Opportunities and Challenges for the California Economy

California Economic Growth Chapter 2

2008 Edition

Center for Continuing Study of the California Economy

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OPPORTUNITIES AND CHALLENGES FOR THE CALIFORNIA ECONOMY

By Stephen Levy

This chapter is written to foster conversations about California's future economic opportunities and challenges. The focus is on the role of public policy in meeting California's economic challenges and converting opportunities into prosperity.

Groups in California are working to make these conversations happen between and among elected leaders, community leaders and residents. California Forward (www.caforward.org) and Common Sense California (www.commonsenseca.org) are two recently formed groups working to increase policy dialogue among Californians. Many other groups are working to get Californians engaged in conversations about our future. I hope this chapter is helpful in giving the state's economy and economic policy issues a spotlight in these conversations.

The bottom line is the same as it has been for several years now. 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. Our future prosperity will depend on our ability to invest for the future and make California a great place to live and work.

California is a state with world famous innovators and entrepreneurs. We are home to firms like Apple, Cisco, Hewlett-Packard and Intel in technology; Ebay, Facebook, Google and Yahoo in pioneering the use of the Internet; DreamWorks, Pixar and Electronic Arts in combining technology and entertainment; Amgen and Genentech in biotech; Jacobs and AECOM in professional technical services; and thousands of firms innovating in the design of clothes, autos, toys, architecture, and advertising.

We are the nation's leading foreign trade center and state firms get more than 45% of national venture capital funding. In the 2nd quarter of 2008 California firms captured 40% of the record $2 billion worldwide venture capital funding for alternative energy projects. In June Tesla Motors announced plans to design and build electric cars in the Bay Area. Opportunities are plentiful throughout California's economic regions.

Getting from Today to Tomorrow—Difficult but Necessary

The state and nation are mired in short-term economic challenges. These challenges compel our attention because people are hurting and the national political campaign is focused on the economy. Residents feel poorer from the deadly combination of falling home prices and rising prices for anything related to energy. Unemployment rates are up and job growth has disappeared. All of these factors affect consumer spending and make it harder to balance state and local government budgets.

These are the problems of **today.** They are, indeed, compelling to residents and elected leaders.

A Quick Word About Today's Economic Challenges

Right now we don't know how deep or long this economic slowdown will turn out to be. A lot will depend on how consumers react to falling stock market and home values and rising energy prices. The slowdown or recession is not likely to be large by conventional measures of job or income loss. However, it feels worse to people (with good reason) because other indicators such as home values and energy prices are reducing the ability of households to maintain their standard of living.

The federal government is responsible for the "heavy lifting" in fighting recessions. The conventional anti-recession tools are lower interest rates and short-term deficit spending by the federal government to stimulate the economy. Each has been used so far. The Federal Reserve Bank has moved to lower interest rates substantially but the next interest rate moves almost certainly will be increases, not further reductions. Congress passed a $150 billion stimulus package in early 2008 with most of the stimulus coming in the form of tax rebates to individuals during the spring and summer of this year.

If more anti-recession efforts are needed, the best ideas are federal government cash payments to individuals, financial aid to state and local governments and federal funding for infrastructure investment. The aid to individuals can be targeted to lower-income households who are likely to spend all of their checks.

If state elected leaders want to show concern for the economic worries of residents, they can be loud advocates for these **federal** actions, especially for increased aid to state and local governments. But if we are honest with residents the message should be that states don't have effective tools to fight recessions. If we want to build credibility with voters here is a good place to start, especially since there are so many **long-term economic challenges** that **state leaders** can help resolve.

Unless there is a true economic miracle, the budget pressures on state and local governments will continue into 2009 and, probably, 2010. The slowdown in housing construction and sales will keep property tax growth low and, when combined with slowing consumer spending, will make sales tax revenue grow slowly or, in some places, decline. Budget "solutions" should not be based on the assumption of a quick or sharp economic recovery.

Getting From Today to Tomorrow

However, this report is about the California of **tomorrow.** And **tomorrow's challenges** must be part of the policy conversations we are having **today** or we will fail to prepare for the future, fail to convert opportunities into prosperity and fail to offer hope to residents trying to build a better future for their family and for our extended "**California family**".

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, working and living in California. 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 **private investment?** Will entrepreneurs and families continue to be attracted to California's economic opportunities? Will residents born in California want to and be able to live here, prosper and enjoy a high quality of life?

Will our schools be good enough to educate and train California residents to replace retiring baby boomers and fill newly created jobs? 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**?

Five Facts About California's Next Ten Years

While the future is uncertain because it has not happened yet, here are five facts you can take to the bank about California's next ten years.

- Baby boomers will age and begin to retire. Immigrants and their children and grandchildren will replace boomers in our workforce and housing markets.

- There will be no growth in the number of residents aged 35 to 54.

- For every 100 new jobs created in California, there will be between 150 and 200 job openings from retirements or replacements.

- Manufacturing job levels will continue to decline—in California, in the nation, in China and around the world.

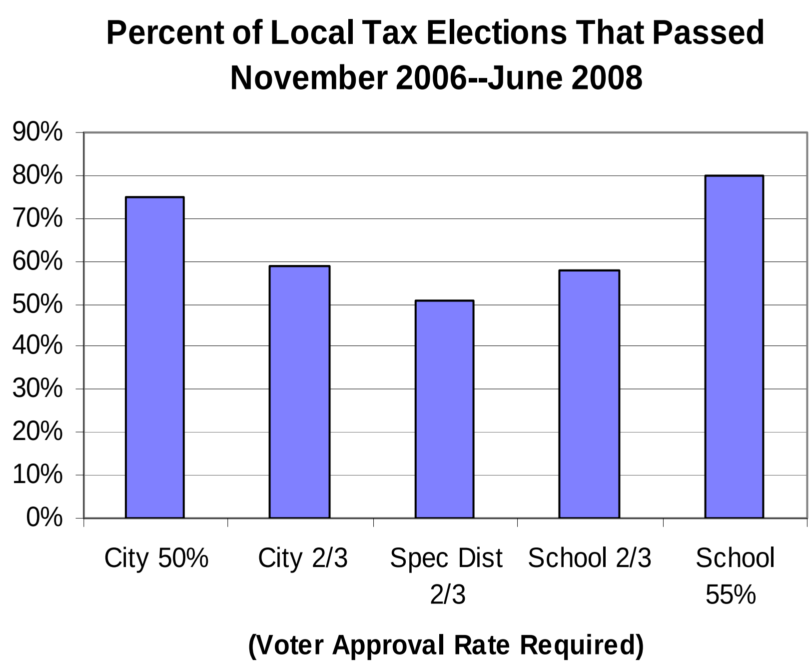
- California's opportunities for prosperity are centered on innovation, design and the application of creativity in areas ranging from biotech and alternative energy to the Internet and entertainment. Expanding world trade will present a different set of opportunities and challenges.

There is one more "fact' that I hope will remain true for the next ten years. It should be an important part of conversations about the state budget and about how residents feel about investing for our "California family's" future.

Local residents have been approving taxes for schools and public services. The data below is compiled from a California city finance website maintained by Michael Coleman (http://www.californiacityfinance.com/) and the site is a wonderful source for information and data on local **and** state government finance.

Counting the elections from November 2006 through June 2008, voters approved 69 of 92 city tax elections (75%) that required a 50% vote for approval and approved 32 of 54 city elections (59%) that required a 2/3 vote for approval. Voters approved 33 of 65 elections (51%) in special districts (such as fire or park districts) where a 2/3 vote was required and approved 22 of 38 (58%) of school elections (primarily parcel taxes) where a 2/3 vote was required.

Most local school district bonds now require a 55% vote for approval in contrast to the 2/3 vote required to approve other local government bonds. Voters approved 117 of 146 school bonds during this period for an approval rate of 80%. And all local bonds come with a property tax increase unlike state bonds that voters approve but are paid for out of existing General Fund revenues.



What are the implications of these facts for California's future? What trends and challenges will be handled easily by the private sector and where does public policy play a role?

We start with the demographic changes expected over the next ten years.

Immigrants and Boomers—The Generational Shift Begins

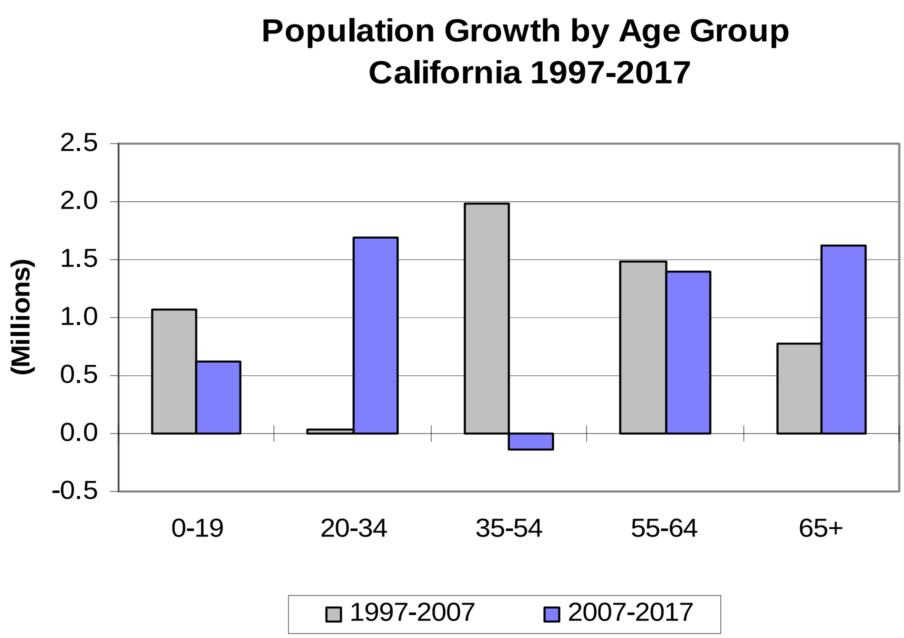
Although many have pointed to these trends, I want to acknowledge that ***Immigrants and Boomers—Forging a New Social Contract for the Future of America*** is the title of a wonderful book written by Dowell Myers from USC and published in 2007-- http://www.russellsage.org/publications/books/070104.997475.

I'll have more to say below about why these trends call for conversations in California about a new social contract for our changing California family.

Three pictures help tell this story.

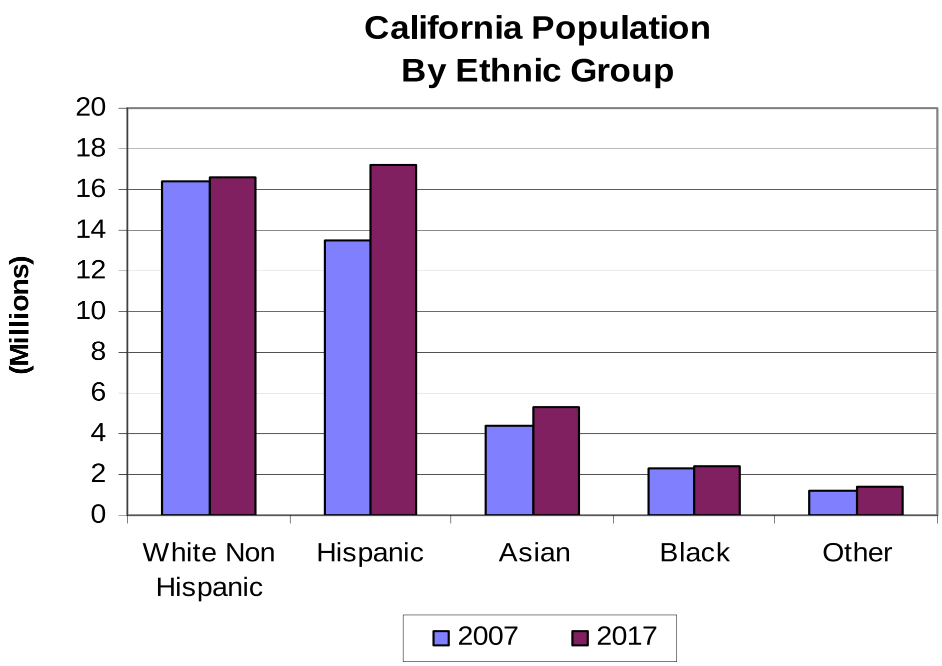
During the past ten years, California added 2 million residents in the 35-54 age groups. This surge defined the state's housing and labor markets as baby boomers moved into these prime family forming and higher-earning age groups.

During the next ten years the number of residents in the 35-54 age groups will remain constant—no growth at all. This change will profoundly affect housing and labor markets throughout California's major economic regions.

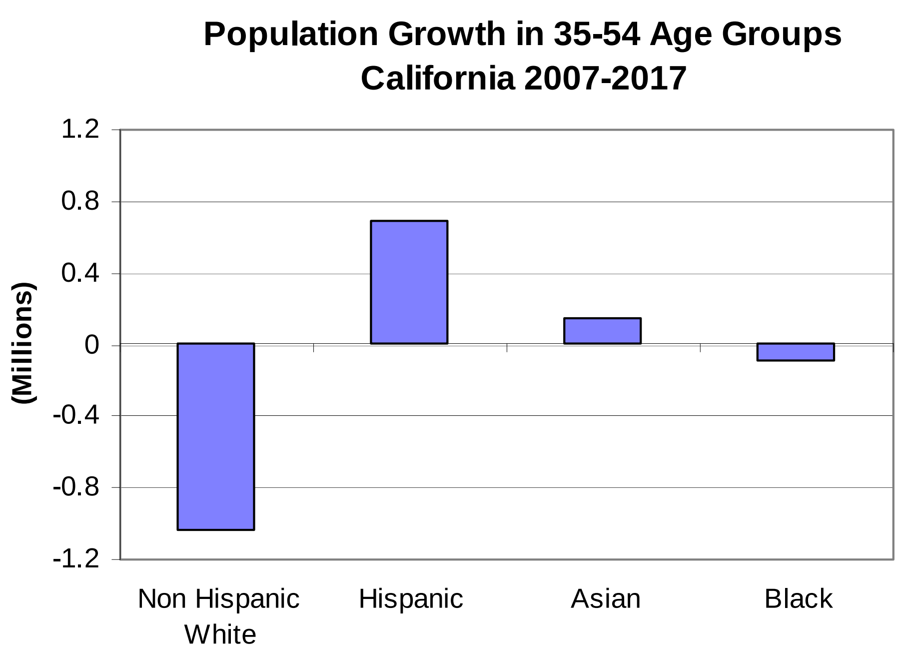


The new surge in California's population will occur among young adults and older residents as baby boomers march into the 55-64 and 65+ age groups over the next ten years. **Between 2007 and 2017 California will add 3 million residents aged 55 and above.** And California will add 1.7 million residents between the ages of 20 and 34 after a decade when this age group showed virtually no growth.

The ethnic population trends in California are well known by now. Most of the state's population growth will be from growth in the number of Hispanic and Asian residents and most of this growth will be from the children and grandchildren of recent immigrants and from new immigrants.



The intersection of age and ethnic population shifts is shown in changes within the state's 35-54 age groups over the next ten years.



Here are some headline implications of these generational shifts. More detailed discussion follows.

Workforce

Baby boomers will begin to retire during the next ten years. The tidal wave of baby boomer retirements will continue in the following decade. Everything the boomer generation (people born from 1946 through 1964) did has been a "tidal wave" including a record number of births of children who filled our schools and became the largest generation of college attendees and, then, flooded America's workforce to the tidal waves that influenced our music, culture and spending patterns.

We know that the tidal wave of baby boomers turning 65 will create challenges for Medicare and our health care system as well as have a profound impact on changes in consumer spending as this huge wave of citizens moves from raising families to other pursuits.

Yet, we talk much less about their inevitable departure from our workforce.

Whether you use what I am told is a completely non-sexy term like **replacement job openings** or a more technical term like **succession planning,** the retirement of baby boomers is going to create a tidal wave of workforce challenges **and** opportunities.

For every 100 new jobs there will be 150 to 200 replacement job openings in California. And because the baby boomers are a well-educated generation, the jobs they leave will include high wage jobs, middle wage jobs and some lower wage jobs. California faces a full range of replacement job openings to fill and a full range of replacement job openings **that can offer hope** to residents looking for a better economic future.

The title ***Immigrants and Boomers*** is relevant because this generational shift is about age, ethnicity and immigration combined in both simple and complicated ways. Many, if not most, of the retiring baby boomers will be replaced in California's workforce by the children and grandchildren of recent immigrants, by immigrants who have now been here for more than ten years ("settled immigrants" is Dowell Myers' term for these residents) and by new immigrants coming here through both legal and unauthorized pathways.

The graph on the previous page shows how this generational shift will play out over the next ten years with younger Hispanic and Asian residents replacing White Non Hispanic (Anglo) residents in the 35 to 54 age groups.

This discussion continues in the workforce section below.

Housing

Demographic trends will affect housing demand by type and location. As shown on page 2-6, population growth will be concentrated in residents aged 20 to 34 and 55 and older with no growth in the 35 to 54 age groups.

There will be a greatly reduced demand for new single-family homes for families in the next ten years compared to the surge experienced during the past 20 years. First, most household growth is in age groups that are less likely to include children. Second, at least some baby boomers will move from single-family homes to condos and townhouses as their children move out. Third, the large wave of foreclosures of recently purchased single-family homes will further increase the supply of these homes on the market.

As a result, more of the existing stock of single-family housing will be available to meet the demands of new family-age households in California.

There are also market pressures for more units in urban settings. Some of the growing number of households in the 55+ age groups will want to downsize but remain near their jobs and prefer locations where walking to stores, restaurants and other activities is possible. And many of the new younger households will be filled with residents who like the excitement of being "close to the action".

Market forces will work to reinforce state and regional planning strategies in the next ten years. The state is considering policies (like SB 375) to provide incentives for infill housing tied to transportation planning and investment. All of the major regions in California have active plans working with communities to add more housing on infill sites and to make some new housing developments denser by building up rather than out. ABAG, SACOG, SANDAG and SCAG have their own versions of regional visioning or "blueprint" plans to accommodate projected housing demand, primarily on existing urban land. **High gas prices and the emergence of global warming as a major concern reinforce these planning strategies.**

A Conversation About California's Social Contract

The economic fate of California's generations is certainly connected. The younger generations will fill the places of retiring boomers in the workforce, will become the major taxpayers for maintaining public services and investing in our future and will be the buyers of homes eventually sold by the boomer generation.

These changes will occur slowly over the next ten years but will continue for at least another ten years after that.

Individual families know that generations are connected—children, parents and grandparents. Different cultures handle these family connections in different ways but everyone knows that generational connections are real and important.
The generations in our larger "California family" are connected as well and these connections are also real and important. The future of boomers is connected to the future of past and future immigrants and their children and grandchildren.

How we handle these connections is our social contract and it exists whether we talk about it or not; so getting these conversations going is a really good idea.

One connection compels our attention. California's future will depend to a great extent on the education and training of our "California family's" children. Yes, we will have some new immigrants but the days when California will attract large numbers of families and workers from other states is gone. Most of our future workforce will be "homegrown"—the children and grandchildren of current residents.

A Public Policy Institute of California study warns that we must increase college participation rates among young residents to meet the skill demands of replacing college-educated boomers (http://www.ppic.org/main/publication.asp?i=750).
Replacing the many middle-skill jobs left by retiring boomers will depend even more on "homegrown" education strategies.

Currently boomers retain much of the voting and financing power over our California family's public investment in education and training. Do they see the connections between their future and the future of California's children and younger workers? Does it make any difference that a majority of the boomers are Anglo and a majority of the students and young workers are Hispanic and Asian?

Can the reforms that experts say are needed be combined with additional funding that the same experts say is needed for at-risk young Californians? What will happen if funding these educational investments and reforms requires higher taxes?

Can minority and immigrant parents be empowered and allowed to take greater control over their children's education with adequate funding?

Can boomers and immigrants envision a California of mutual interest and success?

Can conversations about California's new social contract find a positive beginning in the mutual interest of having an educated and prosperous new middle class to replace boomers as they age and eventually retire?

A New Conversation is Beginning About California's Public Policies for Workforce Investments

Two conversations continue with many forceful voices. One conversation is about 1) strengthening our math and science education, 2) finding pathways for more academically able students to attend college--see the Campaign for College Opportunity at www.collegecampaign.org and 3) agreeing on a fair policy regarding attracting high-skilled immigrants and welcoming foreign student graduates of California universities.

The other conversation, mentioned above, is about improving basic education for California's at –risk students including students from low-income communities and students with language handicaps. There is a ton of good information and ideas on reforming K-12 education and how to effectively add money for at-risk students. The Governor's Committee on Academic Excellence has a set of recommendations and research available at http://www.everychildprepared.org/index.php. Backing up their report is a series of studies coordinated by the Stanford Institute for Research on Education Policy & Practice http://irepp.stanford.edu/projects/cafinance-studies.htm.

The conversation that is now beginning is about middle-level jobs including replacing baby boomers as they leave the workforce; about career technical education (the new and better phrase for what used to be called vocational education); about the importance of developing strategies to upgrade the skills of existing workers; and about community colleges, high school academies and all sorts of partnerships between private sector employers and public sector education and training programs.

In addition to studying the California economy I serve on the NOVA (north Silicon Valley) Workforce Board and am active in the California EDGE Campaign. Both organizations are playing a leading role in these new workforce conversations.

Why Talk About Replacement Job Openings?

Most workforce reports focus on new jobs and, often, on exciting new high-tech job opportunities. They ask which sectors are growing the fastest, where will the most jobs be created and where will new high-paying jobs be found.

The answers to these questions often fuel the first conversation mentioned above, the one about math and science and finding pathways for more people to complete a four-year college education or more.

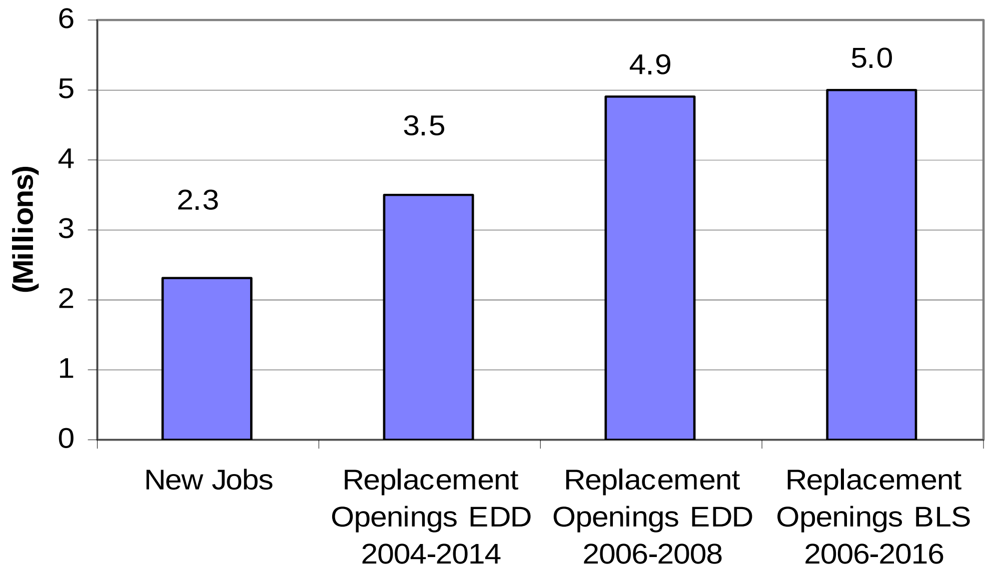
But the conversation is changing now that people recognize that most job openings will come not from new jobs but from replacing workers who retire or permanently switch occupations. And while there may be many middle level jobs that pay well in fields like solar or other alternative energy technologies or Internet services, there are more middle level jobs in fields outside of technology.

How many replacement job openings will need to be filled and be available to Californians over the next ten years?

The chart below looks at three alternative projections of replacement job openings in California over the next ten years.

CCSCE projects that California will add approximately 2.3 million jobs between 2007 and 2017. Using old occupational projections from the California Employment Department (EDD) for 2004-2014, there would be roughly 3.5 million replacement job openings or 150 replacement openings for every 100 new jobs. Using more recent EDD projections for 2006-2008 there would be 4.9 million replacement job openings, which is very close to what you get (5 million) by using the occupational projection trends from recent U.S. Bureau of Labor Statistics national projections for 2006-2016.

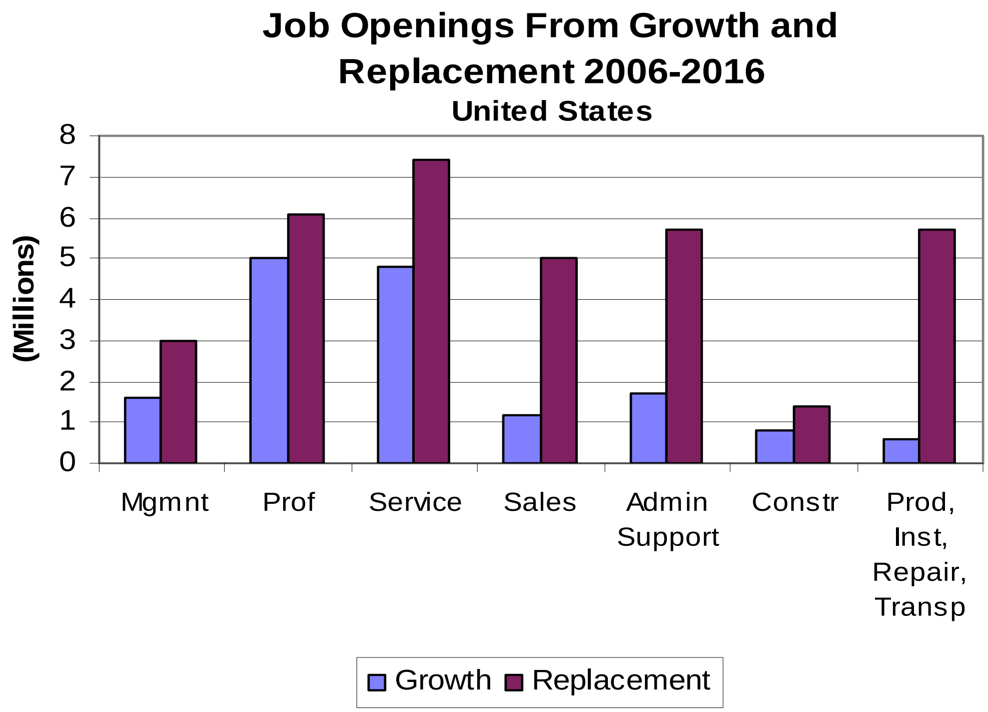
California Job Openings 2007-2017



Another reason to focus on replacement job openings is that **many openings exist in sectors where there is expected to be little or no new job growth.**

The latest national projections shown on the following page demonstrate this clearly. The most striking example is in comparing job growth and replacement job openings in occupations dealing with production, installation, repair and transportation and goods handling. The nation will see just over 500,000 new jobs in the next ten years (many parts of these sectors will lose jobs) but there will be almost 6 million job openings to replace people who are retiring or permanently changing occupations.

You see the influence of the tidal wave of baby boomer retirements in the large number of replacement job openings in managerial and professional jobs, which include teachers, nurses, and other healthcare professionals.



Stories to Go with the Numbers

On March 13, 2008 the NOVA Workforce Board was one of several organizational hosts for a meeting in Silicon Valley to discuss "What is Your Workforce Crisis?". The purpose was to exchange stories and explore the idea that many organizations were facing the challenge of replacing retiring baby boomers over the next five to ten years. To get the conversation started NOVA staff prepared a video with the pictures and voices of Silicon Valley employers telling their workforce replacement stories.

The videos are available at
http://www.youtube.com/user/NOVASiliconValley.

The stories tell of cities where more than half of the key managers may retire within the next five years, cities facing the loss of police and firefighters to retirements; the local water district where 80% of the senior technicians are due to retire; non profit organizations facing the loss of nurses and other staff; and local construction leaders worried about where the next round of trained electricians and carpenters will come from. Then we had a story about the need for technical production and installation workers as Silicon Valley's solar industry builds.

After the video was completed we continued to see stories about retirements and replacement needs. The *Los Angeles Times* had a story that 1,000 machinists were needed even though the total number of machinists was not growing—it was all replacement demand. Then the national media carried a story about the impending retirement of many of the air controllers hired 30 years ago. The Santa Clara Valley Transportation Authority has ongoing opening for transit operators and mechanics due to internal career ladder transfers, retirements and general attrition. According to the federal Office of Personnel Management, one third of the government's top scientists, engineers, physicians, mathematicians, economists and other highly skilled workers will retire in the next five years.

Some Ideas for Workforce Policy Conversations

Here are five ideas (not original to me) for California's workforce policy conversation.

- Gather information about replacement job opportunities as well as where job growth will be.
- Focus on adult workers as well as young students.
- Make ESL opportunities a priority for getting people started on career advancement.
- Keep the drive to make four-year college available to all who qualify but make an equal priority for career technical education and community colleges.
- Think that workforce needs and opportunities vary by region and that partnerships between public and private sector organizations are the best way to identify and collaborate to meet regional workforce challenges.

Anyone interested in these ideas should visit the California EDGE Campaign website at http://www.californiaedgecampaign.org. EDGE is a coalition of organizations working to bring focus to California's workforce policy challenges with an emphasis on building skills for existing workers, increasing post-secondary educational opportunities including career technical education and supporting regional partnerships between public and private sector employers and education and training organizations.

Why Does California Grow—What is the Role of Immigration?

The six concepts listed below are pretty straightforward but people still seem to have trouble grasping that the economy works this way. I hope repetition will be helpful.

- People follow jobs. California grows faster or slower as a result of faster or slower job growth. Both the data and logic are very strong. Economists know one easy way to reduce California's population growth is to have a deep, long recession. Look at the history.

- Making California an **attractive** place to live and work will **attract** people. Some residents want to make California a great place to live and work (i.e., very attractive) but have fewer people come to the state. They are likely to fail in their efforts and may hurt the state by trying. Another sure way to succeed in making the state grow more slowly is to allow California to be an **unattractive** place to live and work.

- Immigration currently accounts for approximately 40% of U.S. population growth. Reducing immigration levels would clearly reduce the level of population and job growth in the nation. But reducing national immigration levels does not translate directly into reducing California's growth rate. Moreover, the fact that immigration accounts for approximately 40% of California's recent population growth does not mean that immigration is the cause of the state's growth.

- There are three main groups of immigrants—1) highly skilled immigrants coming here through normal immigration pathways or through special programs for high-skilled immigrants, 2) unauthorized immigrants many of whom have low education and skill levels and 3) a large number of immigrant who come as a result of family reunification policies and have a wide range of education and skill levels. All three groups have different sets of policy issues.

- Some immigrants affect job and wage opportunities for other California workers. That fact doesn't make these immigrants bad for California or tell us what the best immigrations policies are.

- The "conventional wisdom" is that unauthorized immigrants create a fiscal burden for other residents and that state and local budgets would be easier to balance if there were fewer unauthorized immigrants. There may be good policy reasons (or not) to restrain unauthorized immigration but the fiscal arguments contain important logical and factual errors.

Job Growth Leads, Migration Trends Follow

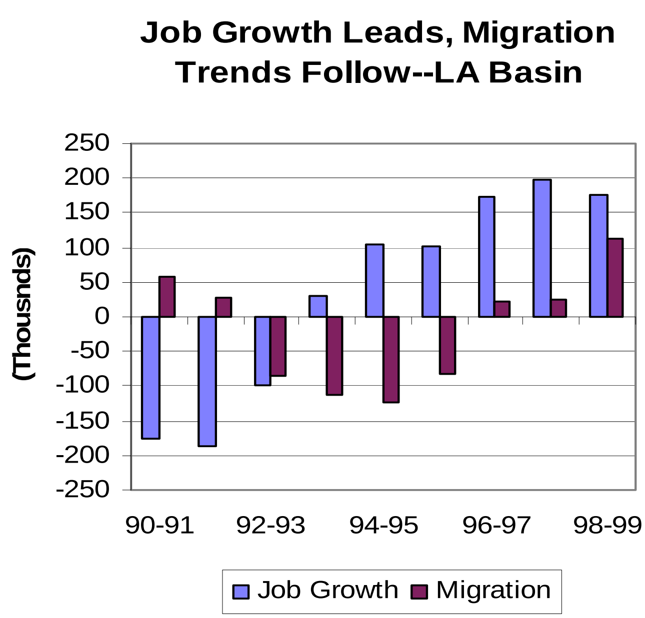
If you think about the question, the logic is overwhelming. Did the aerospace industry decline in Southern California in the early 1990s because population growth was slowing or did population growth slow after the aerospace and homebuilding sectors lost nearly 500,000 jobs? Did a slowdown in population growth in the Bay Area in 2000 cause the Internet bubble to burst and the region to lose nearly 400,000 jobs or did the job losses precede and cause the slowdown in population growth?

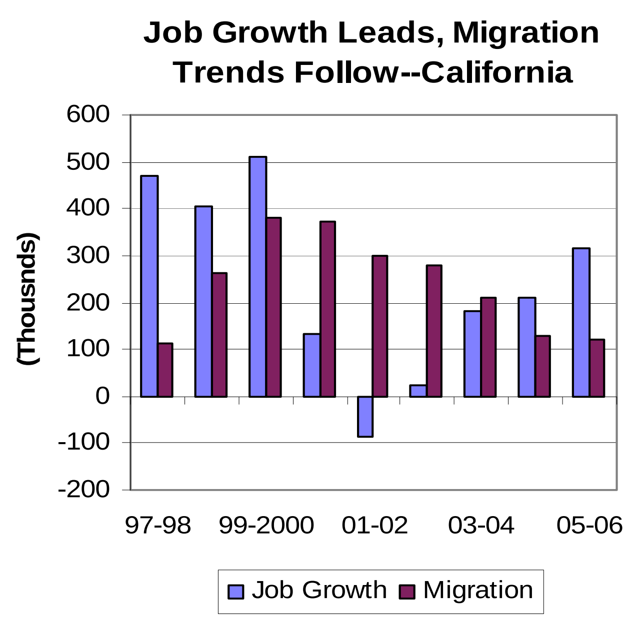
And did people leaving Detroit, Cleveland and Pittsburgh in the 1970s and 1980s cause the loss of auto and steel jobs or was it the job losses that caused people to leave these regions in search of better job prospects?

The data for California show the "people follow jobs" story in picture terms. The graphs below compare the annual change in job levels with annual migration to and from the state. Migration includes both foreign immigration and domestic migration—the movement of people between California and other states.

The picture on the left shows what happened in the Los Angeles Basin (Southern California) during and after the large job losses in the early 1990s. Migration levels were still positive during the two years of greatest job loss in 1991 and 1992. Then as job growth returned to the region, migration grew increasingly negative in reaction to the earlier job losses. It was not until late in the decade after five straight years of job gains that migration was substantially positive again.

The picture on the right shows the same trends for California in the years leading up to and after the Internet bubble job gains and losses. Migration levels increased after the state posted annual job gains over 400,000 and continued high during the period of slowing job growth. Migration levels fell starting **after the** job losses had ended and job growth had begun again. Migration trends **follow** job trends with a lag.





The Two Paradoxes of Growth—Great Places Have More Growth

This section is repeated from our last edition. The paradoxes are still true, yet many people continue to wish that California be an attractive place to live and work; and at the same time, few people choose to come and live here.
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.

These are tough paradoxes for people to accept but the only win-win direction for California on these issues is moving **forward** to work hard to make California communities great places to live and work**.**

Immigrants and Growth—A Clear Connection, Yet Not So Clear

Currently immigration accounts for 40% of the nation's population growth. The Pew Hispanic Center (a great source of information about immigration at http://pewhispanic.org) projects that immigrants and their children and grandchildren will account for approximately 80% of U.S. population growth to 2050.

So reducing the overall level of immigration to the United States will reduce our rate of population growth. Whether that is a good idea is way beyond the scope of this essay, though.

Once the immigrants are here, their influence on California's rate of population growth is much less clear. Two points **are** clear. One, California is a major (though shrinking) first location for immigrants. Two, immigrants move in response to economic opportunities as much or more than native-born residents.

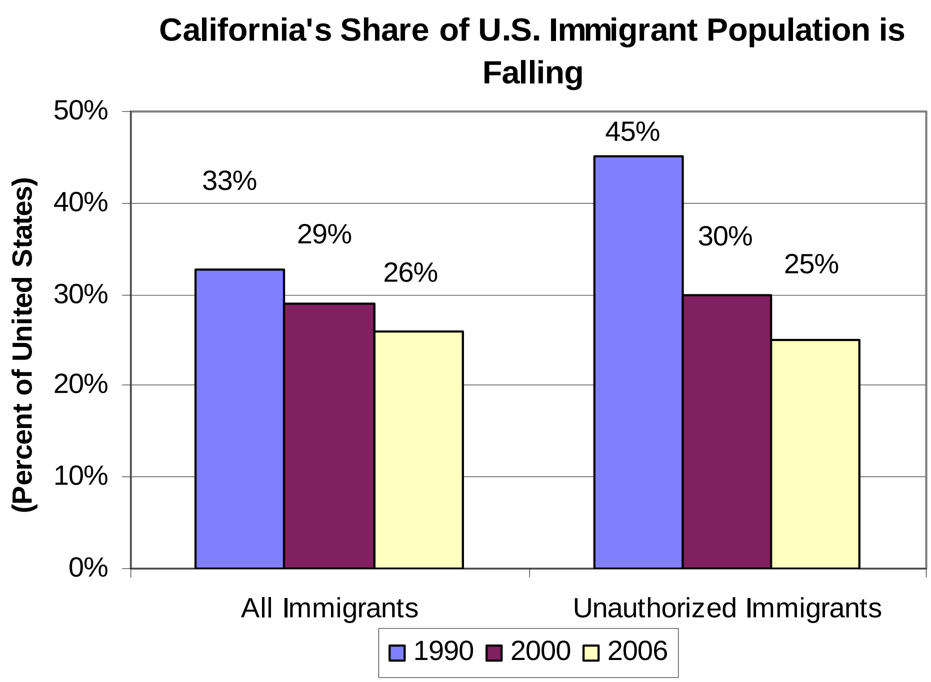
A large level of foreign immigration into California did not stop the state's population growth from slowing dramatically after the aerospace job losses in the early 1990s and after the Internet bubble burst in 2000 and 2001. And immigrants, like other residents, seek jobs in other states when they think job prospects are slowing in California.

There are three major groups of immigrants in the nation and in California—1) highly skilled immigrants who come through normal immigration pathways or through special immigration policies, like H1-B visas for skilled workers, 2) unauthorized immigrants who have an above average concentration of entrants with low educational attainment and skills and 3) a large number of immigrants who come under family reunification quotas and have a wide variety of backgrounds.

"Illegal immigrants" is the term often used for unauthorized immigrants in these debates but I am using the label accepted by the U.S. Department of Homeland Security. A very good description of how complicated the "illegal/legal" distinctions really are is found in the recent PPIC study *Immigrant Pathways to Legal Permanent Residence* (http://www.ppic.org/main/publication.asp?i=768).

There is broad support for trying to attract skilled workers from abroad combined with concern that these immigrants do not unfairly hurt the job prospects of existing residents. California has a large group of immigrants who have high college graduation rates and above average incomes. Silicon Valley and Orange County, two major technology centers in California, have large foreign-born populations with these characteristics.

California also has an above average share of unauthorized immigrants. California's share of both total immigrants and unauthorized immigrants has been declining as immigrants have dispersed throughout the country in response to economic prospects. The Pew Hispanic Center reports that California had 26% of the nation's immigrants in 2006 down from 29% in 2000 and 33% in 1990. The Department of Homeland Security reports that that California had 25% of the nation's unauthorized immigrants in 2006 down from 30% just six years earlier.



Immigrants and Jobs—What are the Connections?

People born in foreign countries sometimes affect (compete with) the job and wage opportunities of native-born workers in California. This is true whether we are talking about people in Finland or South Korea who design and make cell phones, physicians in Thailand doing hip replacement surgeries, people in Japan and Germany who design and make cars and people in India and China making products and delivering services (call centers, for example) that used to be done here.

And people born in foreign countries who now work in California also sometimes compete with other residents for job opportunities.

A quick summary of the evidence and arguments about these competitions is that, on balance, our economy benefits from having more and better product choices, having lower prices, and more access to workers to fill jobs that would otherwise have been hard to fill. This all comes with a price in the form of negative impacts on some workers in California.

Do highly skilled or low skilled workers take jobs from people or fill jobs that would not otherwise be easy to fill? Is immigration good or bad in terms of overall economic impact? Can our immigration policies be improved—maximizing the positives and minimizing the negatives? These are all good questions for our "California family" and national family conversation.

My goal in this section is to present one piece of evidence that I think is fairly clear. It bears on but does not answer the important questions about immigration policy.

Unauthorized immigrants in California are playing the role of filling more and more of the low-skilled jobs in our state. At the same time California has approximately the same share of jobs in low-wage occupations as occurs throughout the nation. The six occupations shown on the graph were identified by the Pew Hispanic Center as having high shares of unauthorized immigrants. **But California doesn't have "too many" cooks, janitors and hotel maids despite having 25% of the nation's unauthorized immigrant residents.**

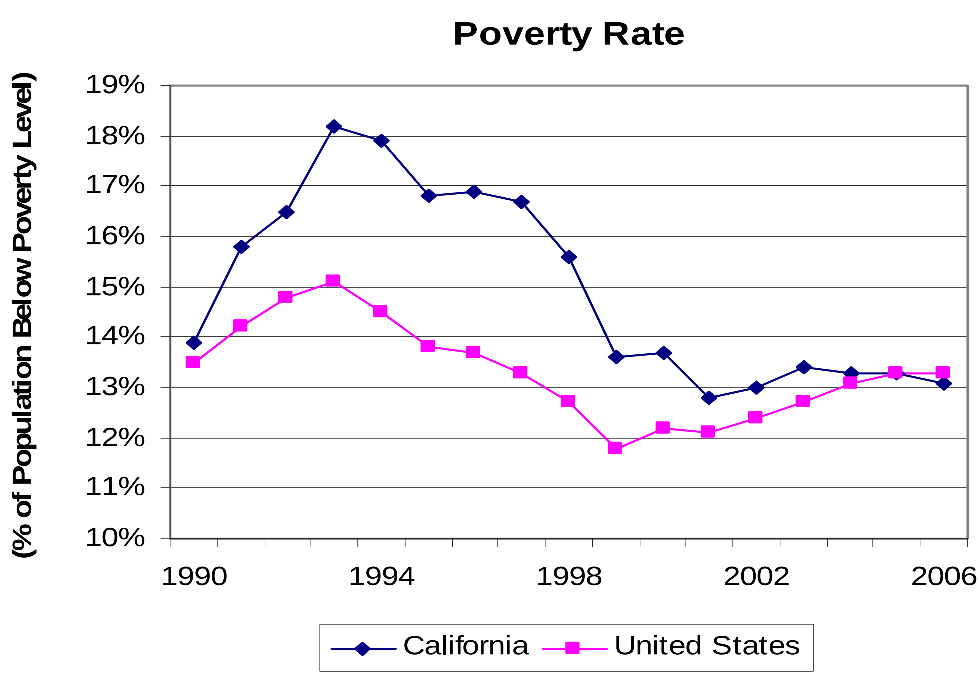
The point is not to debate in these pages whether unauthorized immigration is good or bad—that is our California family's conversation. But it is worth noting the strong evidence throughout these pages that immigrants fit into the economy and move around whenever they find better prospects elsewhere.

That is the point of emphasizing that people follow jobs. It is particularly true for unauthorized immigrants who are not eligible for safety net payments or services like unemployment compensation and "welfare" payments. California doesn't have 25% of the nation's hotel maids because we have 25% of U.S. unauthorized immigrants or 30% of the U.S. Latino population. California has 11% of the nation's hotel maids in keeping with our 11% share of total jobs. And if the state's tourism sector thrives and we have 12% or 13% of hotel jobs, it won't be because more immigrants moved to California. People follow the jobs.

California also doesn't have a high share of people living in poverty despite having an above-average share of immigrants—legal and unauthorized. The data for years after 2000 comes from the new American Community Survey, which has a much larger sample size for California than the Current Population Survey data for earlier years.

California has had large waves of immigration during the past 20 years but these waves of immigration have not changed our share of low-skilled occupations or our relative poverty rates.

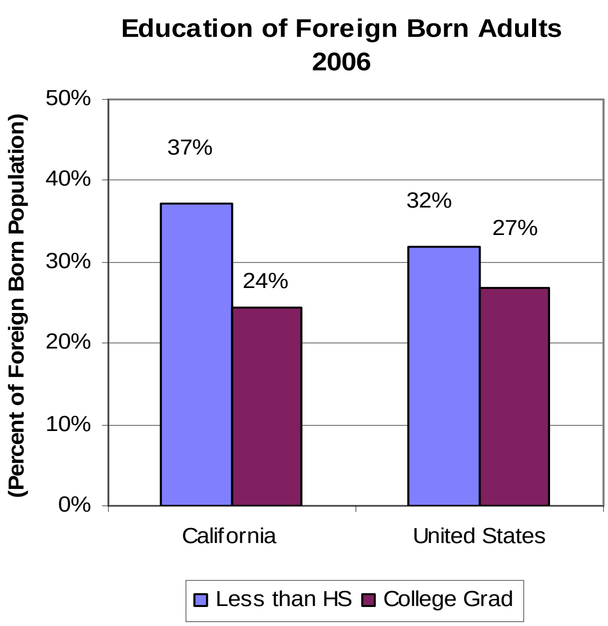
The data seem to be saying that low-skilled immigrants coming to California have changed the profile of who works in low-wage jobs and who is poor (more unauthorized immigrants, more Latino residents) but has not changed the relative number of people in either group.

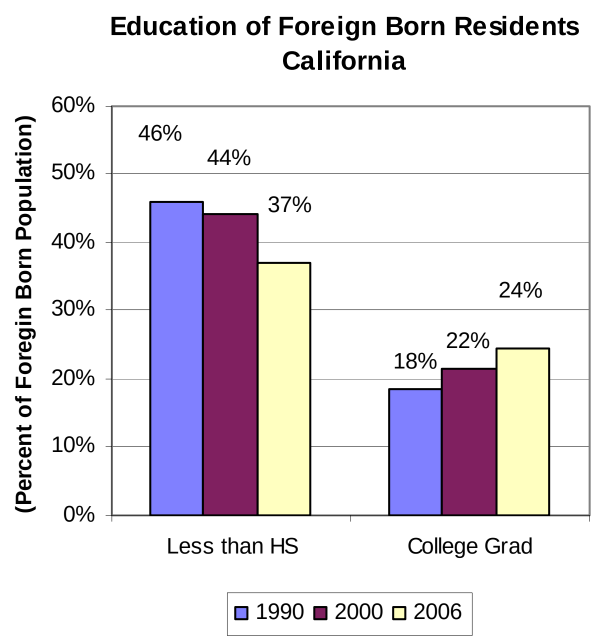


The educational attainment of California's foreign-born population is changing as well in another indication that the state will not end up with "too many" low-skilled workers. California has a slightly higher share of foreign-born residents who did not complete high school and a slightly lower share of foreign-born residents who are college graduates compared to the nation as shown in the graph below on the left.

However, the share of California adult immigrants who did not complete high school is falling while the share with college degrees is rising.

One fact from the 2006 American Community Survey illustrates how immigrants follow jobs and that is it very unlikely that California will end up with "too many" low-skilled workers. **Between 2000 and 2006 California's foreign-born population grew by just over 1 million while the number of foreign-born residents who did not complete high school increased by just 27,000 or less than 1%.**





Summary

At the national level the amount and type of immigration will affect population growth and job opportunities. There are complex but worthwhile topics for our national immigration conversation about immigrants, growth and jobs—should we encourage and allow more highly skilled immigrants to come, should we restrict low-skilled immigration, what would happen if we tried to deport many of the 12 million unauthorized immigrants, how do we feel about "illegal" pathways to immigration.

The economic parts of these questions should be discussed in the context of thinking about the impending tidal wave of baby boomer retirements.

But once the immigrants are here in the United States, highly skilled and low skilled immigrants follow the jobs. When California has high job growth, the state attracts people from other states and from abroad. When California job growth slows, people move—including recent immigrants, long-time immigrants and native-born residents.

If California has communities that are attractive for job growth, our population growth will follow the jobs. If we create more "good, high-paying" jobs, then we will have demand for the lower-wage service jobs that high-income families can afford and do seem to want.

One Confusion About Unauthorized Immigrants Needs to be Addressed

There is a widely heard perception (at least on talk radio and in the blogs) that California's serious budget problems would disappear if there were no "illegal immigrants". I don't hear this from elected leaders in California, which I take as a positive sign in a state where budget disagreements run deep between the two major political parties and blaming immigrants might be considered an easy sell in some political circles.

However I encourage groups like California Forward, Common Sense California and others to take on the challenge of clarifying this confusion as they reach out to more community groups and citizens who hear this charge repeated over and over.

One point is easy to understand and absolutely true. Low-income families usually do not pay enough in state and local taxes to cover the cost of the public services that their families use. It is also true that unauthorized immigrant families have incomes that are well below the state average.

The missing "logic link" that leads to confusion is that California does not have more low-income and low taxpaying families because the state is home to unauthorized immigrants. It is true that unauthorized immigrants probably account for a growing share of the state's low-income families but that does not mean that the total share of families with low-wage jobs is higher than elsewhere.

The discussion on pages 2-18 through 2-22 shows that this is true. California has the same share of low-wage jobs and the same share of people in poverty as the nation. The fact that unauthorized immigrants make up a growing share of California's low-income population does not explain why California has perpetual budget struggles while other states do better.

The next "conventional wisdom' on talk radio is that unauthorized immigrants don't pay taxes or heavily avoid taxes. **This is anther poorly thought out argument.**

One piece of the argument is that unauthorized immigrants work "off the books" and do not pay income taxes. I don't see a lot of evidence that the official job and payroll data undercount the number of workers or their income. The whole controversy over fake Social Security numbers and requiring employers to verify numbers when Social Security can’t match the records means that most people are in the system, even with fake numbers and, therefore, having taxes deducted.

But the whole debate over not paying income taxes misses the point when it comes to poor families. While California has high income tax rates for families making more than $80,000, the state has very low (or 0%) state income tax rates for families making less than $40,000. Nearly all families in California making less than twice the poverty level don’t owe state income taxes.

Low-income families do pay a number of state and local taxes in California but it is hard to see how they can avoid paying these taxes. Everyone pays sales taxes, property taxes (directly or in your rent check), gas taxes, tobacco and alcohol taxes, utility taxes and other state and local taxes and fees.

I wonder what people who say unauthorized immigrants don’t pay taxes are thinking when it comes to these taxes. I doubt it is something like this but what is the alternative?

Our typical unauthorized immigrant at the checkout counter says, “skip the sales tax, please, I am unauthorized and do not pay sales taxes”. Our typical unauthorized immigrant rents from a landlord that deducts their portion of property taxes, buys tobacco products and gasoline from stores that do not charge taxes to unauthorized immigrants. You get the picture. Most taxes are charged to everyone equally at the point of purchase and are hard to avoid.

How about payroll taxes? It is certainly possible that **employers** avoid their responsibility to collect and pay payroll taxes for some unauthorized immigrants. This is true and may add up to “real money” at the federal level. On the other hand, unauthorized immigrants do pay some payroll taxes and get nothing in return because they are not eligible for Social Security or Medicare. **Moreover, payroll taxes are an important source of revenue at the federal level but the discussion about payroll taxes doesn’t affect the state budget.**

Finally, there are the arguments put forth by groups like FAIR about the costs of educating the children of unauthorized immigrants. The poor logic in this thinking has been artfully described in the 1997 National Academy of Science reports and elsewhere.

It is a great American tradition to educate the children from poor families. Moreover, all evidence shows that higher levels of education have financial payoffs to families and the public sector. **In short, education pays!!** There are issues of timing—invest now for the payoff later—and of geography, if local districts are asked to bear large costs now for **federal** tax gains later.

But the essential finding is that if you look at education as an **investment** and not just as a "**cost**", it is a good investment that adds financial reasons to the great American social reasons for investing in all children, even those whose families are poor today. And, once again, remember the tidal wave of baby boomer retirements that will need to be replaced over the next ten and twenty years. I think we need everyone to have access to a good education that allows residents to go as far as their talent and drive can take them.

Unfortunately, I missed the part of the lecture where it was explained why education is a great investment, unless, of course, the parents were born abroad and came here "illegally". So, maybe one of you can explain to me why paying for education is an investment usually but must be looked at as a cost if one of their parents is "unauthorized".

A Conversation About California's State Budget

As I write this section elected leaders in Sacramento are in a familiar debate. Democrats say that Republicans want to balance the budget in ways that will hurt students, low-income and disabled residents. Republicans say that Democrats want to "tax and spend" and that they only favor tax increases on high-income families who already pay most of the state's taxes.

These arguments continue year after year because it takes a 2/3 majority to pass the budget and increase taxes in California and that means that some Republican votes are needed to approve a state budget.

I have written in other venues that I think a permanent tax increase of approximately $8 billion per year should be one part of addressing California's budget challenges. So I have a point of view about the state budget—as an economist and as a resident.

As an economist whose work is studying California's long-term opportunities and challenges such as the ones written about in this chapter, I think **investing more in our people, our communities and our infrastructure** is the best set of public policies for supporting economic prosperity in the state. As a resident, my one vote is in favor of not making our poorest and most vulnerable residents targets for budget cuts. That is my view of how I want to be a part of our California family.

In addition to having a point of view about budget solutions, I spent a good part of four years recently writing and talking to groups about the state budget. I was part of the team that developed the California Budget Challenge for Next Ten and it remains a great tool for having conversations about the state budget (www.nextten.org). I also spent two years writing and talking about the budget under grants from The James Irvine Foundation and the Rockefeller Foundation.

In this work I participated in 30+ budget conversations and came away convinced that residents **could have respectful gut level conversations about the budget.**

In the end there are three questions for our budget conversation that are really important, I think, for reaching any agreement that will last:

- What level of public spending is right for our California family to help make communities, regions and the state great places to live and work?

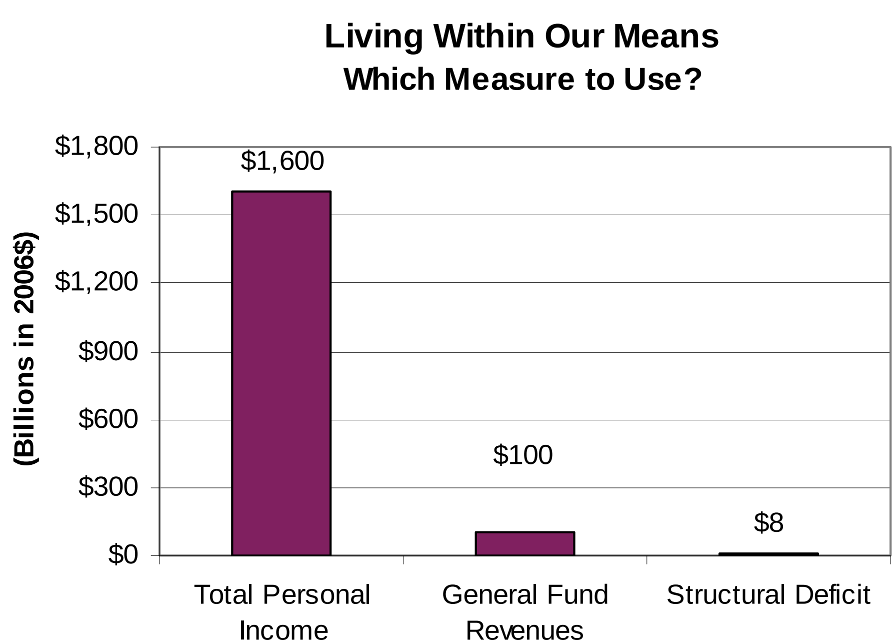
- How can we pay for the public services and investments that we want in a way that is fair **and** that is fiscally responsible so the cycle of perpetual structural deficits can end either through adjusting spending, revenues or both?

- Can we have these conversations as a "family" recognizing our connections between generations, between ethnic groups and between regions of the state?

Here are some facts that I hope people can agree are true and which can be integrated into the conversations that groups like California Forward want to have with residents about budget reform and, ultimately, what state spending and revenues we should adopt to make California a great place to live and work.

One, the current state budget deficit is approximately $16 billion. Most analysts agree that approximately half of the deficit ($8 billion) is long-term or "structural" and that half of the deficit is temporary as a result of the slowdown in California's economy and state revenue growth.

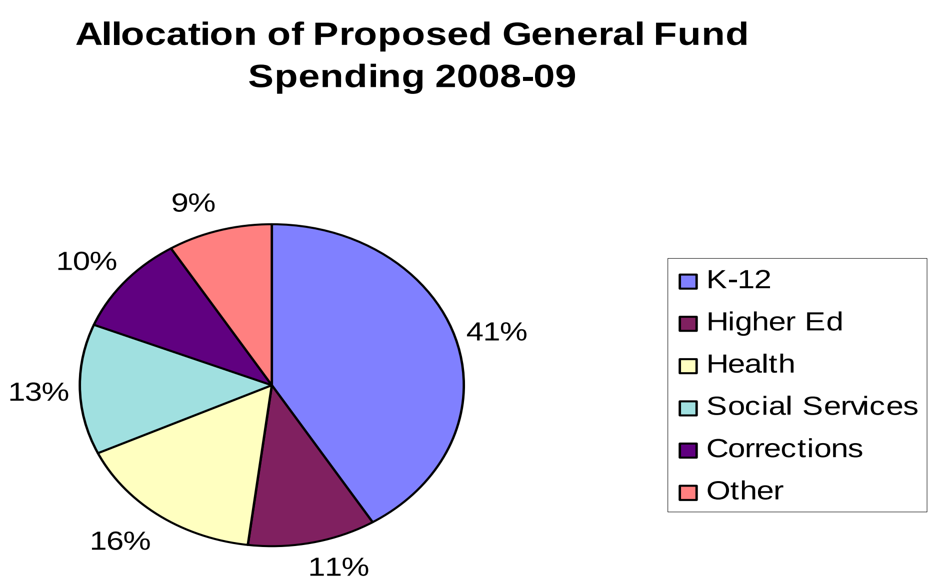
Two, the state General Fund budget is approximately $100 billion while total personal income in California for the 2008-2009 budget year is approximately $1,600 billion. As a result we are spending approximately 6 ½ cents of every dollar of our family income on the state General Fund. The graph below shows this in picture form. I will address the often voiced "living within our means" issue below.



Three, the state General Fund is allocated roughly as follows:

- 41% for K-12 education
- 11% for higher education
- 16% for health and mental health care
- 13% for social services
- 10% for corrections
- 9% for transportation, resources, and legislature, judicial and executive branch activities

That picture is shown below. Roughly 80% of state spending is for students and poor and disabled residents.



Four, there have been four major tax rate changes in recent years—1) an increase in the income tax exemption for dependents, which lowers your tax obligation, 2) a 2/3 reduction in the Vehicle License Fee, 3) a ½% increase in the corporation tax rate and 4) the imposition of a 1% income tax surcharge on incomes over $1 million to fund mental health services (a 2004 initiative passed by voters).

The recent state tax changes followed a much different pattern from the federal tax cuts whose repeal is hotly debated in the current presidential campaign. California's tax cuts went to a broad range of taxpayers and were not concentrated in high-income households. On the other hand the one tax increase was only for households earning more than $1 million per year.

Five, the state government is different from a business and one of those differences is important for our budget conversation. When business revenues fall, it is because sales fell. The business has fewer customers and reacts by cutting back production and employment levels. **But when government revenues fall, it is not because there are fewer customers.** In fact, some government programs that serve low-income clients, such as MediCal for example, have an increase in caseload as a result of the economic slowdown.

I now move from what I hope are accepted facts into the conversations I think are important for addressing our lingering budget gridlock.

We can make the structural deficit disappear in four ways:

- By changing the voting requirement to pass the budget—Democrats would probably raise tax revenues to balance the budget if only a 55% or even 60% majority were required to pass the budget instead of the current 2/3 majority.

- By repealing two recent tax cuts—the increase in the state income tax exemption for dependents and the reduction in the vehicle license fee (aka “car tax”).

- By passing other revenue increases totaling approximately $8 billion per year

- By permanently reducing spending levels by the same $8 billion per year

You knew these choices before I wrote them down. I made the list to get to four other points that I think should be part of our California family conversation about our state budget and future.

The first point is that I think we need to have these conversations. I am skeptical that having elected leaders reach a “deal” can get us very far unless and until we have this gut level conversation about the role and appropriate level of state government. Sooner or later we have to talk to each other about whether raising the growth in revenues or reducing the growth in spending is the best choice or whether some combination (and what combination is also an interesting conversation) is best.

The second point is that we are in gridlock over a very small amount of money. The third point is that all this talk about “living within our means” is true at one important level but not really relevant to California’s budget choices. The fourth point is that the starting point for the conversation matters.

Then there are two highly controversial assertions that get inserted into budget discussions as if they were facts. One assertion is that we have a spending problem, not a revenue problem. Another version of this argument is that the state is out of control because recent spending increases have been greater than population growth and increases in the cost of living. The second assertion is that tax increases hurt the economy, especially in a recession.

The ½% Solution and Living Within Our Means

I know $8 billion sounds like a lot of money but in terms of the "burden" of closing the deficit in our California family state budget, it is not a large amount of money at all. Our family's total income for the 2008-2009 budget year will be approximately $1.6 trillion or $1,600 billion. See the chart on page 2-26.

The $8 billion structural budget deficit is equal to one penny out of every two dollars of our family's annual income or 0.5% of our family budget. People who like to talk about how families make budget choices have a good point. In one sense it is easier for individual families to make tough choices. They feel connected to each other and invested in the future of other family members.

But in another sense our big California family's budget choice is much easier. I can't imagine real families staying in gridlock for so long over a penny out of every two dollars they have to spend. Families regularly wrestle with children going to college, temporary unemployment and a whole host of life events that cause more than a 0.5% change in budget priorities.

By comparison our California family's share of the federal deficit equals 3% of our annual family income.

I do believe we should live within our means. I have spoken out along with many economists and budget analysts to say that neither Obama or McCain have plans to face the federal budget deficits either now nor when the tidal wave of baby boomer retirements pushes Medicare spending much higher. And I congratulate the wonderful Fiscal Wake Up Tour (www.concordcoalition.org) that is ongoing around the country to get people involved in this difficult but necessary conversation.

But in California the talk about living within our means has gotten confused. It will be relatively easy to live within our means and raise taxes to eliminate California's structural budget deficit. After all, the deficit amounts to only one penny out of every two dollars of our $1,600 billion California family annual income. We can easily redirect a small amount of private consumption spending to raise taxes by $8 billion and live within our means.

But most proponents of "living within our means" really mean that if state revenues **under the existing tax structure go down that we should cut spending or cut spending growth to "live within our means" in that sense.** It is equivalent to saying that living within our means is the same thing as saying that if tax revenues go down our family is not allowed to reallocate spending from other areas of our family budget even though we have the "means".

To say the same idea another way, if we spend 6 ½ cents out of every dollar on state services and 93 ½ cents on other spending we are living within our means but we also live within our means if we spend 7 cents of every dollar on state services and 93 cents on other spending.

That leaves us with the original question of how much to spend on state services and investments and how to pay for what we want to spend and invest. What are our priorities?

The Starting Point Matters

At the national level no discussion of the budget occurs without the question of whether or not to repeal the tax cuts passed in 2001. It is a central question in the current presidential campaign.

So is repealing tax cuts that arguably "we can no longer afford" part of the conversation in California about balancing the state budget along with the frequently voiced concern that we should reduce spending increases that "we can no longer afford"? When state revenues grew in the late years of the 1990s the legislature approved spending increases and tax cuts despite the warning from all economists that the revenue increases were unsustainable.

I don't think we have a full conversation if spending increases are on the table to be reduced but the tax cuts aren't on the table to be repealed.

Or look at the starting point question another way. If California spends less per pupil than other states on K-12 education (we do) and embarks on a path to increase spending toward the national average (we did), are those higher rates of increase in K-12 spending "out of control spending growth" or catch up because we "**started behind"?**

If California passes a lot of General Obligation bonds and our debt service payments from the General Fund double, is that "out of control spending growth" or catch up? According to all experts and with broad bipartisan agreement California faces an infrastructure deficit of two decades of relative neglect and I think there is also broad agreement that we **"started behind"** so recent infrastructure bonds are "catch up" and not out of control spending.

I know that some elected leaders and groups want to have a conversation about reforming the state revenue structure to reduce revenue volatility and update our tax structure to keep pace with changes in our economy and how consumers spend.

This is a really good idea and I will add my thoughts on a following page. But this conversation has a **“starting point”** issue as well. It is one conversation to talk about reforming our tax system if we have already agreed on the gut questions of state spending levels and priorities. At that point we will be talking about the best and fairest way to raise the money we have agreed is important to raise.

But there is a danger that these budget reform conversations will try to combine budget reform with eliminating the structural and temporary budget deficits. That, I think is a recipe for confusion and gridlock. The starting point for budget reform discussions does matter.

Some Conversations to Have About Reducing the Growth in Spending and Reforming the Way Services are Delivered

I think this is a good place to put in some ideas about conversations that could lead to a reduction in the growth of state spending in some areas.

- I think residents are concerned about the salaries and benefits that many government employees have. There have been some attempts to start conversations about reexamining benefit promises at the state level. Residents are experiencing a decline in their health and pension benefits from many private sector employers and don’t understand why public sector employees aren’t sharing their pain.

  On the other hand the Legislative Analyst’s Office believes that we are not putting away enough money to fund retiree health benefits that have already been promised to retirees.

  I don’t know what is the right solution here but it is a conversation that could help residents to believe that their concerns are being heard.

- Voters favor a reduction in state prison spending. One way to achieve savings is to not put non-violent drug offenders in state prison for a “third strike” conviction. Other approaches are to not keep elderly sick convicts in state prisons, to shift supervision of low-level parolees to county probation departments and have lower raises for prison employees. The Next Ten California Budget Challenge looks at some of these options.

- California tuition levels for community colleges, CSU and UC are below the national average. On the one hand we have a state priority to increase college-going rates for students who could go to college except for monetary constraints. On the other hand we should have the conversation about whether some increases in college tuition for higher-income students should be part of our long-term budget solution.

- Public-private partnerships are one way to finance infrastructure without adding to state debt service obligations. Residents would pay for some infrastructure through tolls or fees rather than through taxes.

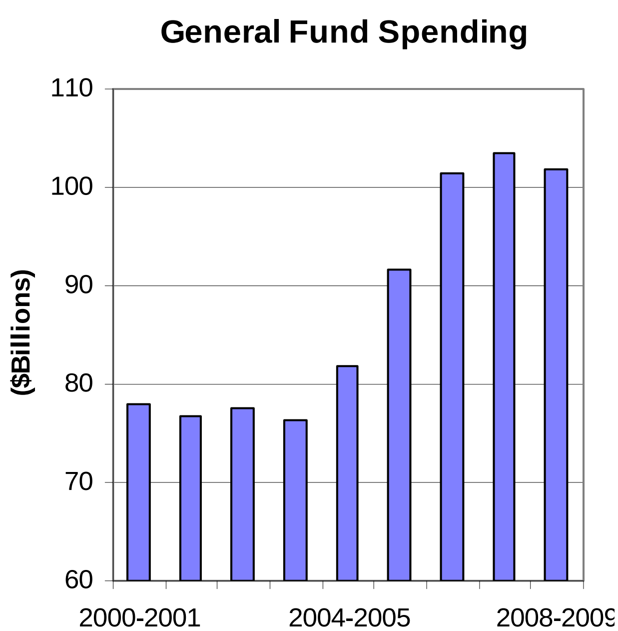
- There are many conversations to have about whether and how state-financed services can be delivered more efficiently

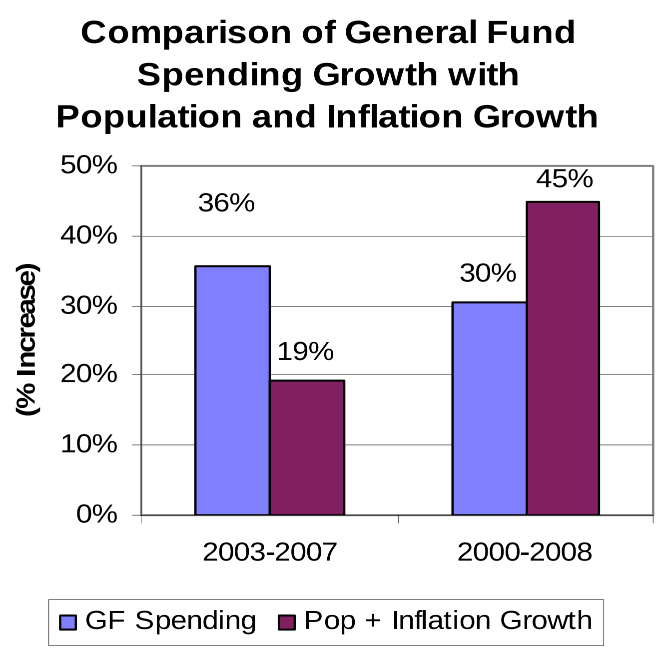
A Spending Problem, Not a Revenue Problem

The phrase “we have a spending problem, not a revenue problem” usually has one of two meanings. The first meaning is that spending has increased faster than revenues and the second meaning is that spending has increased faster than population and inflation growth.

Neither meaning addresses the key issues of what we should be spending to meet our California family state spending priorities or how we should collect the needed revenue so they don’t make for much of a conversation. The assertion that spending growth exceeds revenue growth can be met with the equally true assertion that revenues would cover our $8 billion structural deficit if we had not cut taxes when revenues surged in the late 1990s. This brings you back to a conversation about what is the right **starting point** for these budget conversations.

There is data about how spending growth compares to population and inflation growth. Look at the General Fund spending totals below for the 2000-01 through 2008-09 budget years. Spending was relatively flat for the 2001 through 2004 budget years, took a big jump in the next three years and then leveled off again.



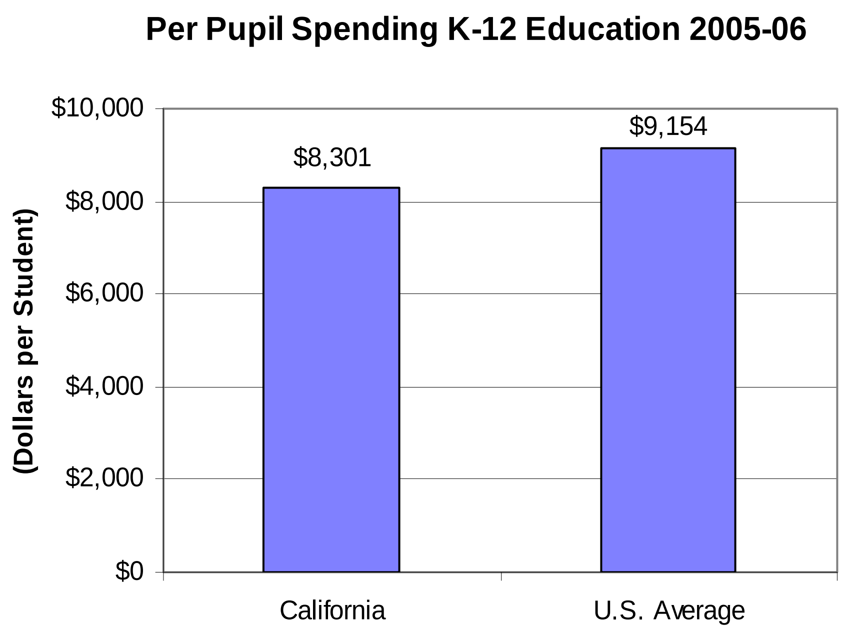


For the 2003-2007 period General Fund spending increased by 36% while population and inflation growth combined was a much smaller 19%. For the longer 2000-2008 period, the comparison reverses with General Fund spending growth of 30% compared to population and inflation growth of 46%. The calculations use data on spending from the Legislative Analyst's Office and data on population and consumer price growth from the California Department of Finance.

But there is a more serious problem with these assertions that goes back to questions of starting point and figuring out our family's priorities.

Here are six facts about K-12 education, by far the largest spending area in California's state budget:

- In recent years California has spent between 5% and 10% less per student than the national average. The latest final data from the National Center on Education Statistics (www.nces.ed.gov) is shown below.



- According to the Legislative Analyst's Office, California per pupil spending adjusted for inflation has remained almost level since 1999. But according to National Education Association tabulations, national spending per pupil has exceeded the rate of inflation since 1999. So, no matter how much money we are spending per pupil, we are not closing the gap in education spending between California and other states.

- The Governor's Committee on Academic Excellence (see page 2-11) has proposed a substantial increase in funding for at-risk students combined with extensive system reforms.

- California regularly ranks in the bottom 10% of states in nurses, counselors and librarians per student.

- All polls of voter opinion show strong support for **increasing K-12 funding.**

- Voters across the state are approving school bonds and parcel taxes that require local taxpayer contributions and super-majority voting margins (see page 2-5).

Maybe our California family, when we sit down to talk about education spending, will decide not to increase spending much; or we will think it is good to increase spending only combined with major reforms or we will want to see reforms first. **But, if we decide as a family to spend more of our resources on educating our family's children how could any reasonable person say that we had a "spending problem"?**

DoTax Increases Hurt the Economy?

There is a reasonable point buried in all the rhetoric about how everyone will leave the state if we raise taxes by a penny out of every two dollars of our family income. **States do need to be concerned that their tax structure does not get too out of line with the tax structures in other states. I**t is a good topic for our budget conversations.

This is why I don't favor increasing income tax rates as part of California's permanent or long-term budget strategy. Temporary income tax rate increases, as we did in the early 1990s, are a different issue.

In the short term a tax increase in California doesn't "hurt the economy". It decreases private spending and increases public spending. The money doesn't disappear out of the economy. If we increase taxes by $8 billion, residents will spend less and state government will spend more. If you want to be picky, in the short term total spending will probably increase a tiny bit. Some of the tax dollars were not going to be spent in California; they would have been saved or spent elsewhere.

But raising taxes to spend on state services will increase spending in those areas and decrease private spending. It is a wash as far as total spending and job impacts are concerned in the short term.

The assertions that companies will leave the state if government does this or that have been around for a long time. The Public Policy Institute of California has done several studies of firm location changes and found no substantial impacts. You can see their research at http://www.ppic.org/main/policyarea.asp?i=3.

But there is a big obvious question that often does not get into our conversations. It should! It is the reason I favor some permanent tax increases to meet our structural budget shortfall.

The question is "what set of public policies best helps to create great places to live and work". What set of public policies attracts companies and families? This is an especially interesting question for conversations in a state with an economic base concentrated in innovation and creativity that is trying to attract entrepreneurs, venture capital and skilled workers.

Will these firms and families be most interested in California's tax rate or whether California has good schools, good transportation, housing and public facilities?

Is it obvious that lower tax rates are what California needs to compete economically or do we need world-class services?

Some Suggestions for Our Budget Conversations

I think California would benefit from having our own version of the Fiscal Wake Up Tour (see page 2-29). I think our conversations would be helped, in addition, if we focused on big issues even though they are harder. Let's bring in the concept of renewing/reviewing our California family social contract and talk about how our futures are connected to each other.

As part of addressing the structural budget gap, I have five suggestions for conversation:

- Broadening the sales tax base to include some service spending. This can **later** be part of a reform package to diversify our tax base combined with lowering the sales tax rate.

- Restore some or all of the vehicle license fee reductions. This can also be part of a reform package to broaden and diversify our revenue base.

- Reduce the voting majority required for local bonds and transportation taxes to 55% as we did for schools. This will let local voters decide if they want to pick up part of our infrastructure financing and eventually reduce state General Fund debt service payments.

- Make some or all State General Obligation bonds self funding by requiring a small property tax increase like we require when local voters approve bonds.

- Consider eliminating some tax exemptions as suggested by the Legislative Analyst's Office.

These ideas serve both short-term and long-term budget goals. They can provide sufficient revenue to address the structural deficit while moving the tax system toward diversification. They will serve to reduce the volatility of the tax base without giving up the strength of income taxes that grow with the economy and make the tax system more progressive. They avoid permanent increases in corporate or personal income tax rates. **These suggestions will also give all Californians a stake in these choices, as the permanent increase in revenues will come from a broad range of income groups.**

We need these conversations. I have my opinion as to the best solutions. Other voices will have different perspectives. But a state that is stuck about whether or not to reallocate one penny out of every two dollars in their family budget is probably in serious need of some serious conversations. I don't think anyone can disagree with that conclusion.

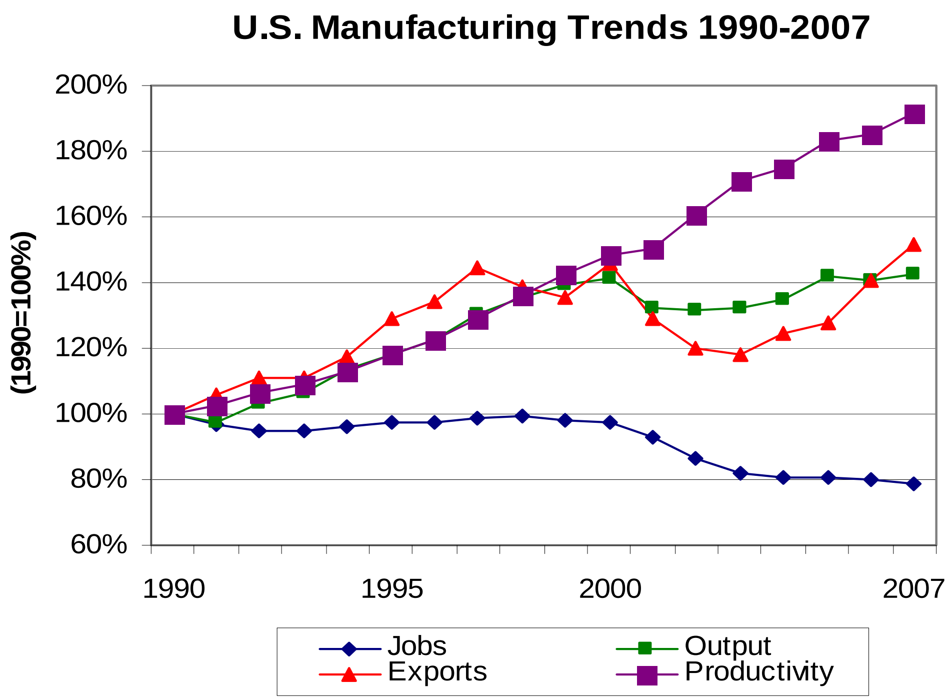
Globalization, Manufacturing Jobs and Earnings Stagnation

It is true that the nation has lost 4 million manufacturing jobs since 2000 at a time when foreign trade was expanding. It is certainly true that the link between stagnant wages, manufacturing job losses and globalization will be the subject of conversations in the upcoming presidential campaign.

Here are some ideas for those conversations.

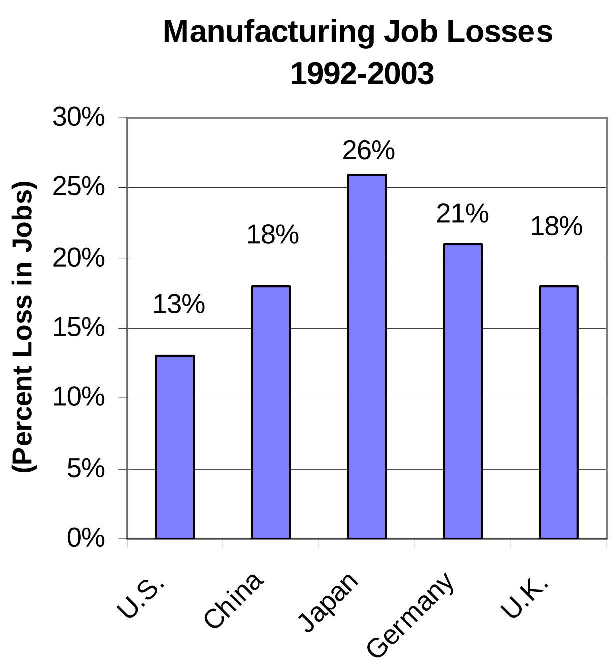
1) The past is past. During the "Golden Era" of U.S. manufacturing and rapidly rising standards of living, European nations and Japan were rebuilding from the devastation of World War II; South Korea, Taiwan and Singapore were just starting to be industrial powers; and China and India were the world's two largest poor nations. **Now the U.S. has lots of competition and other countries are building prosperity for their residents. We can't recreate the past.**

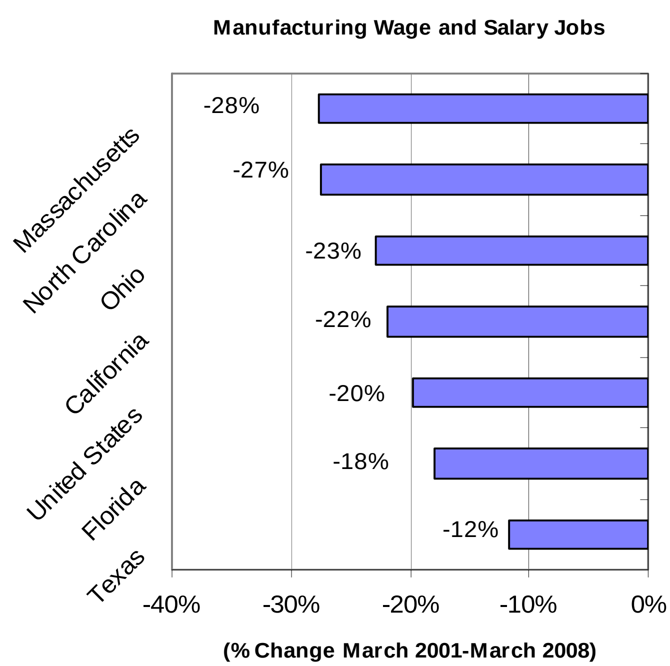
2) Productivity is the "villain" in manufacturing job losses. The Federal Reserve Bank index of real manufacturing output **is up 20% over the past ten years while the number of manufacturing jobs plummeted.** Manufacturing productivity gains far outpaced output growth so companies can produce more while needing fewer workers.



Manufacturing output in the United States is up 40% since 1990. Exports are up more than 50% and now increasing rapidly. Yet the number of jobs is down. The "missing link" is the rapid growth in manufacturing productivity, which allows companies to have rising sales with falling job levels.

3) Manufacturing job losses are everywhere--near 20% in Japan, China, Germany and the U.K.—and California's manufacturing job losses match those in many other states.





Firms **do** shift production between countries, and some goods that were manufactured in the United States **are** now made overseas. On the other hand foreign companies like Toyota and Honda and others make cars and other products here in the United States. And the high price of fuel may change the economics of where to manufacture goods that are expensive to transport and bring some production back to the United States.

Efforts to develop new products in the U.S. such as alternative energy and energy-saving technologies are good ideas and are attracting venture capital.

But all of these efforts are in a context where worldwide manufacturing job levels will continue to decline as productivity gains race ahead of output increases.

4) Productivity growth and foreign trade bring substantial benefits. Foreign trade gives us access to design and innovations developed in other countries. It offers choices and, in many cases, lowers prices for consumers. Productivity growth increases what we can produce and consume and also acts to lower product prices.

The benefits of productivity growth (cheaper products and higher wages) and foreign trade (cheaper products and more choices plus opportunities for export growth) are at the heart of the manufacturing sector dilemma. Lower productivity and less foreign trade, at least fewer imports, might raise manufacturing job levels in the United States. But at what price?

5) Anxiety about wage stagnation and "where are the good jobs" is real. Productivity growth and foreign trade do not help every individual. Some people see their jobs disappear or their wages fail to keep pace with inflation. **But the primary push to raise opportunity and hope must come from moving forward and creating opportunity in the 21st century economy.** It is time for a new "GI Bill" type of thinking and it is time to engage private and public sector institutions in developing education and training programs that recognize the needs and opportunities created by the upcoming wave of baby boomer retirement.

These issues reinforce the urgency of looking at the workforce opportunities and challenges discussed on page 2-10.

A Final Word on Housing

Decisions about housing are made by builders, buyers and communities. A summary overview of the demographic changes that will influence California's housing markets is set forth on page 2-9.

Communities play a large role in what actually happens for housing as local communities make decisions about how to respond to market forces and builders bring housing proposals to communities for approval.

I work on this issue professionally and I have read and heard many presentations on how housing decisions are related to two recent trends: 1) our California family concern with global warming and new policies to be developed in response to AB32 and 2) the effect of high gas prices on consumer housing decisions.

All of these conversations have the same message: **Local land use decisions and, specifically, a commitment to more infill development and density must be a major part of our effort to reduce emissions and must be one of the major policies developed in response to AB 32 goals.**

Demographic and economic trends in California will point market forces in this direction meaning that builders will bring more and more urban infill proposals to communities, as residents desire this kind of living.

If my community of Palo Alto is any indication, these trends will spark many intense conversations. Policymakers can consider what combination of carrots and sticks they should develop to provide incentives for urban communities to take additional residents.