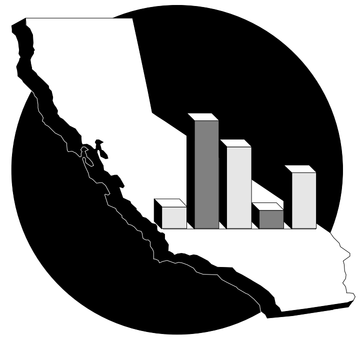


PERSPECTIVES ON THE ECONOMY

Much of the blame for the state's continuing budget shortfalls over the past three years can be placed on the dismal performance of the California economy. The substantial population increases of recent years have maintained constant upward pressure on demands for state services. At the same time, declining employment levels, lower real per capita incomes, and falling property values have limited the ability of the state's major revenue sources to meet these demands. Despite substantial gains in the national economy over the past year, economic activity in most regions of California continues to decline or stagnate. The key questions at this point are:

- When will the California recession end?
- How quickly will employment and income grow thereafter?

CONTRASTING RECENT TRENDS FOR THE STATE AND NATION

The national economy is continuing to recover from the recession that officially ended in the spring of 1991. The interest-sensitive sectors, in particular, have done extremely well over the past seven months. For example, the housing market has accelerated, consumer confidence has rebounded, retail spending has strengthened and the labor market has consistently improved. Overall, current indicators at the national level unambiguously point toward continued economic recovery with low interest rates and low inflation.

The California economy, on the other hand, has stabilized in some areas, but has shown few signs of even the beginnings of a significant recovery. Total nonfarm employment in the state continues to stagnate or drift downward, and the state's unemployment rate remains one of the highest in the nation. Although existing home sales have increased steadily over the past six months, home prices are still falling and construction activity remains very weak. Overall, there is little evidence that the interest-sensitive sectors of the California economy are about to begin the kind of robust cyclical recovery that is needed to offset weaknesses in other sectors of the economy.

National Expansion Still on Course

The national economy, as measured by real Gross Domestic Product (GDP), grew at an estimated annual rate of 5.9 percent in the fourth quarter of 1993, its highest rate since the first quarter of 1987. Much of the recent growth in the national economy can be credited to an improving housing sector that has spilled over into new furniture and appliance sales, helping to boost retail activity and construction-related manufacturing. For instance, existing home sales in 1993 were 7.9 percent above the previous year, driven by low interest rates and resurging consumer confidence. Housing starts climbed 7.1 percent last year to their highest level in four years.

The nation's labor market also shows clear signs of continuing improvement, although there is still weakness in the manufacturing and construction sectors. The national unemployment rate fell to a three-year low of 6.4 percent in December, reflecting the addition of 183,000 new nonfarm jobs, most of them in service industries.

Consumer confidence at the national level climbed to 83.2 percent in January 1994, nearly 25 percentage points above its June 1993 low of 56 percent. This increase helped to bring about a 6.2 percent increase in retail sales for all of 1993, the largest yearly rise since 1989. Improved consumer confidence and retail sales are crucial to a sustained economic recovery because consumer spending accounts for two-thirds of the nation's total economic activity.

Continued low inflation is also a positive sign for sustained growth at the national level. The consumer price index increased by only 2.7 percent for all of 1993, the lowest rise in seven years. Subtracting out the volatile food and energy components, the “core” rate of inflation increased by only 3.2 percent in 1993, its best annual performance in over 20 years.

California Economy Falling Farther Behind

Based on the Department of Finance (DOF) revised payroll employment series, California has lost a total of 868,000 jobs since May of 1990. Over 60 percent of the job losses were in the high-wage manufacturing and construction sectors. These losses resulted from slowdowns in residential and nonresidential building activity, ongoing corporate downsizing and restructuring to meet increased foreign competition, and an acceleration of defense cutbacks and base closures. Unlike previous recessions, California has also lost a large number of jobs in the trade, finance, insurance and real estate sectors.

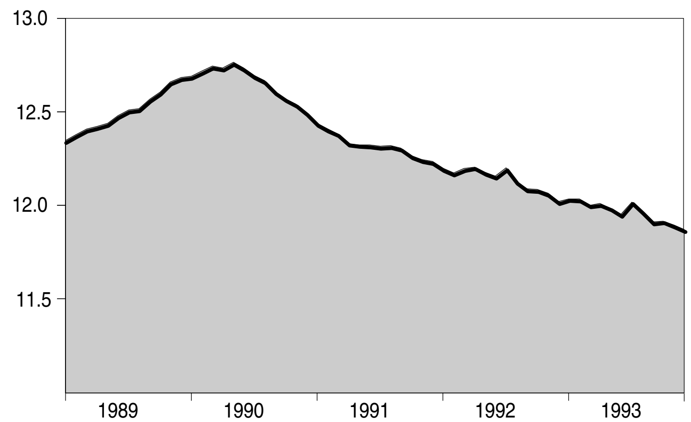
In the past six to twelve months, there has been very little hard evidence that the state economy is poised to begin a significant recovery any time in the near future. In fact, good news is hard to find.

Employment Continues to Fall. From December of 1992 to December of 1993, total payroll employment in California dropped by over 150,000 jobs, as shown in Figure 1. The California unemployment rate, which is based on a separate household survey of all civilian employees and labor force participants, was 8.7 percent last December, one of the highest in the nation, and 2.3 percentage points above the U.S. unemployment rate.

Figure 1

California Nonagricultural Employment 1989 Through 1993

(In Millions)

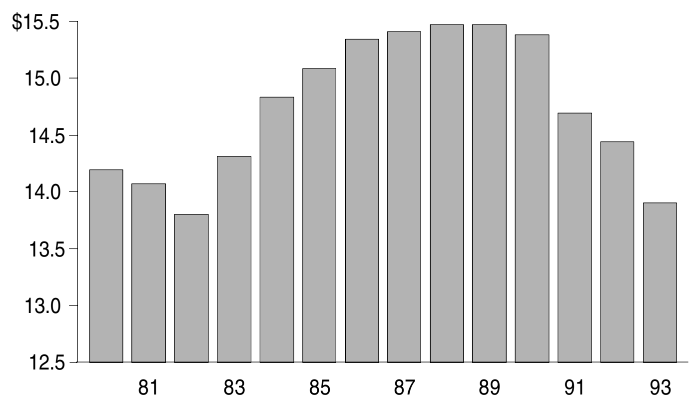


Income Growth Lags U.S. As shown in Figure 2, the level of real per capita income in California has fallen nearly 10 percent during the state's current recession. Over the same period, real per capita income nationally has increased slightly. Although real income levels in the state should begin rising again as the job market and wage rates improve over the next couple of years, California is likely to continue losing ground relative to the nation largely because of the state's declining share of high-wage manufacturing jobs, its faster growing service sector, and the fact that its rapid population growth exceeds the growth in employment potential.

Figure 2

California Real Per Capita Personal Income 1980 Through 1993

(In Thousands)

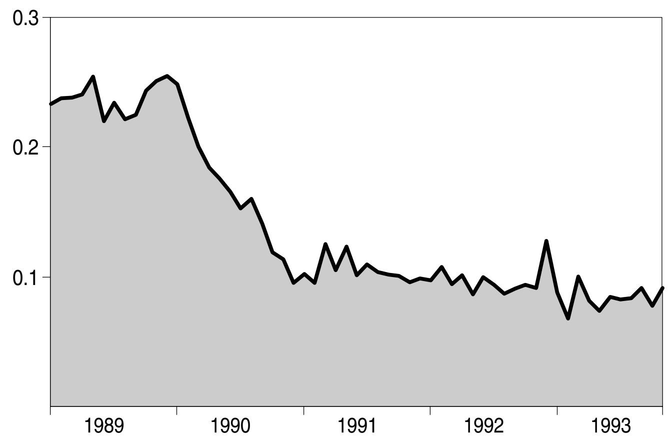


Home Building Slump Continuing. As shown in Figure 3, total housing permits issued in the state have fallen dramatically—by over 65 percent—from their peak in late 1989 to their current level of around 85 thousand units. In addition, the median price of an existing home in California has dropped over 11 percent since its May 1991 peak and is still falling from month to month. Low mortgage interest rates contributed to a moderate increase in home resale activity in the last half of 1993, but this buyer interest has not been translated into increased home building.

Figure 3

California Housing Permits 1989 Through 1993

(In Millions)



Nonresidential Construction Still Sliding. Construction activity in this sector has declined steadily since the beginning of 1990, as shown in Figure 4. Over these past four years, the total volume of nonresidential construction, measured in constant 1987 dollars, has fallen roughly 50 percent. The overbuilding of retail and office space during the 1980s, defense cutbacks, and the severe slowdown in manufacturing activity are primarily responsible for the continued weakness in this sector.

New Vehicle Registrations Flattening Out. After falling by over 20 percent from their 1989 levels, new vehicle registrations appear to have stabilized during 1993. This more positive situation generally reflects a combination of factors, including low interest rates, small price increases for new cars, and the increasing need to replace aging vehicles.

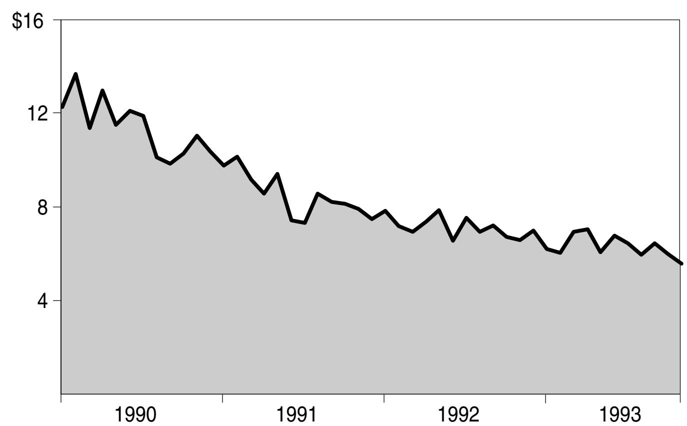
THE GOVERNOR'S BUDGET FORECAST

The DOF's economic forecast assumes the national economy will continue to expand in 1994 and 1995, although at a somewhat slower rate than the pace set in the final months of 1993. The DOF forecast for California, on the other hand, assumes continuing defense spending cuts and military base closures will generate only a small employment turnaround later this year.

Figure 4

Nonresidential Permit Valuations 1990 Through 1993

(In Billions of 1987 Dollars)



The DOF National Outlook—Continued Moderate Expansion

The DOF forecast for the national economy is generally consistent with the consensus view of other national forecasters. Growth in real GDP is expected to moderate from an annual rate of 5.9 percent in the fourth quarter of 1993 to a more sustainable 3 percent average in 1994. This lower growth rate assumes some slowing in retail sales early this year as consumers postpone new purchases to allow income to catch up with late-1993 spending increases. It also reflects the impact of federal tax increases for high-income taxpayers enacted as part of the Clinton Administration's 1993 deficit reduction package. These retroactive tax increases will reduce spendable incomes in 1994 both because of higher payments due on 1993 tax returns and because of the increased withholding and estimated tax payments that take effect this year.

The Department of Finance forecast for 1995 projects real GDP at the national level to continue in the 3 percent range. This assumes recoveries in

Europe and Japan will provide an extra boost to the U.S. economy, and that consumer spending, after slowing somewhat this year, will pick up modestly. Inflation and interest rates, which declined to record low levels during the recession and early recovery periods, will drift upward through 1995, as recoveries in other industrial economies put upward pressure on commodity prices. The Federal Reserve is expected to react to increased inflationary pressures by raising interest rates.

The DOF California Forecast—Defense Cuts Limit Growth of State Economy

The Department of Finance holds "huge cuts" in defense spending primarily responsible for California's massive job losses since 1990, and considers them to be the main obstacle to an economic recovery in the state. The principal question posed by the department's forecast is "...when and whether other elements in the state's economy can muster sufficient strength to overcome the continuing drag of defense cuts."

Figure 5 compares the growth rates for California nonagricultural employment and personal income projected by the Department of Finance in 1994 and 1995 to those of other forecasters. As shown in this figure, the DOF's forecast of aggregate economic growth in the state over the next two years, as measured by employment and income, falls generally in the middle of the range of these forecasts. Apart from relatively minor differences in growth rates, these forecasters all call for continued employment *declines* this year (in the range of 0.2 percent to 1.1 percent) followed by, at best, a weak recovery in 1995. Although these forecasts all project declines in state nonfarm employment in 1994, this represents a significant *relative* improvement in the state's economy when compared to much larger employment declines in the previous three years.

Figure 5

Comparison of California Economic Forecasts 1994 and 1995

	1994		1995	
	Employment	Personal Income	Employment	Personal Income
Department of Finance	-0.6%	4.0%	0.7%	5.0%
UCLA Business Forecasting Project	-0.2	3.6	1.3	3.4
Western Blue Chip Economic Forecast	-0.2	4.3	NA	NA
Commission on State Finance	-0.7	4.6	1.1	5.1

The Department of Finance identifies some "bright spots" in its California forecast which it states may be sufficient this year to offset the continued drop in defense outlays. These include: an upturn in housing related to lower mortgage interest rates; stronger gains in the state's healthy tourism, entertainment and recreation industries; and improved foreign trade. On the *negative* side, the department indicates that military base closings could be a renewed source of weakness next year. Three bases are scheduled to close in 1995, representing a loss of over 32,000 civilian and military jobs. The department also anticipates further declines in aerospace and electronics, continuation of corporate restructuring and downsizing efforts, and slow gains in retail and wholesale trade.

No Immunity From Effects of Health Plan. Although the DOF budget forecast does *not* take into account the Clinton Administration's proposed national health plan, the department does state that the plan, as currently specified, could have a "significant dampening effect" on the California economy. However, we note that the Clinton plan does not require state implementation in 1995-96, and its economic effects could be positive or negative, depending upon the specifics of the legislation. (Please see our policy brief on National Health Insurance Reform.)

THE LAO FORECAST

In this section, we provide our forecast of the California economy, both in the near-term and future prospects.

Figure 6 compares the Legislative Analyst's forecasts for selected economic variables to the DOF forecasts for 1994 and 1995. Our U.S. forecast assumptions are for slightly stronger real gross domestic product (GDP) growth in 1994—3.0 percent versus 2.8 percent—and somewhat weaker GDP growth in 1995—3.0 percent compared to 3.4 percent. The chief downside risks to this forecast are much weaker foreign recoveries, principally in Germany and Japan. Other risks at the national level include prospects for further federal deficit reduction and steeper defense cuts.

California Economy Remains Weak Through 1995

The LAO California economic forecast projects somewhat weaker growth in both 1994 and 1995 than contained in the DOF forecast. For example, we assume that total nonagricultural employment in the state, which fell by 1.5 percent in 1993, will decline by another 1.1 percent in 1994 and will remain virtually flat in 1995. This compares to the department's forecast of a 0.6 percent employment decline in 1994, followed by a 0.7 percent *increase* in employment in 1995.

Figure 6

Comparison of Selected Forecast Data 1994 and 1995

	1994		1995	
	DOF	LAO	DOF	LAO
United States[a]				
Real GDP (%change)	2.8	3.0	3.4	3.0
Personal income (% change)	5.4	6.5	5.9	6.9
Nonagricultural employment (% change)	1.5	2.1	2.1	2.4
Unemployment rate (%)	6.6	6.4	6.2	6.3
Consumer price index (% change)	2.9	2.9	3.6	3.2
California				
Personal income (% change)	4.0	3.6	5.0	4.3
Nonagricultural employment (000)	11,902	11,830	11,987	11,827
Percent change	-0.6	-1.1	0.7	0.0
Unemployment rate (%)	9.6	9.3	9.5	9.5
Housing permits (000)	102	98	124	126
Percent change	19.6	15.3	21.4	28.2
Corporate profits before taxes (billions)	47.1	44.0	50.3	45.8
Percent change	2.8	-2.0	6.8	4.2
New vehicle registrations (000)	1,262	1,231	1,280	1,259
Percent change	1.3	-1.1	1.4	2.2
Total taxable sales (billions)	276.9	279.0	286.6	289.6
Percent change	1.8	2.6	3.5	3.8
Consumer price index (% change)	2.7	2.7	3.8	2.8

[a] The Legislative Analyst's Office U.S. forecast is based on the WEFA Group's December 1993 standard U.S. forecast.

Figure 7 compares the employment forecasts of the Department of Finance and the Legislative Analyst's Office. As shown in this table, our forecast assumes that employment in mining, manufacturing, trade and government will continue to decline through 1995. Although these areas of weakness should be offset by modest recoveries in other sectors of employment, primarily construction and services, we do not expect any significant increases in total nonagricultural employment until the end of this two-year forecast period.

Figure 7

Comparison of California Employment Forecasts (Percent Change)

	Share of Jobs[a]	1994		1995	
		DOF	LAO	DOF	LAO
Total Nonagricultural Employment	100.0%	-0.6	-1.1	0.7	0.0
Mining	0.3	-1.9	-5.4	1.6	-3.0
Construction	3.8	-0.9	-0.3	4.6	2.8
Manufacturing	15.0	-2.4	-4.4	0.5	-2.4
Aerospace	(1.9)	-13.9	-15.5	-11.1	-10.8
Electronics	(2.5)	-1.0	-3.5	2.5	-0.9
Transportation/Utilities	5.0	-1.0	-0.9	0.3	0.9
Trade	23.2	-0.9	-1.8	1.3	-0.2
Finance, Insurance, Real Estate	6.5	0.5	0.0	0.8	0.8
Services	28.8	1.2	0.8	1.8	1.4
Government	17.3	-1.6	-1.1	-2.4	-1.3
Federal Civilian	2.7	-4.2	-4.6	-6.1	-4.3
State & Local	14.6	-1.1	-0.5	-1.7	-0.8
Unemployment Rate (%)		9.6	9.3	9.5	9.5

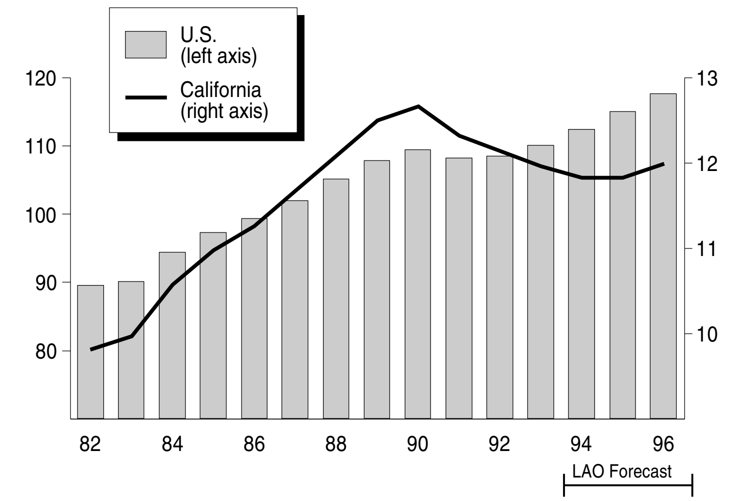
[a] Detail does not add to total due to rounding.

No Rebound Until Late 1995 or Early 1996. Overall, we believe that the DOF forecast for the California economy is consistent with its assumptions that (1) manufacturing employment will level off this year and turn upward in 1995, and (2) home building activity and construction employment will begin a slight recovery this year and grow at a significantly faster pace in 1995. As reflected in our forecast, however, we believe there is at least an *equal possibility* that defense cuts, weak exports, foreign competition and additional restructuring could lead to *continuing* declines in the state's manufacturing sector over the next two to three years. There also is a significant risk that persistently falling home prices, combined with weak job growth and low confidence levels, will delay a significant housing turnaround until early 1995. Under these conditions, residential construction activity may not be strong enough to offset continued weaknesses in the manufacturing and nonresidential construction sectors until the second half of 1995. Under these assumptions, as shown in Figure 8, our forecast indicates that no significant economic growth would occur until late 1995 or early 1996.

Figure 8

Total Nonagricultural Employment Forecast 1982 Through 1996

(In Millions)



Manufacturing Employment Continues to Decline. Slow or declining manufacturing employment growth has been a major source of structural weakness in the California economy. Employment in the manufacturing sector, as a percent of total nonagricultural employment in the state, dropped from nearly 21 percent in 1979 to 15 percent in 1993, and our long-term projections indicate it could drop to 13 percent by the year 2000. Much of this decline reflects trends that are occurring nationally, including fierce global competition, the increasing use of labor-saving equipment, and widespread corporate downsizing and restructuring. These factors have been compounded in California by disproportionately large defense cutbacks in the state, relatively high property values and wage costs, and at least the perception of a more onerous "business climate." Figure 9 compares historical and projected California and U.S. manufacturing employment.

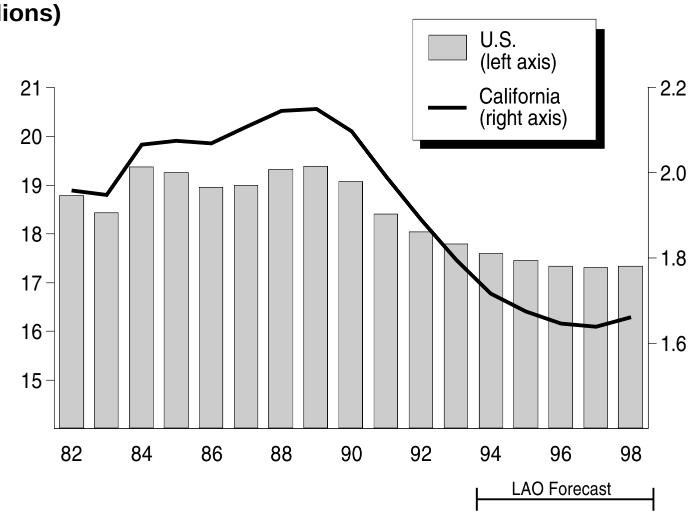
Our forecasts indicate that total manufacturing employment in California could continue to decline through at least the end of 1996. Defense-related aerospace and electronics industries are the principal areas of weakness within the manufacturing sector. Manufacturing employment is not expected to begin a significant recovery either in California or nationally until

1997 and beyond, when it is assumed defense cutbacks will have largely run their course.

Figure 9

U.S. and California Manufacturing Employment Forecast 1982 Through 1998

(In Millions)



Nonresidential Construction Activity Remains Weak. Nonresidential construction activity in California has been either flat or declining since 1986, largely reflecting the overbuilt office and retail markets, cutbacks by defense contractors, and declining employment in the manufacturing sector. As shown in Figure 10, our forecast assumes that total nonresidential construction volume will increase only nominally this year (by a mere 0.3 percent) and by a slightly healthier pace in 1995. The lackluster outlook reflects continued declines in office and retail construction activity offset by some growth in the market for industrial buildings.

Housing Market Key to Short-Term Recovery. Given the potential for continuing structural weakness in California's manufacturing sector, the best chance for a near-term economic recovery in the state is a significant cyclical rebound in new home construction (as expected by DOF). This, in turn, would spur growth in construction employment, building material sales, real estate and financial services, and other building-related activities. Although record-low mortgage rates are expected to lead to some gradual improvement in the state's home building sector this year, particularly in the lower-priced entry level market, we believe a significant cyclical recovery in the California housing market is unlikely to occur until home prices stabilize and begin to at least keep pace with inflation. As discussed earlier, recent data indicate that median home prices statewide, and particularly in southern California, are still falling from month to month. We expect this trend to continue until California's home prices, which were pushed to record highs by speculative buying in the late 1980's, return to more sustainable levels relative to home prices nationally.

Figure 10

Inflation-Adjusted Residential and Nonresidential Permit Valuations 1982 Through 1996

(In Millions)

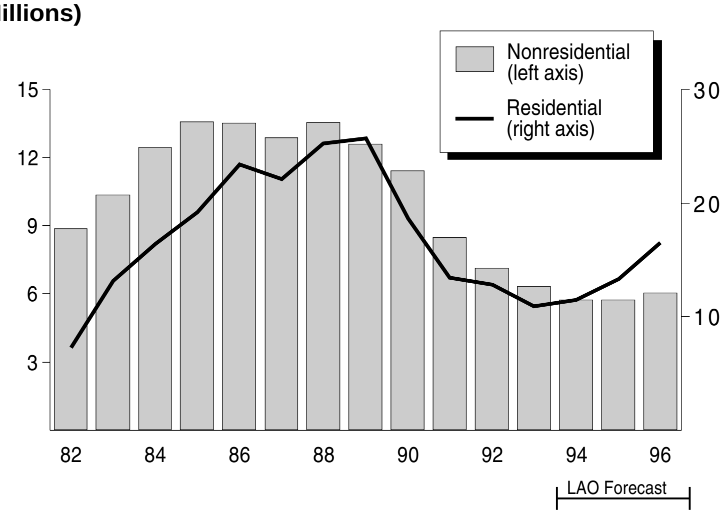
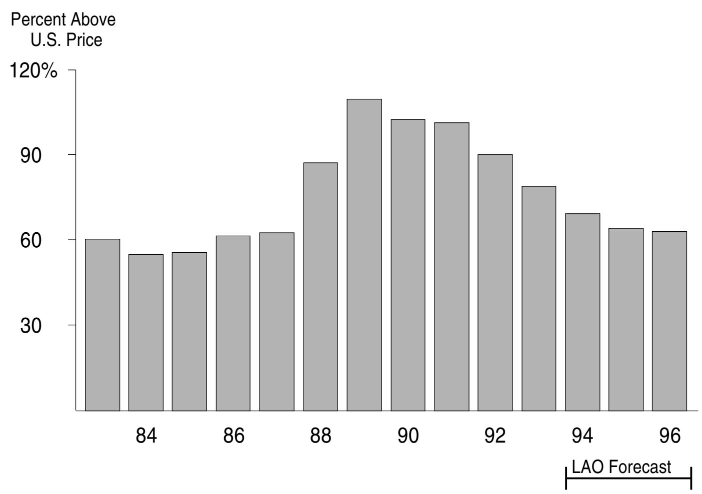


Figure 11 shows the relationship of the median home price in California to the median home price nationally. Between 1980 and 1987, California homeowners paid a relatively stable "premium" for living in the state, averaging about 60 percent above the national median home price. In just two years of skyrocketing prices, however, this premium jumped to its peak level of 110 percent in 1989. In other words, a median-priced home in California cost more than twice as much as the median-priced home for the nation as a whole. As a result of a significant decline in California home prices beginning in 1990, this premium has fallen to around 80 percent in 1993. We assume home prices in California will continue falling through the end of 1994, until they are more in line with their historical relationship to national home prices. Beginning in early 1995, moderately rising home prices in California—combined with more affordable price levels, low mortgage rates, stabilized employment levels, and rising real incomes—are expected to spur a significant upturn in the single-family home building sector. The resulting rebound in construction and related activities should be sufficient to offset continuing weakness in the manufacturing and nonresidential construction sectors, and precipitate some growth in the broader California labor market beginning in the second half of 1995.

Figure 11

California Home Price "Premium" 1983 Through 1996

(In Billions)



The Northridge Earthquake—Significant Downside Risks?

The 6.6 magnitude earthquake that struck the Northridge area of Los Angeles County in January undoubtedly will have a significant impact on the state's economy over at least the next several years. Estimates of the total damage to homes, freeways, commercial structures and other property in southern California currently range in the tens of billions of dollars, which would make the quake one of the most expensive natural disasters in the history of this country. Because of the difficulties in identifying and measuring all of the divergent economic effects of a disaster of this magnitude, we have not attempted to quantify the impact of the earthquake on our forecasts of the California economy. On balance, however, we believe it is likely the quake could add significantly to the *downside* risks of both the administration's and our economic forecasts for California. Although the extensive rebuilding program will provide an immediate boost to southern California's construction industry and construction-related businesses, this could be more than offset by transportation and trade disruptions, commuting logjams, declines in tourism, and other fallout from the quake. The most likely negative regional impacts are increased unemployment, lower incomes and retail sales, and reduced property values.

The potential risk to our statewide forecast over the course of the two-year period is for significantly weaker service and trade employment—partially offset by higher construction-related employment—and lower levels of *new* construction activity. Statewide economic growth also would be dampened to the extent funds to cover uninsured earthquake losses come from increased state taxes or private sector resources that would otherwise be available for consumption and investment spending.

An important concern over the *longer run* is how much the earthquake could further damage the image of the Los Angeles area, which has been battered repeatedly by a series of major disasters in recent years. The key question is whether the *cumulative* effects of these disasters will have a lasting impact on the ability of the Los Angeles area to attract new businesses, investment capital, home buyers, tourists, and skilled employees. Over the long run, however, it is unlikely that the Northridge earthquake, by itself, will significantly alter the direction of economic growth in the region and the state.

The Longer Term Outlook—
Brighter Prospects Ahead for California?

Figure 12 compares our California and national forecasts of total nonagricultural employment through the end of the decade. After a period of stabilization and weak growth over the next couple of years, the California economy should start showing some significant strength as we enter the latter half of the decade, with total payroll employment growing in the 2 percent to 2.5 percent range each year and real personal income increasing by over 3 percent annually. Even at these growth rates, it will take five to six years for the *level* of total California nonagricultural employment to regain its 1990 prerecession peak. In contrast, employment at the national level has already surpassed its prerecession peak.

This long-term outlook assumes (1) a substantial pickup in residential and nonresidential construction activity beginning in 1996, as California home prices resume a moderate upward trend and excess retail and office space is absorbed, and (2) a turnaround in manufacturing employment beginning around 1997, reflecting the end of defense cutbacks and corporate restructuring.

Figure 12

Long-Term Outlook
California and U.S. Nonagricultural Employment
1982 Through 2000

(In Millions)