

THE CALIFORNIA ECONOMIC OUTLOOK

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Overview: A Booming Economy?

If you look at the surface, it would be hard to think that there is anything wrong in California. The labor markets are kicking along, unemployment is falling and incomes are on their way up. The housing market continues to boom along, with median prices continuing to rise and housing permits hitting 160,000 in September, up from 153,000 at that point last year. Taxable sales are also on the rise; the first half of 2005 saw total spending on taxable goods rise by 7% over the same period of 2004.

Overall general fund revenues are growing at a double digit pace over last year (14% through September, fiscal year-to-date 2005-06 over fiscal year-to-date 2004-05) led by surprising increases in corporate taxes, but also income and sales taxes. The growth in state revenues is considerably faster than the Department of Finance (DOF) had originally forecast. DOF, like the UCLA Anderson Forecast, has been amazed at the buoyancy the economy is showing. The issue is simple. While things are booming at the surface, the important mechanisms that drive a healthy economy forward are not showing the kind of numbers that would generate this level of spending in our economy. What we have in California is an economy that is being driven forward by housing, and what is of worry is that housing by late 2005 was showing signs of having peaked.

The outlook for 2006 is dominated by the housing question. With a falling dollar and rising international demand for U.S. and state exports, California will feel some gain in the important external side of the economy. This effect will be offset by a weakening housing sector, a slower pace of building, and slower consumer spending. At best, 2006 will continue to be a year with a slow-growth economy, but the signs of this slow growth will be more obvious, particularly on the public revenue side of the equation. At worst, if housing cools rapidly, it could slow the economy sharply. In either case, we can expect many of the problems that the state's legislative bodies have been largely able to ignore in the current economy: fiscal reform, business climate issues, and a terrible shortage of low-income housing. These issues will dominate the headlines again.

Employment and Income: A Moderate Recovery

June 2005 was a milestone for the California economy, as payroll employment finally caught up and passed the previous peak hit prior to the tech bust that began in 2000-01. Total payroll employment in September 2005 was 15.18 million (seasonally adjusted), eighty thousand more jobs than what we had in January 2001. (Figure 1) It was also a milestone inasmuch as the number of payroll jobs has been expanding within every major economy inside the state for the first time since 2000.

Specifically, San Jose, an economy that lost close to 20% of its formal workforce during the business investment led recession, finally moved into recovery more than four years after the losses began. It has been growing at a .6% annual rate since the start of the year. The Bay Area overall is becoming much healthier. San Francisco has similarly recovered, and the resilient East Bay is one of the faster growing portions of the state. With the good news in the area, the labor force is starting to return there as well.

While that trend is good news, there is still not much to cheer about in the numbers. Payroll job growth in the State for most of 2005 was about 1.4% in annualized terms. At the same point in 2004, the growth rate was nearly 2%. In comparison, the long run average rate for the state is between 2% and 3%. With the exception of Bakersfield, no major economy in the state had more than a 2% growth rate in 2005. While the Bay Area was recovering, we saw a slowing of growth in other previously buoyant economies, such as the Inland Empire, San Diego and Orange County. Real workplace earnings were similarly anemic, growing at a modest 4% annual rate, far below the 7% rate seen in the late nineties. With the rise in the cost of fuel, real earnings growth actually slowed in the first and second quarter of 2005 to below 4%. On a per worker basis (using household employment data), real income per worker actually fell in the second quarter of 2005.¹ (Figure 2)

Falling Unemployment

The one solid sign for the state labor force was the falling unemployment rate. (Figure 3) Indeed, one of the oddities of this recovery is that despite anemic payroll job growth over the two years and strong labor force growth (2.3% seasonally adjusted annual rate during most of 2005) unemployment actually fell to

Figure 1: California Payroll Employment
(seasonally adjusted, thousands, smoothed)

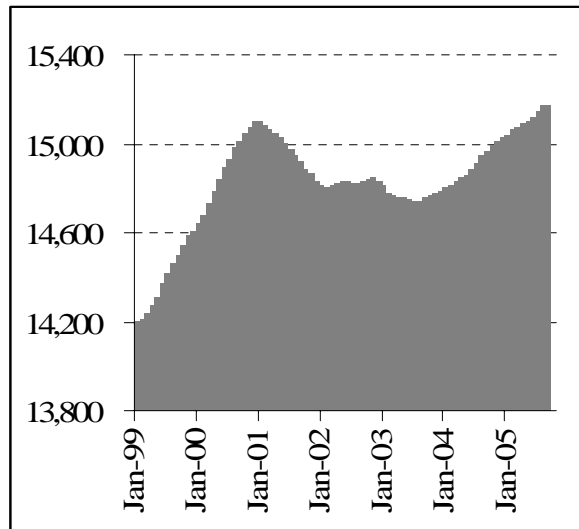


Figure 2: Growth in Real Net Workplace Earnings
(seasonally adjusted annual rates, CPI Deflated)

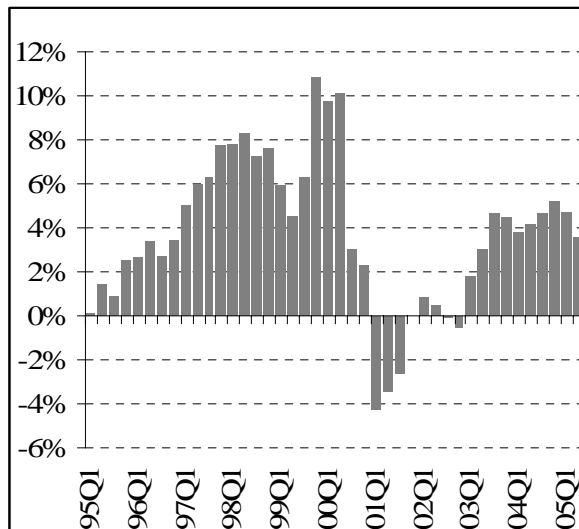


Figure 3: State Employment and Growth (GR) in 2005
(all figures seasonally adjusted annual rates)

	Payroll Emp.		Labor Force		Household Emp.		Unemployment	
	Sep-05	Gr05	Sep-05	Gr05	Sep-05	Gr 05	Sep-05	Gr 05
California	15,179	1.3%	17,945	2.3%	17,012	3.4%	5.2%	-0.7%
Los Angeles	4,035.5	1.1%	4,884.0	1.3%	4,656.0	3.6%	4.7%	-1.6%
Orange County	1,498.2	1.9%	1,640.9	3.6%	1,579.7	4.0%	3.7%	-0.3%
San Diego	1,291.1	1.5%	1,536.6	3.3%	1,472.1	3.7%	4.2%	-0.3%
Inland Empire	1,198.7	1.9%	1,709.2	3.6%	1,623.2	4.2%	5.0%	-0.4%
East Bay	1,040.8	1.9%	1,292.7	3.2%	1,228.9	3.9%	4.9%	-0.5%
San Francisco	949.5	0.7%	937.3	2.3%	895.1	3.0%	4.5%	-0.5%
Sacramento	875.8	0.8%	1,030.7	2.8%	982.6	3.2%	4.7%	-0.3%
San Jose	867.4	0.6%	861.8	2.1%	814.7	2.8%	5.5%	-0.5%
Fresno	333.8	0.9%	410.9	1.1%	371.9	1.2%	9.5%	0.0%
Ventura	309.2	1.1%	423.7	2.3%	404.1	2.9%	4.6%	-0.4%
Bakersfield	256.2	2.7%	324.4	2.1%	296.4	3.0%	8.6%	-0.6%
Stockton	219.6	-0.1%	290.5	1.8%	267.6	1.9%	7.9%	0.0%
Santa Rosa	191.4	0.1%	260.3	1.5%	248.7	1.8%	4.4%	-0.2%
Santa Barbara	188.8	2.0%	220.4	3.1%	210.8	3.3%	4.3%	-0.2%

almost 5%, just above the national average. This figure is a level not seen since 1990, prior to the aerospace crash and the national recession that occurred then.

Unemployment was low in late 2005 most places in the state. Even in hard hit San Jose, the rate was a moderate 5.5%. The rest of the Bay Area and most of Southern California enjoyed rates below the national average. Even economies in the central valley that are used to double digit rates saw unemployment fall to levels below 10%.

The Informal Sector

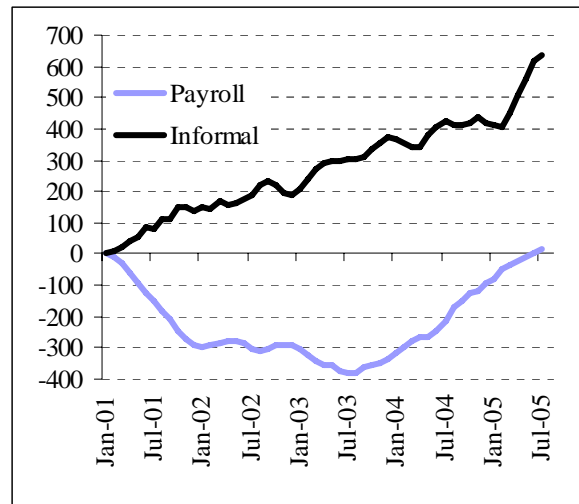
The reason for these different trends is the continued expansion of the informal sector—those jobs that appear to be in the state according to the household employment survey, but are nowhere to be seen in the payroll data. (Figure 4) While the state eventually recovered the 300,000 payroll jobs lost during the tech bust, it added more than 600,000 new informal jobs. Some of these jobs may truly reflect employment that will not normally show up on the payroll data (i.e., the self-employed). But the sheer quantity implies that there is something more going on. The state in late 2005 had almost 1.9 million non-payroll jobs according to the numbers, 12.4% of the normal workforce, twice the rate of any other state. This phenomenon should be a large concern for policy makers, as little is known about what these folks do, the type of benefits they may or may not have, and whether or not they pay taxes.

A job and an income are good things even if they are outside the purview of the government statistician, and these numbers reflect a level of economic prosperity we might miss if we focused only on payroll employment. Yet the formal/informal gap does reflect a serious economic problem in the state having to do with the high costs of doing business here and the continued increase of low skilled workers as a portion of the

workforce. That influx is largely due to the high rate of immigration into the state, with many immigrants having little education. A fifth of the population in California does not have a high school degree, compared to 15% of the rest of the U.S. The average age of this less-than-high-school group is considerably lower in California. As a result of their larger share of the workforce, the average earnings level for these folks is 5% lower than in the rest of the U.S. In contrast, those persons in California with some college education or more earn 15% to 20% more than the U.S. average.(Fig. 5)

Why the increase in informal employment? It is due to raising the fixed

Figure 4: Cumulative Changes in Employment (seasonally adjusted, thousands, smoothed)



costs of traditional payroll employment that developed in California with expanded regulatory issues and increased costs for pensions, payroll taxes, and the various required insurance fees. Many of these low skilled folks have become simply unaffordable to hire under

Figure 5: Income and Education

	California		Balance US	
	Share	Income	Share	Income
No High School	19.6%	\$17,255	15.6%	\$18,144
High school graduate	21.6%	\$26,541	30.6%	\$25,360
Some College	29.4%	\$35,004	27.1%	\$30,891
Bachelor's degree	19.0%	\$48,507	16.9%	\$42,404
Graduate Degree	10.4%	\$65,728	9.8%	\$55,065

the traditional payroll framework, particularly in the service sectors where almost all new employment in the state is forming. In the state's competitive economy, their level of productivity does not warrant the expenses that must be incurred. To find employment these workers have had to seek paying jobs outside of traditional covered employment, and the market has expanded there as a result.

This long run issue needs to be dealt with on many levels, both in reducing the costs of employment and helping these workers gain new skills to increase their productivity. California needs to make sure that it has a public education system that does not create a second generation with the same problem. Unfortunately, our state has been bogged down instead in the political wrangling between the parties, and little is being done to fix these problems.

The New Job

What is a much greater concern is the type of jobs the economy added during the period since the recovery began in earnest. To highlight what has been happening, the

annualized change in jobs for 2003-2005 can be compared to the 25 months of recovery after the 1990 downturn bottomed out. The various sectors can then be ranked according to the relative difference between these two periods.

Overall the economy was adding 260,000 jobs per year through 2004 and 2005. The most recent downturn saw a slower recovery, only 210,000 jobs per year. Between 1993 and 1995 the gains in employment were largely across the board, with the one exception of the finance sector, which had been hit hard by the movement of bank headquarters out of many parts of the state. This time, however, many sectors in 2005 had yet to see a recovery in employment, or, indeed, continued to lose jobs. Government jobs,

manufacturing, information and management of companies all remained weak this time relative to the 1990s recovery in terms of job creation. (Figure 6)

On the other hand, the most improved sectors as of 2005 were finance and construction, each sector adding 32,000 more jobs during this recovery than the last one. Unfortunately, what has been driving job formation in California is the real estate boom that is getting ready to go bust. Also expanding was leisure and retail trade—sectors driven by residents’ wealth (particularly in house prices) and income. Hence, we see both the direct and indirect influence of the bubble on the economy in these numbers. When you think about where jobs and income are heading in California—think real estate.

Real Estate: Is The Party Coming To An End?

In 2005, the primary driver of the California economy remained the residential real estate boom. The pace of construction continues to accelerate, and California is now starting to build at a pace of more than 200,000 residential units annually. All of this new construction has been creating many of the new jobs in the state along with the finance companies working to extend credit. While we lack direct evidence, it appears that consumer spending was being fueled largely by the wealth being generated within the economy by the massive rate of house price appreciation.

Figure 6: California Job Gains During Recovery
25 month gains after employment trough,
annualized

	1993 to 1995	2003 to 2005	Diff.
Total, All Industries	261,200	208,400	-52,800
Finance	-22,600	10,400	33,000
Construction	26,700	57,700	31,000
Leisure	34,500	41,300	6,700
Retail Trade	21,600	27,900	6,300
Real Estate	100	4,200	4,100
Edu & Health	22,400	24,000	1,600
Professional Serv.	16,700	16,300	-400
Wholesale Trade	10,300	6,000	-4,300
Transport	11,300	3,400	-8,000
Other Serv.	13,100	4,400	-8,700
Information	16,400	6,300	-10,000
Durable Goods	17,600	5,600	-12,000
Mgmt of Companies	8,400	-8,900	-17,300
Nondurable Goods	14,500	-2,800	-17,300
Administrative	54,300	32,000	-22,300
Government	10,500	-19,000	-29,500

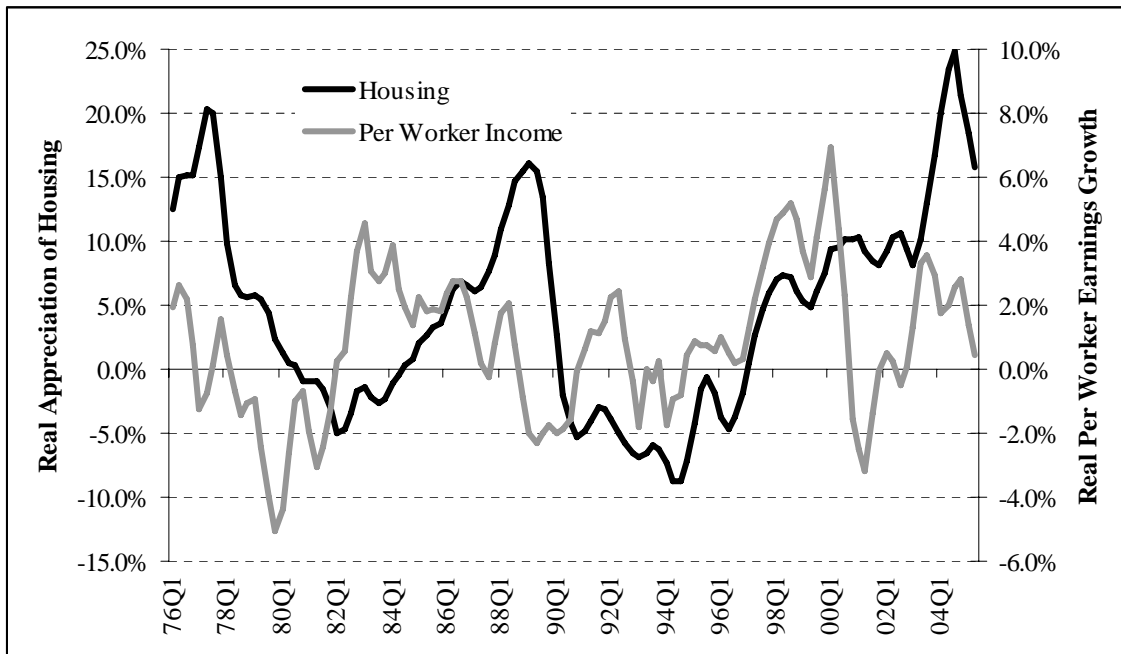
The Housing Bubble

How big is this bubble? Over the past 12 months the average house in California has increased in value by \$80,000. Since this cycle began, real estate prices had increased in real terms by 85% as of late 2005, and continued to climb. To put this trend in perspective, in the late 1980s, real estate prices increased by 45% in real terms. In the late 1970s, the trough to peak increase in prices was 55%. The current record run up in prices is not just occurring in California; it can be seen in the U.S. overall. Real (inflation adjusted) real estate prices in the U.S. have increased by about .5% per year for the past 50 years. Over 2004-2005, they grew at twice this pace.

The nation was investing twice as much in residential real estate on a real per capita basis as ever before. If this pace of investment were to fall to its long run average level, this shift would imply a decline in domestic demand of something on the order of \$300 billion. The decline in business spending that caused the last recession was a downturn in business spending of about \$200 billion.

Figure 7 shows the annualized change in real per worker earnings in California as compared to real increases in housing prices, based on Office of Federal Housing Enterprise Oversight (OFHEO) statistics. Housing prices are highly cyclical, lagging behind real income growth by between two quarters and two years. The primary exception to this general rule occurred in 2000, when earnings began to fall in the midst of the tech bust. Housing appreciation in the state (and indeed in the entire nation)

Figure 7: Growth in Real Housing Prices (OFHEO) and Real per Worker Workplace Earnings
Seasonally adjusted annual rates, smoothed



continued to be robust at that time, unlike any business cycle we have had in the past. Then, when income growth did return in 2003, it caused the housing market to accelerate to a pace of real appreciation never experienced before (at least not during periods of time for which the data are reliable).

Why is the rise in house prices a bubble? The simple answer is that a house is an asset, and houses viewed as assets have a fundamental price based on the potential for future rental growth in a region and the mortgage rate.² From 2003 to late 2005, mortgage rates rose slightly and rental markets had just begun to show some signs of life, with real rents starting to increase.

Housing prices should have basically gone flat as of fourth quarter (Q4) 2002, and instead they have grown at an unprecedented pace. On this basis, we can guesstimate that property in California is now overvalued something on the basis of 30 to 35%.

There are many housing bulls out there who offer all sorts of reasons for why they believe this view is wrong—that the market is fine and prices are in a stable position. One is that we have a housing shortage in California. The current pace of building is at about 1.7 new homes per new worker in California, almost twice the long run national pace of .9 new homes per worker. The U.S. overall is currently building 2.2 new homes per new worker. In any case, if the housing shortage story was true, we would see it in rents first, housing prices second. But, as mentioned, rental rates were functionally flat since 2002, certainly not indicative of a housing shortage. Many bulls respond to this logic that the rental markets cannot be used as a basis for discussing housing since there is an intrinsic value to owning that we callous economists can't possibly fathom. Perhaps there is an intrinsic value, but has it increased by \$200,000 in three years? Most other explanations for the current level of prices fall similarly flat when examined by any objective standard.

Low Income Housing

We do indeed have a housing shortage in California, but it is for low income apartments. This need is not being met due to the high fixed costs of building residential units in the state. The building boom in California added something on the order of 600,000 new units between 2000 and 2004. Yet the number of vacant units during that time actually rose slightly, from 825,000 units to 832,000 units. While California's vacancy rate is lower than the U.S. average, 6.5% is hardly a rate reflective of a terrible shortage. (Figure 8)

Figure 8: Vacancies and Overcrowding

	2000	2004
Balance of US		
Total Units	103,690,092	109,867,032
Vacant	10,260,458	11,937,100
%	9.9%	10.9%
Overcrowded	3,115,354	2,393,190
%	4.2%	3.1%
California		
Total Units	12,214,549	12,804,702
Vacant	825,181	832,544
%	6.8%	6.5%
Overcrowded	1,251,515	997,490
%	11.0%	8.3%

California's crowded housing problem has been reduced somewhat, through a trickle down effect. The number of residences with more than one occupant per room fell from 11% in 2000 to 8.3% in 2004 (this drop includes rented and owned units), but that level is still well over twice as high as the U.S. average of 3.1%.

The Impact of the Boom's End

When this real estate boom does come to an end, as it inevitably must, the economy is going to feel the impact directly and indirectly in almost every sector. In many ways the forecast for California is dominated by this one question: When is the party going to end?

One of the common misperceptions is that it will take an interest rate hike to slow the market down. That wasn't the case in 1989 when the last real estate boom came to a sudden halt and led the California economy into the deep downturn of the early 1990s. Remember how these bubbles work. Price increases cause people to raise their expectations of future appreciation, causing new buyers to enter the market, causing prices to rise yet again and so on and so forth. However, the cycle of self-fulfilling prophecies can only continue as long as there are new entrants into the market and that depends largely on available credit. What happened in the late eighties was credit tightening by the banking system due to the growing problems in the savings and loan system. Mortgage rates were steady right through the slowdown.

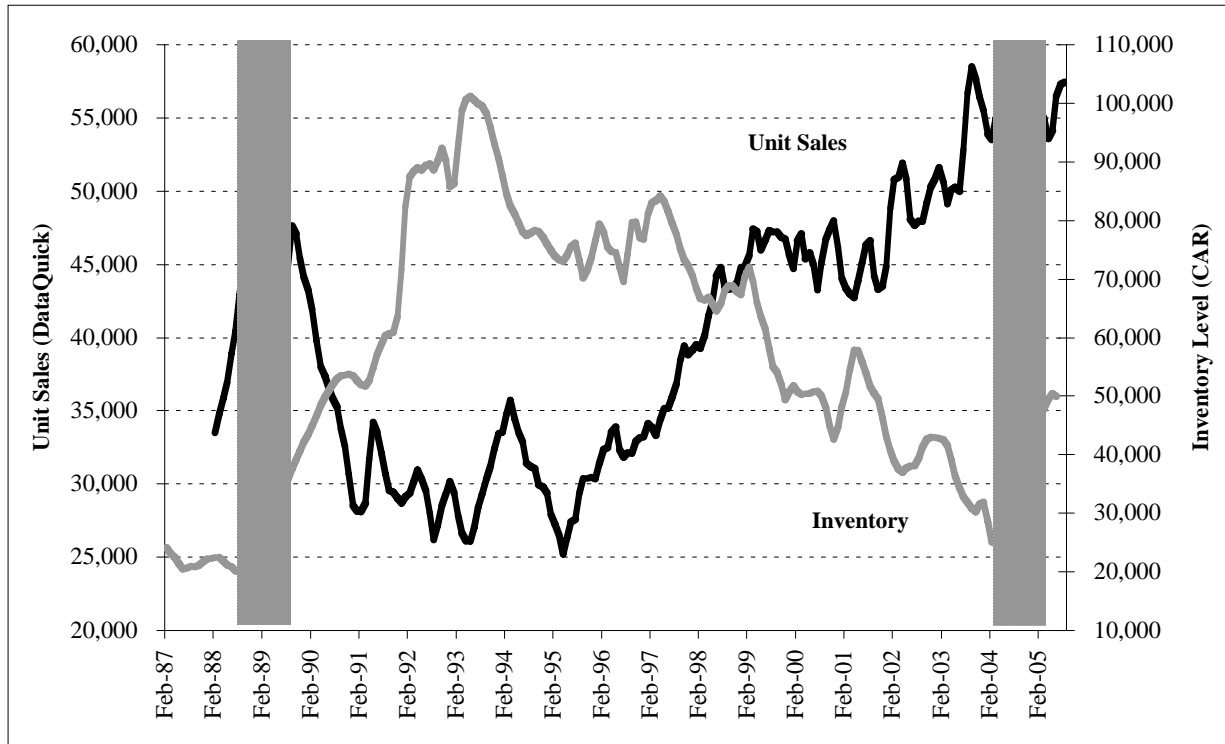
As of late 2005, the market was still red hot. Price appreciation and market activity continued at a record pace. (Figure 9) Nevertheless, the bubble was clearly starting to lose steam inasmuch as prices rose so much relative to incomes that new buyers had to rely on various types of high risk financing—namely variable rate, interest-only loans. This shift represented a market starting to reach a breaking point.

The best indicator that the party is ending is to watch overall market activity—total unit sales and inventories. When inventories rise and sales start to fall, this process spills over into price appreciation and into construction within three to six quarters, and that is when the overall economy will begin to feel the pinch. As of late 2005, the market appeared to be at a crossroads.

Figure 9: Changes in Sales and Prices, Q3 2004 to Q3 2005

County	Unit Sales	Price App.
Ventura	20.4%	15.3%
Orange County	14.0%	14.0%
Riverside	5.7%	16.9%
Solano	1.2%	23.7%
Los Angeles	0.5%	20.8%
San Bernardino	-0.6%	29.7%
Sonoma	-4.2%	19.7%
Napa	-5.7%	17.0%
Contra Costa	-5.9%	22.2%
Santa Clara	-7.9%	20.4%
Alameda	-9.1%	16.6%
San Diego	-9.7%	3.6%
San Mateo	-10.0%	18.3%
Marin	-11.9%	12.8%
San Francisco	-15.7%	15.4%

Figure 10: California Unit Sales and Inventory Levels (seasonally adjusted)



According to the latest numbers available at the time of this writing, market inventories in the state had almost doubled over the prior six months and overall market activity had been flat, albeit at a very high pace. (Figure 10) What these results hid was that some markets were still hot, but others were starting to show signs of weakness. As Figure 10 shows, San Diego, ahead of the home price curve relative to the rest of the state, saw unit sales drop by 10% and price appreciation slow to 3.5%. Much of the Bay Area, while still showing strong appreciation, had also seen total sales falling off.

Of course, there could be offsetting pressures. If the Federal Reserve had decided in the fall of 2005 to slow interest rate tightening due to Hurricane Katrina and the destruction in New Orleans and other Gulf Coast areas (which it apparently did not), that action might have been an offset. If more uncertainty in the stock markets caused bonds to rally, the mortgage interest rate might fall yet again, giving the housing market a few new months of prosperity. But things are clearly at a tipping point. And while it is unlikely that nominal home prices will fall rapidly, the absence of a sudden dramatic price drop does not mean a negative impact on the economy will be averted. A cooling market is characterized by a large drop in market activity (i.e., in new building units and refinancing), not to mention heightened foreclosure activity. Many of California's new jobs will suddenly start to disappear.

No Fix from Non-Residential Activity

Don't expect that non-residential construction will be able to pick up the slack.

The value of non-residential construction permits rose in late 2005, but this increase was not due to new demand for new non-residential investments. It's primarily due to the increased cost of construction. Pull out higher costs and the real level of investment remained flat. With vacancy rates high, and rental rates for commercial and industrial property flat, we can expect this sector to remain cool for some time to come, likely right through the next residential cycle.

Prop 13: Who's paying the property tax tab?

Apart from short term forecasting, the UCLA Forecast is concerned with long run issues such as education, infrastructure investments and tax policy in California. In the late 1970s, in response to rapidly rising property prices and the resulting increases in property taxes, the electorate passed Proposition 13. Prop 13 cut property taxes for a real estate owner, residential or commercial, to 1% of the initial purchase price or the 1976-77 assessment value – whichever was higher – with a 2% inflation factor thereafter. It made it harder in addition to raise other tax rates. One result was that the state had to rely more and more on the income and business taxes it had to fund ongoing programs.

California receives 25% of its state and local tax base from property taxes, compared to an average of 32% for the balance of the U.S. In 2004, the median value of owner occupied property in California was almost \$400,000 compared to \$152,000 in the rest of the U.S. but these higher values do not produce above-average property tax revenues. California is often referred to as a tax-unfriendly place to do business, odd considering that its tax burden as a percent of income is about average (The state ranked 22nd as of 2002).

This reputation is a reflection of the fact that corporate and income taxes are very business-unfriendly relative to property taxes. The taxes California does rely on are taxes on effort and success rather than on wealth. Prop 13 also put a slow strangle lock on California's education system by reducing the ability to acquire local funding and by making school systems dependent on state aid. This effect is one (of many) reasons why the California public education system is in a shambles in many areas.

Taxing the Future or the Past?

Perhaps the most astonishing aspect of Prop 13 is the inequities that have been created within neighborhoods. Two families living next door to one another, with equal access to public services, infrastructure and education may pay vastly different amounts into the system simply on the basis of how long they have lived in their houses. When we consider that those who have lived a long period of time in their house often have quite a bit of equity built up, we see how amazingly regressive the tax system is in a state that normally prides itself on its progressive policies. This system vastly favors those with the longest tenure—in short, it often puts the burden on those who represent the future of the state, rather than the past.

There is some question as to how great these inequities are. In a time of a real estate bubble, these inequalities grow inasmuch as rapidly rising prices expand the gap between the new buyers and existing tenants. Yet, at the same time, the frenetic pace of buying and selling has caused the taxes levied on many properties to rise to a more current level. Indeed, property tax revenues have been increasing, one reason why some of the fiscal stress on our local governments has been waning.

An Empirical Test

To demonstrate the current level of inequity, a simple simulation was performed for Los Angeles County by the UCLA Anderson Forecast. Utilizing a hedonic price equation based on a variety of housing characteristics (size, number of bathrooms, neighborhood, etc.), it was possible to calculate an expected value for a house if it were to sell today.³ Using public data on taxes and initial mortgage rates an estimate of current housing equity and the implied tax rate on that equity can be created. The data were as of April 2005. This calculation included slightly more than one million homes, approximately 75% of the total number of owned homes in the county (The rest were lost do to missing or incorrect data).

Figure 11 shows the average tax rate on the basis of the estimated equity in the house. For example, those homeowners who have between \$50,000 and \$100,000 worth of net equity in their home (calculated as the estimated sales price of the home minus the estimated remaining mortgage based on a 30-year amortization) are currently paying, on average, \$3,000 per year in taxes, or an implied tax rate of 4.5% of equity (these taxes do not include local supplements). Those with less than \$50,000, primarily those who have entered the market with little money down, pay a whopping 120% of equity. Those with

Figure 11: Average Taxes Paid and Implied Tax Rate by Level of Equity
Estimated, Los Angeles County as of April 2005

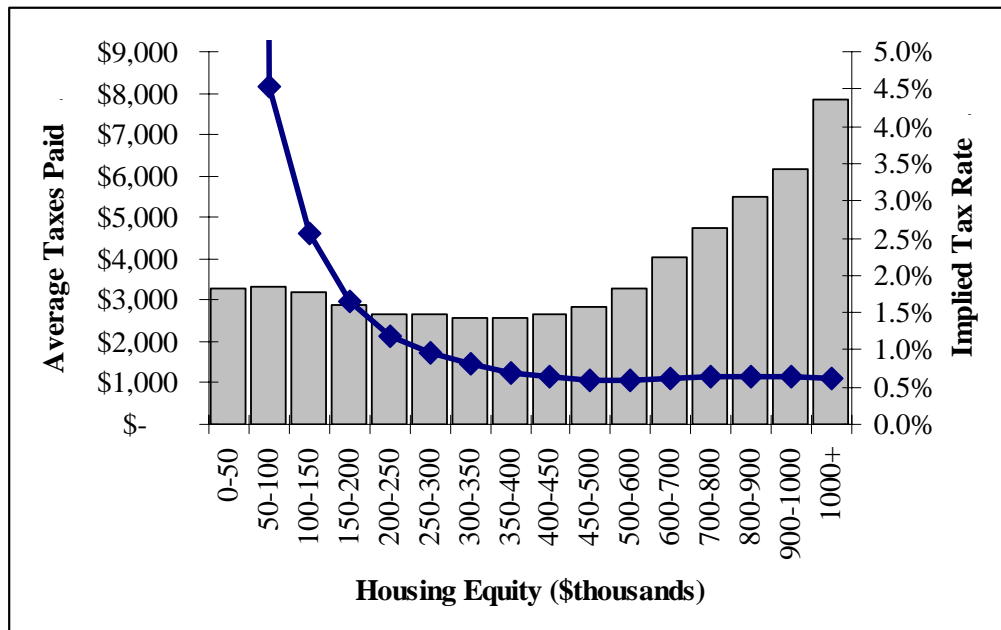


Figure 12: Distribution of Tax Burden by Implied Tax Rate

Los Angeles County, Based on estimates of home prices in April 2005 Market

Implied Tax Rate	Number	Average Home Value	% Total LA Home Value	% LA Property Tax Burden
0 to .2%	101,208	\$511,895	9.8%	2.6%
.2% to .4%	137,681	\$503,628	13.1%	6.5%
.4% to .5%	142,938	\$501,064	13.5%	10.4%
.5% to .6%	190,910	\$488,877	17.6%	16.4%
.6% to .7%	161,551	\$494,083	15.1%	16.5%
.7% to .8%	113,819	\$511,930	11.0%	13.9%
.8% to 1%	122,304	\$530,381	12.2%	18.3%
1% and up	72,630	\$563,611	7.7%	15.4%

\$450,000 worth of equity or more pay on average a .6% rate, or something less than one-seventh the amount paid by those with only one-tenth the home wealth.

In short, those with the most pay the least; those with the least pay the most in relative terms. They even sometimes pay less in absolute terms. The average tax payment of someone with \$400,000 in equity on average pays less than someone with \$50,000!

To be fair, even in states where the tax base is not locked in at the original value will have a skewed tax rate, since the tax is based on the sales value of the house while equity is largely a function of the number of years of ownership, given an appreciating market. To show the inequities in the system, another way to set up the data is to look at the implied tax rate as a percent of estimated home value. Figure 12 breaks the sample into a number of tax-rate brackets. For the most part, these bins have an average home value within each that is roughly consistent across each tax rate class. Over 100,000 homes in the Los Angeles region pay a tax rate of less than .2%. These lucky folks own 10% of the total residential value in Los Angeles, but pick up a mere 2.6% of the property tax burden. On the other end of the spectrum, the 200,000 people who are paying over .8% of their home value each year – due to the fact that they recently purchased their property – own less than 20% of home value in the region, but pick up nearly 34% of the total tax burden.

The data utilized for this analysis has a bias that probably hides some inequity. The types of residences most likely to be dropped from the sample due to missing information are condos and large mansions. Therefore, the numbers presented above likely underestimate the true degree of inequality involved. The analysis presented also completely misses the similar inequalities that exist on the business side of the economy that make this yet again an uninviting place for those thinking about starting a business in California. Any new business entrant is put at a distinct competitive disadvantage relative to incumbent firms.

A Flawed System that Needs Repair

No matter how you slice it, the mechanics of Proposition 13 were flawed. While

it is true that the rapidly increasing tax burden experienced in the 1970s was something that had to be handled, Proposition 13 was not the way to do it; it was a bad solution to a bad problem. Prop 13 has made the government budget situation worse, not better, in that it has forced the state to rely on highly volatile sources of revenues. It will be difficult to repeal the Prop 13 tax system from both a fiscal and political perspective. However, the faster the problems that are being caused by the system – as it currently stands – are understood, the faster a solution can be found.

From a short-term perspective, California's economy is excessively dependent on a real estate market that seems to be in a bubble. The state's economy is therefore particularly at risk once the bubble begins to burst. From a longer-term perspective, the mechanism by which the state taxes real estate makes the fiscal base for state and local government volatile and produces inequities particularly for new homeowners and businesses.

Endnotes

¹ Employment data in California and the U.S. come from two surveys, a survey of employers (payroll or establishment survey) and a survey of households (Current Population Survey).

² Potential home buyers have a choice of purchasing or renting. The rent saved by purchasing can be seen as the value of services provided by the house, apart from any appreciation.

³ Hedonic pricing models break down the value of an item (such as a house) into component attributes (such as size) using empirical data and regression analysis relating item price to the attributes.