STATE BOARD OF EQUALIZATION

ECONOMIC PERSPECTIVE

Summary of Recent Economic Developments *February 2004*

❖ U.S. Economic Developments

Strong Real GDP Growth in 3rd Quarter

Final estimates for the third quarter show real GDP increasing 8.2 percent—the fastest quarterly growth rate in almost 20 years. The preliminary estimate for the fourth quarter indicates that real GDP rose 4.0 percent, which is still quite high.

Many economic forecasters expect relatively strong growth to continue. A survey of 34 professional forecasters by the Federal Reserve Bank of Philadelphia calls for real GDP to increase 4.3 percent in 2004. If this forecast is accurate, growth would be well above the 10-year annual average of 3.2 percent.

Weak Employment Growth

In past economic expansions, such large increases in economic growth were associated with large gains in employment. For example, in 2000—the last complete year prior to the start of the 2001 recession—real GDP increased 3.7 percent. A total of 2.8 million nonagricultural jobs were created in 2000, an average of 700,000 per quarter. Though real GDP has increased rapidly in recent quarters, growth in jobs remains weak in relation to the gains in economic output. Preliminary data show that a total of 77,000 U.S. payroll employment jobs were created in the third quarter of 2003, followed by an additional 144,000 jobs in the fourth quarter. To put these numbers in another perspective, the economy needs to generate about 350,000 jobs per quarter to keep the unemployment rate from increasing, assuming average growth in the labor force of about one percent per year.

Some of the apparent weakness in employment growth may be caused by statistical inaccuracies in the data, which are preliminary and subject to revision. For example, nonagricultural employment data is taken from a survey of employers. Because there is a time lag between when new employers begin to operate and when they are included in the survey, it is possible that new firms (and the employees they have) are underrepresented in the data. This is more likely to occur during economic expansions, such as the one we are in now. When the data are revised later this year, they may show greater employment growth. However, even allowing for some undercounting of new firms' employees, the figures indicate much less employment growth than what would be expected.[1]

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❖ California Economic Developments

Weakness in Employment Similar to Nationwide Trends

Trends in California nonagricultural employment generally followed those of the nation in 2003. The figures indicate that there has been no significant net change in California nonagricultural employment (one of the most comprehensive indicators of statewide economic well-being available on a timely basis) in 2003 compared to 2002.

According to preliminary data, California nonagricultural employment declined 0.3 percent in 2003, identical to the national decline. However, the California Employment Development Department will release its annual "benchmark" revision of the 2003 employment data in late February. Many economists expect the revisions to show more nonagricultural jobs in 2003 because the revisions will more accurately reflect job creation by smaller firms.

Slow Employment Growth Turnaround Predicted

The December 2003 UCLA forecast indicates that California nonagricultural employment will begin to grow modestly this year. The UCLA forecast calls for nonfarm payroll employment to increase 0.9 percent in 2004. The economic forecast in the Governor's Budget, released in early January, includes a forecast of growth in jobs similar to that of UCLA. The Budget forecasts a rise in nonagricultural employment of 1.1 percent in 2004. The UCLA and Budget forecasts are both well below average growth in California nonagricultural jobs of 1.8 percent per year over the past 10 years (1994 through 2003).

Based on Latest Data, Taxable Sales Show Strong Gains in 2003

Based on preliminary data, the Board of Equalization estimates an increase of 3.1 percent in California taxable sales for the third quarter of 2003 compared to taxable sales in the third quarter of 2002. Quarterly taxable sales growth has been over three percent in each of the first three quarters of 2003. Compared to average growth in recent years, these are strong gains. Annual data show that taxable sales have been virtually flat in recent years, decreasing by 0.1 percent in both 2001 and 2002. The 2003 growth rates are still below the long-term average annual growth, as taxable sales have increased an average of 5.0 percent per year from 1993 through 2002. The Governor's Budget forecasts taxable sales to increase 5.8 percent in 2004, higher than the ten-year average.

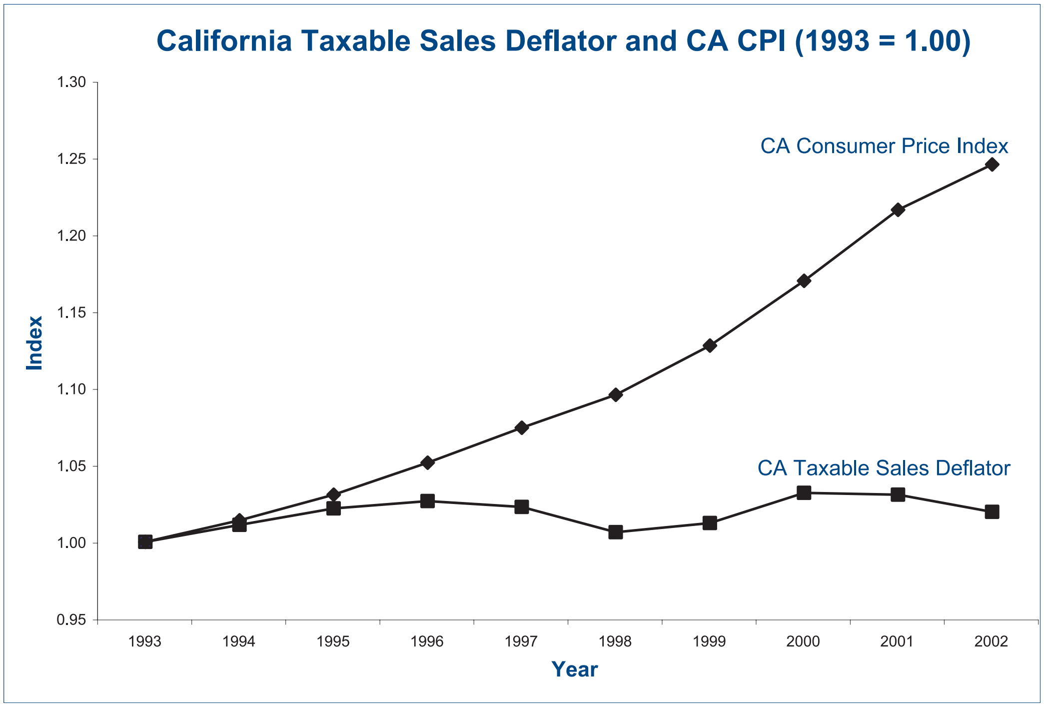
❖ California Taxable Sales Deflator Shows Low Inflation

Accurate estimates of inflation-adjusted taxable sales are important information for economic and revenue analysts and state and local government decisionmakers. Inflation-adjusted (also called real) taxable sales is one of the few economic indicators available to states and localities that measures consumption of goods and services.

How we adjust for inflation

At first glance, one may think that the California consumer price index (CPI) could be used to reasonably adjust taxable sales for price changes over time. However, there are three major sources of potential inaccuracies in applying the CPI to taxable sales.

- First, the index only measures prices paid by consumers. It does not measure prices of goods or services purchased by businesses or governments. National data show that consumer spending is about 70 percent of total GDP. If California is similar to the rest of the nation, this implies that about 30 percent of all transactions would be excluded from the CPI. Furthermore, the composition of goods and services purchased by businesses and governments differs significantly from that of typical consumers.
- Second, many items included in the CPI are not subject to sales and use taxes. Most services are exempt from the California sales tax. Yet, services accounts for almost 60 percent of the typical U.S. "consumer market basket of goods and



services," as defined by the U.S. Bureau of Labor Statistics, which is used as a basis for calculating the CPI. Housing (excluding household furnishings), which includes related utility and insurance expenses, is a major services component, accounting for 36 percent of the typical CPI market basket. Other major service components include medical care, education, and communications services. In addition, food purchased for consumption at home is exempt from taxable sales transactions. Food consumed at home is a major CPI component, accounting for over 8 percent of the typical U.S. consumer market basket of goods and services.

- The third and final reason using the CPI to adjust taxable sales can lead to inaccurate estimates is that inflation rates of specific categories of goods and services have been increasing at vastly different rates in recent years. Computer and electronics prices have fallen rapidly, while services prices have increased faster than average. Price indices from the U.S. Bureau of Economic Analysis (BEA) illustrate examples of these trends.[2] U.S. prices of business equipment and software have declined 18 percent from 1993 to 2002. U.S. prices of durable consumer goods (which include personal computers) have decreased 12 percent over the same ten-year period. In contrast, U.S. prices of consumer services have increased 27 percent from 1993 through 2002.

For all of these reasons, the Board has developed its own index to adjust taxable sales for inflation—called the *taxable sales deflator*. The index is a weighted average of nine U.S. inflation indices applied to California taxable sales by industry.[3] While no index perfectly measures taxable goods prices, we believe the taxable sales deflator is a more accurate measure of them than the overall CPI.

A comparison of the California CPI and the taxable sales deflator, both indexed to equal 1.00 in 1993, is shown for 1993 through 2002 in the accompanying chart. The difference in the trends of the two price measures is dramatic. As shown in the chart, California consumer prices have increased about 25 percent from 1993 to 2002, while prices of goods subject to sales and use taxes have increased about two percent.

There are at least two important economic and policy implications that can be drawn from having so little change in the taxable sales deflator since 1993. First, consumers and businesses on average, have benefited greatly from paying below-average relative prices (compared to the overall CPI price increases) for the taxable commodities they purchase. The relatively small price increases have contributed to increasing real incomes. In addition, while average taxable goods prices have increased little over the past ten years, incomes have increased a great deal. Average California per capita income (unadjusted for inflation) has increased approximately 44 percent from 1993 through 2002.

The second implication is that from the state and local government perspective, sales and use tax revenues and audit assessments have not increased very much from inflation over the past ten years. If the taxable sales deflator is an accurate measure of prices, nearly all revenue growth over this period has come from increases in real sales and increases in population.

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[1] An excellent discussion of current employment and real GDP trends is found in "Mixed Messages From Employment," in the September-October 2003 issue of *California Economic Trends*, available on the Department of Finance website, *www.dof.ca.gov.*

[2] These price indices differ from those used by the U.S. Bureau of Labor Statistics in the CPI. The BEA price indices are cited here because they are broader, covering both business and consumer purchases.

[3] For details on how the index is calculated, please contact Joe Fitz, Chief Economist, Board of Equalization. See box at bottom of page 4 for contact information.

Online Resources

For more information about topics covered in this issue, please visit any of the websites listed below.
Some sites charge a fee to use their services.

National Association for Business Economics
http://www.nabe.com

California Association of Realtors
http://www.car.org/

The UCLA Anderson Forecast
December 2003 Forecast
http://www.anderson.ucla.edu/research/forecast/

Federal Reserve Bank of Philadelphia
Survey of Professional Forecasters, November 24, 2003
http://www.phil.frb.org/econ/spf/index.html

U.S. Department of Commerce, STAT-USA
http://www.stat-usa.gov

U.S. Bureau of Economic Analysis
Survey of Current Business
http://www.bea.doc.gov/bea/pubs.htm

California Department of Finance
http://www.dof.ca.gov

California Employment Development Department (EDD)
Labor Market Conditions in California, January 16, 2004
http://www.calmis.cahwnet.gov

California State Board of Equalization
December 22, 2003, News Release
2003 Taxable Sales—Third Quarter
http://www.boe.ca.gov/news/pdf/nr122203.pdf

Contact Us

Please contact us if you would like to be added to our mailing list, need additional copies, or have any questions or comments.

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