

A Downshift in Growth Foretold

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California is slowing down. The engine of growth driving a significant part of the U.S. recovery seems to have run out of its full head of steam. The business, scientific and technical services sector and the information sector—home for much of the tech boom—have ground to a growth halt in much of the State. But what sounds bad on the surface is just a symptom of good labor markets and tight, very tight, housing markets. This slowdown is one foretold some time ago, at least by the Anderson Forecast.

As far back as two years ago we predicted a slowing growth rate for the California economy in 2017. The forecast produced in December 2015 was for the current year to come in at 1.6% growth for payroll employment and 1.2% growth for total employment. In this regard we have done quite well. Through October of 2017 we are right on track with a 1.3% gain for both payroll and total employment. In this essay we will examine the economics that led us to forecast as well as we did and what it means for the next few years.

Job gains and losses depend on business conditions. When firms are doing well, they expand and hire more workers and when they are doing poorly they do the opposite. A key element to this process is finding the workers that fit the firm's requirements. Coming out of a recession when many skilled workers are unemployed, it is not difficult to hire. In an economy going full bore, one has to search

longer, or engage in in-house training or both to fulfill the requirement. This is where we are now in California and it is a story about good job markets and constrained housing markets. This essay will look first at job markets in the State; what is happening and where there might be room to move the needle towards faster job growth; and second at the housing market as a constraint on finding qualified workers for potential California employment. The final evidence that slower growth in California is real comes from airborne trade through the State's regional airports.

Employment Retrospective

California economic growth depends on three elements; growth in the workforce, growth in the stock of physical capital, and growth in productivity. The last two have been growing, but rather slowly, during this expansion. If Congress passes a tax bill that includes the expensing of investment (charging 100% of depreciation in the year in which the capital good is purchased) as is assumed in our U.S. forecast, then there will be a slight boost to California GDP due to increased capital and increased worker productivity (for the impact of the proposed tax bill on housing, skip ahead to the next section). But this boost to investment and productivity is expected to be short-lived. Sustained rapid growth needs a growing workforce. Thus far, California has been successful in this regard, but that engine is slowing down.

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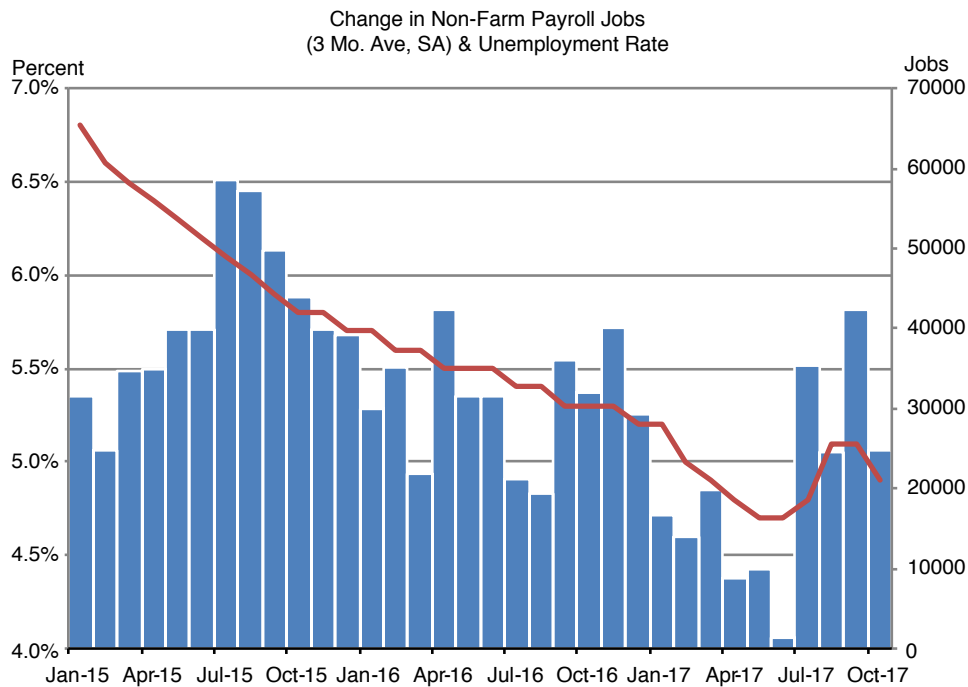
California’s population is on average younger than the rest of the U.S., due to it being an immigrant heavy state. Therefore, one expects the unemployment rate differential to be at about the levels currently experienced relative to the national rate. Younger workers take longer to find employment as they lack as compelling a resume as older workers, and they tend to change jobs more often as they experiment with alternatives for life-long careers. Thus, the slightly higher unemployment rates are not suggestive of room for more rapid job growth. As shown in Chart 1, a fall in California’s unemployment rate has been associated with the slowing in employment growth.

However, the surge of new entrants to the labor force over the last three months--200,000 people entered the workforce--does suggest there may be some more room for

increased employment. Our analysis suggests that there is not much room though.

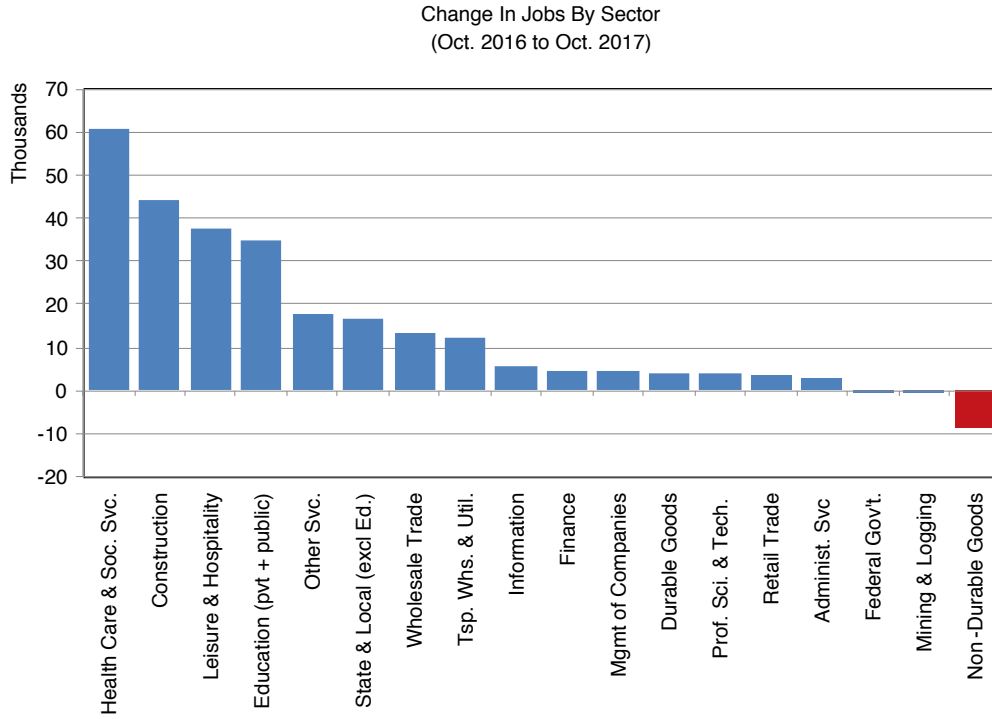
On a sectoral level, job gain has been widespread during the past twelve months. Mining and logging and non-durable goods manufacturing sectors continued to post job losses over the last twelve months (Chart 2). The big winners during this time have been construction, education, health care and social services, and leisure & hospitality (Chart 3). Continued growth in construction is threatened by higher interest rates and the new tax bill. Health care and leisure and hospitality are at risk from changes to Obamacare and reductions in international tourism, respectively. The professional and business service sector, long a bright spot in the recovery from the 2008/2009 recession, has been flat over the last twelve months.

Chart 1



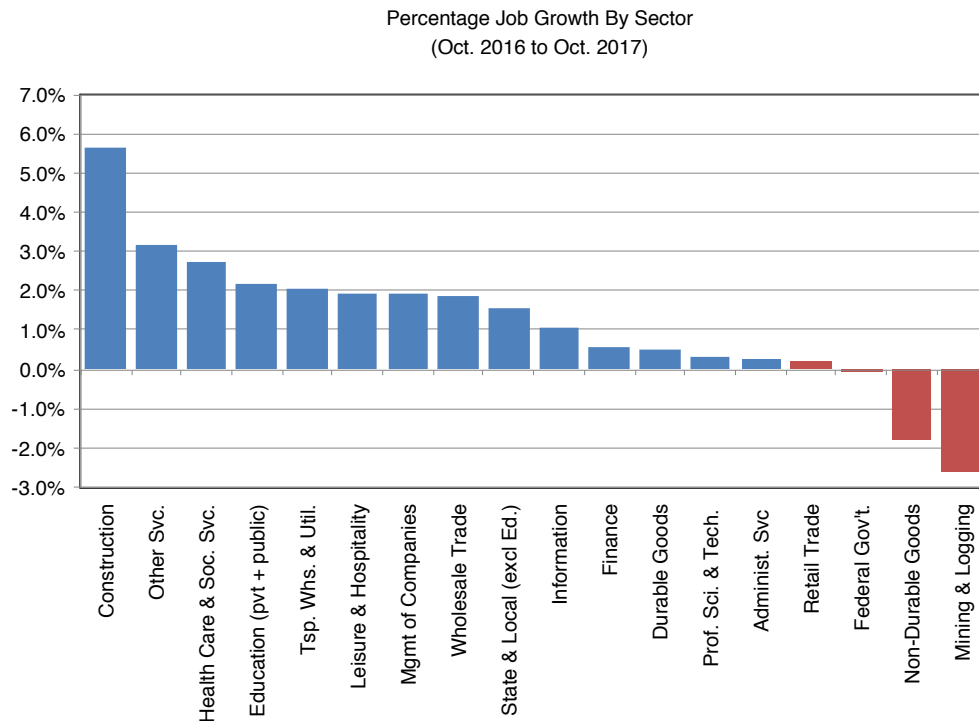
Source: www.edd.ca.gov

Chart 2



Source: www.edd.ca.gov

Chart 3



Source: www.edd.ca.gov

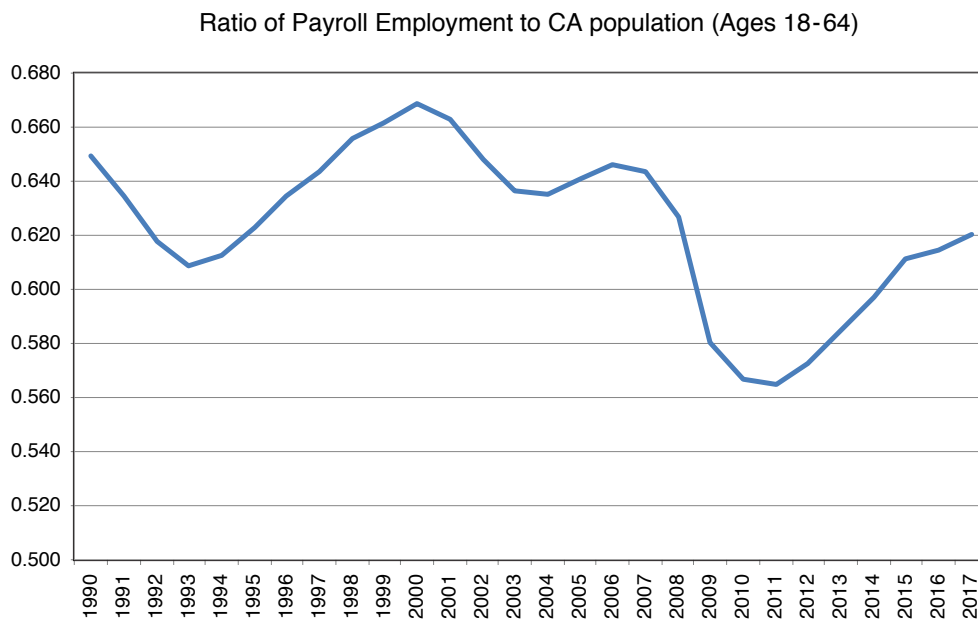
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To see what this means for the possibility of organic labor force growth in the State, consider the employment to population ratio (Chart 4). The chart shows the working age population divided into an estimate of the number of payroll jobs. There is a long-term downward trend in the State beginning in 1999. This corresponds to a national trend towards lower employment/population. The reasons are not entirely clear, though in part the secular decline relates to the decline of manufacturing and the ability of displaced workers to obtain disability insurance, and to some extent to an increase in stay-at-home parents raising children. The dips in the chart correspond to recessions. In the latest expansion, the increase in employment in California lifts this ratio above the previous trend but it remains slightly below the 2007 peak.

When we disaggregate by regions (Chart 5) we find that in most of California the ratio (now of total employment to total population) has returned to or exceeded the 2007 peak. This occurred even though demographics would suggest that the ratio should be somewhat lower. Therefore, it is unlikely that these regions have a pool of labor that can be brought back into the work force, and inducing those who were previously not in the workforce would require substantially higher wages.

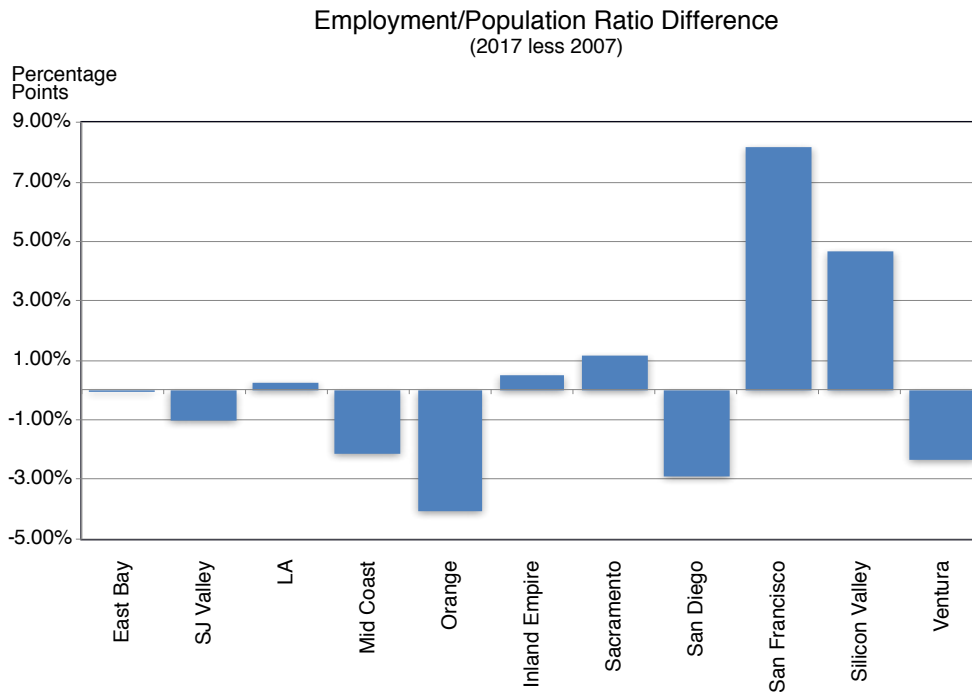
There are several regions that have not returned to the 2007 employment to population peak. There are a number of potential reasons including data errors to be corrected in the expected benchmark revisions coming in March, but there is a sense in which California can still grow faster

Chart 4



Source: www.edd.ca.gov, U.S. Census

Chart 5



Source: www.edd.ca.gov, U.S. Census, www.dof.ca.gov

than the U.S. The Mid-Coast, Ventura County and the San Joaquin Valley, have lagged in the recovery. As lower cost regions of the State, they may well be the next rapid growth regions, though the basis for this is purely speculative. The Orange County and San Diego data are suspect as they have unemployment rates of 3.3% and 3.7% respectively. It may be that San Diego is experiencing a demographic shift with a single-family housing boom in North County increasing the percentage of children in the county and that Orange County is all about an aging population, but we won't know if either are true or just a good story for some time.

Though the national data does not suggest a significant downturn in economic growth over the next twelve months, the ability of the growing U.S. economy to be led by growth in California as it has over the past 8 years, is in doubt. Indeed, to continue the very rapid growth in employment likely requires domestic or international immigration to the State or both. With Trump's policies decidedly reduc-

ing international immigration, net domestic migration to California would be required. And that brings us to the high cost of housing.

Housing Affordability and Population Growth

In previous California Reports, we have focused on the affordability of housing in the State, and therefore, we won't rehash the data here. Suffice it to say that California housing is expensive, it will remain so over our forecast horizon, and it will be a deterrent for domestic migration into the State. Home prices in the major metropolitan areas now exceed their housing-bubble peaks, and with a lack of home building, will continue to go up. This is not organic, but a direct function of the demand for housing increasing as people from California and all over the world want to avail themselves of the California weather and lifestyle, faced with a relatively fixed number of homes.

Building in the State has increased modestly of late. The number of permits has climbed on an annual basis to approximately 119,000 units per year (Chart 6). We expect that to increase a bit more due to State Legislature initiatives on affordable housing and the rebuilding of homes lost in the tragic wildfires this year. Nevertheless, the numbers will neither be large, nor sufficient to move the price needle.

Not enough homes translates into a lack of support for a much larger population. Chart 7 plots the number of new housing units permitted as a percentage of the number of households. Though there has been a modest increase since 2009, the levels are considerably below the averages that supported significant migration to the State in the past. At about a 1% increase in the housing stock per year, new homes are being added at a rate that is only marginally greater than the indigenous increase in population.

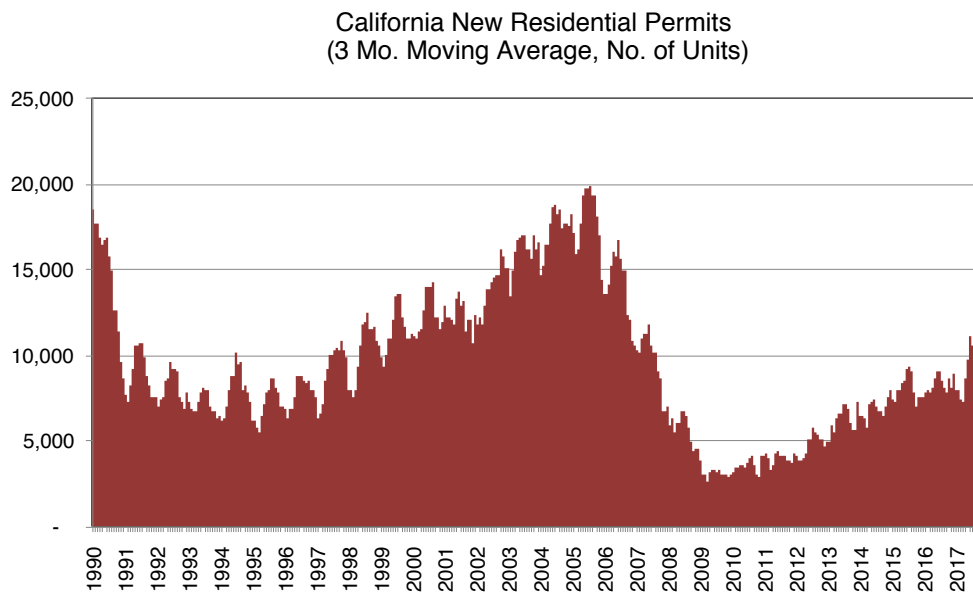
One wild card in home building is the proposed new tax law. As of the time of this writing, tax-exempt municipal bonds for the purpose of constructing affordable units are poised to lose their tax exemption. As well, there is a proposal to eliminate State income tax and possibly property tax deductions on Federal income tax returns. This will lower disposable income in the State thereby reducing the demand for housing. Lower demand (fewer bids) reduces

price (Econ 101), and therefore we should see prices for homes in California decline.

But then we should become excited about a lower demand for housing resulting in more affordable housing. Well, no, the confetti needs to stay in the wrapper. The lower demand did not come from people leaving the State nor from balmy California weather going out of style. It would come because the cost of housing to the potential buyer went up. Were the tax proposals above to become law, housing would be less, not more affordable. How can this be? It is what economists call the incidence of the tax. When prices adjust in response to tax increases, part of the increase can be passed on to others. Where it falls is the incidence.

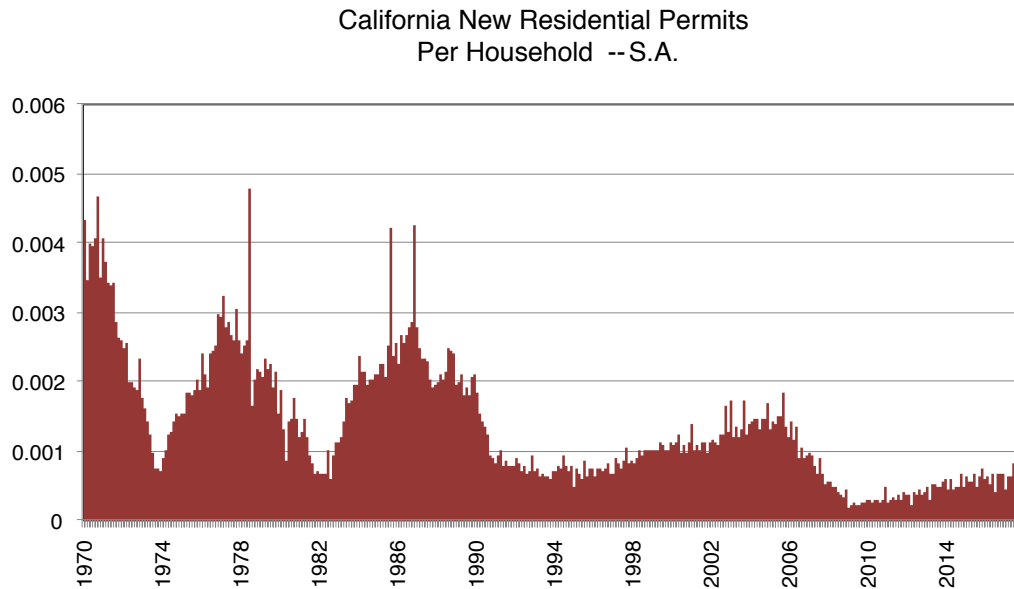
Let's take the potential homeowner, a millennial software engineer looking for their first house. Prior to the tax change, they deducted state taxes from Federal taxes and their disposable income allowed them to pay a mortgage for one of those very nice California bungalow homes in the San Gabriel Valley. When they are not able to deduct their state taxes, adjusted gross income is higher and the Federal tax bill is higher. This is the idea of getting rid of the deduction; a higher revenue for the Feds to pay for tax cuts elsewhere. But our millennial has lower after tax income and now the bungalow is out of reach. This is the reduction in housing

Chart 6



Source: U.S. Department of Census

Chart 7



Source: U.S. Department of Census, www.dof.ca.gov

demand. With fewer people in the market to buy homes, and those in the market having less income, home prices must drop if they are to sell. But it is not lower prices that make the homes more affordable, it is lower disposable income that makes them less affordable. So the effective mortgage payment (principal + interest – tax deduction) goes up with a reduction in the tax deduction. At any given home price, the cost to the buyer increased.

For homeowners the news is not good either. They will be less wealthy as the price at which they can sell their home will decrease. This capital loss will induce some to stay in their homes rather than take their equity and move to Sunny Acres in the Valley of The Sun. And for some others, being able to sell their home to move up, thereby freeing up homes all the way down the line, will be more difficult. So part of the incidence of higher Federal taxes will be borne by a capital loss on the part of homeowners, and part by everyone who pays State taxes on their income.

The implication for building is that with lower prices to the builder, less will be built. As a result, we have shaded, slightly, the new home construction forecast from 125,000 units to 121,000 units in 2019. This is not a huge change and there is risk on both the upside and the downside to the forecast. The State, for example, may take counter-measures that might offset the tax changes or their consequence for home building.

Domestic Trade Indicators

The final piece of evidence that the slowdown is real comes from cargo shipments through California's main regional airports; Lindberg Field, Ontario International, Oakland International, San Jose Mineta, Sacramento International and Mather Field.

One might ask, why are we leaving out the two largest airports in the State, LAX and SFO? The reason lies in the

fact that these airports process a lot of cargo for international uses and for trans-shipments to other parts of the country. It is difficult to sort through that data and ascertain how it relates to the California economy. Having said that, we do look at these airports for tourist flows and for exports from California manufacturers. But here, we want to look more broadly at the State economy.

These airports were chosen because they turn out to be the preferred airports by package carriers for the transport of package goods in and out of the State. As such they are also a good indicator of overall economic activity. Chart 8 plots cargo shipments in tons through these airports. In each case there has been growth since the recession and both San Diego Lindberg and Ontario International traffic today exceed the pre-recession tonnage.

However, a closer look (Chart 9) reveals that the last 12 months are a bit different. In each case the growth in tonnage has ground to a halt. It might be possible, with squinting, to see some growth early in the year in the Northern California airports due to growth in the Sacramento region, but that dissipated in the latter part of the year. An acceleration of online purchases this holiday season could boost all of these, but that would be at the expense of brick and mortar retail.

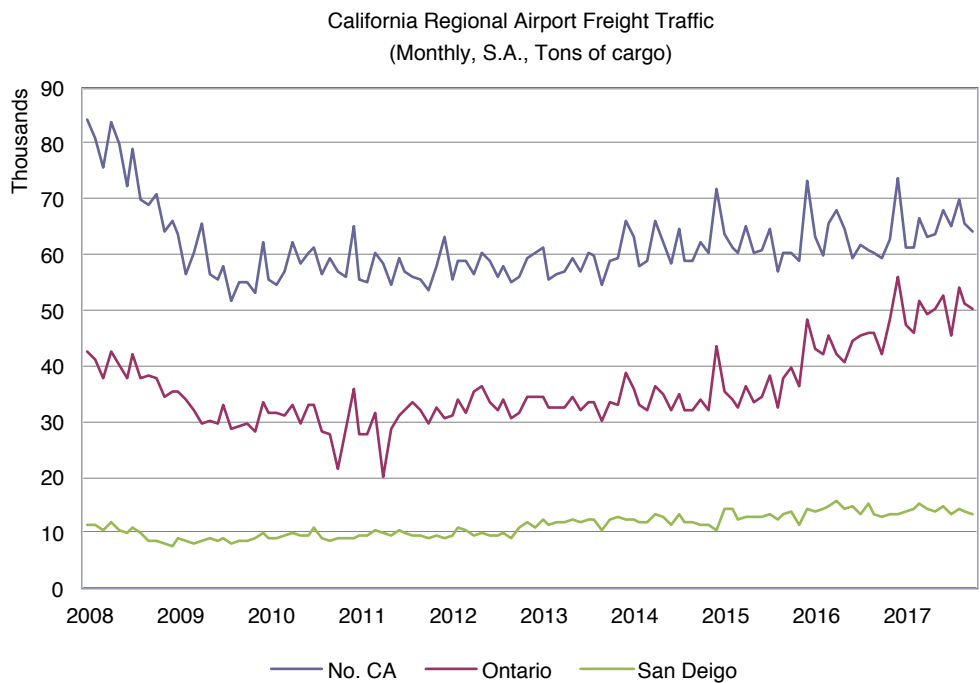
Thus, the data are not showing continued robust growth in the State in the coming year.

The Forecast

Our current forecast for California differs from the previous one in two ways. First, the aforementioned modest dampening of housing due to the new tax bill, assumed to pass in some form in our national forecast, reduces economic growth in the State. Second, the investment incentive, in particular the bringing forward of investment due to expensing, increases our forecast growth rate for employment and income in 2018, though reduces it slightly by the end of 2019. The most likely outcome of these two opposite economic forces is for California’s unemployment rate to fall to 4.6% by the end of the forecast period (2019).

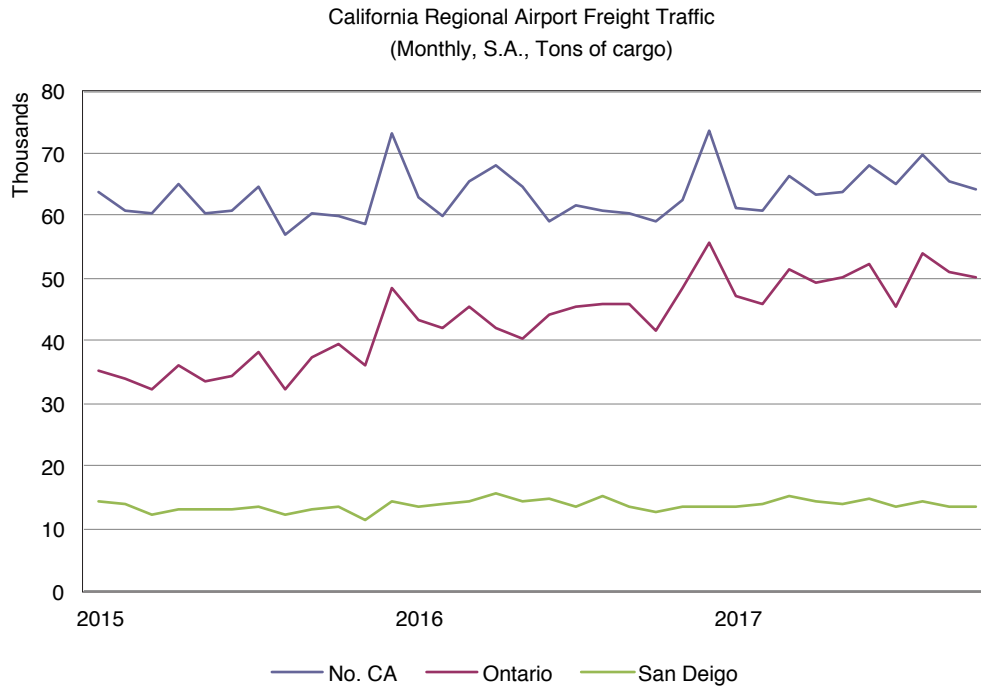
Our forecast for 2017, 2018 and 2019 total employment growth is 1.2%, 1.5% and 1.1%, respectively. Payrolls will grow at about the same rate over the forecast horizon. Real personal income growth is forecast to be 1.6%, 3.1% and 3.6% in 2017, 2018 and 2019, respectively. Homebuilding will reach about 121,400 units per year at the end of the forecast horizon.

Chart 8



Source: UCLA Anderson Forecast, Traffic reports for each airport

Chart 9



Source: UCLA Anderson Forecast, Traffic reports for each airport