California Fiscal Focus

A Monthly Report from State Controller Betty T. Yee

February 2019

State Revenues Opened 2019 Mostly Below Projections

State Controller Betty T. Yee reported California's total revenues of $18.79 billion in January were lower than estimates in the governor's 2019-20 fiscal year budget proposal by $1.81 billion, or 8.8 percent, but higher than projections in the FY 2018-19 Budget Act by $1.21 billion, or 6.9 percent.

Total revenues of $74.42 billion for the first seven months of FY 2018-19 were lower than expected in the proposed and enacted budgets by $2.87 billion and $1.32 billion, respectively. In the fiscal year to date, state revenues are just 0.2 percent lower than the same time last year.

Sales tax and corporation tax — two of the state's "big three" revenue sources — came in higher than assumed in last month's proposed budget.

For January, personal income tax (PIT) receipts of $16.36 billion were $2.53 billion, or 13.4 percent, less than the Department of Finance forecasted last month but $403.6 million, or 2.5 percent, higher than assumed in the budget enacted last June. PIT revenue was still 4.8 percent higher than in January 2018.

Sales tax receipts of $1.59 billion for January were $602.8 million higher than anticipated in the proposed FY 2019-20 budget and $647.4 million higher than in the FY 2018-19 Budget Act.

Last month's $579.2 million in corporation taxes were 9.0 percent higher than estimates in the FY 2019-20 budget proposal and 12.0 percent higher than in the enacted FY 2018-19 budget.

For more details and comparisons, read the monthly cash report.

In this newsletter...

California Faces Imperative to Maintain Climate Leadership

In November, the federal government released the National Climate Assessment that concluded evidence is now stronger and clearer than ever the climate is rapidly changing primarily as a result of human activities, including the copious burning of fossil fuels. Observed weather extremes also are on the rise. The report concludes the nation can expect increased impacts on everything from crops to fresh water supplies, and better and broader plans for adaptation are needed.

For more than 15 years, California has been a world leader in addressing climate change. In 2018, the California Air Resources Board announced that greenhouse gas (GHG) emissions were down 13 percent, the first time they had dipped below 1990 levels. California's per-capita emissions continue to be the lowest in the country.

The state's aggressive program to reduce GHG emissions continues to be creative and successful. Strategies to increase renewable energy, reduce petroleum use in vehicles, increase energy efficiency savings in existing buildings, and reduce short-lived climate pollutants will be central to ongoing success.

However, there are challenges.

- The federal government has proposed reducing regulatory standards for GHG emissions at the federal level (which the auto industry negotiated with the prior administration) and is threatening to take away California's unique ability to regulate GHG emissions from automobiles.

- The framework to direct expenditures of cap-and-trade revenues to poor and underserved communities is in the early stage of development.

- The pending PG&E bankruptcy likely will disrupt the ability to maintain contracts that are essential to meeting the renewable portfolio standard.

New strategies to address land use and local government actions require creativity, and funding is critical. California has been at the forefront of developing new emission-reducing technologies that incubate here and expand internationally and will need to continue to invest in green technology. Success in maintaining emission reductions will require commitment by state leaders.

Equally important is a successful adaptation program. California has completed its Fourth Climate Change Assessment, which discusses the challenges of adaptation. By 2050, emerging findings for California indicate direct climate impacts will be dominated by sea-level rise damage to coastal properties, potential droughts and mega-floods, increased ocean temperature, and increased heat across our communities.

The costs will be on the order of tens of billions of dollars. For example, over the last few years, increased wildfires have devastated communities and challenged our creativity to rebuild. The state report concludes half of southern California beaches will completely erode by 2100 without large-scale human intervention. Statewide, damages could reach nearly $17.9 billion from inundation of residential and commercial buildings. A 100-year flood on top of predicted sea-level rise could double that.

The Ocean Protection Council and the Coastal Commission have developed strategies for mitigating the impacts of sea-level rise. The State Lands Commission is reviewing sea-level rise plans for the major ports to develop the best way to protect this key infrastructure.

California must remain a leader in emission reductions and develop action plans for communities to adapt. Sustaining this level of commitment is critical to California's continued economic resiliency.

To Conform or Not to Conform: California's Unending Tax Law Debate

The debate over California conforming to the federal tax code has existed as long as the state has had income tax. Should there be automatic conformity to federal tax law, modified conformity on a specified date, or a completely separate tax system?

In 1983, California enacted laws to require modified conformity to the Internal Revenue Code (IRC) as of a specified date. Only the differences between the two laws are required to be separately identified. Through modified conformity, the legislature and tax policymakers are provided with the opportunity to evaluate the various federal tax changes and decide which should be incorporated into California law.

Past Conformity

The first major change came in 1987 when California conformed to the IRC as of 1986 in response to the Tax Reform Act of 1986, which simplified the IRC, broadened the tax base, and eliminated many tax shelters. Prior to the conformity, California used a stand-alone tax return, requiring taxpayers to complete a form similar to the federal tax form. California's modified conformity reduced the tax compliance burden and improved tax administration.

Most recently, the Conformity Act of 2015 changed California's conformity date from January 1, 2009, to January 1, 2015. Although California's conformity resulted in numerous substantive changes to both personal and corporation tax law, there continued to be differences between California and federal law.

Federal Tax Cuts and Job Act

The changes made to federal law under the 2017 Federal Tax Cuts and Jobs Act (TCJA) have not been incorporated into California tax law. California Revenue and Taxation Code section 19522 requires the Franchise Tax Board (FTB) to report on all IRC changes enacted in the prior year. FTB staff finalized the Summary of Federal Income Tax Changes (SOFITC) in May 2018. The SOFITC identified all of the federal changes, noted whether California previously conformed to the federal tax provision, and calculated the revenue impact if California was to continue with the conformity. For those items that California did not previously conform to – federal tax rate, standard deduction, personal exemption deductions, and more – the impact to California revenue was not calculated.

Federal Tax Cuts and Jobs Act of 2017
Sections Under Consideration for Conformity

13102	Small Business Accounting Method Reform and Simplification
11032	529 Account Funding for Elementary and Secondary Education
11051	Repeal of Deduction for Alimony Payments
13504	Repeal of Technical Termination of Partnerships
13303	Like-Kind Exchanges of Real Property
11043	Limitation on Deduction for Qualified Residence Interest
13823	Special Rules for Capital Gains Investments in Opportunity Zones

Source: H.R. 1—115th Congress (2017-18)

Any modified conformity to the TCJA must have the goals of simplifying the preparation of California income tax returns, expediting the return filing process, and enhancing the efficient administration of California income tax laws. Since the majority of taxpayers use software that computes state and federal income and deductions, or have access to free services such as CalFile and Volunteer Income Tax Assistance/Tax Counseling for the Elderly, modified conformity may not be necessary to simplify filing.

California Earned Income Tax Credit

An Earned Income Tax Credit (EITC) is a federal or state credit that provides cash back to working individuals and

(See CONFORMITY, page 4)

(CONFORMITY, continued from page 3)

families. The credits are part of the federal income tax code and the tax codes of 29 states plus the District of Columbia. The California version of the credit (CalEITC) was established in 2015 with modified conformity to the federal EITC. California Revenue and Taxation Code section 17052(h) provides that CalEITC refunds, just like federal EITC refunds, are not counted as income for calculated CalWorks, CalFresh, or Medi-Cal benefits.

In response to calls for reexamining age and income limits, the California legislature changed the age requirement to 18 or older, allowing college students and senior citizens to benefit from CalEITC. (Prior to this change, individuals without children only were eligible for the credit if they were between the ages of 25 and 65.) There was no corresponding change in federal law. For the 2018 tax year, an adult with no qualifying children is eligible for up to $232 through CalEITC, and a family of three is eligible for up to $2,879.

Potential Changes

The governor's proposed 2019-20 state budget would expand CalEITC by providing an additional $500 for each child under age six, increasing the maximum qualifying income by about 20 percent, and increasing the credit for people with earnings at the higher end of the eligibility range. Increasing the qualifying income would allow a mother of three working full-time at California's minimum wage to continue to qualify for CalEITC when the minimum wage increases to $15 per hour.

The governor proposes to rename CalEITC to the "Working Families Tax Credit" to highlight the biggest beneficiaries of CalEITC. However, this could have the unintended consequence of leading individuals without children to not claim the credit. The name CalEITC also has allowed for joint marketing with the federal EITC and National EITC Awareness Day.

As CalEITC continues to help low-income working people participate in the economy, consideration may be given to providing quarterly or monthly CalEITC payments. While installment payments would help better address the financial instability many families experience, such payment arrangements would face significant and potentially costly implementation challenges.

CalEITC and Conformity

The estimated annual cost of the proposed CalEITC expansion is $1 billion. The governor has proposed conformity to certain provisions of the TCJA to cover the additional CalEITC cost including the following: flexibility for small businesses; capital gains deferrals and exclusions for opportunity zones; and limitations on fringe benefit deductions, like-kind exchanges, and losses for non-corporate taxpayers.

With the objective of not increasing the tax compliance burden or hindering tax administration, the legislature and tax policymakers should carefully consider which portion of the TCJA, if any, should be subject to conformity. (See the box on page 3 for highlights.)

California
Fiscal Focus

A Monthly Report from
State Controller Betty T. Yee

www.sco.ca.gov

EOinquiry@sco.ca.gov

(916) 445-2636

P.O. Box 942850
Sacramento, California
94250-5872