REPORT OF THE ECONOMIC ADVISORY COUNCIL OF THE CALIFORNIA INSTITUTE TO THE BOARD OF DIRECTORS

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I. INTRODUCTION

This economic update of the California Institute's Economic Advisory Council is presented to you in the format that we will use in all of our upcoming reports. This format includes three sections: a review of the previous report's outlook (omitted in this edition since this is our first formal report), the current outlook, and a section that analyzes key issues facing the California economy. In this report we explore four issues:

- How California's economy is restructuring to form the "New" California Economy
- The growing importance of trade
- Empowerment zones and enterprise communities
- Military base re-use.

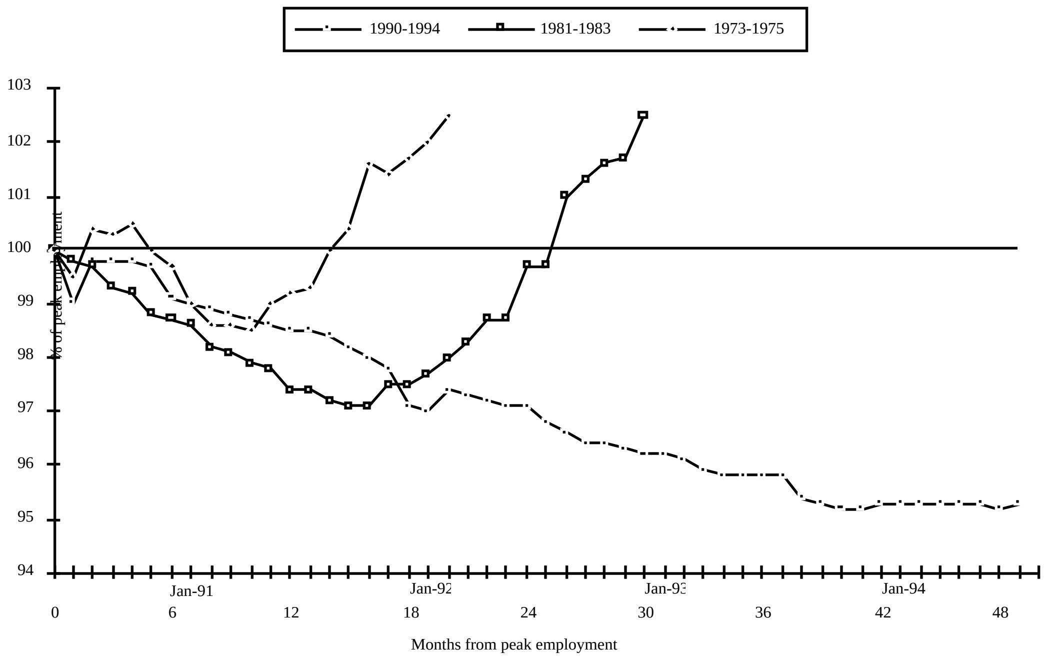
II. CURRENT OUTLOOK

The status of California's economy continues to be a major concern among residents (Table 1). Although crime now leads as the most important issue, an August, 1994, poll indicated that economic problems (the state's economy, creating new jobs, the state's fiscal crisis, and unemployment) accounted for four of the top eight issues.

Table 1
MAJOR CONCERNS OF CALIFORNIANS

Rank	**Issue**
1	Crime
2	State's economy
3	Controlling spread of AIDs
4	Creating jobs in new industries
5	Public schools
6	Illegal drug use
7	State budget deficit
8	Unemployment
Source: California Opinion Index, August, 1994	

Persistent public concerns about the economy likely result because of the severity of the most recent recession in California and the slow rate of economic recovery. Unlike recessions in the 1970s and 1980s, this most recent recession has been both deeper and longer. Figure 1 illustrates indexed non-agricultural wage and salary employment for recessions in 1973-75, 1981-83, and 1990-1994.



Source: EDD, Workforce Preparation and the Future of California, March, 1994; unpublished EDD data; unpublished PG&E data

Figure 1—Months until return to pre-recession employment

Employment in the 1973-75 recession fell over 1 percent before returning nearly one year later to its pre-recession level. Employment in 1981-1983 fell almost three percent, but returned to its pre-recession level in about two years. The rebound in the 1991-94 recession has been far less robust, with employment falling about 5 percent and remaining well below employment levels in 1990.

According to California's Employment Development Department (EDD), over the last six months non-agricultural wage and salary employment has steadied at about 12 million, or about 500,000 below employment in 1990. Because of growth in the labor force, the state's unemployment rate has increased from 5.6 percent in 1990 to about 9 percent currently.

SIGNS OF RECOVERY

A number of economists believe that the EDD data understate employment because the data exclude non-salaried workers, including entrepreneurs and many emerging small businesses. Indeed, other economic indicators suggest that a recovery is underway in California, despite the EDD's generally pessimistic employment data.[1] These other positive indicators include rising consumer confidence, rising home sales and new construction permits, and increasing retail sales receipts (Figure 2). Retail sales receipts between January and June, 1994, were more than 4 percent above receipts for the same period in 1993.[2]

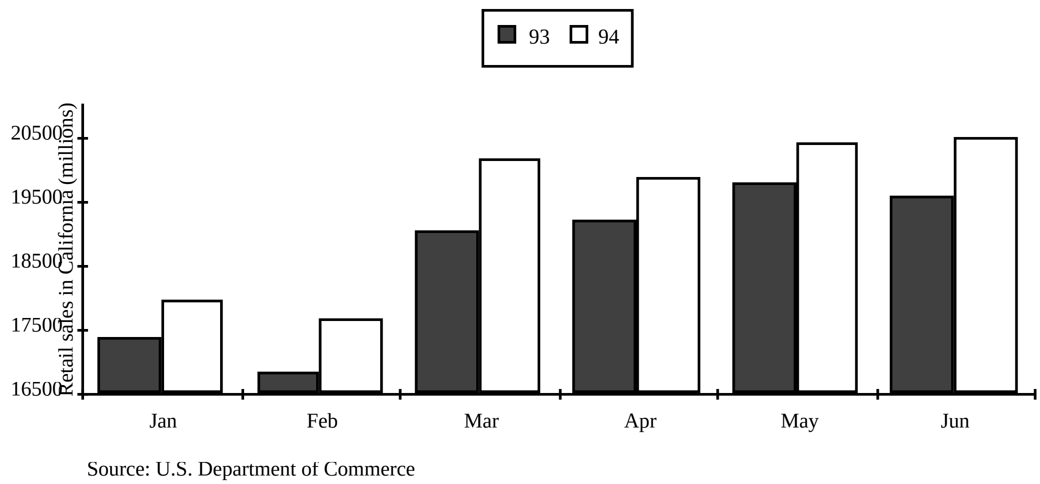


Figure 2—Retail sales receipts, 1994 versus 1993

Recently released data from California's Department of Finance (DoF) appear to confirm a modest recovery. The DoF data, based on more recent interim revisions to EDD data, indicate that the level of employment in March, 1994, was 220,000 higher than reported by EDD. DoF estimates an additional 11,000 jobs in construction, 17,000 in manufacturing, and 191,000 in service producing industries (Figure 3). The largest differences between the EDD and DoF data are in business, entertainment, engineering and management consulting services, and in wholesale and retail trade.

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[1]The Federal Reserve Bank of San Francisco reports that California reached the bottom of a long down cycle in mid-1993. However, the Federal Reserve notes that the recovery has been slow and uneven across industrial sectors. Federal Reserve Bank of San Francisco, *Western Economic Developments*, September, 1994.

[2]Most recent data available.

Most economists now believe that California's economy is growing and that employment will expand at roughly 1-2 percent annually, or between 100,000 and 200,000 jobs.[3] Based on these projections, California could regain its 1990 employment level in 1996 or 1997 (Figure 4).[4] However, the growth in the labor force since 1990 suggests that the unemployment rate will not return to its pre-recession level until near the end of the decade.

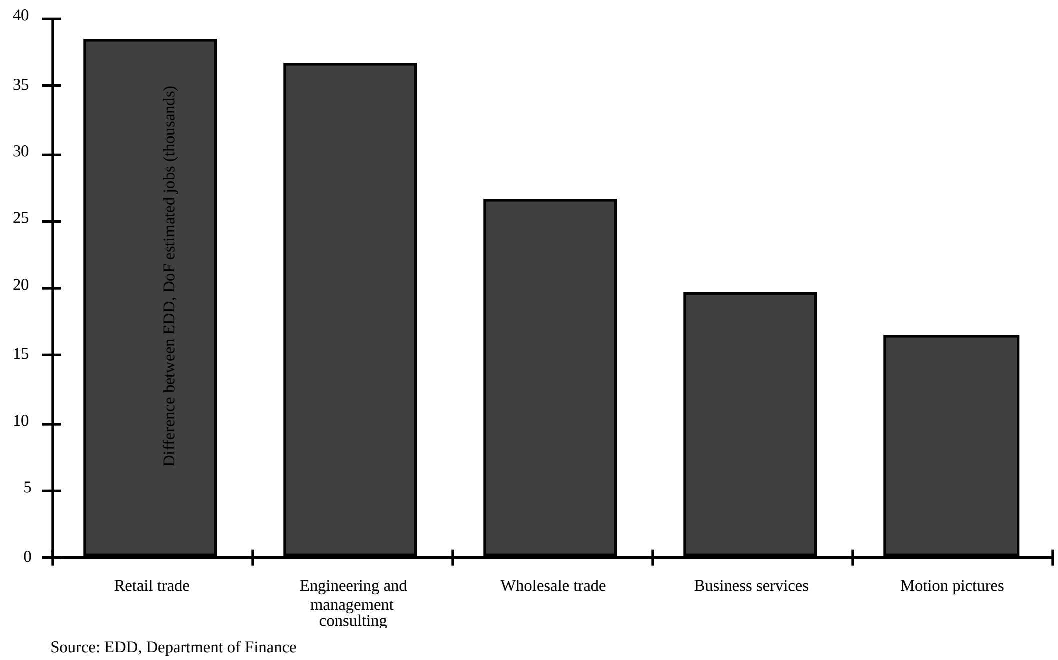

Figure 3—Significant differences between EDD, DoF employment data

Another reason for our increasing optimism about the state economy is the sustained performance of the national economy. The national economy expanded at a 1994 first quarter annual rate of 3.3 percent and a second quarter rate of 3.8 percent. This follows a 1993 increase in GDP of 3.1 percent.

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[3]The most recent UCLA Business Forecast Project suggests 111,000 net new jobs over the next year.

[4]This figure represents the high estimate (2 percent) for job growth.

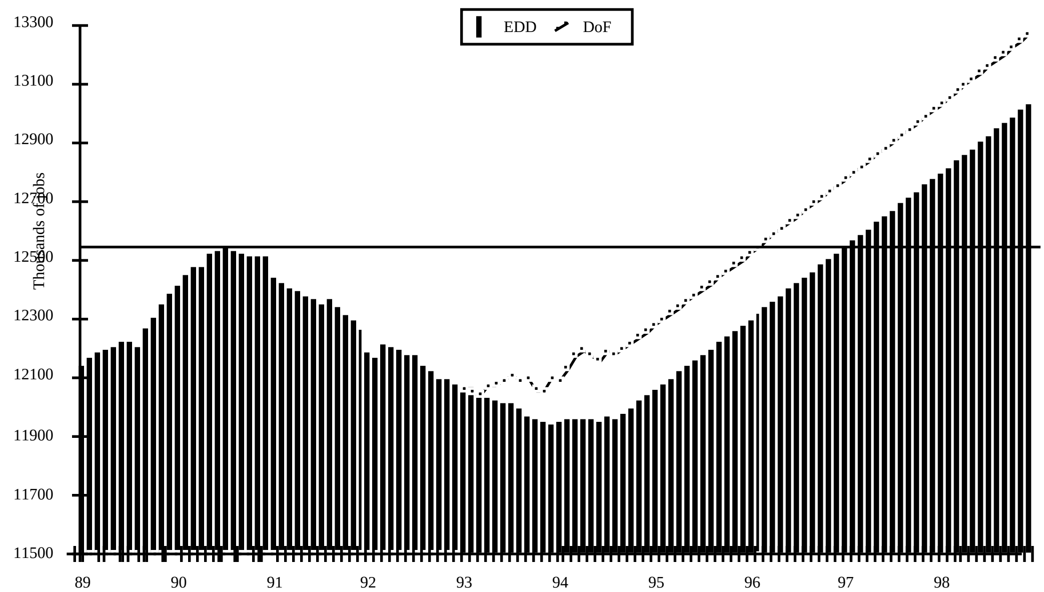

Figure 4—Employment and projections to 1998

FEDERAL POLICIES AND THEIR EFFECTS ON CALIFORNIA

Federal policies can have significant effects on California's economy. Some federal policies appear to be having a net negative effect on California's economy, at least in the short term.

Restrictive monetary policy (higher interest rates) appears to be slowing economic expansion considerably. Second, a continuation of the rapid drawdown in defense spending, affecting both procurement and military installations, clearly has hurt California more than other states. Third, higher marginal tax rates have hit California's higher than average share of wealthy individuals. California now pays one-third more in federal taxes than its population share. FDA regulations, particularly delays in product approvals, could eliminate many of the jobs in California's emerging biotechnology industry. Finally, business leaders have expressed concerns that the Federal Implementation Plan's regulations on air quality would have a negative effect on the economy. Local agreement appears to have allayed these concerns.

Federal policies can also positively affect the state's economic prospects. There is broad agreement that NATFA and GATT will help California. In general, policies that expand trade will have a differential impact in California as a result of the state's large share of the nation's foreign trade. Policies that aid technology industries like the decontrol of some technology exports and California's large share of the Technology Reinvestment Project grants are helping the California economy.

III. KEY ISSUES

HOW CALIFORNIA'S ECONOMY IS RESTRUCTURING

Like the national economy, California's economy continues to restructure as it pulls itself out of recession. However, restructuring in California is different from the rest of the nation. Defense downsizing has been far more severe, the real estate slump has lasted longer and been more severe, and the shift from high-wage manufacturing to non-manufacturing employment has been more rapid. Approximately 60 percent of the state's lost jobs are unlikely to come back since they are in industries that are going through major long-term structural changes.

Defense Downsizing

Defense downsizing, both in terms of procurement and base closures, has affected the state disproportionately because the sector is larger in the state than elsewhere. Base closures in 1988, 1991, and 1993 have eliminated or will eventually eliminate 22 of California's 72 major military installations. Defense procurement reductions also have hit California hard. Defense reductions are likely to continue over the next several years, falling a total of 37 percent between the peak in 1987 and 1998, or about 13 percent beyond current levels.

National defense spending[5] has fallen much more rapidly in California than in the nation. Between 1988 and 1994, national defense outlays fell from $290 to $277 billion. During the same period in California, spending fell 25 percent, from $60 to $45 billion (Figure 5). Since the peak, aerospace employment in California has fallen two and one-half times as far as it grew during the defense build-up of the 1980s.

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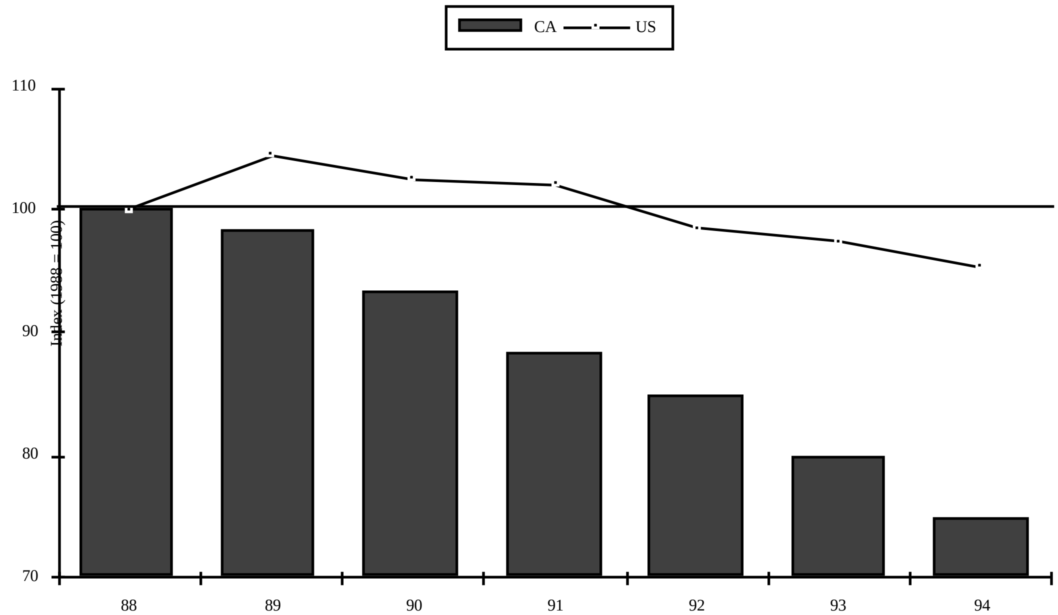
[5]Figures refer to national defense spending, which is greater than DoD spending. National defense includes defense-related Department of Energy spending.



Sources: Defense Budget Project, Commission on State Finance, Council's estimates

Figure 5—Defense spending in California, U.S.

Real Estate Slump

Unlike many other states, the real estate slump has been more severe and lasted much longer in California. The home building industry also continues to have problems. Housing starts in 1993 stood at 85,000 units, compared to 98,000 units in 1992, despite low interest rates and lower home prices. Housing permits in 1994 are running at an annual rate of 98,000, 12 percent over 1993 levels, but still far less than the more normal 140,000. A full recovery in the housing industry, which is probably several months away, is critical to the recovery of the state's economy.

This sluggish growth is in marked contrast to the national picture where housing starts in the 1992-1993 period increased by nearly 8 percent and have continued to increase since 1993 at an annual rate of 9.2 percent. The low level of construction in the state is due primarily to the weak economy, particularly a weak job market, and resulting problems with consumer confidence.

Home sales provide a somewhat brighter picture of economic activity. During the last year, single family home sales statewide have increased 4.6 percent, while condominium sales have increased 8.5 percent. Of particular importance, home sales in Los Angeles have increased 21 percent over 1993.

Problems in non-residential real estate exist, as well. Industrial prices have dropped considerably, and vacancy rates are now 10.5 percent in the San Francisco Bay Area and 9.7 percent in Southern California, compared with a national average of 7.9 percent. This sluggish market appears to be driven in part by corporate and defense downsizing.

Shift from Manufacturing to Non-manufacturing Employment

Finally, like the nation, the shift from manufacturing to service employment continues in California. However, the rate of manufacturing job loss in California since 1988 is more than double the nation's. The number of manufacturing jobs in California fell from 2.1 to 1.8 million. Many of the job losses in manufacturing have been in high technology, high wage industries like aerospace and electronics and are associated with defense cuts (Figure 6). Job growth in manufacturing has occurred almost exclusively in low-wage industries, including textiles and food products (Figure 7).

Service industries continue to contribute the most to California's recovery. Despite the recession, services added nearly 400,000 jobs between 1988 and 1993 (Figure 8). The strongest growth occurred in the business, health, engineering, and entertainment industries. Of particular importance, compensation in these industries is generally above average and has stemmed the erosion in statewide average wages (Figure 9).

The long- and short-term job creation aspects of these new industries remains significant. Equally important, the ripple effects of these industries support high numbers of jobs throughout the economy (i.e., indirect jobs), in addition to jobs in each industry (i.e., direct jobs). Figure 10 illustrates both direct and indirect jobs supported in industries in the new California economy. Computer and data processing services, for example, supports 2.5 indirect jobs for each direct job supported.

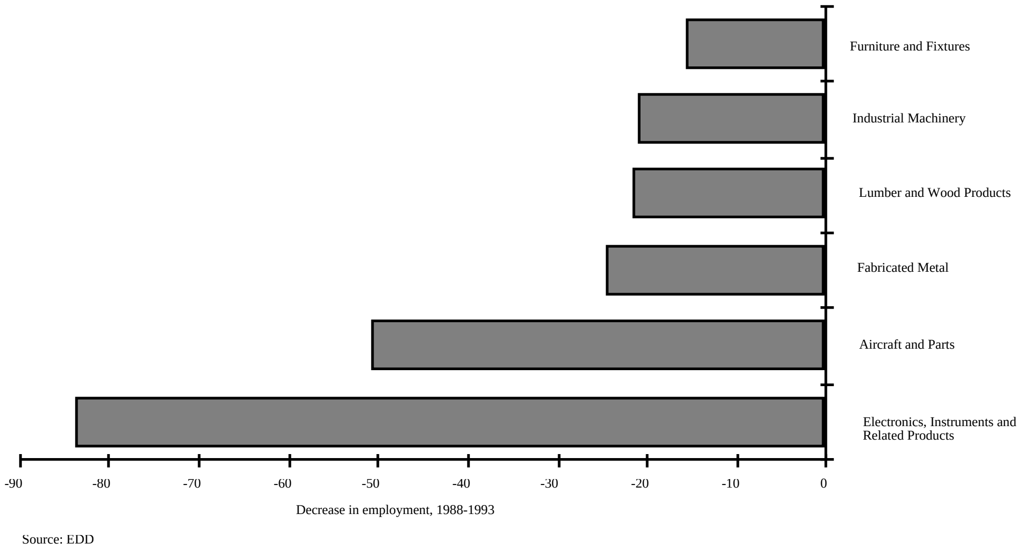


Figure 6—Manufacturing industries with largest job losses, 1988-1993

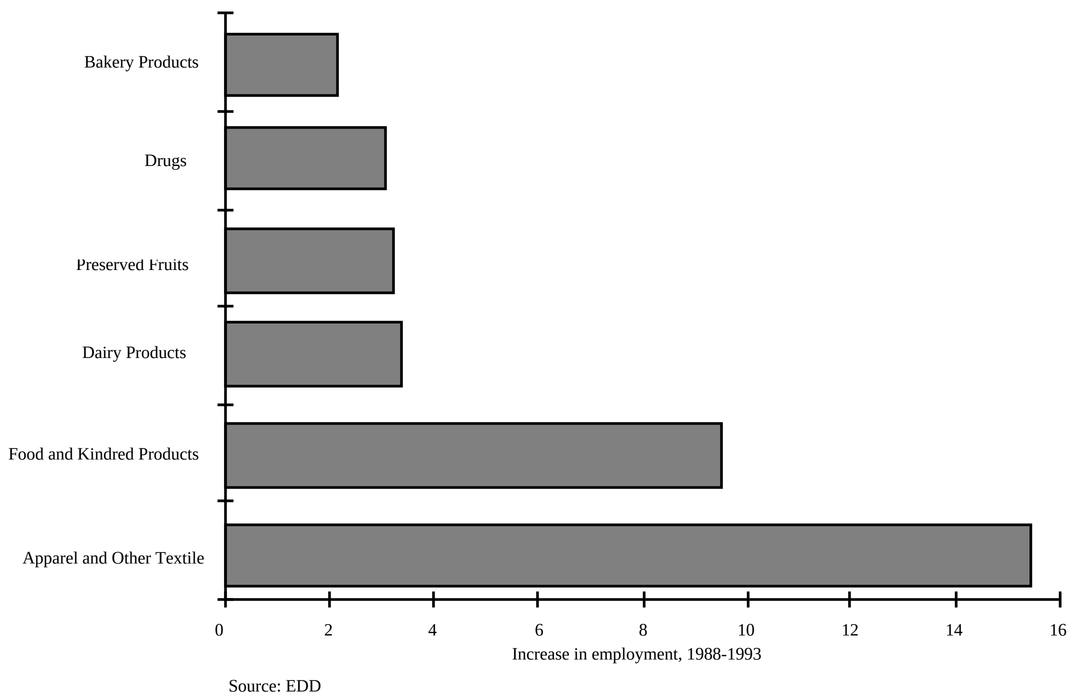


Figure 7—Manufacturing industries with largest job gains, 1988-1993

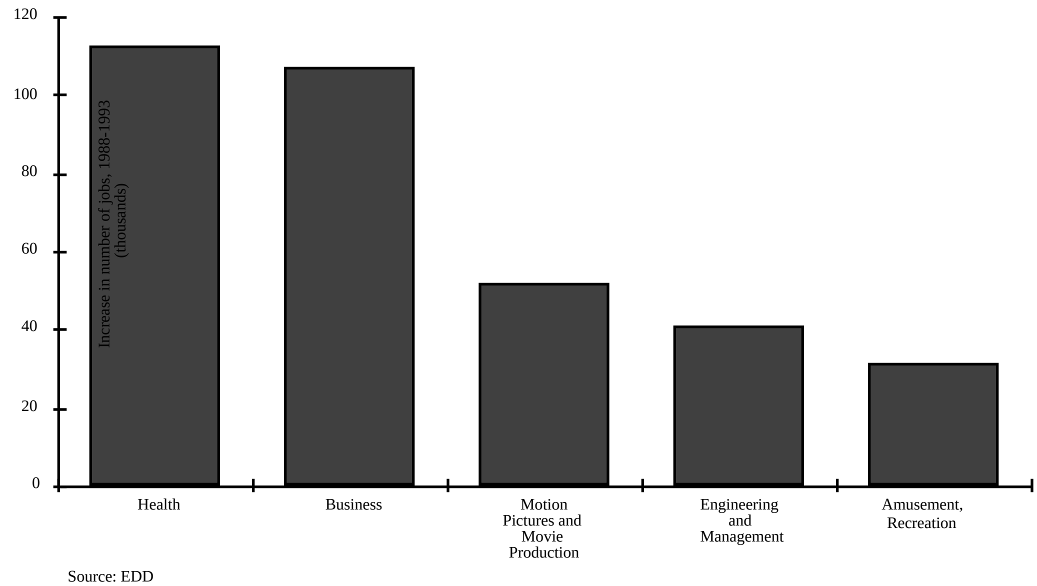


Figure 8—Service industries with largest job growth, 1988-1993

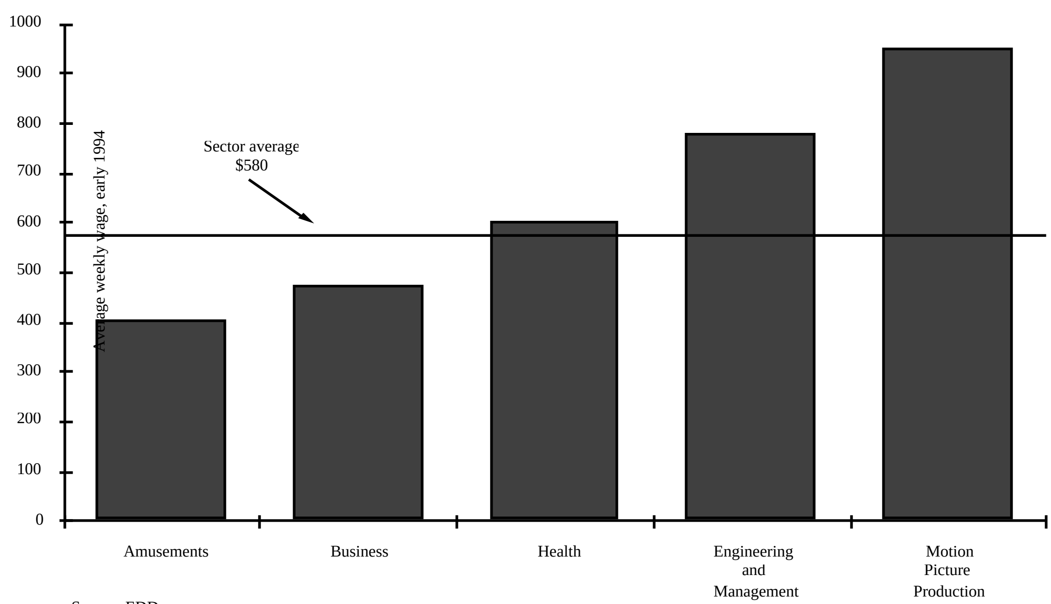
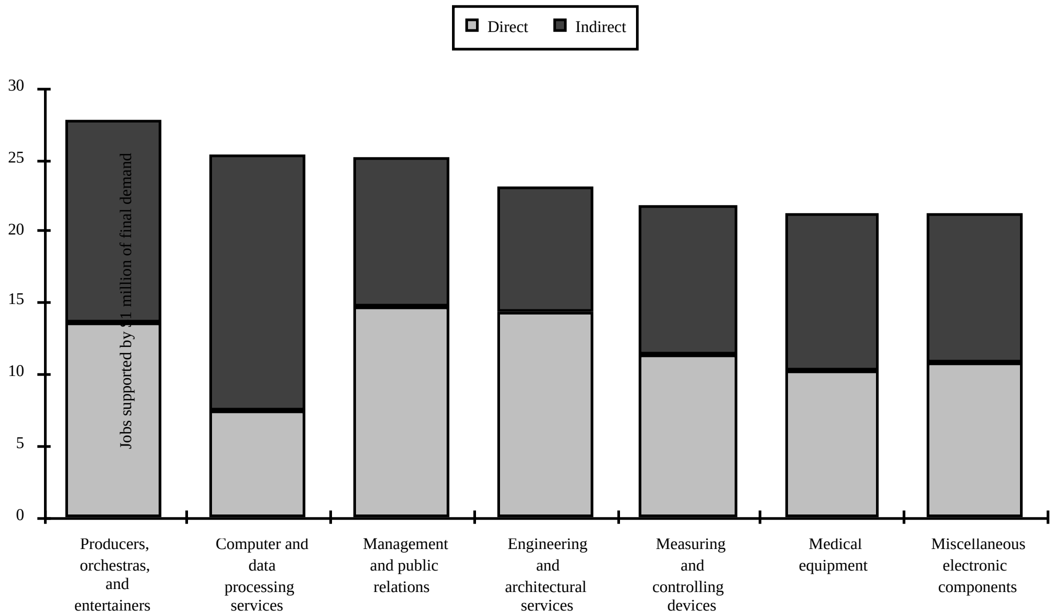


Figure 9—Average weekly wages in rapidly growing service industries



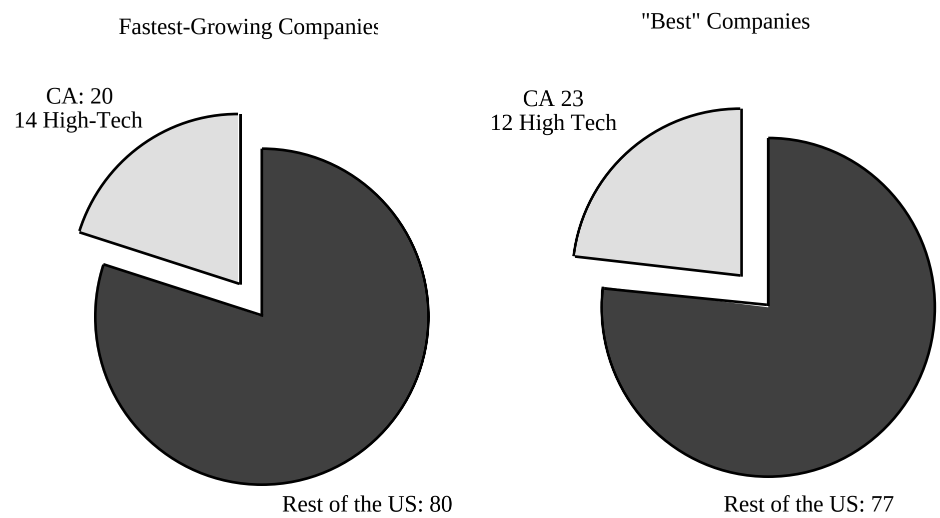
Source: Bureau of Labor Statistics

Figure 10—Jobs Supported by California's Emerging Industries

The "New" California Economy

Over time several industries have formed the core regional economic bases for California, including aerospace and defense, computers, electronics, agriculture, apparel, transportation, entertainment, and tourism. As the economy responds to structural and other challenges, the state's regional economic bases are shifting, in some cases, away from traditional industries to industries that include medical and transportation equipment, and legal, business, environmental, and engineering services. Indeed, California is well positioned to become the global leader in a number of these new industries.

These structural shifts are apparent in the high number of growing companies that are located in California. Twenty percent of America's fastest-growing companies, including 14 high-tech firms, are located in California, even though California represents just 13 percent of U.S. population (Figure 11). An even greater share of other top companies are located in California, and 33 of the Inc. 100 are in California. Nearly one-half of these firms are high technology companies. A disproportionate share of the nation's high technology production (22 percent), biotechnology (29 percent), and professional service (14 percent) industries are located in California.



Sources: America's 100 Fastest-Growing Companies, Fortune, August 9, 1993; Business Week, May 24, 1993

Figure 11—Fastest-growing and best companies in California and the U.S.

Many of these industries—and some of California's healthy old ones—are experiencing rapid increases in output, but limited increases in employment. In short, layoffs in many of the industries, except for aerospace, are a result of higher productivity due to investments in new equipment and technologies as businesses face enormous global competition. This drive toward greater productivity is not just in manufacturing, but is spreading to service businesses such as finance and retailing.

In this connection, the case of Silicon Valley is dramatic. The home of high technology in Northern California continues to maintain its viability in a global economy via rapid productivity increases. But this, not surprisingly, has meant rapid increases in output with *declining jobs,* at least in the near future.

Federal Policies

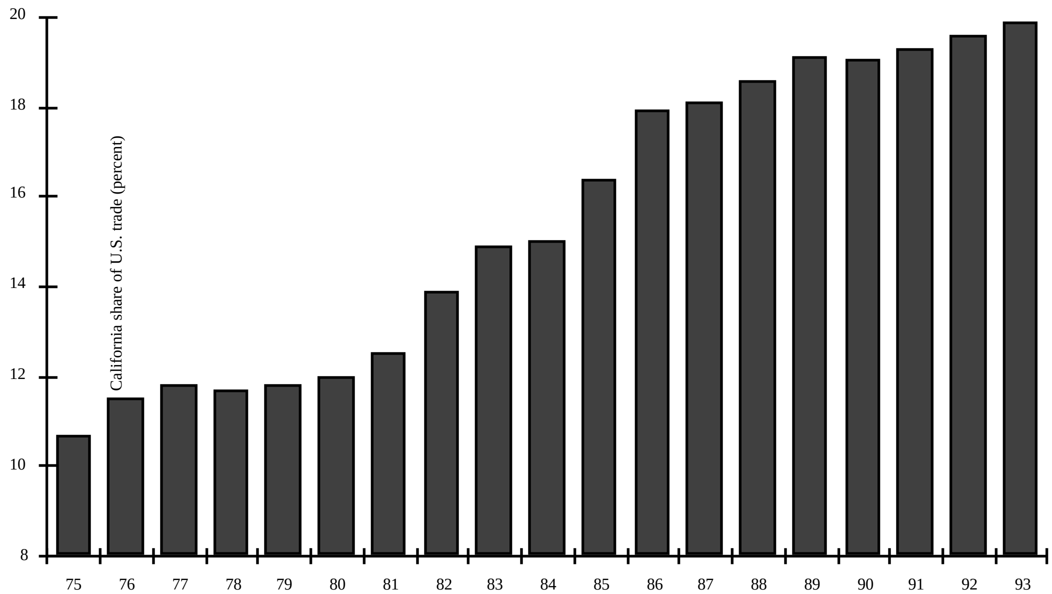
Federal policies can help speed up California's economic restructuring and establish the foundations for long-term growth. Infrastructure improvements, financial incentives for job training and small businesses, and leadership to support this "new" California economy can help. In addition, federal efforts to update U.S. government economic data collection to reflect the changing economy are needed. Many new industries and industry clusters represent hybrids of traditional industries. For example, biotechnology, environmental technology, and multimedia represent California's rapidly expanding "new economy;" however, measurement of the economic impact or importance of these industries is rendered nearly impossible by an outmoded data collection and categorization structure in the Departments of Labor and Commerce.

THE GROWING IMPORTANCE OF TRADE

International trade also continues to contribute greatly to California's economic recovery. California now accounts for nearly one-fifth of total US trade, almost double its share twenty years ago (Figure 12). Exports now account for more than 10 percent of Gross State Product, about double the level in 1987 (Figure 13). Had trade not expanded at this recent rate, but instead remained unchanged, employment in California would have increased to only about 11.4 million rather than the current 12 million since 1987.

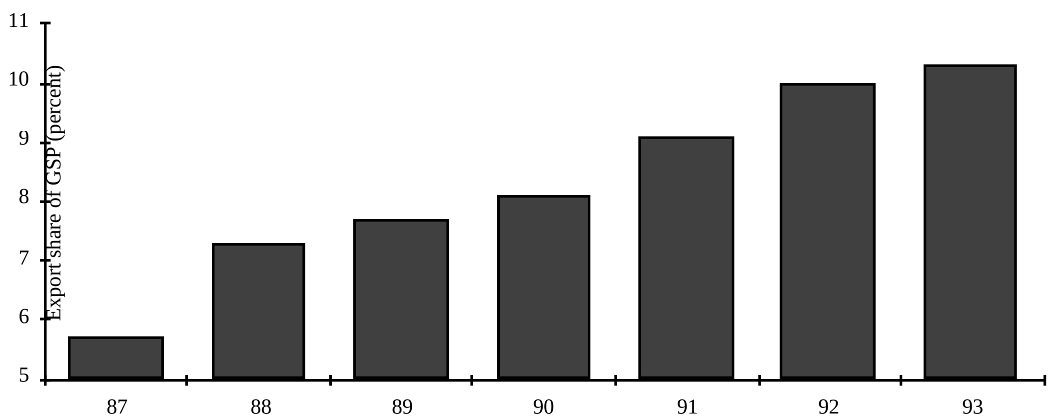
In 1993, trade grew in California at a 7.9 percent rate and was particularly impressive in San Francisco, where trade volume rose 13.1 percent. Trade growth in each region of the state exceeded the national average. Were it not for a slowdown in commercial aircraft exports, trade in California would have increased at an even faster rate.

U.S trade should expand over the next several years at almost double the GDP growth rate. Trade in California will likely expand at an even faster rate. Trade with Asian and Latin American partners should continue to accelerate as their economies grow at a rapid pace.



Sources: US Department of Commerce, MISER.

Figure 12—California's share of U.S. trade



Sources: MISER, WEFA

Figure 13—Export share of California Gross State Product

The new California economy should add to the state's trade potential. In particular, California's strength in services should add to its exports (Figure 14). The state should perform well in business and professional services, such as management and engineering (where California has accounted for virtually all of the net national job increase since 1988), computer processing, and management consulting, in addition to travel services and motion pictures (Figure 15).

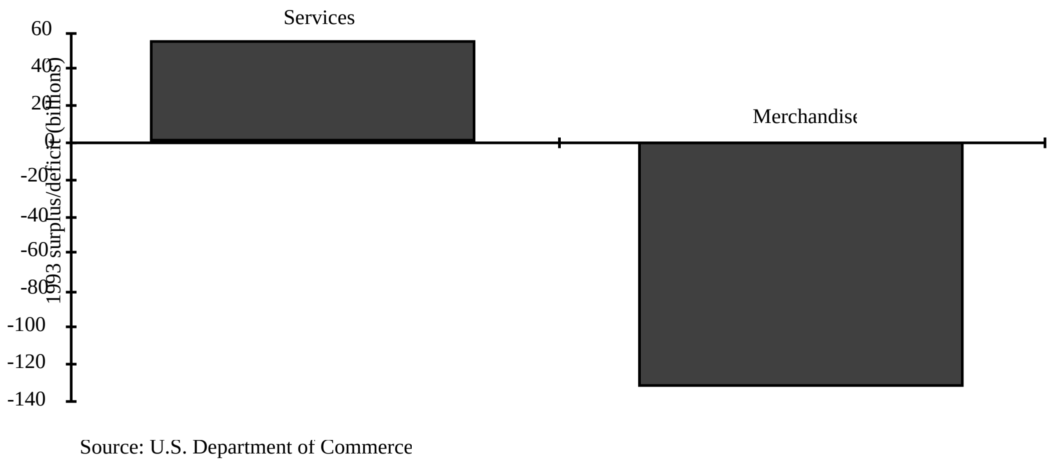


Figure 14—U.S. trade balance in services and merchandise

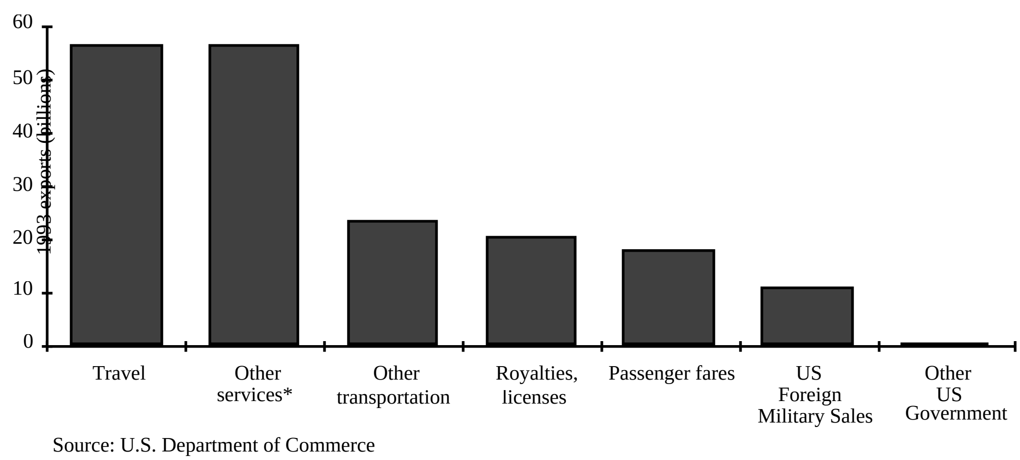
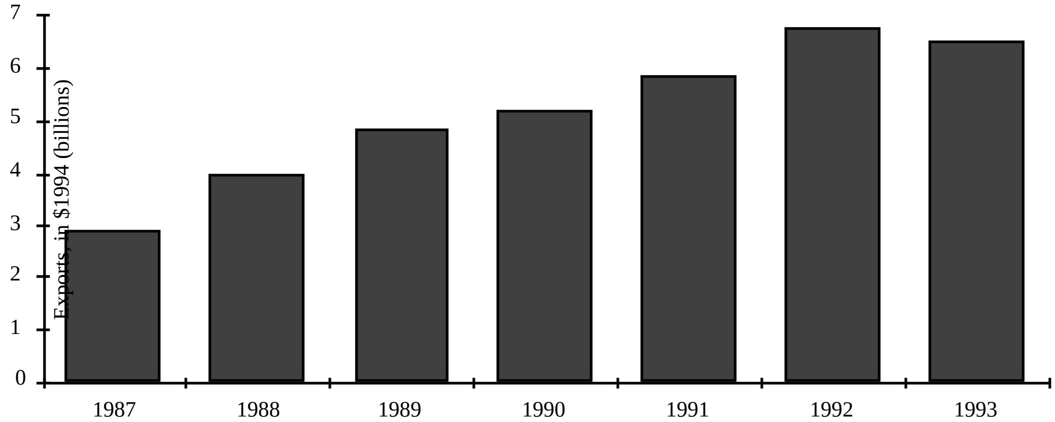


Figure 15—U.S. Non-manufacturing exports[6]

Trade Liberalization

Recent trade liberalization agreements have helped California expand its trade base. For example, trade with Mexico grew from $3 billion in 1987 to more than $6 billion in 1993, after adjusting for inflation (Figure 16). The recent passage of NAFTA, possible agreement on GATT, Pacific rim economic growth, and recent extension of most favored nation status for the People's Republic of China suggest a bright future for California.

[6]Other services consist primarily of advertising, computer and data processing, data base and other information, research, development, and testing, management consulting, and public relations, legal, construction, engineering, architectural, mining services; industrial, engineering, installation, maintenance, and repair of equipment.



Source: MISER

Figure 16—California's Exports to Mexico

Implications of GATT on the California Economy

The recent Uruguay Round Agreement of the General Agreement on Tariffs and Trade liberalizes trade for a number of industries in which California has a comparative advantage. In particular, the adoption of intellectual property laws into GATT should provide California a substantial long-run economic boost. For example, although the International Trade Commission does not expect a large increase in US exports of audiovisual services (e.g., motion picture production and distribution),[7] GATT provides 50 year copyright protections, as well as detailed dispute resolution procedures for copyright disputes. Trade liberalization also will undoubtedly harm some California industries, but the net effects will be highly positive.

GATT is expected to provide a number of California industries with a boost from increased exports. Table 2 highlights ITC projections of increases in US exports resulting from GATT in selected industries. In some cases, US business revenues are expected to increase more than the anticipated increase in exports. For example, while business service exports are anticipated to increase 1-5 percent, revenues will likely rise up to 15 percent.

[7]Many industry sources disagree with this assessment, pointing to Latin America and the PRC as new markets.

Table 2

ANTICIPATED INDUSTRY EXPORT GROWTH RESULTING FROM GATT

1-5 percent increase	**5-15 percent increase**
• Computers and office equipment	• Wine
• Semiconductors and other electrical components	• Electronic equipment and components
• Instruments	• Recorded media
• Medical equipment	• Value-added telecommunications services
• Business and professional services	• Telephone and telegraph apparatus and optical cable

Federal Policies

A number of federal policies and a range of federal support can help California expand its economy via trade. First, and most important, continued trade liberalization and the leveling of the international playing field has and will continue to benefit California disproportionately.

Second, infrastructure improvements that provide opportunities to expand trade should be pursued vigorously. Among the improvements that would benefit the state are:

- Improved air traffic control systems
- Port and road improvements, such as the Alameda corridor in Los Angeles
- A communications "superhighway."

The restructuring of California's economy and the growing role of trade suggest a bright economic future. Two other issues, empowerment zones and base re-use, suggest significant opportunities.

EMPOWERMENT ZONES AND ENTERPRISE COMMUNITIES

The 1993 Ominbus Budget Reconciliation Act provides for the establishment of nine Empowerment Zones and 95 Enterprise Communities in 1994. Zones and Communities are eligible for substantial assistance,[8] including tax-exempt facilities bonds, block grant funds, employer wage credits, and accelerated deprecation for business properties. Empowerment Zone designations

[8]About $100 million per Empowerment Zone.

will be effective for 10 years. (Although each Empowerment Zone will receive up to about $100 million in federal assistance, the amount on a per capita basis remains relatively small.[9])

California is likely to be awarded at least one empowerment zone, and this federal assistance could be critical. However, very little is known about the underlying reasons for success in empowerment zones or enterprise communities. While public education and investment in community-wide projects appear to be important to success, policymakers would be well served to investigate other factors that are critical to success.

In the future, California lawmakers should consider definition changes in Empowerment Zones to increase opportunities for California. For instance, current designations require the submission of applications based on census tracts. Because areas of high poverty are generally more dispersed in western states, census tracts are an inappropriate measure. In addition, current application procedures preclude the inclusion of central business districts (CBDs) unless the average poverty rate is a very high 35 percent. Because most western cities have a greater number of census tracts that qualify as CBDs, fewer areas qualify.

This definitional problem should pose a less serious problem for California in this year's competition. President Clinton has created a federal Enterprise Board comprised of appropriate Cabinet level secretaries providing a single point of contact within the federal government. The Board is to be given broad waiver authority to assist local governments in the more efficient use of existing federal programs. The intent is to streamline regulations, rules and paperwork and deliver "one-stop" federal responsiveness.

MILITARY BASE RE-USE

California has sustained a disproportionate number of job losses stemming from base closures. California has 15 percent of the nation's military base employment, but the state absorbed 69 percent of the job losses for the first three rounds of base closures—in 1988, 1991, and 1993. In Northern California alone, the direct and indirect job losses from the 1993 round of base closures will top 80,000 over the next 5 years, or greater than the number of jobs lost in the recent recession. An accurate estimate of job losses from base closures is difficult at best

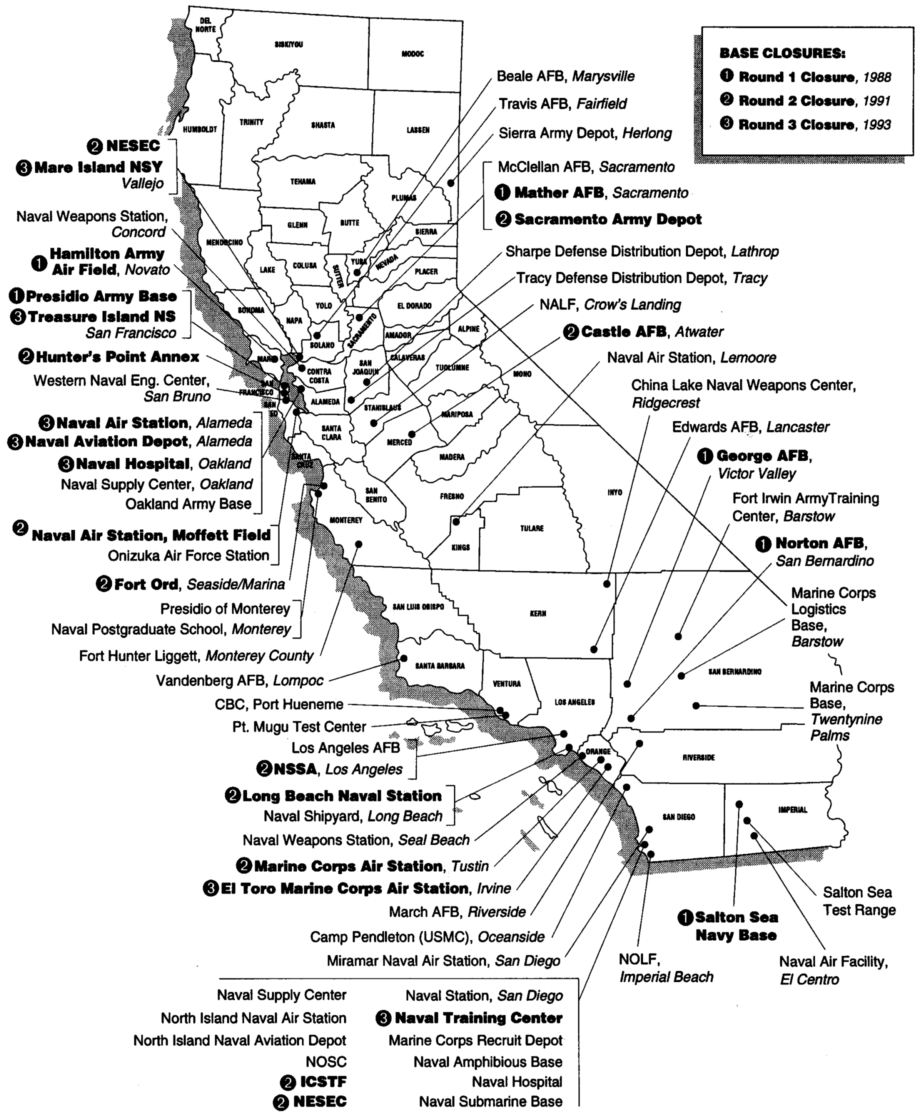
[9] For a Zone with 200,000 persons, the per capita amount is $500 over ten years.

since the outcome, to a considerable degree, depends on the speed at which base closures are implemented, and more importantly, the effectiveness of base re-use plans. Base re-use plans with community-wide economic development focus can make up for the jobs lost over the long term.

Despite the large number of actual and planned base closures to date, it is likely that California will suffer additional losses in the 1995 BRAC round (Figure 17). After three rounds of closures, California remains home to 50 major installations (i.e., employment of more than 5,000).

Because of the closures to date and the likelihood of additional closures next year, it is important that additional steps to facilitate re-use be taken. These include amending the McKinney Act to expedite re-use, fully funding clean-up of contaminated parcels, and allowing greater flexibility in the use of federal re-use funds for community-wide economic development projects.

California Military Base Closures and Major Active Military Bases



Source: California Military Base Re-use Task Force

Figure 17—Military bases in California