Perspectives on the State’s Revenue Structure

Legislative Analyst’s Office

Presented to:
Commission on the 21st Century Economy
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What Criteria Do You Use to Judge a Tax System?

- Reliability (Growth and Stability)
- Broad-Based Levies
- Impact on Economic Activity
- Equity Considerations
- Administrative Feasibility
How Our Tax System Stacks Up—The Positive

- “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

- 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

- **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

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Personal income tax</td>
<td>1.09%</td>
<td>6.24%</td>
</tr>
<tr>
<td>Sales and use tax</td>
<td>1.33</td>
<td>1.44</td>
</tr>
<tr>
<td>Corporation tax</td>
<td>2.57</td>
<td>3.33</td>
</tr>
<tr>
<td><strong>Totals, All Revenues</strong></td>
<td><strong>1.39%</strong></td>
<td><strong>3.51%</strong></td>
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</table>
Volatility—Impact on the State Budget

- 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

- 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

- 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
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*

- Tax Gap
- Tax Expenditures
- Income Taxes Collected
Base Broadening—High Marginal Rates

- **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

- **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

- 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)

<table>
<thead>
<tr>
<th>Program</th>
<th>Type of Provision</th>
<th>Revenue Reduction</th>
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<tbody>
<tr>
<td>Mortgage Interest Expenses</td>
<td>Deduction</td>
<td>$4,885</td>
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<tr>
<td>Employer Contributions to Pension Plans</td>
<td>Exclusion/Exemption</td>
<td>4,450</td>
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<tr>
<td>Employer Contributions to Accident and Health Plans</td>
<td>Exclusion/Exemption</td>
<td>3,975</td>
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<tr>
<td>Basis Step-Up on Inherited Property</td>
<td>Exclusion/Exemption</td>
<td>3,030</td>
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<tr>
<td>Capital Gains on the Sale of a Principal Residence</td>
<td>Exclusion/Exemption</td>
<td>1,770</td>
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<tr>
<td>Dependent Exemption</td>
<td>Credit</td>
<td>1,650</td>
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<tr>
<td>Charitable Contributions</td>
<td>Deduction</td>
<td>1,600</td>
</tr>
<tr>
<td>Real Property Tax Deduction</td>
<td>Deduction</td>
<td>1,315</td>
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Addressing Base Broadening—
A More Radical Approach

- **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

- 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