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Opportunities and Challenges for the California Economy

California Economic Growth Chapter 2

2006 Edition

Center for Continuing Study of the California Economy

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CCSCE staff specializes in analysis and long-term projections of economic and demographic variables in California and subareas of the state. *California Economic Growth—2006 Edition* is the product of an internally financed, ongoing program of CCSCE to provide business and government decision makers with an independent assessment of the future growth of California and subareas of the state.

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OPPORTUNITIES AND CHALLENGES FOR THE CALIFORNIA ECONOMY

California's economic base is concentrated in sectors with above-average growth potential in the national and world economy. The state faces substantial opportunities for job growth and economic prosperity in the next ten years.

A reasonable expectation is that California will add 3 million jobs, 5 million people, and 2 million households between 2005 and 2015.

Californians are hopeful that the opportunities can be converted into a broadly shared prosperity, and they are aware of the challenges that lie ahead.

Exciting Economic Opportunities

California accounts for 20% of the nation's high tech jobs and production, 25% of new patents, and 45% of new venture capital. The state faces new opportunities in stem cell research and alternative energy technologies. California is the center of innovation in new ways to use the Internet for businesses and consumers.

California is the nation's center for rapidly growing trade with China and the Pacific Rim. California has the nation's largest entertainment and tourism sector, and stands ready to benefit from a growing world economy.

California has an above-average share of jobs in most high-wage and fast-growing professional services, including computer, architectural, scientific, and management consulting services.

Challenges Converting Opportunities to Success

Yet, California faces many well-known challenges in converting opportunities to success. Housing, infrastructure, education, workforce, and budget challenges remain unresolved. And there are questions about whether Californians can be governed—and whether the benefits of prosperity, if they come, will be broadly distributed or shared by only a few. The role of immigration in the economy has also surfaced again as a major topic of public discussion.

There are many groups and organizations struggling with these challenges today in California. The goal of this chapter is to put forth some questions and ideas about these challenges, based on analyses of California's economic and demographic future. The goal is to stimulate and broaden the conversations that Californians will have in planning for our future.

Planning for Economic Prosperity—Starting the Conversation

Most of the decisions underlying California's economic growth prospects will be private sector decisions. Most of the projected job growth will be in private sector jobs. Firms and workers will make the decisions about investing and working in California. Most housing will be built by the private sector. Workers and students will make decisions about acquiring new skills to improve their job and income prospects.

Yet these private decisions are made in a context of public policies. Will California provide the **public foundations** that attract venture capital and **private investment?** Will our schools be good enough to support the projected job growth? Will California's infrastructure measure up to that in other locations?

Will the lack of housing or housing affordability be a barrier to creating a climate for innovation and private investment? Can the state budget be balanced while meeting California's public investment priorities? Which policies best get the state to long-term budget balance?

Making California a Great Place to Live and Work

What kinds of public policies or **public foundations** will make California attractive for private investment and build support for future broad-based prosperity? Let's see what happens if we start with the broad theme of making California a great place to live and work.

The theme "A great place to live and work" might seem a little short on specifics about what public policies best support a prosperous economy. **The power of the phrase is that it recognizes that two sets of choices need to be made to create a prosperous economy.** Entrepreneurs must find California a great place to start or expand their business. And workers and their families must find California a great place to live.

A prosperous economy requires the consent of both constituencies. One piece of good news is that often the goals of businesses and families are in sync. Another piece of good news is that many residents are already working hard to make California a great place to live, and many residents and businesses are working hard to make California a great place to work.

A great education system helps respond to the increasing skill requirements of the California economy. A **great education system is also a requirement for attracting workers who care about the education of their children.**

World-class infrastructure is necessary to attract innovative firms, and world-class infrastructure is also required to attract families who have a choice of where to live. Congestion is a business problem **and** a quality-of-life problem. Housing affordability is a problem for families trying to live in California, and it is also a problem for businesses trying to hire workers in California.

The bad news is that when public policy addresses only one constituency at a time, as often happens, the result is conflict and gridlock.

Difficulties in Creating Great Places to Live and Work

Making California a great place to live and work sounds like a "no-brainer." Why is it so hard to do? Along with all the expected potential disagreements about the details of what makes a great place to live and work, **there are two big stumbling blocks:**

- Some residents want to create a great place to live and work, **but they do not want the job and population growth that such policies attract.**

- We are also in conflict about money—about whether we want to pay to create great places to live and work, and about who should pay.

The issues of public investment and how to pay for these investments are discussed later in this chapter. First we discuss whether growth is "inevitable," or at least very likely, if California becomes a great place to live and work.

The Paradox of Growth—Great Places Have More Growth

There are two paradoxes of growth. Each paradox has powerful economic logic behind it, but often the reality of these paradoxes is difficult for people to accept.

Attractive Communities Attract Growth

Economists know a lot about why regions experience slow economic growth, measured in terms of jobs and income:

- A region that loses a key industry will have slow or negative population growth. Southern California in the early '90s saw large declines in aerospace job levels as part of a long recession that induced more than one million people to leave the region. The same trends have been seen in Detroit, Pittsburgh, and Houston when their economic bases shrank.

- Communities that are less attractive places to live lose population to other regions over time. Residents can move to locations with cheaper housing, less congestion, better air quality, and better schools if their own communities become too unattractive.

Regions that create great places to live and work can and should expect growth in terms of the number of jobs and residents. People and businesses will be attracted to regions where the schools are good, transportation systems move people and goods efficiently, the environment is good or improving, and housing is available and affordable.

Creating great places to live and work puts us in a constant struggle with the impacts of growth. Success means that more people will choose to start businesses and invest in California communities—because they are "great places to live and work."

Having more people does put pressure on the transportation system, public facilities, the environment, and especially the housing markets. But efforts to limit growth are usually ineffective and are almost always counterproductive, in that they discourage new private investment. Efforts to limit growth also usually favor existing residents who own homes over new residents and people who cannot afford homes.

The problem is that it is hard to be in "go mode," creating communities where people want to live and work, while at the same time saying, "Don't come to California."

Economies Can't Have Only "Good Jobs"

One "solution" proposed by people who are disturbed by the impacts of growth is to try to attract "only the good jobs." **The economy doesn't work that way**.

First, all economies need people who work at jobs that pay below-average wages. All economies have restaurants and retail stores and the other industries that employ lower-skilled workers. And all economies in California have teachers, nurses, firefighters, and similar workers who are struggling to find housing.

The paradox is that affluent communities with a majority of high-income residents are able to spend more income—and choose to do so—in sectors that employ lower-wage workers. If success means attracting more high-wage jobs, then success means having these higher-income families hire nannies and gardeners and housecleaners and also having these high-income families spend more at restaurants, stores, cleaners, and other industries that employ a high share of workers who earn less than the average wage.

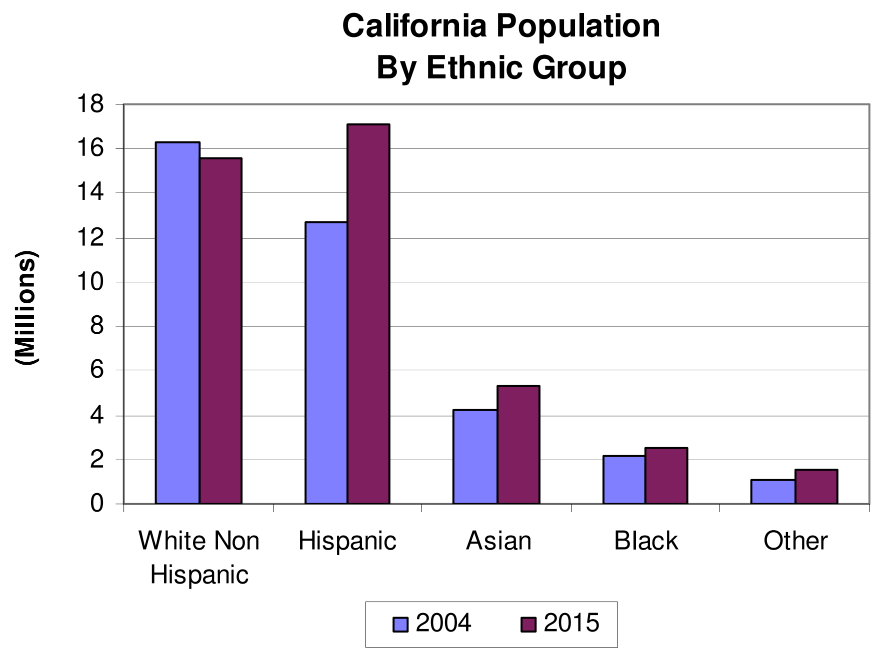
Who We Are: Population Shifts by Age and Ethnic Group

California's population is projected to increase by 5 million in the next ten years. The increase is smaller than between 1995 and 2005, when 5.3 million residents were added. In terms of growth rates, California's population is expected to grow by 1.3% per year, slightly less than the 1.6% annual population gains during the past ten years.

Behind these similar growth numbers, however, is a substantial shift in California's demographic characteristics by age and ethnic group.

Ethnic Population Shifts

The ethnic group population shifts that have characterized California for two decades will continue. Most of the state's population increase is expected to be among Hispanic residents, with smaller increases for Asian and Black residents. Sometime between 2010 and 2015, California's Hispanic population will surpass the White Non-Hispanic population in numbers.



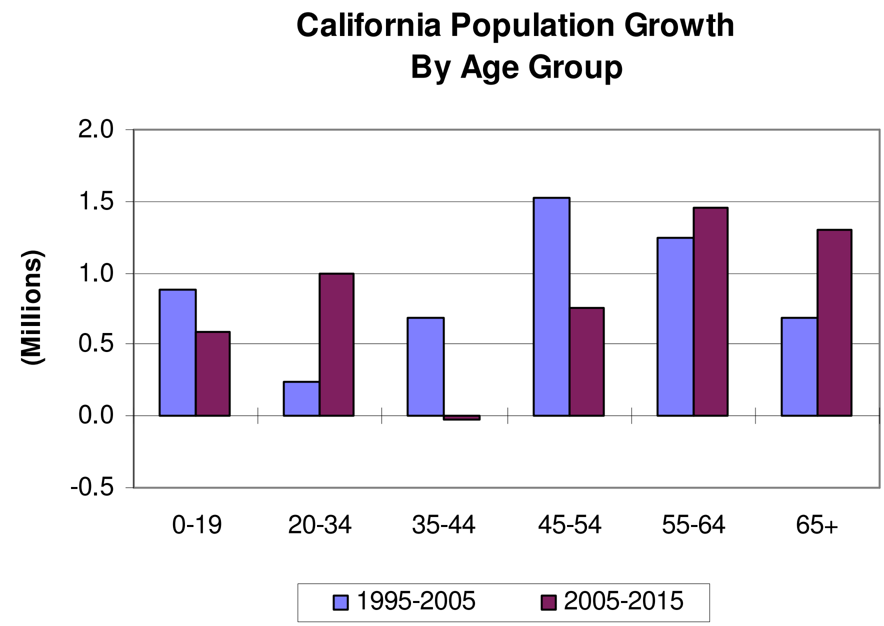
Changes in Age Structure

The composition of California's population growth by age group will change in a fairly dramatic fashion in the next ten years:

- There will be a gain of 1 million residents in the 20-34 age group, where many residents enter the labor force for the first time and move into their first apartment or house. During the past ten years, population growth in this age group was only 250,000.

- Population in the prime working-age groups (ages 35-54) is projected to increase by only 750,000, following a gain of more than 2.2 million during the past ten years.

- More than half of the state's population growth will be in the 55+ age groups. The first baby boomers turn 60 in 2006. The retirement of baby boomers will become a significant factor in California's workforce after 2010.



The Intersection of Age and Ethnic Population—Change Ahead

When the projections of age and ethnic change are combined, the results show substantial shifts in the next ten years (as shown on the graphs on the next page).

- In all groups under age 55, the state's White Non-Hispanic population will decline while the Hispanic population increases.

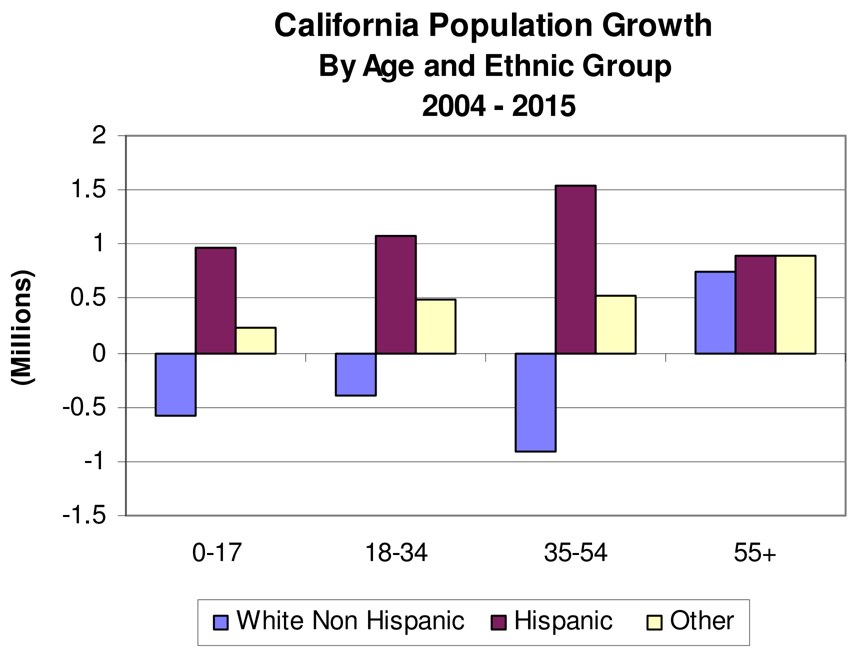
- In the under-18 population, the Hispanic population is projected to increase by 1 million while the White Non-Hispanic population declines by 500,000.

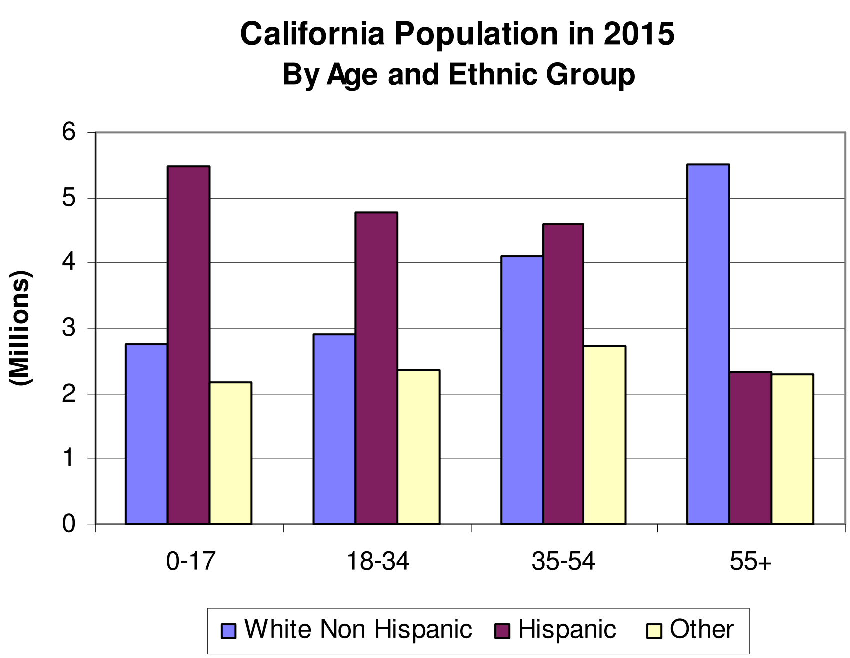
- For the 18-34 age groups (people pursuing higher education and entering the workforce), the Hispanic population is expected to increase by more than 1 million; the White population is expected to decline by nearly 500,000; and Black, Asian, and other ethnic groups are projected to increase by 500,000.

- The largest shifts are in the 35-54 age groups. The White Non-Hispanic population will decline by approximately 1 million. This decrease will be offset by a projected gain of 1.5 million Hispanic residents and 500,000 residents from other ethnic groups.

- Population growth for residents aged 55 and above is projected for all ethnic groups.

By 2015 more than two thirds of California's population under the age of 35 will be Hispanic, Asian, and Black. The White Non-Hispanic population will account for more than 50% of the state's population only in the 55+ age groups. In 2015 the last wave of the baby-boom generation will be turning 55.


California Population Growth
By Age and Ethnic Group
2004 - 2015
2
1.5
1
0.5
0
-0.5
-1
-1.5
(Millions)
0-17
18-34
35-54
55+
White Non Hispanic
Hispanic
Other


California Population in 2015
By Age and Ethnic Group
6
5
4
3
2
1
0
(Millions)
0-17
18-34
35-54
55+
White Non Hispanic
Hispanic
Other

Immigration and Demographic Changes

The impact of immigration on California's economy and related public policy issues are explored in a separate section at the end of this chapter.

Workforce Issues and Challenges

Much has been written about certain aspects of California's future workforce. There is broad agreement about the following points:

- The number of residents reaching college age will surge in the next ten years. There is concern about whether California is prepared to handle this "tidal wave" and whether the students will be prepared and have sufficient financial support to attend college.

- California's economic competitiveness and prosperity require an increase in the number of highly skilled residents.

- There is concern about whether California's K-12 education system can prepare **most or all** of the next generation of students for college or work.

- The baby-boom generation will begin to retire during the next ten years.

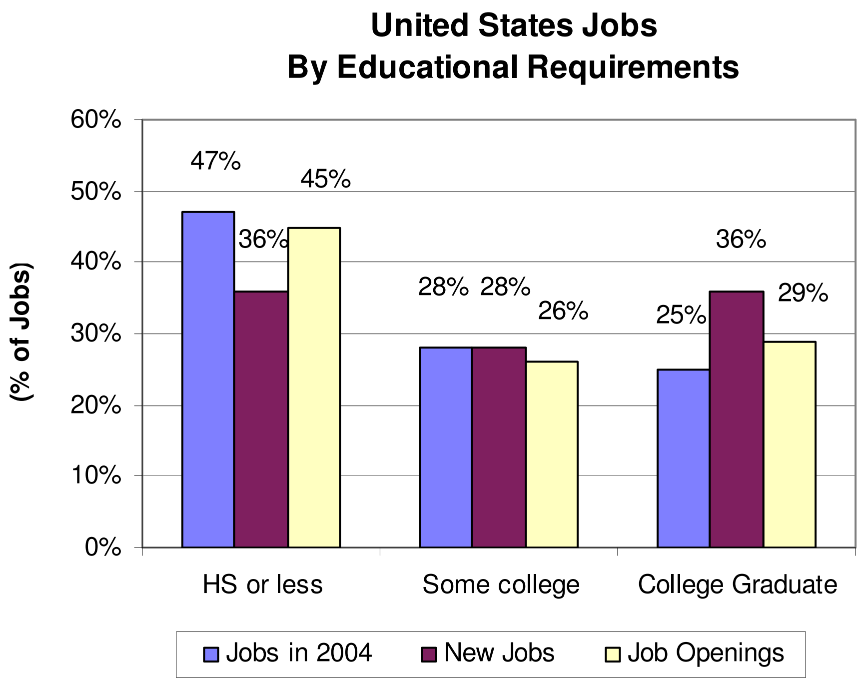
Following are three ideas to continue the conversation about the role of public policy in creating a California workforce that can meet the state's economic opportunities. Workforce strategies and programs that meet the state's economic opportunities will also provide children and families with pathways and hope that they can participate in the state's prosperity.

Jobs Are Being Created at All Skill Levels

It is true that an increasing share of new jobs require a college education. National projections show that 36% of new jobs during the next ten years will require a college degree, compared to 25% currently.

But most jobs now and in the future do not require a college degree. There are many additional jobs that require some training after high school, such as specialized courses at a community college—courses designed in collaboration with local industries.

The economy has many job openings for skilled workers that do not require a four-year college degree. These jobs, in turn, offer the prospect of a good living to families throughout California. Sometimes the conversation about workforce makes it seem like the only jobs are either in areas like rocket science or food service. **The needs and opportunities of the economy are much broader.**



Most Job Openings Come from Replacements

Conversations about workforce tend to focus on the new jobs that will be created and, most especially, on the new jobs in exciting and innovative new industries.

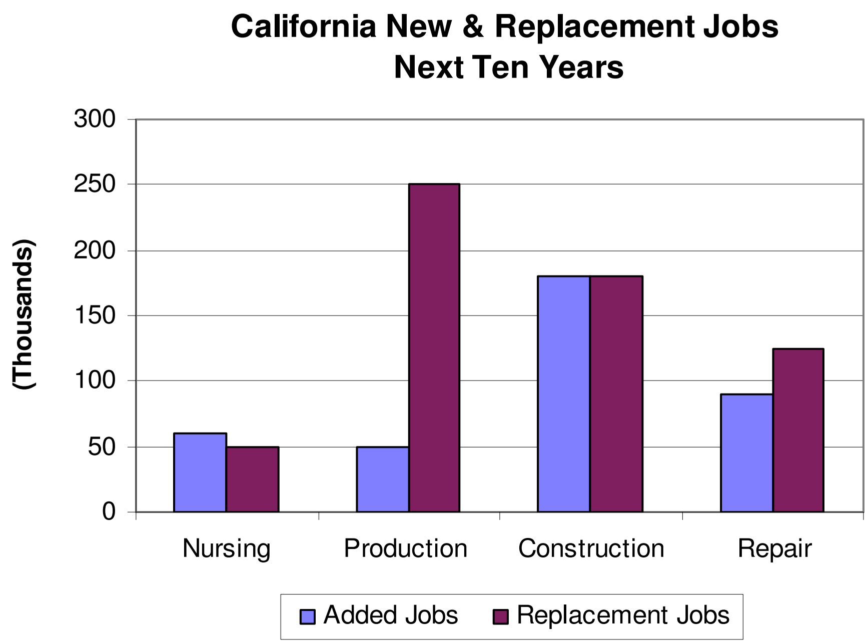
But national and state projections confirm that the number of job openings from replacements (people retiring or moving to a new occupation) exceeds the number of openings from job growth in many occupations. At the national level there are projected to be 19 million new jobs during the next ten years—and 36 million additional job openings from replacement jobs.

- Managerial occupations will have 2.2 million new jobs and 2.7 million job openings from replacements.

- Construction, production, and other manual occupations will have 2.9 million new jobs and 8.1 million job openings from replacements.

According to projections from California's Employment Development Department (EDD), every California job opening from a new job will be accompanied by 1.5 job openings from replacements. The graph on the next page shows some of the EDD projections for the next ten years.

The California economy needs attention focused on these replacement jobs. Families, teachers, and workforce organizations can help spread information about the broad range of job needs and opportunities in the California economy.



Don't Forget About the Existing Adult Workforce

An exciting new initiative is beginning with the objective of pushing workforce issues into the California policy spotlight. One very important component of its effort is to focus attention on workforce strategies for existing workers.

Many groups are already focused on the challenges facing K-12 and higher education systems in California relative to preparing the next generation of citizens and workers. The newly formed California EDGE Campaign, which CCSCE endorses, is focusing on the broader challenges of developing strategies for all workers, especially the existing workforce. Following are the five pillars of their thinking (for more details, visit www.californiaedgecampaign.org):

- Invest in regional workforce and economic development strategies to build prosperous communities and competitive industries.

- Provide all Californians access to high-quality post-secondary education and training.

- Provide working adults with opportunities to move up the career ladder.

- Link workforce programs and institutions to create pathways to high-wage jobs.

- Align program goals and measures to achieve a shared vision of California's future and to ensure accountability.

California's State Budget and Infrastructure: Are We in Denial?

Making the case to invest more in California's people and infrastructure seems easy. Most business and community groups, as well as a majority of elected officials, are currently campaigning to persuade residents to support a wide variety of local and state infrastructure initiatives on the November 2006 ballot.

And everyone seems to favor spending whatever is necessary to give all residents an opportunity for a good K-12 education **and** some kind of post-secondary education or training.

Getting agreement on how to pay for these investments and balance the state budget is much harder.

For example, newspapers recently announced a new initiative to persuade state leaders to support the high-tech industry in California. Here's the dilemma. The proposal calls for two new spending initiatives (R&D programs and a math/science teacher initiative) and also new tax incentives. Each of these may be a good idea (or a bad idea). But together they add up to more spending and lower tax revenues on the near-term and medium-term horizon.

Following are some more dilemmas that should be part of the conversations Californians will have about our future.

The State Budget

The latest published estimates of the ongoing state budget deficit were in the $4.5 to $5 billion range. New five-year projections from the Legislative Analyst's office are being prepared and will be published shortly after this edition of *California Economic Growth* is published.

CCSCE expects that the new deficit projections will be higher than the previous estimates. It seems certain that projected prison spending will be higher by perhaps $1 billion or more, reflecting higher caseloads and the requirements to improve prison conditions and prison healthcare.

Additionally, the Legislative Analyst has issued a warning about impending retiree health benefit costs. Funding these costs would add another $1billion (at least) to annual spending. It is likely that there will also be continuing efforts to increase funding for K-12 and higher education beyond what is included in long-term budget projections.

And it is likely that revenue estimates will be reduced for the short term, thus increasing the budget shortfall facing the state in 2007.

CCSCE expects that the California State Department of Finance will follow the recent economic forecast from the UCLA Anderson Forecasting Project and lower its income and taxable sales forecasts accordingly for 2007 and, perhaps, for 2008.

In addition, it seems less likely—given the forecast of slowing national growth—that corporate income tax revenues and stock option gains can give budget revenues a strong boost next year, as they did in 2005 and the first part of 2006.

Living Within Our Means: What Does That Mean?

California's budget-making process appears to be on autopilot, although not in the usual sense in which that phrase is used.

The budget-making process appears to consist of 1) estimating the revenues that will be received by the current tax system, and 2) developing a budget plan to spend these revenues. At least, this is the way budgets work when revenues are growing.

When revenues surged in the late 1990s, spending rose to match the surge in revenues. The same scenario occurred in 2006, when revenues surged again, at least temporarily. There is a presumption that the increased levels of spending are good policy, and that lawmakers have just been waiting for revenues to grow so that they could fund programs that benefit the state's residents and economy.

When revenues fall, the process stumbles. For a variety for reasons, residents don't want spending cuts to match the lower revenues.[1]

When balancing the budget is difficult due to slow revenue growth, one response is that we Californians should **"live within our means."** There are two interpretations of the phrase "live within our means." One interpretation is that residents shouldn't spend more on public-sector and private-sector purchases than their current income.

That would mean not borrowing long-term to finance current expenditures. The sum of our current expenditures (private spending and public spending combined) should fit within our expected long-term income capacity.

The other interpretation, the one that is usually meant in the context of California budget policy discussions, is "don't raise taxes to balance the budget." Living within our means is usually meant to imply that spending should fit whatever revenues the current tax system is bringing in.

So the phrase "living within our means" could mean raising taxes so that California does not borrow to finance current spending, or it could mean reducing spending to whatever current revenues add up to.

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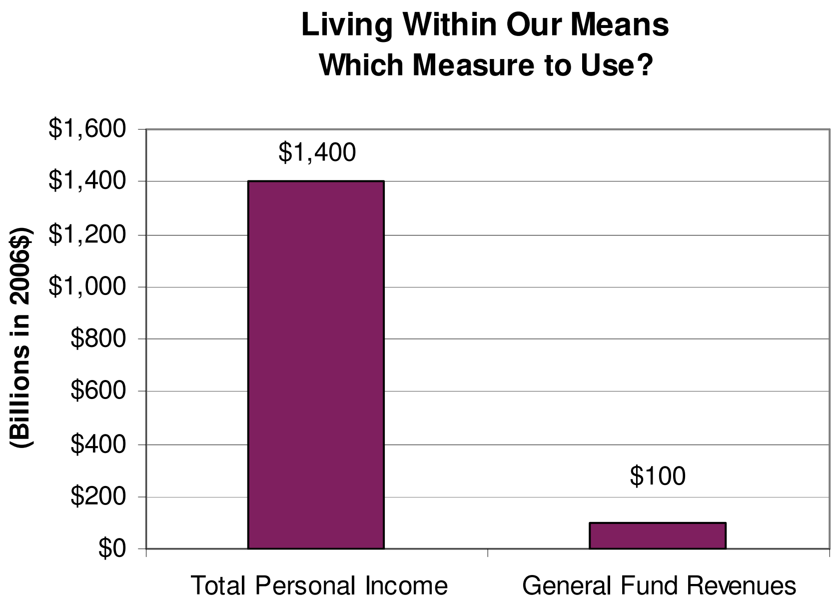
[1] In 2004 voters approved an initiative that, among other provisions, requires the establishment of a budget reserve. Most budget analysts think that it is a good idea to build up reserves that can be used when revenue growth slows.

Raising taxes or fees is the way that residents transfer money from their private spending to public (that is, government) spending.

And that distinction raises the question of which "means" we are supposed to live within. In 2006 California residents will have total personal income of approximately $1.4 trillion. In 2006 the state government will raise approximately $100 billion in revenues to support state General Fund spending.



Does the phrase "live within our means" make more sense as meaning that the total of public and private sector spending should be within the $1.4 trillion in annual personal income? Or should it mean that we should live within the $100 billion that the current General Fund revenue system will raise?

Suppose residents decide to raise state taxes and transfer $10 billion per year from private spending to public spending because they think the extra spending will benefit residents and make the state's economy more competitive. Are residents still "living within their means"?

Are There Ways to Save Money in Current Programs?

Here are two additional conversations for Californians to begin.

1) There is broad agreement that the nation needs a new conversation about long-term Medicare funding. It is also possible that a conversation about the long-term funding for Social Security is needed.

There is agreement that long-term funding deficits are likely in these programs unless there are changes in the program structure, although there is no agreement yet on what changes to make.

California public agencies face a similar challenge regarding pension and healthcare benefits. The current benefit structure will likely require more funding than is currently available. Yet benefits for current employees were negotiated and are legally binding.

What can be done to avoid having pension and healthcare benefits for public employees drain money from other programs over time?

2) Several California foundations are sponsoring research on possible ways to reform the way K-12 education funds are currently allocated, as well as on the adequacy of overall funding for education in California. The first results should be released in early 2007.

K-12 education funding is, by far, the largest category of public sector spending. The results can spark a conversation about whether there are ways to save money by rethinking how existing funding is used.

Job Killers—Another Ambiguous Phrase

The phrase "job killer" is usually applied to legislation that some business groups feel will hurt the state's economy. It is the phrase used by such groups to describe legislation they oppose. Often tax increases or environmental regulations are described as "job killers."

However, these same groups often proclaim that other policies will really harm the state's economic prospects, although they don't use the "job killer" phrase.

There is widespread recognition among business and non-business groups that not spending enough on infrastructure such as transportation, water, and ports will hurt the economy.

There is similar recognition that not having a world-class education system can be a "job killer." And not providing capacity and programs in support of innovation and technology in California's public higher education system can be job killers. And not focusing on the needs of adult workers for lifetime retraining can be a job killer, in the sense that it encourages firms not to locate in California.

Currently the twin challenges of housing availability and affordability may be the biggest potential threat to California's future economy.

There is a conversation to be had about how to choose when you have to choose among "job killers."

What if tax or fee increases are the means to having world-class infrastructure or great schools or an environment that people want to live and work in?

Which policy is best for the economy then?

Infrastructure

Californians will be voting in November 2006 on more than $40 billion in state General Obligation bonds related to various kinds of infrastructure construction and repair. These investments appear to have broad bipartisan support.

Californians are accepting the idea that we are "behind" on the level of infrastructure investment necessary to be able to offer a "great place to live and work" to residents and businesses.

The approval of state General Obligation bonds, however, does not bring a revenue source to pay off the bonds. This is different from local bonds, where voters understand that property tax rates will be increased slightly to provide funds to pay off the bonds if they are approved.

Payment of the interest and amortization for state bonds comes out of the state's General Fund. These payments, called *debt service* in the state budget, compete with other General Fund expenditures, such as education and healthcare.

Bonds Can't Pay for the Next $40 Billion and the $40 Billion After That

There is no disagreement that the $40 billion in state bonds on the November 2006 ballot represents only a small portion of the infrastructure investments that California needs in the next few years.

The Legislative Analyst's Office reports that paying for the bonds, even if all are approved, would not push the budgeted amount for debt service outside the range considered reasonable by the financial community.

But bonds cannot be prudently used for all of the state's infrastructure investments—that is, the next $40 billion and the $40 billion after that. And current revenue sources (such as the gas taxes, sales taxes, and federal funding) don't come close to paying for even the transportation investments that are already identified as needed.

So sometime soon, Californians are going to need to have the conversation about how to pay for the next rounds of infrastructure investment.

How Shall We Pay for the Next Round of Infrastructure?

An increase in pay-as-you-go financing, rather than a sharp increase in state borrowing, is likely to be how the next rounds of infrastructure investments will be financed.

There are many ways to “pay as you go” for infrastructure:

- Higher gas taxes, increased local sales taxes, and greater use of tolls can raise more funds for highway and public transit investment.

- Shipping companies and port users can be asked to pay for cleaning up pollution caused by expanded port activity.

- We can see if truckers would be willing to pay tolls that could support the creation of faster, truck-only capacity on the freeways.

- User fees are already the primary financing tool for water and energy investments. Should user fees be levied for flood control?

- Many other ways for users to pay for infrastructure have been suggested by other organizations.

State bonds could be financed on a pay-as-you-go basis. A statewide property tax increase of 10 cents per $100 of assessed value could raise more than $3 billion per year. And that $3 billion per year could be used to pay off the next $40 billion in state bond investments.

Currently, state bonds appear “free” to voters because voters are not asked to put aside money to repay the bonds. In contrast, local bonds have a clear tax attached to repay the borrowing. Voters approve the new tax when they approve the bonds.

An increase in property taxes has not stopped voters from approving a large majority of local school bonds. The self-financing nature of local school bonds prevents the repayment of bond funds from competing against classroom funding.

And the 10 cents per $100 could be added to the county-administered tax bill, just as the property tax increase to pay for local school bonds is added to our local tax bills currently.

However we choose to pay, Californians will need to move beyond our current practice of approving state bonds to pay for an increasing share of our next rounds of infrastructure investments.

Housing—What Role Should Public Policy Play?

There are three major dimensions of California's regional housing markets that are important to focus on in the next ten years: 1) changes in the type of units that will be demanded, 2) affordability challenges, and 3) how to ensure that enough housing gets built to support the needs of residents and the economy.

Changes in Housing Demand

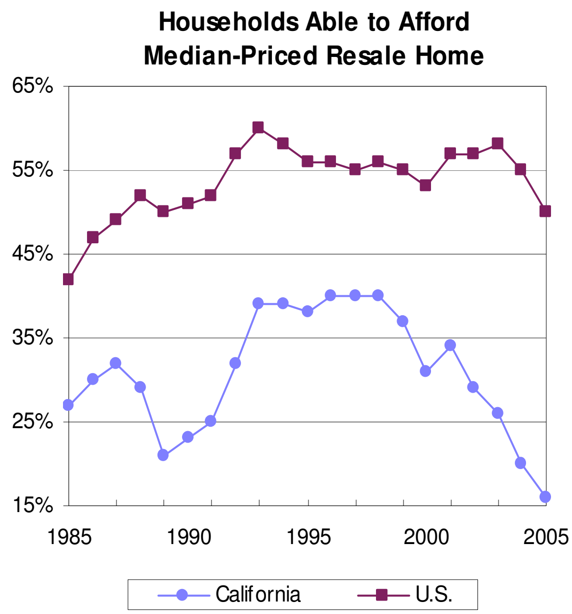
The changes in California's age structure are shown on page 2-7. Half of the state's population growth in the next ten years will be in the 55+ age groups. The next-largest growth will be in 20-34 age group. Population growth in the 35-to-54 age groups will drop sharply from the growth rates of the past ten years.

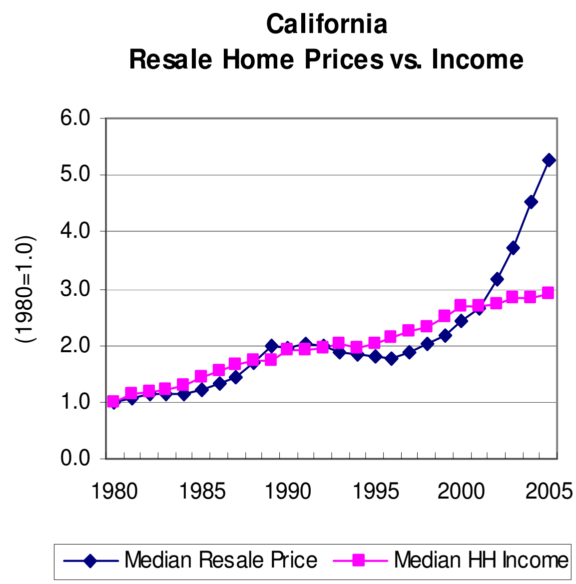
These changes should push housing demand more toward smaller units and probably more toward housing in urban settings. The 55-64 age group will make some existing single-family housing available to new residents as they sell the homes they occupied while raising their families. The market should be able to respond to these demographic changes if local land use policies are flexible.

Housing Affordability

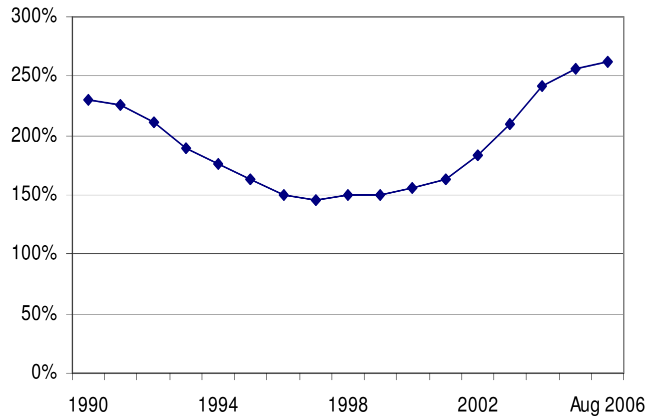
California housing prices have become increasingly out of line with median incomes and the prices of homes in other Western metropolitan areas.

Affordability, measured as the median price of resale housing compared to median household income, is at an all-time low in nearly every regional market in California. The cost of housing in formerly inexpensive markets such as Sacramento and the Inland Empire is now higher than in Las Vegas, Denver, Seattle, Phoenix, and Portland.

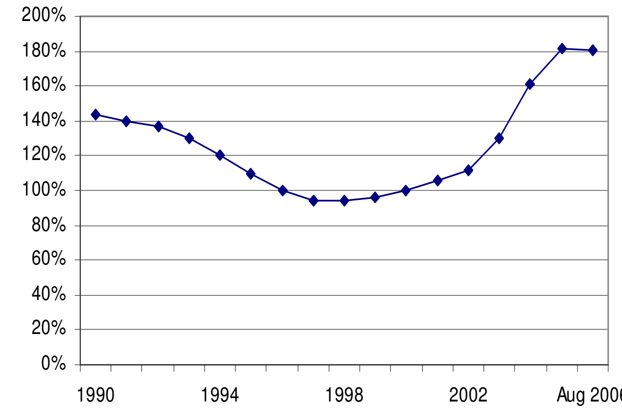




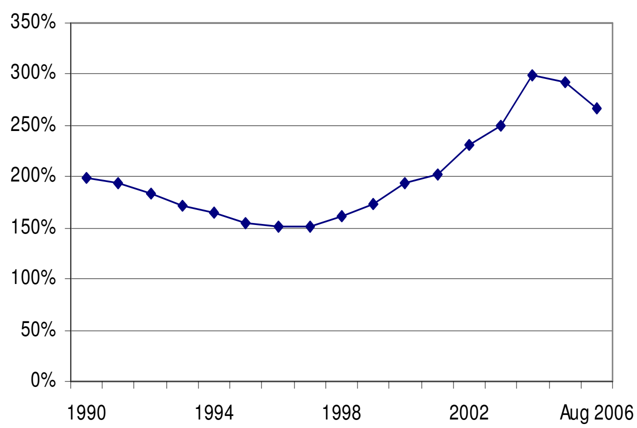
Median Resale Housing Prices
Los Angeles County as % of U.S.



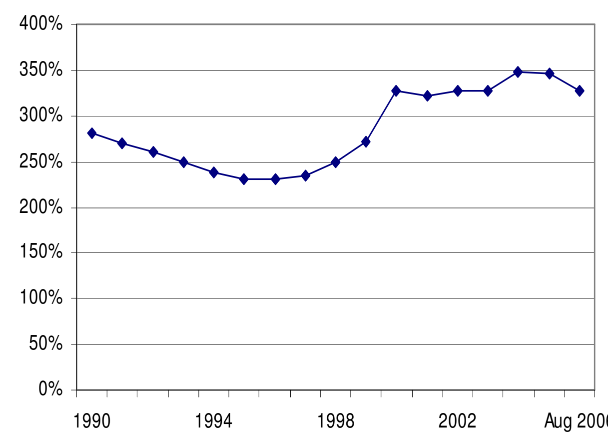
Median Resale Housing Prices
Riverside-San Bernadino Region as % of U.S.



Median Resale Housing Prices
San Diego County as % of U.S.



Median Resale Housing Prices
San Francisco Bay Area as % of U.S.



Median prices in California have reached record highs relative to median prices in the nation, as shown on page 2-19.

A correction in housing prices has begun, and CCSCE expects the price correction to continue into 2007—and possibly longer, depending on how quickly prices adjust. Housing construction levels are dropping, partly in response to the realization that further price appreciation is unlikely.

A moderate-to-sharp correction in housing prices is preferable to lower construction levels as a way of bringing the housing market into balance. California needs housing construction to remain at 2004 and 2005 levels in order to support job growth and income gains.

There is an existing role for public policy in supporting housing affordability for low-income and lower-to-middle-income residents. Bonds to provide housing support for a limited number of families are on the November ballot. But these efforts are limited to a very small percentage of the households facing affordability challenges. They offer very little help to middle-class families trying to make a decision as to whether they can afford to live and work in California.

Public policies that support private-sector housing construction will generally have some impact on housing affordability for middle-income residents.

Local Communities and Housing Approvals

New housing in California is debated and ultimately approved or not approved by local communities. The state cannot force local communities to approve housing developments.

Regional planning agencies like ABAG, SACOG, SANDAG, and SCAG all project the amount of housing that is needed to support projected job growth. Each of these regional planning agencies has an active program to work with residents and local governments to get enough housing planned for and approved. But the regional planning agencies are themselves **voluntary associations of local governments.** They have no power to force local governments to approve housing.

The state does set targets for affordable housing for low-income and moderate-income families in each region of California. However, it is not clear what power the state can exercise or is willing to exercise if these targets are not met.

The human dilemma is clear. From the state or regional perspective the importance of housing for economic competitiveness and quality of life is compelling. But from the local perspective, residents can see that more housing may adversely affect their quality of life. And it is easy to assume that, “If housing is rejected in our community, it can just be built elsewhere.”

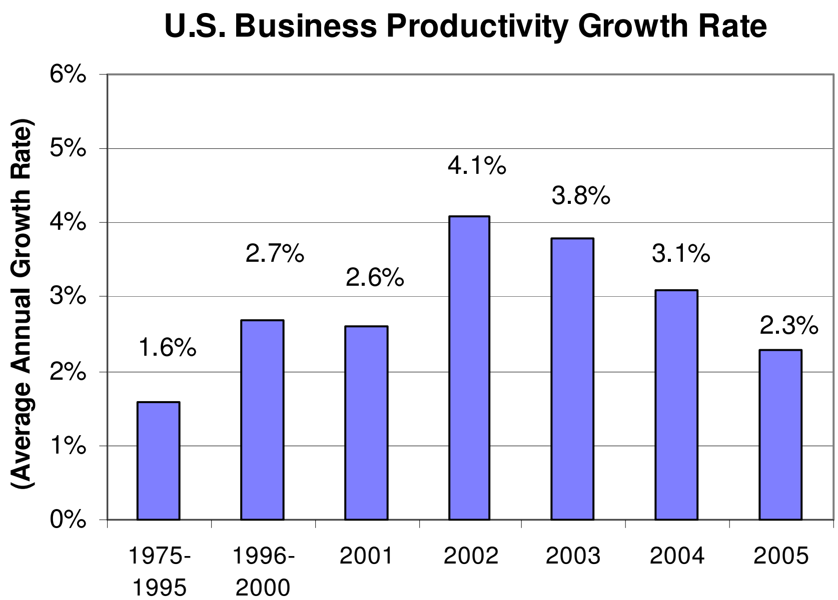
The housing dilemma is repeated for airports and other public facilities that add to traffic and put pressure on resources. There is a regional need, but the locality where the facility is located may experience negative consequences.

This "regional benefit, local impact" dilemma is so clear that it seems like Californians ought to be able to have civil conversations and craft some win-win solutions.

If the state cannot find a way to express the statewide interest in having more housing available, the negative impact on California's competitiveness will eventually hurt many residents.

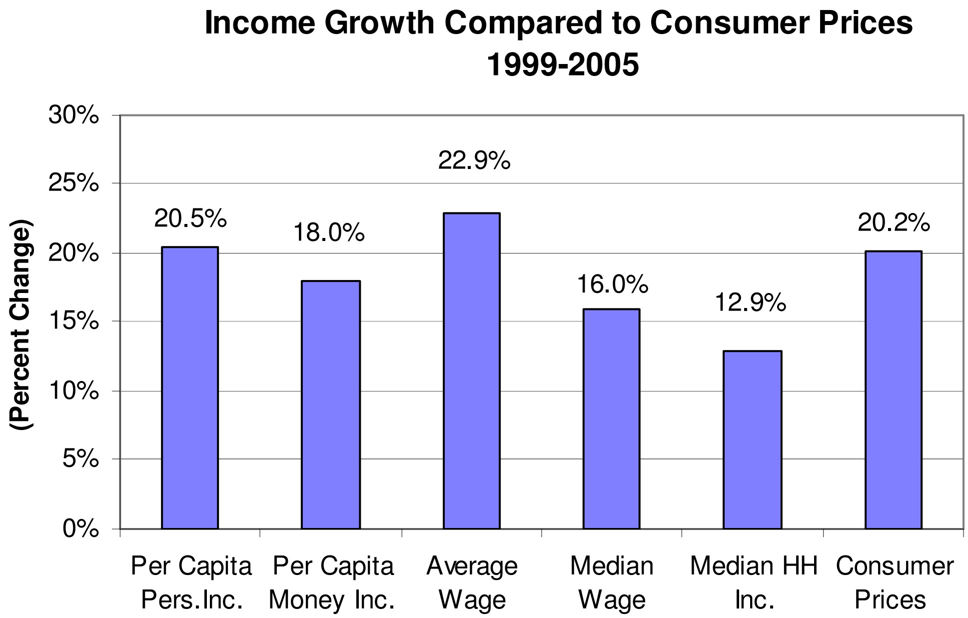
Growing Productivity, Declining Real Earnings

Productivity growth has averaged 2.9% per year since 1996, and 3.0% annually between 1999 and 2005.



Normally, this level of productivity growth would translate into substantial gains in real income. This did not occur between 1999 and 2005, as shown on the graph on page 2-22.

Measures of income growth such as per capita income and average wages barely kept pace with consumer price gains. This left many families no better off after six years of strong productivity growth. **In fact, the slow growth in median wages and median household income left many families with lower real incomes in 2005 than in 1999.**



Inequality and Declining Standards of Living

If Californians are to have a conversation about the middle class falling behind, it is important to distinguish that conversation from the conversation about inequality and the share of income going to high-wage earners and investors.

There is no disputing the national and state data, which show an increase in inequality during the past ten years, an extension of the gradual increase in inequality of incomes that has taken place over the past 30 years. The earnings of the most highly educated workers have grown more than the earnings of workers with middle and lower education and skill levels.

Finding the best approach for restoring increases in real earnings and the standard of living for many middle-class families may or may not reduce inequality. Toward the end of the 1990s, the strong economy and very low unemployment rates resulted in real income gains for middle- and lower-income workers. These gains came as a result of economic forces and not as the result of any effort to reduce incomes for high-wage workers.

One topic for conversation is “How much does inequality matter?” if middle- and lower-income families are keeping pace with overall economic gains.

Middle Class and Lower-Income Families—Competitors or Teammates?

Another conversation to continue is whether there are policies that improve economic prospects for middle- and lower-income families simultaneously. Policies that improve the economy, improve educational and training opportunities, and provide solutions to rising healthcare costs should help a very broad group of California residents and families.

Many groups in California focus on the economic challenges facing the bottom 20% of families, as measured by income. The usual policy ideas are regular increases in the minimum wage, having a state complement to the federal earned income tax credit, and universal access to healthcare.

Those issues are part of an important conversation as well.

But it is important to acknowledge that “falling behind” is now reaching middle-class, as well as lower-income families. If middle-class and lower-income families can see themselves as teammates in search of a better standard of living, rather than as competitors in the public policy arena, the difficult conversations may become easier. As Californians and as Americans, they can have more productive conversations about the disconnect between productivity growth and earnings.

There are all sorts of “villains” in the public debate. Sometimes corporations are blamed. Often the declining membership in unions is cited. Outsourcing and globalization are also commonly cited as villains.

Probably the degree of blame is overstated, and the amount that we don’t understand is overlooked. In addition, there are some signs of a returning connection between productivity growth and broadly shared real earnings growth.

The impending retirement of baby boomers may create a tighter labor market. Although economic growth is slowing now, perhaps a return to the strong economy of the late 1990s is on the horizon.

There are probably limits as to what state policy can do to help workers see the benefits of productivity gains translated into higher real wages. Federal policies are also appropriate. Even then, there may be limits as to what can be done.

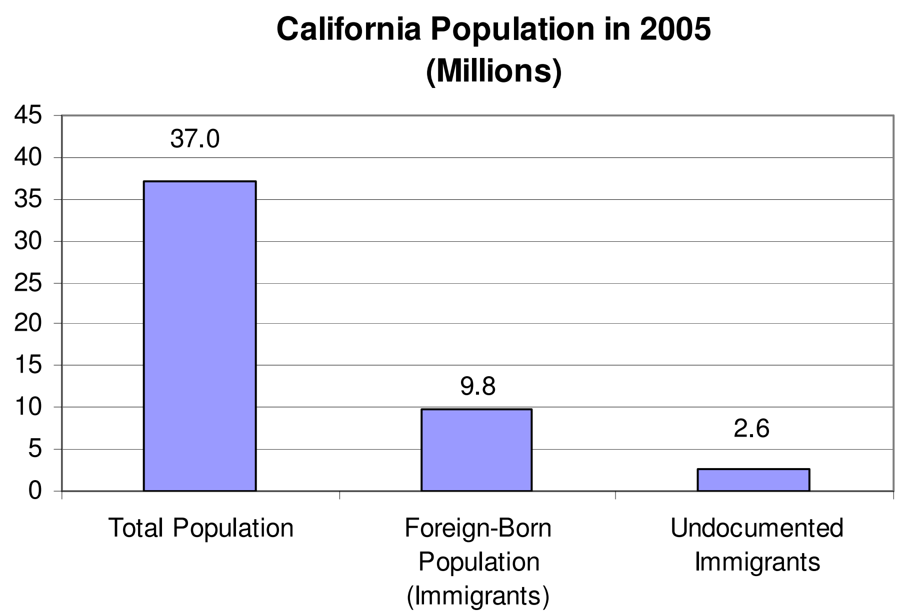
But this is a conversation we need to have because for now the data is completely clear. The gains from the recent surge in productivity growth have not been broadly shared, and the number of residents who feel at risk is large and probably growing.

Immigration and the California Economy

In late 2005 CCSCE published a report (sponsored by the California Economic Strategy Panel and available at www.ccsce.com) titled *The Impact of Immigration on the California Economy*. The following pages provide an update to that 2005 report. Additional updates are expected in 2007 and will be posted on the CCSCE website.

Basic Demographic Information about Immigration in California

Immigrants account for slightly more than 25% of California's population. Of the state's 37 million residents in 2005, nearly 10 million were foreign born.[2]



The Pew Hispanic Center (www.pewhispanic.org) estimates that there were approximately 2.6 million unauthorized (undocumented) immigrants in California in 2005. Undocumented immigrants accounted for 7% of the state's total population.

The terms *foreign born* and *immigrant* both refer to current California residents, including children, who were born outside the United States. The terms *undocumented immigrant*, *unauthorized immigrant*, and *illegal immigrant* all refer to current residents who were born outside the United States and who did not enter the country through the legal immigration process.

[2] The estimate of 9.8 million foreign-born residents in 2005 is the average of the American Community Survey 2005 estimate (9.6 million) and the Current Population Survey 2005 estimate (10.0 million).

Demographic characteristics of immigration to California are as follows:

- Immigration has accounted for approximately 200,000 new residents per year (40% of California's population growth) over the past 15 years.

- California's share of both legal and undocumented immigrants has declined since 1990. There is a strong national trend for immigrants to locate outside of the traditional immigrant centers in California, Texas, Florida, and New York.

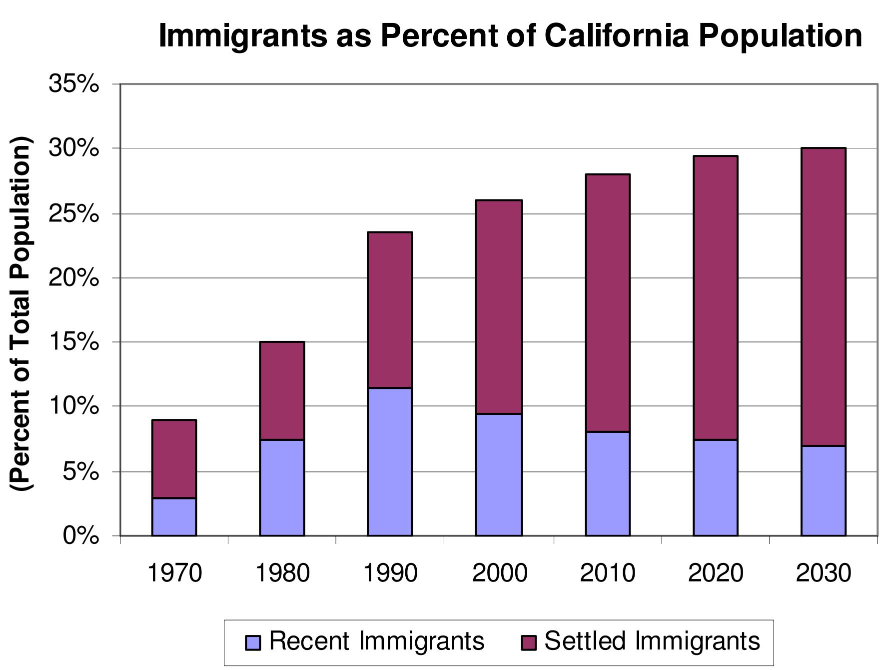
- Half of California's legal immigrants come from Mexico and Central America, while 40% come from Asia. Most (80%) undocumented immigrants come from Mexico and Central America.

- Immigrants are younger than the rest of California's population. More than 75% of immigrants to California are below the age of 40.

- Half of California's undocumented immigrants did not graduate from high school. More than 30% of California's legal immigrants have college degrees. This is slightly higher than the college graduation rate for native-born residents.

Immigration Characteristics Will Change

The share of immigrants in California's overall population is projected to increase slightly, but **the share of recent immigrants (those here for less than 10 years) should decline.**

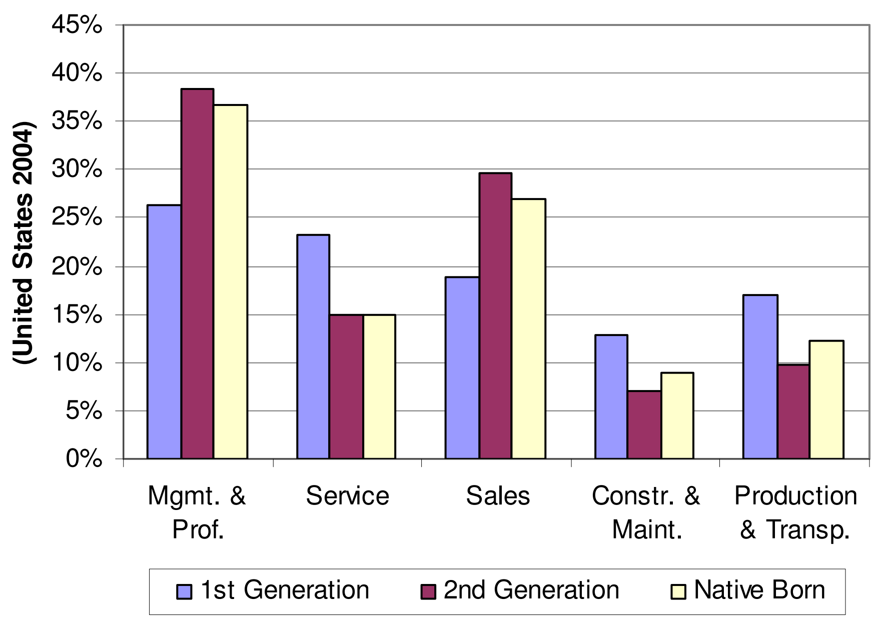


In the preceding graph, which was prepared by the Demographics Future Project of the University of Southern California (USC), the term *settled immigrant* refers to immigrants who have lived in the United States for ten years or more.

The Pew Hispanic Center reports that the primary language of immigrants from Mexico and Latin America changes dramatically across generations. By the second generation (that is, the children of immigrants), Spanish is the primary language for fewer than 10%. In the third generation (grandchildren of immigrants), 80% of residents are English dominant, and the other 20% are bilingual.

The Pew Hispanic Center also reports that second-generation immigrants (the children of immigrants) move up the occupational ladder compared to their parents. The share of second-generation immigrants in management, professional, technical, and sales occupations increases while the share in service and manual occupations declines, relative to the occupational profile of their parents.

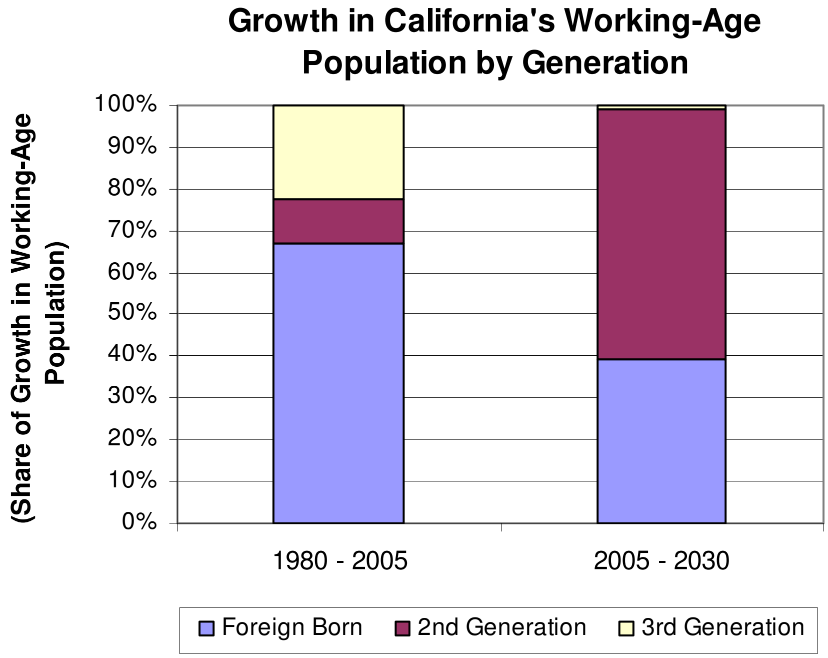
Workers by Major Occupation



California's Future Workforce—Immigrants and Their Children

According to projections prepared by the USC Demographic Futures Project, **immigrants and their children will account for 100% of the increase in California's population aged 16-64 during the next 25 years.**

This projection does not mean that every new entrant to California's workforce will be an immigrant or the American-born child of an immigrant. It does mean, however, that the inflows of native-born workers into the workforce will be offset by the retirement of other workers.



The graphs on pages 2-7 and 2-8 tell the same story. California's existing older workforce (primarily White Non-Hispanic) will be retiring and will be replaced by the children of immigrants and new immigrants, who are mostly Latino or Asian.

The primary focus of current conversations about immigrants and the California workforce is on two issues:

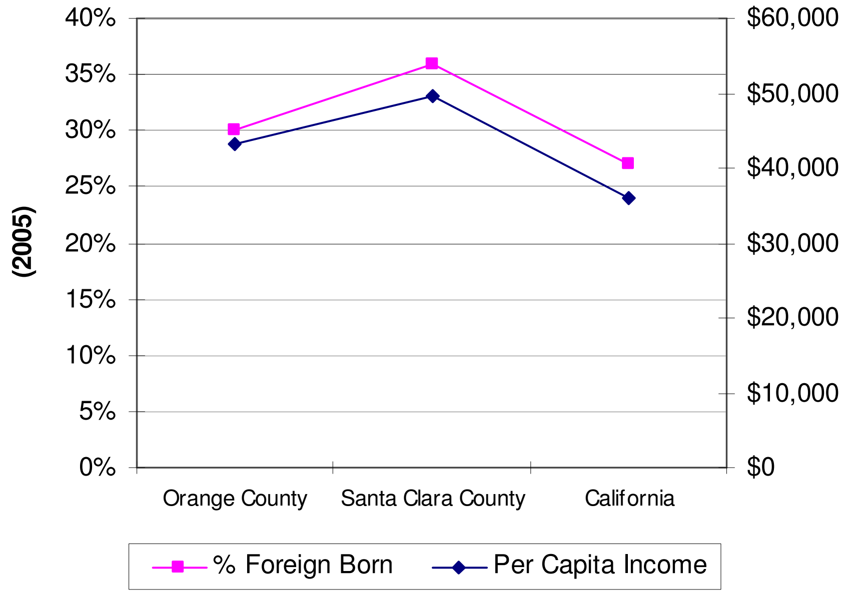
1) Is there a mismatch between the skills of immigrants and their children and the state's future workforce requirements?

2) How do undocumented immigrants fit into the California workforce?

However, there is a third dimension to conversations about immigrants and the workforce that is mentioned less often: California's leadership in high-tech innovation is fueled, in part, by a wave of highly educated immigrants.

Santa Clara County and Orange County are California's largest centers of high-tech innovation. Each of these counties had an above-average share of immigrants (foreign-born residents) in 2005. Each of these counties also has above-average wage levels and per capita income compared to the state average. AnnaLee Saxenien of U.C. Berkeley and others have reported on the large contribution that immigrants make to California's high tech leadership in the global economy.

Immigrants in High Tech Regions



California has an economic interest in attracting foreign-born entrepreneurs and skilled workers. Some challenges have surfaced in this post-9/11 environment. Worries about terrorism and increased scrutiny of new immigrants are making it harder for universities to attract foreign students and for companies to hire foreign-born workers. The incentives for foreign students and workers to return to their countries of birth are increasing, as opportunities there are increasing rapidly.

It is important for California and the nation to remain accommodating to foreign-born students, workers, and entrepreneurs, as they have made a significant contribution to our economic success.

California's Future Economy and Workforce—A Mismatch?

The arithmetic of a **potential mismatch** between the skill requirements of the economy and the skills of immigrants and their children is clear. If the educational and occupational profile of the children of poorly educated immigrants does not change from that of their parents, many of these children will not find a place in the California economy. And the state economy will need to look elsewhere to fill some of its future jobs.

On the other hand, **the arithmetic of potential advantage** is also clear. If the children of immigrants make educational and occupational progress, the result is that California has a relatively younger and more enthusiastic skilled workforce while many of the world's developed nations are struggling with an aging workforce and population.

Take a look again at the graphs on pages 2-10 and 2-11.

California will need workers at all skill levels. Many jobs will require some specialized training beyond high school graduation, but most job openings will not require a four-year college degree. And the number of low-skilled jobs will continue to increase as well.

The theoretical pathway to avoiding a labor force mismatch is clear. The growing number of low-wage jobs can be filled by native-born and immigrant workers that begin with low skill levels. The growing number of high-skilled jobs can be filled by immigrants with high skills and by the children and grandchildren of immigrants that increase their college participation and graduation rates.

But filling the middle-level jobs is critical. With experience, increased English language skills, and some additional training, many recent immigrants can move up to middle-level jobs and replace retiring workers. This "move up" strategy is critical for the economy and for creating hope for both native-born residents and immigrants and their children. A "move up" strategy also allows some low-wage workers to move up the career ladder and make room for the next generation of entry-level workers.

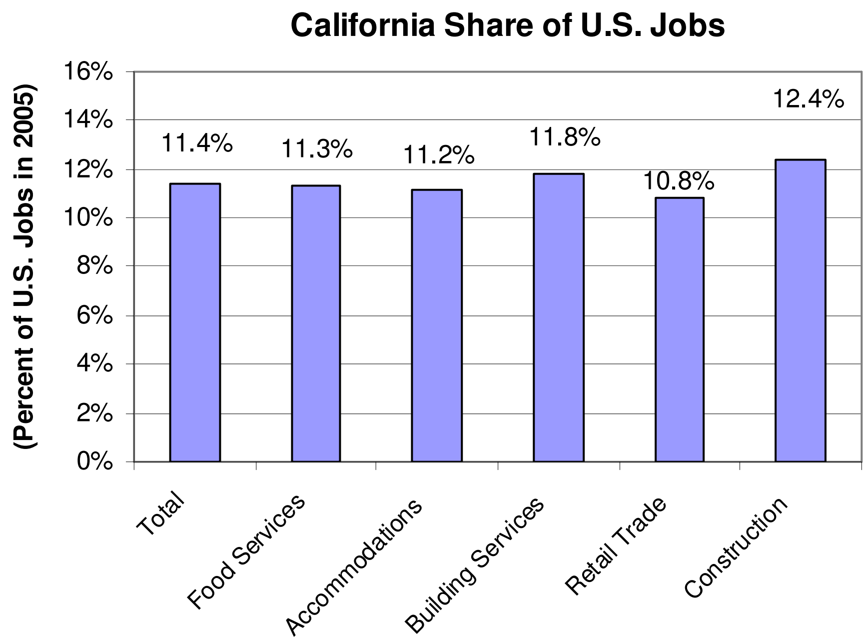
Will California Have "Too Many" Low-Skilled Workers?

Two concerns are raised about a possible mismatch between the skills of residents and the requirements of the California economy. One concern, discussed above, is that California will not have enough skilled workers. The other concern is that the state will end up with "too many" low-skilled workers and poor families.

This second concern is sincerely voiced, but the feared result is not likely to happen—even if the state does not improve education and training. **Despite high levels of immigration, California does not currently have above-average shares of low-wage jobs.**

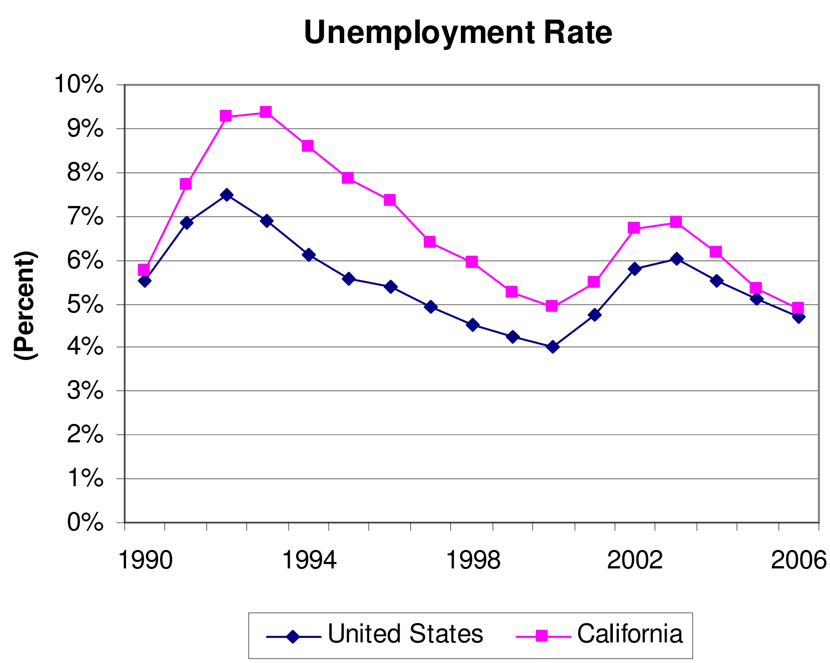
The graph on page 2-30 shows California's share of jobs in major low-wage industries. All sectors except Retail Trade have a relatively high share of immigrant workers. California had 11.4% of U.S. jobs in 2005 and close to that same share of jobs in each of the low-wage industries shown on the graph.

The migration of immigrants into California is closely tied to job opportunities. California will not end up with a dramatically high number of waiters, dishwashers, hotel maids, or gardeners simply because low-skilled immigrants want to move to the state. History reminds us that families will move elsewhere if there are few job opportunities where they live. This was true for Southern California when aerospace jobs disappeared and true in places like Detroit, Cleveland, and Pittsburgh when key industries had sharp declines in employment.



The data since 1990 show a broad movement of immigrants toward new areas of job opportunities all throughout the United States.

Another way to look at the impact of immigration on job opportunities is to examine the trend in unemployment rates during the past 15 years, when immigration levels (and particularly, for unauthorized immigration) were high. The national and state trends are shown below.



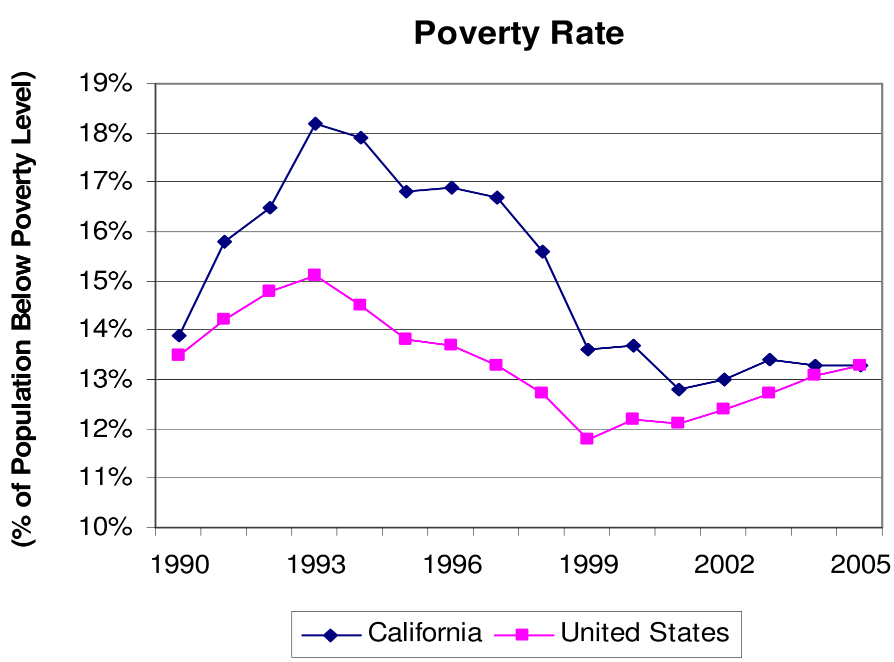
Unemployment rates rise and fall with the economy, as shown on the preceding graph. Unemployment rates rose in the recession periods after 1990 and 2000, and they fell during periods of sustained economic expansion.

After 15 years of historically large levels of immigration, unemployment rates in the state and nation are relatively low. California's unemployment rate is now equal to the national rate, after having been higher for most of the past 15 years. And California's unemployment rate has come closer to the national rate despite comparatively high levels of legal and unauthorized immigration into the state.

What happened to poverty rates during this period of substantial immigration? The trends for poverty rates are similar to the trends shown in the preceding graph for unemployment rates.

Poverty rates rise and fall with economic conditions. There was a large increase in California poverty rates in the early 1990s recession period, and there was a large drop during the period of strong job and wage growth between 1994 and 2000.

Poverty rates are still higher than we would like, especially among children. However, poverty rates in California have not increased for the past 15 years—despite two recessions and the addition of 3 million immigrants to the state's population.



The Past 30 Years—Difficult for Workers Without a College Degree

The number of jobs in U.S. manufacturing and mining industries has declined dramatically during the past 30 years. There are now 4 million fewer manufacturing jobs than at the previous peak, and the number of mining jobs has fallen by 50%. Moreover, wages and benefits for the remaining manufacturing and mining jobs have been under pressure from global competition.

Numerous studies report that earnings for workers with a high school education or less have not kept pace with inflation and have fallen far behind wage gains for college-educated workers.

One of the highly emotional issues related to undocumented immigration (discussed below) is the impact of such immigration on wages for less-educated workers.

Immigration **does** have some negative effects on the wages of less-educated workers, but it is important to remember that **most of the economic difficulties for less-educated workers have nothing to do with immigration.** Globalization and increases in productivity explain the job losses in industries such as steel, auto manufacture, and apparel. And globalization is the primary culprit in the downward pressure exerted on wages and benefits for the remaining jobs that are subject to international competition.

As a result of these global pressures, there has been a change in the occupations where workers with low levels of educational attainment work. It is currently much more difficult than in previous decades to build a relatively well-paying career in manufacturing or mining industries.

Today, low-skilled jobs are found more in the service sector—in restaurants, hotels, landscaping, and personal services.

This loss of middle class wage opportunities for less-educated workers has had profound effects for some segments of the American population. But the challenges posed by the loss of these job opportunities are not caused by the immigration of low-skilled workers, and they will not be reversed by changes in U.S. immigration policy.

Economic Insecurity Touches Many Middle-Class Families

As discussed starting on pages 2-21 through 2-23, real wages have fallen for many middle-class families in recent years—despite strong gains in productivity. These families also feel the pressure of rising healthcare and college tuition costs. The number of families feeling some degree of economic insecurity has greatly increased during the past ten years.

This growing insecurity sets a context for the conversations taking place about unauthorized immigration.

Economic Concerns about Unauthorized Immigration

California's future economy will depend on the education and training of immigrants and their children. The broad economic data cited in the preceding pages confirm that recent immigrants have been absorbed into the California economy without any obvious imbalances in the number of low-wage jobs or in unemployment or poverty rates.

Yet people in California and across the nation have strong feelings about immigration. Some people worry about immigration creating more population growth and pressure on natural resources and the environment. Other people worry that immigrants speak different languages and may have different values.

Concerns and emotions seem to run the highest in discussions about unauthorized immigration. This report does not discuss the cultural and legal issues related to immigration. However, it does address some of the many concerns about the economic impact of unauthorized immigration.

The general conclusions of the vast amount of economic research about immigration are that 1) immigration creates overall benefits for the economy, and that 2) some individuals (primarily some low-skilled workers) may be harmed by immigration.

The immigration debate has similarities to the debate about foreign trade. Economists broadly agree that there are net benefits from expanded world trade and that in certain circumstances some individuals will be harmed by losing a job or by pressure on their wages and benefits.

A civil conversation about immigration, and especially about unauthorized immigration, can take place if we acknowledge this challenge of dealing with overall benefits to the economy while understanding that some individuals are harmed.

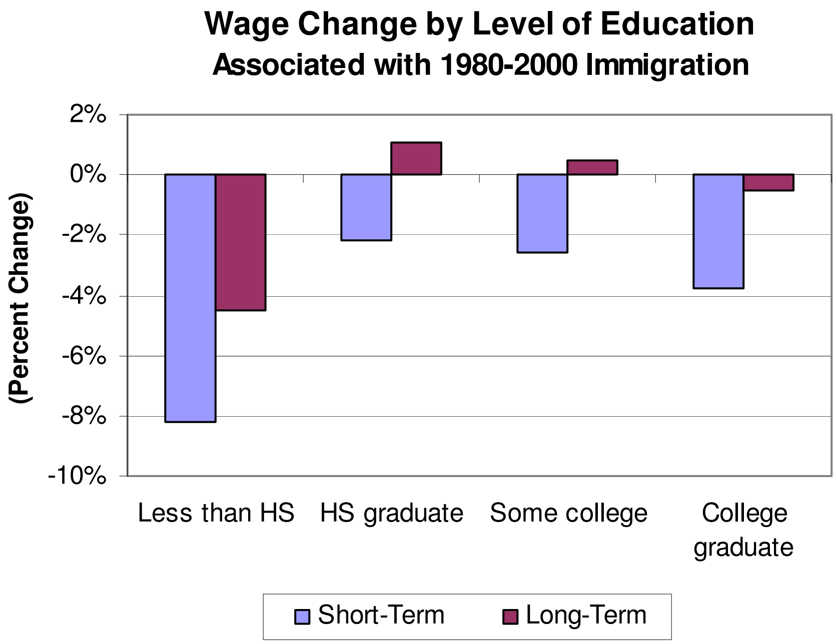
The Wage Impact of Unauthorized Immigration

There are two widely publicized claims about the impact of unauthorized immigration on the state and national economy. Each claim has a measure of truth. Moreover, each is valid for low-skilled immigrants, regardless of whether they come to the United States through legal or unauthorized pathways.

The first claim is that low-skilled immigrants negatively affect the wages and job opportunities of other low-skilled residents. Several studies have concluded that the inflow of low-skilled immigrants **has** affected the wages of residents that have not completed high school. However, the wage effects are very small or non-existent for workers with higher levels of education.

Studies by the National Academy of Sciences and an analysis in the *2005 Economic Report of the President* characterize the impact of immigration on the wages of low-skilled resident workers as true but "weak" or "little."

Research by George Borjas and Lawrence Katz of Harvard University reports a typical profile of wage impacts from Mexican immigration between 1980 and 2000. This profile is shown in the following graph.



The relatively larger short-term and long-term wage impacts are confined to residents with less than a high school education. Borjas writes in an April 18, 2006 *Wall Street Journa*l article that "[n]ational wage trends confirm the common-sense notion that immigration has labor market consequences. A larger pool of competing workers lowers relative wages. This does not imply that immigration is a net loss for the economy."

The Fiscal Impact of Unauthorized Immigration

The second claim is that undocumented immigrants have a negative fiscal impact on state and local communities.

K-12 education accounts for by far the largest public service cost associated with unauthorized immigration, as all children in America are entitled to free K-12 education. Prison costs and a limited number of healthcare services account for the other major fiscal costs.

Undocumented immigrants are not entitled to most health, social service, and economic benefits in programs such as MediCal, welfare, unemployment insurance, and disability payments. Some restrictions on these programs apply to legal immigrants as well.

Let's focus on the fiscal impact of educating the children of unauthorized immigrants, since these costs account for the majority of the public service costs cited in studies and the public debate. Since the families of unauthorized immigrants have below-average incomes, it is not surprising that their taxes do not cover the full costs of public education.

In fact, **all poor families** receive more in public services than they pay in taxes. This is true for native-born residents, legal immigrants, and undocumented immigrants.

However, education spending is usually considered as an investment that brings future returns in the form of income growth and increased civic participation. **The distinction between education spending as a cost and education spending as an investment is important for evaluating public policy about immigrants, just as it is important in making public-spending decisions concerning non-immigrant poor families.**

The National Academy of Sciences published the following finding in its study of the fiscal impact of immigration:

> . . . [E]ducation expenditures on immigrant children are invariably counted as a cost in the accounting schemes of the various papers. However, they are also an investment designed to make the young generation more productive in the future. Thus, the extra education expenditures result in future higher fiscal inflows that should be counted in the analysis at an appropriate discount rate.[3]

Americans have always accepted the concept that investing in education has both a monetary and a social payoff for society. Numerous studies document the benefits to individuals and to the economy of having a more-educated workforce. And Americans have always accepted that educating the children of poor families has an economic and social payoff for society.

Our whole language about education speaks to the investment aspects of spending to educate everyone to their fullest potential.

Treating education as an investment has even more compelling meaning when we consider the future large-scale retirement of the baby-boom generation. California's future workforce growth will come from immigrants and their children and grandchildren. To a great extent, the capacity of our workforce depends on what kind of job we do in educating the children and grandchildren of immigrants.

It is also true that poor families do not cover the current costs of educating their children. The returns from these investments come in future years. Even then, much of the fiscal return from the investments in education goes to the federal government and not to the state and local governments.

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[3] National Academy of Sciences, National Research Council, *The Immigration Debate: Studies on the Economic, Demographic, and Fiscal Effects of Immigration* (Washington, D.C.: National Academy Press, 1998) 61.

Tough Questions Worth Talking About

Assume for the purpose of discussion that all unauthorized immigrants were replaced by legal immigrants with the same education and skill level and the same number of children. The economic and fiscal impact of these legal immigrants would be nearly identical to the impact of similar, but unauthorized, immigrants.

Economic concerns about the immigration of low-skilled workers are mostly concerns about distributional effects of immigration. The economy gains, but some workers may lose. The long-term fiscal impacts are minimal, but in the short term, local and state jurisdictions with a high share of relatively poor immigrants incur extra costs.

The state and nation are at the beginning of conversations that are needed to sort out what to do when emotions are high and the “facts” are not 100% one-sided. Following are some tough economic and fiscal questions for us to be talking about—while realizing that economic issues are only one part of the national conversation about immigration.

Tough Questions about Jobs and Wages

- Do you think the current immigration of low-skilled workers provides a net benefit to the economy?

- If immigration of low-skilled workers were reduced, would the number of low-wage jobs decrease? Why? Who would fill the low-wage jobs if there were fewer immigrants?

- What role should the minimum wage or programs like the Earned Income Tax Credit play in helping low-wage workers and their families?

- If you believe immigration should be reduced to help low-wage workers, do you believe that imports of apparel from China and elsewhere should be banned to reverse the loss in U.S. apparel jobs? How do you balance the higher prices from reduced trade with the gain to apparel workers?

- Should we be encouraging more native-born residents to aspire to low-wage careers so we can reduce the immigration of poorly educated workers? If not, who should fill the growing number of low-wage jobs?

- Are there ways to keep the benefits of immigration while helping individuals who may suffer economic harm? Who should receive help if they are harmed by public policy? People harmed by expanded foreign trade? By immigration? By outsourcing? By changes in defense spending?

- Do your answers depend on whether the low-skilled immigrants came through legal or unauthorized pathways? Why? Does the legal status of immigrants matter when looking strictly at economic effects?

Tough Questions about Public Service Costs and Revenues

The costs of educating children are incurred now, yet the economic benefits come later. The costs are mostly incurred by states and local jurisdictions, yet a large portion of the future tax benefits goes to the federal government. The economic benefits may occur in a different place from where the children went to school.

Most fiscal impact studies look at one recent year. Yet all economists agree that analyzing fiscal effects of immigration requires looking over time to incorporate the future fiscal (and economic) effects of current immigration. Here are some questions for conversations about immigrants, education, and public policy:

- Is investing in the education of children from poor families good for the economy? Does it matter where their parents were born? Why?
- What is the correct public policy to deal with financing the costs of educating the children of poor families? Does it matter whether the parents are native-born residents, legal immigrants, or unauthorized immigrants?
- What should happen if educating the children of poor families is a good investment, but communities with a high share of poor families don't pay enough in taxes to cover the costs of education?
- Do high levels of immigration help build a tax base to help when the large numbers of baby boomers retire?
- Are the current immigration levels of low-skilled workers good for the overall economy? Will the impact of this current immigration be more or less positive 10 to 20 years from now?