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TO: Budget Project Friends

FROM: Stephen Levy

SUBJECT: The Role of State Government in California Economic Growth

1. This is the fourth in a series of memos related to the California economy and budget, supported by a grant from The James Irvine Foundation. The previous memos are posted at www.ccsce.com.
2. The recall campaign has brought increased attention to the role of state government in promoting economic growth in California. Candidates are putting forth their plans to increase the rate of job growth in the state. Today's "sound-bite debate" about whether businesses are leaving California in record numbers can begin a serious discussion of the potential and limitations for state government policies about the California economy and how these economic policies relate to state budget choices.

The goal of this memo is to provide some background for the ongoing discussion of the role of state government in promoting a "good business climate".

3. Short-Term versus Long-Term

Governors and legislatures do not create recessions nor do they have the tools to end recessions. Moreover, state governments do not have tools to affect short-term industry trends or the stock market. The desire of state elected officials to help residents overcome layoffs and unemployment is not matched by any effective means of doing so.

Governor Wilson did not create the national recession of the early 90s, did not cause the simultaneous aerospace downturn and did not make the recession last longer in California than in the nation. Similarly, Governor Davis did not create the national recession of 2001, did not create the international tech downturn, did not cause the stock market

drop, did not cause the current national job level to be nearly 3 million below the previous peak and cannot cause any of these to end.

Governors and legislatures do have a role in creating the conditions for long-term private sector job growth and can be held responsible for these policies as discussed in the next section. The role of state government in supporting long-term economic growth has budget implications but also is affected by policy choices outside the budget process.

4. Long-Term Growth — Governors and Legislatures Have a Role

Some businesses serve state, national and, even, world markets. These businesses export goods and services to people and businesses located outside of their immediate location. California firms export motion pictures, apparel, software, consulting services and a range of high-tech and other manufacturing products.

Firms that export a high percentage of their products and services **have a choice of where to locate facilities**. States and localities can and do “compete” for the location of businesses in export industries.

The current California recall campaign has called attention to the process whereby firms make location decisions for new and existing facilities. The debate about whether businesses are “leaving California” provides an opportunity to discuss the serious issues surrounding the question of what makes a state or local area “business friendly” and who has the responsibility and power to affect California’s “business climate”.

Public policy creates the foundations for attracting private-sector investments. While state policies cannot affect the long-term growth in demand for technology products and services, public policy does play a role in determining, for example, what share of new technology start-ups choose to locate in California. There are three broad areas where state public policy can affect the location decisions of firms:

- 1) Public investment and public policies play a critical role in a state’s infrastructure — roads, public transportation, school and university facilities, energy and water systems, ports, and airports.
- 2) Public funding and policies play a critical role in helping local governments create **great places to live and work**.
- 3) Public policies play a critical role in defining the regulations and tax system that affect both businesses and residents. In the current debate about California’s economy, the workers’ compensation

system has received a lot of attention as a factor in raising business costs in California compared to in other states.

All three of the above areas of public policy affect business decisions and there is great debate about the priority that should be given to each area. At times, the attention given to workers' compensation makes it seem as if business groups care only about regulations and tax rates, but business groups have also been great supporters of investments in California's education and infrastructure systems.

Public Investment in Education and Infrastructure

Businesses that can locate anywhere will certainly require California to maintain a competitive public investment program for education and infrastructure. This is especially true for companies whose main asset is creative people who can find employment anywhere in the world.

There is not really any disagreement about the importance of investment in education and infrastructure. Nor is there any disagreement that California is still well below where we should be — California is 30th in per pupil funding for K-12 and in the bottom 20% of states on most measures of infrastructure investment.

The Governor and Legislature have a significant role re education and infrastructure investment. Investment monies are directly allocated in the state budget. The legislature approves bonds that go to the voters for approval. The state economy and budget play a role in determining the level of bonds that can be invested and the interest rate that will be charged.

The voting rules for passing the budget (a 2/3 majority is now required) and for passing infrastructure bonds (local education bonds require a 55% majority) are another way that public policy affects the level of investment. There will be initiatives next year to lower the voting majority to 55% for both the state budget approval and for other types of local infrastructure bonds

Great Places to Live and Work

For decades, California communities were recognized as great places to live and work. A great climate, excellent recreational facilities, access to both mountains and oceans, good local parks and public facilities and steady improvements in air and water quality helped California rank at or near the top in polls asking "where would you like to live".

These attributes, together with good schools and infrastructure, constitute the main elements of “a high quality of life”. And a high quality of life is one of California’s major “competitive” forces in attracting new entrepreneurs and innovations. When you can locate a business anywhere, why would you locate in a place that was not attractive for living as well as working?

The Governor and Legislature have a significant role in developing public policies that affect the quality of life in California communities. Both the state budget and Proposition 13 heavily influence local government funding and land use choices.

During the past decade, state budget difficulties have resulted in the Legislature transferring money from local government programs to help balance the state budget. State policies to raise pension benefits for public employees have created pressures for local governments to follow along. The loss of property tax revenues for local governments after Proposition 13 led to the imposition of increasing fee levels on new homes and new businesses by local governments.

The end result has been continuing fiscal pressures and uncertainty for many of California’s local governments and a set of fees that discourage new housing and new economic activity. The fiscal rules surrounding local government finance have influenced land use choices in a way that restricts the ability of cities to create great places to live and work.

There is general agreement on these points but little consensus yet on how the state should change the rules to restore more power and funding to local governments.

Business Regulations and Taxes

By now most Californians have heard an ongoing series of complaints about the costs and rules of the state’s current workers’ compensation system. The case against the current workers’ compensation system has often been combined with complaints that a much broader set of tax and regulatory policies are “job killers” and that the state’s business climate is terrible.

There is no disagreement that regulations and taxes are a consideration in business location decisions and no disagreement that the current workers’ compensation system has high costs compared to other states and inadequate controls on medical costs and usage. Beyond the issue of workers’ compensation, there is little agreement, either on the contention that businesses are leaving California in record numbers or that the regulations and taxes being criticized are “job killers”.

The arguments can, in theory, be separated. For example, there is probably agreement that the workers' compensation system will be a negative competitive force in the future even if today's rising costs did not create the tech downturn and even if today's California economy is not performing below the national average.

As a result, it is possible to support extensive reform of the workers' compensation system without accepting the argument that California's economy is in terrible shape.

There can, however, be no doubt that these regulations and tax policies are the direct responsibility of state government.

Two Dilemmas in Creating a Great Business Climate

The first dilemma is that not all businesses are attracted by the same factors. For example, high-tech startups may care more about the educational system, infrastructure and quality of life, while paint manufacturers may care more about energy costs and taxes.

So, in part, what makes a good business climate and what the state should do depends on what kind of industry you want to attract.

The second dilemma is that the three major roles for the state in supporting and attracting private investment **sometimes point in different directions**. Investing more in education and infrastructure and creating great places to live and work may require more public funding than is currently being spent, while lowering tax rates or granting tax incentives for business will reduce the funds available for public services and public investment.

The search for public policies that support the creation of new private investment and associated jobs is caught in the same set of choices that have paralyzed the state's budget process. Do Californians think the way to attract business is to support spending for education, infrastructure and local governments, which will require at least a temporary increase in public revenues? Or, is the best approach for increasing private investment to reduce the level of public services in an effort to balance the budget and fund additional tax cuts?

4. Short-Term Growth—Governors and Legislators Have No Role

The "sound-bite" debate has raised two questions—1) is the California economy under-performing? and 2) what can a governor do to stimulate immediate job growth? The second question is addressed first below.

The federal government and the Federal Reserve Bank have the tools and the legislative mandate to stimulate the economy when it is weak. Governors and legislatures, whether Republican or Democrat, whether in California or Colorado, have almost no influence over short-term economic trends. This is a point of agreement among economists.

If a person (or candidate) is unhappy with the immediate state of the national or California economy, they should complain to Congress and the President, not to the Governor and Legislature.

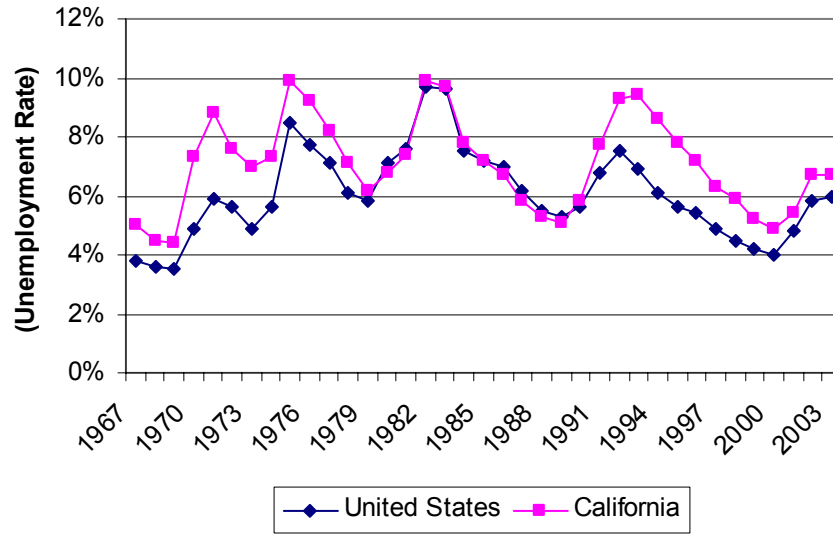
The role of the national economy in dictating the major trends of state economy activity is clear from the data. The role of the federal government in fighting recessions is clear from an analysis of what causes recessions and from observation of the tools available to the federal versus state governments.

National Economic Cycles Drive State Cycles

The graphs below look at two measures of economic conditions — the unemployment rate and the growth in per capita income. The graphs show the close similarity of national economic cycles to cycles in California. The graphs show clearly that there has never been an economic upturn in California that was started independently of a national economic recovery.

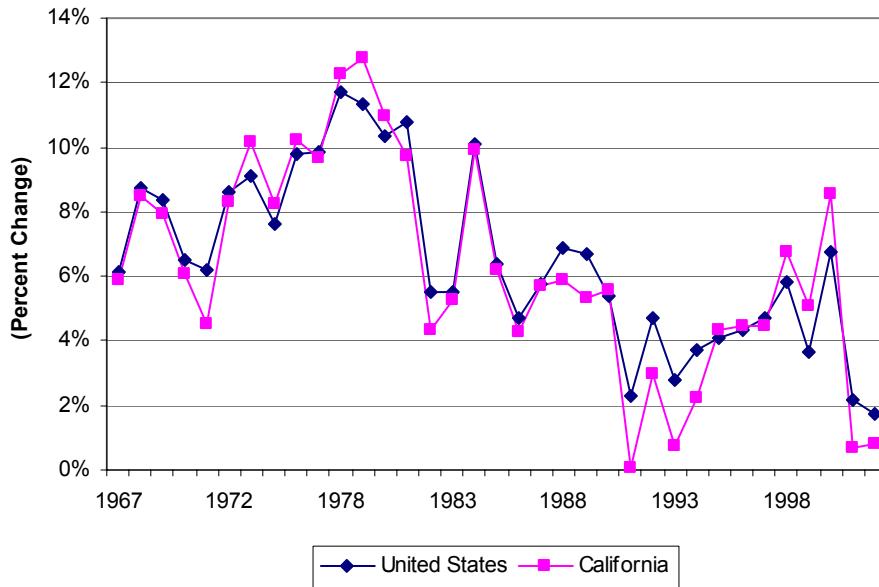
The unemployment rate trends for the state and nation are virtually identical. The rates move up and down together. In two instances, in the early 1970s and early 1990s, the state downturn was steeper and longer than the national downturn as a result of the impact of defense spending cuts.

State and National Economy Move Together



The per capita income trends for the state and nation are also virtually identical. Per capita income in the state rises and falls in sync with the national trends.

Per Capita Personal Income



The Federal Government Has the Tools

Recessions are caused by a decline in the demand for goods and services. Usually some sectors of the economy experience a sharp decline and the declines in these sectors spread to other sectors. The current national downturn was initiated by a sharp decline in business capital investment and a sharp decline in stock market prices and new venture capital funding. The decline in business investment was compounded by a decline in economic growth in the nation's major trading partners including Japan and Europe, and, as a result, a decline in export demand.

The recession did not start in California and spread to the United States. It started in the national and world economies and spread to California and other states.

A recession in California would not have the power to create a recession in the nation, while a recession in the nation would certainly have the power to create a recession in California.

Why States Can't Fight Recessions

Recessions are caused by a drop in total spending. The federal government has three primary tools to stimulate total spending and help lower unemployment:

- 1) The Federal Reserve Bank lowers interest rates to make borrowing and spending less expensive. Consumers benefit from lower interest payments. For example, in the current downturn, interest rate cuts have allowed many homeowners to refinance and reduce their monthly payments. In addition, interest rates cuts are supposed to provide an incentive to businesses to invest.
- 2) Congress reduces tax rates temporarily to increase the cash available to consumers to spend.
- 3) Congress can increase the level of government spending, for example, through spending on defense and non-defense purchases or by increased grants to state and local governments that act to prevent cuts and layoffs at the state and local level.

The reason that temporary tax cuts and increased federal spending work in fighting recessions is that **the federal government can spend more than it takes in as a tool in fighting recessions**. That is, the federal government can run a deficit and **it is this deficit that provides the extra stimulus to total spending**.

There are two major reasons why state governments are ineffective at fighting recessions:

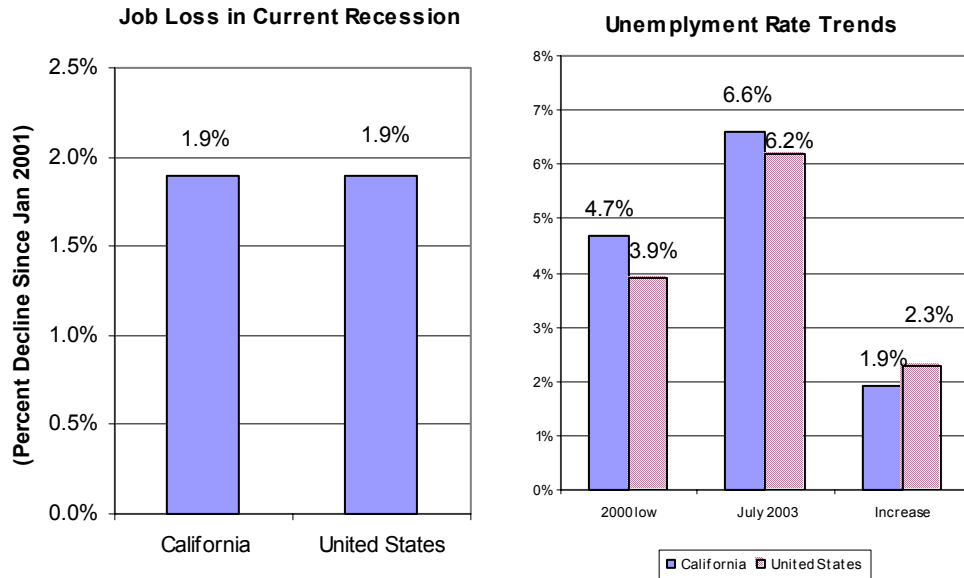
- 1) State budgets must be balanced. If states were to increase spending as the federal government is doing, they would be required to raise revenues, **which would negate the stimulus effect. Similarly, tax cuts would need to be balanced with spending cuts, again providing no net boost to spending.**
- 2) State governments do not possess broad economy-wide powers. States do not control interest rates, nor do state budgets (even if deficits were allowed) have enough scope to boost **national spending levels.**

As much as Governors or candidates want to help residents caught up in job loss and tough times, the tools available to Governors give them a **significant economic role, but it is in building long-term foundations to attract private sector investment, not in fighting today's recession.**

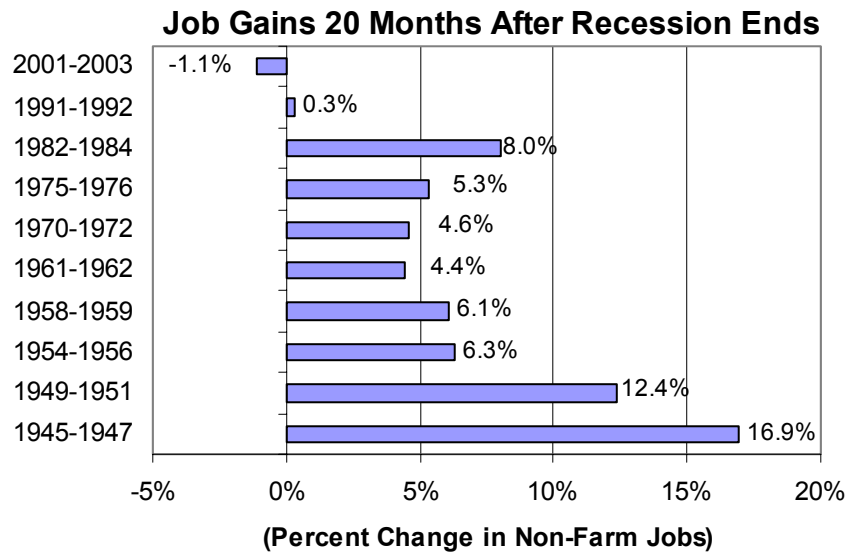
Current State of the California Economy

The state economy is in the midst of a lingering recession as measured by job levels and unemployment rates. Since January 2001, California has lost nearly 300,000 jobs for a decline of 1.9%. Unemployment rates have risen from a low of 4.7% to 6.6% in July 2003.

However, California's job and unemployment situation is right in line with the national average. The 1.9% job loss exactly matches the national job loss and the state's rise in unemployment rates is actually slightly smaller than the national rise.



What **is** different about this post-recession period is that it is the weakest national recovery since World War II. In every other post-war recovery, job levels were **higher** 20 months after the recession ended, but in this post-recession period job levels are still **lower**.



Finally, today's (September 2, 2003) Wall Street Journal editorial contained the statement "No wonder employment in California has lagged the rest of the country in recent years". The chart accompanying the editorial covered the period beginning in 1995. Since the editorial may

become a part of the current debate in California, I am including comparative job and unemployment data below for the 1995-2003 period.

Non-farm job levels increased by 18.2% in California between July 1995 and July 2003, while national job levels grew by 12.8%. The state unemployment rate **fell** from 7.9% in July 1995 to 6.6% in July 2003, while the national unemployment rate **rose** from 5.7% in July 1995 to 6.2% in July 2003.

