PACIFIC RESEARCH INSTITUTE

Ending the Revenue Rollercoaster

Flat Tax Reform for California

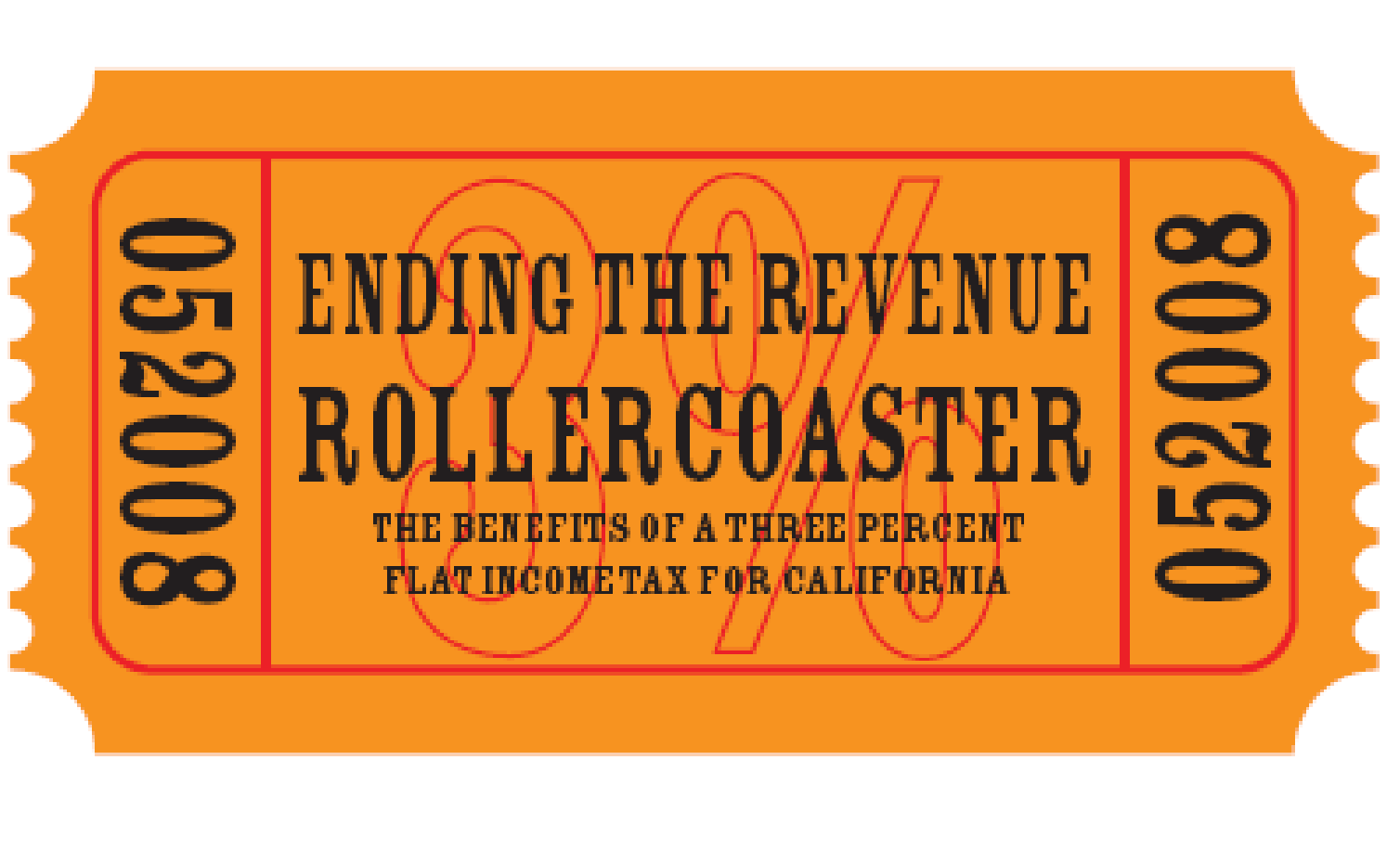
Prepared for the COTCE by

Robert P. Murphy

Senior Fellow in Business & Economic Studies

Pacific Research Institute

http://pacificresearch.org



Study available at:
http://liberty.pacificresearch.org/docLib/20080505_Flat_Tax.pdf

California's Revenue Rollercoaster

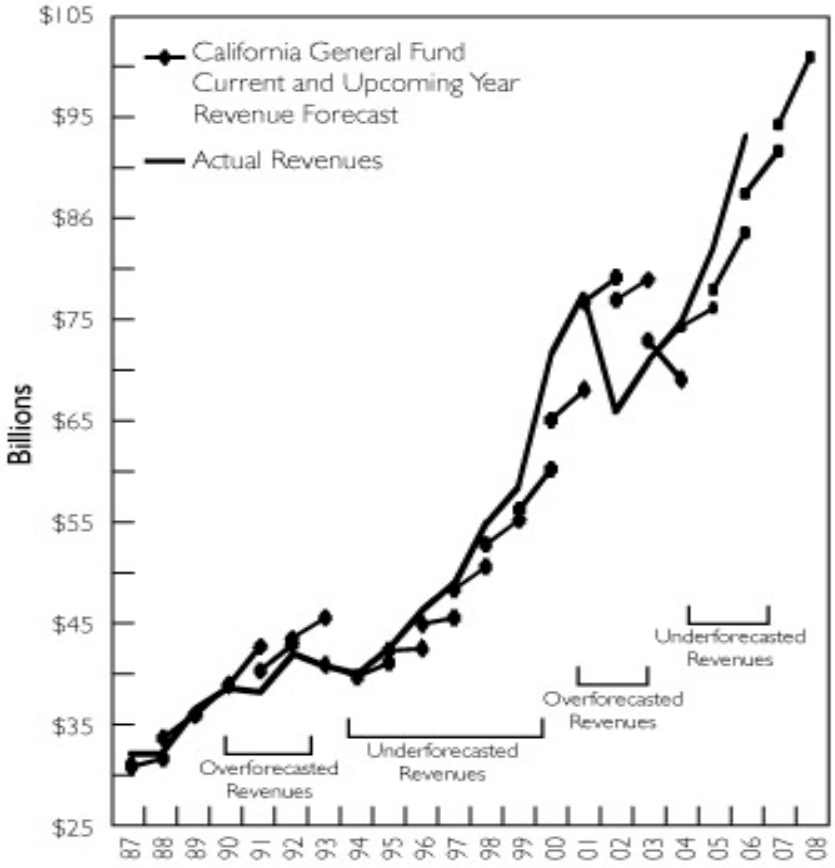
During 1997-2006, California had 4th most volatile income tax revenues (after Alaska, Florida, and TN).

Counting the millionaire's surcharge (Prop. 63), California's top PIT rate of 10.3% is highest in nation.

Not a coincidence!

Figure 2

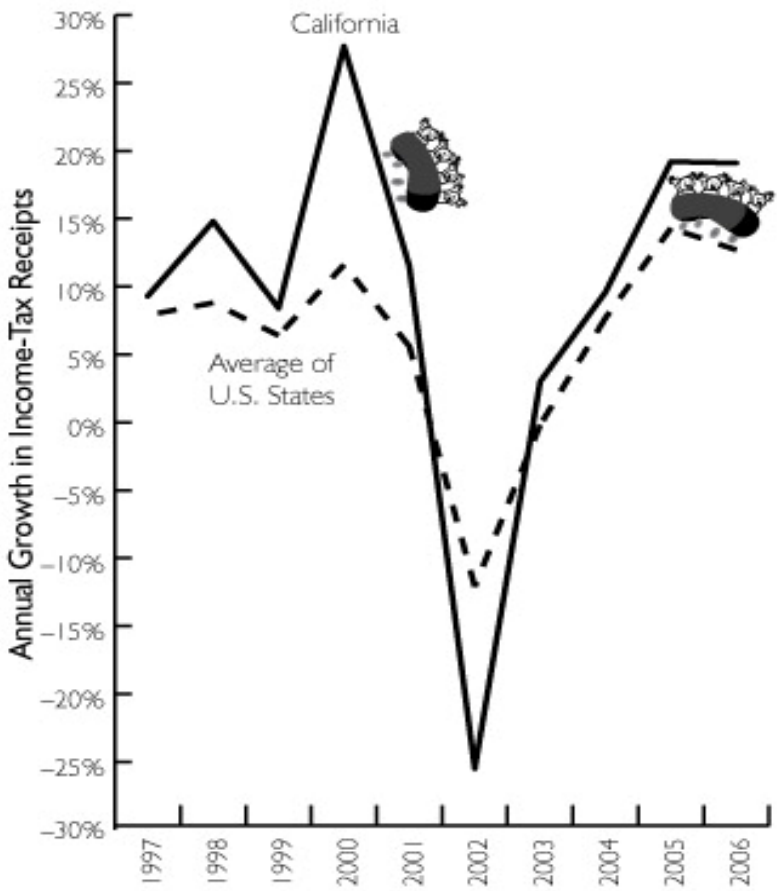
Politicians underestimate revenues in good times and overestimate revenues in bad times.



Source: Laffer Associates[5]

Figure 3

No thrills: California's revenue rollercoaster has bigger dips and climbs than other states.



Source: U.S. Census Bureau

Why the Revenue Rollercoaster?

- Progressive tax code *exaggerates* the boom-bust in receipts.

- A *flat tax* automatically smoothes revenue stream over the whole business cycle.

Other Benefits of a Flat Tax

- Flat tax closes special-interest “loopholes” and lowers the marginal tax rate on the highest incomes.
- Lower rates encourage work and investment, boosting the economy as well as tax receipts.
- Business decisions based on bottom line, not tax code.
- Flat tax would draw workers and businesses back to California.

Table 2

1,597 filers with adjusted gross incomes of $200,000 or more had no tax liability. Below are their favorite loopholes.

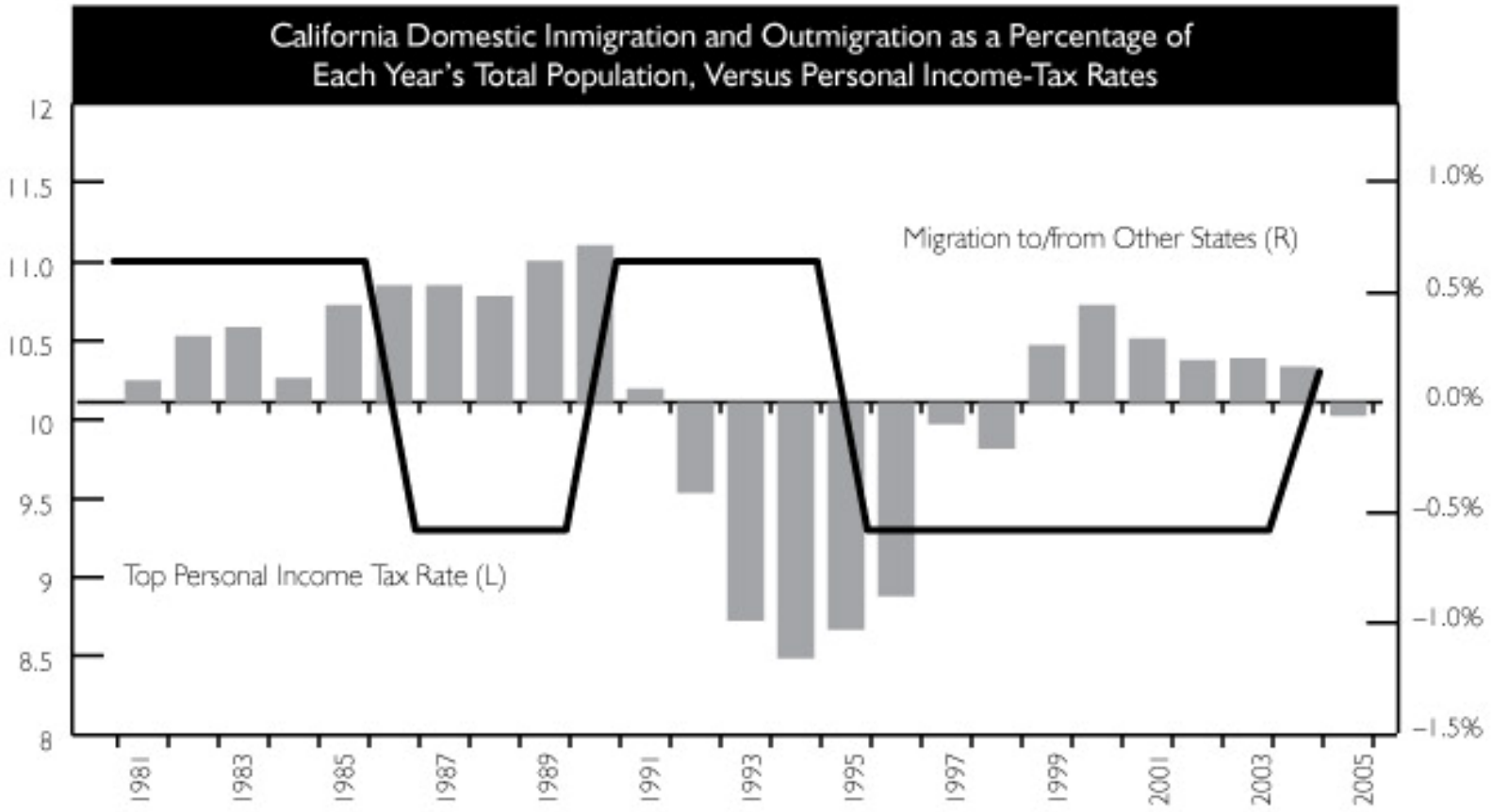
CONTRIBUTING CREDITS AND DEDUCTIONS	NUMBER OF RETURNS	PERCENT OF TOTAL
Enterprise Zone Hiring, Sales and Use Tax Credit	465	29.1
Miscellaneous Deductions	362	22.7
Other State Tax Credit	110	6.9
Research Credit	97	6.1
Total Charitable Contributions	97	6.1
Medical Expenses	91	5.7
Casualty Losses	78	4.9
Los Angeles Revitalization Zone Credit (carryover)	56	3.5
Mortgage Interest Paid to Institutions	55	3.4
Manufacturer's Investment Credit	50	3.1
Prior Year Alternative Minimum Tax Credit	39	2.4
Job and Other Miscellaneous Expenses	33	2.1
Targeted Tax Area Credit	17	1.1
Investment Interest Credit	12	0.8
State Taxes Paid Deduction	12	0.8
Natural Heritage Preservation Credit	6	0.4
Real Estate Tax	5	0.3
Mortgage Interest Paid to Individuals	*	*
Low Income Housing Credit	*	*
Solar Energy Credit (carryover)	*	*
Residential Rental and Farm Sales Credit (carryover)	*	*
Agricultural Transportation Credit (carryover)	*	*
Unknown Credit or Deduction	*	*
Total	1,597	100.0

** Three or fewer returns, not shown in frequency data but included in totals.*

Source: Franchise Tax Board

Figure 4

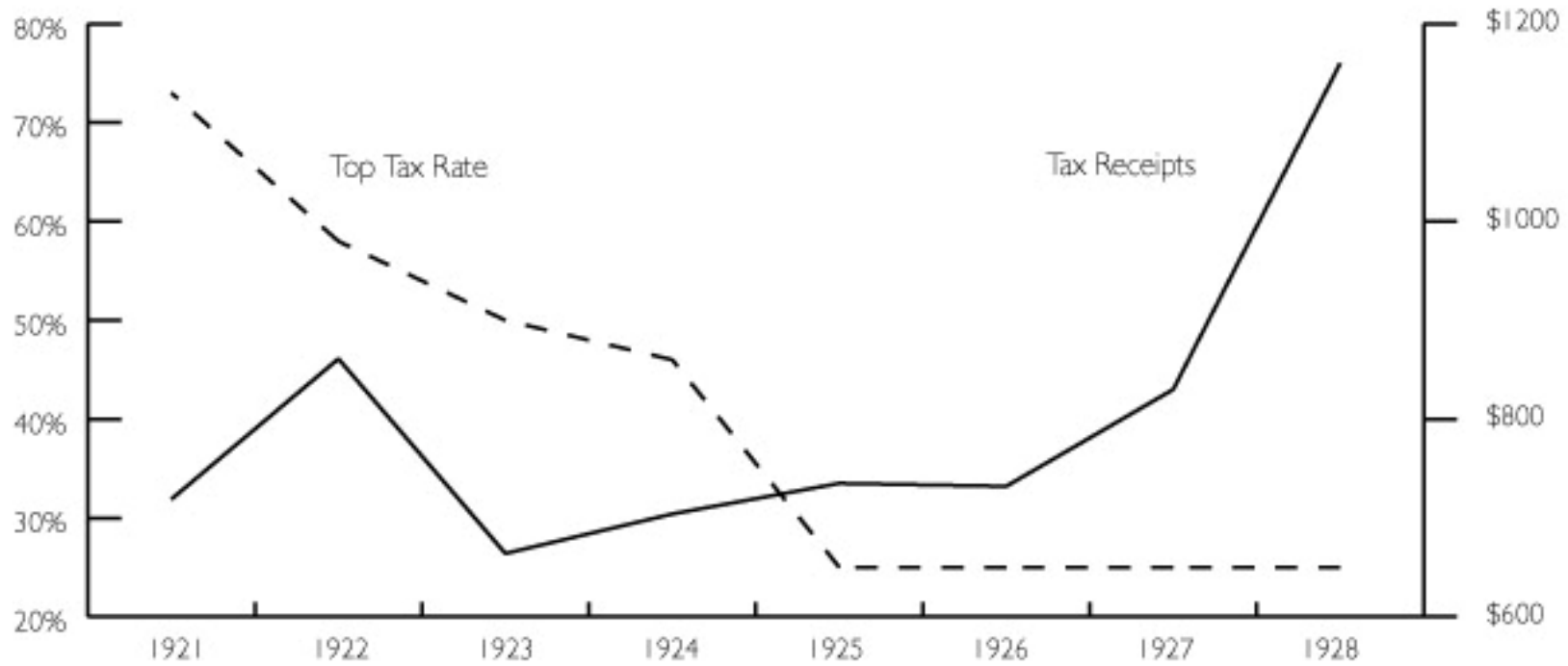
Affluent Californians come and go, depending on their tax rate.



Source: Laffer Associates[8]

Figure 5

Tax Rates and Revenues during the 1920s
(top marginal income-tax rate vs. $ millions total federal income-tax receipts)



Sources: The Tax Foundation, Joint Economic Committee

Figure 7

Tax Rates and Revenues during the 1980s
(top marginal income-tax rate vs. $ billions total federal income-tax receipts)

Sources: The Tax Foundation, U.S. Census Bureau

The Laffer Flat Tax Plan for CA

- Replace (almost) all state and local taxes with a business VAT and personal income tax of about 6%.
- Pros: Simplicity, economic efficiency (taxes consumption not income)
- Cons: Counterintuitive tax liabilities, resistance from local governments

The Murphy Flat Tax Plan for CA

- Replace corporate & personal income tax with flat rate of 3%. Eliminate AMT, estate, inheritance, and gift taxes.

- Pros: Fewer surprises, fewer complications (unemployment insurance, dedicated spending, etc.)

- Cons: Taxes income not consumption, increases regressivity (relative to Laffer plan)