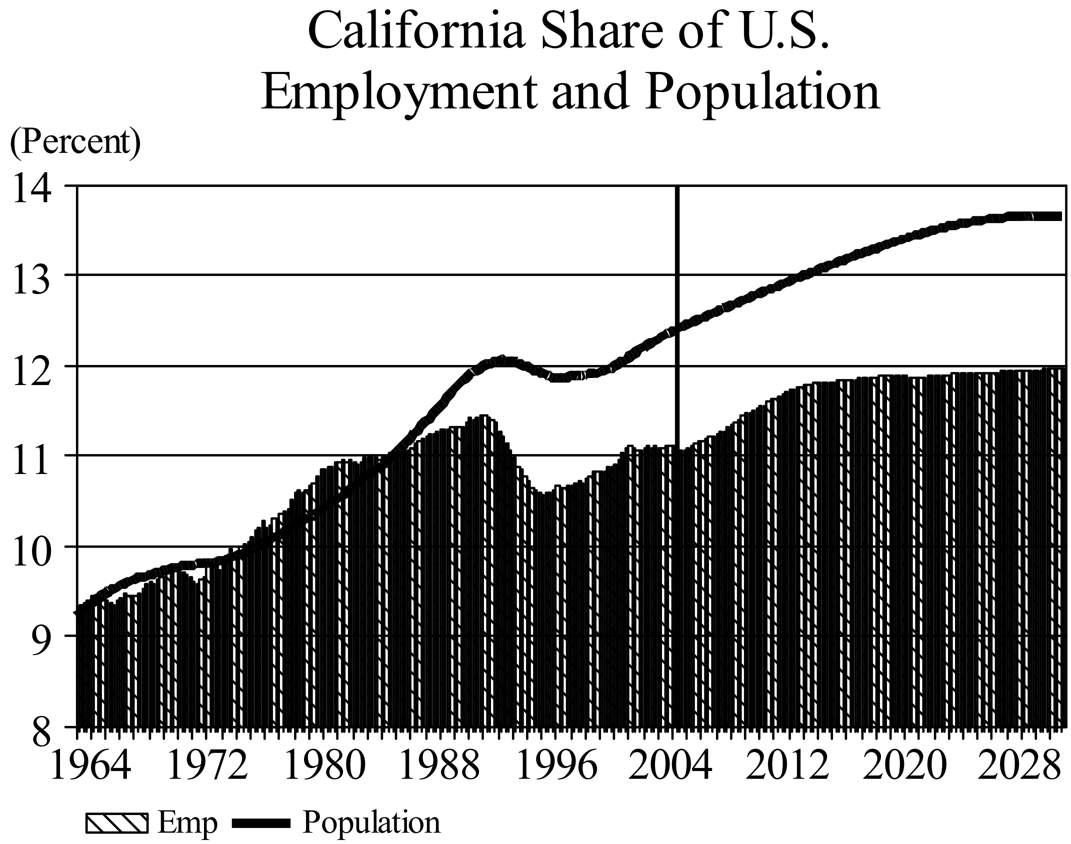
The California electorate (which lags state demographic trends) opted for Prop 187 in the mid-1990s – an abortive attempt to halt illegal immigration - and forced the legislature to reverse a law that would have enabled illegal aliens to obtain drivers' licenses in 2003. One can imagine a tacit alliance running left to right on the political spectrum that would endorse a variety of "job killer" policies, tough environmental laws, limits on new housing and development – whether in-fill or sprawl – and block infrastructure additions and improvements. If the combination of such actions inhibited employment and population growth, many voters would apparently not be upset.

What kind of economy would emerge from such an eventuality. One result could indeed be that employment and population growth slow below the UCLA predictions. The population would continue to grow absolutely, although increasingly immigrants would view California as a kind of Ellis Island, a transitional pathway to somewhere else in the U.S. where opportunities were better.

For some natives who have "made it" and already own homes in attractive neighborhoods, life might remain relatively pleasant. For others, who provide services to the incumbent residents, life would not be so pleasant. Housing would be costly, commutes would be long, and education for their children would be inferior. In this view, California becomes a kind of Santa Barbara – a high-end community with pricey housing, restrictive zoning, and upscale restaurants and retail establishments – serviced by low-wage providers living somewhere out of sight in the hinterland.

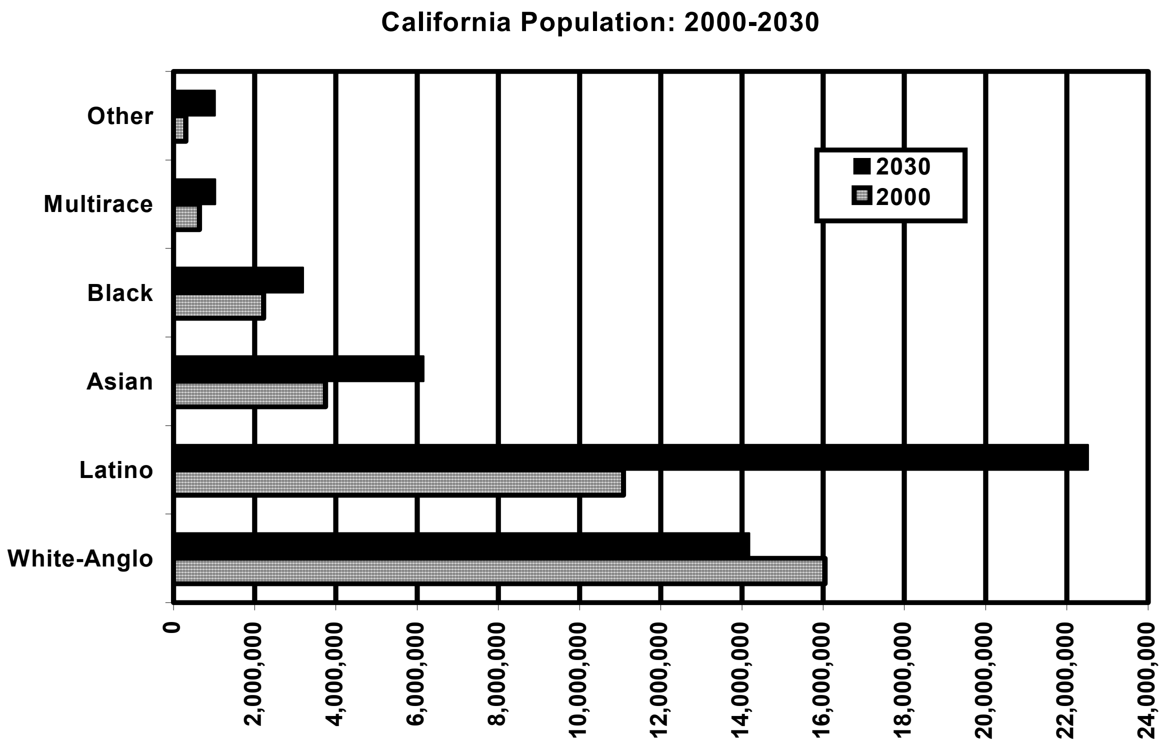
But when most readers – whatever their take on particular public policies in California – are confronted with that scenario, our guess is they will likely be repelled. As Christopher Thornberg – a senior economist at the UCLA Anderson Forecast put it, "California needs to accept population growth and begin to plan accordingly."[3] Whether that message is accepted will be a key determinant of California's future economic outlook.

**Chart 1**



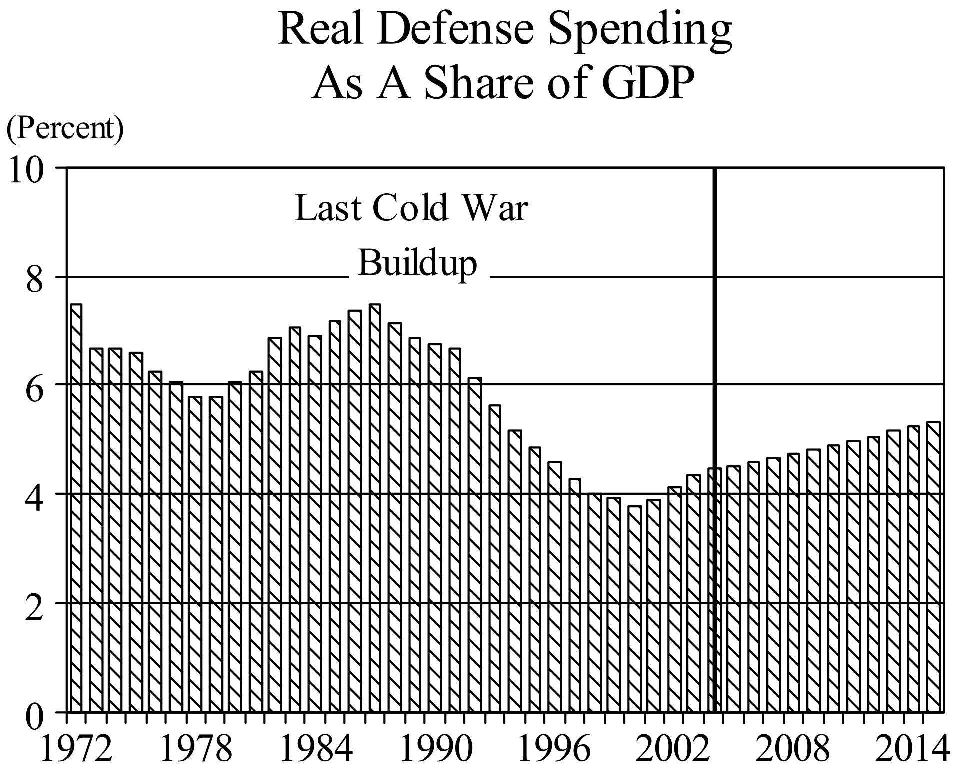

**Source: UCLA Anderson Forecast, <u>The UCLA Anderson Forecast for the Nation and California</u> (September 2004), p. Calif.-A.7.**

**Chart 2**



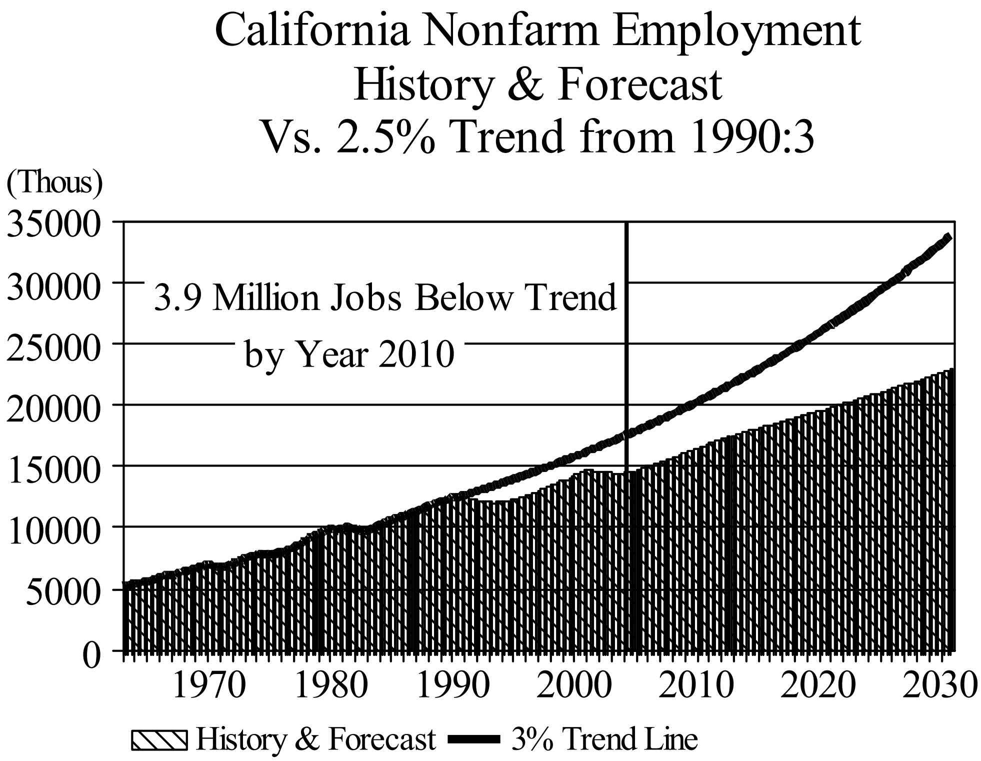

**Source: Data available from California Department of Finance, www.dof.ca.gov.**

**Chart 3**



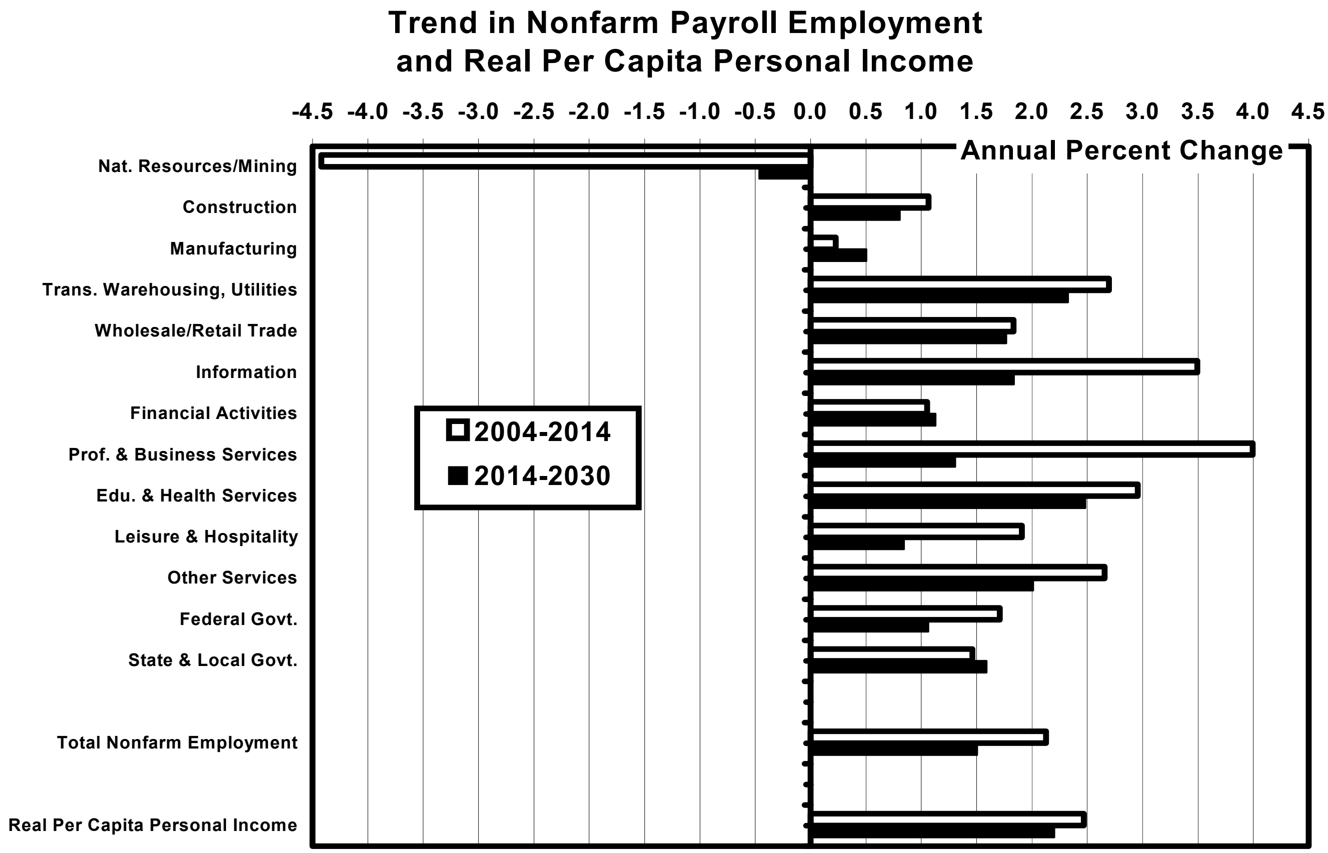

**Source: UCLA Anderson Forecast, <u>The UCLA Anderson Forecast for the Nation and California</u> (September 2004), p. Nation-A.9.**

**Chart 4**




**Source: UCLA Anderson Forecast, <u>The UCLA Anderson Forecast for the Nation and California</u> (September 2004), p. Calif.-A.7.**

## Chart 5




**Source: UCLA Anderson Forecast, <u>The UCLA Anderson Forecast for the Nation and California</u> (September 2004), pp. Calif.-B.4-B.6.**

## Endnotes

[1] This chapter draws heavily on the UCLA Anderson Forecast projections and the papers and presentations of Joe Hurd, Christopher Thornberg, Michael Bazdarich, and Edward Leamer at the September 8, 2004 Forecast conference. See UCLA Anderson Forecast*, The UCLA Anderson Forecast for the Nation and California* (September 2004) for details. Information about the UCLA Anderson Forecast is available at www.uclaforecast.com.

[2] Gregory Rodriguez, “Pouty White People: Why So Downbeat on the Future? Well, Start with Racial Changes,” *Los Angeles Times*, September 26, 2004.

[3] ChristopherThornberg, “The Long-Term Demographic Outlook for California and Los Angeles County” in UCLA Anderson Forecast, *op. cit*., p. Calif.-2.10.