DEPARTMENT OF FINANCE
OFFICE OF THE DIRECTOR

EDMUND G. BROWN JR. ▪ GOVERNOR

STATE CAPITOL ■ ROOM 1145 ■ SACRAMENTO CA ■ 95814-4998 ■ WWW.DOF.CA.GOV

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California Congressional Delegation
Washington. D.C. 20515

Dear Members of the California Congressional Delegation:

As the Governor's chief fiscal advisor, I write to express the Administration's significant concerns with several provisions currently contained in the House and/or Senate versions of H.R. 1 now under consideration before the conference committee.

• **Massive Expansion of the Deficit by at Least $1.4 Trillion Over Ten Years**—Deficit-financed tax cuts are not likely to lead to significant growth effects because the negative economic effects of the debt would crowd out investment. Further, fiscal stimulus at this point in the business cycle – with the economy at full employment and corporate profit margins and cash balances at all-time highs – is unlikely to lead to significant growth above what would have occurred in the absence of these changes. If certified by the Office of Management and Budget, the deficits are large enough that even with continued economic growth, they would entail automatic cuts of more than $100 billion a year under pay-as-you-go rules unless waived by Congress. This would undoubtedly lead to billions of dollars of cuts affecting California. In the next recession, deficits would balloon even further.

• **Removing the State and Local Tax (SALT) Deductions While Capping the Property Tax Deduction at $10,000**—Over 6 million California tax returns – one out of every three – claim SALT deductions, including millions of middle-income households that may not benefit from the increased standard deduction. While allowing up to a $10,000 deduction on property taxes provides some offset, only one-fourth of the state and local tax deduction consists of property taxes paid. The average deduction for state and local income taxes alone is nearly $16,000 per return, while state and local property taxes average less than $6,000 per return.

• **Unfavorable Treatment of Children and Families**—Under the House plan, the new $300 Family Flexibility Credit for the tax filer, their spouse, and for non-child dependents is temporary and expires in 2023. While it provides a tax benefit for many low-income families in the first four years, its expiration leads to those same families having much smaller net tax cuts or overall tax increases by 2023 and beyond. In addition, unlike the current dependent exemptions it is intended to replace, there is no indexing of the Child Tax Credit, which leads to its positive impact eroding over time.

Similarly, by limiting the expansion of the refundable portion of the child tax credit; and then having that expansion expire in 2025, the Senate bill significantly skews the benefits of this change to high-income families. According to an analysis by the Tax Policy Center the Senate bill would cause, on average, relatively small tax decreases for families with children in 2019. And the tax savings to families in the lowest two income quintiles would be especially small: $30 on average for families in the lowest quintile and several hundred dollars, on average, for families in the second quintile. By 2027, however, families with children in these two quintiles would see actual tax increases. In fact, by 2027 the only families with children who would benefit from the Senate tax bill would be those in the highest income quintile.

Requiring a Social Security number for the refundable portion of the child tax credit punishes working undocumented immigrants in California who file their tax returns using a Taxpayer Identification Number. More than $3.4 billion in federal refundable child tax credits were claimed by Californians in 2015, and a portion of those would have been undocumented immigrants filing with a Taxpayer Identification Number.

• **Negative Impacts on Renewable Energy, Clean Transportation, and the Economy**— Multiple provisions in the both versions of the bill would threaten California's programs to meet its air quality, climate, and renewable energy goals, and would jeopardize thousands of jobs in these sectors. The electric vehicle (EV) Tax Credit is critical to ensuring continued growth of the EV market, which contributes to US energy independence, strengthens our economic competitiveness, and increases jobs. Its elimination, as proposed in the House bill, would put our manufacturers at a competitive disadvantage while China and other countries race to dominate in this strategic market segment.

• **Overall Tax Cuts for the Wealthy**—Lower tax rates on business income will disproportionately benefit higher-income individuals who are more likely to have income from limited liability companies, S corporations, or partnerships. Further, the repeal or dilution of the estate tax will disproportionately benefit the wealthy. The Senate version amends the estate tax by raising the exemption to $5.5 million. In the House version, the estate tax would be fully repealed for deaths after December 31, 2023 and there would be no change to the basis step-up rule that currently revalues appreciated capital assets at market value at the time of death. As a result, wealthy people would be able to simply hold on to assets until they die, pass the assets on to their heirs, and all the increase in the value of the asset during the wealthy person's life will not be taxed. Removing the tax on inherited wealth without also repealing the basis step-up rule leads to increasing inequality. The Joint Committee on Taxation analysis shows that for 2027, the highest-income Americans -- less than one-half of one percent of taxpayers -- will realize almost one-third of the total benefits.

• **Prioritizes Corporations Over Individuals—**The net benefits of H.R. 1 are weighted heavily towards corporations in both the House and Senate versions, with the significant cut in the corporate tax rate coupled with the removal of relatively few corporate tax breaks. Instead, many deductions and tax credits taken by lower- and middle income households are either reduced or eliminated. The tax cuts for corporations are also permanent, while individual tax cuts are phased out to reduce the calculated deficit. A November 3 Joint Committee on Taxation analysis of the House version indicates that more than half of the tax cut goes to corporations while about one-third goes to businesses that pass through income to individuals. Allowing immediate expensing of capital investments would also accelerate trends toward automation, making job and wage growth even less likely. As a result, this provision could lead to job losses while decreasing the corporate tax base.

• **Makes It Harder for Middle Class Families to Buy a Home—**This change in the House version will increase the cost of homeownership for many middle-class Californians. Given the high cost of housing in the state, mortgages for many mid-level homes are significantly above this cap. More than 4 million California tax returns claim the mortgage interest deduction at an average of over $12,000 per return. Again, this provision will disproportionately affect California.

• **Undermines State's Ability to Secure Housing for Homeless Veterans and Other Californians**—The House version repeals the interest exclusion for PABs and advance refunding bonds, while the Senate version only repeals the interest exclusion for advance refunding bonds. The exclusion on advance refunding bonds also removes an important mechanism for state and local governments to reduce their interest rate costs. Disallowing the interest exclusion for PABs will remove an important tool used by the Low Income Housing Tax Credit program to construct affordable housing, which was used to fund nearly 20,000 affordable housing units in 2016.

The state's Infrastructure and Economic Development Bank (iBank) has issued Private Activity Bonds in support of museums, schools, performing arts centers, charitable organizations and research institutes throughout the state. Elimination of Private Activity Bonds would greatly increase borrowing costs for such borrowers resulting in the delay, downsizing or outright abandonment of these socially beneficial projects and the people and jobs who depend on them.

Further, this would hurt California veterans by ending bond issuances that help around 1,000 veterans buy a home every year. This program has been around since at least World War II. It serves veterans that would not otherwise qualify for private financing, while maintaining foreclosure rates of less than 0.25 percent.

• **Bars Wildfire Victims from Deducting Property Losses—**October's devastating wildfires in northern California have alone caused billions of dollars in losses, with more than 10,000 homes damaged and over 4,700 destroyed. The December fires in Southern California are still ongoing, and the costs are yet to be calculated. For these and other disasters to come, it is important to maintain the casualty loss deduction as a way of providing relief to the victims of casualty losses both large and small. The repeal of the casualty loss deduction starting in 2018 under the House and Senate bills is an unnecessary step that will only compound the difficulty for the many thousands of Californians who either are or will be struggling to recover from devastating losses.

• **Revokes Education Credits from Students and Increase Student Debt—**Multiple provisions now in H.R. 1 in the House version negatively impact the cost of education for both students and educators, including the elimination of the student loan interest deduction, imposing a new tax on tuition waivers, elimination or reduction of various tax credits, and a new tax on net investment income of private colleges and universities if their endowments exceed $250,000 per full-time student. In total, all of the changes to education provisions will raise taxes on Americans by over $60 billion over ten years.

If you need any additional information on any of these subjects, please do not hesitate to contact me.

Sincerely,

Michael Cohen
Director, California Department of Finance