

PERSPECTIVES ON THE ECONOMY

The economic outlook, in combination with demographic trends, is a primary determinant of California's fiscal condition. This is because these factors affect both state revenues and expenditures. Particularly significant is the fact that economic developments such as the growth in jobs, income, and retail spending translate into corresponding changes in revenues from the state's various taxes. For example, the severe California recession of the early 1990s depressed state revenues and contributed to major budget shortfalls, while the subsequent economic recovery translated into improved revenue and fiscal conditions in 1994-95 and 1995-96.

A key question with respect to the 1996-97 budget outlook is whether California will continue to experience solid economic growth, especially in light of a slowing national economy. In this part, we review 1995's economic performance, summarize the economic assumptions underlying the 1996-97 Governor's Budget, and provide our own perspective on the U.S. and California economic outlooks.

1995 ECONOMIC PERFORMANCE IN RETROSPECT

The Nation's 1995 Performance

Over the past year, U.S. economic growth slowed in response to monetary tightening undertaken by the Federal Reserve in late 1994. These actions were taken in order to avoid a downturn and provide for continued economic expansion without future inflation. Infla-

tion-adjusted gross domestic product (GDP) rose by a bit over 3 percent during 1995, down from the 1994 rate of about 4 percent. The slowdown in the underlying trend was even more pronounced than these data suggest because part of the 1995 GDP growth was related to an unintended build-up in business inventories in the third quarter of the year. Reports of weak employment, production, orders, and sales during the final weeks of 1995 suggest that economic growth slowed sharply—to around 2 percent by year-end.

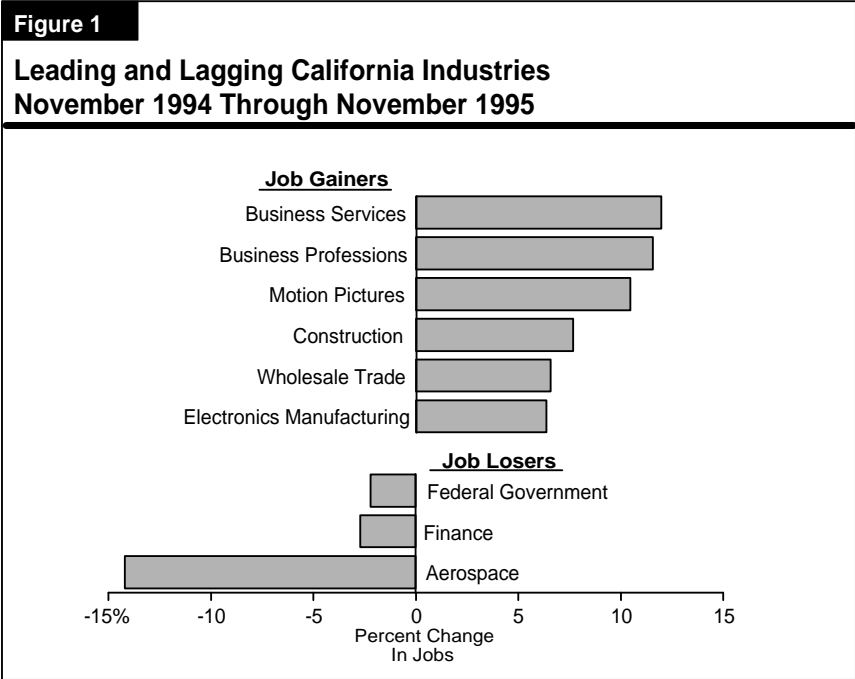
The limited economic data thus far available for January suggest that 1996 is starting on a soft note as well. For example, the national employment report for January showed that jobs fell and the unemployment rate rose during the month. Analysts believe that much of the job decline was due to the temporary effects of the unusually harsh weather in the northeast and, therefore, does not have significant implications for the U.S. outlook. However, if the drop is indicative of a more fundamental weakening of the U.S. economy, it would have negative implications for current national forecasts, including our own.

One of the most positive developments over the past year has been the continued good news on inflation. The consumer price index (CPI) increased just 2.8 percent in 1995, the third consecutive year below 3 percent and the second lowest increase in 30 years. Partly in response to the positive inflation developments, long-term interest rates declined over the year, with 30-year U.S. Treasury bond yields falling below 6 percent at year-end.

California's 1995 Performance

In contrast to the slowing national economic trend, the California economy accelerated in 1995. The state added over 340,000 jobs during the past year, with almost every major industry experiencing increases. As indicated in Figure 1, the fastest-growing economic sectors were business services and professions, motion pictures, construction, wholesale trade, and electronics manufacturing industries.

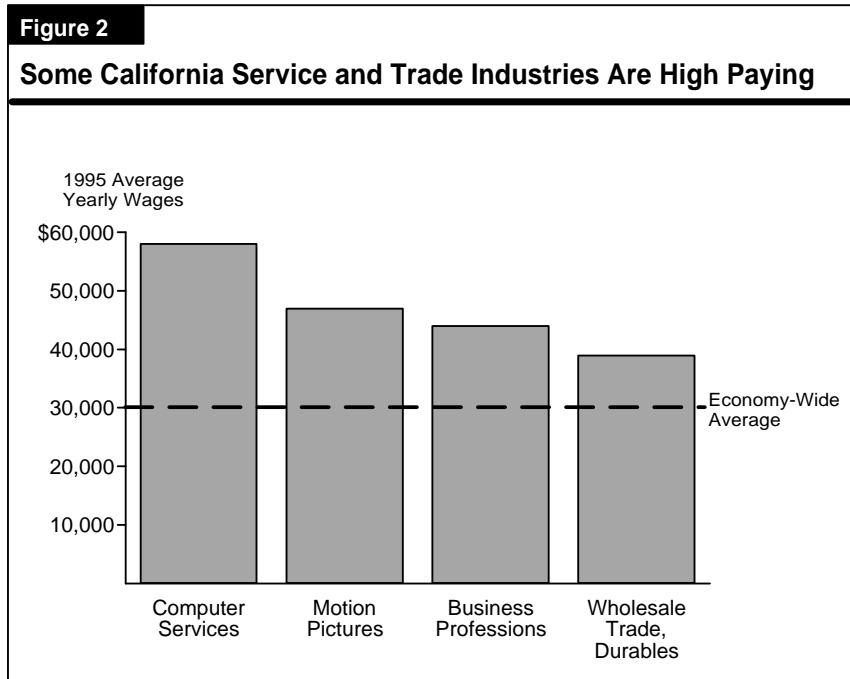
Industries losing jobs included aerospace, which continues to be affected by national defense cutbacks; the combined finance, insurance, and real estate sectors, which continue to undergo consolidations and restructurings nationwide and in California; and the federal government sector, which is being negatively affected by defense base closures.



Many but Not All New Jobs Are High Paying

A key theme of the Governor's economic outlook (see below) is that job growth in California is being led by gains in high-paid, high-skilled occupations. Our review of job and wage data for 1995 suggests that the picture has been somewhat more mixed. We specifically found that (1) most of the jobs *lost* over the past two years have been in high-paying aerospace and financial services industries; (2) the job *gains* have been in a mixture of low-paying and high-paying occupations; and (3) the average annual wage of all jobs gained has been near the economy-wide average of about \$30,000.

Nevertheless, it is true that an encouraging number of high-paying jobs are being created in California—even in the trade and services sectors. As indicated in Figure 2 (see page 20) computer services (which is a subcomponent of the business services category shown in Figure 1) has an average yearly wage of \$58,000, nearly double the economy-wide average. Motion pictures, professional services, and wholesale trade also are high-paying sectors.



California's Recent Performance Has Outpaced Expectations

California's economic performance in 1995 was significantly stronger than expected by most forecasters. For example, Figure 3 shows that the employment gains in the past year have far surpassed those expected in the May Revision forecast, which itself was slightly above the consensus view of economists at that time. The recent employment increases have been particularly encouraging in view of the lack of a meaningful recovery in the state's real estate industry last year, where homebuilding remained near historic lows and home prices continued to decline in many regions of the state.

THE BUDGET'S ECONOMIC FORECAST IN BRIEF

The budget's national and California economic forecasts are summarized in Figure 4.

Figure 3

California Job Performance Has Exceeded Expectations

(In Millions)

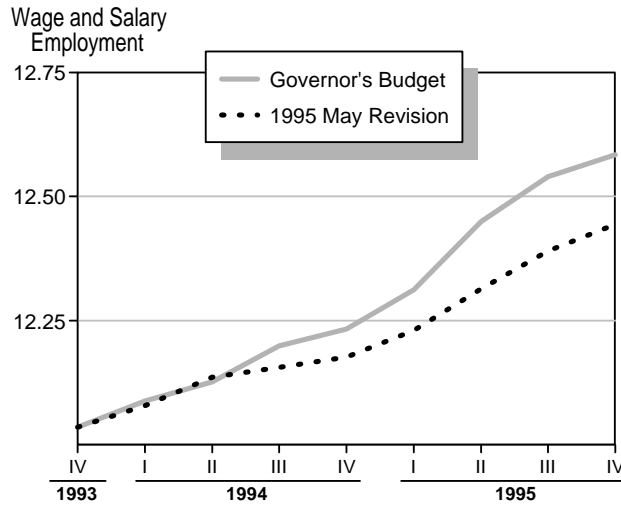


Figure 4

Summary of the Department Of Finance Economic Outlook

	Actual 1995	Projected	
		1996	1997
United States Forecast			
Real GDP (percent change)	3.3%	2.5%	2.6%
Unemployment rate (%)	5.6	5.8	6.0
Federal funds interest rate (%)	5.8	5.3	5.5
California Forecast			
Percent change in:			
Personal income	7.6%	5.7%	5.9%
Wage and salary jobs	2.5	2.6	2.3
Consumer price index	1.8	2.3	2.6
Unemployment rate (%)	7.8	7.3	6.9
New housing permits (000)	88.0	113.0	133.0

The Budget's National Outlook

The Department of Finance's national economic forecast reflects the consensus view of private economists as of year-end 1995. It assumes that, after slowing sharply in the fourth quarter of 1995, the national economy will settle into a trend of moderate growth and low inflation during the next two years. The department specifically forecasts that real GDP will increase by 2.5 percent in 1996 and 2.6 percent in 1997, a modest slowing from the 3.3 percent growth experienced in 1995. Unemployment is projected to trend slightly upward to around 6 percent by 1997, as labor force growth slightly exceeds the pace of job growth. Both inflation and interest rates are projected to remain relatively low.

The Budget's California Outlook

The department's California economic forecast assumes that the state's current positive trends will continue, and that our economy will expand at a moderate rate during the next two years. As indicated in Figure 4, the administration projects that wage and salary employment will increase by 2.6 percent in 1996 and 2.3 percent in 1997, while personal income will expand by 5.7 percent and 5.9 percent during the two respective years.

The budget's projections for the U.S. and California are generally consistent with others prepared near the end of 1995, including the forecasts in our November 1995 publication *California's Fiscal Outlook*. In the following sections, we provide the Legislative Analyst's Office's (LAO's) perspective on the U.S. and California economies—including an update of our November forecast—and contrast the budget's economic projections with our own.

THE LAO'S OUTLOOK FOR THE ECONOMY

The National Forecast

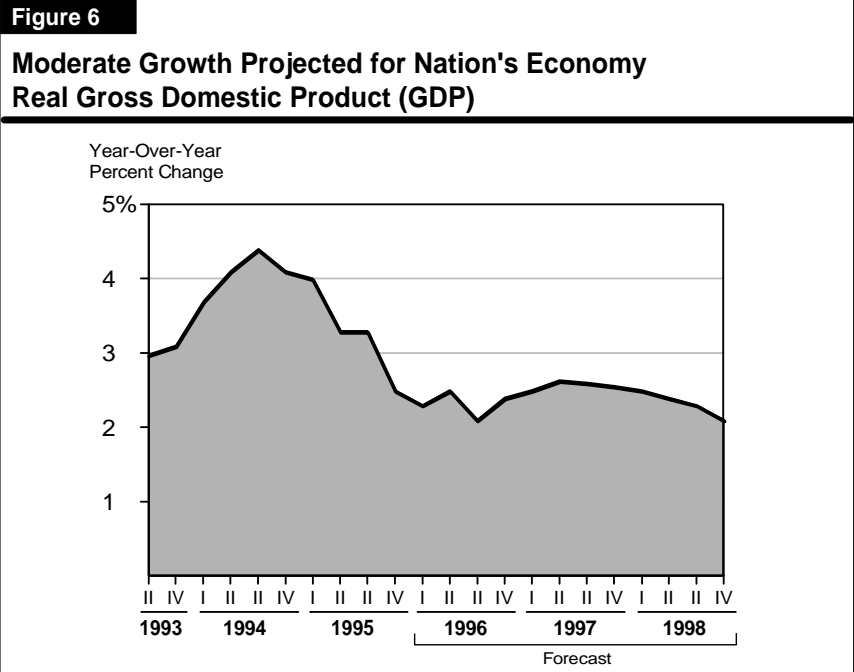
Figure 5 summarizes the LAO's current economic forecast. Based on recent developments, we have made relatively minor adjustments in updating our November forecast for the nation. We have slightly lowered our near-term outlook, reflecting somewhat weaker-than-expected retail spending during the 1995 Christmas shopping season. However, we continue to believe that U.S. economic growth will stabilize in the range of 2 percent to 2.5 percent over the next three years (see Figure 5 and Figure 6).

Figure 5

Summary of the LAO's Economic Outlook

Percent Change (Unless Otherwise Indicated)

	1995	1996	1997	1998
United States				
Real GDP	3.3	2.4	2.4	2.4
Wage and salary jobs	2.3	1.4	1.5	1.5
Consumer Price Index	2.8	2.6	2.7	2.9
Unemployment rate (%)	5.6	5.9	6.0	6.1
Housing starts (000)	1,331	1,379	1,390	1,320
California				
Personal income	7.9	6.0	5.8	5.5
Wage and salary jobs	2.5	2.4	2.3	2.3
Consumer Price Index	1.8	2.4	2.7	2.9
Population	1.3	1.5	1.6	1.6
Unemployment rate (%)	7.9	7.4	6.8	6.5
Housing permits (000)	88	112	128	145



A key positive factor is the current low-inflation environment, which will provide the Federal Reserve with the latitude to adopt more expansionary monetary policies if necessary to keep the U.S. economy on a growth path. Thus, as Figure 7 shows, we expect interest rates to remain moderate.

Figure 8 indicates that other positive factors in the outlook include rising demand for U.S. exports, which will be bolstered by an improvement in the economies of our major trading partners, and a continuation in the growth of business fixed investment spending (which includes business purchases of computers and other equipment, as well as new construction spending). Slower growing sections include consumer spending, which is being constrained by high debt levels, and federal government purchases, reflecting ongoing efforts to reduce the federal deficit.

Economic Forecasts

Both the Legislative Analyst's Office's and the Department of Finance's U.S. economic forecasts were prepared prior to the release of the revised National Income and Product Accounts by the U.S. Bureau of Economic Analysis. These revisions include a change in the way that real output and prices are measured in the economy. Specifically, the new measures will use what economists call a "chain-weighted" index for calculating price changes, instead of the traditional "fixed-weighted" index. The new index is designed to more accurately reflect the changing spending patterns taking place in areas of the economy undergoing major price and technological changes, particularly the computer industry.

These revisions are expected to subtract about one-half percentage point from the measurement of real growth and add about one-half percentage point to the inflation rate during 1996 and 1997. Thus, for example, the administration's current forecast of real gross domestic product (GDP) growth of 2.5 percent in 1996 would be equivalent to about 2 percent under the new chain-weighted methodology. Therefore, it is likely that future economic forecasts of real GDP based on the revised economic data will be lower than the current forecasts, which are based on unrevised data. This would occur even if the underlying economy is unchanged. These changes relate solely to the measurement of GDP and its components in the U.S. product accounts. They should have no impact on national income or employment measurements, nor will they have any direct impact on the data variables included in our California economic outlook.

Figure 7

**U.S. Inflation and Interest Rates to Remain Moderate
1989 Through 1998**

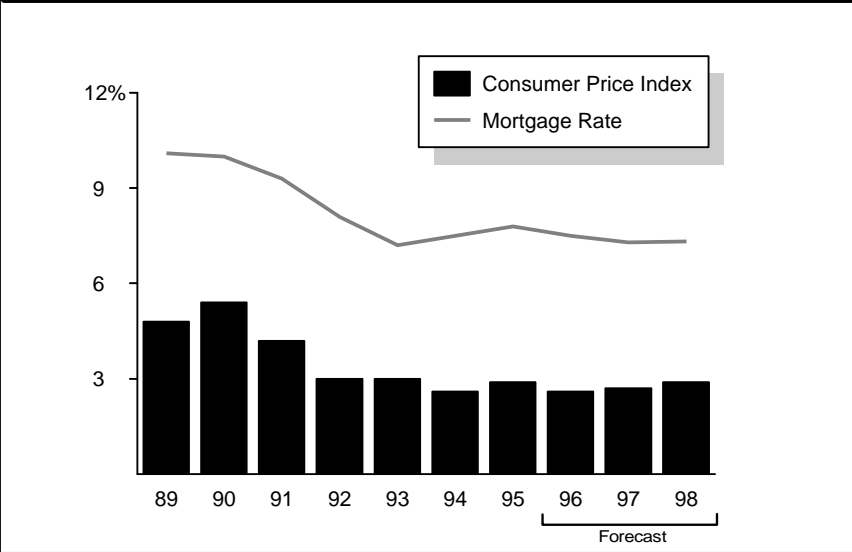
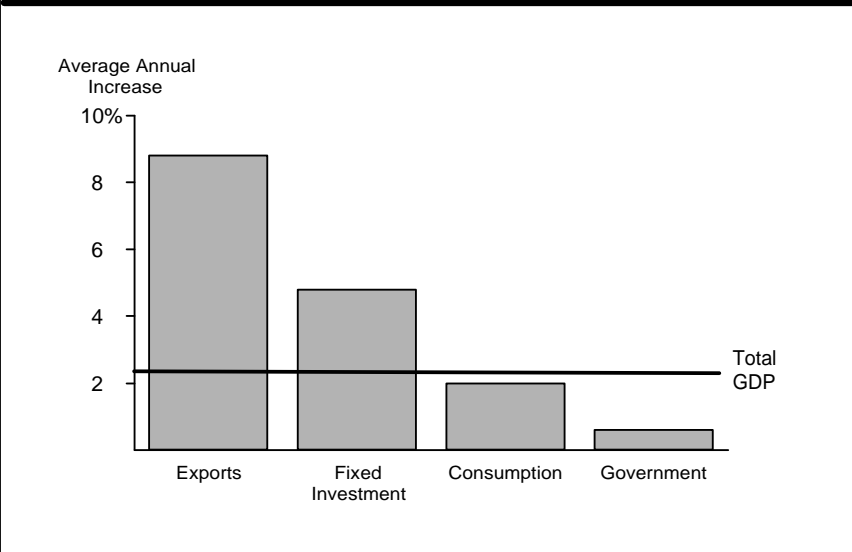


Figure 8

**Exports and Investment to Lead U.S. Economy
1995 Through 1998**



Implications of National Outlook for California

Despite the outlook for a slowing growth, the national economic environment remains, on balance, positive for California. Above-average U.S. export growth will aid a variety of key California industries that benefit from expanding international trade, including wholesale trade (which includes import/export firms), computers, electronic components, and transportation. Similarly, U.S. business investment in “high-tech” areas also will bolster employment and sales in California's important high-technology industries.

The LAO's California Economic Outlook

We project that California's recent job growth trends will continue during the next three years. As shown in Figure 5 (page 23), we forecast that wage and salary employment will increase at an average annual rate of about 2.3 percent from 1996 through 1998, while personal income will grow by an average of about 5.8 percent per year. Most industries and most regions of the state are expected to experience growing employment and incomes. The majority of the new jobs will continue to be in the services and trade sectors, while aerospace and finance, insurance and real estate will continue to experience job declines.

California to Outpace Nation

As indicated above, we expect California to outpace the nation in each of the next three years, reflecting the state's favorable mix of industries, and the fact that California is currently in an earlier stage of its economic cycle than is the rest of the nation. This is illustrated using employment data in Figure 9, which compare recent and forecasted job performance for California and the nation. As the figure indicates, California's performance fell short of the nation's in the early stages of the current economic expansion, but the trends are now reversing.

Population Growth to Rebound

We project that California's population will grow at an average annual rate of about 1.6 percent over the next three years, from 32.6 million in 1995 to 34.1 million by 1998. This projected increase is up significantly from the 1.3 percent average growth experienced during the 1992 through 1994 period. The key reason for the acceleration is an anticipated increase in net migration from other states and countries. As shown in Figure 10, total net migration into California fell sharply during the state's recent recession, reflecting net out-migration of people

Figure 9

California Nonagricultural Employment To Grow Faster Than Nation

(In Millions)

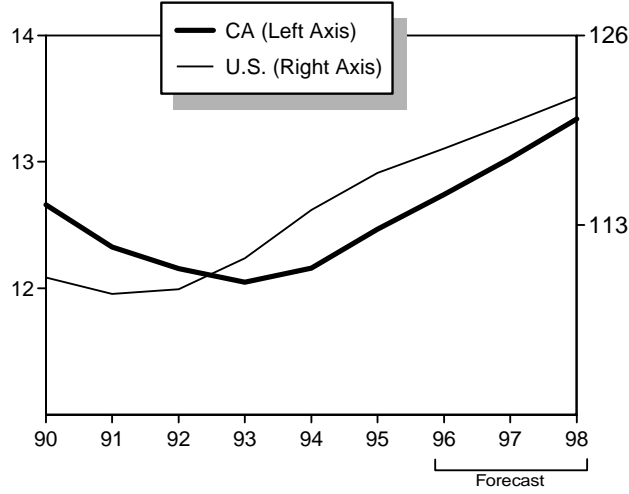
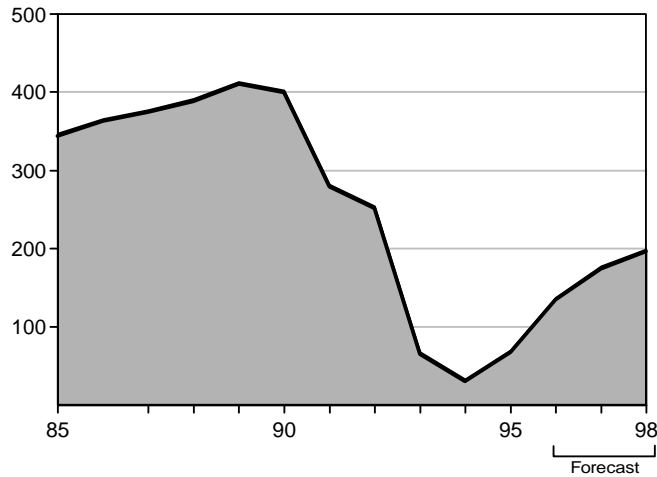


Figure 10

California Net Migration to Partially Rebound 1980 Through 1998

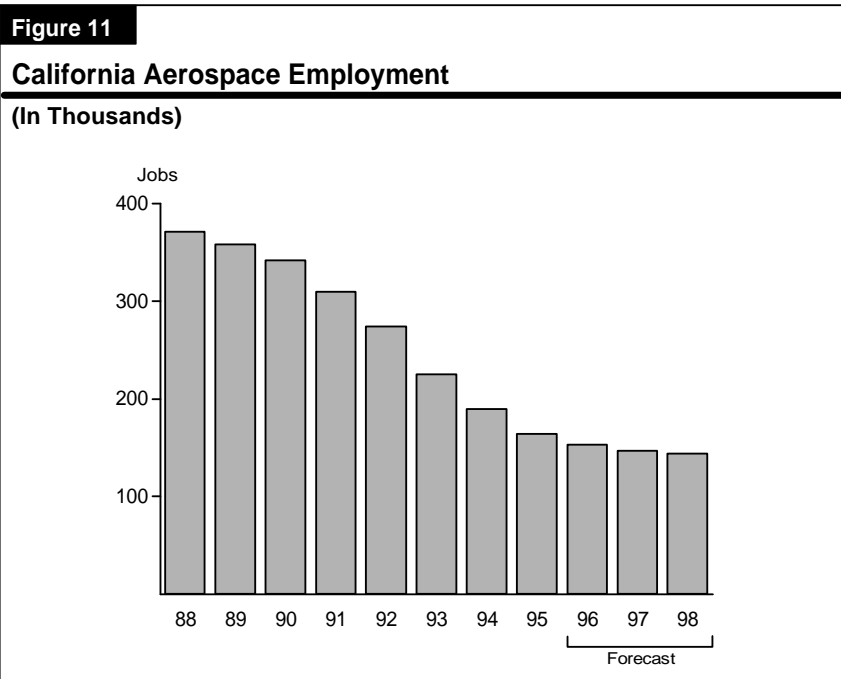
(In Thousands)



to other states, and a slowdown in in-migration from other countries. However, with the improvement in the California economy, we expect net migration to partially rebound over the next three years. This in turn will contribute to a rise in the state's overall population growth rate.

Aerospace Job Losses Subsiding

One of the major factors contributing to the length and depth of California's recent recession was the loss of aerospace jobs. At the peak of the defense build-up in the 1980s, the aerospace industry in California (which includes firms engaged in the production of aircraft, missiles, satellites, and navigation equipment) employed around 390,000 workers. However, the end of the cold war and the national defense "build-down" caused a significant drop in aerospace employment starting in the late 1980s (see Figure 11). The employment declines in this relatively high-paying industry have affected many regions of California, but particularly Los Angeles, which employed nearly 40 percent of California's aerospace workers in the mid-1980s.



On a more positive note, recent developments provide evidence that the worst of the defense cutbacks are over. Employment declines have subsided over the past eight months, and recent orders for military and commercial aircraft produced in California will boost aircraft-related jobs in the state. Overall, we estimate that aerospace employment will continue to decline, but at a much more modest rate. Thus, while aerospace cutbacks will continue to dampen economic growth in California, they will be less of a negative factor than in the recent past.

Housing Has Been Disappointing

Housing is one of the more important sectors in California's economy, given that California is a growing state and residential construction generates considerable numbers of jobs and related economic activity. One of the most disappointing aspects of the California economy over the past several years has been the housing sector. Recoveries from the 1974-75 and the 1980 to 1982 recessions were characterized by dramatic gains in home sales and new construction. However, housing has lagged in the current recovery, with new home construction in 1995 actually falling from the prior year to the third lowest level in the past three decades.

A key factor depressing the housing market has been ongoing declines in home prices. The California median home price has fallen by nearly 20 percent since reaching a peak in 1991, and some geographic areas of the state have experienced declines approaching 30 percent. These declines have resulted in losses in home equity values to homeowners, thereby reducing the amount of available "cash" they have for trading up to higher value homes or to spend for other purposes. In addition, the declines have made prospective home buyers wary of future losses in home equity, and thus has made some reluctant to buy. Finally, the price declines are contributing to a sharp rise in home foreclosures, which in turn is putting further downward pressure on home prices. According to industry sources, as much as one-third of the home sales in some southern California markets are "institutional" sales of foreclosed properties, many of which are being heavily discounted. These sales are competing with new projects for prospective home buyers.

Relative California Home Prices Have Fallen Sharply in Recent Years

Given the recent home price declines and the effects they are having on real estate markets, a key question for the California outlook is how much further prices will fall before its real estate markets stabilize.

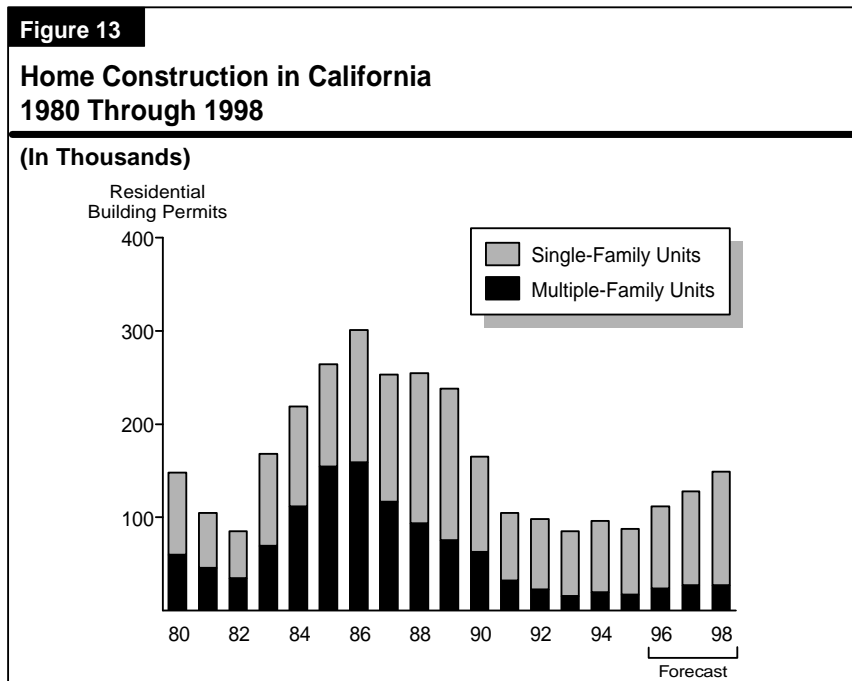
Figure 12 provides a broad perspective regarding California home prices by comparing them to the nation's during the past two decades. The figure shows that in the mid-1970s, the median price of a California home was about 40 percent above the national median. This home-price margin jumped in the late 1970s, stabilized in the early 1980s, but increased sharply again during late 1980s. At the end of California's speculative real estate boom in 1991, the median home price was about \$205,000, which was about double the nation's.

The recession has taken a major toll on the state's real estate values. As a result of successive years of price declines, the home-price margin had shrunk to 50 percent as of late 1995, or about where it was in 1980. While it is not possible to tell exactly how much further prices will fall, it is clear California home prices are now more competitive with the rest of the nation than they have been in many years. Partly for this reason, many forecasters are predicting that home prices will stabilize in the near future, as inventories of foreclosed homes are worked off and confidence returns to the markets.

Figure 12**California's Housing Price "Premium"
1977 Through 1998**

Modest Rebound in Home Building Projected

The LAO's forecast assumes that home price declines will soon moderate. This development, coupled with continued low interest rates and moderate job expansion, should lead to a modest recovery in home building (see Figure 13). Despite our projected increase in construction levels, however, the volume of home building would remain well below the levels of the mid-1980s.



Comparison of Recent Economic Forecasts

Figure 14 (see page 32) compares the LAO's current forecast to the 1996-97 budget projections and our November 1995 outlook. It shows, for example, that our current forecast for the nation is slightly more conservative than the budget's, reflecting the disappointing end-of-year retail spending in 1995, the negative effect of the continued federal budget stalemate, and the effect of harsh weather on the outlook for early 1996. Our forecast for California, however, is similar to both the department's budget projections and our November outlook, as the employment and income data reviewed by our office since the release of the budget forecast are basically consistent with our earlier projections.

Figure 14				
Comparison of Economic Forecasts				
(Percent Change)				
	1995	1996	1997	1998
U.S. Real GDP:				
LAO November 1995	3.1%	2.4%	2.4%	2.3%
1996-97 Governor's Budget	3.3	2.5	2.6	—
LAO February 1996	3.3	2.4	2.4	2.4
California Wage and Salary Employment:				
LAO November 1995	2.0	2.4	2.2	2.1
1996-97 Governor's Budget	2.5	2.6	2.3	—
LAO February 1996	2.5	2.4	2.3	2.3
California Personal Income:				
LAO November 1995	7.8	6.2	5.8	5.6
1996-97 Governor's Budget	7.6	5.7	5.9	—
LAO February 1996	7.9	6.0	5.8	5.5

Key Risks to the Outlook

A key risk to the national economic forecast at this point in time is that the federal budget impasse will continue, contributing to economic uncertainty, concerns over higher future federal budget deficits, and upward pressures on interest rates. Combined with disruptions to the economy related to an unusually harsh winter, and ongoing concerns over high consumer debt levels, a continued federal budget stalemate could lead to slower economic growth or even a downturn in 1996. As one indication of the stalemate's potential negative effect, Wharton Economic Forecasting Associates projects that U.S. economic growth could drop into the range of only 1 percent, instead of its baseline forecast of 2 percent, and remain there as long as the federal budget impasse is unresolved.

Although a significant slowdown or national downturn would certainly affect California, we believe that the prospects for continued economic growth in California are somewhat more certain than for the rest of the nation, as the state clearly entered 1996 with more momentum than other regions of the country. Nonetheless, even a modest slowdown in California could have a significant negative impact on the state's budget condition in 1996-97.