

Chapter 2

Economic and Demographic Projections

Economic and demographic trends generally are the principal determinants of the state's fiscal condition, including revenues, expenditures, and the budget surplus or deficit. This chapter presents our economic and demographic projections through 1999 that will influence the state's fiscal position in 1996-97, 1997-98, and 1998-99.

THE ECONOMIC OUTLOOK

Our forecast calls for moderating economic growth and continued low inflation for both the nation and California during the next three years. Figure 1 summarizes our U.S. and California economic outlooks.

Recent Developments

One year ago, our forecast reflected the consensus view that the national and California economies would experience moderate growth with low inflation in 1996 through 1999. National economic developments over the past 12 months have been consistent with this outlook, while California has performed better than expected.

After slowing sharply in 1995, U.S. real gross domestic product regained momentum in early 1996, and appears to have settled into a growth rate of between 2 percent and 2.5 percent as of the second half of this year.

California wage and salary employment growth has accelerated over the past year, and is now showing year-over-year increases of more than 325,000 jobs, the strongest gains since the

Figure 1

LAO Economic Forecast

Percent Change (*Unless Otherwise Indicated*)

	1996	1997	1998	1999
United States				
Real GDP	2.4	2.2	1.9	2.2
Wage and salary jobs	2.0	1.3	1.3	1.4
Consumer Price Index	3.0	3.1	2.9	2.8
Unemployment rate (%)	5.4	5.5	5.7	5.8
Housing starts (millions)	1.48	1.36	1.27	1.34
California				
Personal income	7.4	6.1	5.5	5.3
Wage and salary jobs	2.7	2.8	2.3	2.1
Consumer Price Index	2.1	2.9	2.9	2.8
Population	1.6	1.6	1.5	1.5
Unemployment rate (%)	7.2	6.8	6.4	6.0
Housing permits (thousands)	94	109	116	120

late 1980s.

The National Outlook

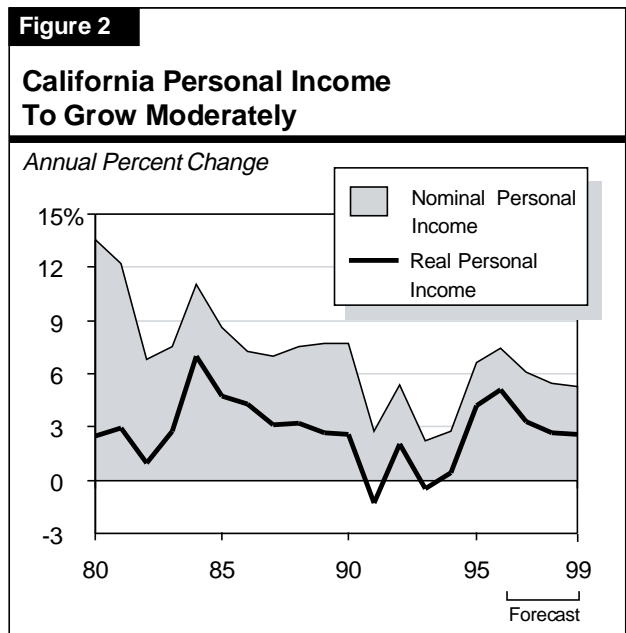
We forecast that current economic trends will continue, and that real gross domestic product will increase slightly more than 2 percent per year through 1999. This forecast is in line with the growth rate that many economists believe is consistent with low inflation. After four years of expansion, the U.S. economy is experiencing low unemployment and operating close to its productive capacity. At this point, above-average growth would likely prompt more restrictive monetary actions by the Federal Reserve, and thereby lead to higher interest rates.

Main Features of U.S. Outlook. U.S. economic growth over the next three years is expected to be led by above-average increases in business investment (particularly in computers and related electronic equipment) and by continued gains in exports. Consumer spending is forecast to increase at about the same rate as the overall economy—slightly more than 2 percent per year in inflation-adjusted terms. High consumer confidence levels and steady job growth should be positive factors. However, relatively high consumer debt levels are likely to hold future gains in consumer spending to increases which are no greater than those of personal income. Slower growing sectors include residential construction and government spending.

The California Outlook

As indicated in Figure 1, the main features of the California outlook are moderating employment and income growth, continued low inflation, a declining unemployment rate, and a modest recovery in home construction.

Figure 2 provides a broader perspective on one of the state's most important economic variables—personal income. The growth of this measure slowed sharply during the early 1990s' recession before accelerating beginning in 1994. We estimate that personal income growth will peak at 7.4 percent this year, reflecting healthy gains in employment, wages, investment earnings, and business income. The measure is projected to grow at more moderate rates in 1997 through 1999, as the state's expansion matures.

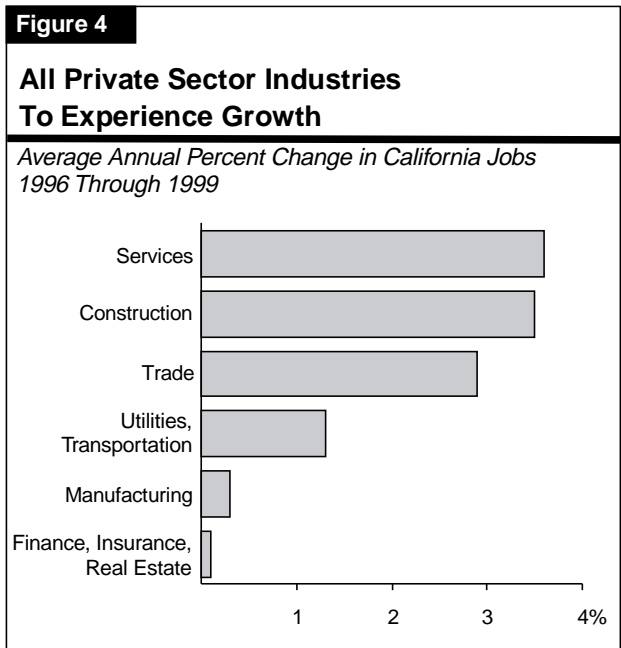
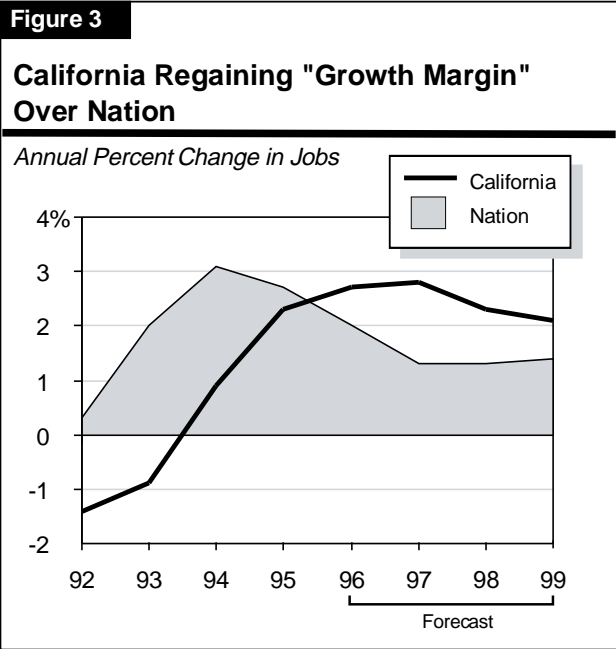


Although the rate of economic growth in California is expected to subside over the next three years, the increases in employment and income will likely exceed the nation as a whole by a significant margin (see Figure 3). This expected above-average performance is partly due to the positive outlook for many of California's key high technology and export-related industries. It also reflects the fact that this state is in an earlier stage of its economic cycle than the nation as a whole, and thus has more "room" to expand.

California's Economic Expansion Is Becoming More Broad-Based. As shown in Figure 4, virtually all major private industry sectors are projected to grow over the next three years. The breadth of the expansion is a positive factor because it means the state is not overly dependent on any single industry for continued future growth.

The fastest growing industries are projected to be services—including gains in such business-related areas as software design and management consulting, and in tourism—as well as the trade and construction industries.

The slowest growing industries are projected to be manufacturing and the finance, insurance, and real estate sector. The performance in even these sectors, however, represents a marked improvement from their poor experience in recent years caused by sharp declines in the aerospace and banking industries. Both of these sectors have bottomed out in recent months. This has been a positive development, especially for



Southern California, which had borne the brunt of the above-noted declines in aerospace and banking.

Home Construction To Recover Slowly.

Home construction remains the weakest area of California's economic outlook. Despite improving home sales, permits for new residential construction will likely remain below 100,000 units in 1996, or less than one-half of the average during most of the 1980s. The weakness is most pronounced in the multi-family market, where new construction remains at only about 15 percent to 20 percent of the 1980s average.

Continued softness in new home prices in key regions of the state, coupled with a large inventory of existing homes on the market, appear to be contributing to the ongoing weakness.

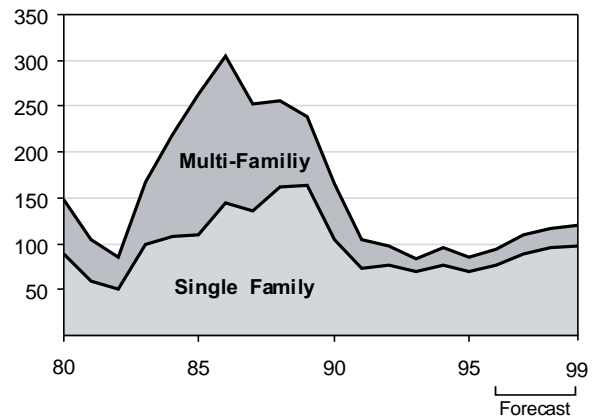
Our forecast assumes that continued job and income growth, coupled with modest increases in home prices, will lead to higher construction rates during the next three years. However, as shown in Figure 5, we project that home construction will remain well below the levels routinely achieved during most of the 1980s.

Although our economic forecast is consistent with the consensus view of economists generally, economic performance over the next couple of years could differ from our projections. For example, although few economists are predicting a recession in the near future, one popular alternative economic scenario is that, given the length of the current national economic expansion, the

Figure 5

Housing Sector Recovering Very Slowly

California Residential Building Permits
(In Thousands)



economy could experience a slowdown. Should this occur, our economic forecast and the General Fund fiscal outlook that we are projecting would prove overly optimistic.

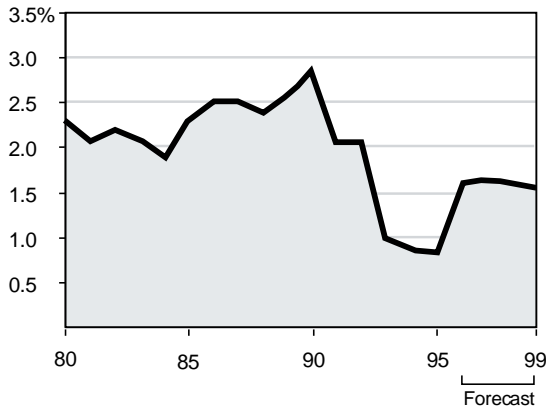
THE DEMOGRAPHIC OUTLOOK

We project that California's population will grow at an annual average rate of 1.6 percent over the next three years (see Figure 6). While this projected rate is about twice the average gain of 0.8 percent experienced during the latter part of the recent recession, it is well below the 2.5 percent average increase that occurred in the rapid growth years of the late 1980s and early 1990s. Numerically, we expect the state to add somewhat over 525,000 persons annually, with total population reaching 34.1 million by 1999.

Figure 6

California's Population to Grow Moderately

Annual Percent Change



Population Growth Components. California's population growth consists of two main components—*natural increase* (births minus deaths) and *net migration* (persons moving into California from other states and nations minus people leaving the state). We project that natural increase will average slightly over 300,000 annually, while net migration will be about 225,000 annually.

Modest Upswing in Net Migration. As Figure 7 shows, net migration is the main reason why the state's population growth has rebounded from its recessionary lows, but nevertheless remains well below its previous peaks. Net migration turned negative during the recession after having exceeded 400,000 previously. This was mainly due to a net *domestic* out-migration to other states, which peaked at 345,000 in 1994 due

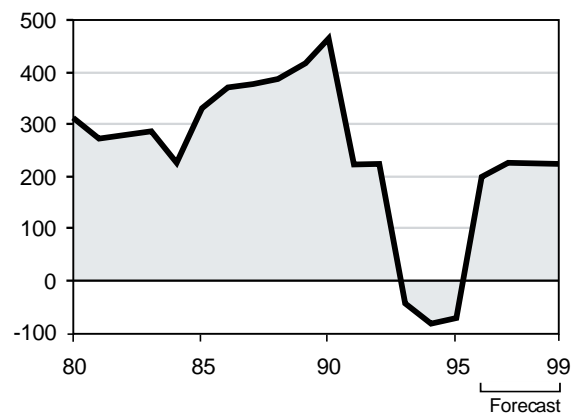
to California's especially severe recession. We expect net domestic out-migration to slow considerably, to about 25,000 per year in the late 1990s. With regard to *foreign* migration, we are projecting a net inflow of 250,000 annually, only slightly less than the average for the first half of the decade.

Growth to Vary by Age Group. Figure 8 (see next page) shows our population growth projections by age category. The most rapidly growing groups are K-12 school-age children (reflecting past birth-rate patterns) and the 45-64 age group (aging baby-boomers). These various age-group projections have significant implications for state expenditures in many different program areas, including education, health, and welfare. For

Figure 7

California Net Migration Turns Positive Following Sharp Decline

Persons (In Thousands)



example, population growth in the 5-17 and 18-24 age groups influence K-12 and higher education enrollments.

