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December 20, 2018

Destiny Delayed

For years, the CERF team has predicted that California's crushing regulation of the private economy would eventually weigh on economic growth in the State. The growth premium historically enjoyed by California over the Nation was destined to shrink. Earlier this year, data seemed to indicate that the anticipated convergence was imminent.

In March, we wrote:

We are currently forecasting a convergence in the fortunes of California and the nation. While California has historically grown at a rate that is significantly higher than the nation's, 2017 may have been a turning point.

In September we noted:

The state economy has continued to change in the direction of slower growth...After experiencing job growth of greater than 3 percent during all of 2013, 2014, 2015 and more than half of 2016, statewide growth is now hovering near 2 percent.

GDP data also appeared to show a significant drop-off in economic growth for California. State GDP growth was 4.6 percent in 2015, followed by only 3 percent in each of the three years that followed.

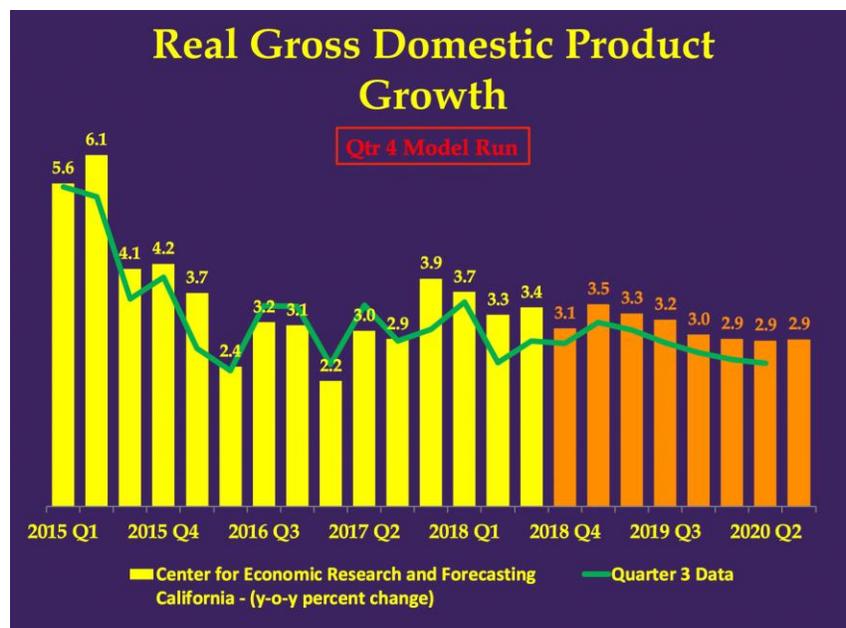
Meanwhile, as California was entering the third year of an apparent slowdown, the U.S. economy entered a new phase of higher growth, owing mostly to changes to the corporate tax system. With U.S. economic growth accelerating and California's slowing, it seemed almost certain that California's growth premium had vanished. In our [September 2018 forecast](#), we predicted that, for 8 of the next 10 quarters, California's economic growth rate would be equal to or lower than that of the U.S.

And then history changed.

The BEA's November GDP data release provided an additional quarter of data, the first estimate of GDP growth in California for 2018 Q3. Year-on-year growth in that quarter was 3.4 percent,

beating our forecast by 50 basis points. The new number was also accompanied by significant, and truly surprising, revisions to growth estimates across the previous 3 years. Most notable were revisions to economic growth estimates for the last quarter of 2017 and the first two quarters of 2018. The previous growth estimates were 3.1, 3.5 and 2.5 percent for these quarters. Revisions came back at 3.9, 3.7 and 3.3, respectively.

Plainly, these revisions paint a different picture than the one that we described in the September Forecast publication. First, the economic slowdown between 2015 and 2016 looks even more dramatic following the revisions—growth is now estimated to have slowed from 4.9 percent in 2015 to 3.1 percent in 2016, a 1.8 percentage point decline compared to an earlier estimate of only 1.5 percentage points. Second, California’s economy looks to have performed substantially better in each of the last 4 quarters than previously thought. That is to say, California’s economy also jumped to a higher level of growth at the same time as the broader national economy. We had assumed that California would enjoy a smaller share of the benefits of corporate tax reform, but it appears that the State fared at least as well as the nation under this new policy.



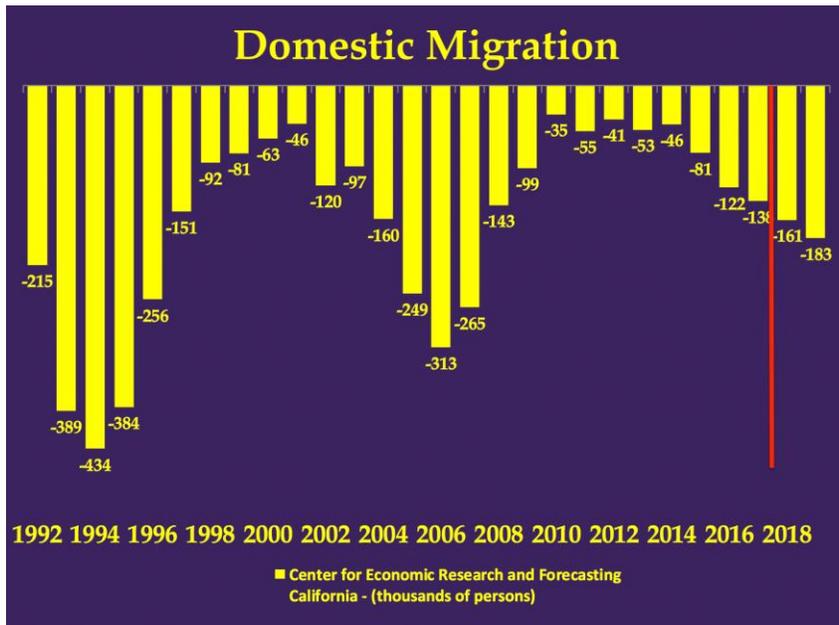
If we drill down deeper into the data, we see that no single sector of the California economy appears to dominate the state’s GDP revisions. As noted by green in the table below, economic output was revised upward in 10 of 16 sectors. Some of this is particularly good news – high value-added sectors such as Durable Goods Manufacturing, Information, and Professional & Business Services saw the largest upward revisions.

California GDP (YOY growth)

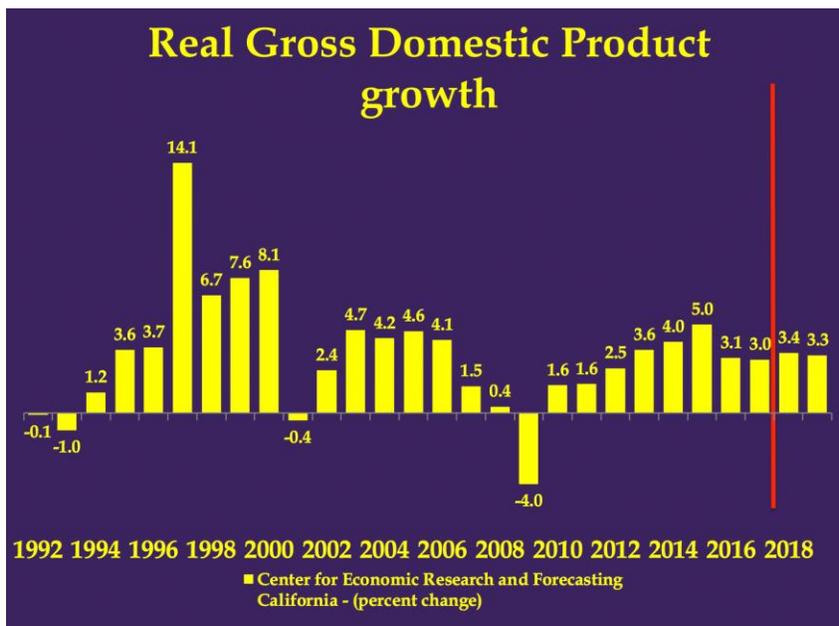
Description	July 2018 Release		November 2018 Release	
	2017:Q4	2018:Q1	2017:Q4	2018:Q1
All industry total	3.1	3.5	3.9	3.7
Agriculture, forestry	-8.4	8.3	-6.5	-9.2
Mining and extraction	1.1	12.8	2.7	2.7
Utilities	-5.7	-0.9	2.3	-5.5
Construction	4.7	7.4	4.3	7.4
Durable goods manufacturing	5.4	4.1	7.6	5.6
Nondurable goods manufacturing	-1.4	0.5	1.5	-1.3
Wholesale trade	3.1	3.2	5.3	1.4
Retail trade	6.8	5.6	5.1	5.6
Transportation and warehousing	4.0	4.3	3.3	6.6
Information	11.4	8.8	14.3	13.9
Financial services	0.0	1.5	1.1	0.5
Professional and Business services	4.8	5.6	5.5	7.7
Educational and Health services	6.2	4.8	3.1	4.4
Leisure and Hospitality services	1.0	1.6	0.6	1.6
Other services	9.7	9.0	1.1	2.1
Government	-0.5	-1.2	1.3	0.3

Jobs data are not quite as optimistic as GDP data. Job growth still shows a sustained decline beginning in 2015. It is an important note that the increases in output do not correspond tightly to increases in jobs. There are a couple of explanations for this divergence. Some of the gains in output stem from automation or other improvements to productivity. Some of the gains in output are accompanied by relocation or outsourcing of lower value functions – think of Amgen relocating its human resources function to Tampa, Florida or Apple Computers planning to move thousands of customer support roles to Austin, Texas.

The divergence of GDP and jobs data give us reason to worry about the continued hollowing out of the Middle Class in California and the continued exodus of younger, working age adults. We still hold to our earlier forecast that negative net domestic migration is accelerating as more and more individuals flee the state in search of greater economic opportunity somewhere else.



The current forecast calls for economic growth of 3.4 percent in 2018 followed by 3.3 percent in 2019. These numbers compare favorably to the forecast of 2.9 percent growth for the United States in each of these years.



Over the entire forecast horizon, California’s growth premium is forecasted to be 0.3 percentage points. In September, we anticipated that it would be zero. For the time being, California’s economy will continue to grow at a pace which is stronger than the nation. This is especially meaningful considering that the U.S. economy is now growing at a faster pace relative to the past decade.

Quarter	December 2018 Forecast			September 2018 Forecast		
	CA GDP	US GDP	Premium	CA GDP	US GDP	Premium
2017 Q1	2.2	1.9	0.2	2.5	1.9	0.6
2017 Q2	3.0	2.1	0.9	3.5	2.1	1.4
2017 Q3	2.9	2.3	0.6	2.9	2.3	0.6
2017 Q4	3.9	2.5	1.5	3.1	2.5	0.6
2018 Q1	3.7	2.6	1.1	3.5	2.6	0.9
2018 Q2	3.3	2.9	0.4	2.5	2.9	-0.4
2018 Q3	3.4	3.0	0.4	2.9	2.9	-0.1
2018 Q4	3.1	3.1	-0.1	2.8	3.1	-0.3
2019 Q1	3.5	3.2	0.3	3.2	3.2	0.0
2019 Q2	3.3	2.9	0.5	3.1	2.8	0.2
2019 Q3	3.2	2.7	0.5	2.8	2.7	0.1
2019 Q4	3.0	2.7	0.3	2.7	2.6	0.0
2020 Q1	2.9	2.7	0.2	2.5	2.6	0.0
2020 Q2	2.9	2.7	0.2	2.5	2.5	0.0
2020 Q3	2.9	2.7	0.2	n/a	n/a	n/a
Average	3.1	2.8	0.3	2.8	2.8	0.0

Sources: U.S. BEA and CERF. † CERF Preliminary estimate.

We caution readers of this forecast publication that destiny delayed is not destiny denied. Although the crossing point may not have already been reached, the substantial growth premium which California has enjoyed over the nation is shrinking. Given the major economic advantages that the state enjoys, this is a tragedy in the making. Policy matters, and growth inhibiting policies are driving the exodus of individuals and jobs from the state and the decline in California’s growth premium.

The greatest risk to the current forecast is California itself.

We fear the utter political transformation that California has undergone over the past decade, whereby a traditionally diverse state has been transformed into the most politically monolithic state in the Country.

Speaking to this transformation at our November Ventura County forecast event, columnist Dan Walters noted that:

We now have a legislature that is going to be three-quarters Democrats and a new Democratic Governor who has made pretty significant promises. This is what Gavin Newsom said he wanted to do on election night in June, when he won the primary: ‘Guaranteed healthcare for all, a Marshall Plan for affordable housing, a Master Plan for *aging with dignity*, a middle class workforce strategy, a cradle-to-college promise for the next generation, and an all-hands approach to ending childhood poverty.’

Add all those up – its another 150 billion dollars a year!

Policy matters. And we have serious concerns about the policies that may suddenly be feasible now that one party has an ultra-super-majority in the legislature and now that the moderating hand of Jerry Brown has left Sacramento.

Dan Walters also noted that he believes little on the Governor’s wish list will actually be passed. Although we really like the sound of “Walters’ Rule of Single Party Domination,” whereby monolithic, single-party rule actually results in a fractured party which is ineffective at implementing policy, we respectfully fail to share his optimism.

The risk to the current forecast is that that California’s destiny will not be delayed enough.

Additional forecast charts are provided on the next page.

Forecast Charts

