



# Commission on the 21<sup>ST</sup> Century Economy

## **Tax Structure Options**

- Background Issues**
- Personal Income Tax**
- Sales and Use Tax**

# Background Issues

- Revenue Volatility
- Tax Burden and Tax Rates
- Revenue Neutrality
- Tax Burden Distribution



---

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

---

# Background Issues

## Why Is Volatility Important

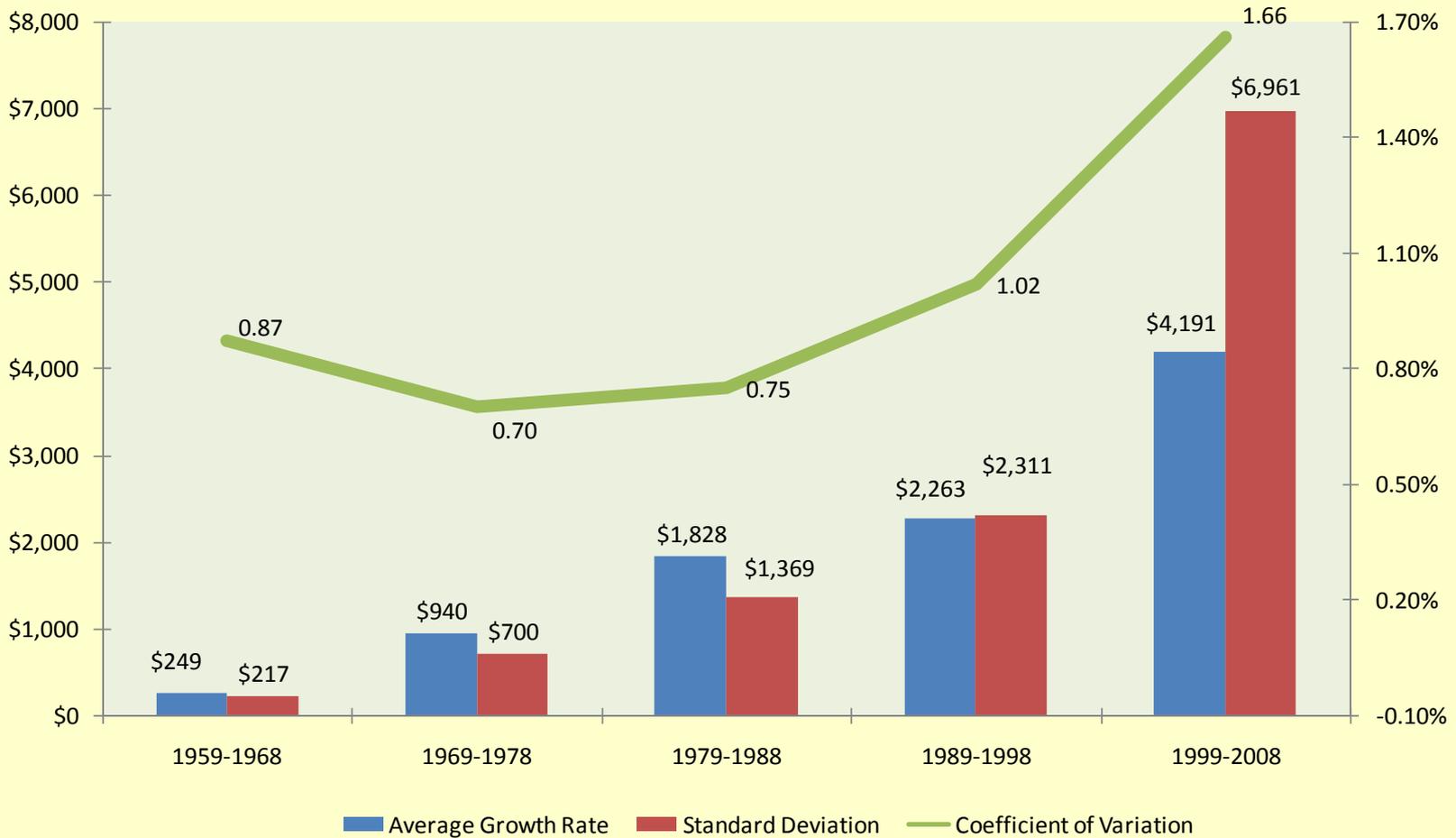
- Reasonable reserves can not protect against all downturns
  - For a given size of reserve, high volatility offers less protection
  - The same level of protection requires higher reserves for higher volatility
    - For example, if volatility were to be twice as high, the same level of protection would need reserves that are twice as high.



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

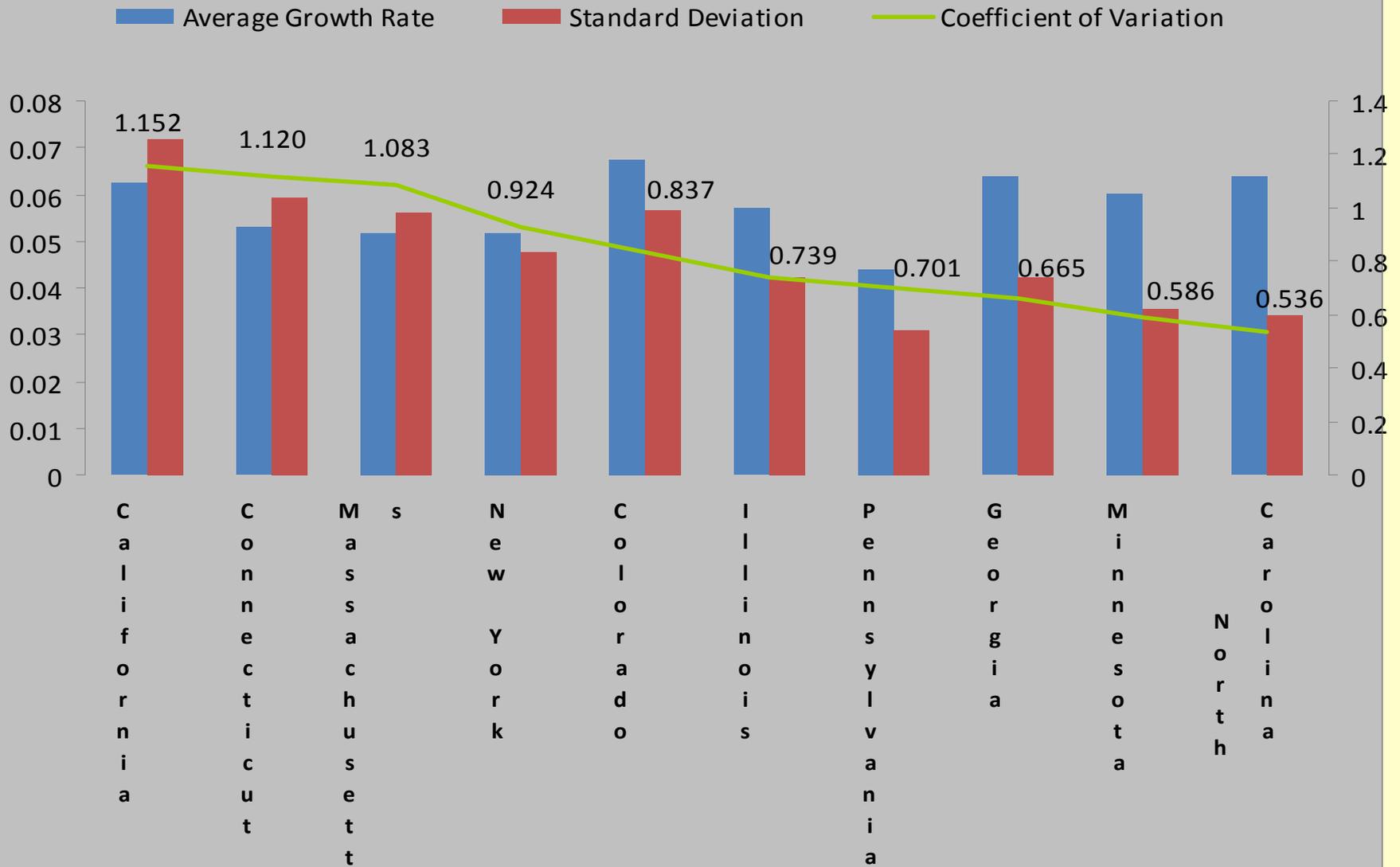


# General Fund Variability





# Revenue Volatility of Comparable States 1993-2007



# Ways to Reduce Revenue Volatility

- The Personal Income Tax (PIT) accounts for 55% of general fund revenues
  - Reduce PIT volatility
- Move to less volatile revenue sources
  - In declining order of volatility are:
    - Income taxes
    - Transaction taxes
    - Consumption taxes
    - Taxes on asset values
    - Head tax



# Background Issues

## Tax Burden and Tax Rates

- California is generally an average tax burden state
- State's marginal rates are high and have risen over the decades
- Tax rates are higher than many neighboring and competitive states
- Marginal rates can have an impact on investment and economic activity



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

# State Tax and Revenue Comparison

	2006			
	Own Source Revenue		Tax Collections	
	% Personal Income	Rank	% Personal Income	Rank
Louisiana	21.0%	3	14.0%	6
New York	21.0%	4	15.7%	2
New Mexico	20.9%	5	12.9%	9
Indiana	19.8%	6	11.9%	17
Utah	18.9%	12	11.8%	19
South Carolina	18.3%	14	10.3%	44
Oregon	17.6%	17	10.8%	40
<b>California</b>	<b>17.6%</b>	<b>18</b>	<b>12.1%</b>	<b>14</b>
Ohio	17.2%	22	11.8%	18
Minnesota	16.9%	26	11.8%	20
Washington	16.6%	27	11.2%	29
Michigan	16.4%	33	10.9%	38
New Jersey	16.3%	34	12.5%	10
Florida	16.2%	35	10.8%	41
Pennsylvania	16.1%	36	11.4%	26
Nevada	15.7%	38	10.8%	39
Illinois	15.4%	41	11.2%	28
Arizona	15.3%	43	11.0%	34
Massachusetts	15.2%	44	10.9%	36
Texas	15.0%	45	10.0%	46
Maryland	14.6%	48	11.1%	31
<b>U.S. Average</b>	<b>16.9%</b>		<b>11.6%</b>	

Source: U.S. Bureau of the Census and Bureau of Economic Analysis

# Comparison of State Marginal Tax Rates

	<u>Personal Income Tax</u>	<u>Corporation Tax</u>	<u>Statewide Sales Tax</u>
Arizona	4.54%	6.97%	5.60%
California	10.30%	8.84%	7.25%
Colorado	4.63%	4.63%	2.90%
Illinois	3.00%	7.30%	6.25%
Maryland	5.50%	8.30%	6.00%
Massachusetts	5.30%	9.50%	5.00%
Minnesota	7.85%	9.80%	6.50%
Nevada	No income tax	No corporate tax	6.50%
New Jersey	8.97%	9.00%	7.00%
New York	6.85%	7.50%	4.00%
Ohio	6.24%	8.50%	5.50%
Oregon	9.00%	6.60%	No sales tax
Pennsylvania	3.07%	9.99%	6.00%
Texas	No income tax	1% of gross revenues	6.25%
Utah	5.00%	5.00%	4.65%
Washington	No income tax	No corporate tax	6.50%

*Note: California's statewide tax rate will increase to 8.25% on April 1, 2009.*

# Background Issues

## Revenue Neutrality

- **The state general fund revenue (GF) share of California personal income (PI) has been remarkably steady.**
  - **From 1973 to 2008 it has been about 6%.**
  - **During that time span, 10% changes to PI would tend to 10.2% changes to GF revenues.**
- **This implies that a GF revenue system that in the long run would generate revenues of about 6% of PI would be revenue neutral to our current revenue system.**
- **If that tax system were to be less volatile than our current tax system, it would generate more revenue in downturns and less in economic booms.**

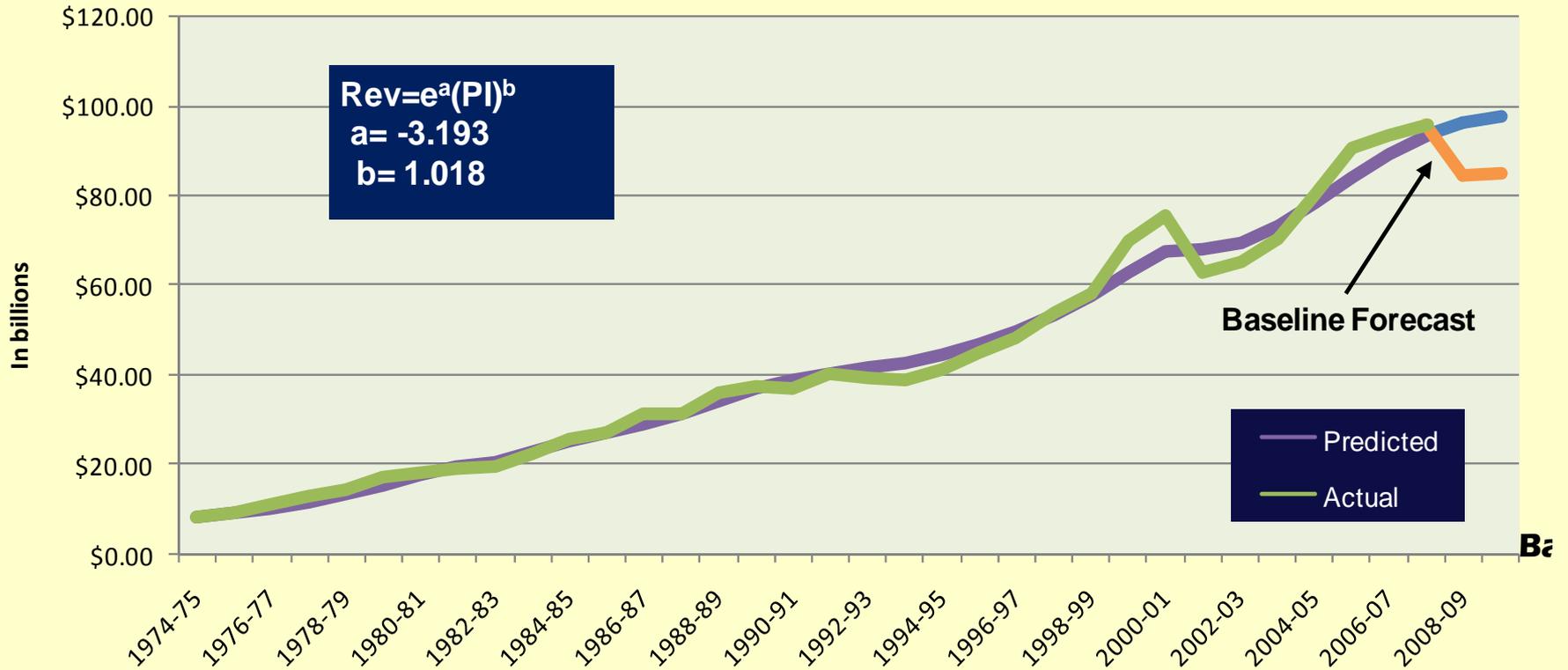


---

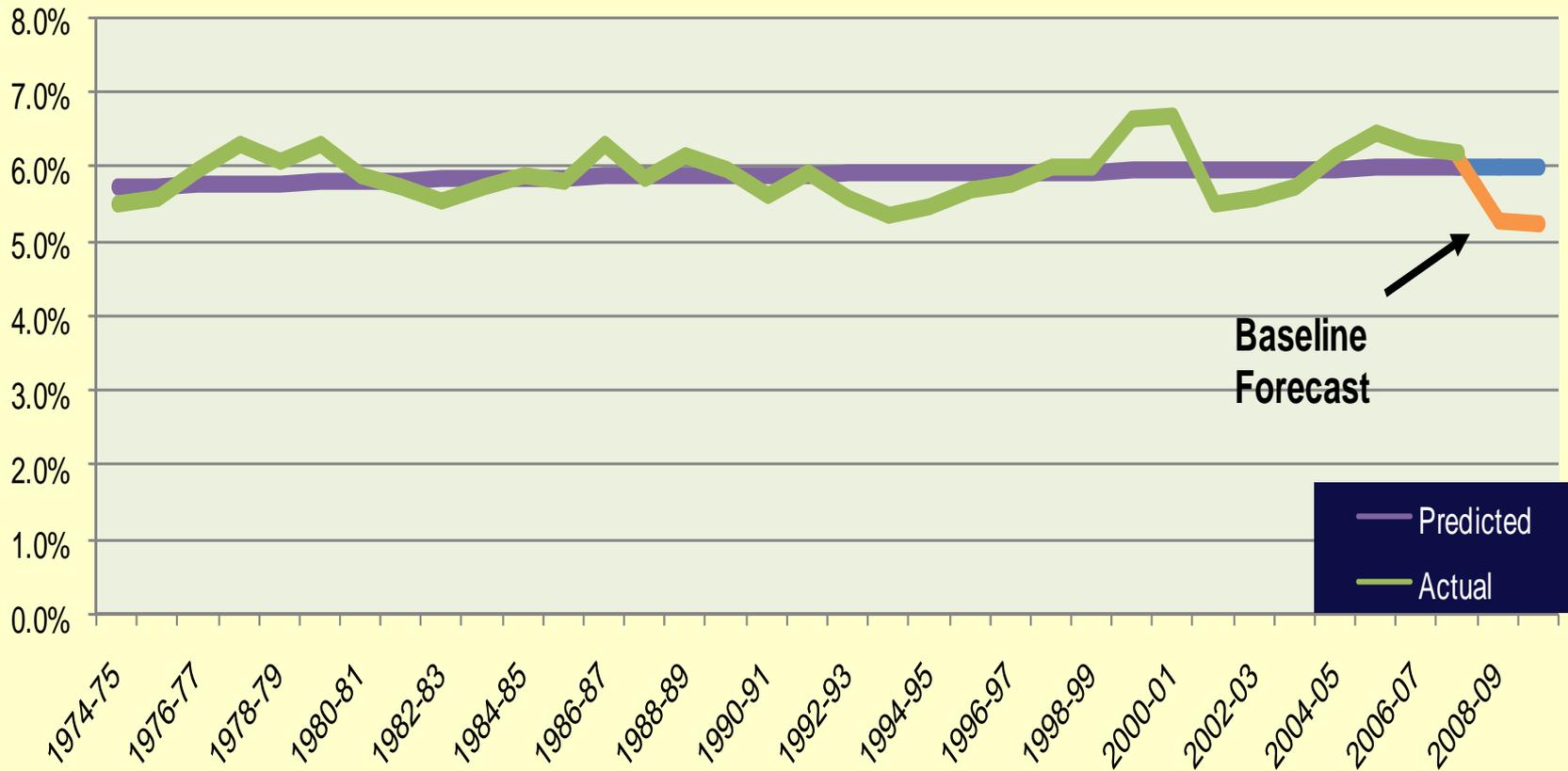
Commission on the  
21<sup>ST</sup> Century Economy

---

# General Fund Major Revenues Actual and Predicted



# General Fund Major Revenues as a Percent of Personal Income



# Background Issues

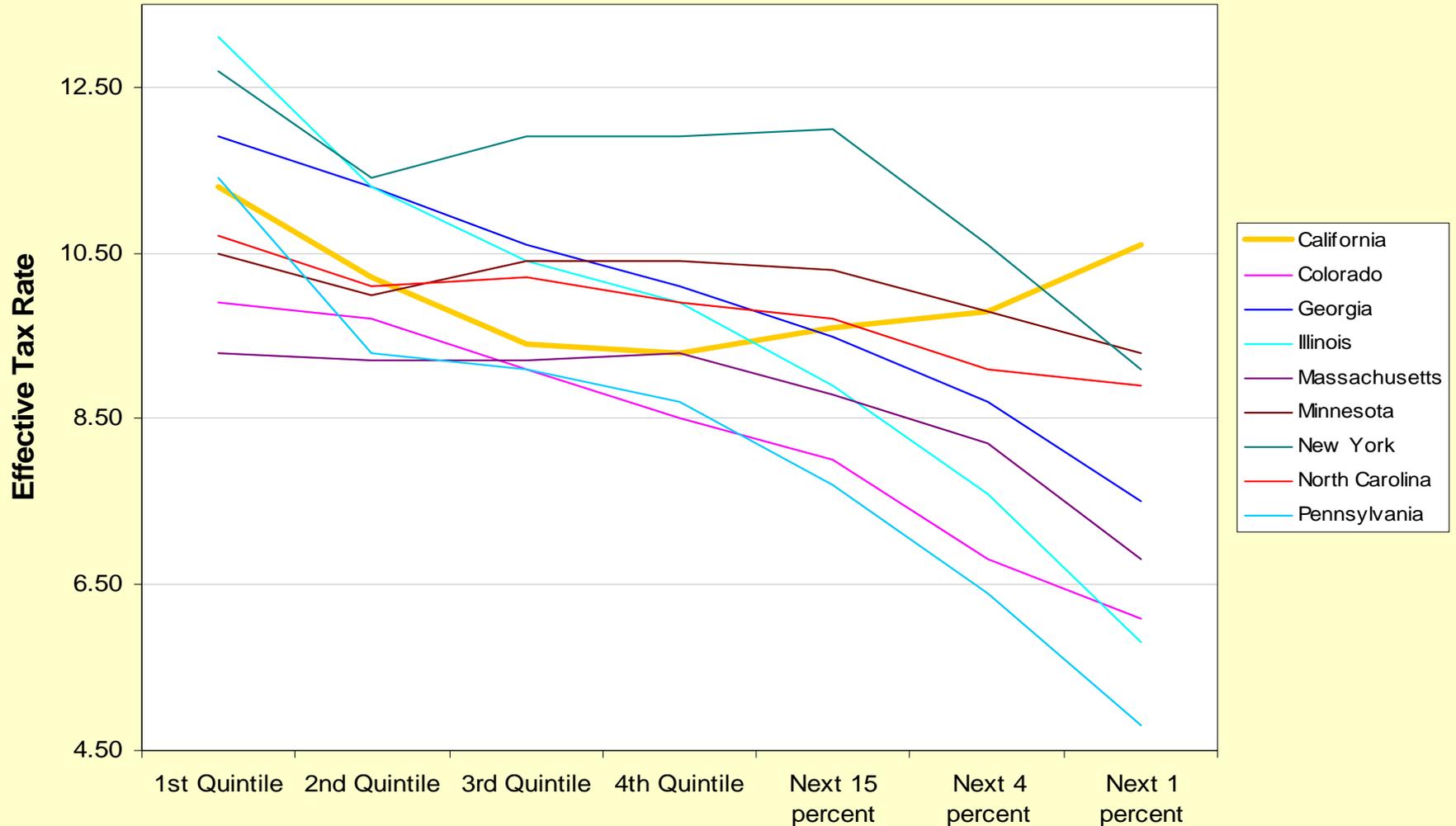
## Tax Burden Distribution

- California's tax burden distribution has changed over time
- Shifts in the burden have occurred as the tax portfolio has changed
- Tax rates have also been altered over the decades
- Changes in the distribution of income has also had an impact on tax burden

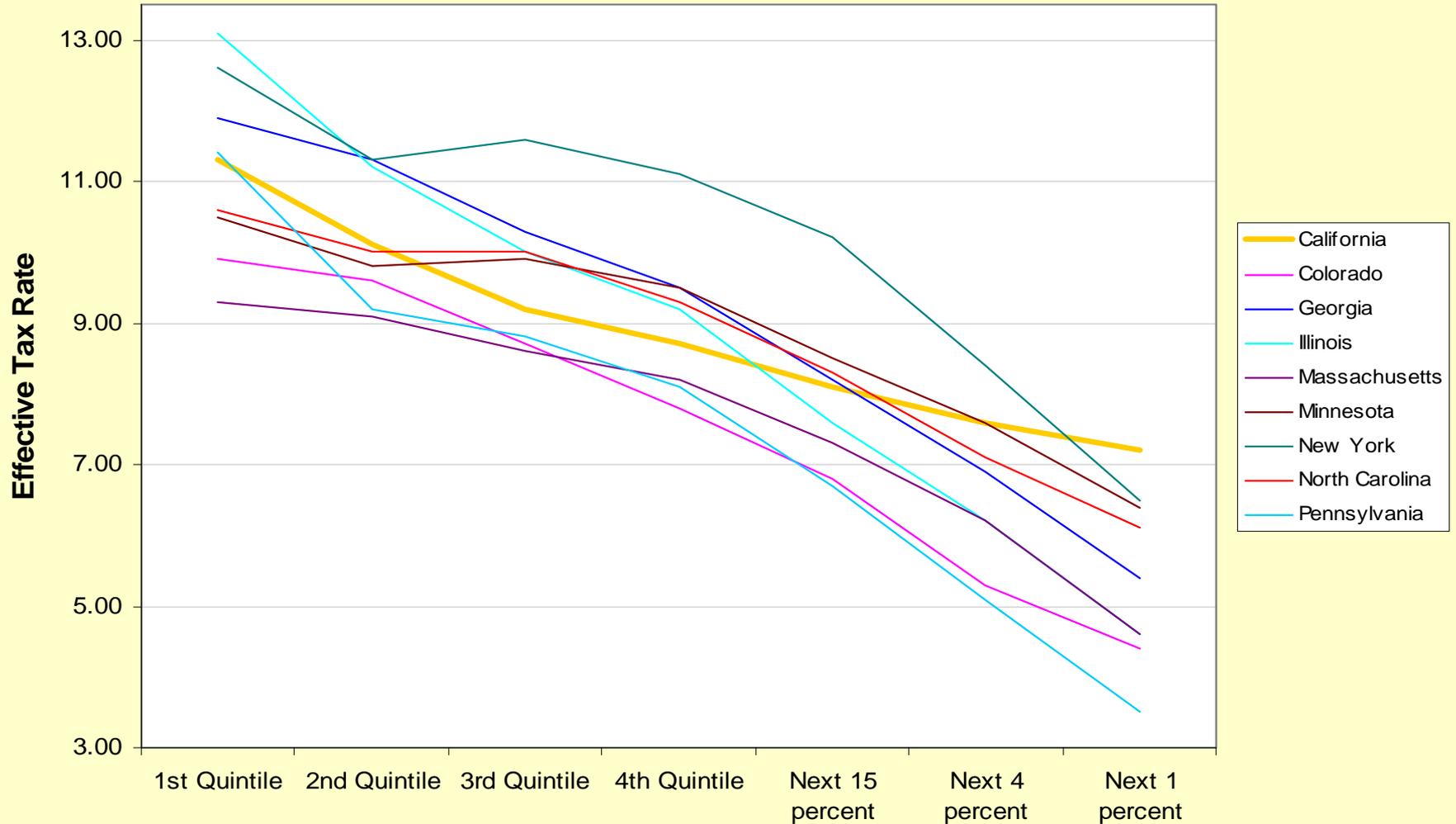


Commission on the  
21<sup>ST</sup> Century Economy

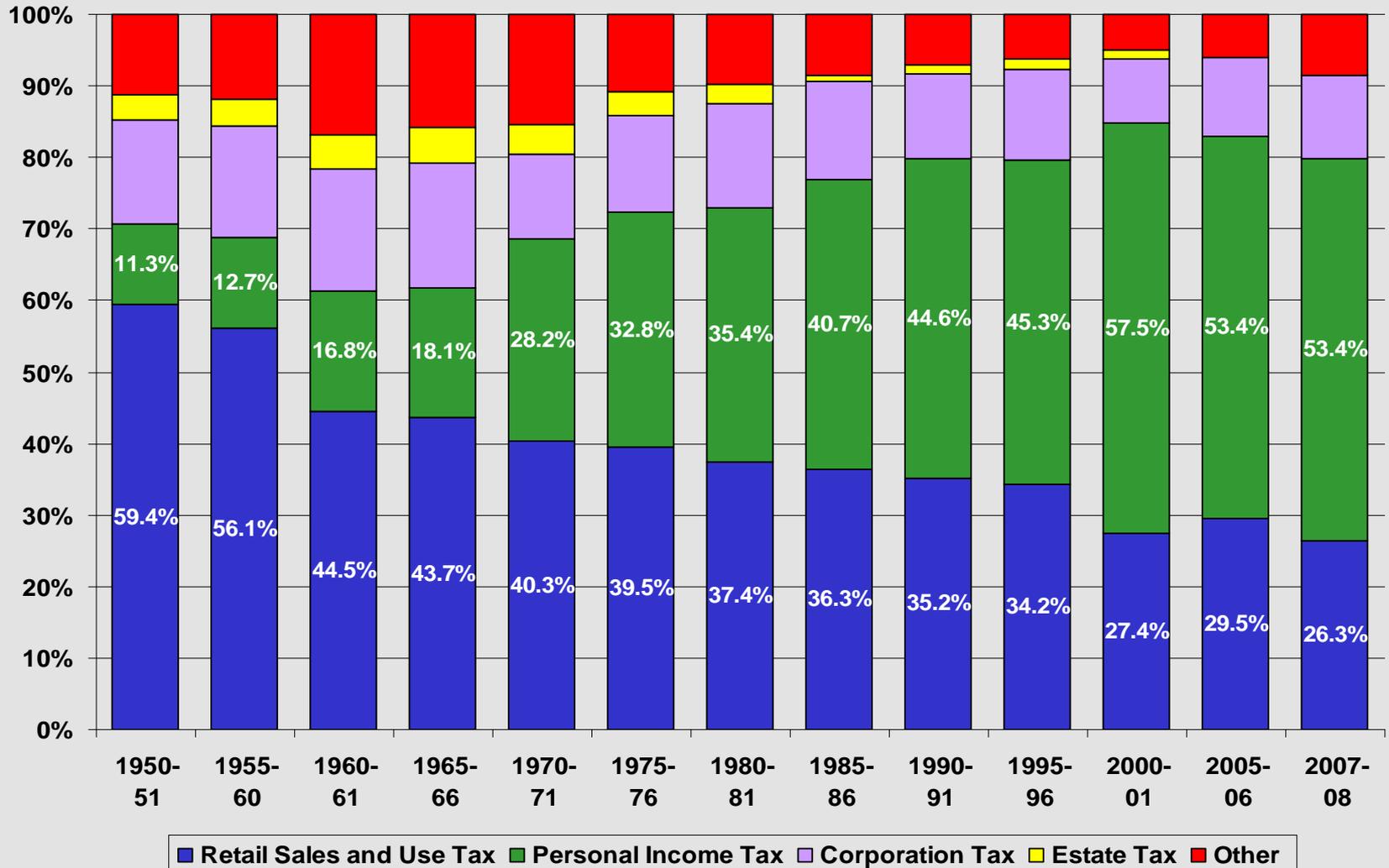
# State and Local Tax Distribution- No Offset



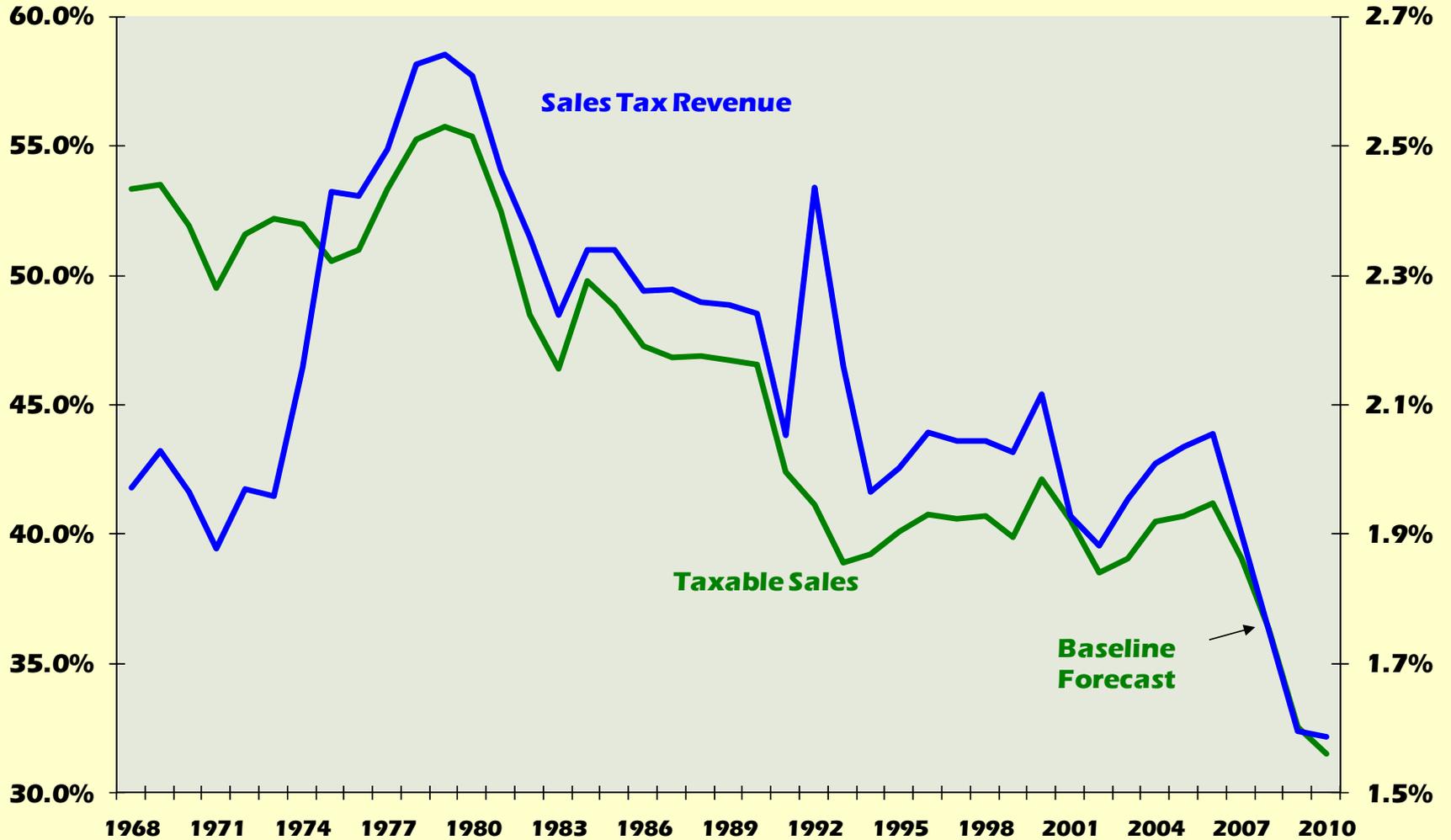
# State and Local Tax Distribution-Offset



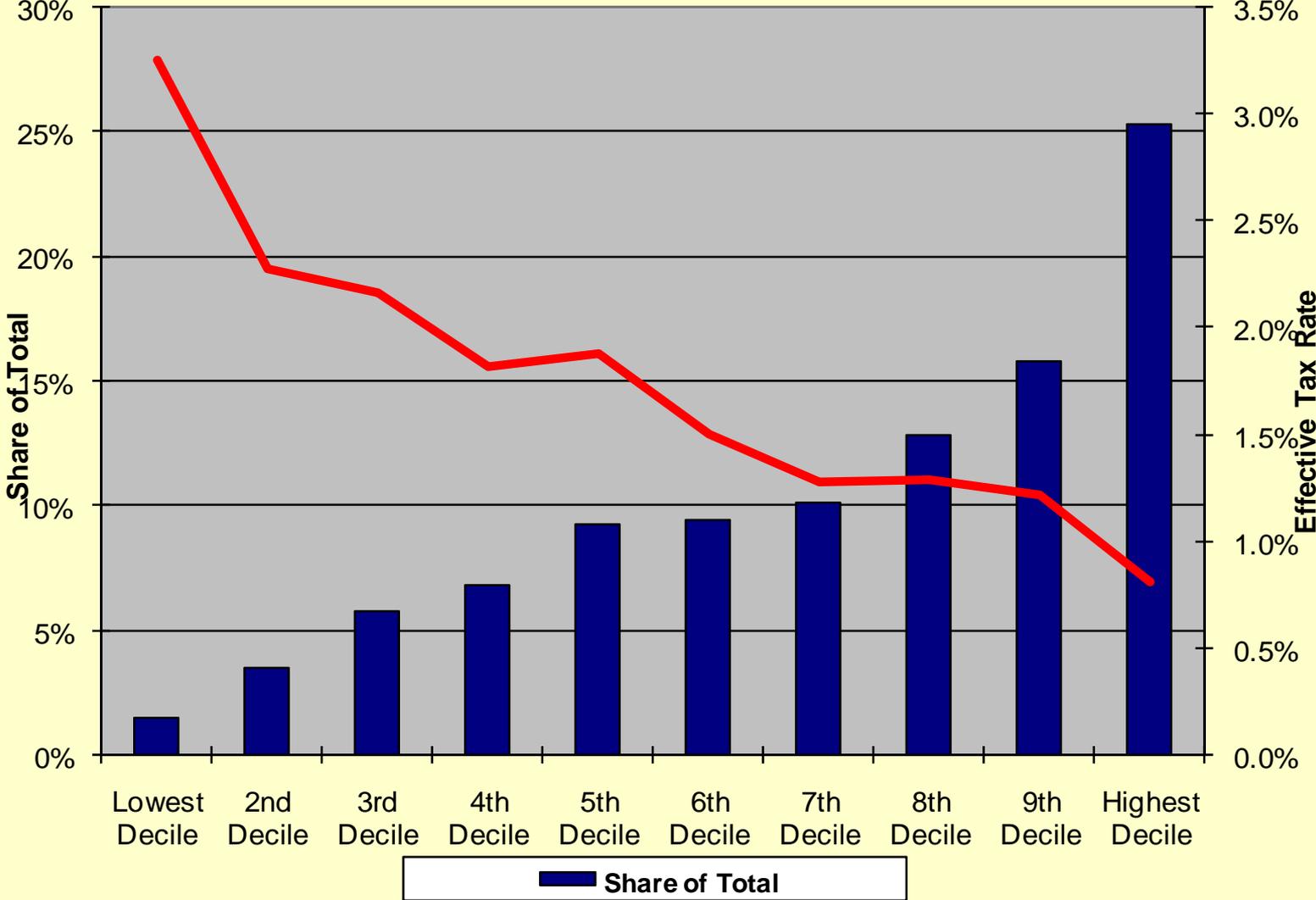
# California State Revenues by Source



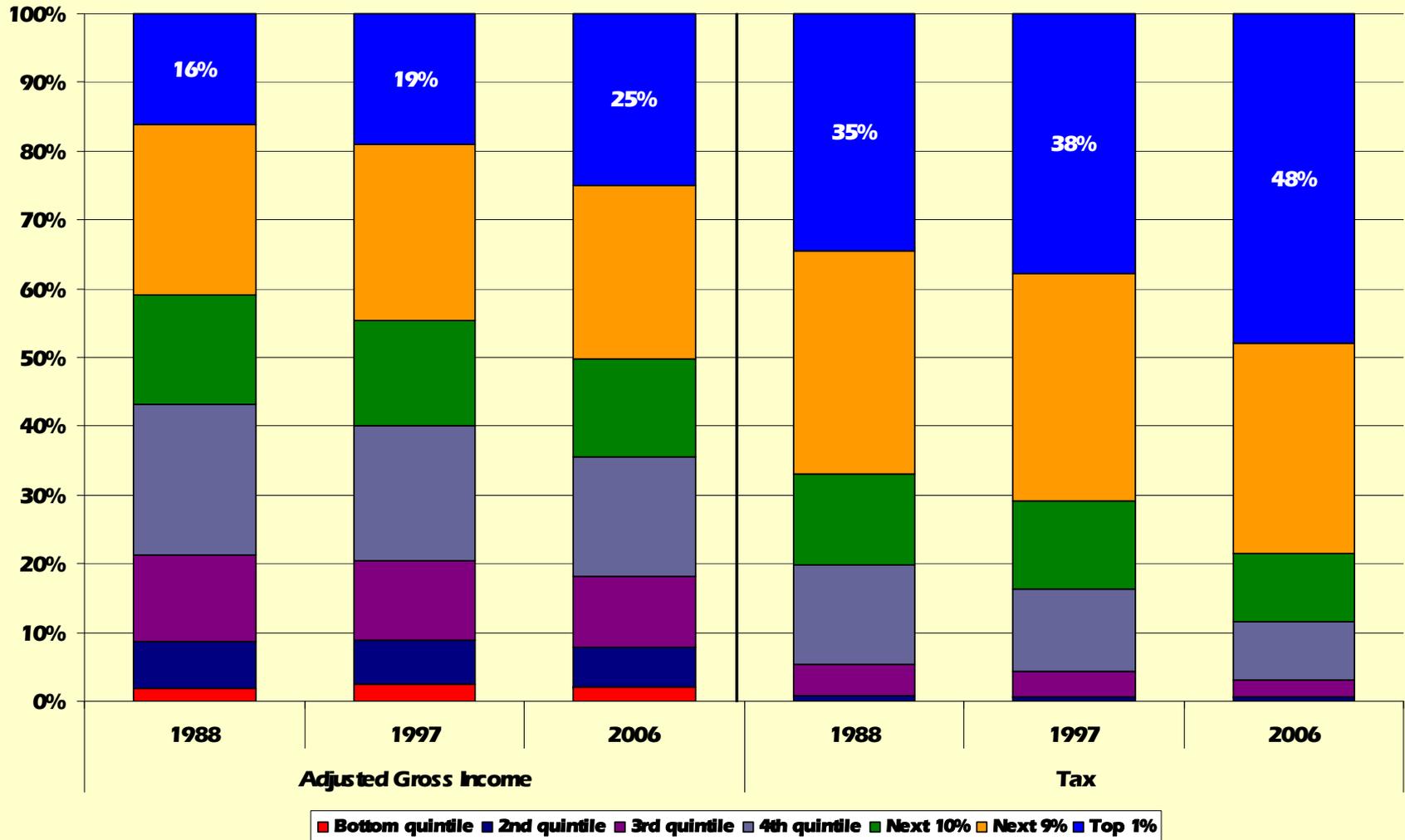
# Ratio of Taxable Sales and Sales Tax Revenue to Income



# Distribution of Sales Tax Burden

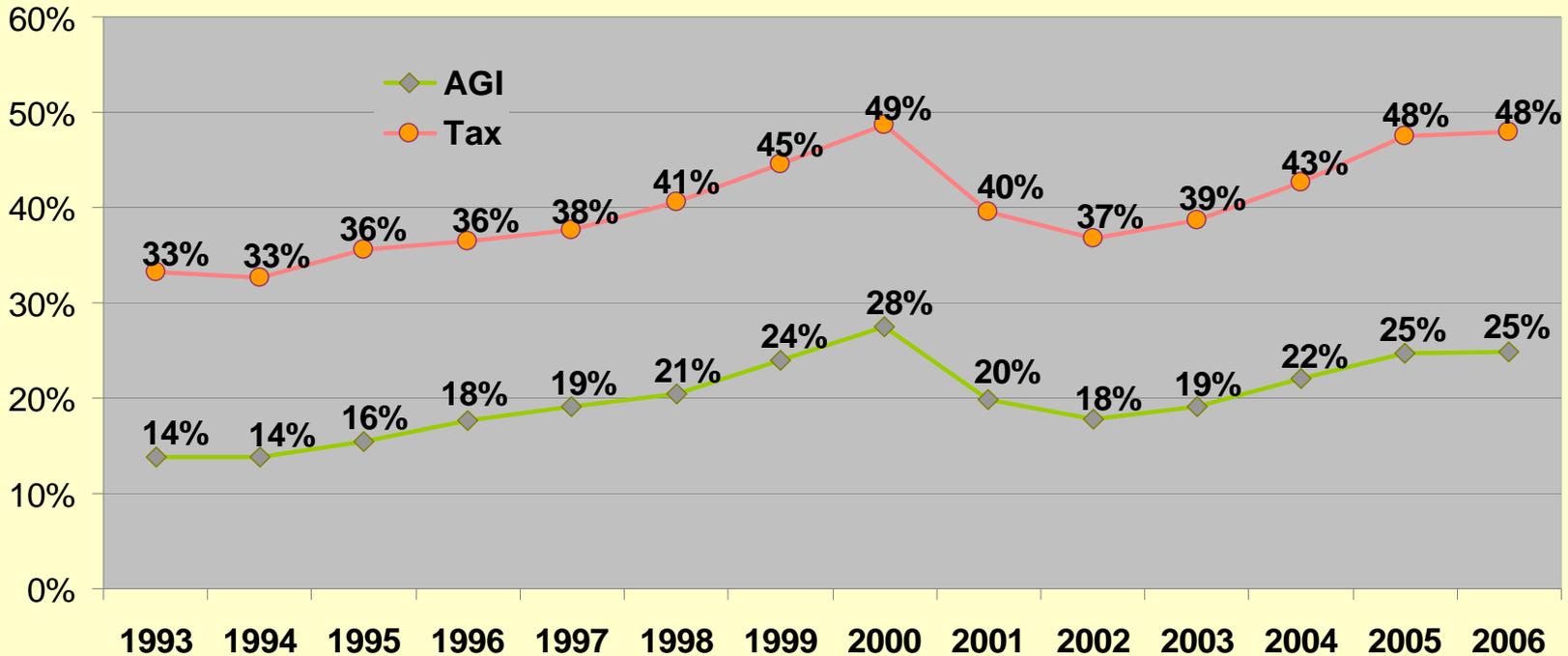


# Distribution of Income and Personal Income Taxes



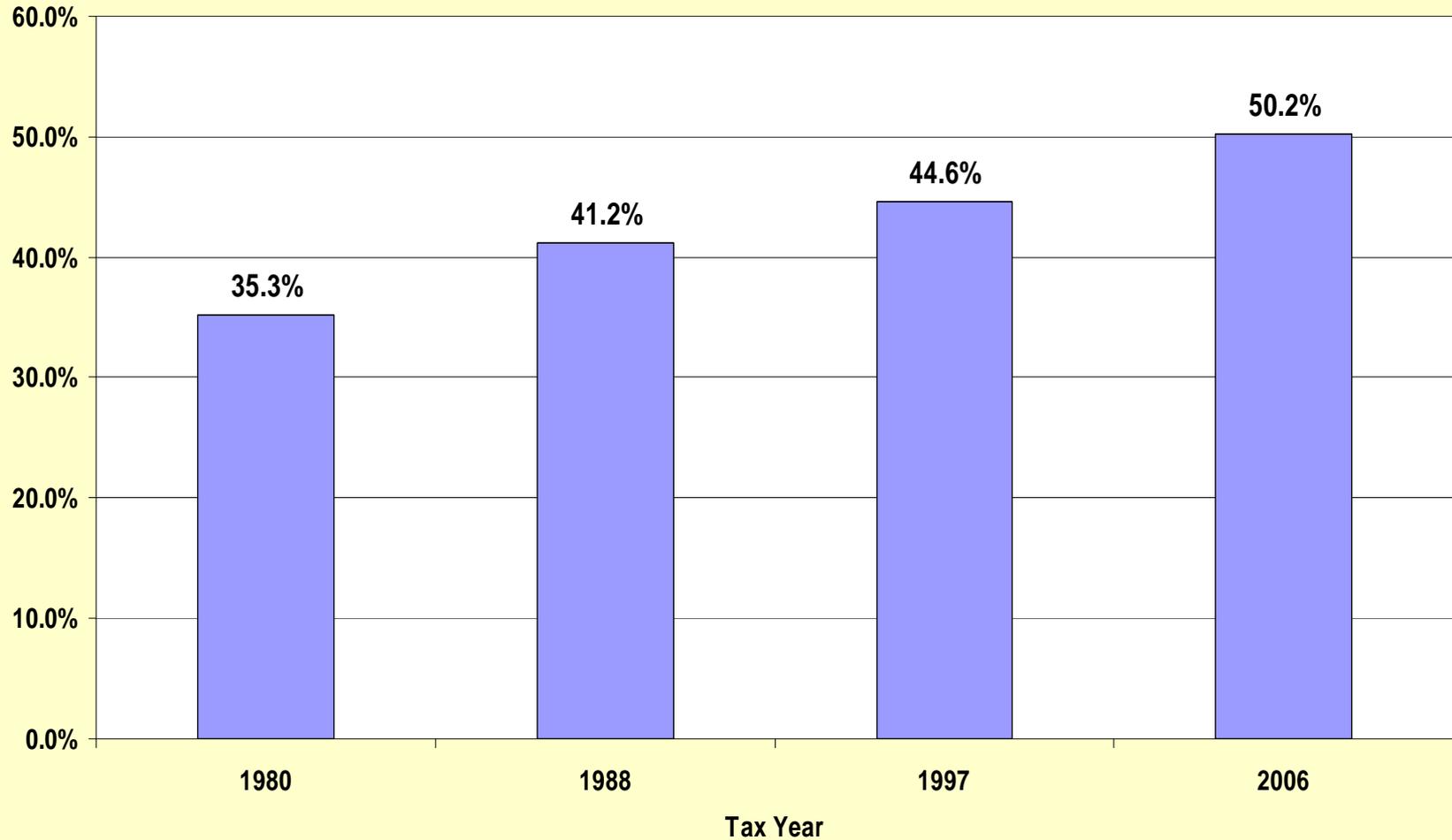


# Shares of AGI and Personal Income Tax Paid by Top 1% of Taxpayers



# Personal Income Tax (PIT)

Adjusted Gross Income for the Top 10%



# Tax Burden Distribution

Changes in Progressivity Due to Changes in General Fund Shares of the Personal Income Tax (PIT) and the Sales and Use Tax (SUT)

Percentage of GF Revenue for Top 10%				
	<u>SUT</u>	<u>PIT</u>	<u>SUT + PIT</u>	<u>SUT + PIT</u>
				<u>Hypothetical Top 10% for 2006</u>
				<u>Tax Year</u>
1950-51	59.4%	11.3%	70.7%	33.8%
1970-71	40.3%	28.2%	68.5%	47.2%
1980-81	37.4%	35.4%	72.8%	51.2%
1990-91	35.2%	44.6%	79.8%	55.0%
2007-08	26.3%	53.4%	79.7%	60.9%

**2006 Tax Burden share of the top 10%**

**SUT - 25.3%**

**PIT - 78.5%**

# Personal Income Tax (PIT)

## Broaden the Tax Base and Reduce the Tax Rate

- **The tax base can be broadened by eliminating deductions and credits**
  - **Eliminate all deductions and credits**
    - **In 2006, a 4.08% flat tax rate would be revenue neutral to 2006 tax year revenue law**
      - **But many winners and losers**
      - **Extreme changes to the tax burden distribution**
      - **To achieve a similar tax burden distribution required a four rate tax schedule and a \$200 per return exemption**
    - **However, that raised the top tax rate to 8.35%**



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

# Personal Income Tax (PIT)

## Broaden the Tax Base and Reduce the Tax Rate

- Why is the tax reduction so small
- The tax base for high income PIT taxpayers is already broad, so base broadening primarily affects lower income taxpayers
- Phase-out of itemized deduction and credits for high income taxpayers
  - For 2007, itemized deductions phased out to 20%, starting above adjusted gross income (AGI) of \$310,837 (\$155,416 for single)
  - Exemption credits are fully phased out, starting above AGI of \$310,837 (\$155,416 for single)
- Even without phase outs, deductions and exemption credits are a higher proportion of AGI for lower income taxpayers.

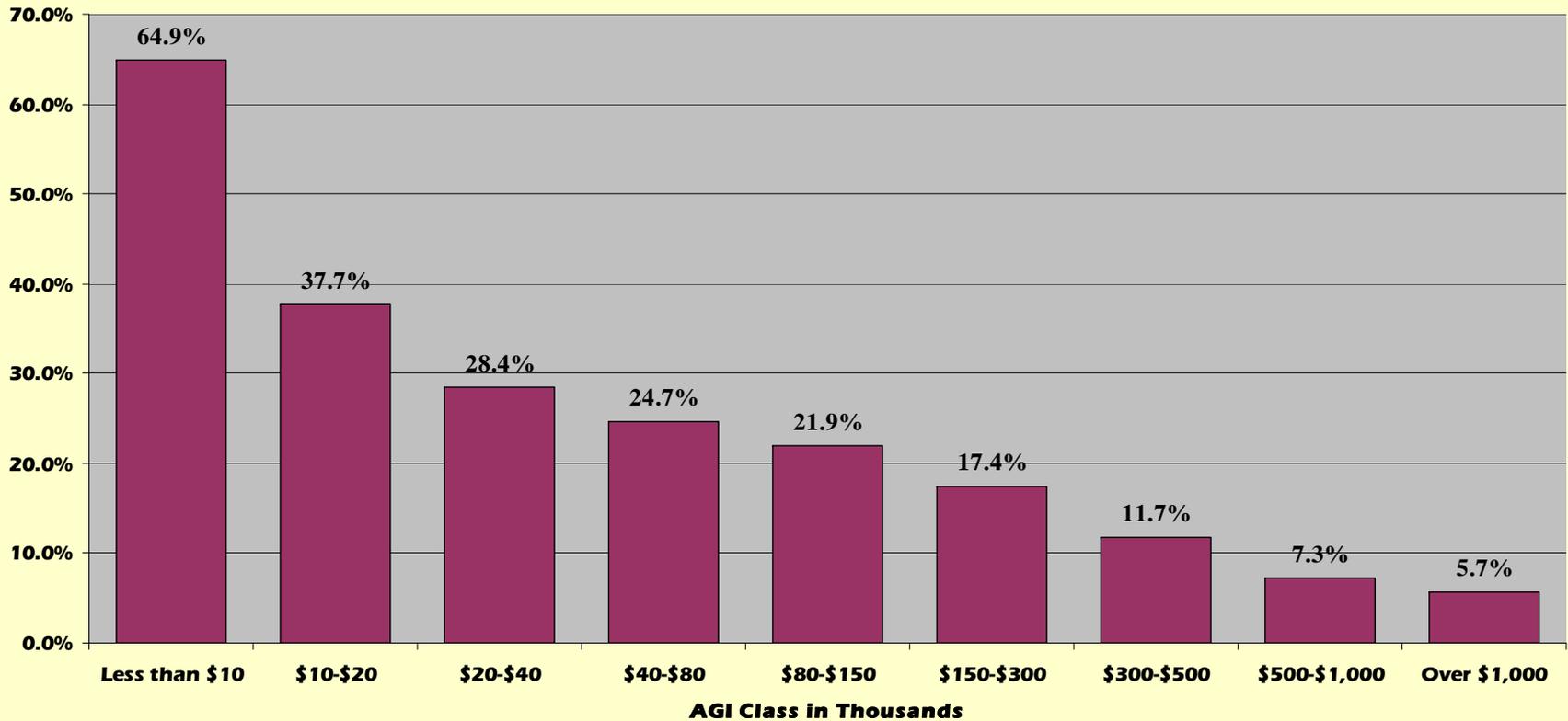


---

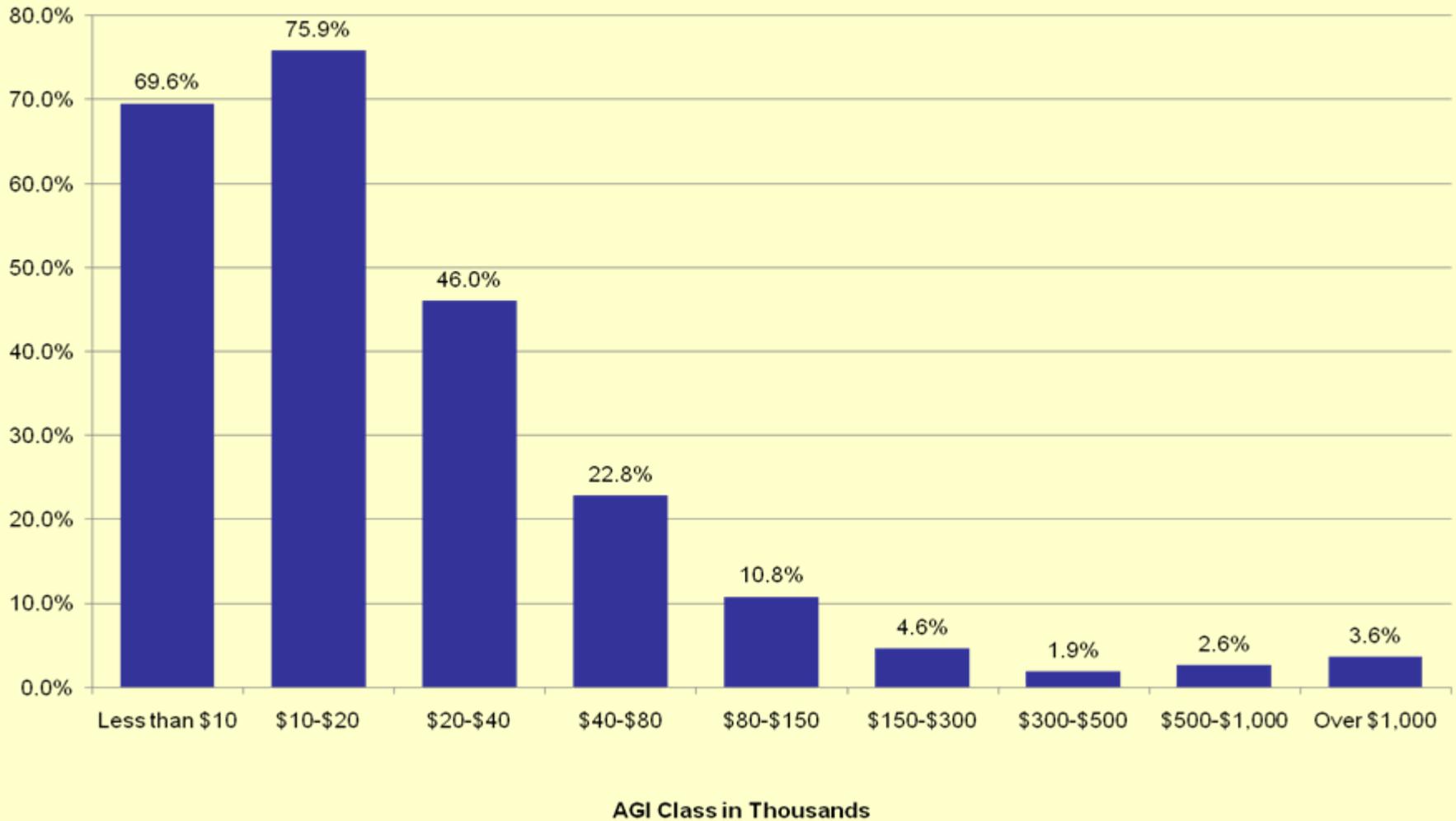
Commission on the  
21<sup>ST</sup> Century Economy

---

# Personal Income Tax Deduction as Percent of AGI 2006 Tax Year



# Personal Income Tax Tax Credits as a Percent of Tax Before Credits 2006 Tax Year



# Personal Income Tax

Eliminate All Deductions and Credits and Substitute Current Law Tax Rates  
with flat 4.3% Tax Rate (2006 Tax Year)

AGI Bracket			Number of Returns (000)	Current Law Tax (\$Mil)	Difference (\$Mil)	Percent Difference	Current Law Tax per Return	Diff per Return
Negative	-	-	172	4	-	0%	25	-
1	-	10,000	1,920	13	472	3579%	7	246
10,000	-	20,000	2,295	69	1,447	2091%	30	630
20,000	-	40,000	3,510	816	3,743	458%	233	1,066
40,000	-	80,000	3,501	4,009	4,852	121%	1,145	1,386
80,000	-	150,000	2,002	7,522	1,878	25%	3,758	938
150,000	-	300,000	695	7,619	(1,567)	-21%	10,964	(2,256)
300,000	-	500,000	154	4,106	(1,592)	-39%	26,642	(10,330)
500,000	-	1,000,000	83	4,448	(2,008)	-45%	53,543	(24,172)
1,000,000	-	5,000,000	44	7,346	(3,345)	-46%	165,130	(75,202)
Over		5,000,000	7	9,763	(4,250)	-44%	1,487,553	(647,539)
<b>Total</b>			<b>14,383</b>	<b>45,716</b>	<b>(371)</b>	<b>-1%</b>		

# Personal Income Tax

Eliminate All Deductions and Credits and Substitute Current Law Tax Rates with Four Tax Rates (2006 Tax Year)

AGI Bracket		Number of Returns (000)	Current Law Tax (\$Mil)	Difference (\$Mil)	Percent Difference	Current Law Tax per Return	Diff per Return
Negative	-	172	4	-	0%	25	-
1	- 10,000	1920	13	213	1611%	7	111
	10,000 - 20,000	2295	69	636	919%	30	277
	20,000 - 40,000	3510	816	1,304	160%	233	372
	40,000 - 80,000	3501	4,009	1,499	37%	1,145	428
	80,000 - 150,000	2002	7,522	(241)	-3%	3,758	(120)
	150,000 - 300,000	695	7,619	(1,593)	-21%	10,964	(2,292)
	300,000 - 500,000	154	4,106	(793)	-19%	26,642	(5,147)
	500,000 - 1,000,000	83	4,448	(568)	-13%	53,543	(6,840)
	1,000,000 - 5,000,000	44	7,346	(435)	-6%	165,130	(9,774)
	Over 5,000,000	7	9,763	(105)	-1%	1,487,553	(16,009)
<b>Total</b>		<b>14,383</b>	<b>45,716</b>	<b>(83)</b>	<b>0%</b>	<b>3,179</b>	<b>(6)</b>

## Tax Rates:

Under \$40,000	2.0%
\$40,000-\$150,000	4.1%
\$150,000-\$300,000	8.0%
Over \$300,000	8.3%

# Personal Income Tax

Eliminate All Deductions and Credits and Substitute Current Law Tax Rates with Four Tax Rates and a \$200 Per Return Exemption (2006 Tax Year)

AGI Bracket			Number of Returns (000)	Current Law Tax (\$Mil)	Difference (\$Mil)	Percent Difference	Current Law Tax per Return	Diff per Return
Negative	-	-	172	4	-	0%	25	-
1	-	10,000	1920	13	(13)	-100%	7	(7)
	10,000	-	2295	69	177	256%	30	77
	20,000	-	3510	816	602	74%	233	172
	40,000	-	3501	4,009	1,103	28%	1,145	315
	80,000	-	2002	7,522	(4)	0%	3,758	(2)
	150,000	-	695	7,619	(796)	-10%	10,964	(1,146)
	300,000	-	154	4,106	(370)	-9%	26,642	(2,401)
	500,000	-	83	4,448	(328)	-7%	53,543	(3,943)
	1,000,000	-	44	7,346	(279)	-4%	165,130	(6,275)
	Over	5,000,000	7	9,763	(36)	0%	1,487,553	(5,434)
<b>Total</b>			<b>14,383</b>	<b>45,716</b>	<b>56</b>	<b>0%</b>	<b>3,179</b>	<b>4</b>

## Tax Rates:

Under \$40,000	2.00%
\$40,000-\$150,000	4.56%
\$150,000-\$300,000	8.00%
Over \$300,000	8.35%

# Sales and Use Tax Alternatives

- Extend Tax to All Tangible Personal Property**
- Extend Tax to Limited Selection of Services**
- Extend Tax to Expanded Array of Services**
- Exempt Business Intermediate and Investment**
- Combine Extended Tax and Exemptions**



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

# Sales and Use Tax Alternatives

- Options include extending the tax to untaxed tangible personal property and services
- Options also address exempting business intermediate and investment purchases
- Results of options are expressed in terms of additional revenues
- Base expansion could be used to fund reductions in the tax rate



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

# Sales and Use Tax Alternatives

- Tax liability is approximately 2/3rds households and 1/3 business
- Distributional data is based on household portion of the tax
- No effort has been made to attribute the portion of the tax paid by business
- Distribution of the tax burden is based on annual income



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

# **Sales and Use Tax-Alternative 1**

## **Extend Tax to All Tangible Personal Property**

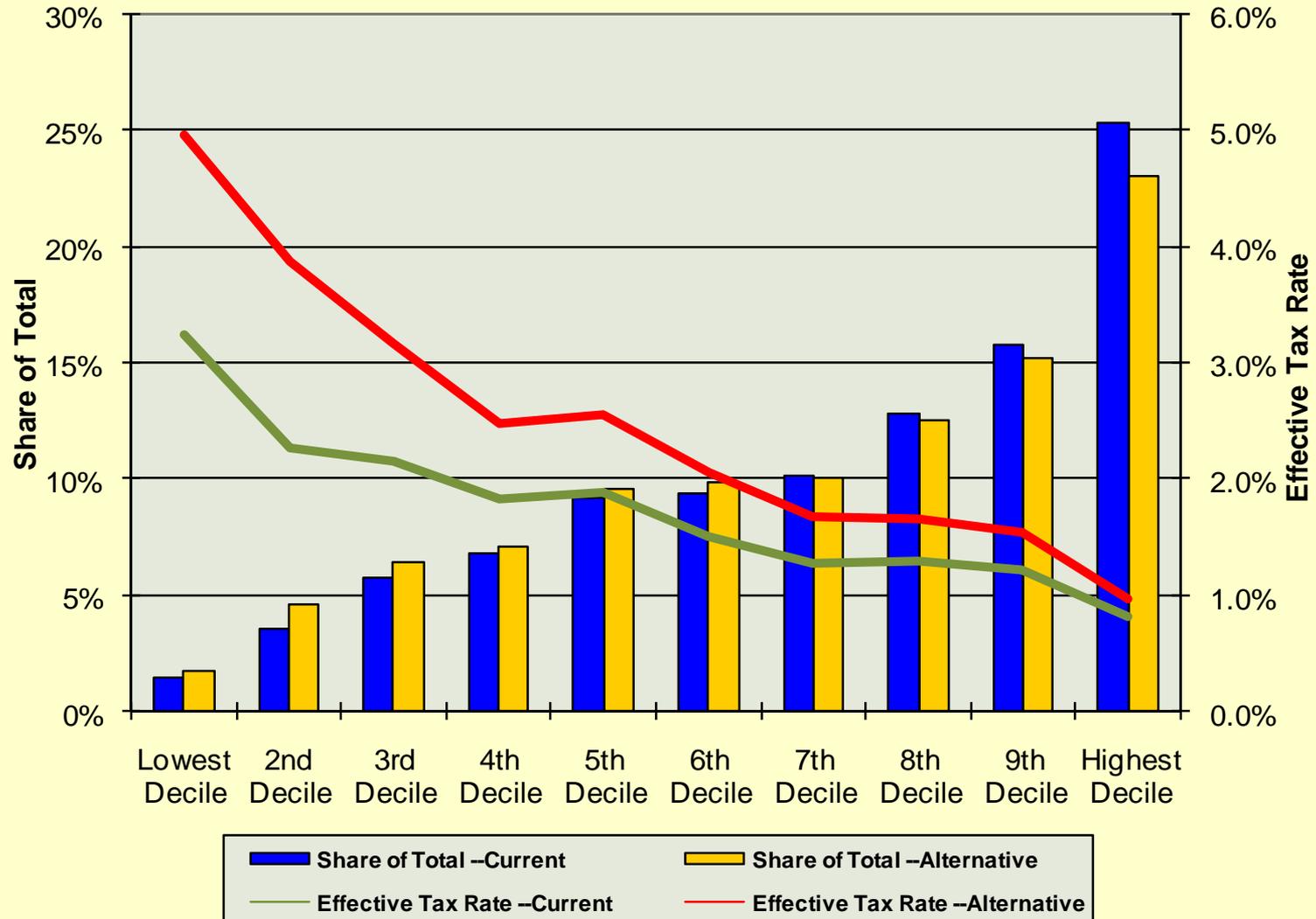
- ❑ Current tax is levied on most tangible personal property**
- ❑ Alternative 1 would extend the tax to all tangible personal property**
- ❑ 90 percent of the additional liability would result from food and medication**
- ❑ Impact would be revenues of about \$5.2 billion or a rate reduction of approximately 0.8%**



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

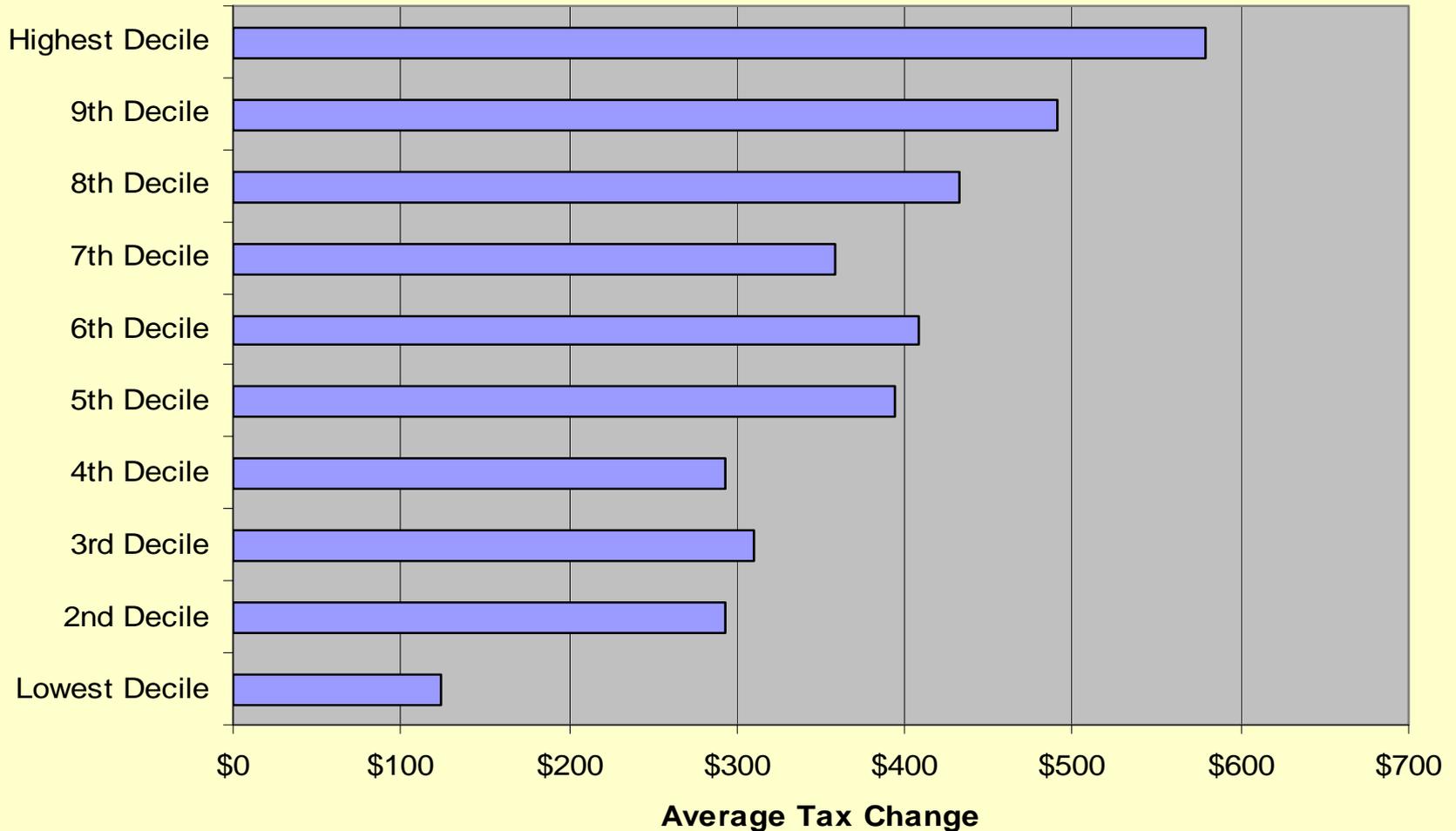
# Sales and Use Tax-Alternative 1

## Extend Tax to All Tangible Personal Property



# Sales and Use Tax-Alternative 1

## Extend Tax to All Tangible Personal Property





# **Sales and Use Tax-Alternative 2**

## **Extend Tax to Limited Selection of Services**

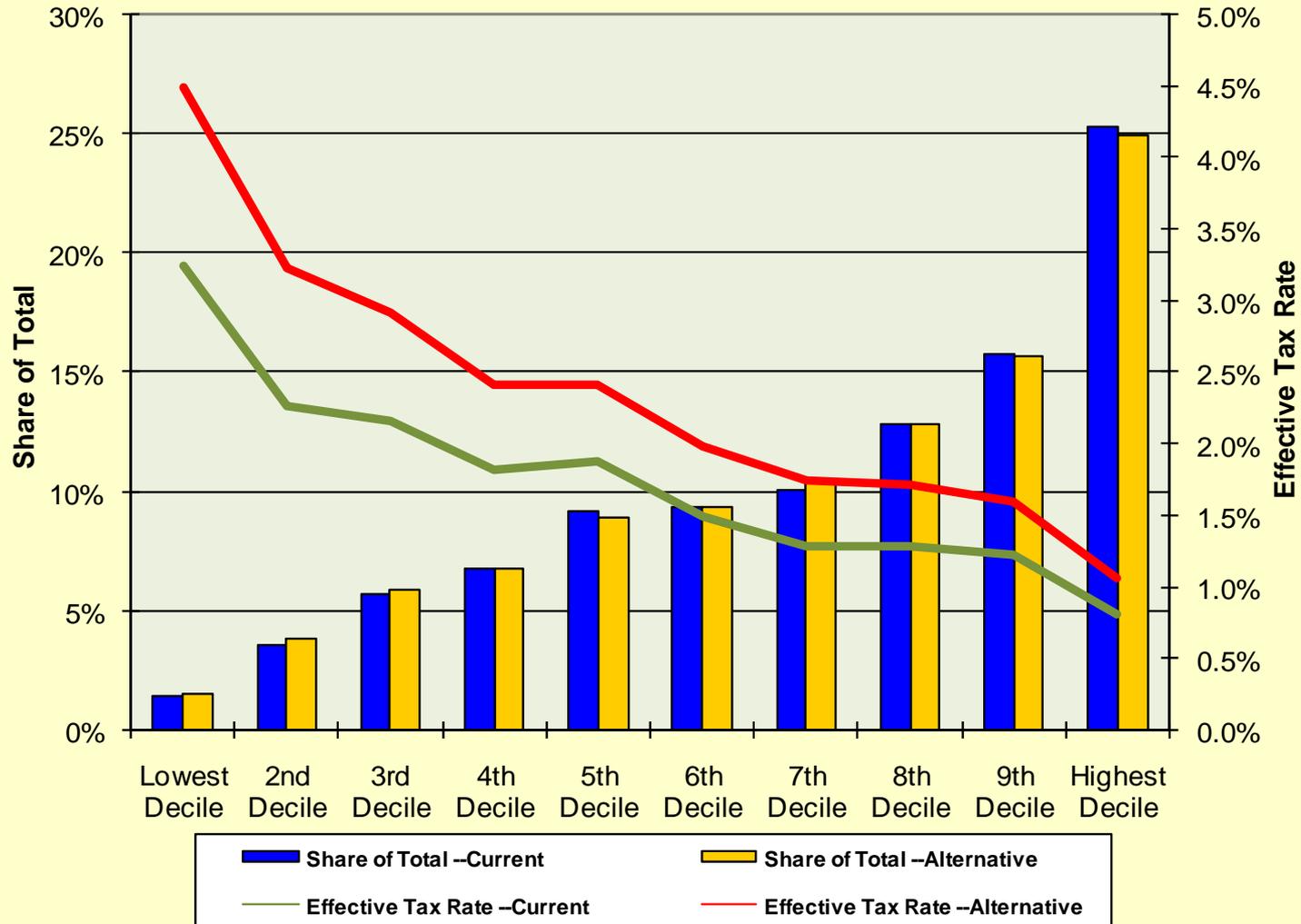
- ❑ Alternative 2 would extend the tax to selected personal services**
- ❑ Taxed services include automobile and other repair, amusements and admissions, personal services**
- ❑ Taxed services would also include lodging, energy, telecommunication currently subject to special or local taxes**
- ❑ Impact would be revenues of about \$6.2 billion or a rate reduction of approximately 1.0%**



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

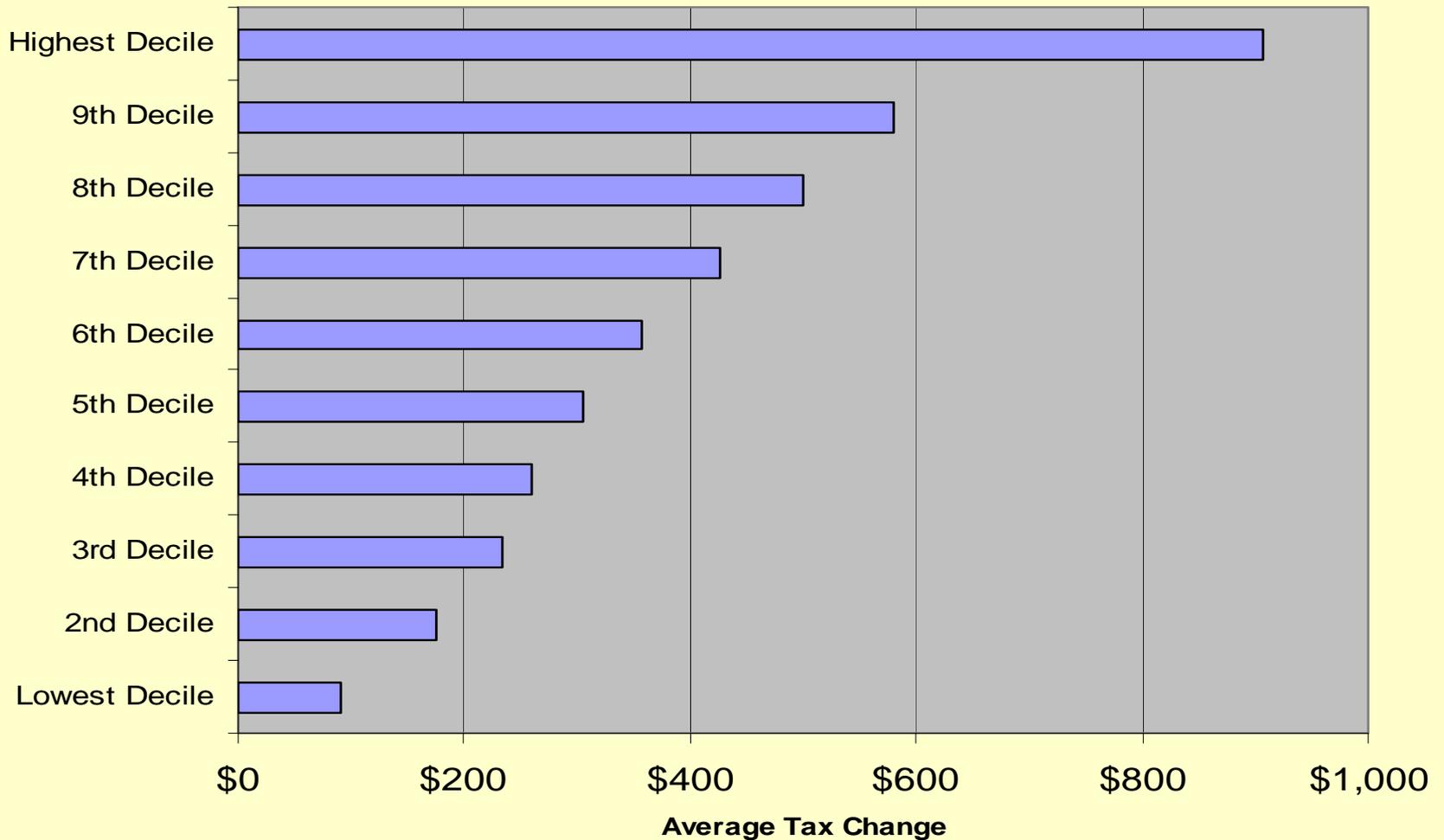
# Sales and Use Tax-Alternative 2

## Extend Tax to Limited Selection of Services



# Sales and Use Tax-Alternative 2

## Extend Tax to Limited Selection of Services





# **Sales and Use Tax-Alternative 3**

## **Extend Tax to Expanded Array of Services**

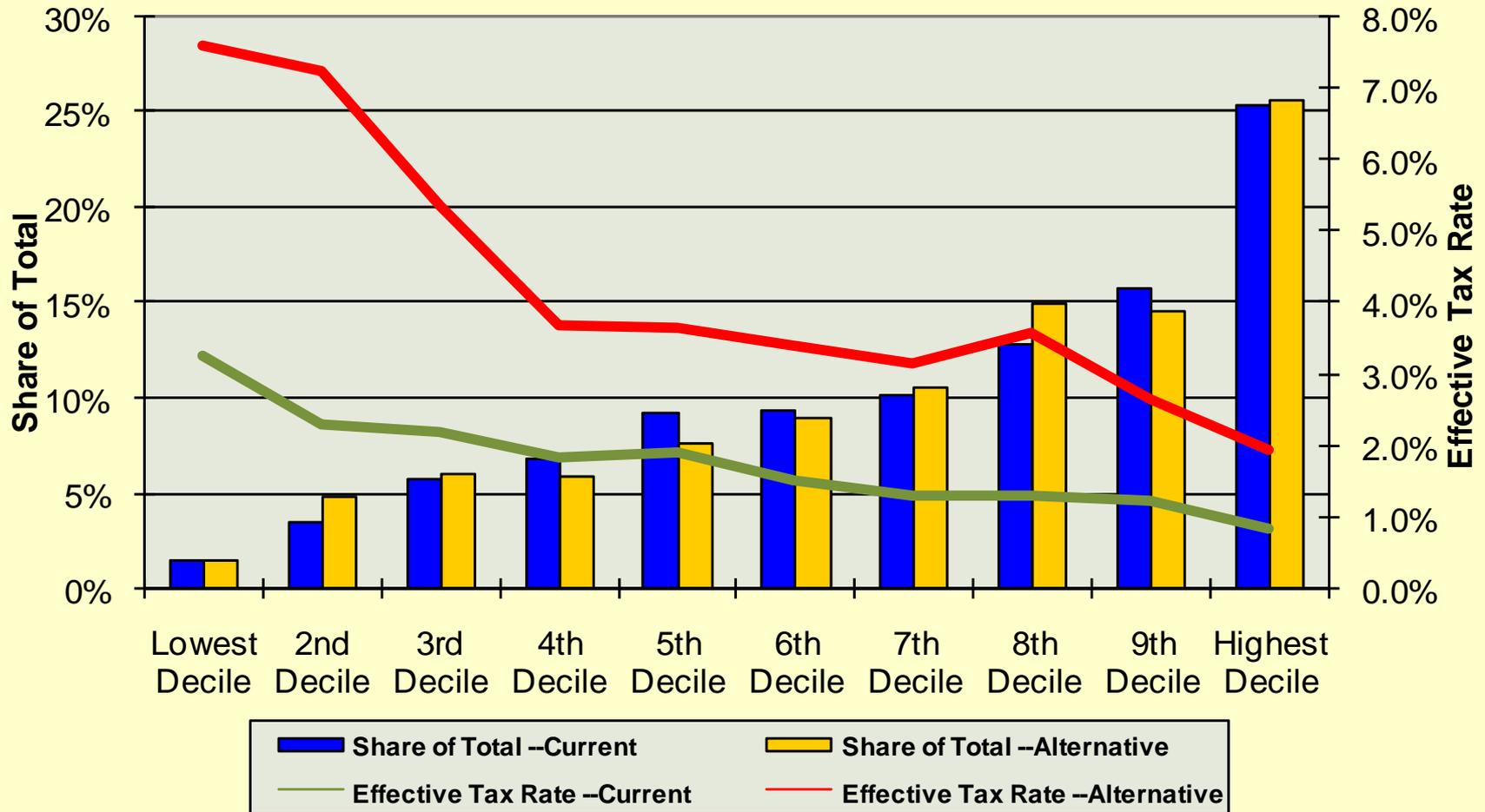
- ❑ Alternative 3 would extend the tax to selected personal services and extended services**
- ❑ In addition to services taxed under Alternative 2, taxed activities would include legal and financial services**
- ❑ Taxed services also include health care and education, as well as services currently subject to special or local taxes**
- ❑ Impact would be revenues of about \$21 billion or a rate reduction of approximately 2.3%**



**Commission on the  
21<sup>ST</sup> Century Economy**

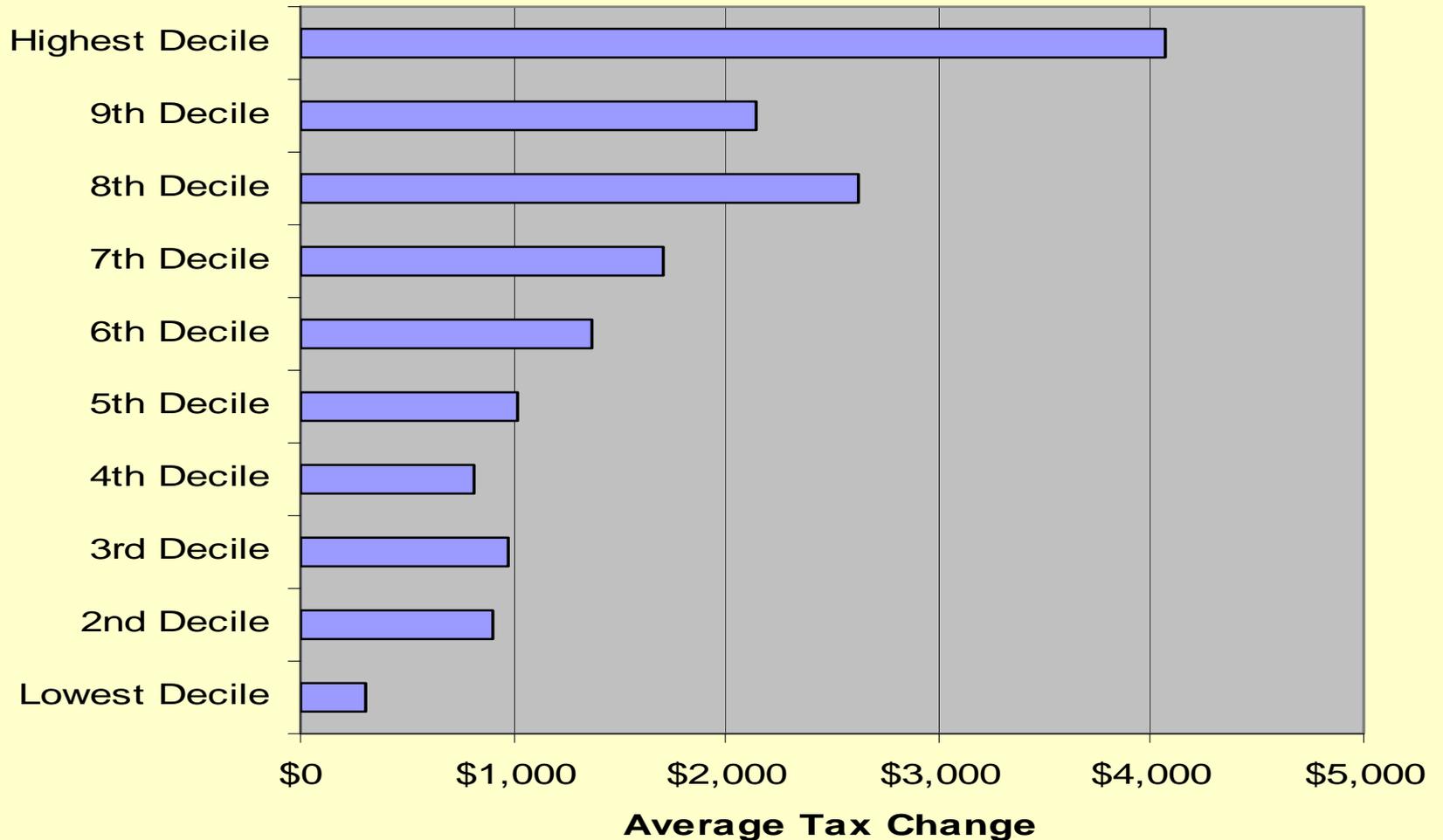
# Sales and Use Tax-Alternative 3

## Extend Tax to Expanded Array of Services



# Sales and Use Tax-Alternative 3

## Extend Tax to Expanded Array of Services



# **Sales and Use Tax-Alternative 4**

## **Exempt Business Intermediate Purchases**

- ❑ Current sales and use tax results in taxing business intermediate inputs**
- ❑ Treatment results in multiple taxation if business final output is also taxed**
- ❑ Alternative would exempt the taxation of intermediate purchases except for construction**
- ❑ Alternative would result in a revenue reduction of approximately \$900 million annually**



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

# **Sales and Use Tax-Alternative 5**

## **Exempt Business Investment Purchases**

- Current sales and use tax taxes business investment purchases such as machinery**
- Treatment results in multiple taxation if business final output is also taxed**
- Alternative would exempt from the tax the purchase of investment goods**
- Alternative 5 would result in a revenue reduction of approximately \$4.8 billion annually**
- Option of a partial exemption or conversion of the investment good exemption to an investment credit**



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

# **Sales and Use Tax-Alternative 6**

## **Combine Tax Extensions and Exemptions**

- The alternative would extend the sales tax to a limited selection of services**
- It would also exempt from the tax business intermediate and investment purchases**
- Distribution of the alternative would be the same as Alternative 2**
- Would result in an increase in tax liabilities of around \$500 million**
- Impacts could be altered as in Alternative 5 to reduce the impact of the exempt for business purchases**

