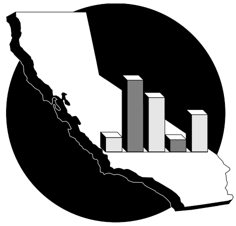
II

Perspectives on the Economy and Demographics

Perspectives on the Economy and Demographics



Economic and demographic developments have important effects on California's budget outlook. For example, the strength of California's economy is an important determinant of the level of revenues collected from personal income taxes, sales and use taxes, and corporate income taxes. Similarly, both economic and demographic variables affect state government expenditure programs, including education, health and social services, and youth and adult corrections.

In recent years, California's economic expansion has provided sufficient resources to enable the Governor and Legislature to simultaneously balance the budget, increase budgetary reserves, reduce taxes, and raise expenditures for education and a variety of other state programs. The Governor's budget for 2000-01 assumes that healthy economic growth will continue, albeit at a more moderate pace than in the past several years.

In this part, we review recent economic developments in the nation and state, discuss the Governor's economic forecast, and present our own perspective on California's economic outlook. We also discuss current demographic developments and highlight our population projections through 2002.

1999 IN RETROSPECT

Another Strong Year for The Nation

Once again, the U.S. economy outpaced projections in 1999. Driven by high levels of consumer confidence, strong income growth, and increased wealth, real gross domestic product (GDP) expanded by around

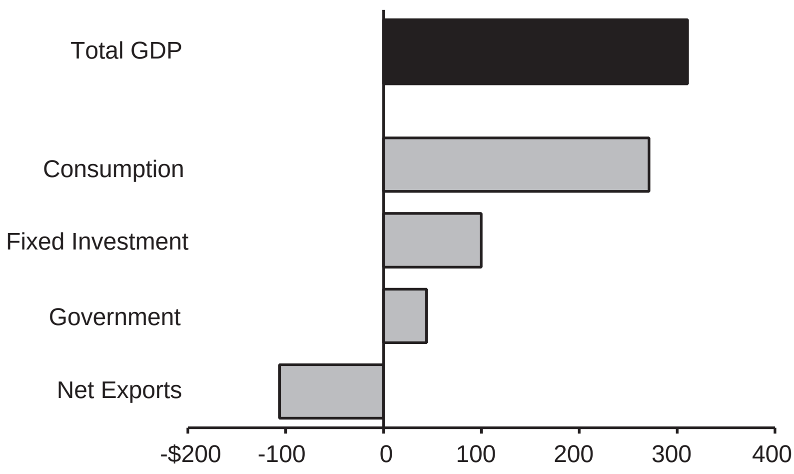
4 percent for the fourth year in a row. The increase was unprecedented for an economy in its ninth year of expansion and operating at near full employment.

Most Sectors Were Strong. As indicated in Figure 1, the majority of the dollar increase in real GDP between 1998 and 1999 was attributable to consumer expenditures. Real consumer spending grew by 5.2 percent, led by particularly rapid increases in purchases of autos and other durable goods. Business fixed investment was the second largest contributor to GDP growth last year, reflecting booming business expenditures on computers and software, and continued increases in nonresidential construction activity. The only "soft spot" in the economy was foreign trade, where strong U.S. demand for imported goods caused the U.S. merchandise trade deficit to increase sharply during the year.

Figure 1

Consumer Spending and Business Investment Led 1999 GDP Growth

Change in Real GDP, 1998 to 1999
Billions of Dollars



Yet Inflation Remained Tame. Inflation remained low nationally in 1999, despite some increases in energy and related commodity prices. The U.S. Consumer Price Index (CPI) rose just 2.1 percent during the year, while the U.S. GDP price deflator (which reflects the costs of *all* goods and services produced in the economy) was up just 1.3 percent.

Although inflation has continued to remain low, the Federal Reserve (FED) has expressed concerns that persistently strong spending growth, coupled with extremely tight labor markets, will eventually lead to price increases. In an attempt to slow growth and ease inflationary pressures, the FED raised interest rates three times last year, and additional increases are expected in 2000. In response to these factors, long-term interest rates rose during 1999—from 5.5 percent at the beginning of the year to over 6.5 percent by December—and have continued to edge up during early 2000.

Data Revisions Reveal Major Productivity Improvement

Late last year, the U.S. Bureau of Economic Analysis released major historical revisions to the nation's gross domestic product accounts. These revisions indicate that the economy has been growing faster than previously thought, largely due to higher estimates of worker productivity gains. For example, based on the new estimates, productivity gains since 1995 have averaged about 2.7 percent annually, compared to the previous estimate of about 2 percent.

The higher productivity estimate is very significant from an economics standpoint. Specifically, it provides evidence that the vast amounts of business investment in computer and information technologies over the past decade have indeed paid dividends, by raising the level of output-per-worker in a variety of industries. The higher productivity figures have caused many economists to reassess long-held assumptions about how fast the U.S. economy can grow on a sustained basis. Prior estimates of the economy's long-term GDP "speed limit" were in the range of 2 percent to 2.5 percent per year. In contrast, the recently experienced added productivity growth, if sustained, implies a noninflationary growth potential of more than *3 percent* annually—a very significant upward reassessment. As discussed below, this positive development is reflected in our economic forecasts for the nation and California.

1999 Was Best Year of the Decade for California

California enjoyed the strongest year of the current expansion in 1999. Although comprehensive GDP data are not available at the state level, evidence of California's strength is widespread (see Figure 2, next page).

It includes healthy employment growth, major increases in income tax withholding receipts (which are a reflection of large wage gains), strong gains in taxable sales, and record levels of home sales.

Figure 2

Recent Evidence of California's Economic Strength

Factor	Performance
Personal income tax withholding receipts	Up by 17 percent during the fourth quarter of 1999 compared to the prior year, signifying major gains in wages and stock-option income.
Employment	Grew by 3.4 percent in 1999, reflecting widespread gains. Unemployment was at the lowest level since 1970.
Taxable sales	Up nearly 9 percent in 1999—by far the strongest increase in the current expansion period.
New vehicle registrations	Up nearly 10 percent, reflecting major increases in sales of cars, sport utility vehicles, and light trucks.
Nonresidential construction	Surged to an over-$20 billion annual rate in November, one of the highest levels on record.
Home sales and prices	Home sales topped 675,000 units, an all-time record. Prices rose throughout the state.

Wealth Effect Boosted Sales and Income

As with the nation, California's economy was boosted by the "wealth effect" associated with the rising stock market. In addition to the general increase in the market, large gains in equity values specific to California's high-tech firms further boosted the wealth of Californians by increasing the values of stock options granted by high-tech firms to their employees. It appears that California's taxpayers "cashed out" a portion of their accumulated capital gains in 1999 to purchase autos, homes, and other "big-ticket" items. This was likely a major factor behind the nearly 9 percent increase in taxable sales that occurred last year.

Overall, we estimate that California personal income increased by 7 percent in 1999—the largest gain of the current economic expansion. Wage and salary employment increased by about 3.4 percent, reflecting particularly large gains in the services and construction industries. The unemployment rate fell from 5.9 percent in December 1998 to 4.9 percent in December 1999, the lowest level in three decades.

Exports Rebounded in Second Half of Year

A year ago, one of the few negative elements in California's economic picture involved exports to foreign countries. Asia's economic problems were resulting in substantial declines in California's exports to the region, and consequently were depressing sales and employment in California's high-tech manufacturing industries (which are major exporters to the area).

As 1999 unfolded, many Asian economies started to rebound, boosting foreign demand for California goods. Reflecting these improved conditions, California exports increased over 10 percent in the third quarter of 1999 compared to a year earlier, as shipments soared to such countries as South Korea, Taiwan, and China. Exports to Japan continued to fall, reflecting near-stagnant economic growth in that country. However, exports fell at a much-diminished rate compared to 1998.

The recovery in exports to Asia bodes well for California's producers of computers and electronics, which are the leading exporters to that region. Employment in these industries stabilized in the second half of 1999, and appears set to expand in 2000.

Problem Areas—Aerospace and Inflation

Two problem areas in an otherwise bright economic picture for California during 1999 were a resumption of job losses in the state's aerospace industry, and a significant increase in inflation.

- ***Aerospace.*** After growing at modest rates in both 1997 and 1998, employment in the aerospace industry fell about 15,000 jobs between December 1998 and December 1999. Most of the decline was among aircraft producers, reflecting cutbacks in planned commercial aircraft production in this state.
- ***Inflation.*** In contrast to the nation, inflation rose significantly in California during 1999. Growth in the California CPI accelerated from slightly over 2 percent in 1998 to just under 3 percent last year. The increase was primarily due to soaring rental housing costs in the San Francisco Bay Area, where the index for residential rent jumped by 7 percent. The spike in gasoline prices last spring also boosted the CPI, particularly in the first half of the year.

Despite these problems, 1999's overall economic performance in California was the best in well over a decade, and the state's economy entered 2000 with considerable upward momentum.

The Budget's Economic Outlook in Brief

The Governor's budget forecast assumes that economic growth will continue at a healthy, though moderating, pace through 2001. As shown in Figure 3, real U.S. GDP is forecast to slow significantly—from 3.9 percent in 1999 to 3.1 percent in 2000 and 2.8 percent in 2001. The administration forecasts that inflation will rise modestly in 2000 due to increases in employee compensation costs and commodity prices, before easing in 2001 in response to slower national growth.

Figure 3

Summary of the Budget's Economic Outlook

		Forecast	
	1999	**2000**	**2001**
United States Forecast			
Percent change in:			
Real GDP	3.9%	3.1%	2.8%
Personal income	5.2	5.3	5.0
Wage and salary jobs	2.2	1.8	1.6
Consumer Price Index	2.2	2.9	2.5
Unemployment rate (%)	4.2	4.0	4.0
Housing starts (000)	1,670	1,560	1,550
California Forecast			
Percent change in:			
Personal income	6.6%	6.5%	5.7%
Wage and salary jobs	3.3	2.9	2.5
Taxable sales	8.8	5.7	6.0
Consumer Price Index	3.0	3.5	3.3
Unemployment rate (%)	5.3	4.8	4.7
New housing permits (000)	140	154	167

As regards California, the budget forecast assumes that the state will continue to outperform the nation during the next two years. Personal income growth is forecast to slow only marginally—from 6.6 percent in 1999 to 6.5 percent in 2000—before further slowing to 5.7 percent in 2001. The budget forecasts similarly healthy but moderating increases for employment, led by computer-related services and the construction industry.

Finally, the budget anticipates that rising home ownership and rental costs will continue to put upward pressure on inflation in California. It forecasts that the California CPI will increase 3.5 percent in 2000 and by 3.2 percent in 2001.

THE LAO'S ECONOMIC OUTLOOK

Reflecting continued positive developments in both the U.S. and California economies, we estimate that 1999 ended on a stronger note than is reflected by the administration, and similarly that economic growth will continue at a significantly stronger pace through 2000. Our national and state economic forecasts through 2002 are summarized in Figure 4.

Figure 4

Summary of the LAO's Economic Outlook

		Forecast		
	1999	**2000**	**2001**	**2002**
United States Forecast				
Percent change in:				
Real GDP	4.0%	3.6%	3.1%	2.9%
Personal income	5.9	5.4	5.0	4.9
Wage and salary jobs	2.2	1.8	1.5	1.1
Consumer Price Index	2.1	2.5	2.6	2.5
Unemployment rate (%)	4.2	4.0	4.2	4.4
Housing starts (000)	1,668	1,575	1,520	1,500
California Forecast				
Percent change in:				
Personal income	7.0%	6.7%	5.8%	5.7%
Wage and salary jobs	3.4	3.0	2.5	2.2
Taxable sales	8.8	6.1	5.6	5.6
Consumer Price Index	2.9	3.1	2.9	2.9
Unemployment rate (%)	5.2	4.7	4.5	4.6
New housing permits (000)	139	154	164	170

National Forecast

Following its 4 percent increase in 1999, we forecast that U.S. real GDP will increase at a more moderate 3.6 percent in 2000, 3.1 percent in 2001, and 2.9 percent in 2002. The recent increase experienced in interest rates is expected to have *some* dampening effects on consumer and business spending, but their growth will nevertheless continue at a healthy pace. The same forces that boosted growth in 1999 will be present this year, and likely in 2001 and 2002 as well. Consumer spending will continue to grow, reflecting high levels of wealth, consumer confidence, and incomes. Investment spending is also projected to be strong, reflecting continued strong business spending on computers, information systems, and software. Also contributing to growth during the next two-to-three years is an improving outlook for exports, due to the strengthening of economic conditions in Asia and other foreign markets.

Despite continued robust economic growth, however, we expect inflation to remain moderate. The U.S. CPI is forecast to rise 2.5 percent in 2000 and 2.6 percent in 2001, compared to 2.1 percent in 1999. A key positive factor in the inflation outlook continues to be large anticipated productivity gains, which enable businesses to increase wages without raising the prices of their products and services.

California Forecast

We forecast that California is set for another year of strong growth in 2000, before its economy slows to a more moderate, but still healthy pace in 2001 and 2002. As shown in Figure 5, we expect California's economy to outperform the nation by a significant margin over the next two years.

Key Strengths and Concerns Regarding California

Figure 6 indicates that there are both strengths and concerns inherent in our upbeat forecast for California.

The Strengths

California's current positive economic outlook reflects a variety of both *external* factors (such as strong U.S. and worldwide demand) and *internal* forces (such as high confidence levels, rapid growth in business startups, and rising incomes). As shown in Figure 6, two particularly important factors are (1) the large and growing presence of dynamic high-tech industries in this state, and (2) the resulting increases in wealth and income accruing to many of California's households and businesses.

The High-Tech Sector. California has a large and growing presence of computer, telecommunications, electronics, software, and Internet-related firms, all of which are major beneficiaries of the continued strong national investment in new technologies. The state's high-tech manufacturing industries will receive an added boost from the recovery in foreign demand for computers, electronics, and related goods. While the San Francisco Bay Area has been California's high-tech center in the past, growth is spreading to Los Angeles and other regions of the state.

Figure 5

California to Continue Outpacing the Nation

Year-Over-Year Percent Growth in Personal Income
1995 Through 2002

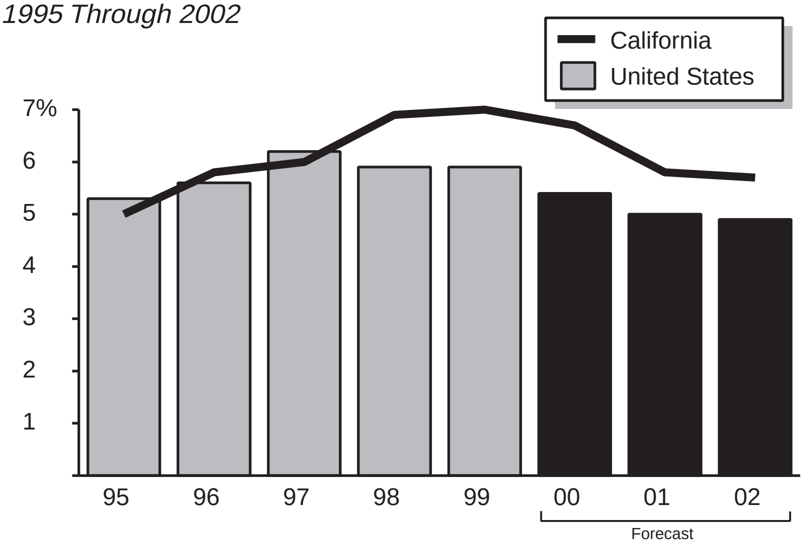


Figure 6

Key Strengths and Concerns In California's Economic Outlook

Strengths

- ✓ **Positive outlook for high-tech industries, reflecting:**
  - Continued strong national investment in high-tech goods.
  - Strengthening foreign economies to which California exports.
  - Expansion of new Internet-related technologies and applications.
- ✓ **High levels of wealth and consumer confidence**

Concerns

- ✓ **Possible major retrenchment or correction in the stock market**
- ✓ **Potential housing shortages**

The Wealth and Income Effects. As indicated above, California is the home of a large share of high-tech companies which have experienced dramatic appreciation in stock values in recent years. Absent a substantial drop in stock valuations, the tremendous amount of capital gains already "stored up" in stock options held by the employees, management, and owners of these firms will likely have significant positive impacts on wealth and confidence in California's economy for a number of years to come.

Concerns—Stock Market Uncertainties and Weak Home Construction

The past dramatic increases in stock market values, particularly in the high-tech area, are both a reflection of *past* strong business activity and, as indicated above, a positive force in the *future* economic outlook. However, the added importance of the stock market also carries risk. For example, if the market were to suffer a steep and sustained retrenchment, significant slowdowns in consumer spending and perhaps reduced levels of new business expansions, could be experienced.

A second source of concern and uncertainty, particularly for the longer term, is whether home construction will "keep up" with new demands brought about by economic growth and population increases. Home construction in 1999 was 139,000 units, which is well below the 170,000 to 180,000 annual level that many analysts believe is necessary to accommodate demand. In many areas where economic growth has been strongest—particularly Silicon Valley—there is limited land capacity for new construction. Likewise, in many other areas of the state, new housing development has become a contentious issue, due to concerns about the environmental and societal impacts of additional growth. At some point, shortfalls in new home construction could limit economic expansion in California.

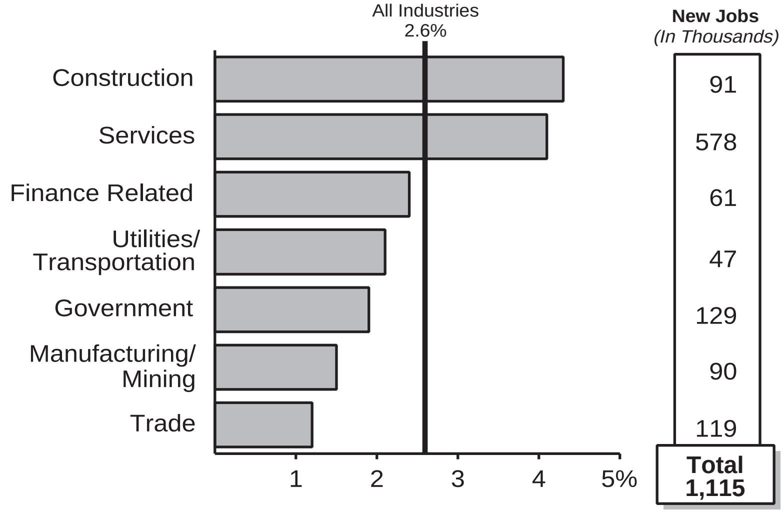
The California Outlook by Industry Sector

As indicated in Figure 7, over the three-year period 2000 through 2002, California wage and salary jobs are projected to increase at an average annual rate of nearly 2.6 percent. In numeric terms, over one-half of the new jobs are expected to be in the state's large and diverse service sector, reflecting gains in business services, hotels, automotive repair, health services, and entertainment. In percentage terms, the fastest-growing sector will continue to be construction, where employment is expected to grow by about 4.3 percent, reflecting continued gains in both residential and nonresidential building activity in the state.

Figure 7

Widespread Job Growth Anticipated

Average Annual Percent Change in California Jobs 2000 Through 2002



More moderate job increases are forecast for a variety of other sectors and industries, including trade, manufacturing, finance, insurance, real estate, and government. In the context of the current outlook, these moderate projected growth rates are not a sign of weakness, but rather reflect tight labor market conditions, and the continued utilization of labor-saving technologies by businesses.

Computer Services Employment Growing Rapidly

As indicated above, the bulk of new jobs created over the next three years is likely to be in the state's large and diverse services sector. We expect job gains throughout this sector. However, the single fastest growing individual industry is likely to be business services, which now includes over 1.2 million employees (almost 8 percent of all California jobs) and has been growing consistently in recent years by more than 8 percent annually.

In past years, business services primarily consisted of such low-wage industries as temporary employment agencies, security services, and building maintenance services. However, in the current expansion, a rapidly growing component has been computer-related services, which includes companies involved in the Internet and related software design, as well as computer systems design.

Jobs in computer-related business services have been increasing at a dramatic pace. We estimate that growth over the past year has exceeded 15 percent, and that total jobs in these industries amount to more than 300,000. The computer services industry is now about twice the size of the state's aerospace industry. As indicated in Figure 8, wages in key subsectors within the computer services industry *averaged* between $80,000 and $100,000 last year, well over twice the economy-wide average. We expect that employment in computer-related services will continue to expand by more 10 percent annually in both 2000 and 2001, making it one of the fastest growing employment categories in the state.

Nonresidential Construction to Lead Building Sector

Both residential and nonresidential construction activity were hit hard by the early-1990s' recession. The number of permits for residential units fell by nearly two-thirds and the value of nonresidential permits declined by over 50 percent between the late 1980s and early-to-mid-1990s. In the second half the decade, however, the performance of the two sectors varied significantly.

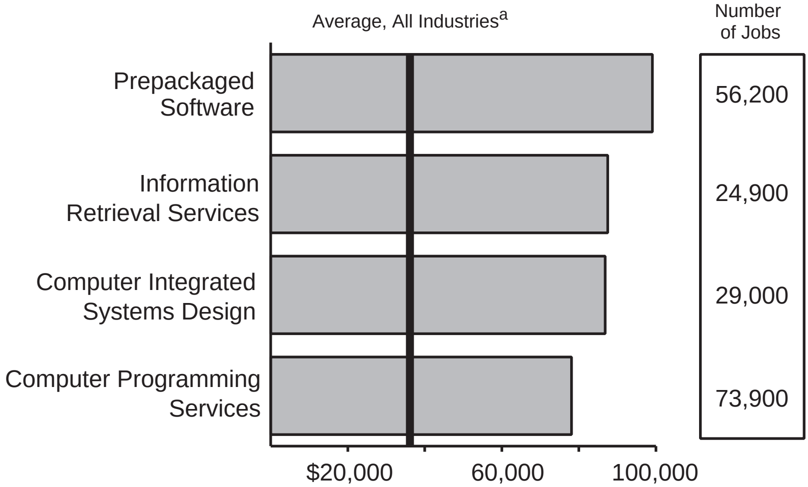
Residential Construction Has Lagged. On the one hand, the recovery in the residential construction sector has been *tepid* by historical standards. Housing permits totaled 139,000 units last year, and we expect the annual number to further increase to 170,000 by 2002. However, even if our forecast is realized, home construction will still be well below the over 220,000 average for the 1980s.

Nonresidential Construction Has Soared. In contrast, nonresidential construction has seen booming performance in recent years, and is now nearing the levels achieved in the mid-1980s (see Figure 9). Over the past five years, for example, the annual value of new industrial buildings has quadrupled while the annual value of commercial buildings has more than doubled. This growth was concentrated in the San Francisco Bay Area during the earlier stages of the recovery, but more recently has spread to Southern California and the Central Valley as well. We expect that the projected ongoing business expansion will result in even further gains in nonresidential construction activity. As shown in Figure 9, we expect that total valuations will surpass the 1980s' peak by the end of our forecast period.

Figure 8

Wages in Computer-Related Services Are Booming

Average Wages in Selected Categories (1998-99)

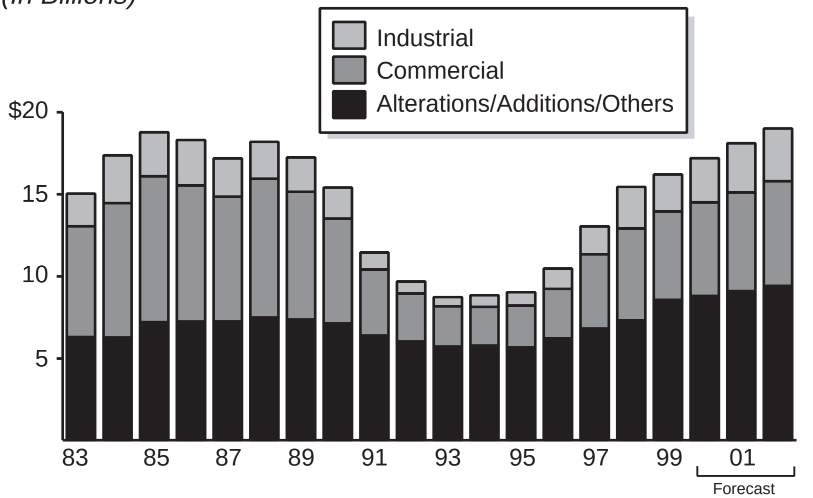


[a]Private sector only.

Figure 9

Nonresidential Construction Climbs Back to 1980s' Level

Value of Permits in Constant 1999 Dollars (In Billions)



Comparisons of Recent Economic Forecasts

Figure 10 compares our forecasts for the nation and California to those we made in November 1999 (see *California's Fiscal Outlook*), as well as those of the University of California, Los Angeles (December 1999), the consensus forecast published in *Blue Chip Economic Indicators* (January 2000), *Western Blue Chip Economic Forecast* (February 2000), and the Governor's budget forecast. Our current forecast for California is generally more optimistic than each of the other projections shown, particularly with regard to personal income.

Key factors behind our more optimistic outlook include (1) the upward revisions to historical GDP and productivity estimates and (2) recent data showing strong withholding, employment, and sales, which suggest that California is entering 2000 with more momentum than previously thought.

As discussed in "Part Three," the combination of our more optimistic near-term economic outlook and recent strong revenue receipts is responsible for our more optimistic revenue forecast compared to both our November report and the Governor's budget forecast.

CALIFORNIA'S DEMOGRAPHIC OUTLOOK

California's demographic trends both directly and indirectly affect the state's economy, revenue collections, and expenditure levels. For example, they influence the size of the labor force, the demand for autos and homes, the volume of taxable sales, and the amount of income taxes paid. Similarly, the population and its age distribution affect school enrollments and public programs in many other areas, such as health care and social services. Given this, the state's demographic outlook is a key element in assessing and projecting the state's budgetary situation.

Population to Surpass 35 Million

Figure 11 (see page 32) summarizes the LAO's updated demographic forecast. We predict that California's total population will rise from an estimated 34.6 million in 2000, to 35.2 million in 2001 and 35.8 million in 2002. This translates into an annual growth rate of somewhat over 1.6 percent—less than the boom years of the late 1980s but still well above the nation's 0.9 percent.

The number of new Californians being added each year—upwards of 600,000—is well-above the size of such cities as Long Beach, Oakland, and Fresno; and similar to a state like Vermont. About half of this yearly

Figure 10

Recent Economic Forecast Comparisons[a]

(Percent Changes)

		Forecast	
	1999	**2000**	**2001**
United States Real GDP:			
LAO November	3.9%	2.8%	2.6%
UCLA December	3.8	3.2	2.8
DOF January	3.9	3.1	2.8
Blue Chip "Consensus"[b] January	3.9	3.6	3.0
LAO February	4.0	3.6	3.1
California Wage and Salary Jobs:			
LAO November	3.5%	3.1%	2.5%
UCLA December	2.8	2.7	2.4
DOF January	3.3	2.9	2.5
Western Blue Chip "Consensus"[c] Febuary	2.9	2.7	2.4
LAO February	3.4	3.0	2.5
California Personal Income:			
LAO November	6.7%	6.1%	5.5%
UCLA December	6.4	6.1	5.7
DOF January	6.6	6.5	5.7
Western Blue Chip "Consensus"[c] Febuary	6.7	6.2	5.8
LAO February	7.0	6.7	5.8
California Taxable Sales:			
LAO November	8.1%	5.5%	5.2%
UCLA December	8.9	5.8	5.7
DOF January	8.8	5.7	6.0
Western Blue Chip "Consensus"[c] Febuary	7.0	5.9	5.4
LAO February	8.8	6.1	5.6

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

b Average forecast of about 50 national firms surveyed in January by *Blue Chip Economic Indicators*.

c Average forecast of organizations surveyed in February by *Western Blue Chip Economic Forecasts*.

growth is attributable to net in-migration from other nations and states, while the remainder is due to "natural" increase (that is, births minus deaths). Regarding the net in-migration component, the foreign share is by far the most significant—well over 200,000 annually.

Figure 11

Summary of the LAO's California Demographic Forecast

2000 Through 2002
(Populations in Thousands)

	2000	2001	2002
Total population (July 1 basis)	34,629	35,198	35,765
Changes in population			
Natural change (birth minus deaths)	281	280	282
Net in-migration (in-flows minus out-flows)	282	289	285
Total changes	**563**	**569**	**567**
Percent changes	1.65%	1.64%	1.61%

Growth By Age Group to Vary

The implications of demographic trends for the budget depend not only on the total number of Californians, but also on their characteristics. California is well-known for having one of the world's most dynamic and diverse populations in the world, including an increasingly rich ethnic mix; a large number of in-migrants; and a wide geographic dispersion encompassing both highly urban, suburban, and rural lifestyles. The state's current age and ethnic mix is shown in Figure 12.

Regarding ethnicity, we project a continuing trend toward increased diversity, as the white share drifts down and that for Hispanics and a variety of other ethnic groups drifts up. The age-related characteristics of California's population growth are especially important from a budgetary perspective, given their implications for such program areas as education, health care, and social services. Figure 13 shows our forecasts for both the percentage and numeric changes in different population age groups. It indicates that by far the greatest growth is expected for the 45 to 64 age group (the so-called "baby boomers"). It also shows that the under 5 age group is expected to decline over the period, presaging a further slowdown in K-12 enrollment growth in coming years.

Figure 12

The Age and Ethnic Mix of Californians

July 1, 2000

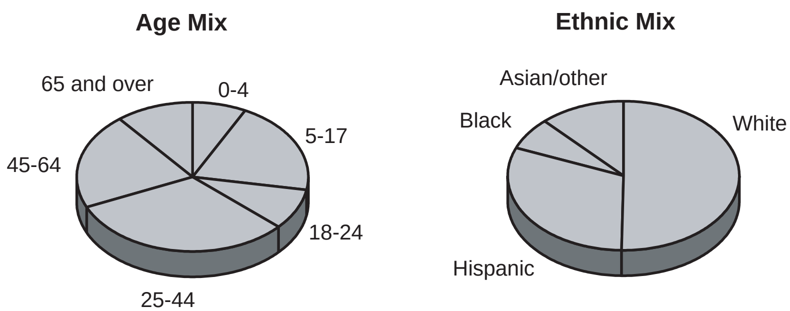
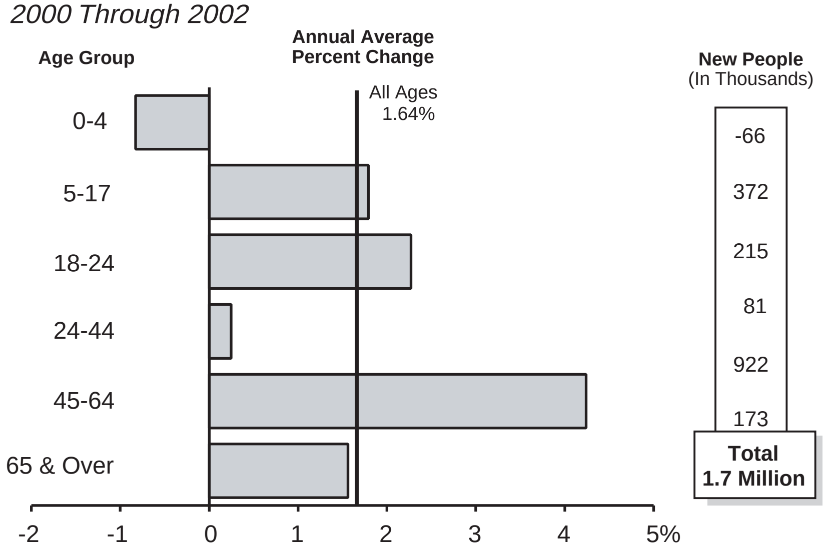


Figure 13

California's Population Growth By Age Group

Population Change 2000 Through 2002



Overall Budgetary Implications

California's continued strong population growth—including its age, ethnic, and migratory characteristics—can be expected to have many implications for the state's economy and public services in the budget year and beyond. For instance:

- Economic growth will benefit from an expanded labor force and growing consumer sector; however, additional strains will at the same time be placed on the state's physical and environmental infrastructure.
- Growth in the young-adult population will place greater demands on higher education, job training programs, and possibly the criminal justice and correctional systems.
- The increasing ethnic diversity of the state's population will mean that many public institutions, especially schools, will have to serve a population that speaks a multitude of languages, and that has a wide range of cultural backgrounds.