California Fiscal Focus

A Monthly Report from State Controller Betty T. Yee

January 2019

As Governor Releases First Budget Proposal, Controller Reports State Closed 2018 Short of Expectations

On the day Governor Gavin Newsom proposed his first budget, State Controller Betty T. Yee reported California's revenues in December fell short of assumptions in the 2018-19 fiscal year budget by $4.82 billion. For the fiscal year, revenues of $55.63 billion are 4.4 percent ($2.54 billion) less than projected in the budget, which was enacted at the end of June.

"With our economy continuing to hover on the brink of a downturn, I applaud Governor Newsom's budget planning with an eye towards building a strong foundation of long-term cost savings and fiscal discipline. The Governor's proposals for debt and pension liability reduction; bold programming investments for education, health care, child care, and housing; and rainy day savings will pay dividends," said Controller Yee, the state's chief fiscal officer. "With thoughtful allocation of finite resources, we can shape solutions to one of our most vexing challenges — the widening inequality that plagues our state."

Personal income tax (PIT), sales tax, and corporation tax — the state's "big three" revenue sources — all were lower than projected in the FY 2018-19 budget. The shortfall in December could be partly due to lags in taxpayer filings at the end of the tax year as a result of federal tax deduction changes. Consequently, January receipts are expected to catch up to the FY 2018-19 budget forecast.

For December, PIT receipts of $6.76 billion were $3.45 billion less than expected in the FY 2018-19 Budget Act. PIT receipts in December 2017 were $11.50 billion.

Sales tax receipts of $1.16 billion for December were $1.42 billion less than anticipated in the FY 2018-19 budget. Last month's corporation taxes of $2.09 billion were $179.5 million lower than FY 2018-19 Budget Act estimates.

The General Fund ended December with an internal loan borrowing balance of $11.80 billion, which was $4.85 billion less than anticipated in the FY 2018-19 budget. For more details, read the monthly cash report.

In this newsletter...

Examining Effects of U.S.-China Tariffs on the California Economy

California and the People's Republic of China enjoy an economic and cultural relationship with mutual benefits. The open exchange of creativity, capital, and trade has resulted in economic benefits for both California and China.

In recognition of China's importance to California's prosperity, former Governor Jerry Brown in 2012 signed AB 2012 (Perez) making the Governor's Office of Business and Economic Development — otherwise known as GO-Biz — the lead agency for international trade and investment activities. The law authorized GO-Biz to contract with a nonprofit organization to open a California Trade and Investment Office (CTO) in Shanghai.

By a significant margin, California ranks as the nation's number one importer of Chinese goods and services. According to the U.S. Census Bureau, 2017 Chinese imports to California totaled more than $159 billion, accounting for 36 percent of the state's imports. In comparison, Texas — China's second-largest U.S. import partner — had a Chinese import total of $43 billion.

Topping the list of imports from China to California are finished and unfinished electrical machinery, motor vehicles and parts, industrial machinery, oil and mineral fuels, and precision instruments. Many of the imports are unfinished goods, used by California manufacturers to create products that are sold domestically and exported to other countries.

China also represents a significant export destination for California products, ranking as the state's third-largest export destination behind Mexico and Canada. In 2017, California exports to China totaled $16 billion. Exports to China from California consist largely of computers and electronics, transportation equipment, agricultural products (especially fruits and nuts), software, and machinery.

The volume of well-paying jobs and new business opportunities attributable to California exports cannot be understated. According to the U.S. Department of Commerce, the value of exported goods from California in 2017 totaled $171 billion, supporting more than 683,000 jobs from 70,000 small and medium-sized businesses.

Citing national security and unfair trade practices, the U.S. government initiated sanctions in March 2018, including aluminum and steel tariffs under Section 232 of the Trade Expansion Act of 1962, and tariffs on specified Chinese products based on Section 301 of the Trade Act on 1974. While the Section 232 tariffs are based on national security concerns and apply to all trading partners, unless specifically exempted, the Section 301 actions specifically target China for unfair trade practices.

The U.S. contends that China's trade practices related to technology transfer, intellectual property, and innovation hinder U.S. trade and investment. Consequently, the U.S. imposed an initial 25 percent tariff on a list of goods and services totaling $50 billion, subsequently adding an additional 10 percent tariff on $200 billion in trade. The U.S. had intended to increase the 10 percent tariff to 25 percent beginning January 1, 2019, but recent discussions between the two nations resulted in a 90-day delay.

In retaliation, China threatened tariffs for $234 billion in U.S. imports including a variety of food stuffs, electronics, machinery, chemicals, and other common U.S. products.

Most policy analysts agree that trade barriers such as tariffs result in

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Federal Tax Reform Balloons Deficit, Necessitating Spending Cuts

In December 2017, the U.S. Congress passed the Tax Cuts and Jobs Act and President Donald Trump signed it into law. The Act permanently reduced corporate tax rates, temporarily lowered most individual tax rates, limited the state and local tax deduction to $10,000 and the mortgage interest deduction to the first $750,000 of principal, and enacted deemed repatriation (a mandated tax on past earnings held abroad).

The most notable and immediate impact of the tax changes showed in the business community. Beginning in January 2018, companies set upon a historic run of stock buybacks, enriching corporate shareholders from the windfall of corporate tax breaks. As of mid-December, corporate buybacks had totaled a record $1 trillion, according to TrimTabs Investment Research.

While some companies offered employees one-time bonuses, there was no widespread enhanced investment in worker salaries, benefits, retirement contributions, or training. According to the Federal Reserve Bank of San Francisco, median earnings of full-time workers rose just 2 percent on an annual basis, well below what would be expected in a robust labor market.

The reduction in federal revenue may come at a price for California. In its analysis of the Tax Cuts and Jobs Act, the Congressional Budget Office (CBO) estimates the federal deficit will increase by $1.9 trillion over 10 years as a result of the tax changes. This will put pressure on policymakers to cut federal spending, likely resulting in additional cost to the state's general fund.

Reacting to a 17 percent jump in the federal deficit, President Trump instructed his cabinet secretaries in October to look at 5 percent across-the-board cuts for the upcoming federal budget. With the defense budget declared off-limits, cuts likely will be concentrated in programs that support the most economically disadvantaged, therefore transferring additional costs to states.

The tax changes also are likely a factor negatively affecting California's expensive housing market. CBO predicted the increase in the federal deficit resulting from the tax law changes would put upward pressure on interest rates. That has been the case, with interest rates on a 30-year home loan increasing from 3.93 percent in December 2017 to 4.6 percent in December 2018.

Higher interest rates, coupled with the capped value of the home mortgage deduction, make it increasingly challenging to purchase a home in California. According to October statistics from the California Association of Realtors, home sales declined by 7.9 percent year-over-year. The Mortgage Bankers Association reports mortgage applications have decreased by 11 percent from a year ago.

Interestingly, while home sales declined in all sub-million-dollar categories, sales actually increased by 19.1 percent for homes costing above $2 million. This suggests that wealthier individuals are far less affected by the new federal tax law. The Tax Policy Center estimates that — when fully phased in — the federal tax changes will benefit the top 1 percent (by income) by over $60,000 a year while providing the bottom 60 percent of households an average annual savings of about $400.

Unfortunately, when crafting their tax package, the president and Congress missed an opportunity to enact policy changes to benefit all Americans. Instead of balancing the equation by including proposals that would assist struggling American families — such as increasing the Earned Income Tax Credit or adding funding to programs that support upward mobility — the plan largely rewarded corporations over workers, increased pay inequity and the opportunity gap between rich and poor, and ballooned the national deficit.

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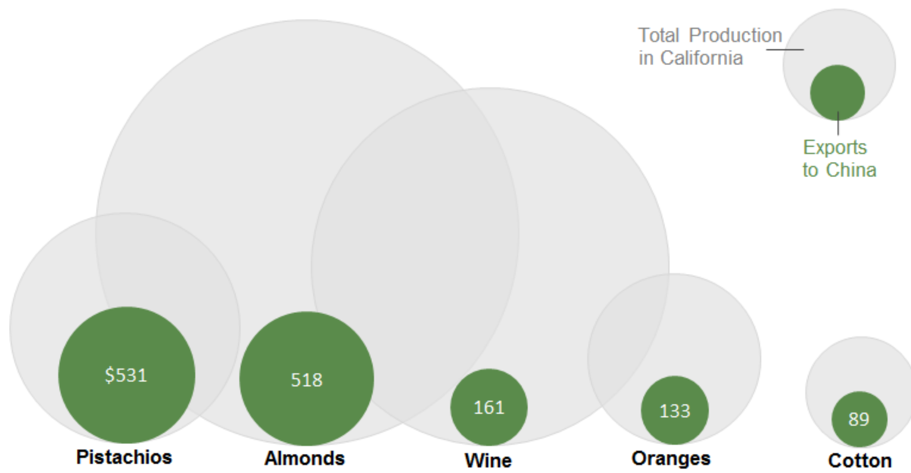
higher prices and fewer choices for consumers, increase costs for business and industry, and stifle demand. Tariffs even may cause some businesses to shut down if they cannot find alternative markets for their products.

As evidence to that concern, a growing chorus of large American companies including Walmart, Macy's, and Procter & Gamble are publicly warning the current trade dispute could lead to increased prices and lost jobs.

Top California Agricultural Exports to China

Value of production in millions, 2016



Source: Legislative Analyst's Office; April 16, 2018

Focusing on California, four specific industries may be at greatest risk as a result of the current trade dispute.

Agriculture

A report by the University of California (UC) Division of Agriculture and Natural Resources estimates the higher tariffs could cost major U.S. fruit and nut industries $2.64 billion per year in exports to countries imposing the higher tariffs.

In 2016 and 2017, China spent more than $500 million to buy 40 percent of all almond exports, and nearly $600 million for pistachios. UC foresees another $3.34 billion in losses from reduced prices caused by diverting produce from high-tariff countries to alternative markets.

California's robust wine industry also may be affected negatively by targeted tariffs. According to the Wine Institute, China is one of the fastest growing wine markets in the world, and U.S. wine exports grew 450 percent over the past decade. The increased tariffs put California wines at a price disadvantage. As of June 2018, Beacon Economics reports wine exports had declined by 15 percent.

Housing

According to the UC Berkeley Terner Center for Housing Innovation, the cost to build new homes in California already is higher than the rest of the nation. The California Building Industry Association cited comments from contractors that tariffs could add $8,000 to $10,000 per house for lumber costs and about the same amount for steel products such as nails, fasteners, and wire mesh.

Add tariffs to already-high labor, land, and permitting costs, compounded by rising interest rates, and there is a perfect storm to slow down much-needed housing growth.

The added cost of tariffs also comes at a difficult time for people trying to rebuild after a series of natural disasters. Homeowners are finding that insurance policies not updated for today's construction market are leaving them short of funds for the cost to rebuild. One study of recently displaced homeowners found the average insurance deficit to rebuild was at least $100,000.

Manufacturing

The increase in manufacturing costs associated with tariffs on Chinese imports almost certainly will have a negative effect on California's manufacturing sector. Many of the goods and products made in California will become more

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expensive compared to similar products produced outside the U.S. That is mainly because California manufacturers consume a lot of Chinese unfinished goods in their processes.

Small businesses are especially susceptible to cost increases because larger, more diversified companies are better able to temporally absorb higher production costs as they work to establish new supply chains not subject to tariffs. This is especially troublesome given that 96 percent of the 73,000 companies exporting from California are classified as small- or medium-sized businesses by the U.S. Department of Commerce.

Also troubling is the potential impact a decline in the manufacturing sector may have on the California economy and jobs. In 2017, manufacturers accounted for $300 billion of the state's total output, employing 1.3 million workers with an average annual compensation of approximately $87,000, well above the state's average income for non-farm jobs.

Transportation

The California Association of Port Authorities estimates more than 40 percent of total containerized cargo entering the U.S. flows through California ports. In 2017, southern California ports handled approximately $173 billion in Chinese imports, about a third of all goods shipped from China to the U.S. In addition, $130 billion in American goods and commodities flowed through these ports to China. As a central hub for international trade, California ports are part of a larger infrastructure with the ability to efficiently move freight by air, rail, and roads. It also includes significant warehousing and specialized storage capabilities. Accordingly, the ports of Los Angeles and Long Beach estimate they support nearly one million jobs in southern California.

Should the trade dispute continue and freight begin to slow, the impact on California ports, trucking lines, warehouses, and distribution centers could be severe. The executive director of the Port of Los Angeles recently said as much as 25 percent of latent cargo could be affected by tariffs.

As the nation's leader in international trade, California stands to be hardest hit by the ongoing tariff dispute. The longer the dispute continues, the worse it will be for California workers, California companies, and the California economy.

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