California Futures: Money, Weed, and War!

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In the last California Report we discussed the onset of full employment and what that meant for growth in California going forward. Unemployment rates relative to the U.S. still remain elevated but that is a direct consequence of good labor markets drawing more workers into labor markets. In the latest jobs report, 40% of all jobs in the U.S. were generated in California. For a State that ranks at the bottom of “business friendly,” this consistent over-performing is evidence of the power of geography and knowledge communities.

The aggregate numbers tell some of this story. Employment in California is now at record levels. The number of payroll jobs has reached 16.5 million and is 6.7% above its previous peak. The number of people employed including farm labor and the self-employed hit a record 18.2 million and is 7.0% above its previous peak (Figure 1). One might claim that this is not near enough since California’s population has grown by 9.5% since 2007 and therefore the state is a bit away from that elusive full employment level. However, it is not the population per se, but the age profile of the population that matters when considering full employment. Adjusting for demographics (Figure 2) the gap between predicted full-employment employment/population level of employment and the current level has fallen to 14,000 jobs. By the time this article goes to press there should no longer be a gap.

How long can this go on? In less than two months there will be a presidential election and on January 20, 2017, less than four months away, a new president will be inaugurated. Who that president will be is unknown but to be sure, whomever it might be will impact the forecast for California. The contrast between the economic consequences of the two candidates proposed policies has been discussed elsewhere and will be the topic of our discussions and the three panels at the upcoming September 28, 2016 Anderson Forecast Conference at UCLA.

In this California Report we focus on three possible outcomes of the election that have California specific impacts. In November we will see a mind-numbing 17 initiatives on the ballot. Two of them, the extension of Prop 30 taxes and the legalization of marijuana are potential drivers of economic outcomes that could differ from the current forecast. Also, we hear of the threat of WAR; a trade war that is. The impact of a trade war on the logistics industry, a vital industry for California, requires further investigation as it bears directly on the risk to the California forecast.

Figure 1

Califonia Employment Trends

Sources: California EDD

Figure 2

Ratio of Employment to CA population (Ages 18-64)

Sources: California EDD and UCLA Anderson Forecast
Money and The Primrose Path of the Prop 30 Extension Measure²

Prop 55 an initiative to extend Prop 30’s temporary income tax surcharges currently due to expire in 2018, until the year 2030 has made it to the 2016 ballot. The rationale according to Gale Kaufman, strategist for the initiative, is to “keep our state budget balanced, and prevent devastating cuts to programs affecting students, seniors, working families and health care.”³ However, both economics and the empirical evidence strongly suggest that the risk of opposite is quite large. Two potential reactions were Prop 55 to pass will affect the current California forecast. The first is the difference in incentives between a temporary and a permanent increase in income taxes. The second is the differential impact of the tax over the business cycle.

When Prop 30 was proposed it was billed to voters as a temporary tax increase that would bail the State out of a recession induced financial crisis. In the political campaign Jerry Brown framed it as “It’s about putting money into California’s schools or taking money out of it … there is no third way.”⁴ Though at the time there was talk of a mass exodus of high-income earners from the state were Prop 30 to be enacted that did not happen. Sure a few left, but the evidence illustrated in the employment data above is that the Golden State has prospered.

Why were the doomsayers wrong? There is no data on this nor is there on the difference between a temporary Prop 30 like tax increase and a permanent one. The counterfactual simply does not exist. However we do know that people react differently when presented with the same policy if they think there is a crisis (let’s all pitch in and solve this) or if they think it is business as usual (why am I contributing if they think there is a crisis (let’s all pitch in and solve this) or if they think it is business as usual (why am I contributing this amount?)?⁵ Will there be a significant move to Seattle compared to those of other states.

The Governor commented on the second issue in his May Revision to the 2015/2016 fiscal year budget proposal.⁶ He stated, “Despite these (current) stronger revenues, the budget remains precariously balanced and faces the prospect of deficits in succeeding years.” This somewhat gloomy message refers to the fact that the benefits of Prop 30 generated higher revenues are benefits that have accrued during a relatively strong expansion in California’s GDP.

A recession is coming. When we do not know, but it is coming and tax revenues decline in a recession. Disruptive economic policies by the new president could make it happen sooner rather than later.⁷ So when that next recession hits, as it must, one ought to expect that California’s high-income earners will take a greater hit than the decline in the State’s GDP. The heavier the reliance on them to fund State government, the greater will be cuts in State government employment and programs. Our current dependence on high-income earners to balance the State budget is why the three bond rating agencies, Fitch, S&P, and Moody’s, rate California bonds as relatively high risk investments compared to those of other states.

Figure 3

REAL CALIFORNIA BUDGET DEFICIT
(adjusted for inflation, 1961-2014 fy)

What is the supporting evidence? From 1967 when the Reagan Tax Bill was passed to 2012 when Prop 30 was passed, aside from some minor adjustments, California’s income tax schedule has been relatively constant. The progressive tax schedule of 1967, a schedule which itself was to be temporary, engendered a close and deleterious relationship between fluctuations in the income of high-income earners and State finances.\(^8\)

The impact was not pronounced in the early years (1967 through 1990) because the California economy was dominated by large manufacturing firms. Factory layoffs, including highly compensated managerial employees, had a negative but not dramatic effect. As innovation, technology, and their concomitant entrepreneurial activity replaced large-scale manufacturing, the importance of high-income earners soared.\(^9\)

The income of the new entrepreneurial class is quite different than their high-income predecessors.\(^10\) In good times these entrepreneurs and their team rake in profits. Their companies issue IPOs, they exercise stock options, and they receive generous bonuses. In addition owners of the companies also earn large profits. But when the economy tanks, so do their incomes. It is just not the same as a 15% reduction in the workforce at a GM plant in Van Nuys hitting revenues. It is a virtual wipe-out of a major source of revenue. Figure 3 graphically shows this change in California’s finances. Actual deficits, an excess of general fund spending over general fund revenues (not counting savings from previous years) have, even adjusting for inflation, grown dramatically. There is nothing in the revenue structure today to suggest it is any different from the recent past.

One counterargument is that the State now has a “rainy-day” fund thanks to Prop 2.\(^11\) The current budget projects between $3.0B and $4.0B in the fund at the end of the fiscal year. It cannot be more because of Prop 98 requirements and the promise to dedicate some of the increased income to restoring expenditure cut at the time of the previous recession. One then needs to ask, compared to the deficits the last time around is this sufficient? A dispassionate reading would suggest is not even close. Do we remember the $26B deficit of 2009? A much milder recession with heavier


\(^9\) Income taxes paid by the top 1% of income earners grew from 33% of the total in 1994 to over 50% in 2012, the first year of the Prop 30 tax surcharges. https://www.ftb.ca.gov/Archive/aboutFTB/Tax_Statistics/Reports/Revenue_Estimating_Exhibits/05022014.pdf


reliance on high-income earners wipes the rainy day fund out and then some. If Proposition 55 were to pass, look for the downturn in California in the next recession to follow the same roller-coaster as the previous one and to be more severe than in most of the rest of the U.S.

Weed: How Green Is The Grass?

One of the ballot measures California voters will consider this year is the legalization of recreational marijuana. While it was on the ballot in 2010 and lost, there is more than budding sentiment for its passage this time and it seems likely to make it through the initiative process. This turn of events is undoubtedly helped by the experiences of Washington and Colorado, leaders in marijuana legalization and by the growing number of Millennials in the body politic.

California is somewhat famous for the size of its marijuana industry. This is not surprising. The agriculture industry in the state is large and diverse due to good soil and climactic conditions and the local market is imbedded in a population of nearly 40 million (one does not have to violate interstate transport of controlled substances). Indeed, California’s Emerald Triangle was described by a DEA agent as producing the “best marijuana in the world.”

Consequently, there are predictions of a boom in production, distribution and sales and even in marijuana tourism along the lines of California’s popular wine tourism industry. From all of this will come jobs and state tax revenue. The question for us at The Anderson Forecast is: how much difference will this make to the growth of the State’s economy and to the risk to State finances described above.

One way to obtain an estimate is to look at Colorado’s marijuana industry. Recreational—or retail as they like to call it—marijuana became legal in 2014 in Colorado. Medical marijuana had achieved this status in 2000. Thus, the situation in Colorado is similar to that of California. Medical marijuana outlets can, and often did, expand into the retail marijuana market quite easily and they could possibly do this without an increase in staff. The producers of medical marijuana may also achieve economies of scale in growing, processing and distributing retail marijuana. This pre-existing structure will dampen any gains from the legalization of the purchase of weed for recreational uses.

Though there are other taxes and licenses required by businesses engaged in marijuana production and sales, the 2.9% sales tax in Colorado provides the best data on the dollar volume of sales. Employment in beverage production and estimates of cannabis employment might also contribute to our understanding of the impact of retail marijuana legalization. Since the latter is not generally available from government sources we will rely on the vested interest Marijuana Business Daily to provide estimates of cannabis related job creation.

Before turning to the data, a little economics will help our analysis. Retail marijuana in Colorado is a consumable good which substitutes for some consumption and complements others. The most obvious substitute is alcohol. Job loss from declines in alcohol consumption must be netted out from increases in jobs in the cannabis industry to get a true picture of the stimulative impact. What would confound the data is the possibility of simultaneous increases in the consumption of both as consumers shift from physical goods to experience consumption.

Figure 4 graphs the sales tax revenue for medical, retail and alcohol and figure 5 employment in beverage production. There are a couple of useful observations. The first is there is no tailing off of alcohol consumption with the introduction of retail weed. Perhaps there is a reduction from what might have been consumed absent legalization but that is a counter-factual that cannot be known. From Figure 5 we see an increase in employment in the manufacturing of beverages of all types. Not too much can be made of this data except to say, whatever the economic impact of legalization was, it was not dramatic.

The second observation is that the sales of medical marijuana did not appreciably change. One would have expected that there would be a shift as weed lovers prior to 2014 had no other legal alternative for bud acquisition. Now, with no reason to spend time being medically authorized, they would simply buy retail. One possible explanation is that while recreational users posing as medical users are now

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12. Sobol and Holcombe estimate using data from the 1991 recession that states need rainy day funds equal to about 1/3 of their budget. For California that would mean a fund more than 10 times as large.
Figure 4

Mary Jane Sales Tax Revenue  Colorado

Sources: State of Colorado Department of Finance

Figure 5

COLORADO BEVERAGE MFG EMPLOYMENT

Sources: Colorado Department of Labor and Employment
not, some who would not previously toked have received prescriptions for pain abatement as society finds it more acceptable. However, the exact reason for the lack of decline in medical marijuana sales is not known.

So what is the explanation for the continued increase in retail marijuana sales? In part this is a growing market due partly to the increased social acceptance. But also, Colorado has become a destination state for marijuana tourism. California can expect the same and whatever the aggregate impact, it will transform the Emerald Triangle.

Using the Colorado data for the increment to the legal marijuana industry post-retail marijuana legalization we calculated a back of the envelope impact. To be sure, California is not the same as Colorado and the calculations could be way off, but not unreasonably so. Using population to gross-up the Colorado numbers and assuming a California 10% sales tax, the revenue calculation from marijuana sales would be $501 million or 0.4% of the State’s general fund. The retail marijuana sales in Colorado are growing, so this number might be a bit on the low side, but it has a long way to go to make an significant impact on the budget, and it surely won’t cure what Prop 55 ails.

The estimate for the size of the cannabis industry in Colorado is $5 Billion, and the job gain is 28,000. Evidence on the licensing of marijuana employees suggests the numbers maybe 3 to 4 times as high, but those numbers count an unknown number who were engaged in the industry before. Translating those numbers to California results in an industry which is 0.2% of California’s $2.5 trillion dollar economy and 0.13% of California’s employment; important for those who benefit but not enough to impact the forecast in any significant way. To simulate the impact of this one factor on the forecast, we used a 5% and a 9.4% reduction in the year 2017 and re-ran the forecasting model.

Though much else will be going on in the event of a trade war, one cannot minimize the impact of this shrinkage in the logistics industry, particularly as it affects Southern California. The simulation at -5% and -9.4% of transportation, warehousing and utilities employment yielded an 0.28% and 0.68% reduction in overall employment growth and a 0.16% and 0.22% reduction in personal income growth in 2017. These numbers should be taken with a grain of salt as our econometric models are built on post World War II data and the United States has not engaged in a trade war since the Smoot Hawley tariffs were imposed in 1930. Nevertheless, they are indicative of the hit California will take in the event a significant trade war takes place.

The Forecast

Though there are risks to the forecast, we think that the most likely outcome is that economic policy, taxes and grass will not be significant players of the next 2 ½ years. California is very nearly at full employment and that is good news. It does bear repeating however that we should not be too sanguine as part of the reason is a large number of late career Californians never recovered from the recession, they just aged out of the work force. Still, we expect the California economy to continue to grow, and continue to create jobs through our forecast horizon.

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Full employment also has the characteristic that growth slows down. When there are only new entrants to the job market and not new entrants plus the unemployed to draw from, growth is perforce slower. Immigration can augment growth, however with the high cost of living in California and the lack of a prospect for international immigration reform, that will add very little to growth rates.

The current forecast is for continued steady gains in employment through 2018. What this means is a steady decrease in the unemployment rate in California over the next two years. We expect California’s unemployment rate to be insignificantly different from the U.S. rate at 5.4% by the end of the forecast period.

Our estimate for the 2016 total employment growth is 2.0%, and for 2017 and 2018 the forecast is for 1.7% and 1.1%. Payrolls will grow more at about the same rate over the forecast horizon. Real personal income growth is estimated to be 2.6% in 2016 and forecast to be 3.7% and 3.6% in 2017 and 2018 respectively. Homebuilding will continue in California at about 120,000 units per year in 2017. In spite of the Governor’s policy to ease building restrictions, a million new homes in California is not in the offing and home prices will remain at a premium.