San Diego County Manufacturing Industry Report
"Can Manufacturing Survive in California?"
May 2008

Economic activity in the manufacturing sector contracted in April for the third consecutive month, according to the Manufacturing Institute for Supply Management's Report on Business, while the overall economy grew for the 78th consecutive month. The PMI registered 48.6 percent, the same as in March. A reading of 50 percent indicates that the manufacturing economy is generally expanding and below 50 percent indicates that is generally contracting. "Manufacturers are in a situation where both new orders and production are slowly declining, but prices continue to rise at highly inflationary rates, said Norbert J. Ore, C.P.M., chair of the Manufacturing Business Survey Committee. "Bright spots this month are the growth in the Backlog of Orders index after six consecutive months of decline."

Confidence among large manufacturers eroded in the first quarter of 2008 to the lowest level in five years, with some sales expectations falling to their lowest level since the second quarter of 2001 according to David Huether, Chief Economist, National Association of Manufacturers. Half of all U. S. manufacturers expect a recession in 2008.

The burst of the housing bubble and the downward spiraling of credit markets have already hit some regions hard, sliding them into recession already. Arizona, California, Florida, Michigan, Nevada, Ohio, Rhode Island, Tennessee, and Wisconsin are now considered to be in recession. (U. S. Regional Outlook: The States of Recession, April 15, 2008)

The U. S. Manufacturing Technology Consumption report for March 2008, compiled by the Association for Manufacturing Technology and the American Machine Tool Distributors' Association, provides regional and national consumption data of domestic and imported machine tools and related equipment. The March manufacturing technology consumption was up 36.1 percent higher than March 2007 for a year-to-date total up 16.4 percent compared with 2007. The Western region technology consumption for March totaled $62.71 million, which was 64.3 percent higher than February's $39.99 million, and 2.3 percent higher than March 2007. However, compared with 2007 at the same time, the year-to-date total of $142.91 million is down 14.0 percent.

Daniel Meckstroth, chief economist for the Manufacturers Alliance/MAPI said, "An important counterweight preventing the manufacturing recession from becoming much worse is that the declining dollar has made United States' exports very competitive in world markets, but a worrisome factor in the marketplace is the escalating prices of oil, food, and metal commodities."

As an example of increased costs of metal, the world's largest steel maker, ArcelorMittal, advised its contract customers, including automakers and other large-volume buyers, that it is adding a $250/ton surcharge to all sheet and plate products shipped after April 20, 2008. Non-contract orders will be fixed with a $150/ton surcharge. (April 27, 2008, *Metal Producing & Processing*)

There was some positive news because the high-tech industry continued growing for the third year in a row, adding 91,400 net jobs for a total of 5.9 milion in the United States. California led the nation in adding 21,400 jobs in the high-tech industry according to the 11th annual Cyberstates 2008 report, released by AeA on April 2, 2008. Christopher Hansen, President and CEO of AeA, said "Tech jobs make critical contributions to the U. S. economy in terms of innovation, and pay extremely well – the average tech industry wage is 87 percent higher than the average private sector wage." However, the sectors that grew were software services and engineering and tech services, while high-tech manufacturing lost 29,800 jobs nationwide in 2007. Seven of nine manufacturing sectors lost jobs in 2007. Only the defense electronics and electromedical equipment sectors added jobs.

San Diego's Manufacturing Industry Continues Slow Down

San Diego County's manufacturing industry continued to slow down during the fourth quarter of 2007, with only a slight upturn in the first quarter of 2008 as companies replenished inventories they had allowed to contract by year-end. Again, the slow down hasn't been across the board for all market segments, but has become more pervasive than it was in early 2007. Biotech and medical device manufacturers seem to be the most insulated from the slow down, while manufacturers producing products for the consumer, recreation, and housing market have been the most impacted.

Manufacturers in the aerospace and defense industry who produce consumable products for the "war on terrorism" continued to be very busy. However, other defense and aerospace companies continue to experience an adverse affect from the war because when so much of the Federal defense budget is being spent on supporting the troops and "consumable" supplies, weapons and munitions, other types of defense-related systems and Research & Development, receive fewer funds or no funds at all.

With the "war on terrorism" continuing in Iraq and Afghanistan, San Diego's ship repair industry is now in its fifth year of recession. With Navy ships out to sea longer, the Navy only contracts out the repairs that are absolutely necessary while in port and delays doing any major overhauls so the ships can go back out to sea as soon as possible. General Dynamics NASSCO's contracts to build new ships continue to be the only bright spot in San Diego's ship building/repair industry. Unfortunately, the small ship repair companies don't seem to benefit from these contracts for new ships. Several small shops have closed down in the past four years, and there will be more closures in the future as long as the war continues.

San Diego's off road vehicle industry slowed down even more in the fourth quarter 2007 and only started to pick up at the end of the first quarter 2008 as companies finally started to rebuild inventories that took nearly a year to deplete. As mentioned in my report of November 2007, the reasons behind this slow down are complicated. Inquiries revealed that a majority of people who purchase off road vehicles (dune buggies, quad wheelers, and dirt bikes) work in the building industry. With the housing market in a big slump, fewer homes, condos, and apartments are being built so people working in this industry are experiencing a tight money situation and don't have the money to purchase off road vehicles or even keep the vehicles they have already purchased. Over the last 15 years, the industry changed from low-cost home "kit" models to expensive "custom-built vehicles made by companies specializing in this field. Today, the price of new custom-built off road vehicles ranges from $50,000 to $70,000.

Many people took advantage of their increased equity as home values doubled or tripled over the past decade by using a portion of their equity from home equity loans to purchase off road vehicles they never dreamed to be able to afford. The mortgage crisis caused by sub prime loans and the high rate of foreclosures has made things worse in the past six months. There have been so many used off road vehicles for sale that the market for new vehicles is way down, causing the slow down in the industry.

Some Business is Coming Back from Offshore

A couple of years ago, one San Diego company moved most of their sheet metal fabrication offshore to China to get a 40 percent cost reduction in the piece pricing of the parts. However, they were required to purchase significantly larger lots of parts resulting in a higher cost for the larger inventory. In turn, the larger inventory required more storage space. In addition, transportation costs for shipping from overseas were higher. All of these additional costs and other "soft" costs, such as travel expenses to visit vendors, communication costs, and make up what are referred to as the "total cost of ownership." After realizing that these additional costs were eating up the cost savings in the piece pricing, this company brought their sheet metal back to a local supplier in the fourth quarter of 2007. The local supplier was able to nearly match the Chinese costs by developing more efficient and creative production techniques, using recyclable packaging for parts delivery, and utilizing larger lots sizes delivered on a just-in-time schedule. The company was able to reduce their inventory significantly and reduce the space required for inventory due to smaller lot sizes being delivered just in time. They are now getting higher quality parts at less-than China prices when the costs of inventory, space, and shipping costs are taken into consideration.

Harder to Compete for California Companies

While all American manufacturing companies face a challenge in competing against offshore companies, California's manufacturers face an additional challenge because the business environment grows increasingly unfriendly. In 2005, California dropped to 50th in ranking in the Small Business Survival Index by the Small Business & Entrepreneurship Council (SBE Council), and its rank did not change in the 2006 and 2007 reports. However, California's rank rose one point to 49th in the 2008 report, with New Jersey dropping to 50th. This low overall ranking was based on California's anti-business environment in the following areas:

- Highest personal income tax rates
- Highest state gas taxes
- Highest capital gains tax
- 5th highest cost of worker's compensation premiums
- 6th highest electric utility costs
- 8th highest corporate capital gains tax rates
- 9th highest corporate income tax rates
- High state and local property tax rates

In addition, from August 2003 to August 2007, job growth registered eight percent in the top 25 states, compared to 4.7 percent in the bottom 26 (including the District of Columbia) where California ranks at 49th.

Manufacturers, most of which are small businesses in California, have to struggle every day with the costs of taxation. These costs affect a wide array of decisions, including hiring, investment, expansion, and location. While the federal tax burden and the complexity of that system is quite heavy, state and local taxes can add significantly to that load. The SBE Council's "Business Tax Index 2008" captures these tax costs and provides a measure of how the states stack up against each other in this regard. California ranks 48th with a tax score of 49.541 compared to South Dakota's tax score of 10.29 as rank number one. (www.sbecouncil.org)

To make maters worse, the deepening of California's economic problems and the estimated $14-18 billion deficit for the fiscal year 2008-2009 are causing legislators to propose legislation to impose tens of billions of new taxes.

Since taking office in late 2003, Governor Schwarzenegger vetoed 10 out of 10 of the California Chamber's identified "job killer" bills in 2004, seven of eight in 2005, and nine of the eleven in 2006. In 2007, the California Chamber of Commerce reported that Governor Schwarzenegger vetoed all 12 "job killer" bills sent to his desk for action by the legislature. Here are a few of the bills that have been introduced this year that would add to the tax burden of Californians:

AB 20 (Feuer) - would lower the threshold for local transportation infrastructure bonds from two-thirds to 55 percent.

SCA 17 (Simitian) – would lower thee two-thirds vote threshold for school district parcel tax increases to 55 percent.

SCA 21 (Kehoe) – would lower general obligation bond threshold for essential services buildings from two-thirds to 55%.

SCA 22 (Torlakson) - would eliminate the two-thirds constitutional requirement to pass a budget and would also prohibit a referendum on "any bill scheduled to take effect immediately."

AB 2897 (Hancock) – would impose new income tax rates of 10 and 11 percent on those making $136,000 and $272,000 respectively.

AB 2372 (Coto) – would place a one percent tax increase on those making over $1 million annually to fund higher education.

Since the top ten percent of income earners pay 75 percent of California's income taxes according to Franchise Tax Board data, an increase in taxes would encourage those already contributing the most to consider leaving our state. It won't be limited to the extremely wealthy – small businesses and the middle class would make up a large portion of those who may leave. A report called "Rich States, Poor States" by economists Arthur Laffer and Stephen Moore states "Out of the 25,000 or so seven-figure-income families, more than 5,000 left in the early 2000s, and the loss of their tax payments accounted for about half the budget hole."

This is not the time to raise taxes or fees. This is not the time to implement regulations that kill jobs. As it is, unemployment shot up a half-percent to 6.2 percent in California in March, the highest rate since June 2004, before the housing boom drove rates to below 5 percent. Only two states have higher unemployment rates, Michigan and Alaska.

California manufacturers are also facing regulatory uncertainty to comply with the regulations that will be promulgated by the California Air Resources Board to implement AB32, the Global Warming Solutions Act of 2006. This law, which requires California to reduce its greenhouse gas emissions to 1990 levels by 2020, would be a 30 percent emission reduction from business as usual. The California Chamber of Commerce states that it is working to minimize the compliance costs for businesses by actively pushing for measures that reduce carbon while allowing for continued economic growth.

It is critical for California's future economic health to provide reliable water supplies and increase water storage. Two bond bills introduced last year to increase water supplies/storage were unsuccessful. A third year of below normal rainfall and snow pack this past winter makes it look like water shortages and possibly water rationing will be a reality later this year. Developing additional water storage and conveyance facilities can no longer be postponed. (For more information see the California Chamber's 2008 Business Issues and Legislative Guide at www.calchamber.com).

We need to make some drastic changes in California's business climate so that we can maintain as much as possible of our manufacturing base in California. I recommend that the following actions be taken by the State Legislature to help improve the business climate of California and stem the tide of companies leaving California or going out of business:

- Lower corporate and personal income taxes
- Restore the capital equipment investment tax credit
- Eliminate burdensome regulations on small businesses
- Reform workers' compensation to address the issues of fraudulent claims and frivolous lawsuits
- Provide reliable water supplies
- Reduce costs for energy

The initial list of 40 companies of companies that had gone out of business or moved out of California that accompanied my first report of March 2003 more than doubled to 85 by the end of 2003. The mass exodus of companies moving out of San Diego County slowed down after the Schwarzenegger reforms in early 2004. Even so, another 63 companies have either gone out of business or moved out of state since 2004 for a total of 148 companies no longer in business or located in San Diego County.
Based on employment data for companies listed in the 2000 Technology Directory for San Diego County and estimating 20 employees for companies not listed in the directory, the current list of companies represents a loss of nearly 8,000 jobs.

San Diego has always been a "start-up business" area where companies grew to a certain size and were acquired by mostly out-of-the area companies. The new owners usually kept the division or subsidiary in San Diego because they were afraid of losing key people if they moved have taken a look at their bottom line for their San Diego-based acquisition and decided they couldn't afford to stay in California. For example, in December 2007, Ametek Inc acquired California Instruments that has been in San Diego for more than 40 years. Ametek is now moving manufacturing, quality and materials to New York. Only sales, engineering, customer service, and accounting will stay in San Diego.

As a result of the unfavorable business climate in California, San Diego companies have been moved to such former business unfriendly states as Ohio, Minnesota, Maryland, and New York. No wonder that we lost nearly 300,000 manufacturing jobs in California since early 2001.

The economic data indicates that each manufacturing job creates three to four other jobs while service jobs only create one to two other job. Therefore, the loss of 300,000 manufacturing jobs may have caused more than one million other jobs to vanish. Nationwide, a staggering 3.2 million manufacturing jobs have disappeared since the year 2000. The U. S. Department of Labor predicts that another 1.5 million manufacturing jobs will be lost between 2006 and 2016. If this trend is not reversed, it is only a matter of time before California's economy and America's economy becomes primarily a service and retail one. It will be virtually impossible for the United States to remain a superpower if this trend becomes a reality. We need to restore California and our country to the "land of opportunity" they once were.

Background: As background for how this series of reports came to pass, ElectroFab Sales is a manufacturers' sales representative agency for "job shop" companies that perform custom fabrication services. Our primary market is OEM's (Original Equipment Manufacturers) in San Diego County that utilize sub-contract manufacturing services.

We began losing customers and prospective customers in early 2001 because of the adverse business climate in Caifornia and the effects of the recession. We started keeping a record of the companies that moved out of state or had gone out of business since January 2001. This list evolved into an analytical report that I have been e publishing periodically since then in an effort to make key policy makers aware of the seriousness of the situation. This15th report provides an update on the state of various San Diego industry sectors, along with a focus on the effects of outsourcing offshore and California's competitiveness in the challenging global economy.

About the Author: Michele Nash-Hoff is President of ElectroFab Sales, an independent manufacturer's representative agency, which she founded in 1985. She is past president of the San Diego Electronics Network, the San Diego Chapter of the Electronics Representative Association, and The High Technology Foundation, as well as several other community and non-profit organizations. She was a candidate for San Diego City Council in 1996 and the California State Assembly in 2000. She has a B.A. from San Diego State University and later earned a certificate in Total Quality Management. Prior reports are accessible at Michele's website of www.electrofab.com