

# Perspectives on the State's Revenue Structure



**Legislative Analyst's Office**

Presented to:

Commission on the 21<sup>st</sup> Century Economy

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# What Criteria Do You Use to Judge a Tax System?

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**Reliability (Growth and Stability)**

**Broad-Based Levies**

**Impact on Economic Activity**

**Equity Considerations**

**Administrative Feasibility**

# How Our Tax System Stacks Up— The Positive

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## “Robust” System

- Grows in line with the economy

## Broad-Based Taxes, Levied on:

- Income
- Consumption
- Wealth (Property Tax)

# How Our Tax System Stacks Up— The Negative

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**Significant Volatility**

**High Marginal Rates**

**Challenges to Tax Bases**

- Sales tax (services and remote sales)
- Tax expenditures
- Tax gap

# How Our Tax System Stacks Up— Other Issues

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## Tax Burden

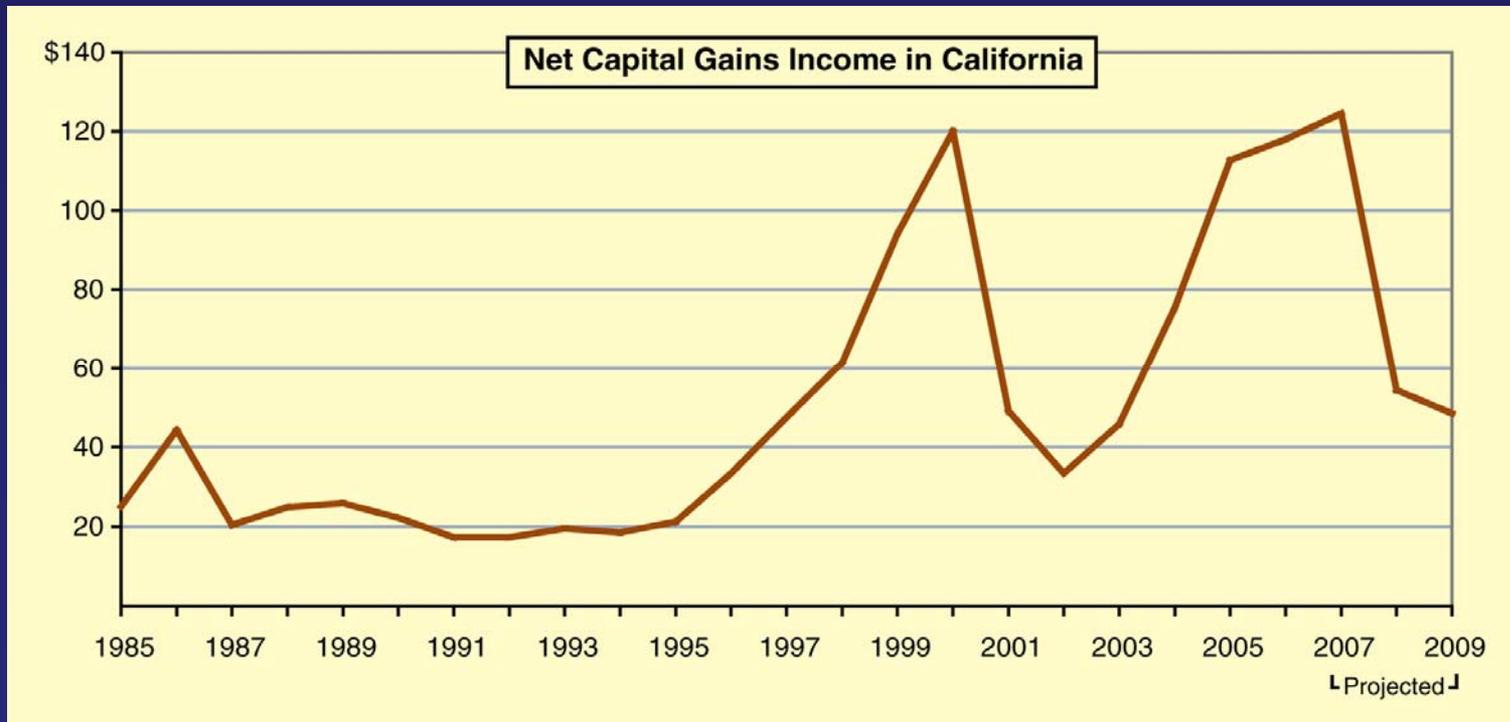
- Overall distribution of tax burden

## Administrative

- Complexity (particularly corporate tax)
- Simplification
- Conformity

# Volatility— Capital Gains Are the Main Story

(In Billions)



# Volatility— Impact on State Revenues

## Historical Effects of Economic Cycles on General Fund Revenues

	Effects of a 1 Percent Change in Personal Income On Percent Changes in Revenues	
	1979-80 Through 1990-91	1991-92 Through 2003-04
Personal income tax	1.09%	6.24%
Sales and use tax	1.33	1.44
Corporation tax	2.57	3.33
<b>Totals, All Revenues</b>	<b>1.39%</b>	<b>3.51%</b>

# Volatility— Impact on the State Budget

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**Boom/Bust in PIT Revenues Complicated  
Our Budgeting Process Enormously**

**Problems in Late 1990s and Mid-2000s**

- Surge of revenues one-time or ongoing?
- Over-committed ongoing spending programs
- Failure to set aside revenues

**Result: Huge Operating Shortfalls**

# Addressing Volatility: Budget Management Options

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## Most Effective Tool: Set Aside Above-Average Revenue Growth in Reserves

- Funds are available during below-average years

## State Has Taken Action in This Regard

- Proposition 58
- Budget reform measure on spring ballot

## Other Tools:

- Use “overages” on one-time spending
- Spending cap

# Addressing Volatility: Revising the Revenue System

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**Reduce PIT Rates on Capital Gains**

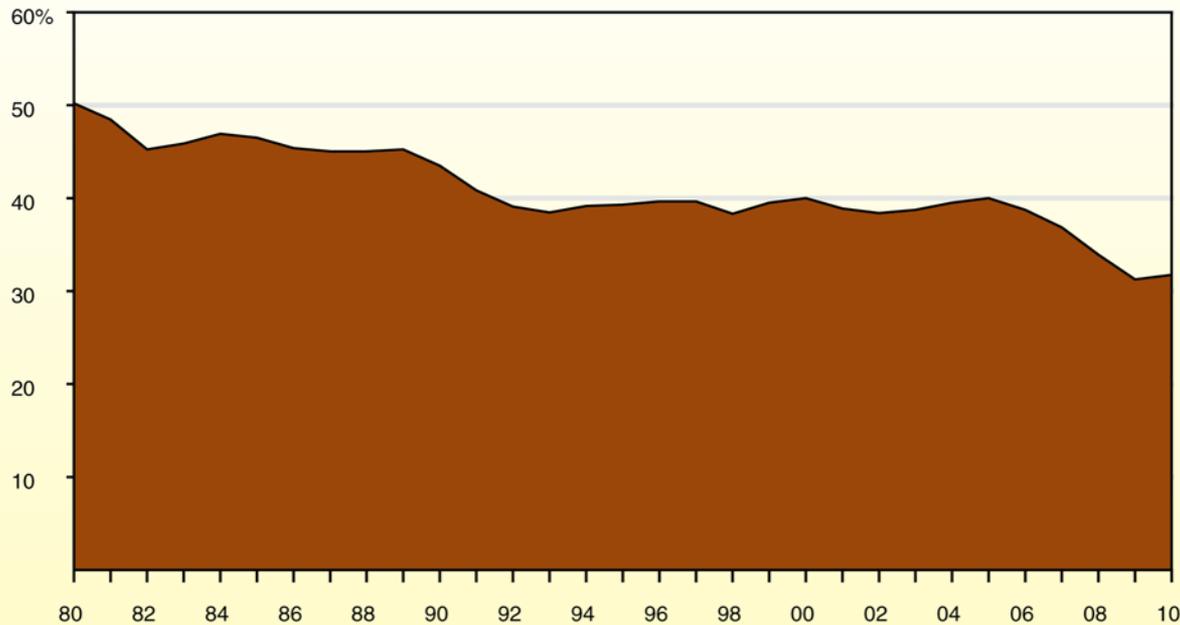
**Reduce Progressivity of Rate Structure**

**Rebalance Mix of Taxes Away From PIT**

**Income Averaging on Capital Gains/  
Stock Options**

# Base Broadening— Declining Sales Tax Base

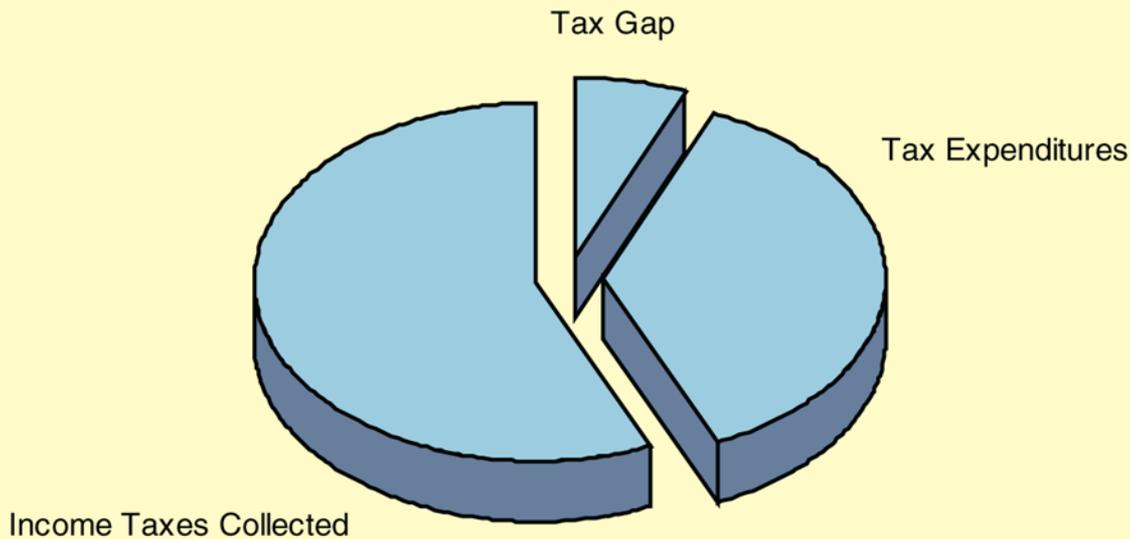
Taxable Sales as a Percent of Personal Income



# Base Broadening— Inroads on Income Tax Base

**Income Taxes Paid Amount to Less  
Than 60 Percent of the Income Tax Base**

*2005-06 and 2006-07*



# Base Broadening— High Marginal Rates

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## **PIT—Highest Rate in the Country**

- Top rate starts at low income

## **Sales Tax—Highest Uniform Rate In the Country**

## **Corporate Tax—One of the Highest In the Country**

# Addressing Base Broadening— Expand Sales Tax to Include Services

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## Turn Tax on All Tangible Goods Into More of a Tax on Consumption

- Lower rate
- More equitable treatment of economic activity

## Issues

- How inclusive?  
Will it apply to: Housing? Schooling? Medical?
- Administrative issues

# Addressing Base Broadening— Expand Income Tax Base

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**Reduce/Eliminate Tax Expenditure Programs (TEPs) and Lower Rates**

**Many TEPs Result in:**

- Distortions
- Inequitable treatment among taxpayers

# Addressing Base Broadening— Tackling Tax Expenditures

2006-07  
(In Millions)

## Largest PIT Tax Expenditure Programs

Program	Type of Provision	Revenue Reduction
Mortgage Interest Expenses	Deduction	\$4,885
Employer Contributions to Pension Plans	Exclusion/Exemption	4,450
Employer Contributions to Accident and Health Plans	Exclusion/Exemption	3,975
Basis Step-Up on Inherited Property	Exclusion/Exemption	3,030
Capital Gains on the Sale of a Principal Residence	Exclusion/Exemption	1,770
Dependent Exemption	Credit	1,650
Charitable Contributions	Deduction	1,600
Real Property Tax Deduction	Deduction	1,315

# Addressing Base Broadening— A More Radical Approach

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## State Could Adopt a Simplified PIT

- Start with federal Adjusted Gross Income
- Few adjustments “below the line”
- Fewer and lower rates
- No Alternative Minimum Tax

# Conclusion

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## **The State has a Sound Tax System Improvements Should Be Focused on:**

- Reducing volatility
- Keeping bases as broad as possible and rates as low as possible