CENTER FOR CONTINUING STUDY OF THE CALIFORNIA ECONOMY

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DATE: June 30, 2009

TO: COTCE Members and Staff

FROM: Stephen Levy

SUBJECT: Considerations in Evaluating Tax Reform Packages

My understanding is that staff is developing background material for the two tax reform packages posted on the website dated June 26, 2009.

This memo focuses on three topics: 1) how do various taxes grow in relation to state economic growth; i.e. what is the revenue growth potential for various tax reform packages; 2) how do alternatives affect the progressivity of the tax structure; and 3) what are the important characteristics of the state economy looking ahead that should affect design of a tax structure?

A separate memo reviews the discussion of "business climate" issues that has been a part of each meeting and will probably be discussed again in light of the recent Milken Institute report. That memo concludes that the "everyone is fleeing California" story is not consistent with quantitative evidence and, supporting the testimony of Richard Sims before the commission, that such anecdotal findings are not a solid basis for designing major tax structure reforms.

The final section outlines ideas for additional tax reform packages building on the discussion in the two memos.

Revenue Neutrality, Data Considerations and inviting Outside Review and Comment

I encourage the commission staff to examine revenue neutrality with a longer time period than the 2012-2016 period identified at the last meeting. In the economic forecasts CCSCE recently reviewed for clients, the years 2012, 2013 and 2014 include some "bounce" or rebound from the recession, which will affect the analysis of revenue neutrality over this short time period. In any event a period of longer than four years is appropriate for evaluating revenue neutrality.

The chart on page 2 shows some compelling findings about the long-term growth potential of some of the state's major taxes.

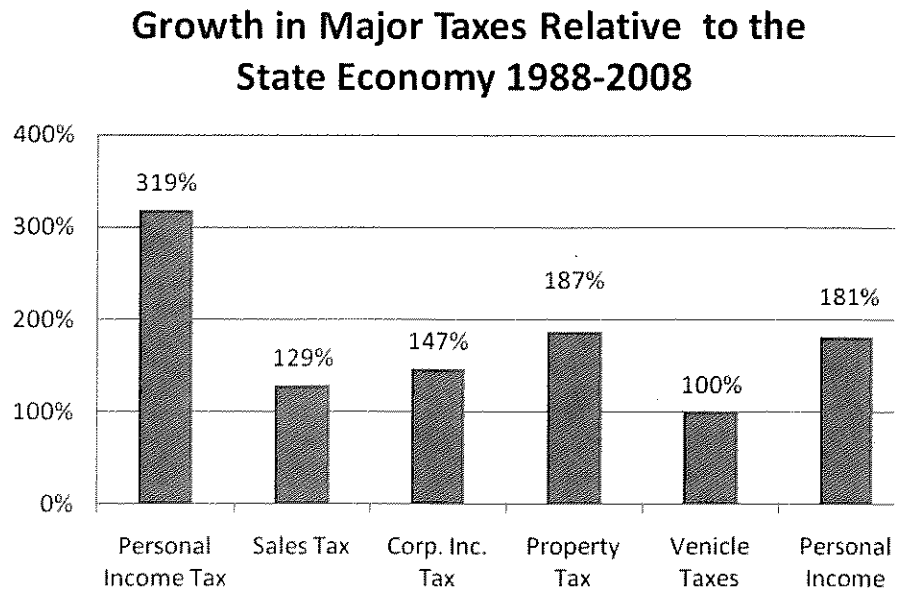
It is likely that other economists and organizations will be concerned with both the growth and progressivity characteristics of recommended reform packages. Although the staff included a great deal of data in the presentation handouts, it will be helpful if staff makes the full data set available for outside review.

These are very significant changes being recommended and time for careful and open analysis (transparency) is important. Perhaps the commission is planning that time for such analysis will take place after the commission concludes. But how will commissioners have time in the July meeting to both receive and review staff findings before being asked to vote? Is an additional meeting possible to invite outside comment?

The Personal Income Tax is California's Fast-Growing Revenue Source

The chart below compares the growth of major tax revenues in California between 1988 (the 1987-88 budget year) and 2008 (the 2007-2008 budget year). The right hand bar is the growth in total personal income from 1998 through 2008. Vehicle taxes include license fees and the per gallon tax on fuels. All of the data is from the 2009-2010 DOF budget appendices.

Personal income tax revenues outpaced the growth in the state economy as measured by personal income. Personal income tax revenues were the only major state revenue source to grow faster than the state economy during this 20 year period. The slowest growth was recorded for sales and vehicle taxes. The data somewhat understate the growth rate for vehicle taxes because these years include a decline in the VLF tax rate.



In the absence of some new compelling analysis I would expect these relative growth relationships to continue with one possible exception. Although property

tax revenues kept pace with economic growth in past years, future trends should be carefully reviewed since the 1988-2008 period included some years of very rapid home price appreciation, which may not be repeated any time soon.

The results about income tax revenue growth are not surprising because the California personal income tax is progressive and, as staff and the California Budget Project reported; high-income households have recorded the fastest income growth among all income groups in the state.

It appears from chart 7 of the staff's June 11th presentation the existing tax structure outperforms all of the alternatives in terms of growth from 2012 through 2016. Is this correct? Having the actual numbers for each year would allow commissioners and outside participants to do their own calculations and improve the chance that important policy issues are being discussed, not misunderstandings about numbers.

Could staff double check the taxable sales growth rates on chart 4 (titled Business Cycle)? They show taxable sales growing faster than personal income in each year from 2010-11 through 2013-14. This contradicts the UCLA Forecast findings for the first two years and CCSCE's long-term projected growth trends.

Volatility

Concern about the volatility of personal income tax revenues was expressed at several commission meetings. The capital gains component of income tax revenues **is** volatile and progressivity accentuates the volatility of income tax revenues. But there is an approach to volatility that retains the growth and progressivity of California's personal income tax. That approach involves treating volatility as a spending issue, not a revenue issue.

The idea of allocating "unexpectedly high" income tax revenues to a reserve has been discussed before the commission and elsewhere in tax reform discussion in California. This approach prevents surges in revenues from being built into ongoing operational budgets while preserving what to many people are the strengths of California's progressive income tax structure.

The Proposed Reforms Reduce the Progressivity of State Taxes

The commission staff has provided analyses that the proposed reform packages would reduce the progressivity of California's state tax system. The progressivity of the income tax would be reduced under the alternatives being considered and staff analysis is that the proposed "carbon tax" (an additional 18 cent per gallon tax on fuels) would also be regressive. None of the proposed new taxes restore the existing level of progressivity.

Beyond the issue of volatility, is there a policy analysis that supports reducing the progressivity of the state's tax structure? Is staff arguing that the progressive income tax has negative effects on the economy?

The Tax System and California's 21st Century Economy

CCSCE prepared an analysis of future economic trends in California and their implications for budget reform at the request of California Forward. These comments were submitted to the commission by California Forward and posted on the COTCE website with a February 13, 2009 date.

The discussion in that paper relates to what kind of industries and jobs are critical in the 21st century economy, how these industries are different from the key sectors 30 years ago and what constitutes being a competitive state. These issues are discussed again in the separate memo being submitted about business climate/job loss concerns.

In addition, the paper for California Forward pointed to two future revenue trends that are important for designing tax reform strategies.

The first trend is the slow growth of the existing sales tax base relative to the growth of the California economy. The data from page 2 complements testimony and correspondence to the commission that the current taxable sales base will not keep pace with economic growth. Discussion at the commission and in correspondence points to the clear "21st century economy" change that spending is moving more toward services (not currently taxed) and away from goods.

The second trend is the slow growth of taxes that fund transportation investment. This is particularly true for taxes tied to the number of gallons of fuel used. Projected trends in fuel use in the 21st century economy point to slow growth or even decline as auto efficiency and financial incentives reduce fuel use.

The proposed carbon tax while understandable on policy grounds will surely hasten the decline in use of the product being taxed—one of the principal policy rationales for the tax. So, whatever the merits of the 18 cent a gallon increase in fuel tax, it will not keep pace with the growth in the economy and, as noted above, make the tax structure more regressive.

These trends are an additional reason to be careful and long-term oriented when assessing the revenue neutrality of proposed tax reform packages.

The CCSCE analysis also points to the difficult period ahead for local government revenues. Both the sales tax base and property tax base are in for a period of below average growth relative to the economy and local funding needs. Organizations like California Forward and the Bay Area Council are now actively

discussing reforms that transfer revenue and responsibility to the local level and these reforms will have an impact on state revenue trends.

There are two implications of the challenges and discussions regarding local government revenue trends. First, reforms like broadening the sales and property tax base will help local governments as well as the state. Faster local property tax growth lowers General Fund K-12 spending obligations.

Second, there are now two major tax structure reform discussions underway or about to be underway in California—one that provided the impetus for the commission's original mandate and the second, more recent but equally critical, discussion of realignment of local government revenues and responsibilities.

It is very late in the commission's timeline but perhaps the legislature and governor would have interest in again extending and expanding the commission's role so that one comprehensive reform package can be discussed for consideration next year. Linking these two discussions will be helpful to policy makers and community leaders who will ultimately have to make decisions on tax system reform.

Other Options for Tax Reform Packages

Would commissioners be interested in considering tax reform packages that do not include changing the structure of the personal income tax?

Could staff analyze the implications of adopting a business receipts tax to substitute for a portion of the sales and corporate income tax? It would be a revised version of tax package 1. Perhaps this alternative could be combined with broadening the sales tax base to allow further rate reduction, including possible rate reduction in the personal income tax while maintaining the progressive structure of the tax.

I am sure there are ways that such a package could be designed to maintain the growth and progressivity characteristics of the current system while broadening the overall tax base, bringing it some more in line with 21st century spending trends and allowing some reduction in existing tax rates. Broadening the sales tax base at least starts to address the upcoming crisis for local government revenues and perhaps there is a way to structure the business receipts tax so it, too, can play a role in broadening the local government revenue structure.