May 9, 2019

TO: TAMC Executive Committee
FROM: Gus Khouri, Principal, Khouri Consulting LLC

RE: STATE LEGISLATIVE UPDATE – MAY REVISE

On May 9, Governor Newsom released the May Revision to his proposed 2019-20 State Budget. The May Revise includes an additional $3.2 billion in revenue from January but are constitutionally obligated to reserves, debt payment, and schools. The increase is attributable to gains from personal income tax revenues ($1.9 billion), corporation tax receipts ($1.7 billion). Total May Revision revenues, including transfers, is projected to be $138 billion in 2018-19 (up by $1.1 billion) and $143.8 billion (up by $1.2 billion) in 2019-20.

Given uncertainty at the federal level, the risks to the current economic forecast, and the need for a solid fiscal foundation, the Budget allocates $13.6 billion of the windfall (including debt payments and reserve deposits required by Proposition 2) to building budgetary resiliency and paying down the state's unfunded pension liabilities. This includes $4 billion to eliminate debts and reverse deferrals, $4.8 billion to build reserves, and an additional $4.8 billion to pay down unfunded retirement liabilities, which will save over $14 billion in obligations for the future.

The Budget assumes an additional $1.8 billion transfer in the budget year and an additional $4.1 billion over the remainder of the forecast period, leaving a reserve of $15.3 billion and bringing the Rainy Day Fund to $19.4 billion by 2022-23. The state however will continue to face uncertain times, given that we are overdue for a recession, the volatility of our reliance on personal income tax and capital gains, and the ramifications of the recently enacted federal tax bill, which have not yet been factored into the Budget’s economic or revenue forecasts. A one-year recession in 2019-20 that is larger than the 2001 recession, but milder than the 2007 recession, could result in a nearly $70 billion revenue loss and a $40 billion budget deficit over three years.

Tightening the Nexus Between Housing and Transportation

Governor Newsom maintains his January proposal to strongly encourage jurisdictions to contribute to their fair share of the state's housing supply by linking housing production to certain transportation funds and other applicable sources, if any. The Administration will convene discussions with stakeholders, including local governments, to assess the most equitable path forward in linking transportation funding and other potential local government economic development tools to make progress toward required production goals.

The May Revision repurposes the $500 million from the $750 million previously dedicated to general purpose incentive payments for the Infill Infrastructure Grant Program administered by the Department of Housing and Community Development (HCD).

The Infill Infrastructure Grant Program provides gap funding for infrastructure that supports higher-density affordable and mixed-income housing in locations designated as infill. Under the augmented Infill Infrastructure Grant Program, developers and local governments can partner to apply for infrastructure funding. At the same time, certain areas designated as infill may also qualify as federal Opportunity Zones and provide additional tax benefits to investors to spur development of economically distressed communities by guiding investment toward mixed-income housing.

South Dakota v. Wayfair

The May Revise included updated revenue estimates as a result of the passage of AB 147 (Chapter 5, Statutes of 2019), which brought California's definition of retailer in line with the U.S. Supreme Court's ruling in *South Dakota v. Wayfair, Inc.* This legislation clarified the economic nexus threshold California will use to determine if out-of-state retailers, including online sellers, are required to remit sales and use taxes to California. The May Revise estimates that sales and use tax revenues are expected to increase by $174 million in FY 2018-19 and $616 million in FY 2019-20, representing a decrease of $45 million from the Governor's Budget in FY 2018-19 and an increase of $62 million in FY 2019-20. The decrease in FY 2018-19 is due to the fact that marketplace sellers are not required to comply with AB 147 until October 1, 2019.

Cap-and-Trade Program

The May Revise includes $537 million for the Low Carbon Transportation Operations Program in the proposed cap-and-trade expenditure plan, an increase of $130 million compared to the January Budget proposal. This program provides incentives for the purchase of zero-emission vehicle technology and replacement of older diesel buses with renewable-fuel alternatives. Of this amount, the budget proposes to allocate $182 million for the Clean Truck, Bus, and Off-Road Freight Equipment Program, which is $50 million above the January Budget proposal.