

Commission on the 21st Century Economy

December 1, 2009



Introduction to the Commission on the 21st Century Economy (COTCE)

- 14 member commission established via Executive Order by Governor Schwarzenegger and tasked with “establishing a 21st century tax structure that fits the state’s 21st century economy”
- Primary goals:
 - stabilized revenues
 - interstate competitiveness for jobs and investment
 - promotion of long-term growth
 - efficiency, fair and equitable tax burden
 - ease of compliance

California's Current Tax System

- California's current tax system consists of three main sources of revenue for the state General Fund:
 - personal income tax (PIT)
 - sales and use tax (SUT)
 - corporate tax (CT)
- These three sources consistently constitute 90%-95% of General Fund Revenue

General Fund Revenue 2009-2010

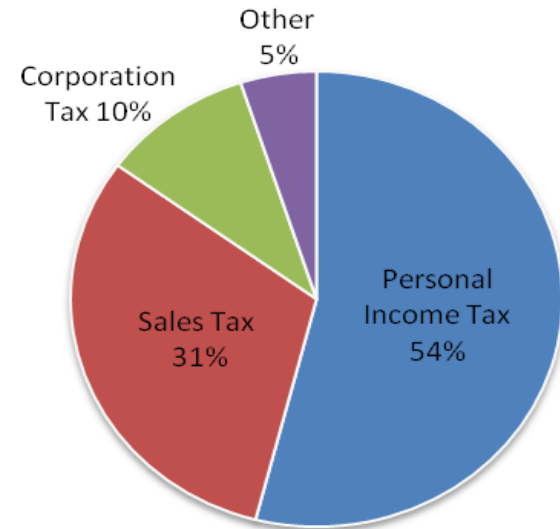


Figure 1: Sources of General Fund revenue for fiscal year 2009-2010

Source: Commission on the 21st Century Economy final report, September 2009

Commission's Case for Reform

- The Commission's final report identifies four key reasons to reform California's tax system:
 - Narrow Tax Base
 - Volatility in General Fund Revenues
 - California is uncompetitive with other states for new investment and job creation
 - Unnecessarily complicated

California Has a Narrow Tax Base

- Historically California was heavily reliant upon the SUT as a primary source of revenue.
- Over the past 70 years economic activity in California has shifted from production of tangible goods to service industries. This has narrowed California's tax base.

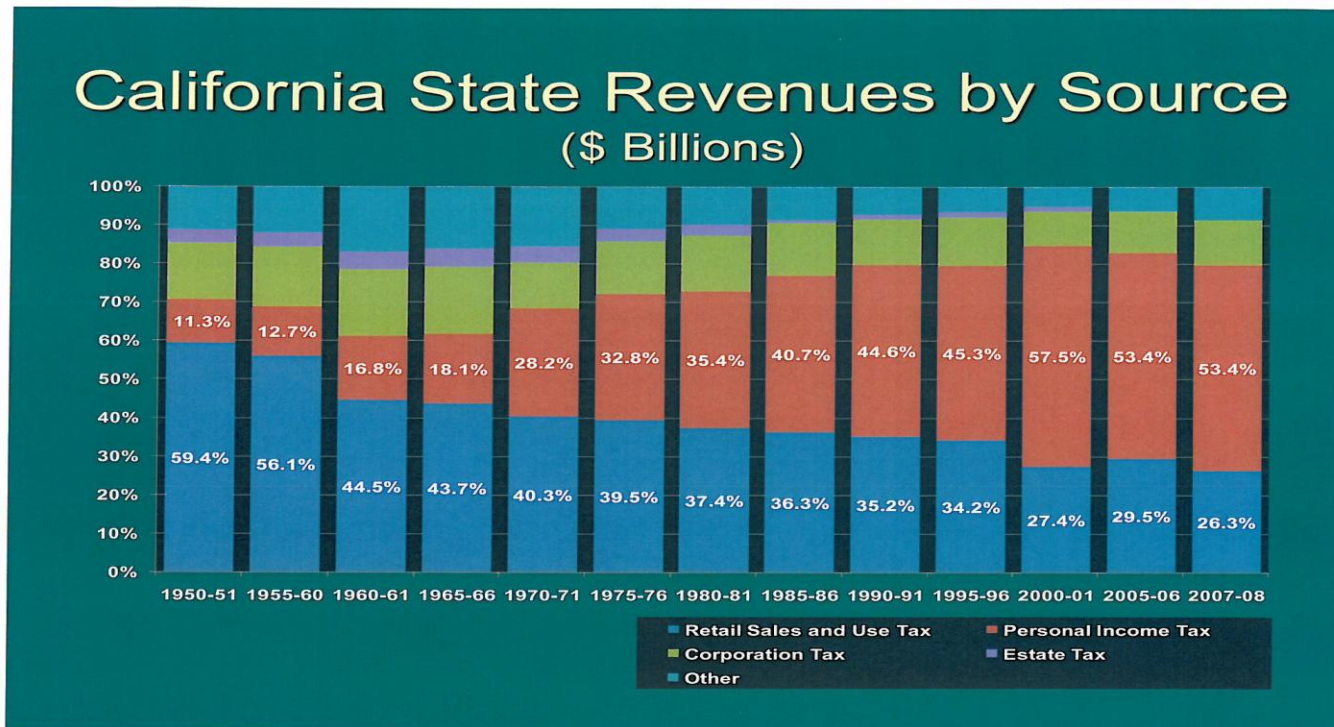


Figure 2: Sources of General Fund revenue for FY 1951-FY 2008

Source: Commission on the 21st Century Economy final report

California Has a Narrow Tax Base

- California's current SUT system only taxes the sale or transfer of tangible personal property.
- Largest sector of California's economy is comprised of provision of services and intangible goods.
- Roughly 30% of California's economic activity accounts for 100% of SUT revenues.

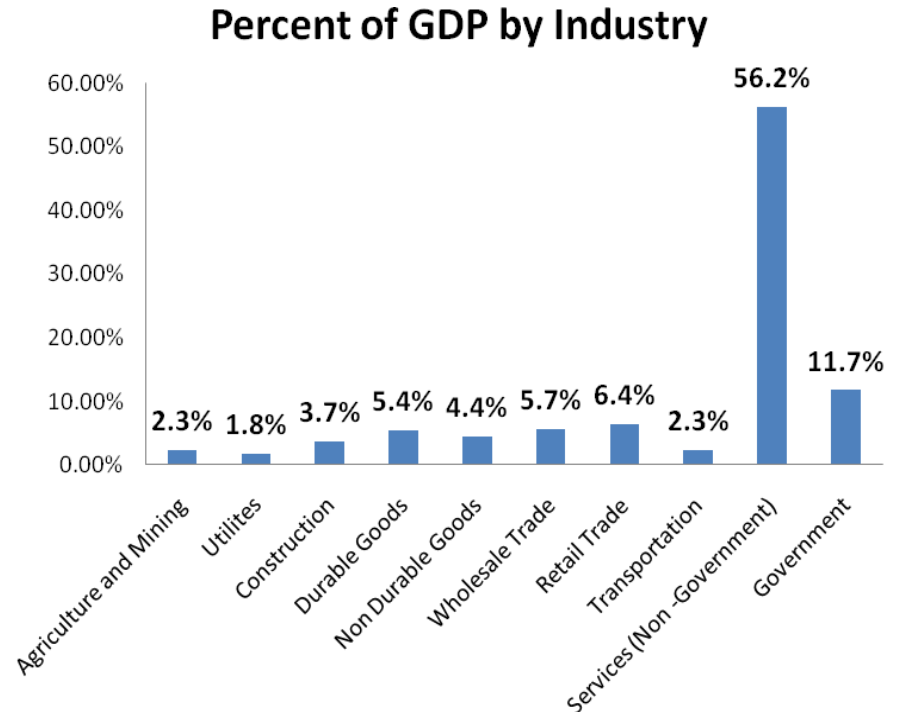


Figure 4: Percent of California GDP by industry, 2008

Source: Bureau of Economic Analysis, Annual GDP Reports

California Has Revenue Volatility

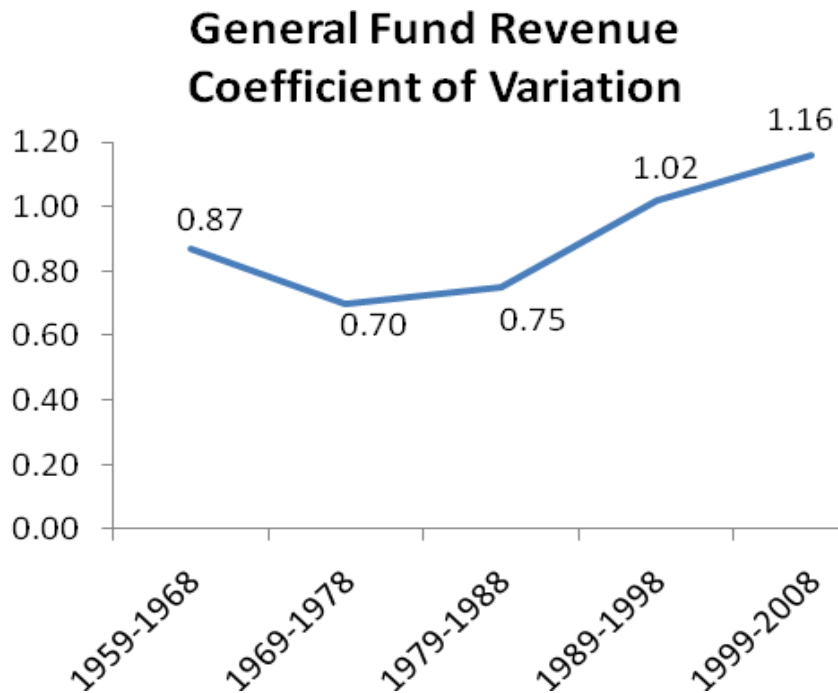


Figure 4: Variation in General Fund Revenues

Source: Commission on the 21st Century Economy final report,
September 2009

- California's coefficient of variation for General Fund tax revenue has been increasing for every ten year period since 1969. The Commission sites California's narrow SUT tax base and the PIT's heavy reliance upon high income earners as sources of volatility.

California Faces Interstate Competition

- California's SUT and PIT rates are among the highest in the country and well above the national average.

Highest SUT rates by state

<u>State</u>	<u>SUT rate</u>
California	8.25%
Indiana, Mississippi, New Jersey, Rhode Island, Tennessee	7.00%
Minnesota	6.875%
Nevada	6.85%
Washington	6.5%

SUT rates are as of July 2009, Source: www.taxfoundation.org



The Tax System is Complicated

- California's PIT system currently has 74 separate classifications of tax expenditures.
- These expenditures manipulate personal income figures in a way that can make it very difficult for the average citizen to determine which tax rate they will be subject to.

Commission's Proposed Reforms

- The Commission's package of reform includes 6 key elements:
 - Restructure the PIT
 - Eliminate the Corporate Tax
 - Eliminate the SUT
 - Establish a Business Net Receipts Tax (BNRT)
 - Create an independent tax dispute forum
 - Establish a new Rainy Day Reserve fund
- The proposal imposes tax revenue neutrality and aims to maintain current level of progressivity in the tax system.

Reform 1: Restructure PIT

- Decrease California's reliance on the PIT for tax revenue.
 - Reduce the number of tax brackets from 6 to 2. The first tax rate of 2.75% would apply to taxable income up to \$56,000 for joint filers (\$28,000 for single filers), and the second tax rate of 6.5% would apply to taxable income above \$56,000 for joint filers (\$28,000 for single filers).
 - Eliminate all itemized deductions with the exception of mortgage interest, property taxes, and charitable contributions.
 - Eliminate all income tax credits
- The Commission estimates that under the proposal PIT paid across all levels of income would decrease by an average of 29%.

Reform 2: Eliminate the Corporate Tax

- The Commission proposes to completely eliminate the Corporate Tax (currently 8.84%) as well as the \$800 minimum franchise tax paid by those Corporations who do not report positive net income.

Reform 3: Eliminate the SUT

- The proposal suggests that California should eliminate the state General Fund portion of the SUT (5%), while maintaining the temporary 1% increase as well as the state portion of the SUT on gas and diesel fuel.

Reform 4: Establish a BNRT

- Reduction in the PIT, Corporate Tax, and SUT would be offset by the introduction of a Business Net Receipts Tax. The tax would apply to all entities conducting business within California.
- Business net receipts are defined as gross receipts (income from all sources of business activity) minus gross purchases (all purchases made from other firms).
- Gross purchases and total costs are not analogous, as gross purchases do not include compensation paid to employees.

Reform 4: Establish a BNRT

- Calculation of the BNRT would be as follows:

$$\text{(Gross Receipts – Gross Purchases) * BNRT rate} = \text{BNRT liability}$$

- The Commission recommends a BNRT rate of 4% be implemented to fully recover lost revenues due to changes in other major forms of taxation.

Reform 5: Independent Tax Forum

- Currently, the Board of Equalization (BOE) is in charge of both collecting taxes and resolving disputes regarding the collection of taxes.
- The Commission suggests establishing an independent tax court with the purpose of hearing all tax disputes previously handled by the BOE.
- The tax court would be established according to guidelines set forth in the American Bar Association's "Model State Tax Tribunal Act", in which the independent agency is comprised of judges with expertise in tax law.

Reform 6: Rainy Day Reserve Fund

- The Commission proposes to increase the legislative target of 5% to 12.5%.
- The Commission suggests creating more stringent conditions for withdrawing funds from the reserve.

Policy Implications of Reforms

- Positive Results:
 - Broadens current tax base
 - Alleviates tax revenue volatility
 - Reduces complication of the PIT system
 - Establishes a more just tax appellate system
- Negative Results:
 - Potentially discourages job creation/promotes outsourcing
 - Shifts overall tax incidence to lower income residents
 - Introduces a new and untested tax system (BNRT) that will be more intensive to implement than current system

Reforms Could Broaden Tax Base

- Although the SUT and Corporate Tax explicitly exclude certain types of businesses from being subject to taxation on their operations, the BNRT by definition is applicable to all entities doing business within California.
- The proposal will increase the share of Californians responsible for generating PIT revenues.

Reforms Could Alleviate Tax Revenue Volatility

- Two primary features of the proposal can potentially alleviate California's tax revenue volatility problem:
 - Broader tax base
 - Diversifies California's tax revenue portfolio thus potentially decreasing overall volatility
 - Rainy Day Reserve Fund
 - The California legislature is required to operate a balanced budget. The Rainy Day Reserve fund helps to alleviate this issue by providing legislatures with excess reserves to be used during periods in which revenues are low.

Reforms Could Reduce Complication in PIT

- The restructured PIT system is less complicated for two reasons:
 - Fewer income tax deductions and no income tax credits make it easier to calculate adjusted gross income
 - Reduces the number of tax brackets from 6 to 2

Reforms Could Improve Tax Appeal Process

- The proposal would establish a system under which appeals of tax liability are heard by a third party agency as opposed to the agency responsible for tax collection. This serves to remove any potential conflict of interest that may arise in the current system.

Reforms Could Discourage Job Creation

- Under the proposed system businesses would not be allowed to subtract employee costs from gross receipts in the calculation of tax liability, but would be allowed to subtract payments made to outsourced or independently contracted workers.
- This provides incentive for businesses to replace employees with independently contracted workers who do not necessarily live in California.

Reforms Would Shift Tax Incidence

- Despite the Commission's stated intent to maintain the level of progressivity inherent in California's current tax system, they fail to meet this goal in two ways:
 - Restructured PIT shifts greater tax burden onto lower income residents
 - Establishment of the BNRT increases the overall regressivity of the tax system

Current & Proposed Tax Incidence of PIT

Income Tax Incidence

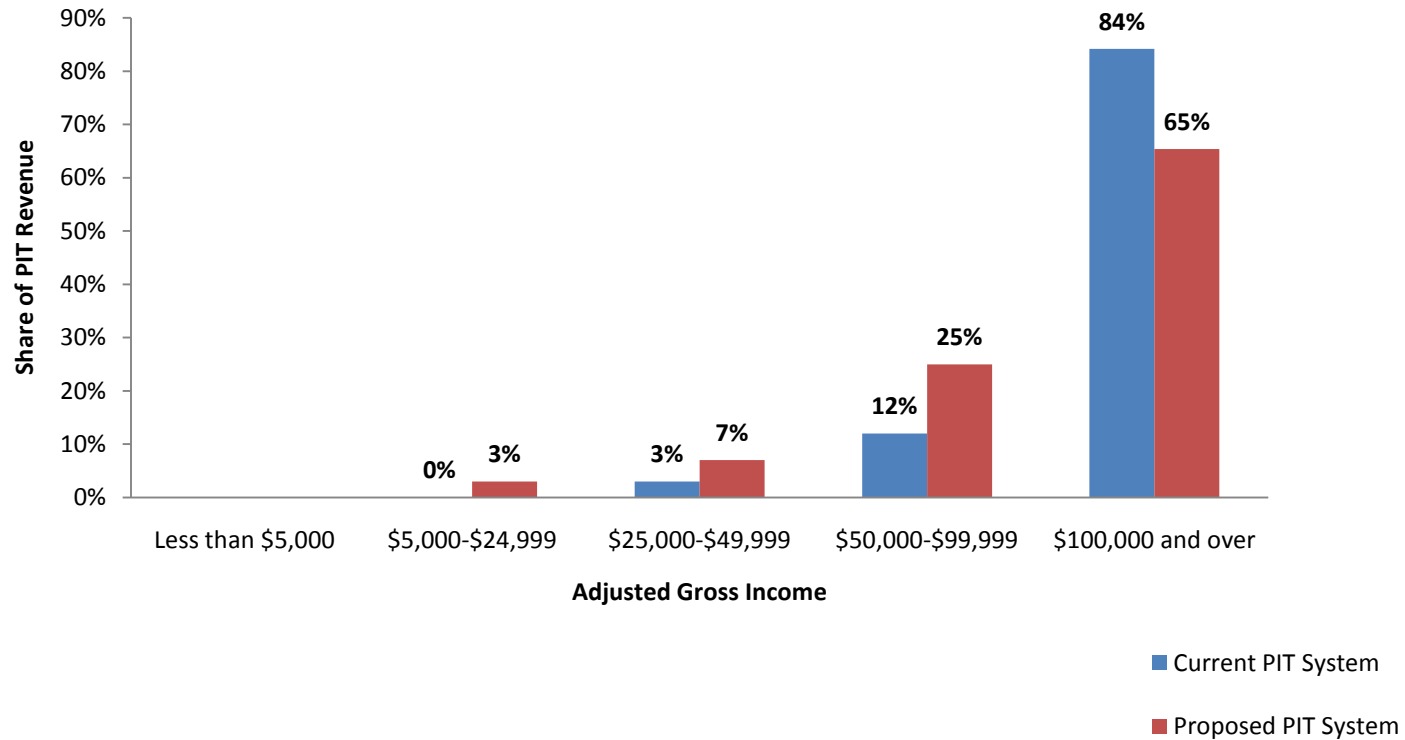


Figure 6: Compares Income Tax Incidence for current and proposed systems based on 2006 AGI figures

Tax Incidence of BNRT vs SUT

- A large portion of taxes on production and sale of goods and services are eventually passed on to consumers in the form of higher prices.
- The proportion of an individual's income spent on consumer goods decreases as income increases. Thus an increase in the price of a consumer good has a greater impact on lower income residents.
- For this reason, taxes such as the SUT and BNRT are typically recognized as regressive taxes.
- The SUT currently accounts for 26.4% of California's overall tax revenue. The proposed BNRT would account for a much greater percentage as it must account for lost revenues from restructuring of the PIT.
- Therefore, the proportion of California's overall tax revenue dependent upon a regressive tax would increase.

BNRT Reforms Face Complications

- Has never been implemented in large scale in any economy in the United States. Estimates of revenue generation are largely based upon theoretical models that cannot be tested empirically.
- Implementation will require a costly transition in accounting and finance practices for business and establishment of new regulatory agencies to ensure compliance.