

California: One Business Climate or Many?

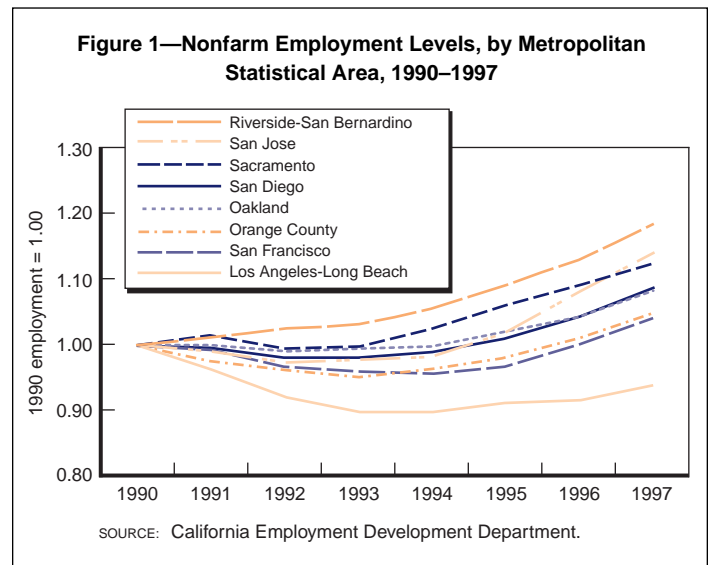
The level of business activity in a state is affected by the costs and benefits of doing business there—in short, by the state’s “business climate.” Given the importance of economic growth, much attention is paid to how well a state’s business climate compares to that of other states. Concerns about a state’s competitive advantage in attracting businesses are amplified during recessions—even more so during prolonged recessions, such as the one in the early 1990s. California was especially hard hit during that recession: Employment dropped sharply and did not return to pre-recession levels for nearly five years. The sluggish recovery led many to claim that California was no longer competitive, especially because the national recovery was fairly rapid.

Most discussions of the business climate involve comparing aggregate data across states. Michael Dardia and Sherman Luk take a different tack in *Rethinking the California Business Climate*. In this study, the authors examine some of the key factors affecting businesses (for example, tax rates, wages, and regulatory practices) and how these factors vary across metropolitan areas and industries in California. They find wide variation in the nature and effect of these factors and conclude that the idea that one business climate applies to all businesses and regions in the state is too simplistic: A software firm in Palo Alto has little in common with an agribusiness in Fresno or an apparel manufacturer in Los Angeles. Thus, the appropriate response for policymakers to the question “What’s the condition of the business climate in California?” should be “For what kind of firm, in which region?”

Trends in Employment by Region and Industry

As shown in Figure 1, employment trends varied widely across metropolitan areas during the 1990s recession. Employment in the Inland Empire never faltered, and the Oakland and Sacramento metropolitan areas experienced little decline. Although Orange County and San Francisco employment fell by slightly more than the state average, employment in Los Angeles—the largest metropolitan area

in the state—fell by more than 10 percent. Even five years after the recession began, when the state itself had just about recovered all of the jobs it lost, employment in Los Angeles had barely increased. However, with the exception of Los Angeles, the rest of California actually had a smaller percentage decline in employment than did the nation. These regional patterns challenge the idea that a bad statewide business climate was responsible for the extent of the job losses.

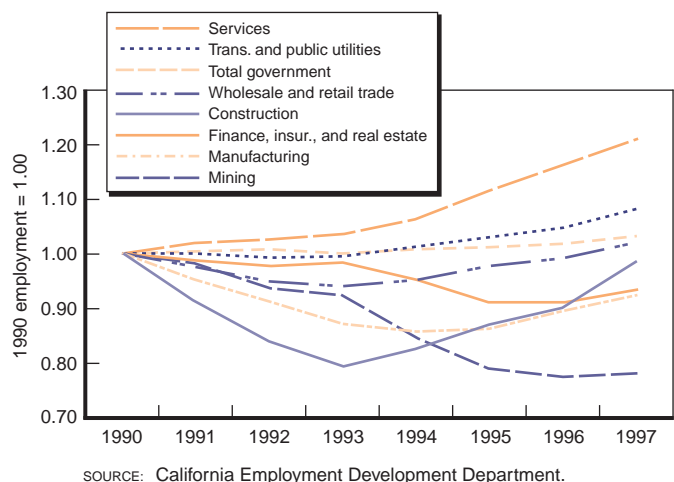


Employment patterns differed markedly throughout the state during the 1990s recession and recovery.

During the recession, various studies and newspaper articles established the image of a state hemorrhaging jobs because of government-induced problems. They expressed concern that the state’s business taxes, workers’ compensation costs, regulatory restrictions, and environmental laws were contributing to a decline in the state’s competitiveness and to a deteriorating business climate that would continue to cause jobs to leave California.

Yet, large sectoral differences in employment patterns occurred during and after the recession—a fact that is diffi-

Figure 2—Nonfarm Employment Levels, by Industry Sector, 1990–1997



The major industrial sectors in the state experienced widely different employment outcomes during and after the recession.

cult to reconcile with the claim that there was a uniform deterioration in the state's business environment. Figure 2 shows changes in employment from 1990 to 1997 by major industrial sector: The dispersion in performance across sectors was even larger than that across metropolitan areas. Although employment in construction, mining, and manufacturing fell by 15 percent or more, employment in transportation and public utilities increased slightly, and employment in services grew by more than 20 percent.

The Importance of Targeting

In the rivalry between states for business activity, business climate rankings have a strong appeal to business leaders, politicians, and the media. Having a single number that captures the "competitiveness" of a state is guaranteed to attract media attention and can stimulate policy debate. To be sure, fostering business activity in the state—whether by encouraging start-up firms, attracting outside businesses, or retaining existing ones—should receive specific and significant attention from policymakers. Some public policy outcomes are more conducive to business activity than others, and it is often the case that the effects on business are not adequately considered during policy formulation. However, the large variation in industrial and regional characteristics presented in this study shows that California is simply too large and heterogeneous for the notion of a uniform climate to be very helpful in setting policy.

Although past concerns about the state business climate have led to positive changes in state policies (for example, reform of workers' compensation, shareholder lawsuits, and business permit processes), legislators need to more explicitly consider regional and sectoral variations and target policies accordingly. For example, efforts to improve education for the sake of the business climate should be focused on the needs of particular industries. The current employment needs of Silicon Valley computer firms are not going to be met by local elementary school reforms, as important as they may be in the long run. Instead, improvements in undergraduate and graduate education, especially in the engineering and computer sciences, would be more immediately helpful to Silicon Valley. Conversely, local retail firms might benefit quickly from improvements in the local K–12 system.

California is too large and diverse to be the appropriate level of analysis for the business climate debate. Business climate issues should be analyzed at the industry and regional level instead, where most business decisions are actually made and policies can be better targeted.

It is important for policymakers to have input and feedback from specific business communities. Efforts such as the "Index of Silicon Valley" are examples of how business climate studies can be better targeted regionally (and in this particular example, sectorally as well). By focusing on a specific region, such reports can give policymakers information on the factors that matter most to local firms and workers.

The task of examining the "microclimate" at the intersection of industry and region is time-consuming and costly, but it is essential when crafting relief for specific problems. The annual *Economic Report of the Governor* would be a natural place to begin this kind of detailed approach, because it expresses the administration's assessment of the economy and the government's role in it. The Legislative Analyst's Office, in its role as adviser to the state legislature, would be another good source for this kind of information. Policy initiatives could then be tailored toward the specific business problems outlined in such reports.

This research brief summarizes a report by Michael Dardia and Sherman Luk, Rethinking the California Business Climate. The report may be ordered by calling (800) 232-5343 [mainland U.S.] or (415) 291-4415 [Canada, Hawaii, overseas]. A copy of the full text is also available at www.ppic.org. The PPIC is a private, nonprofit organization dedicated to independent, nonpartisan research on economic, social, and political issues affecting California.
