A MONTHLY REPORT FROM STATE CONTROLLER BETTY T. YEE

California Fiscal Focus

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CA Controller Reports Encouraging July Revenues

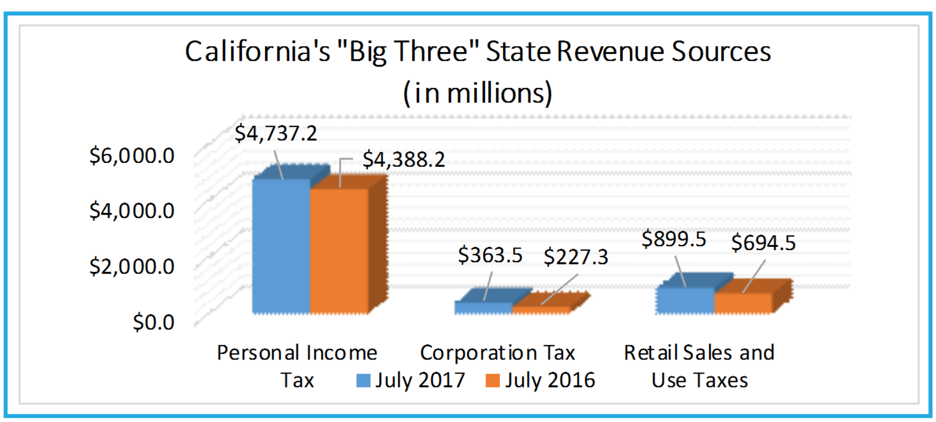
California started the 2017-18 fiscal year with encouraging revenues, State Controller Betty T. Yee reported, with total revenues of $6.09 billion in July exceeding projections in the state budget approved in June by $188.8 million, or 3.2 percent.

Total revenues in July 2017 were $667.9 million higher than in July 2016. In July, each of the "big three" revenue sources beat expectations.

Personal income tax receipts of $4.74 billion in July were $77.3 million higher than 2017-18 Budget Act estimates. July corporation tax receipts of $363.5 million were $18.9 million more than anticipated in the budget, or 5.5 percent. Retail sales and use tax receipts of $899.5 million for July surged $84.6 million, or 10.4 percent, above budget estimates.

Outstanding loans of $8.97 billion in July were $604.5 million less than budget estimates. This loan balance consists of borrowing from the state's internal special funds. Available borrowable resources were $3.40 billion more than expected.

For more details, read the cash report.



Inside this issue

Foreign Earnings and Repatriation: Evaluating Previous Action and Possible Tax Reform

For federal tax purposes, U.S. companies are taxed on their worldwide income. American companies generally operate in foreign countries indirectly by owning subsidiaries. When ownership in the foreign subsidiaries is more than 50 percent, the subsidiaries are known as controlled foreign corporations (CFCs). Operating income from the CFCs are subject to U.S. tax only when the income is repatriated as dividends to the U.S. parent corporations or U.S. shareholders. Since the earnings are not subject to tax until distributed as dividends, many policy analysts argue that American companies with CFCs are encouraged to keep the foreign earnings overseas.

Tax Holiday

In 2004, President George W. Bush enacted the American Jobs Creation Act, which created a temporary incentive for companies to repatriate earnings held by CFCs. The intent of the law was to stimulate the economy by expediting the return of offshore revenue. Companies were required to invest repatriated funds in domestic operations, thereby creating jobs.

The tax holiday allowed U.S. corporations to deduct 85 percent of the dividends received from CFCs for one taxable year (2004, 2005, or 2006) if they met certain requirements. There was no requirement for dividend proceeds to be segregated or traced, or to be applied to a permitted U.S. investment within a specific time period.

However, there were limitations on what constituted a permitted investment, and companies were required to follow a management-approved domestic reinvestment plan. Companies participating in the tax holiday paid an effective tax rate of 5.25 percent on repatriated income instead of the highest federal corporate income tax rate of 35 percent.

Success or Failure

In 2011, a subcommittee of the U.S. Senate Committee on Homeland Security and Governmental Affairs reported the tax holiday did not produce any of the promised benefits of new jobs or increased research expenditures to spur economic growth. The subcommittee found an increase in executive compensation after repatriation and a $3.3 billion cost to the U.S. Treasury.

However, other analysts said the tax holiday achieved its objective of repatriating offshore funds because 843 of the nearly 9,700 companies with CFCs took advantage of the program. As a result, $362 billion of the expected $400 billion was repatriated.

Time for Change

In recent years, President Barack Obama and congressional leaders from both parties proposed various changes to eliminate the tax deferral on overseas profits and/or reduce the tax rate on repatriated profits. In July, Republican congressional leaders stated one of the goals of tax reform is a "system that encourages American companies to bring back jobs and profits trapped overseas." According to proposals, President Donald Trump may seek a 10 percent tax on offshore earnings. The State Controller's team will continue to monitor developments and weigh in with federal decision-makers to make sure tax reform results in a system that is fair and effective.

How is the Housing Crisis Hurting California's Economy?

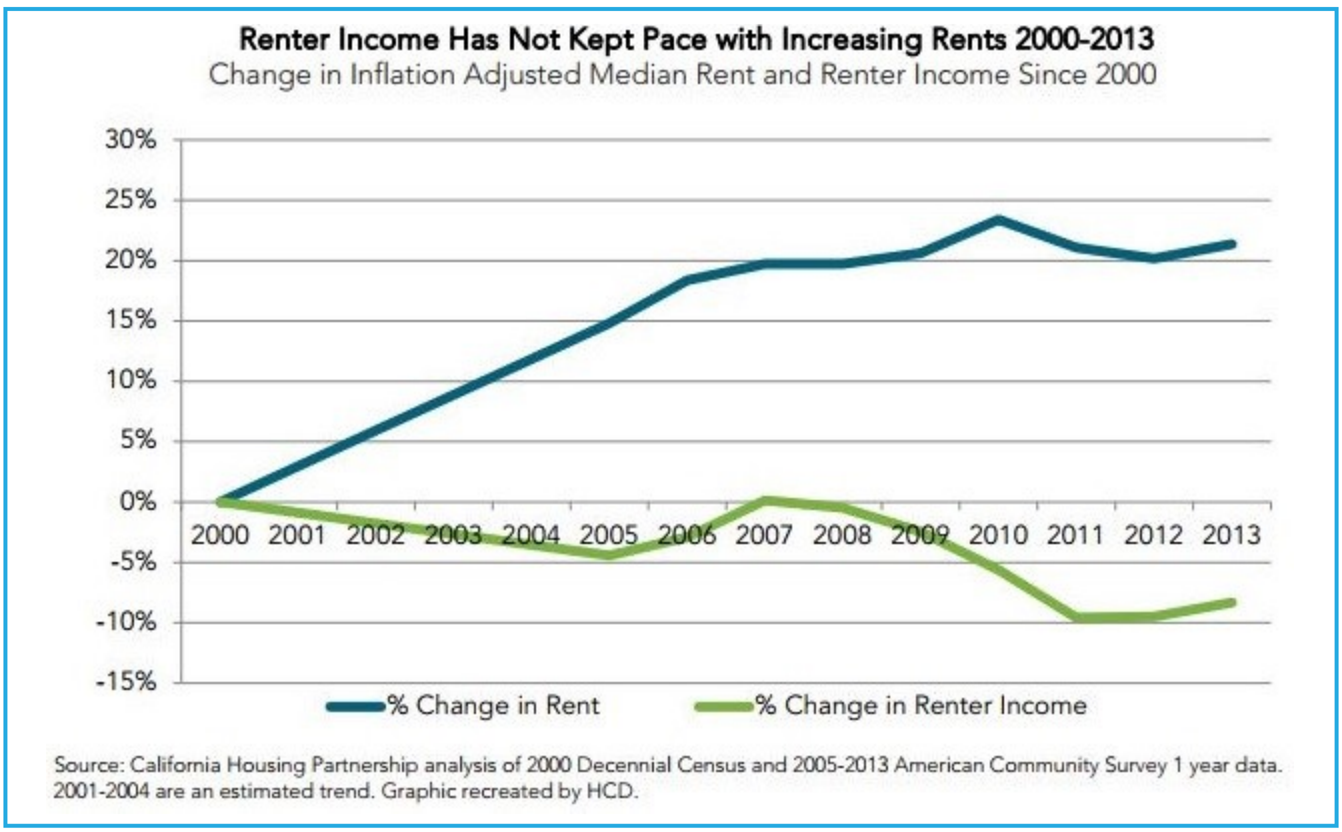
California is in a housing crisis. Construction of new housing to meet the needs of a growing population is below historic levels. Home prices and rents are rising while income largely remains stagnant. The problem is felt across the state at an individual level as long-term renters are displaced from communities, prospective buyers are priced out of the market, and many are forced to commute to work from longer distances. The economy as a whole is experiencing the crisis as well.

According to a 2017 draft housing plan from the California Department of Housing and Community Development (HCD), housing production lags by 180,000 units per year based on current population growth projections, and home ownership rates are at their lowest since the 1940s. More than half of California renters are "rent burdened," paying more than 30 percent of their income in rent. Approximately 1.5 million Californians spend more than half of their income in rent. In the state's 10 highest-cost metropolitan areas, half of renter households earning less than $75,000 are rent burdened. The HCD report documents these problems as even more severe across communities of color and others experiencing a history of discrimination.

As negative consequences of the state's housing crisis become more apparent at the individual level, numerous researchers have sought to measure the impact on the economy. Notably, many offer differing approaches to measure the effect.

A 2016 report by the McKinsey Global Institute found California's housing crisis costs California $140 billion per year in output from lost construction investment and missing consumption caused by housing costs. McKinsey's analysis of the "crowding out" impact uses similar data as those cited by HCD, showing how the lack of affordability reduces consumption among low- and moderate-income households.

(See HOUSING, page 4)



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McKinsey estimated a statewide affordability gap of between $50 million and $60 million, and focused on the reduced consumption by households with high-cost burdens from reduced disposable income. If the affordability gap is closed, there potentially could be increased consumption of $47 billion to $56 billion for lower-income households, and $3 billion to $4 billion for middle-income households.

Earlier this year, economists from the University of Chicago and UC Berkeley measured the relative impact between diminished labor mobility and housing constraints in 220 cities on U.S. economic growth. The three Metropolitan Statistical Areas with the greatest productivity from 1964 to 2009 were New York, San Francisco, and San Jose (Silicon Valley). Using complex modeling, the researchers found local land-use regulations and housing costs led to labor constraints resulting in a 50 percent reduction in U.S. Gross Domestic Product growth. Although the model – seeking to isolate local regulations, amenities, and labor market conditions – warrants further research, the analysis suggests diminished economic growth from housing constraints negatively affected workers' wages at all levels. Co-author Enrico Moretti suggested these constraints cost the average worker $5,000 in lost wages.

Each of these studies examined the economic impact of housing differently, with varying emphasis on the labor market. However, all three underscore how the affordability of housing is central to the state's economy.

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