A MONTHLY REPORT FROM STATE CONTROLLER BETTY T. YEE

California Fiscal Focus

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CA Controller Reports 2018 State Revenues Off to Strong Start

California's total revenues of $17.35 billion for January beat the governor's 2018-19 proposed budget estimates by $2.37 billion, or 15.8 percent, and outpaced 2017-18 Budget Act projections by $1.45 billion, or 9.1 percent, State Controller Betty T. Yee reported.

Personal income taxes (PIT) and corporation taxes, two of the "big three" sources of General Fund dollars, exceeded estimates for the second consecutive month and are both surpassing assumptions for the fiscal year. For the first seven months of the 2017-18 fiscal year, total revenues of $74.56 billion are higher than expected in the January budget proposal by 4.0 percent, 7.5 percent above the enacted budget's assumptions, and 11.7 percent higher than the same period in 2016-17.

For January, PIT receipts of $15.60 billion were $2.25 billion, or 16.9 percent, above the proposed budget's projections and $1.33 billion ahead of 2017-18 Budget Act estimates. For the fiscal year, PIT receipts of $54.70 billion are higher than anticipated in last summer's budget by $3.61 billion, or 7.1 percent.

Corporation taxes for January of $551.6 million were $211.3 million, or 62.1 percent, higher than expected in the proposed budget and $143.4 million above the enacted budget's estimates. This variance is partially because refunds were approximately $38.0 million lower than anticipated. For the fiscal year to date, total corporation tax receipts of $4.81 billion are $1.08 billion, or 28.8 percent, above assumptions in the 2017-18 Budget Act.

Sales tax receipts of $1.01 billion for January were $138.0 million, or 12.0 percent, lower than anticipated in the governor's budget proposal unveiled last month. Notably, for the fiscal year, sales tax receipts of $13.03 billion are $151.2 million lower than January's assumptions but $396.6 million, or 3.1 percent, above the enacted budget's expectations.

For details, read the monthly cash report.

Inside this issue

Exploring the California Impacts of Federal Tax Changes

The recently enacted federal Tax Cuts and Jobs Act (TCJA) permanently reduces taxes on corporations, temporarily reduces federal personal income tax rates, and makes significant changes to several mainstay deductions and exclusions. As the state's chief fiscal officer and chair of the Franchise Tax Board, Controller Yee is closely examining the TCJA to understand how these changes will affect individual Californians and the state's thriving economy.

Effects on Individuals

As a longtime proponent of strategic and equitable tax reform that generally expands the tax base, lowers tax rates, and acknowledges and addresses economic inequity, Controller Yee points out how this flawed tax plan will affect Californians.

Unfair Treatment of California Taxpayers

Federal tax reform placed a cap of $10,000 on the amount of state and local taxes (SALT) that a taxpayer may deduct from a federal tax bill. Previously, taxpayers were entitled to deduct the full amount of SALT from their federal tax liability. The inability to deduct state taxes was considered a form of double taxation and was thought to violate longstanding federalist principles regarding the proper relationship between states and the federal government.

Unfortunately, limiting the SALT deduction disproportionately hits many California taxpayers compared to other states. According to the State Franchise Tax Board (FTB), California residents account for more than one-fifth of SALT deducted nationally, totaling nearly $70 billion a year.

The average SALT deduction per tax return is estimated between $12,000 and $16,000. As such, many California taxpayers will be negatively affected. However, taxpayers on the lower end of the tax schedule may opt for the larger standard deduction, and taxpayers on the very high end of the tax schedule may already be subject to the Alternative Minimum Tax and therefore not be eligible for the SALT deduction.

Regardless, while most in the nation will not be affected by the TCJA because they live in states with relatively low property values—and therefore relatively low property taxes—many residents of states like California and New York will face a higher tax bill as a result of the federal changes.

An Increasing Equity Gap

Take this example from the Tax Policy Center that describes the distributional benefit of the TCJA:

Taxpayers in the bottom quintile (those with income less than $25,000) would see an average tax cut of $60, or 0.4 percent of after-tax income. Taxpayers in the middle income quintile (those with income between about $49,000 and $86,000) would receive an average tax cut of about $900, or 1.6 percent of after-tax income. Taxpayers in the 95th to 99th income percentiles (those with income between about $308,000 and $733,000) would benefit the most as a share of after-tax income, with an average tax cut of about $13,500 or 4.1 percent of after-tax income. Taxpayers in the top 1 percent of the income distribution (those with income more than $733,000) would receive an average cut of $51,000, or 3.4 percent of after-tax income.

Using these figures to illustrate a point, over a period of five years, a low-income taxpayer will save $300. During that same time period, a taxpayer in the top bracket will save $255,000. In more practical terms, one family could fully pay the tuition for two children to earn a degree from a four-year public university, while the other family might be lucky enough to pay for one child's books for a single semester.

Of course, the standard deduction doubled from $12,000 to $24,000, which will influence how much taxpayers who do not itemize their returns will save.

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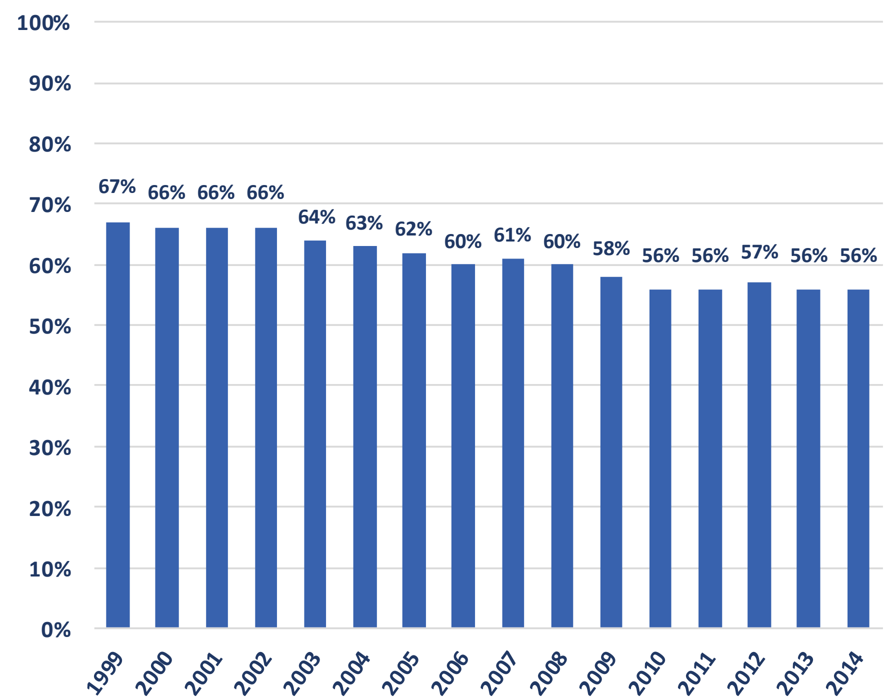
Health Care Reform and the Changing Nature of Work

Percentage of U.S. Population Under 65 Enrolled in Employer-Sponsored Health Care Coverage, 1999-2014



Data Source: Kaiser Family Foundation analysis of National Health Interview Survey, 1999-2014.

Former President Barack Obama's 2009 promise that "you will be able to keep your health plan" did not account for all of the forces changing health plan decisions. Vanderbilt University Professor John Graves (a former Obama adviser) recently estimated that 11 million Californians will change their source of health coverage in the next two years, underscoring the fluctuating dynamics.

The employer-based health insurance market is changing as the nature of work changes. To best support the experience of the insured, reforms need to address individual financing of health care, changing employment relationships, and stagnating incomes. How reforms curb rising costs, deliver value, eliminate waste, address an aging population, and respond to new technology are being debated in an environment of changing social and economic circumstances.

According to the Kaiser Family Foundation, 56 percent of Americans under age 65 are insured through employer-sponsored coverage, down from 67 percent in 1999. In California, 51 percent of individuals under age 65 are covered by employers. These same data indicate the loss of coverage was more pronounced at lower income levels. Employees have shouldered an increasing share of the rising cost of health care delivery. From 2009 to 2017, the percentage of workers with annual deductibles of $3,000 or more increased from 31 to 57 percent.

These changes in the employer-sponsored coverage market may mirror other changes in the labor market generally. For example, changes in the nature of work correlate with losses of employer-based group coverage. A 2017 study by the Internal Revenue Service shows self-employed workers such as those in the gig economy had lower rates of employer-based group coverage, and almost 10 percent were covered through Affordable Care Act (ACA) exchanges. Notably, higher-earning self-employed individuals had higher rates of coverage and were more likely to deduct their premium costs. It is estimated that one in five ACA exchange enrollees is self-employed.

Historically, government strategies like enacting tax subsidies were

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Untying the Safety Net

Large corporations and wealthy individuals are the undisputed beneficiaries of the TCJA, which is estimated to increase the federal deficit by $1.5 trillion over 10 years. As the federal government begins to come to terms with its self-inflicted budget wound, California has good reason to fear the consequences will fall largely on underserved populations that rely on federal support for critical programs such as Medicaid, Medicare, and housing assistance. State leaders anticipate the federal government likely will tell California and its taxpayers to pick up the bill, citing the out-of-control federal deficit.

"I am concerned these changes will increase the tax burden on many Californians, increase the equity gap between rich and poor, and put the state's most economically fragile children and families at greater risk," Controller Yee said. "I find it unconscionable that this new plan did not give consideration to programs such as the Earned Income Tax Credit, which encourages work and provides meaningful financial support to some of the most vulnerable people in our communities."

Effects on the Economy

A key provision of the new tax plan is a reduction of the federal corporate tax rate from 35 percent to 21 percent. In addition, so called pass-through companies—those passing their profits directly to shareholders who then pay taxes based on the shareholders' personal income tax rates—also received a reduction. Further, the TCJA "deemed repatriated" foreign profits held outside the United States, effectively taxing an estimated $2.6 trillion nationwide not previously subject to state or federal tax.

California accounts for the largest portion of the nation's Gross Domestic Product, having contributed more than $2.6 trillion in 2016 according to the federal Bureau of Economic Analysis. Consequently, federal tax changes likely will result in substantial tax savings for California businesses. At this point, it is undetermined just how these changes will affect the state's overall economy.

"I find it unconscionable that this new plan did not give consideration to...the Earned Income Tax Credit, which encourages work and provides meaningful financial support to some of the most vulnerable people in our communities."

—Controller Betty T. Yee

Controller Yee notes, "I expect companies considering how to best utilize the benefit of this permanent tax savings to recognize, invest in, and reward their dedicated employees—especially those at the lower end of the pay scale. However, I am discouraged by recent reports that many companies have decided to participate in corporate buybacks—$97 billion so far this year—compared to $2.5 billion in one-time employee bonuses."

The choices California businesses make in the months ahead about how to invest their permanent tax windfall will have a material effect on the health of the California economy. Will companies invest in their workers, or will they further enrich those who already have benefited greatly from the new tax law?

Lessening Attraction of Skilled Workers

The SALT deduction limit may dissuade highly skilled workers from choosing to live and work in the state. By increasing the tax burden on high-income earners, the federal government essentially tipped the scale and created an economic incentive for highly skilled workers to select low-cost states. The long-term impact on California's economy is unknown.

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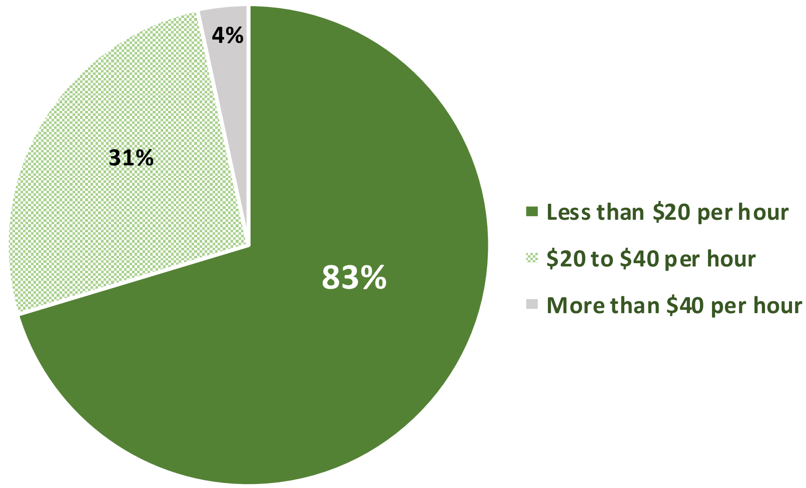
intended to encourage employer-sponsored coverage. Some ACA reforms sought to address the reality that an increasing share of Americans are self-employed or contract workers who do not have access to employer-sponsored plans. ACA critics say mandates to increase the quality of coverage will swing the pendulum in the opposite direction by encouraging employers to drop group coverage.

Overall, the ACA impact on the employer group market so far has been limited as it has expanded coverage to workers separate from their jobs. In addition to the self-employed, ACA added the Medicaid expansion population, where 79 percent of families have at least one working member.

The changing workforce must be a central consideration in further enhancements to the ACA or even more far-reaching reforms such as a single-payer system. Last year, the California Health Care Foundation defined such a system as fundamentally a single, centralized, publicly organized means to collect, pool, and distribute money to pay for the delivery of consistent health care services for all members of a community. This definition includes models in Canada (provincial funds directly paying providers), the United Kingdom (centralized system employing providers), and perhaps even Germany (public exchange with nonprofit insurers funded through payroll and general taxes).

Share of Jobs with High Probability of Automation, by Occupation's Median Hourly Wage



Source: White House Council of Economic Advisors, December 2016.

These systems differ from other universal coverage options—such as advocated by the late Uwe Reinhart—which seek to preserve the employment-based system and develop a robust, parallel system of fully portable insurance with regulations and subsidies that are separate from one's employment.

A transitioning workforce, with rapid changes caused by automation and other technologies, is likely to influence this ongoing debate. The McKinsey Global Institute estimates in the next 15 years at least one-third of the activities of 60 percent of occupations will be replaced by automation, and one-third of workers in advanced economies will need to find new occupations. People with lower incomes are likely to be affected the most.

A 2016 White House report found that 83 percent of jobs earning less than $20 per hour risked elimination by automation. At the same time, McKinsey estimates that many new jobs will be created in health care due to an aging population and rising incomes from productivity growth. These jobs are anticipated to span the spectrum of complexity and include traditionally low-paying jobs such as home health and personal care aids.

In 2016, U.S. health care spending accounted for 18 percent of the Gross Domestic Product, the highest of any industrialized nation. An evolving labor market surely will affect health care as it changes the economy as a whole.

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Suppressing Property Values

According to Moody Analytics, "The SALT changes plus the higher standard deduction and tighter limits on the mortgage interest deduction also reduce the tax incentive for home ownership, which is likely to slow home construction and sales, and moderately suppress home values and property tax growth in higher-price markets."

As California is home to several of the most expensive communities in the nation, it is likely that a larger share of property tax and mortgage interest deductions will be unavailable to California taxpayers. While the net impact on housing values likely will be a decline in the rate of growth, this may have a slight impact on the vitality of the state's economy.

Policy Considerations in a New Paradigm

A One-Time Windfall

As deemed repatriated profits have not been subject to taxation, California might experience a one-time windfall in tax revenue. The FTB is working on initial estimates.

With this important caveat, Controller Yee recommends, "Policymakers should consider leveraging these funds with resources from the education community, private industry, philanthropic groups, and nonprofit organizations to address our shared challenge of the changing nature of work. There are targeted and strategic initiatives that we might jointly champion to align the workforce of today with skill sets demanded by our changing economy due to the increased prominence of technology, artificial intelligence, and robotics driving productivity."

State Tax Reform

The actions of the federal government have severely complicated tax reform efforts here in California. As a proponent of meaningful tax reform and its importance to the long-term economic prosperity of the state, Controller Yee argues California must not halt its momentum on this important front nor adopt ill-conceived remedies to counter the effects of the TCJA. This is a time for all stakeholders to come together to tackle comprehensive state tax reform. While California's economy currently is vibrant and its coffers are full, we run the risk of becoming complacent. The fiscal crisis may very well be on our doorstep.

Controller Yee declares, "For the good of the state and our future prosperity, we need to figure out a tax system that is sustainable for our current and ever-changing economy."

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