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Whither California?

The current recession in California has lasted longer than any other post-war downturn and has cost the state well over a half a million jobs. This *Weekly Letter* assesses where California's economy stands and where it appears to be headed by looking at the main sectors of the state's economy, defense, construction and real estate, manufacturing, trade and services, and also at the implications for the state's budget. Evidence suggests that we may be at or near the bottom of the cycle, but several problems remain. Therefore, California is unlikely to see a normal recovery for some time after the trough of the state's cycle is reached.

Serious problems

The current downturn in California has turned out to be the most severe of the post-war period. Typically, the state's economy falls and rises with the nation's. This time, true to form, California's payroll employment peaked nearly three years ago, within a month of the national employment peak. However, while national employment hit its low point in February 1992, the number of jobs in California is still falling.

If California's job losses had ended when the national recession ended, as is typical, this downturn would not have been unusual compared with other post-war downturns. But so far, the period of employment decline in California has been nearly three times longer than the state's longest previous post-war recession, which was in 1970–1971. Because the decline has lasted so long, this downturn also is severe in terms of job losses: During the past three years, California has lost 585,000 jobs, a drop of 4.7 percent.

Other measures of economic activity also show that the current downturn has taken a much bigger toll on California than is typical for recessionary periods. For example, real per capita personal income is down 5.8 percent, compared with an average drop of 1.4 percent during the past four recessions; in the worst of those, 1981–1982, real per capita personal income dropped 2.1 percent. Likewise, retail sales, housing permits, and nonresidential construction activity all have fallen much more sharply than in previous California recessions. By all of these measures, California's current downturn is the state's most severe in at least the past 30 years.

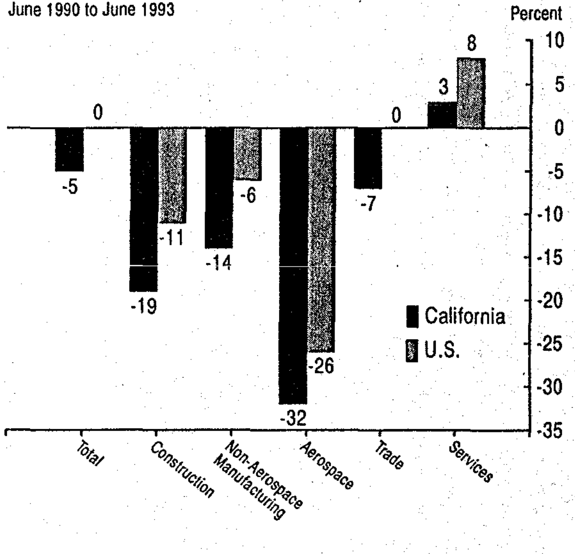
Defense cutbacks

Defense cuts have contributed significantly to the severity of the downturn. According to the California Commission on State Finance (COSF), the volume of real defense dollars going to California has fallen 21 percent, or $13 billion, since the peak in 1988. Most defense contracting activity is in the aerospace industry, which has been hit hard. The aerospace industry, which also includes commercial aircraft and space production, has lost 137,000 jobs since the peak, a decline of 37 percent (see figure). While defense spending in California has fallen fairly steadily since 1988, 105,000 of the lost aerospace jobs have come since the middle of 1990.

The defense cutbacks planned by the federal government are nowhere near complete. The budget cuts proposed by President Bush would lead to a further $11 billion reduction in defense spending in California by 1997. According to COSF, President Clinton's proposed cutbacks would result in an additional $6 billion loss in revenues in California during that period. COSF estimates that the state will lose around 90,000 more aerospace

Employment Change by Industry

June 1990 to June 1993



jobs by 1997. The 1988 and 1991 lists from the Base Closure and Realignment Commission called for cutbacks of 49,000 military and civilian jobs in California, and the changes included in the 1993 list will result in another 30,000 civilian and military jobs lost. In addition, California probably will have to deal with further shrinkage in military base employment, since more reductions will be proposed in 1995 and 1997.

Construction and real estate troubles

Economic troubles in the construction and real estate sectors also are more severe than they would be in a "typical" California recession. The number of housing permits has fallen more than 70 percent since the 1989 peak, and the number of existing homes sold is down about one-fifth. The statewide median home price has been fairly stable, but residential property values have fallen significantly in many local markets, with the largest drops in high-end communities and areas closer to the state's coast.

Commercial construction activity also has fallen sharply. Even so, more than 20 percent of office space is vacant in many markets. Commercial property values and rental rates are down significantly, with many properties selling for substantially less than the values they fetched a few years ago. Given the weakness in real estate markets and the dearth of activity in both residential and nonresidential construction, it is not surprising that construction employment has fallen 20 percent since early 1990, for a loss of more than 100,000 jobs.

Although low interest rates and reduced home values make home ownership in California more affordable than it has been in years, there has not yet been a significant improvement in any measure of housing activity, such as home sales or new housing permits. Commercial real estate remains troubled as well. With a slow economy, it will take several more years to absorb the space that is already built. Thus, nonresidential construction will not contribute to growth in California until at least the end of the decade.

Nonaerospace manufacturing

California's problems are not confined to the defense and real estate sectors, however. For example, nonaerospace manufacturing has lost 150,000 jobs, or 9.1 percent of the total, since California's downturn began. Following the national pattern, the lost jobs are spread across a broad range of durable-goods industries, including lumber and wood products, primary and fabricated metals, furniture and fixtures, and electronic equipment. However, the job losses have been much more severe than those nationally, where the number of jobs fell 5.5 percent during the same period.

One possible reason for the generalized weakness is that some of California's "nonaerospace" manufacturing firms may sell their products to local aerospace companies. Close linkages among various types of manufacturing firms could cause the cutbacks in defense spending to reverberate through a broad range of industries. For example, within the fabricated metals industry, the fabricated structural metal products sector has been especially hard hit, probably due to reduced demand because of the declines in aircraft and missile manufacturing.

Another possible reason for weak manufacturing activity in California is that a poor business climate may have led some producers to leave the area. Anecdotal reports suggest that a large number of firms, and jobs, is leaving California for sites with lower costs, fewer environmental regulations, easier permitting procedures, and lifestyles that are more attractive to employees. It is difficult, however, to get a handle on how important these business climate factors have been in explaining California's recent troubles.

Trade and services

Since mid-1990, employment in wholesale and retail trade has fallen 6.9 percent, a loss of 207,000 jobs, compared to only a 0.1 percent decline nationally. Since the beginning of 1990, the real dollar volume of retail sales has fallen by 10 percent, while taxable sales have fallen 15 percent. While consolidation by some retailers may account for some of the weakness, California's poor retail performance relative to the national economy is due primarily to the generally weak economy.

The number of jobs in services grew through most of the recession, although at a much slower pace than during the earlier expansion. The slowdown reflects generally weak economic conditions. The aerospace cuts and business climate factors that exacerbated the manufacturing troubles may have hurt some service industries as well, but these problems do not appear to have been crucial for most service sectors. For the past several years, services has been the economy's fastest-growing sector, and robust growth in California's health care and motion picture industries during the recession has kept the number of service jobs up. Since July of 1990, the number of service jobs in California has risen 2.7 percent.

Fiscal troubles

Partly as a result of California's broad-based economic problems, state and local governments have faced severe fiscal troubles in recent years. For the fourth consecutive year, lawmakers this June addressed a large budget shortfall—this time amounting to $8 billion. Earlier in the downturn, state and local government employment did grow, but during the past year and a half it has fallen steadily. This year's solution to the budget impasse will result in cutbacks in public services, particularly those provided by local governments. The budget cutbacks will reduce the funds available to government employees and recipients of public aid or services, so they will tend to have a constraining effect on economic growth in the state.

Where are we now?

It is clear that California's economic troubles go well beyond a small number of industries. The severity of the recession reflects the fact that several problems have hit California's economy at once. The national recession, large cutbacks in defense spending, and serious overbuilding in some real estate markets, taken together, go a long way towards accounting for the magnitude of California's troubles to date.

Some measures of California's economic health have been flat for the past year or so. For example, taxable sales (adjusted for seasonality and for changes in the "snack tax") have been more or less flat since the end of 1991, and the number of existing homes sold has not fallen below where it was at the end of 1991. Moreover, the number of construction jobs was the same in June as it was six months earlier, a big change from the persistent declines seen previously. At the same time, though, the number of housing permits issued has fallen again after a brief upturn (on a seasonally adjusted basis) around the beginning of the year, and total payroll employment continues its persistent decline.

Where are we headed?

While there is some evidence that the worst of the downturn is past, it is important to distinguish between the end of a downward trend and the beginning of a normal recovery. For one thing, California is likely to see additional large defense cuts during the next few years. These defense cuts alone would normally not be enough to keep California from recovering; historical relationships suggest that even slower-than-expected national economic growth, with the number of jobs rising only 1 percent a year, would be more than enough to offset the anticipated defense cuts and any associated secondary effects. However, these clearly are not normal times. Overbuilt commercial real estate markets and persistent fiscal problems also will continue to be a drag on California's economy during the next few years. Nevertheless, taxable sales and home sales do appear to have stabilized, suggesting that there are fewer sources of downward pressure than there were earlier in the recession. Taken together, these factors suggest that California is likely to "bump along the bottom," with little trend either up or down, during the next year.

The longer-term outlook is somewhat brighter. California continues to offer a large, wealthy market for many products. The recent passage of workers' compensation legislation suggests that lawmakers may be willing to make changes aimed at improving California's business climate. Its location makes California a natural headquarters for international trade in the growing Asian markets. Expanded trade with Mexico also is likely to be a positive development for many in California. California's diverse and growing population offers strong promise for a future in which international ties are likely to take on added importance.

Immigration brings promise for the future, but it also brings the responsibility of giving new residents and their children the tools to become self-sufficient. That responsibility, along with fiscal changes that will result from the series of fiscal crises California has faced in recent years, make the future of the state's taxation and public service structure unusually uncertain. If California comes through this difficult period as a high-tax state that provides poor public education and few other public services, it would become a less attractive location for potential resident and businesses. California's challenge is to work toward making California a better place in which to live and work.

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Reference

California Commission on State Finance, "Impact of Defense Cuts on California: An Update," Sacramento, California, May 1993.