CALIFORNIA BUDGET PROJECT

September 2, 2009

Mr. Gerald Parsky, Chairman
Commission on the 21st Century Economy
c/o California Department of Finance
915 L Street, 8th Floor
Sacramento, CA 95814

Dear Chairman Parsky:

First, I would like to thank you and your fellow Commissioners for the time and effort spent considering changes to California's tax system. This letter conveys the California Budget Project's (CBP) concerns on the options for modifying California's tax system pending before the Commission on the 21st Century Economy as you prepare to finalize recommendations for submission to the Governor and the Legislature. In brief, we are concerned that the Commission is moving in a direction that would slow, not increase, growth in tax revenues, thus leading to wider, not narrower, budget gaps in the future. Second, we are concerned that the Commission's recommendations would shift a greater share of the cost of financing public services from high- to low- and middle-income taxpayers, thus widening income disparities that are already at near-record high levels. Specifically:

The Commission's working proposals would reduce the growth in state tax revenues and thus lead to larger, not smaller, budget gaps in the future. Wider budget gaps are likely because the Commission's changes would reduce reliance upon or, in the case of the corporate income tax, eliminate the two taxes that have posted the strongest average annual growth rates over the past four decades and replace them with taxes that are likely to grow more slowly. The impact on future growth rates is illustrated by modeling done for the Commission, as well as an examination of long-term economic trends. Documents prepared by Commission staff clearly show that the changes under consideration would lower the growth of revenues relative to the state's existing tax structure.[1] This report estimates that the revenues raised by California's current tax system would rise by 40.2 percent between 2012 and 2016, while the options under consideration by the Commission would increase revenues by 32.4 percent or 35.6 percent over the same period. In dollar terms, the difference translates into $4 billion to $7 billion at the end of the five-year period. By way of comparison, the state currently spends about $5 billion per year to support the California State University and University of California systems combined. The difference is significant and slower growth rates would require deep cuts or tax increases to close the resulting gap.

[1] Commission on the 21st Century Economy, *Tax Structure Options* (July 16, 2009) downloaded from http://www.cotce.ca.gov/meetings/2009/7-16/testimony/documents/STAFF_PRESENTATION_7-16-09.pdf on August 31, 2009.

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The Commission's working proposals would lessen the state's reliance on the personal income tax, particularly taxes paid by those at the high end of the income distribution, by reducing both the number of tax brackets and the rate that would apply to taxpayers at the high end of the income distribution. In order to assess the impact of the Commission's likely direction, the CBP compared the amount that married taxpayers with incomes of $50,000, $200,000, and $999,999 would have paid under the state's 2008 personal income tax law to a structure that imposed a 4 percent rate on incomes up to $50,000 and a 7 percent rate above that level with a $30,000 standard deduction for married taxpayers.[2]

This analysis, designed to mirror proposals under consideration by the Commission, finds that as a percentage of 2008 liability, a married couple with adjusted gross income (AGI) – income reported for tax purposes – of $999,999 would receive a tax cut that is nearly two and a half times as large as that received by a couple with an AGI of $50,000. In absolute dollar terms, the new structure would reduce the amount owed by a couple with an AGI of $50,000 by $85, while the $999,999 AGI couple would receive a tax break of $21,315.

The level of inequality in California is already large and growing larger, and we believe that it is not in the best interest of California and the state's future to move toward a tax system that exacerbates these gaps. The average taxpayer in the top 1 percent had an AGI of $1,832,123 in 2007 – 50.7 times that of the average middle-income taxpayer ($36,115). California's income gap has been widening for years. The latest Franchise Tax Board data show that one-quarter (25.2 percent) of total AGI went to the wealthiest 1 percent of taxpayers in 2007, nearly twice the share (13.8 percent) in 1993, which is the earliest year for which data are available. In contrast, taxpayers with incomes in the middle fifth of the distribution had just 10.0 percent of AGI in 2007, down from 13.0 percent in 1993. This means that the top 1 percent of taxpayers received approximately 25 times their proportionate share of AGI in 2007, while middle-income taxpayers received half their share.

The Commission's working proposals would increase prices for California consumers, place downward pressure on wages, and create an incentive for businesses to outsource. According to documents prepared for the Commission, about three-quarters (71 percent) of the Business Net Receipts Tax (BNRT) would be passed on to consumers in the form of higher prices, just under one-fifth (19 percent) would be passed on to workers in the form of lower wages or fewer benefits, and the remainder would be divided between shareholders and business owners (9 percent) and individuals outside of California (1 percent). The same report estimates that the lowest-income Californians would pay twice as much of their income toward the new tax as the highest income Californians. That makes the BNRT substantially more regressive than California's current tax system – which results in the lowest-income Californians paying about one-third more as a share of their income than the wealthiest Californians.

Moreover, we are concerned that the BNRT would encourage California businesses to outsource to firms outside the US that are not subject to taxation in California. The incentive to outsource results from the fact that wages are not taken into account for the purposes of calculating net receipts subject to tax, while purchases of services are taken into account. To the extent services are purchased from firms with a clear nexus in California, those firms would be subject to the BNRT. However, the state's ability to tax firms without clear nexus is uncertain and would likely be subject to lengthy and complex litigation. The negative implications of this are two-fold: a potential loss of California jobs and a reduction in state tax revenues.

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[2] This analysis does not take into account personal credits and assumes that all taxpayers claim the standard deduction under both current law and the hypothetical new structure. The CBP used the 2008 tax structure since it does not reflect the impact of the temporary personal income tax surcharge enacted in February.

The BNRT would impose a new tax on necessities, such as food and child care. A number of exemptions in the state's existing sales and use tax law serve important public policy functions. Lawmakers have exempted food purchased for consumption at home, prescription drugs, and essential services such as health and child care. All of these items would be subject to tax under the BNRT, which would exacerbate the regressive impact of the tax on lower-income households.[3] While the CBP supports extending the sales tax to selective services (see below), we believe that it is inappropriate to tax necessities, particularly to finance reductions in other taxes that would disproportionately benefit the wealthiest Californians. Similarly, the proposed changes to the personal income tax would eliminate deductions for medical care, as well as the child and dependent care tax credit, which is targeted to working families, while substantially reducing the taxes paid by the highest-income Californians.

Placing half the state's budget in the hands of the BNRT is a risky proposition. No state in the country current imposes a tax similar to the BNRT, as outlined in staff documents. With sizeable budget shortfalls projected for the foreseeable future, California can ill-afford to rely on an untested tax for upwards of half of state revenues. Other states that have recently adopted consumption-based taxes, such as Texas and Ohio, have seen revenues fall significantly short of initial forecasts. There is no guarantee that the BNRT will perform as projected and the tax is likely to face significant legal and administrative challenges that could lead to devastating budget consequences. The constitutional requirement that state tax increases be approved by a two-thirds vote of the Legislature could make it difficult, if not impossible, to remedy such a shortfall if it were to occur.

Positive options for change. As we noted in testimony before the Commission earlier this year, the CBP strongly believes that the Commission's recommendations should aim to maximize the growth potential of the state's tax system and should work to mitigate the widening gap between the state's rich and low- and middle-income Californians that typifies the 21st century economy. The Commission's proposals move in exactly the opposite direction and would slow the state's revenue growth and widen after-tax income disparities. Positive options for change include:

- **Creating an oil severance tax.** California is, we believe, the only oil-producing jurisdiction in the world without such a tax. Imposing an oil severance tax, such as that previously proposed by the Governor, would make significant progress toward giving California a 21st century tax system.

- **Repealing the corporate tax breaks included in the September 2008 and February 2009 budget deals and using the revenues gained to restructure the personal income tax bracket structure in a manner that does not disproportionately benefit the wealthy.** The corporate tax breaks – elective single sales factor apportionment, net operating loss carrybacks and the extension of loss carryforwards, and the ability of related firms to share tax credits – in these two budget agreements were approved almost literally in the dark of night with no opportunity for public review or comment. As the CBP has previously documented, they provide massive benefits to a small handful of firms.[4] They should be repealed. The revenues gained from their repeal could be used to stretch out the state's personal income tax bracket structure, so that as incomes increase, taxpayers move more gradually into higher marginal rates. The existing 9.3 percent top bracket for taxpayers other than millionaires should be retained, if not increased.

[3] We understand that purchases of services from nonprofit entities would not be taxed. However many individuals purchase child and health care from for-profit entities.

[4] California Budget Project, *To Have and Have Not* (June 2009).

- **Extending the sales tax to selective services, preserving exemptions for necessities.** The CBP supports selectively extending the sales tax to services, preserving exemptions for food, health and child care, utilities (which are taxed at the local level), and other necessities. There are multiple benefits of this approach relative to creation of a BNRT. First, the tax can be extended in a targeted manner so as to minimize the impact on low-income households and to avoid "pyramiding" through the taxation of business inputs. Second, this approach would build off the state's existing sales and use tax administrative structure and could be implemented quickly and reliably. While the CBP believes that the state needs additional revenues to close projected budget gaps, an extension of the sales tax to services could be enacted in a "revenue neutral" manner by lowering the sales tax rate.

- **Improving the accountability and transparency of the state's tax code through greater disclosure.** The CBP supports Commissioner Pomp's recommendation to require disclosure of the name of any taxpayer receiving tax credits or expenditures worth more than $5 million in a tax year. We also urge the Commission to recommend mandatory sunsets for existing and future tax expenditures, improved evaluation of the effectiveness of tax expenditure programs, and adoption of a "unified" budget that would consider tax expenditures as part of the annual state budget process.

In closing, thank you again for your hard work on behalf of all Californians. We would be happy to discuss any of the above with Commissioners or Commission staff.

Sincerely,

Jean Ross
Executive Director

cc: Assembly Speaker Karen Bass
Senate President pro Tem Darrell Steinberg