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DATE: April 14, 2004

TO: Budget Project Friends

FROM: Stephen Levy

SUBJECT: An Update on the California Economy

IRUS has received support from The James Irvine Foundation to continue this memo series on state budget issues and their relationship to the California economy. This memo provides an update on California economic trends. An accompanying memo discusses the concept of “what we can afford” in relation to state budget choices. Previous memos in the series are posted at www.ccsce.com.

The state is in a transition period between the adoption of Proposition 57, which provides funding to erase past budget deficits, and the upcoming debate over future state budgets, where the outlook is for the reemergence of long-term budget imbalance.

SUMMARY

- Proposition 57 authorizes up to \$15 billion in deficit reduction bonds. The Governor proposes to use \$12.3 billion to erase past and current deficits.
- The Legislative Analyst’s Office (LAO) forecasts that a budget deficit of \$7 billion will reemerge in 2005 even if all of Governor Schwarzenegger’s current proposals are adopted. The LAO states that the Governor’s current budget carries significant risks.
- Budget revenues are directly related to the strength of the economy but the strength of the economy is also directly related to budget spending choices.
- March 2004 brought 308,000 new jobs nationwide but the current “recovery” finds the nation with 6 million jobs fewer than in a typical recovery.

- March 2004 job gains of just 5,200 for California were disappointing. For the March 2003-2004 year, private sector jobs have grown by 0.9% in the state compared to 0.6% in the nation.

- California lost 56,900 government sector jobs last year, showing the first round of impacts from recent budget cuts for state and local governments.

- The Bay Area lost more jobs than the state as a whole. Eight of California's nine economic regions outperformed the nation in job creation since March 2001 and six regions added jobs while the nation was losing jobs.

- Many industrial states, including the high tech states of Colorado, Massachusetts and North Carolina have experienced significantly larger job losses than California.**

- California has lost more manufacturing jobs than the nation –18.3% versus 15.9%. Colorado, Massachusetts and North Carolina had larger manufacturing job losses than California.

- Wage levels in California increased by 3.9% in the year ending in the third quarter of 2003 (the latest data); average wages were up 3.1% nationwide.

PROPOSITION 57 AND STATE BUDGET DEFICITS

The passage of Proposition 57 authorizes the state to issue up to \$15 billion in long-term bonds to be used for deficit reduction. The bonds are scheduled to be repaid within 9-15 years depending on the strength of the economy and choices of the Governor and legislature. Proposition 58 created a budget reserve fund that may be available to help retire the deficit bonds in as few as nine years.

The Proposition 57 bonds replace a plan adopted last year by the legislature to issue approximately \$11 billion in bonds to be repaid in five years. The legislature's proposal was approved without a vote of the electorate and thus subject to legal challenge.

The Governor's January budget for 2004-2005 proposed to use approximately \$12.3 billion of the bond funds to cover deficits in 2002-2003, 2003-2004 and 2004-2005. The remaining bond funds could be used to further reduce current deficits.

The 2004-2005 budget, as proposed by the Governor in January, is balanced but a deficit emerges again in 2005-2006 and will remain until additional budget balancing measures are taken according to estimates published by the Legislative Analyst's Office (LAO).

The LAO projects that the ongoing deficit will be in the \$5-7 billion per year range **even if all of the budget proposals included in the Governor's 2004-2005 budget are adopted.** The LAO Perspectives and Issues report

(http://www.lao.ca.gov/analysis_2004/2004_pandi/pandi_04.pdf) concludes that about \$7 billion in state budget deficits will reemerge in 2005-2006, as one-time measures adopted in 2004-2005 are no longer available.

Many of the governor's proposed budget solutions for 2004-2005 are controversial including cuts in payments to MediCal providers, reallocation of property tax revenues away from cities, counties, and redevelopment agencies to schools (which reduces the amount of required state K-12 spending), and reductions in health and social service program eligibility and spending.

Finally, although the state economy is now growing again, the LAO and others already assume continuing economic growth in their projections of long-term state budget deficits.

So, the bottom line of Proposition 57 is that it clears away the state budget deficits from previous years but neither Prop 57 or moderate economic growth provides an answer to the question of how to prevent or "solve" future budget deficits.

THE ECONOMY AND THE BUDGET—SOME GENERAL RELATIONSHIPS

Many factors are taken into consideration in developing a state budget. One factor is the impact of budget choices on the California economy, the subject that is the primary focus of this series.

Californians face two alternative approaches in closing future state budget deficits: 1) reducing spending or 2) raising revenues. The "reduce spending" choice can represent either 1) reductions in the level of services provided or 2) elimination of costs, while maintaining service levels—i.e., the elimination of alleged "waste, fraud and abuse".

These basic choices—reduce services, raise revenue, eliminate waste—will be at the heart of all future budget debates in California. And the impact of each choice on the state's economy will be an important feature of these debates.

A Good Economy Helps the Budget

The California economy and the state budget are related in two distinct ways. First, the strength of the economy is a major determinant of the level of tax revenues. When the economy sinks, tax revenues sink. When the economy does well, tax revenues rise more rapidly.

California has just experienced both cycles in the economy and state revenues. In the late 1990s, job and income levels rose rapidly and state income tax revenues grew even faster. After 2000, job and income growth slowed and state revenues fell.

There are mainly winners when the state's economy grows rapidly. Job and income levels rise; unemployment and poverty rates fall. Usually, inequality stops increasing and real wages for lower-income workers rise. All of these trends boost state and local tax revenues.

So, when people say that a strong economy provides the foundation for long-term revenue growth, it is an accurate statement. And, it is also accurate that most job and income creation in California is the result of private sector business activity.

Some people and organizations have gone from this “strong economy, strong revenues” relationship to argue that tax increases to balance the budget are bad policy because they will hurt the economy and lower revenues in future years. Governor Schwarzenegger echoed this viewpoint during the recall campaign.

A “Good” Budget Can Help the Economy

However, the budget/economy relationship is more complicated than “better state economy, more revenues” and “higher taxes, worse economy”.

The budget/economy relationship works both ways. **State budget decisions affect the prospects for economic growth.** While most jobs are ultimately created by private businesses, public investment plays a critical role in determining California's economic competitiveness.

For example, California's investment in education and transportation affects the decisions of firms, especially new innovative firms, to locate in the state. And the quality of life in our major regions, which is affected in part by local spending decisions, is also a link between public spending and economic growth.

So the economy affects budget revenues and budget expenditures affect the economy. **And, if tax increases are required to fund public investments that are necessary to attract firms to California, the question of whether tax increases are good or bad for the economy gets a lot more complicated to analyze.**

Governor Schwarzenegger has also said that the economy is his first priority right now and that he would reevaluate his position on taxes if he thought increases would help economic growth.

A Strong National Economy is Critical to A Strong State Economy

Much of the cyclical nature of job and income trends **is a national problem, not a state problem.** In the current environment as discussed throughout this memo series, **state job losses are primarily the result of the national economic situation and beyond the short-term control of state policy.**

State economic cycles are not caused by governors or legislatures and cannot be ended by them either. State policies can affect the relative growth rates for jobs and income among states, but these affects relate to the long-term attractiveness of states as places to live and work, not to short-term economic cycles.

A strong national economy is critical for strong economic growth to occur in California.

AN ECONOMIC UPDATE

New data on California economic trends and trends in the tax burden faced by individuals and corporations has been published in the past few weeks. This new information provides an updated context for the debate about short-term and longer-term budget choices in California.

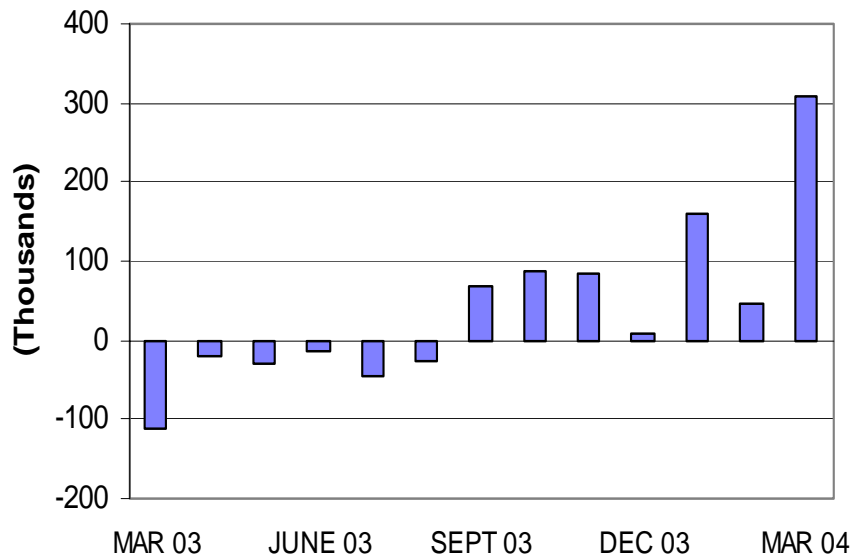
The National Jobs Picture

The nation added 308,000 non-farm wage and salary jobs in March 2004 (this measure excludes farm and self employed jobs)—the largest monthly jobs increase since April 2000. Job levels have now increased for seven consecutive months.

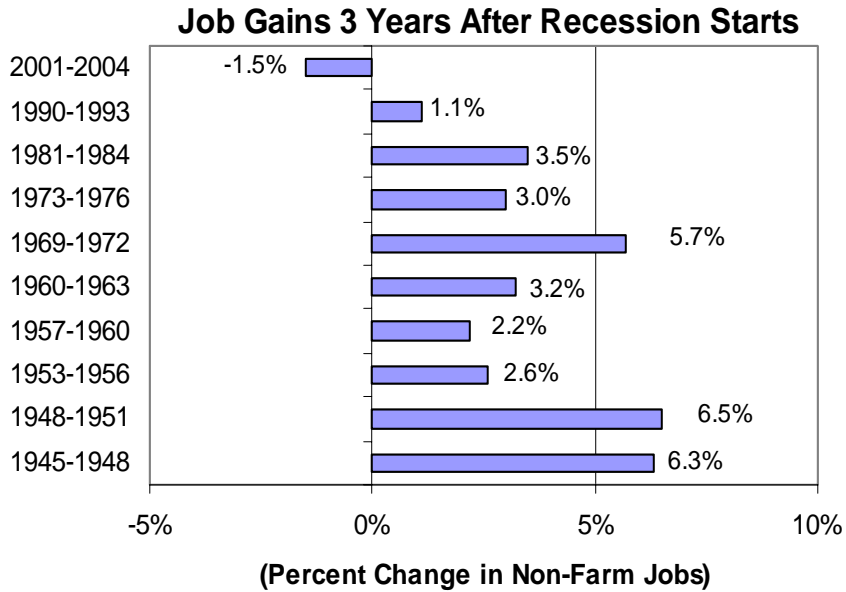
The job growth follows two quarters of strong GDP increases. Real GDP, the measure of total goods and services produced in the U.S. economy, grew by 8.2% in the third quarter of 2003 and by 4.1% in the fourth quarter.

At this point, it is too soon to be certain that future job gains will continue at this pace or be large enough to significantly reduce unemployment. In March 2004, job growth was matched by an increase in the labor force as some people came back into the labor force to look for work. As a result, the unemployment rate actually rose slightly in March.

**Change in U.S. Nonfarm Jobs
Mar 2001–Mar 2004**

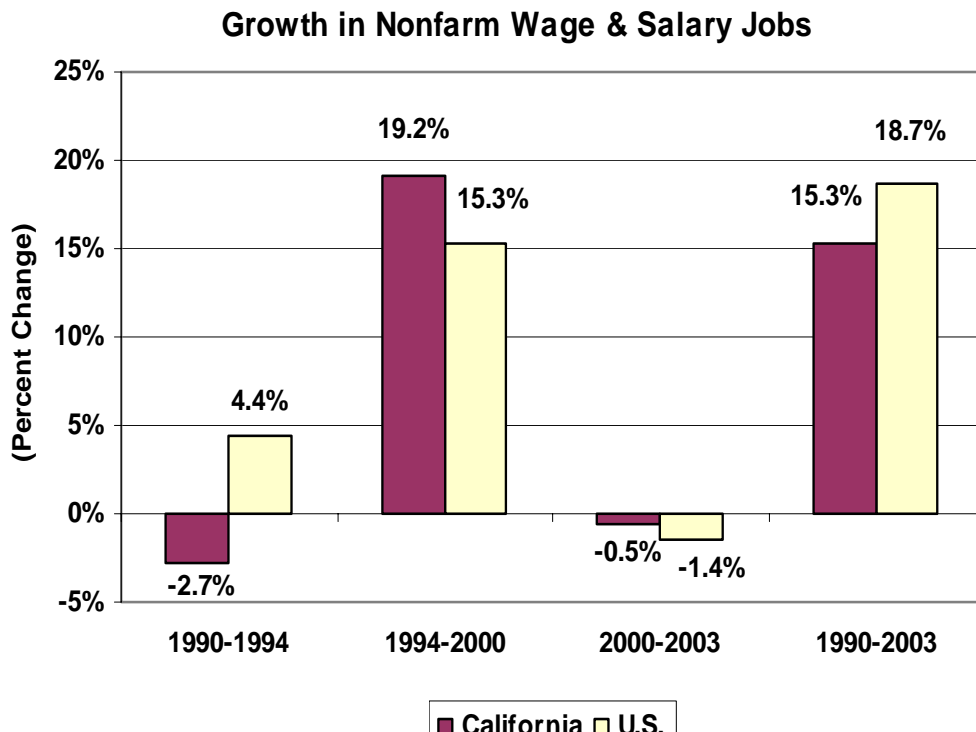


Even with the robust job gains in March, U.S. job growth over the past three years has been the lowest of any three-year period following the start of a recession since the Great Depression. The nation has lost 1.5% of the pre-recession (March 2001) job level or nearly 2 million jobs. The average job gain three years after a recession begins is 3.0% or, in this case, 4 million jobs. So, the nation is **6 million jobs below** the normal post-recession experience. California's share of the 6 million "job gap" is approximately 700,000 jobs.



California's Job Picture—The 1990-2003 Period

California's job growth since 1990 lagged behind the national jobs growth rate. However, all of the disparity came in the 1990-1994 recession where the state, unlike in the current recession, did much worse than the nation.

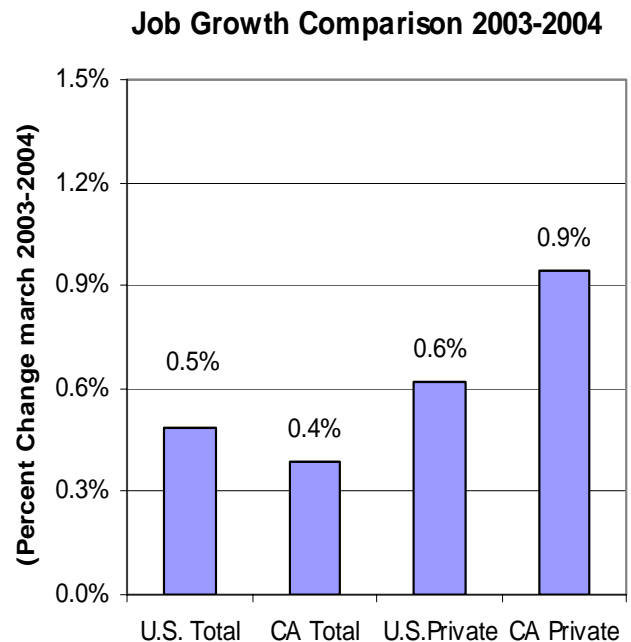
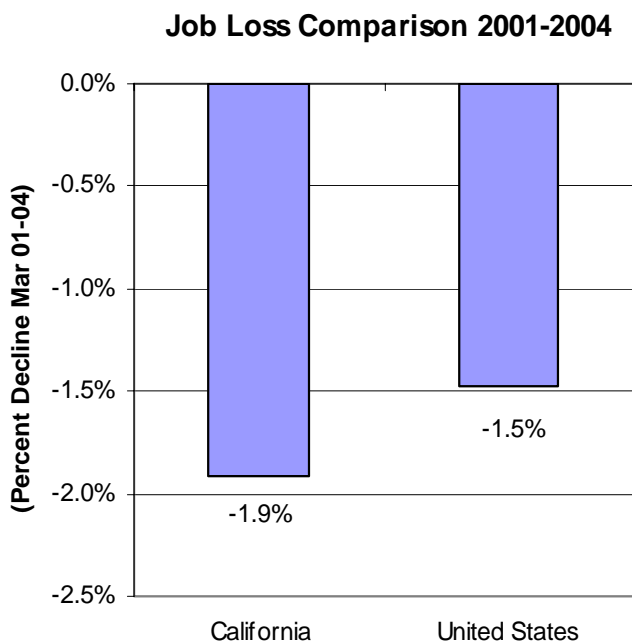


California lost 2.7% of the state’s non-farm wage and salary job base between 1990 and 1994, while the national job total grew by 4.4%. In each of the following two periods—1994-2000 and 2000-2003—California did better than the nation.

The period beginning with the national recession in March 2001 is the period in which it has been alleged that California “hemorrhaged” jobs. Data for the period ending in March 2004 show that California lost 1.9% of the March 2001 non-farm wage and salary base compared to a loss of 1.5% nationwide. Half of the difference came in February and March 2004 when U.S. job growth accelerated faster than job growth in the state.

For the most recent year—March 2003 to March 2004—California added 55,500 jobs (+0.4%), while the nationwide gain was 0.5%. **However, the number of government jobs fell by 56,900 (larger than the losses in manufacturing) as state and local fiscal problems led to layoffs.** In terms of private sector jobs, California added 112,400 jobs or +0.9% compared to the nationwide gain of 0.6%.

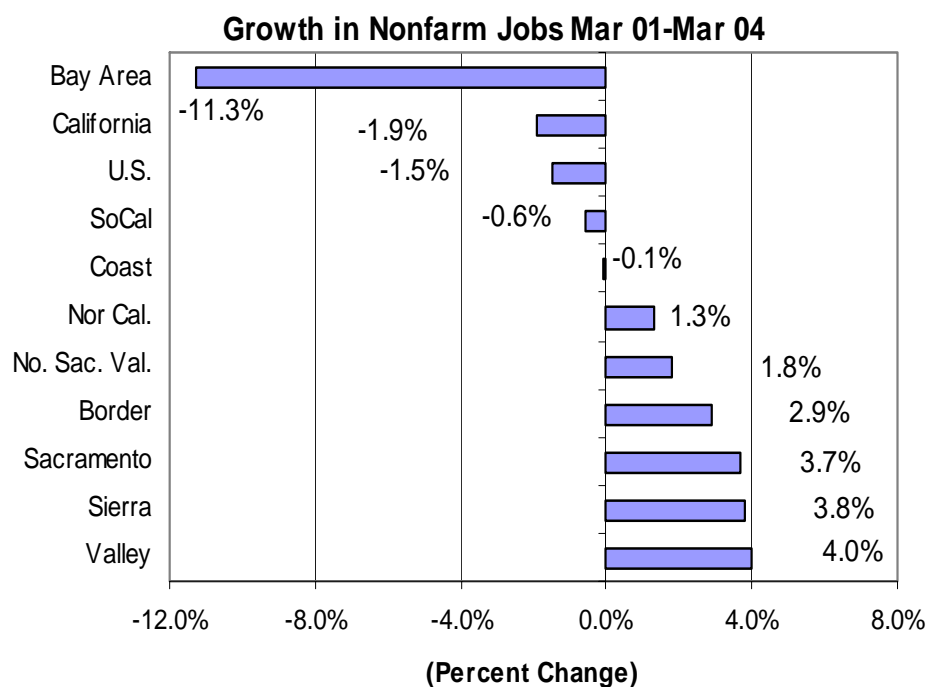
Two points about the government job losses are worth noting. First, the California government job losses (56,900) exceeded the government job losses in the nation (43,000). **Second, the government job losses are another way that budget choices are related to the state economy.** California’s government sector job losses are almost completely the result of budget cuts at schools, local governments and the state.



Bay Area Had More Job Losses than the Entire State

Eight of California's nine economic regions did better than the nation in terms of job growth during the past three years. Virtually all of the state's job losses occurred in one region—the Bay Area. Between March 2001 and March 2004, the Bay Area lost 416,000 jobs or 11.3% of the region's job base. During the same period, California lost 282,000 jobs so the other regions **added 134,000 jobs**.

Job levels in six of the nine regions were **higher** than before the recession began, the Coast region experienced no change in job levels and Southern California had a loss of 0.6% or less than the nationwide decline.



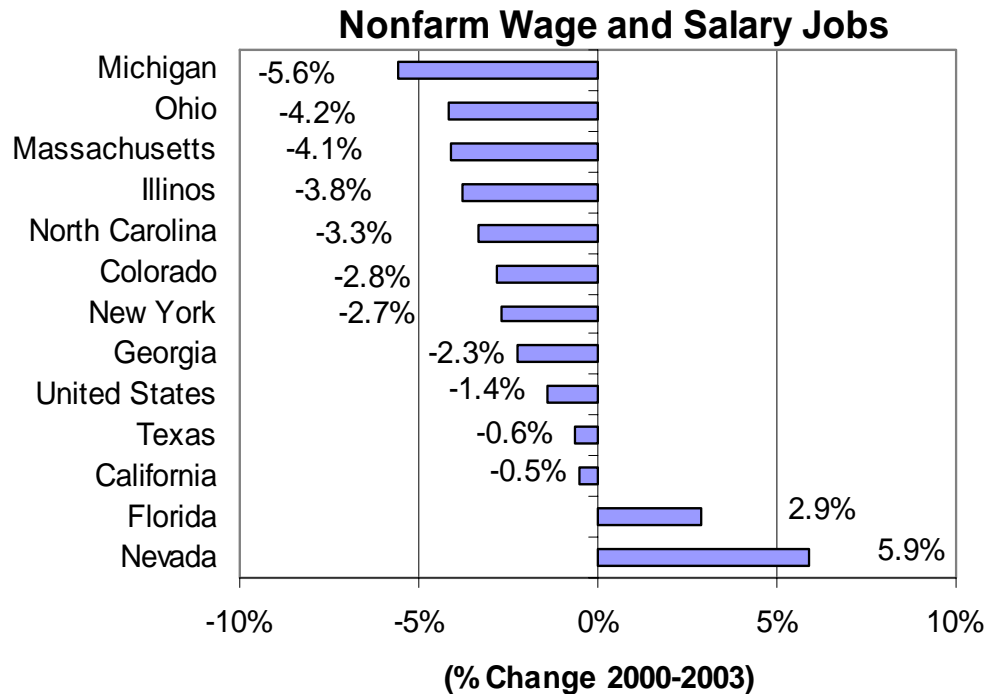
California Versus Other States

Invariably these days, discussion of the California economy includes analyses of how the state is doing compared to other states. Some recent data is displayed below.

As shown on a previous page, between 2000 and 2003, California had a non-farm wage and salary job loss of 0.5%, slightly lower than the nation's loss of

1.4%. This period presents a somewhat favorable comparison for California as it includes the large gain in jobs at the end of 2000.

How did other states fare during this period? Some states, including Florida and Nevada, added jobs. Texas had nearly the same job loss as California (0.6%). **But, many large industrial states had job losses far greater than California.**



Many Midwest industrial states, including Michigan, Illinois and Ohio shown above, had job losses far greater than California. These states had the heaviest burden from the downturn in industrial and export demand after 2000. **But, most other “high tech” states did far worse than California.**

While most media attention focused on the Texas/California comparison, Colorado (-2.8%), North Carolina (-3.3%) and Massachusetts (-4.1%) all had far greater job losses than California after 2000. Massachusetts, California and Colorado rank 1,2,3 in the latest Milken Institute state technology and science index—Texas ranks 23rd.

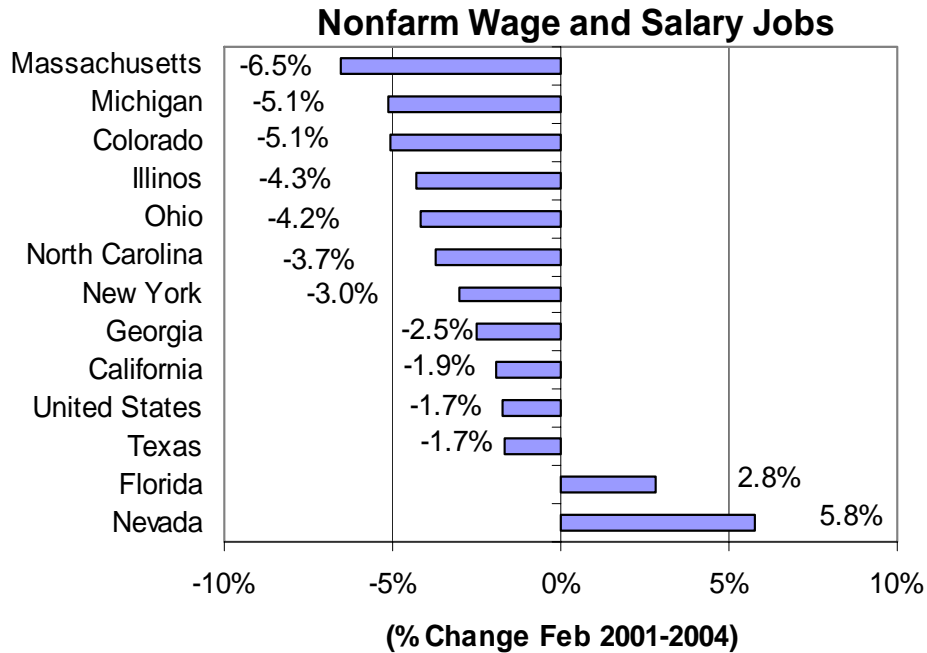
State Comparisons for February 2001-February 2004

If California has been “hemorrhaging” jobs, that would seem to imply that most other comparable states have been doing much better. What do the data show?

The latest data for state-by-state comparison are through February 2004. IRUS tabulated data for the February 2001-February 2004 period. The results for selected states are shown below.

The data are clear and compelling. Many other states, including Massachusetts, Colorado and North Carolina, all high tech centers, had far greater percentage job losses than California. Massachusetts, which is the nation's other leading high tech and biotech center, experienced a non-farm wage and salary job loss of 6.5% between February 2001 and 2004. Both Colorado and Michigan each had job losses of 5.1%. The Midwest industrial states as a group had substantial job losses.

Job losses in Texas were 1.7%, slightly less than the 1.9% for California during the same period.



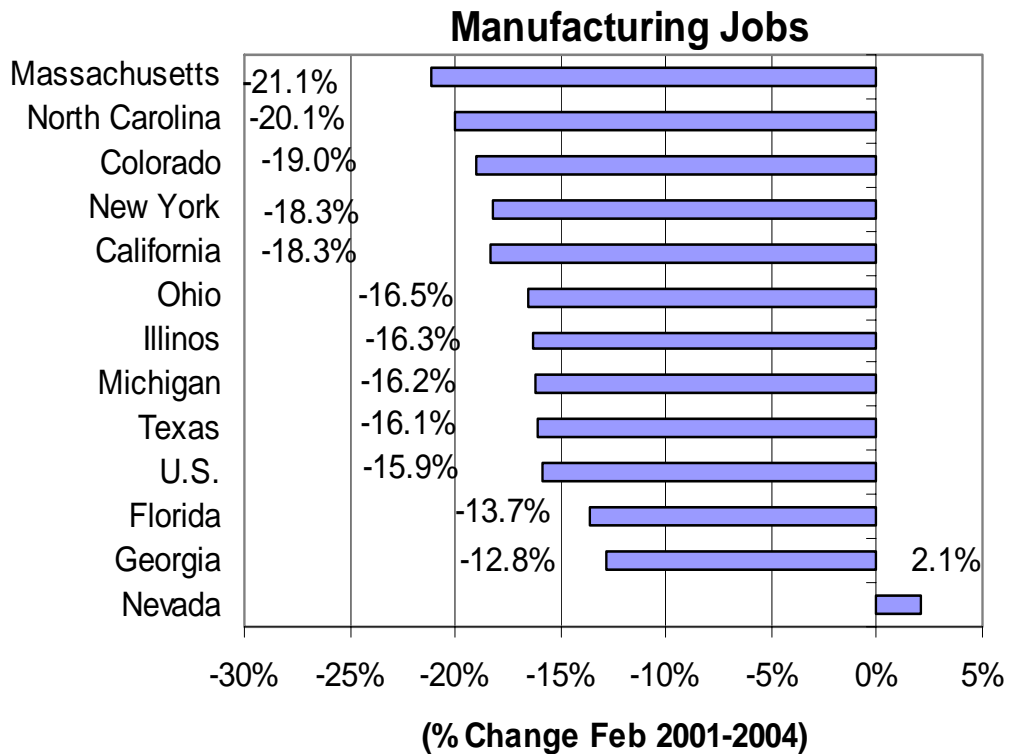
Manufacturing Jobs

Manufacturing job losses have been substantial in both the nation and state. The United States lost 2.6 million manufacturing jobs and California has lost 330,000 manufacturing jobs between March 2001 and March 2004. In both case, the amount of manufacturing job losses has exceeded the number of overall job losses.

California has been comparatively hard hit by manufacturing job losses. Between March 2001 and March 2004, the state suffered an 18.3% decline in manufacturing jobs, slightly more than in the nation (15.9%) or Texas (16.1%).

But, as with total jobs, the state's large job losses in manufacturing were matched or exceeded in other large industrial and high tech states.

In fact, three other high tech centers—Massachusetts (-21.1%), North Carolina (-20.1%) and Colorado (-19.0%) all did worse than California.



OTHER ECONOMIC UPDATES

Two pieces of good economic news about California were released during the past month. The Board of Equalization announced that taxable sales for 2003 are estimated to have been \$454.0 billion, up 3.0% from 2002. Sales rose in each quarter of 2003 and last year's results were the best since 2000.

The Bureau of Labor Statistics released wage data through the third quarter of 2003 and the data shows good news for California. **Average wage levels in California were up 3.9% over the third quarter of 2002 compared to a 3.1% gain nationally.** Average wage levels were up 2.2% in Texas, 2.6% in North Carolina, 3.6% in Massachusetts and 4.5% in Colorado.

WORKERS' COMP REFORM COULD BE A PLUS FOR THE BUDGET AND ECONOMY

A compromise workers' compensation reform plan that could be adopted by the Legislature should provide a plus for both the budget and the economy. State and local governments incur workers' compensation costs just like

private employers. If costs are reduced through eliminating fraud and/or medically unnecessary treatments (assuming agreement can be reached on these concepts), then state and local government costs will be reduced, even if they self-insure instead of paying workers' compensation insurance premiums.

And reduced workers' compensation costs would directly increase the relative attractiveness of California as a place to start and run a business.

THE MISSING MOVING VAN STORY

This memo ends on a lighter note. In the early 1990s and again after 2000, there was a news story each year about moving vans leaving California for other states. There was in fact, a lot of out-migration to other states in the early and mid 1990s as a result of the deep and long lasting California recession.

This year's moving van story did not get a big media play. Data from the Allied Van Lines website released on January 27, 2004 is summarized below so readers can make up their own minds about what, if anything, the data mean.

California is identified on the website map as one of approximately 20 states with "inbound and outbound moves about equal". The data for this company showed 9,023 (47% of total) moves into California and 10,377 (53%) moves out of California.

The five states with the highest percentage of outbound moves were Illinois (60.2%), Oklahoma, Michigan, New Jersey and Ohio (56.5%). The five states with the highest inbound percentages were Vermont (69.1%), Alaska, Montana, Arkansas and Mississippi (60.7%).