Commission on the 21ST Century Economy

MEMORANDUM

TO: Chair and Commissioners
FROM: Staff, Commission on the 21st Century Economy
DATE: March 27, 2009
SUBJECT: Commissioner Information Requests

At the March 10th meeting at UC Berkeley, Commissioners had questions for staff related to the material that was presented as well as other requests for information. Responses to these questions and issues raised are provided below.

1. Revenue Volatility and Growth

a. Volatility by Population Quintile

Commissioners expressed interest in the volatility of the personal income tax (PIT) for each population quintile. The following table shows the volatility during the period from 1996 to 2006. The values were calculated by aggregating the average tax liabilities by population quintile in each of the years from 1995-2006. Note that due to inflation as well as shifts in the income distribution, quintile measures evolve in each year. Historical quintile brackets and related information are displayed in the data made available by the Franchise Tax Board (FTB) in Attachment 1.

	(a)	(b)	(c)	(d)	(e)
	Average Growth Rate	Standard Deviation	Coefficient of Variation	2006 Revenue Chg (1 Stdev)	% of Total
1st quintile	5%	26%	5.40	$ 9,400,000	0%
2nd quintile	4%	12%	2.79	$ 29,400,000	0%
3rd quintile	4%	13%	3.00	$ 195,700,000	3%
4th quintile	4%	13%	2.93	$ 562,700,000	7%
top quintile	9%	17%	1.98	$ 6,938,100,000	90%
				$ 7,735,400,000	

As shown in the table above, for the 1st quintile, the average growth rate of tax liability for a return is 5 percent (column a); the standard deviation (or the volatility) of that tax liability is 26 percent (column b); and, the coefficient of variation[1] is 5.4 percent (column c). A comparison of coefficients of variation across quintiles indicates that that the average volatility per return is the highest for the bottom quintile, and gradually decreases as we move to the top. This is because the tax liability filed for each return for the bottom quintile is smaller in magnitude without a similar reduction in the variation. This results in greater fluctuations as a proportion to the base.

In order to determine the contribution to total revenue volatility by quintile, we computed one standard deviation of change of average tax liability per return and multiplied by the number of returns in each quintile. Column (d) shows the total dollar amount by each quintile. Thus, for the 1st quintile, this means the aggregate amount corresponding to one standard deviation of change to revenue is $9.4 million. Lastly in column (e), each quintile's value is divided by the total, showing that the contribution to revenue volatility is concentrated in the top quintile.

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[1] The coefficient of variation is the standard deviation of the quintile divided by the average growth rate. This measure allows for a standardized comparison

b. Volatility Reduction for Staff Alternatives

For staff simulations relating to changes in the PIT, the volatility reduction, expressed as the reduction of the coefficient of variation, is as follows:

- The four-tax rate structure applied to the Federal AGI and no "below the line" deductions or credits, would achieve a 15 percent reduction in volatility from the current PIT structure.
- The single 4.3 percent tax rate applied to federal AGI and no "below the line" deductions or credits would achieve a 27 percent reduction in volatility from the current PIT structure.

This simulation was conducted absent the application of credits and exemptions to the AGI. Thus, this could result in an overestimation in the volatility reduction due solely to the reduction in the tax rate. In other words the reduced volatility would occur due to changes in the base as well as changes in the rate.

c. Sensitivity Measures for Staff Alternatives

Staff also computed measures for how the growth rate and volatility of total PIT revenue responds to changes in rates. It is estimated that a 1 percent reduction in the top bracket rate would reduce average growth rates by 0.3 percent and reduce standard deviation by 0.7 percent. A 1 percent reduction in the tax rate applied to capital gains across all income classes would reduce average growth rates by 0.15 percent and reduce the standard deviation by 0.4 percent. Due to data limitations, staff was not able to compute changes in volatility for alternatives under the sales and use tax.

2. Proposition 1A

The Commission heard a presentation by the state's Director of Finance about the propositions that have been placed on the ballot as a result of the 2009 budget agreement. Commissioners requested more information about the impact of the budget reform measure—Proposition 1A—and its effect on budget volatility.

The Department of Finance (DOF) has not carried-out projections of the effect of the ballot propositions in future years. Instead, DOF has relied on looking at historical patterns to see how the measure would work. DOF reports that if Proposition 1A had been in effect since 1998, the state would have had a $9 billion reserve at the beginning of 2008-09 and the budget deficit at that point in time would have been $5 billion, rather than $15 billion that actually occurred. Therefore, based on these DOF estimates, Proposition 1A would not have solved the entire budget problem, but it would have mitigated it substantially.

3. Multi-year Budgets

Commissioners raised the issue of multi-year projections of state spending. DOF regularly publishes its projections of state spending on its web site under the heading of *Multi-year General Fund Budget Projections.* The latest projections were published in January based upon the spending proposed in the Governor's 2009-10 Budget. These projections are located at:

http://www.dof.ca.gov/reports_and_periodicals/

The Legislative Analyst's Office (LAO) also regularly publishes multiyear spending plans as well as revenue projections. The LAO publications occur in the fall under the title *State Spending Plan* and *Fiscal Outlook*. These publications can be found at:

http://www.lao.ca.gov/laoapp/main.aspx

4. Federal Income Tax "Piggybacking"

For a discussion of the advantages and disadvantages of California using federal taxable income or federal tax liability as the base for calculating California tax liability, please see Attachment 2.

5. Changes in California's Corporate Nexus/Apportionment Rules

As part of California's recent budget agreement, legislation was enacted giving multi-state and multi-national businesses a choice in how they apportion their income for purposes of the California corporation tax. Currently, corporations are generally subject to a four-factor apportionment formula based on property, payroll and double-weighted sales. Under the adopted legislation, beginning in 2011 such entities will have the choice of either continuing to use the current formula or a single-sales factor formula, based entirely on the proportion of their sales that are made in California relative to all of the firm's sales.

As part of that legislation, provisions were added to accomplish the following:

- Provide a bright line test for when an entity is doing business in California based on an economic presence standard. A taxpayer will be considered to be doing business in the state of any of the following conditions are satisfied:
    - The taxpayer is organized or commercially domiciled in the state.
    - Sales by the taxpayer in the state exceed the lesser of $500,000 or 25 percent of the taxpayer's total sales.
    - The taxpayer's property in the state exceeds the lesser of $50,000 or 25 percent of all of the taxpayer's property.
    - The amount of compensation paid by the taxpayer in the state exceeds the lesser of 450,000 or 25 percent of all compensation paid by the taxpayer.
- Modify the rules for assigning certain receipts. Sales of tangible personal property will be assigned to the state if either of the following tests is met:
    - If the product is delivered to a purchaser in the state and the taxpayer or any member of the combined reporting group is taxable in the state.
    - If the product is delivered to a purchaser out of state and the taxpayer or any member of the combined reporting group is not taxable in the destination state.

  Sales of other than tangible personal property will be assigned to California if any of the following is true:
    - Sales of services are in the state to the extent the purchaser receives the benefit in the state.
    - Sales of intangible property are in the state to the extent the property is used in the state.
    - Sales from selling, leasing, renting, or licensing real or tangible personal property are in the state if the property is located in the state.
- Define sales. Gross receipts are defined as the sum of money and the fair market value of other property or services received, but would not include the following:
    - Repayment of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument.
    - The principal amount received under a repurchase agreement or other loan.
    - Proceeds from issuance of stock or from the sale of treasury stock.

- Damages and other amounts received from litigation.
- Property acquired by an agent on behalf of another.
- Tax refunds and other tax benefit recoveries.
- Pension reversions
- Contributions to capital.
- Income from the discharge of indebtedness.
- Amounts realized from exchanges of inventory that are not recognized under the Internal Revenue Code.
- Amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's unitary business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets.
- Amounts received from hedging transactions involving intangible assets.

The FTB has estimated the revenue effect of these changes in total to be in the range of $40 million to $80 million annually. The estimates for each of the provisions separately are shown below:

- Economic presence—some corporations would have substantial increases in liabilities and others substantial decreases in liabilities. In gross terms, these could total in the hundreds of millions. On a net basis, revenue gains to the state would be in the range of $10 million to $20 million dollars.
- Market-based sourcing—gross increases and decreases in tax liabilities in the hundreds of millions of dollars with approximately zero net revenue effect.
- Definition of sales—approximately $20 million revenue gain.
- Determination of nexus for related groups—gross increases and decreases in tax liabilities in the hundreds of millions of dollars with approximately a $25 million net revenue gain.

Each of these provisions has a large number of winners and losers. The revenue effect shown is the net of much larger pluses and minuses. For market-based sourcing, the pluses and minuses are approximately equal, resulting in no net revenue impact. If further information becomes available regarding this issue, staff will provide it to the Commission.