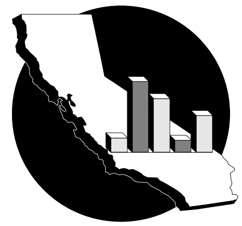
# II

# Perspectives on the Economy and Demographics

## *Perspectives on the Economy and Demographics*



Economic and demographic developments play key roles in California's fiscal outlook. For example, state tax revenues are significantly affected by changes in key economic variables such as employment, income, retail spending, construction, and trade-related activities. Similarly, spending levels in education, health and social services, corrections, and other state programs are influenced by state population and economic trends.

The impact of the economy on the state's budget condition has been particularly significant in recent years. California's severe recession in the early 1990s contributed to major funding shortfalls in the 1991-92 through 1994-95 General Fund budgets, while the subsequent and ongoing economic expansion has led to noticeable improvements in the budget's condition. The Governor's current budgetary proposal is predicated on continued, though moderating, economic growth through 1998.

In this part, we review the recent performance of the national and California economies, discuss recent demographic trends in the state, summarize the economic and demographic forecasts assumed in the *1997-98 Governor's Budget*, and provide our own perspective regarding the economic and demographic outlooks for California.

## 1996 ECONOMIC PERFORMANCE IN RETROSPECT

As indicated in Figure 1, 1996 was generally a good year in terms of economic performance, as both the nation and California experienced moderate economic growth with low inflation.

**Figure 1**

**1996 Economic Performance in Retrospect**

**Economic developments were mostly positive . . .**

- ✔ The U.S. economy expanded at a moderate, noninflationary pace.
- ✔ California's economy accelerated during the year, with growth surpassing the nation for the first time since 1989.
- ✔ Many jobs in California were created in high paying services and manufacturing industries.
- ✔ Employment growth in the state continued to become more broad-based, with most industries and regions adding jobs.

**However, some problems remained**

- ✔ Home prices continued to slide in many regions, and new residential construction failed to recover as expected.
- ✔ California still faces uncertainties relating to consolidations in the defense and finance-related industries.

## Recent U.S. Developments

***Economic Growth.*** The national economy completed its fifth year of sustained economic expansion in 1996. Following a sharp slowdown in late 1995, the economy regained momentum during 1996. Despite considerable quarter-to-quarter volatility during 1996, real gross domestic product (GDP) grew by about 2.5 percent for the year as a whole. This annual growth was roughly in line with the consensus of projections made at the beginning of the year.

An especially favorable development was the strong note on which the year ended. Real GDP increased by 4.7 percent during the October-through-December quarter, led by strong growth in exports and consumer spending. Preliminary evidence for January indicates that good economic performance is continuing, with the economy settling into a moderate growth pace.

***Inflation.*** Price inflation remained low in 1996, with the Consumer Price Index (CPI) increasing by about 3 percent during the year. The “core” rate of inflation (which excludes the volatile food and energy sectors) increased by just 2.6 percent—the lowest rate in 31 years. Accelerating gains in hourly earnings during the latter part of 1996 suggest that wage pressures will eventually translate into some increase in the core inflation rate in 1997. However, most forecasters expect the near-term increase in the overall inflation rate to be limited, due to continued softness in prices of food and raw materials, as well as strong competition from abroad.

***Financial Markets.*** Interest rates rose modestly over the past twelve months, but as of early 1997 remain well within the range experienced in recent years. Stock market prices surged to record levels over the past year, led by record inflows of investor funds and continued strong corporate earnings. The dramatic increase in stock prices has boosted the wealth of U.S. households, and has contributed to increasing their incomes through such avenues as stock options and dividend payouts. At the same time, however, the current high ratio of stock prices relative to current corporate earnings has led to concerns about whether the stock market is vulnerable to a major downward correction and, if so, what effect a major setback of this sort would have on the economy at large.

## Recent California Developments

### Generally Speaking, 1996 Was a Good Year for California

***Significant Job Growth.*** The California economy generally outperformed expectations in 1996. For example, the state added nearly 350,000 jobs during the year, surpassing its pre-recession employment peak of 12.7 million jobs. Many of the new jobs were created in such high-paying industries as computer services, software design, motion pictures, and high-technology manufacturing. All major economic regions grew, with particularly large gains in the Silicon Valley region of northern California.

***Other Positive Developments.*** In other developments, personal income increased by over 7 percent, reflecting healthy gains in wages, business earnings, and investment income. Nonresidential construction activity rebounded during the year, led by a nearly 34 percent increase in the San Francisco Bay Area. Finally, international trade through California customs districts increased by 17 percent during the first three quarters of 1996, led by major growth in exports to Pacific Rim countries and to Mexico. Growth in international trade has had especially positive effects on a number of California industry sectors, including manufacturing, transportation, and wholesale trade.

## However, Some Problem Areas Remain

***Construction—Slow to Recover.*** Although the economic news for California was mostly positive in 1996, several problem areas remain. Two are particularly significant. The first is the persistent weakness in California's residential construction sector. Permits for new housing increased only modestly in 1996 from the prior year, and fell short of most forecasters' expectations. The continuing weakness in this area may be partly due to ongoing declines in real estate values, particularly in the inland regions of the state. These declines, which may reflect supply-demand imbalances, are leading to uncertainties among developers and prospective home buyers.

***Restructuring—Still Taking a Toll.*** A second area of concern involves the further consolidations taking place in certain key industries, such as aerospace. For example, there have been recent mergers involving major California aerospace-related companies such as Hughes Electronics, McDonnell Douglas, and Rockwell. Presumably, these restructurings make economic sense to the companies involved, and may even boost California's economic health in the longer term. However, they also produce various economic dislocations, at least in the near term. Thus, even though the worst of aerospace job losses are over, the job outlook for many workers remains uncertain. The finance sector is another area where ongoing uncertainty persists regarding continued restructuring. Although such restructuring is aimed at making the companies involved more efficient and thus competitive in the longer term, it produces a variety of negative economic outcomes in the shorter term, including job losses.

## California's Expansion From an Historical Perspective

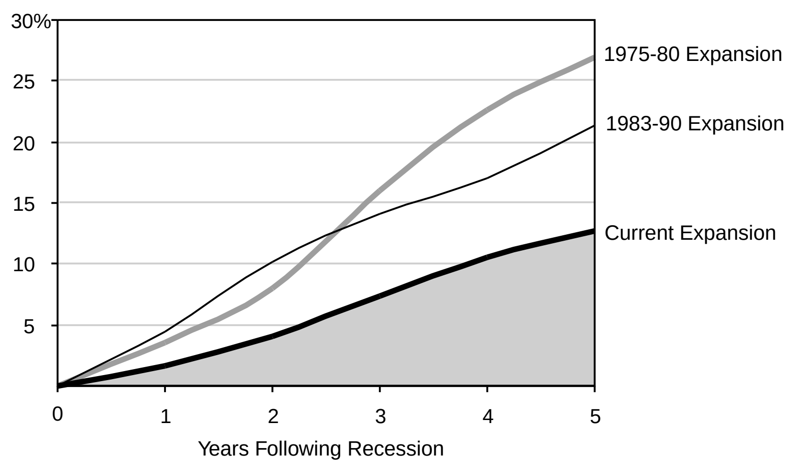
Although the California economy's recent performance has generally been favorable, it is important to note that its post-recession expansion has been considerably less robust than those in past decades. Figure 2 shows that the current recovery's pace has been roughly one-half that of the expansions following the 1973-74 and 1981-82 recessions. This comparatively slower rebound is especially notable in view of the severity of the early-1990s recession, when the state lost over 725,000 jobs. The state's subdued rate of growth is partly due to the below-average pace of the national economic expansion. It also reflects ongoing industry restructuring and weakness in California residential construction activity.

This "half-speed" recovery has had significant implications for California's fiscal condition. It has resulted in a slower improvement in the state's fiscal balance sheet than was the case following past recessions. It also implies that future budgets cannot count on rapid revenue growth to ease fiscal pressures.

**Figure 2**

**California's Economic Recovery During the 1990s Modest by Historical Standards**

*Cumulative Percentage Employment Increase Following Recession*




## THE BUDGET'S ECONOMIC OUTLOOK IN BRIEF

### U.S. Outlook

The budget's national and state economic forecasts are summarized in Figure 3 (see next page). The budget's national forecast reflects the consensus view that the U.S. economy will continue to experience moderate economic growth and modest inflation over the next two years, the latter reflecting some tightening in certain labor and input markets. Specifically, the administration assumes that real GDP will expand by 2.4 percent in 1997 and 2.5 percent in 1998, or about in line with the 2.5 percent gain of 1996. (At the time the budget was released, this gain was estimated to be 2.3 percent.) Inflation is projected to increase a bit yet remain modest over the next two years, while interest rates are predicted to remain relatively stable, fluctuating within a fairly narrow band.

**Figure 3**

**Summary of Department of Finance's Economic Outlook**

*Percent Changes*[a]

| | | Projected | |
|---|---|---|---|
| | Preliminary 1996 | 1997 | 1998 |
| **United States forecast** | | | |
| Real GDP | 2.3% | 2.4% | 2.5% |
| Pre-tax corporate profits | 4.8 | 2.4 | 8.1 |
| Unemployment rate (%) | 5.4 | 5.2 | 5.2 |
| Federal funds interest rate (%) | 5.3 | 5.1 | 5.0 |
| **California forecast** | | | |
| Personal income | 7.2% | 6.6% | 5.9% |
| Wage and salary jobs | 2.7 | 2.6 | 1.9 |
| Consumer prices | 2.0 | 2.7 | 2.7 |
| Taxable sales | 6.8 | 5.0 | 4.3 |
| Unemployment rate (%) | 7.3 | 6.8 | 6.9 |
| New housing permits (000) | 94 | 110 | 121 |

[a] Unless otherwise indicated.

### California Outlook

The budget assumes that California will continue to grow at a moderate pace in 1997 and 1998. Figure 3 shows that California personal income, a key determinate of state revenues, is projected to increase by 6.6 percent in 1997 and 5.9 percent in 1998. This is down from 7.2 percent in the current year. The budget assumes that state growth in jobs and income will exceed the rest of the nation during the next two years.

## THE LAO'S ECONOMIC OUTLOOK

We share the administration's view that U.S. and California economic growth will continue through the budget year. The LAO's updated outlook is summarized in Figure 4.

### The National Economy

Based on recent developments, we have made only modest adjustments to our previous forecast for the nation that we released in November 1996. Our forecast continues to assume that the U.S. economy will expand at a moderate rate over the next three years (see Figure 5).

Figure 4

## Summary of the LAO's Economic Outlook

*Percent Changes*[a]

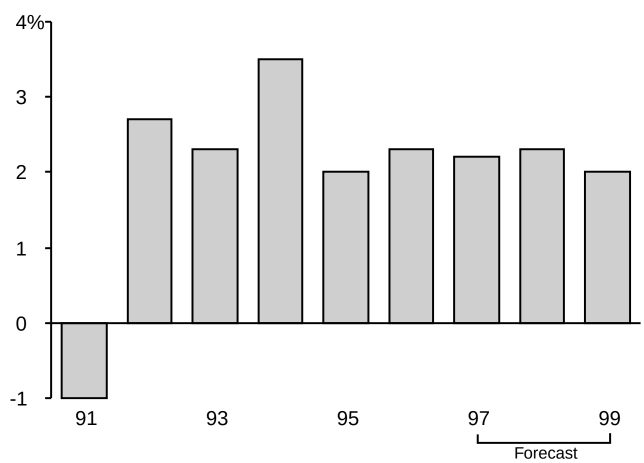
| | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|
| **United States** | | | | |
| Real GDP | 2.5% | 2.2% | 2.3% | 2.0% |
| Personal income | 5.5 | 5.1 | 4.9 | 4.9 |
| Wage and salary jobs | 2.0 | 1.5 | 1.4 | 1.5 |
| Consumer Price Index | 2.9 | 2.8 | 2.9 | 3.1 |
| Unemployment rate (%) | 5.4 | 5.5 | 5.6 | 5.7 |
| Housing starts (000) | 1,474 | 1,359 | 1,307 | 1,318 |
| **California** | | | | |
| Personal income | 7.3% | 6.3% | 5.6% | 5.5% |
| Wage and salary jobs | 2.8 | 3.1 | 2.3 | 2.4 |
| Consumer Price Index | 2.1 | 2.9 | 2.9 | 3.0 |
| Unemployment rate (%) | 7.3 | 6.7 | 6.1 | 5.9 |
| New housing permits (000) | 96 | 108 | 122 | 137 |

[a] Unless otherwise indicated.

Figure 5

## Stable Economic Growth Expected

*Percent Change in Real Gross Domestic Product (GDP)*
*1991 Through 1999*



## The CPI Controversy . . .

For some time, there has been concern that the Consumer Price Index (CPI) overstates inflation, and that this in turn drives up the cost of government expenditures in entitlement programs whose recipients receive cost-of-living adjustments (COLAs) tied to the CPI (for example, the California Necessities Index [CNI], which is used for adjusting welfare benefits).

### Recent Commission Findings

In December, a bipartisan advisory commission reported to Congress that the Consumer Price Index overstates inflation by slightly over 1 percentage point per year, and made several recommendations regarding how to deal with this bias. The report cites two principal factors as being responsible for the inflation overstatement. The first is a substitution bias, which occurs because the CPI is a "fixed-weight" index that fails to account for the substitution by consumers from more-expensive to less-expensive goods when relative prices change.

The second factor is a quality change bias, which occurs when improvements in the quality of products are not fully accounted for in measuring their prices or when new products are not included in the CPI's calculation at all.

The commission recommended a two-track approach to adjusting for the bias.

***Methodological Changes.*** The first track involves implementation of specific changes to the way the Bureau of Labor Statistics (BLS) calculates the CPI. These changes include continuous updating of the spending weights in the CPI (the weights have been updated only periodically in the past), and the more frequent inclusion of new products in the CPI's price surveys.

***Separate Inflation Adjustments.*** The second track involves subtracting part or all of the estimated bias remaining in the CPI at

***Business Investment Leading the U.S. Expansion.*** We project that the U.S. economy will be led by gains in business investment, as firms continue to modernize and expand their use of high-technology innovations. We anticipate that consumer spending will grow no faster than the overall economy, as high consumer debt levels restrain household expendi-

## . . . Recent Developments

given points in time for purposes of making cost-of-living adjustments to federal expenditure programs.

### Effect on State Programs

***Methodological Changes.*** To the extent that the Commission's recommended methodological changes are adopted by the BLS, any resulting reduction in the CPI's inflation measure could affect state COLAs that are tied to—or influenced by—the CPI or its components. (For example, even though the weights in the CNI are different from the CPI, changes in the inflation rates of certain CPI components could affect overall CNI inflation.) Any such changes could also affect state personal income taxes (through their impact on the annual indexing adjustment), and local property taxes (through their effects on assessed valuation growth under Proposition 13). However, it is important to note that some of the methodological changes would require federal legislation and additional funding for the BLS. Even if the changes are made, it is unlikely that they would eliminate all of the bias inherent in the current index. Thus, the timing, magnitude, and scope of future changes to BLS methodologies resulting from the commission's recommendations currently are uncertain.

***Separate Inflation Adjustments.*** The establishment of a separate cost-of-living adjustment for federal programs (whether by simply adjusting the CPI downward or using an entirely new alternative adjustment factor), if approved by Congress, would not *directly* affect state programs, although the Legislature could choose to make similar adjustments to state COLAs. However, the reduction in federal COLAs could affect federal contributions to some jointly funded programs, such as SSI/SSP.

Exactly what steps the federal government will be taking regarding the CPI bias and how to deal with it in the context of federal expenditure programs will likely become clearer later this year.

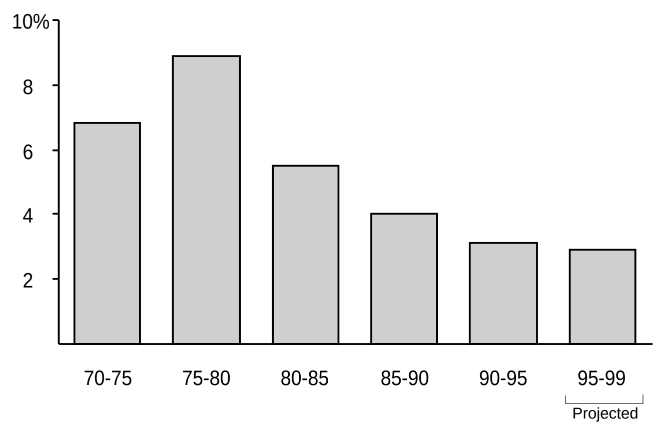
tures through the forecast period. Federal government spending is projected to grow slowly, due to continued pressure to reduce the deficit.

***Inflation to Remain Low.*** As Figure 6 (see next page) shows, we expect inflation to remain at historically low levels, with the CPI increasing by slightly less than 3 percent annually between 1996 and 1999. Increases in wage rates are expected to put some upward pressure on price levels;

however, increases in product prices in many industries likely will be restrained by strong international competition.

**Figure 6**

**Historically Low Inflation Environment Expected Average Annual Inflation Rate by the Half-Decade 1970-75 Through 1995-99**




Reflecting the moderate growth and stable inflation environment, we project that interest rates will remain near current levels during the forecast period.

### Implications of U.S. Outlook for California

The national outlook continues to be positive in terms of its implications for California. In particular, continued strength in business investment in high-technology goods will boost sales and thus employment in many of California's manufacturing and services industries, while the stable interest rate environment is a positive factor in California's housing outlook.

## California's Outlook

Our current forecast for California is generally consistent with the projections we made for the state in our November 1996 report. We continue to assume that the state will experience healthy, though moderating, broad-based economic growth over the next three years. We are projecting that employment will increase by 3.1 percent in 1997, before slowing somewhat to 2.3 percent in 1998 and 2.4 percent in 1999. All regions and all major industries are expected to share in these gains.

## California to Outpace Nation

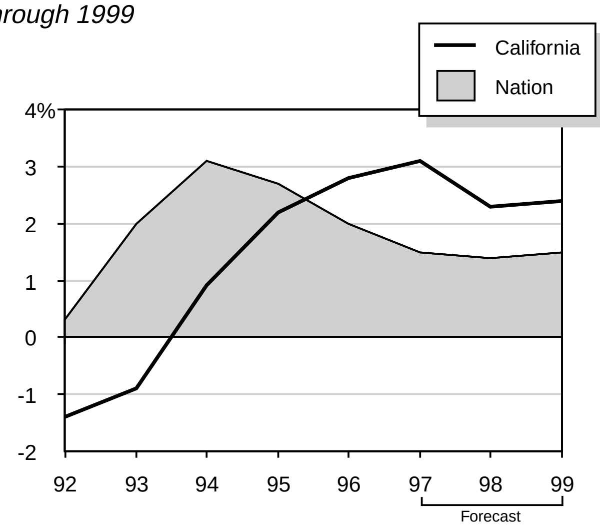
Throughout the 1970s and 1980s, California's economy consistently grew faster than the nation's. Even during periods of economic slow-downs and downturns, California's performance tended to be better than the rest of the U.S. However, this relative relationship changed abruptly in 1990, as the state's severe recession, followed by its delayed and subdued recovery, caused California's employment and income performance to lag the nation's. This comparative weakness persisted throughout the first half of the 1990s.

As Figure 7 shows, however, California has regained its "growth margin" over the nation. It indicates, for example, that economic growth in California in terms of job gains surpassed the rest of the U.S. in 1996, and we expect this trend to continue through 1999. Our forecast that the state will out-perform the nation over the next several years reflects the

**Figure 7**

**California Regaining "Growth Margin" Over Nation**

*Annual Percent Change in Jobs*
*1992 Through 1999*



relatively favorable outlook for this state's key manufacturing and services industries, as well as the fact that California remains in an earlier stage of its economic expansion than the rest of the country.

## The General Outlook for Key Industry Sectors

Figure 8 portrays the relative importance of different industry sectors in California, using the distribution of employment among sectors as a general measure. It shows that about one-third of the state's jobs are in the broadly defined services sector. Although this industry sector has often been associated in the past with lower-skilled and lower-paying occupations, the characteristics of this sector have been evolving dramatically. Many of the jobs created in recent years have been in highly skilled industries, such as computer and software design, engineering, and management consulting. These fields are among the highest-paying job categories in the state. Thus, although many jobs in the services sector today continue to be lower-paying, it does include a very heterogeneous mix of jobs in terms of skill levels and compensation.

**Figure 8**

**Composition of California Nonagricultural Employment By Major Industry Sector**

*1996*

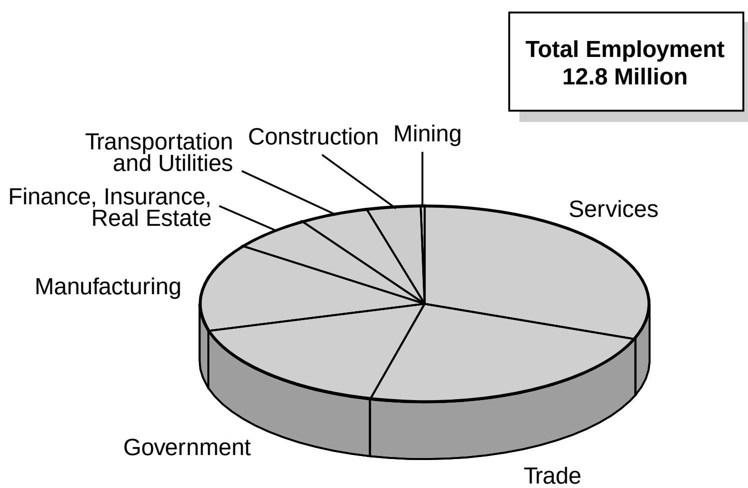


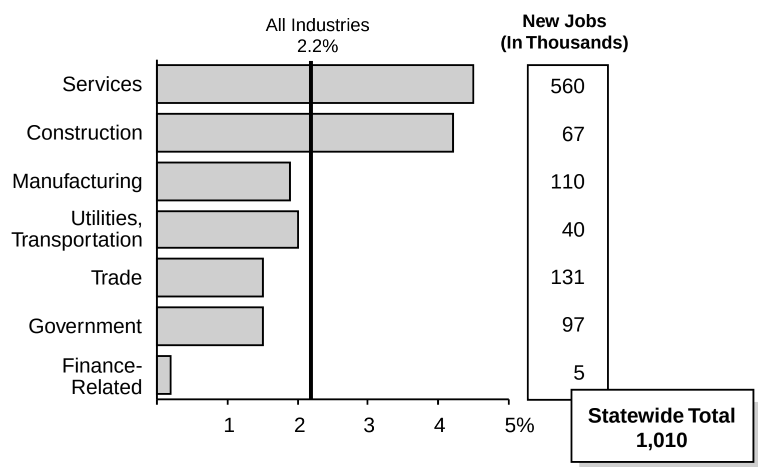

Figure 8 also indicates that about one-fourth of the workforce is in the trade sector, which includes retail stores, wholesalers, and import-export businesses. Another one-sixth of jobs is in manufacturing industries, including aerospace and commercial computers and electronics. (This sector's share of output in the economy significantly exceeds its share of employment, due to its high degree of automation.) The remaining jobs are in government, construction, finance-related, transportation, utilities, and various other smaller industry sectors.

***Services to Lead California's Economy.*** Figure 9 shows our outlook for job growth in individual industry sectors in California. It indicates that in both numeric and percentage growth terms, services will continue to lead the state's expansion over the next three years—accounting for over one-half of the 1 million in total new jobs projected to be created during this period. As in recent years, we expect that a large number of the new services jobs will be in high-paying, high-skilled job categories, including computer services, software design, and motion picture-related occupations.

**Figure 9**

**All Industry Sectors Projected to Grow**

*Average Annual Percent Change in California Jobs*
*1997 Through 1999*




***Construction Gains Expected.*** Construction employment is forecast to increase by an average annual rate of 4.2 percent over the forecast period, due to anticipated gains in both residential and nonresidential construction activity. Although this outlook is favorable given the stagnant growth thus far experienced in this sector since the recession, total employment in this industry will still remain below prerecession levels.

***Positive Outlook for Manufacturing.*** Manufacturing employment is expected to grow at an average annual rate of about 1.9 percent over the next three years. While Figure 9 shows that the increase for this sector is modest compared to the gains projected for services and construction, the outlook is quite favorable when compared to the rest of the nation, where manufacturing is expected to decline slightly. California's more favorable expected performance is due to the presence of a large number of fast-growing computer and electronic firms, as well as continued growth in the apparel and textile industries in the state.

## State to Benefit From Stabilization of Aerospace and Finance-Related Industries

As seen in Figure 9, a key feature of our current outlook is that virtually all major industries are expected to share in the economy's growth between 1996 and 1999. This is in contrast to the first three years of California's economic recovery, when the state's key aerospace and finance-related industries were declining.

Figure 10 shows that aerospace and finance-related industries combined lost 264,000 jobs between 1990 and 1995. These declines added to the depth of the state's recession during the 1990 through 1993 period, and held down economy-wide growth during the early stages of the recovery.

However, the job losses subsided sharply in 1996, and our forecast assumes that the two industries will grow marginally over the next three years. While the net increases will be extremely limited due to further consolidations, at least the two industries will no longer be as significant a drag as previously on California's economic growth.

## Home Construction Slowly Recovering

We believe that residential construction will continue its slow recovery over the next three years. As shown in Figure 11, we project that total residential housing permits (single-family plus multifamily) will increase modestly from 96,000 units in 1996 to 137,000 by 1999. A key assumption behind our forecast is that home prices in most regions will finally stabilize over the next year, and start to rise slowly in 1998 and 1999. Combined with continued growth in jobs and income, a stabilization in home price levels should bring a return in confidence on the part of prospective buyers and building developers. Even with the increases we are projecting, however, the level of building permits is expected to remain well below the 200,000-plus permits issued annually through most of the 1980s.

**Figure 10**

**Aerospace and Finance-Related Industries Have Become Less of an Economic Drag**

*Jobs (In Thousands)*

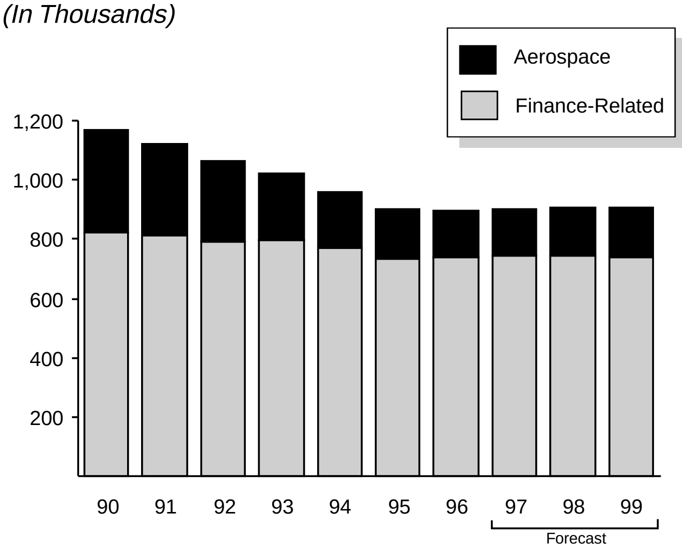
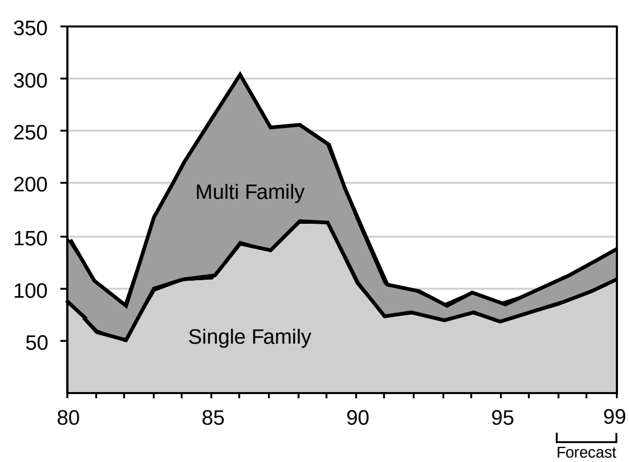



**Figure 11**

**Housing Sector Recovering Slowly**

*California Residential Building Permits (In Thousands) 1980 Through 1999*



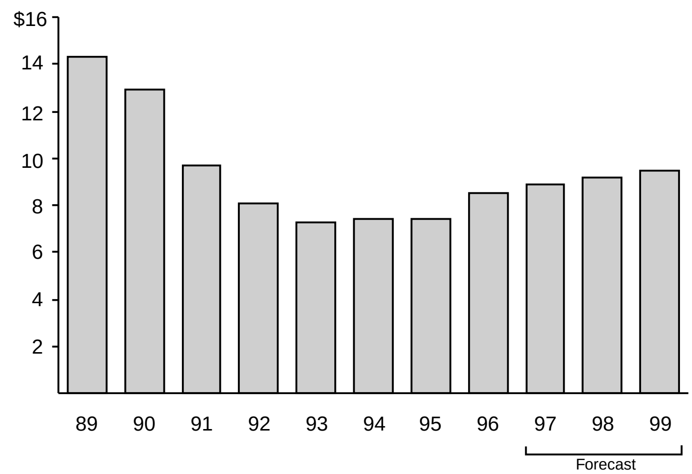
### Nonresidential Construction to Continue Growing

Following its favorable performance in 1996, we expect nonresidential construction to continue increasing from 1997 through 1999, primarily reflecting a strong expansion in industrial building. As indicated in Figure 12, we project that inflation-adjusted nonresidential construction will rise from $8.5 billion in 1996 to $9.5 billion by the end of the forecast period.

**Figure 12**

**Nonresidential Construction Growing Again**

*Value of New Permits (In Billions of Constant 1992 Dollars)*




## COMPARISON OF RECENT ECONOMIC FORECASTS

In terms of their general characteristics, both our current forecast and the budget outlook are consistent with economic projections made by other forecasters in recent months. Although there are differences in the details of various projections, there is fairly broad consensus among economists that both the nation and California will grow moderately over the next two years.

Figure 13 compares our current forecast to the budget's economic projection, as well as UCLA's December 1996 projections and our November 1996 outlook. It shows that compared to the budget's economic forecasts, we project slightly less growth in personal income, but more growth in taxable sales. The difference between the taxable sales forecasts have significant revenue implications, as discussed in Part III.

**Figure 13**

**Comparison of Economic Forecasts[a]**

*Percent Changes*

| | 1996[b] | 1997 | 1998 | 1999 |
|---|---|---|---|---|
| **United States Real Gross Domestic Product:** | | | | |
| LAO November | 2.4% | 2.2% | 1.9% | 2.2% |
| UCLA December | 2.3 | 2.5 | 2.4 | 2.4 |
| DOF January | 2.3 | 2.4 | 2.5 | — |
| LAO February | 2.5 | 2.2 | 2.3 | 2.0 |
| **California Wage and Salary Employment:** | | | | |
| LAO November | 2.7% | 2.8% | 2.3% | 2.1% |
| UCLA December | 2.8 | 3.1 | 2.3 | 1.9 |
| DOF January | 2.7 | 2.6 | 1.9 | — |
| LAO February | 2.8 | 3.1 | 2.3 | 2.4 |
| **California Personal Income:** | | | | |
| LAO November | 7.4% | 6.1% | 5.5% | 5.3% |
| UCLA December | 7.9 | 5.7 | 5.6 | 5.6 |
| DOF January | 7.2 | 6.6 | 5.9 | — |
| LAO February | 7.3 | 6.3 | 5.6 | 5.5 |
| **Taxable Sales:** | | | | |
| LAO November | 7.7% | 6.1% | 5.5% | 5.1% |
| UCLA December | 6.9 | 5.5 | 6.1 | 6.5 |
| DOF January | 6.8 | 5.0 | 4.3 | — |
| LAO February | 7.0 | 5.8 | 5.5 | 5.3 |

[a] Acronyms used apply to Department of Finance (DOF); Legislative Analyst's Office (LAO); and University of California, Los Angeles (UCLA).

[b] All 1996 estimates are preliminary.

Figure 13 also shows that, relative to our November 1996 forecasts, we are now projecting slightly faster increases in employment and income, but slower gains in taxable sales. These adjustments primarily reflect the incorporation of more-recent historical revisions to employment, sales, and income data, rather than any fundamental reassessment of the basic economic outlook.

Finally, the figure shows that our current projections, particularly of employment growth, are generally similar to UCLA's December forecast.

## A Regional Perspective on California's Outlook

California's economy is diverse, not only in terms of its statewide industry mix, but also in terms of the economic characteristics and performance of its various geographic regions. Figure 14 shows how California's total employment is divided among five major regions within the state—Southern California, the Central Coast, the San Francisco Bay Area, the Central Valley, and the remainder of the state.

**Figure 14**

**California Employment by Major Economic Region**

*1996*


### Characteristics of Major Regions

As Figure 14 indicates, the majority of the state's employment base is in the seven-county region of *Southern California.* This region is large in size and highly diversified in terms of economic activities. In 1996, about 57 percent of the state's 12.8 million jobs were located in this region, with Los Angeles County alone accounting for 30 percent of the statewide total. The region has been undergoing massive changes in recent years, with job losses in aerospace and related industries being partly offset by expansion in a variety of emerging services and international trade-related sectors. Given its size, any significant economic developments affecting the region generally have important economic consequences for the state as a whole.

The nine-county *San Francisco Bay Area* accounts for about 3 million, or about one-fourth, of the state's total jobs. This region includes the high technology industries of Silicon Valley, as well as a large number of businesses involved in services, wholesale and retail trade, tourism, multimedia activities, and international trade.

The *Central Valley* region accounts for about 1.8 million of California's job totals. It has long been the state's major agricultural region. In more recent years, however, it has seen growth in manufacturing and services industries, as people and firms have migrated out of the heavily populated coastal regions of Northern and Southern California.

The *remaining two regions*—the Central Coast and the rest of the state—account for a relatively small share of California's jobs. However, they have experienced significant growth in recent years and should continue to do so in the future.

## All Major Geographic Regions Are Currently Growing

Each of the state's major geographic regions are now experiencing moderate economic growth, generally in the 2 percent to 3 percent range. Within the major regions, however, there are some significant variations. For example, while the nine-county San Francisco Bay Area as a whole experienced moderate growth last year, Santa Clara County increased rapidly, reflecting the continued boom in high technology industries. Similarly, within Southern California, Los Angeles County has been growing less rapidly than its neighboring counties. Despite these differences, however, the economic recovery is now extending to and within all regions of the state.

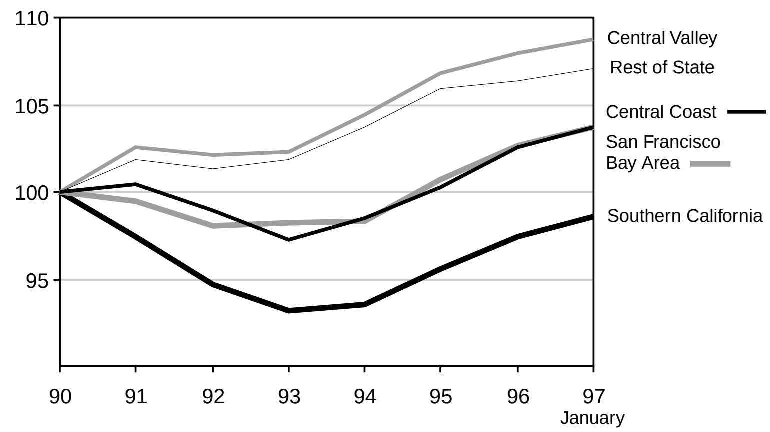
## Nevertheless—Underlying Regional Employment Trends Show Significant Variation

Although all regions are currently expanding, they have exhibited significant differences during the 1990s. This can be seen from Figure 15 (see next page), which displays the cumulative percent change in employment by region between 1990 and the end of 1996.

**Figure 15**

**Some Regions Have Recovered More Rapidly Than Others**

*Employment Index (1990=100)*




The figure shows that the recession that hit Northern California was *comparatively mild,* with the San Francisco Bay Area experiencing job losses of less than 2 percent between 1990 and 1993, and the Central Valley actually adding jobs during the period.

In contrast, the downturn in the south was *severe,* with employment falling by nearly 7 percent during the same interval. And, within Southern California, Los Angeles County lost over 11 percent of its total jobs during this three-year period.

Figure 15 also shows that while four of the state's five economic regions have now surpassed their prerecession employment peaks, Southern California has yet to fully recover its job losses from the recession. The continued weakness in the south is, again, concentrated in Los Angeles County, which is still down over 250,000 jobs from 1990.

## Factors Responsible For the Regional Variations

One factor explaining these regional variations is the south's greater dependence on the cyclical aerospace and construction industries, both of which experienced dramatic declines in the early 1990s. For example, well over one-half of the statewide reduction in aerospace jobs between 1990 and 1996 occurred in Los Angeles County alone. A second factor was the "high-tech" boom that boosted employment in Silicon Valley—and in the San Francisco Bay Area economy generally—beginning in 1992.

A third (and more fundamental) factor is that the recession coincided with more basic underlying changes taking place in Southern California's economy—particularly in Los Angeles County. These changes have involved a shift *away* from manufacturing activities and *toward* a more services-based and trade-based economy. Such changes have been painful for the region, especially in terms of the permanent job losses they have caused in many of the region's shrinking industries. However, the emerging growth in movie production, entertainment, multimedia, and international trade-related businesses is leading to a more diversified economy than in the past—and thus one which is less vulnerable to economic malaise caused by downturns in just one or a few industries.

Given these factors, we expect the Southern California region to continue expanding in line with the state's overall economy during the next three years.

## CALIFORNIA'S DEMOGRAPHIC OUTLOOK

California's population is highly dynamic along a variety of dimensions—its growth properties, foreign and domestic migration trends, age composition, ethnic and racial mix, and intrastate mobility patterns. These factors significantly affect, both directly and indirectly, the state's economy, its revenue collections, and its expenditure levels. Thus, the state's demographic outlook is an important element both in its economic outlook and in assessing and projecting its budgetary position.

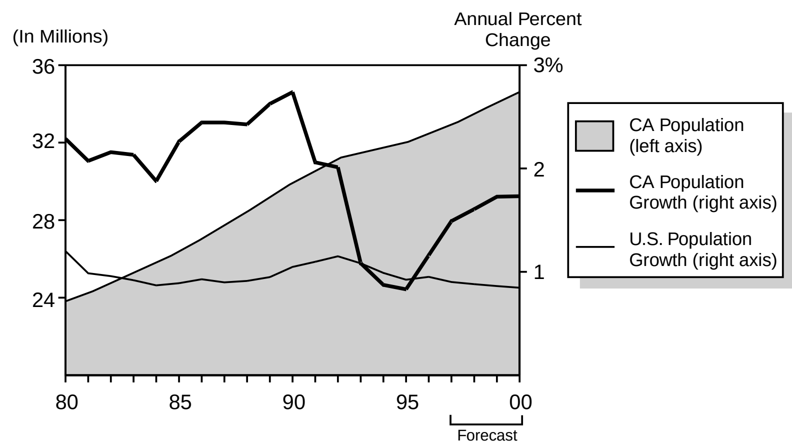
### Population to Exceed 34 Million

Figure 16 (see next page) shows California's population trend and compares recent and projected population growth rates for the state and nation. It indicates that we expect California's population to grow at an average annual rate of about 1.6 percent during the next three years, reaching 34.1 million by the year 1999. In numerical terms, California will gain about 1.6 million new residents during this period—more than twice the size of San Francisco. Our demographic projections are lower than the Department of Finance due to differing assumptions about migrations (see shaded box on pages 48 and 49).

**Figure 16**

**California's Population Growth Will Be Outpacing the Nation's**

*Level and Growth of Population 1980 Through 2000*




The figure also shows that the state's population growth rate fell below the nation's during the first half of the 1990s, largely reflecting the effects of the recession. However, this situation has reversed itself, and we expect California's population growth rate to outpace the nation's during the next three years.

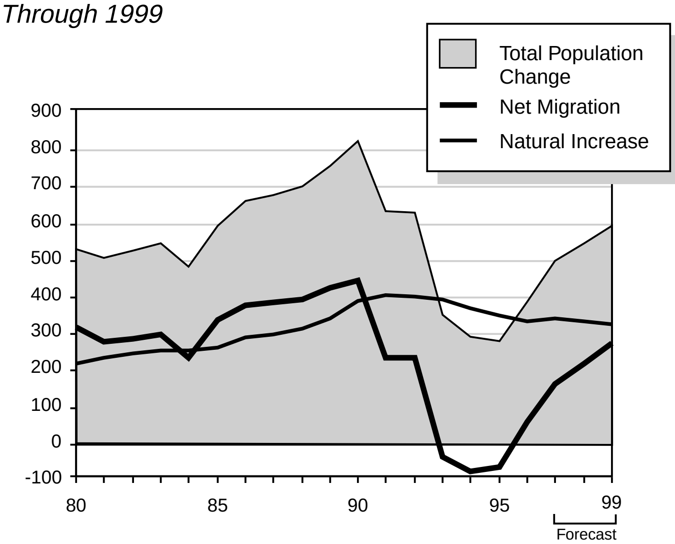
## Migration Turnaround Assumed

There are two main components to population growth—*natural increase* (the excess of births over deaths) and *net migration* (the difference between the number of people who migrate to California and the number that leave). Figure 17 shows the state's annual population change since 1980, and indicates the contributions of each of these two growth components. It shows that a sharp decline (and an actual population *outflow* in three of the years) in net-migration is largely responsible for the slower state population growth that occurred in the first half of the 1990s. Indeed, while the natural population increase remained relatively stable, net migration to California plunged in concert with California's especially severe recession.

**Figure 17**

## California Net Migration Again Becomes Positive

*Persons (In Thousands)*
*1980 Through 1999*




***Net Migration Behavior.*** Net migration itself can be broken down into two categories—*domestic* (movement between California and the other 49 states) and *foreign* (movement between California and other countries).

Substantial numbers of both domestic and foreign migrants made their way into California during the 1980s. California continued to experience a sizable in-flow of population from other countries during the first half of the current decade, but this gain was offset by a large-scale net out-migration of Californians to other states. While most demographers expect net *foreign* migration to remain stable in the next few years, projecting future *domestic* migration flows into and out of the state is the topic of some controversy (see shaded box on pages 48 and 49).

Our demographic forecast assumes that net domestic out-migration will slow during the next two years and reverse completely by the end of the decade, as the state's improving economy reduces the exodus of existing residents seeking economic opportunities elsewhere.

## Controversies Regarding

The U.S. Bureau of the Census disagrees with the Department of Finance (as well as various other state demographers) regarding both their estimates of California's current population and their forecasts about net domestic migration that the state will experience in coming years. For instance, Census estimates that there were 31.6 million residents in California as of July 1, 1995; in contrast, the department estimates that the number is slightly above 32 million.

With respect to net migration, Census projects large net domestic out-migration from California well into the next century; in contrast, the department believes that the outflow is declining and soon will reverse itself. These divergent views regarding the future course of net domestic migration are in large part rooted in differences in the statistical methodology and underlying demographic data that are used to produce migration forecasts.

***Basic Data Problems.*** Unfortunately, no single data source provides estimates of California migration flows that are both dependable and timely. The Internal Revenue Service (IRS) maintains change-of-address data (based on tax returns) which are relatively reliable, but are published with a time lag. Conversely, address changes from the California Department of Motor Vehicles (DMV) driver's license records provide a more timely, but less reliable, measure of domestic migration flows. The raw DMV data, for example, significantly understate the population outflow from California in any given year, because not all members of a household possess a driver's license and because of incomplete reporting by other states of these data.

***Methodological Issues.*** Census utilizes the IRS data and models future migration as a function of past migration, placing heavy em phasis on the most recent observations. Because the IRS data are available only with a time lag, the most recent observations avail-

## Changes in California's Age Mix

Our demographic forecast also sees significant variation occurring in the age-mix of California's population. Figure 18 (see page 50) shows California's current age distribution and how different age groupings will be changing over the next three years. It indicates, for example, that California's workforce will grow older, as the baby boomers enter their late

## California Demographic Data

able are from the years when net domestic migration outflows peaked (1993 through 1995). Census assumes that the large out-migration that California experienced during these years will continue throughout the remainder of the decade.

The main reason why so many Californians left the state during its peak domestic out-migration years appears to have involved the state's especially severe recession and delayed recovery. Now that California's recovery seems firmly established and reasonably good job growth is again occurring, however, it seems appropriate to assume that the outflow of Californians moving to other states should slow, thereby reducing net out-migration. The department and various other state demographers have concerns that Census is not taking sufficient account of the fact that California's domestic migration flows are affected by differences in economic opportunity between California and other states. As a result, they believe that Census projections overstate California's domestic out-migration and thus understate its population. However, there is no consensus among these demographers regarding what the domestic migration assumptions should be. The Department of Finance is assuming that out-migration is slowing dramatically, and thus has significantly higher population estimates for California than does Census. Our own estimates (beginning with 1996) lie between these two extremes, but are closer to the department's.

***When Will the Issue Be Resolved?*** A full reconciliation of California's population estimates from Census and the department will not be feasible until the next actual population count, scheduled for the year 2000. There will, however, be additional information available in the meantime, such as new IRS tax return data. The extent to which these and other interim data will clarify California's true population trends remains to be seen.

40s and 50s, and the number of persons in the 25-to-44 year old group (who represent younger workers) stays relatively flat. Growth in the K-12 school-age population will be twice that of the general population. Conversely, the number of preschoolers is projected to decline, while the elderly population is expected to grow moderately. These trends clearly will have a variety of economic and fiscal effects, ranging from changes in labor force characteristics to impacts on state expenditure programs in such areas as education, social services, and corrections.

**Figure 18**

## The Mix and Growth of California's Population By Age