Revenue Options for the 1990-91 Budget

Prepared for the
Senate Budget and Fiscal Review Committee

Legislative Analyst's Office
June 6, 1990

INTRODUCTION

This document provides a review of 14 revenue options that could be put into effect for the 1990-91 fiscal year. It was prepared at the request of the Senate Budget and Fiscal Review Committee, in order to assist the Committee's review of its fiscal choices for the 1990-91 Budget.

The state's budget outlook has recently worsened, threatening a budget deficit for the 1989-90 fiscal year and dramatic expenditure reductions for 1990-91. Information recently released by the administration indicates that 1990-91 expenditures will have to be reduced by $2.0 billion, in order to balance the budget and provide a $1.3 billion reserve. This figure increases to $2.7 billion if the Governor's proposed legislation to relax statutory spending requirements is not approved. In this context, the resolution of the budget problem requires that the Legislature take action to reexamine its priorities both for expenditures and for revenues.

This document begins with an examination of California's tax burden, including comparisons with other states and over time. It provides some explanation of the reasons for changes in tax burdens and discusses the implications of these data. Next, we identify a number of practical issues the Legislature should consider as it evaluates its options for increasing revenues. The revenue options are then individually presented, along with some discussion of their fiscal and economic implications.

The Committee requested that the following criteria be utilized in selecting the revenue options:

- The options must, in the aggregate, raise at least $1 billion and these funds must be available for budgeting purposes in the 1990-91 fiscal year. On

this basis, no options were selected which require voter approval or phase-in periods, or which have relatively low dollar yield.

- The options should reflect a variety of approaches to raising revenue, including changes in effective tax rates, modification of tax expenditure programs, revisions in accounting practices, and the adoption of changes to increase the conformity of state income taxes to federal income taxes.
- The options should be consistent with the state's existing tax structure, so that no new types of taxes were considered.

Using these criteria, 14 different revenue options were selected for presentation. The Legislative Analyst's Office is not recommending the adoption of any of these options per se, but merely offering them for consideration by the Legislature.

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AN EXAMINATION OF CALIFORNIA'S TAX BURDEN

California's tax burden is best discussed by considering the following four basic questions:

- How much and what types of taxes do Californians pay?
- How do California's tax levels compare to those of other states?
- What has been the trend in California's taxes over time?
- What are the economic effects of California's relative tax burden?

THE AMOUNT AND TYPES OF CALIFORNIA TAXES PAID

How much taxes are paid? During 1988-89, the most recent fully completed fiscal year, California's state and local governments collected about $60 billion in taxes. State taxes accounted for about $41 billion, or roughly two-thirds, of this total. The remaining one-third represented local taxes. These California taxes amounted to approximately $2,100 per capita and were equivalent to about 11 percent of California's statewide personal income.

What types of taxes are levied? California's 1988-89 combined state and local tax burden included $16.9 billion of sales and use taxes, $15.9 billion of personal income taxes, $13.3 billion of property taxes, $5.1 billion of corporate profits taxes, and $4.5 billion of motor vehicle fees and fuel taxes. Together, these taxes accounted for over 90 percent of all state and local tax revenues. Various other levies such as the gross premiums insurance tax, death-related taxes, tobacco and alcoholic beverage taxes, parimutuel horseracing taxes and municipal utility and business taxes accounted for the remainder of California's tax burden.

How is California's tax burden distributed? Most economists believe that state-local tax systems, taken together, generally are somewhat regressive. However, because of California's strong reliance on the personal income tax, which is relatively progressive, and because of uncertainties over the incidence (that is, who ultimately pays the tax) of the corporate income tax and the property tax, it is unclear the extent to which this conclusion applies in California. Figure 1

illustrates the progressive nature of California's personal income tax, as it shows that the percent of income paid as personal income tax rises significantly with income.

Figure 1
Percent of Income
Paid As State Income Tax
1988 Tax Year[a]

Adjusted Gross Income (AGI) ($ in thousands)	Income Tax As a Percent of AGI	
	Single Returns	Joint Returns
Under 10	0.3%	1.2%[b]
10-20	1.5	0.3
20-30	3.1	0.8
30-40	4.3	1.5
40-50	5.0	2.1
50-100	5.9	3.6
100-500	7.3	6.3
Over 500	8.4	8.2

a. Based upon preliminary 1988 California personal income tax return data.
b. Includes significant amounts of alternative minimum tax liabilities.

HOW CALIFORNIA'S TAX BURDEN COMPARES TO OTHER STATES

The most recent fiscal year for which comprehensive government data have been published on the taxes paid in different states is 1987-88. These data indicate the following:

- ***California's total tax burden was roughly in line with the relative size of its economy and population.*** California's taxes were about 12.7 percent of the total for all states. This compared to California's 13.1 percent share of personal income and 11.7 percent share of population.

- ***On a per capita basis, California's total taxes were somewhat above the national average.*** Taxes per capita in California were $1,948. By comparison, per capita state and local taxes for the nation as a whole were $1,772. *These data, however, do not adjust for such factors as California's higher average income levels, and thus tend to* ***overstate*** *its true relative tax burden from an economic perspective.*
- ***In terms of taxes per $1,000 of personal income, California's relative tax burden is somewhat less than the national average.*** Using this yardstick, which we believe is the best single broad measure to use in making interstate tax level comparisons, California's taxes were about $112. By comparison, state and local taxes for the nation as a whole averaged nearly $116 per $1,000 of personal income.

The Bottom Line -- Tax Burden Is Moderate. Given the above findings, California's overall tax level does not appear to be particularly high or low relative to other states. In terms of the yardstick of taxes per $1,000 of personal income, California ranks 25th. It also is important to recognize that the dollar differences between California and some of the other states ranked lower in terms of overall tax burden is not all that great. For instance, California would drop 10 places in the rankings, from 25th to 35th, with less than a $4 decline in this measure of tax burden. And, although its per capita taxes are above the national average, they are less than in such other major industrial states as New York, Massachusetts, New Jersey and Maryland. ***Thus, it would appear that the current level of taxes in California compared to the levels in other states can best be described as "relatively moderate."***

This characterization is supported by past studies of state tax burdens conducted by the Advisory Commission on Intergovernmental Relations (ACIR). The ACIR's approach has been to develop measures of the "tax capacity" in different states, and then compare this to their actual "tax effort." The findings indicate that California ranks fairly high in terms of tax capacity due to its broad diversified economy and above-average income levels, but is about average in

terms of its actual tax effort. Again, this is consistent with the view that California's tax burden is "middle-of-the-road."

CHANGES IN CALIFORNIA'S TAX BURDEN OVER TIME

We have reviewed the historical trend in state and local tax burdens over the past 10 years, both for California and the nation. We focused on two alternative measures of tax burden to illustrate these trends -- taxes per $1,000 of personal income, and "real" (that is, inflation adjusted) taxes per capita. These data indicate that:

- California's state and local tax burden per $1,000 of personal income is below where it stood 10 years ago; and
- California's inflation-adjusted state and local per capita tax burden has increased by about 8 percent over this total period, which translates into an average annual increase of approximately one percent.

Given the above, ***California has not experienced any significant change in its tax burden over the last ten years.*** It also should be noted that California's tax burden has been lower during the 1980s than it was during the 1970s, due to factors such as Proposition 13 and income tax indexing.

THE ECONOMIC EFFECTS OF CALIFORNIA'S RELATIVE TAX BURDEN

Although the tax burden data presented above provide a useful picture of the *level* of taxation in California, both in dollar terms and relative to other states, these data do *not* provide a complete picture of the social and economic well-being of a state's residents and its economy. ***The main reason for this is that tax burden rankings by themselves do not consider the quantity and quality of the public services which are paid for by taxes.*** This has several implications.

First, it is possible that taxpayers in a state which ranks very high in terms of taxes collected could be much better off than taxpayers in other states, if their tax payments provide high-quality public services like roads, schools, and water and sanitation facilities which they value very highly. Thus, what is most important

from an economic and social perspective is not so much the level of taxes per se, but rather that a state's citizens receive whatever amount of public services they desire and are willing to pay for, and that these services be provided as efficiently as possible.

Second, it is impossible to draw any reliable conclusions about the relationship between a state's tax burden and the performance of its economy, without considering the uses that tax monies are put to and what they accomplish. Some types of public expenditures have a greater effect on a state's economic performance than other types. It is widely acknowledged, for example, that certain public infrastructure improvements can have very positive effects on a state's business climate and overall economic performance. Examples include adequate highways and other transportation systems needed to efficiently conduct business-related activities, and good quality schools and universities capable of providing a well educated workforce. Thus, for example, the economic performance of a state that effectively meets needs such as these might be better than another state which does not, even though the first state's tax burden might be higher.

PRACTICAL ISSUES ASSOCIATED WITH ENHANCING 1990-91 REVENUES

This section provides a discussion of several practical issues that should be considered by the Legislature in evaluating revenue options for the 1990-91 Budget. Each of these issues is discussed below.

How Much Could Be Raised Without Exceeding the Appropriations Limit?

The state's appropriations limit currently is estimated to be $31.4 billion for the 1990-91 fiscal year, *without considering the effect of Proposition 111*. This figure incorporates the most recent data on population and cost-of-living changes used in calculating the annual limit adjustment factor. Based on the estimates of revenues and expenditures contained in the January Governor's Budget, the state would be $350 million below its appropriations limit for 1990-91. Thus, incorporating the administration's May estimate of a $1.1 billion revenue shortfall in the January estimates would result in the state then being almost $1.4 billion below its appropriations limit for the budget year. Therefore, state tax revenues could be increased by almost $1.4 billion under current law without exceeding the appropriations limit. The increase could potentially be more than this amount if the additional portion is used for categories of appropriations which are exempt from the limit, such as subventions to local governments.

Proposition 111 increased the appropriations limit for 1990-91 to approximately $32.2 billion, or approximately $800 million higher than under current law. As a result, state tax revenues could be raised by more than $2.1 billion, and potentially more if the additional portion is used for exempt categories of appropriations.

What Is the Potential Interaction With Proposition 98?

Proposition 98, approved by the voters in November of 1988, requires that a certain minimum level of funding be provided by the state for K-14 education purposes each year. This minimum amount of funding is equal to the *greater* of

the amounts generated under two separate formulas:

- *Test 1,* which is equivalent to approximately 41 percent of total General Fund tax revenues; or
- *Test 2,* which is the amount required to keep total state and local K-14 spending constant, after adjusting for increases in enrollment and inflation.

For the 1990-91 fiscal year, we estimate that the minimum funding guarantee is being determined on the basis of "Test 2," and will amount to approximately $17.3 billion from the General Fund. (These estimates do not reflect the administration's new approach to interpreting the requirements of Proposition 98 and are subject to revision.) Since the amount computed pursuant to "Test 1" is approximately $675 million *lower* than the Test 2 requirement for 1990-91, state revenues can be raised to some extent without resulting in an increase in the Proposition 98 funding guarantee. Specifically, revenues can be raised until the Test 1 requirement exceeds the current Test 2 requirement, which would occur if tax revenues were raised by more than about $1.6 billion. At that point, approximately 41 percent of each additional dollar raised would have to be allocated to K-14 schools, unless the Proposition 98 guarantee were to be suspended by the Legislature. These estimates do assume, however, that the Proposition 98 guarantee is suspended in 1990-91 with respect to the existing quarter-cent earthquake sales tax revenue, as it was for 1989-90. Proposition 111 has no effect on these calculations.

When Does Revenue Legislation Need To Take Effect?

The effective date of revenue legislation plays a significant role in its ability to generate revenue for the 1990-91 fiscal year. For example, sales tax legislation taking effect on January 1, 1991 would be "in effect" for only 6 months during 1990-91, resulting in significantly less revenue than if it were in effect for the full year. Traditionally, Personal Income Tax (PIT) and Bank and Corporation Tax (B&C) legislation has affected the entire annual accounting period (that is, income year) on which the annual tax liability is based, although changes often are applied

with regard to transactions occuring before or after a certain "cut-off" date. A "doubling-up" of tax payments also may occur in the initial fiscal year of an income tax change, thereby producing an especially large first-year revenue gain. This is because the revenue the state receives in the first fiscal year includes both tax liabilities attributable to all of the first calendar year and tax prepayments for the first six months of the succeeding calendar year. As a result, PIT and B&C tax changes which are effective for the 1990 income year will generate considerably more revenue for the 1990-91 fiscal year than changes which do not become effective until the 1991 income year. Making tax changes effective for the 1990 tax year would result in the tax changes having a retroactive impact; in some cases this could result in hardship to taxpayers who made commitments with the expectation that tax laws for the 1990 year would not be changed.

What Impact Will Revenue Changes Have on Tax Burden Distribution?

The individual revenue options presented in this document have widely varying impacts on the distribution of the state's tax burden. For example, the addition of new income tax brackets would generally increase the progressivity of the distribution, while the extension of the quarter-cent sales tax would tend to reduce progressivity. These options also have implications for the proportion of the overall tax burden imposed on corporate as opposed to individual taxpayers.

What Is the Impact of Reduced Federal Tax Law Conformity?

The state has adopted a policy of conforming to federal tax law changes whenever it is in the best overall interests of the state to do so. This policy of *selective conformity* was adopted to ensure that the benefits of conforming state tax law to federal law, such as simplified filing of tax returns, could be obtained while also ensuring that the state did not give up its control over tax policy to the federal government. For example, California has chosen to differ in a number of areas from the federal rules, such as the taxation of unemployment and social security benefits, for policy reasons. Thus, in considering revenue options which

would reduce the extent of state conformity with federal tax laws, the Legislature must evaluate whether the loss of simplicity is justified by the policy and/or revenue gains.

REVENUE OPTIONS

	1990-91 Revenue Effect (dollars in millions)
1. Add New Top Personal Income Tax Bracket	$1,000
2. Suspend Income Tax Indexing For One Year	1,000
3. Limit Mortgage Interest Deductions	560
4. Eliminate Capital Gains Exclusion for Inherited Property	200
5. Eliminate Remainder of Personal Interest Deduction	40
6. Adopt Federal Conformity Changes	177
7. Accelerate World-Wide Corporations' Tax Payments	90
8. Accelerate Sales Tax Payments	210
9. Extend Quarter-Cent Sales Tax	325
10. Eliminate Sales Tax Exemption for Candy	65
11. Increase Alcoholic Beverage Taxes	155
12. Change Tax Revenue Recognition Policy	1,000
13. Increase Higher Education Resident Student Fees	22
14. Increase Higher Education Nonresident Student Fees	11

ADDITION OF NEW TOP PERSONAL INCOME TAX BRACKET

Description

Enact legislation adding a new top personal income tax bracket.

Background

California's Personal Income Tax Law provides for six different income tax brackets with associated income tax rates ranging from 1 percent to 9.3 percent of taxable income. These rates were adopted by the Legislature in 1987 in conjunction with its actions to conform to the Federal Tax Reform Act of 1986. The Tax Reform Act (1) broadened the tax base by eliminating many tax exclusions and (2) reduced tax rates. Prior to 1987, the state's top tax rate was 11 percent.

Analysis

Adding a new top tax rate would increase the relative tax burden on high-income taxpayers affected by that rate. If a new top tax rate were applied to taxable income above $200,000 for joint returns ($100,000 for single returns), slightly less than 2 percent of all taxpayers would be affected. For each hundred dollars of additional state tax paid by these taxpayers, there would be a reduction of $28 in federal taxes, due to the deductibility of state income taxes from income for federal tax purposes.

Fiscal Effect

The fiscal effect of adding a new top income tax bracket would depend on the new tax rate selected and the income range to which that rate is applied. For example, SB 520 (Alquist) as introduced would have added an 11 percent rate applied to all income over $100,000 for taxpayers filing single returns and $200,000 for taxpayers filing joint returns in 1990. This change would increase General Fund revenues by approximately $1 billion in 1990-91 and $917 million in 1991-92.

SUSPENSION OF INCOME TAX INDEXING

Description

Enact legislation to effectively suspend the indexing of the personal income tax by establishing new tax brackets for the 1990 income year.

Background

Proposition 7, approved by the voters at the June 1982 primary election, requires that state income tax brackets be fully indexed to compensate for the effects of inflation. State law also provides for the full indexing of certain tax credits. This is accomplished by increasing the income tax brackets and credit amounts by the percentage change in the California Consumer Price Index (CPI) over the last year. Current estimates indicate that these income brackets and credits would be adjusted upwards by 4.9 percent under current law. The Governor's Budget initially estimated that the adjustment factor would be 4.2 percent.

Although the indexing of tax brackets is required by a voter-approved initiative, Legislative Counsel has opined that the initiative does not prohibit the Legislature from adopting new tax brackets, and these new tax brackets could be identical to the tax brackets that would be in effect if indexing were suspended.

Analysis

The suspension of indexing would increase the relative tax burden on middle-income taxpayers who have the greatest percentage of their taxable income in the middle tax brackets. For example, it would have no effect on individuals who have no taxable income. Further it would have a smaller relative effect (as a percentage of total taxes paid) on high-income taxpayers who already have most of their income taxed at the top rate. For example, a single taxpayer with net taxable income of $22,000 in 1990 would pay increased taxes of 6 percent, or $46, if indexing is suspended. In contrast, a taxpayer with net taxable

income of $150,000 would pay increased taxes of one-half of one percent, or $63, if indexing is suspended. A portion of the increased tax would be offset by reduced federal income taxes, due to the deductibility of state income taxes from income for federal income tax purposes.

Fiscal Effect

A one-year suspension of income tax indexing for the 1990 income year would increase state personal income tax revenues by approximately $1 billion in 1990-91 and $780 million in 1991-92.

LIMIT THE MORTGAGE INTEREST DEDUCTION

Description

Enact legislation limiting the ability of taxpayers to deduct mortgage interest expenses when computing their personal income tax liabilities.

Background

Existing law permits California taxpayers to claim an itemized personal income tax deduction for the amount of qualified mortgage interest they pay each year. California's provisions conform to federal law. There are four restrictions on this deduction:

- The deduction cannot be claimed on more than $1 million of indebtedness for mortgages used to purchase or improve residences;
- The deduction is allowed only for a principal residence plus either a second residence or vacation home; and
- The deduction generally can include interest only on a maximum of $100,000 of general-purpose home equity borrowing, with the actual allowance determined by factors such as the home's acquisition cost, extent of improvements and other qualified expenses.

These restrictions apply only to indebtedness incurred after October 13, 1987.

The Franchise Tax Board has estimated that the deduction reduced state tax liabilities in 1989 by $2.5 billion, making it the largest state tax expenditure program. About 30 percent of all taxpayers claimed the deduction in 1989, with the average deduction being about $9,800. Higher income taxpayers receive significantly higher benefits from the deduction than taxpayers at other income levels. For example, 80 percent of taxpayers with income over $100,000 claimed the deduction, with an average deduction of nearly $22,000. The average deduction was about $40,000 for claimants with incomes over $1 million.

Analysis

There are a number of different approaches which could be used to restrict the deduction. However, given that the apparent rationale for permitting the deduction in the first place is to assist homeowners acquire adequate housing, one logical alternative is to phase the deduction out altogether for high-income taxpayers that don't require a public subsidy to purchase adequate housing. Other alternatives would be to reduce the maximum dollar amount of mortgage interest that may be deducted, prohibit the deduction of interest for second and vacation homes, and eliminate the deduction for home equity loans used for nonhousing purposes.

If the deduction is smoothly phased-out beginning at an income level of $150,000 and eliminated altogether for incomes above $200,000 for joint-return taxpayers (or one-half of these amounts for single taxpayers), fewer than 5 percent of all taxpayers who currently claim mortgage interest deductions would be affected and only about 3 percent of taxpayers would be unable to deduct any interest at all. For each $100 of mortgage interest that high-income taxpayers could not deduct, they would pay up to an additional $9.30 in state income taxes. The taxpayer's total income tax (state and federal combined) would increase by only $6.25, however, because of the deductibility of state income taxes on federal tax returns. Thus, a high-income taxpayer with a new $600,000 conventional mortgage would pay up to $6,000 annually in additional state income taxes, offset by a $2,000 reduction in federal income taxes, for a total increase of $4,000 on a combined basis.

This change would lessen the conformity of state income taxes to federal income taxes, as federal law does not phase-out the benefits of this deduction.

Fiscal Effect

A phasing-out of the mortgage interest deduction over the income range $150,000 to $200,000 for taxpayers filing joint returns in 1990 (or $75,000 to $100,000 for taxpayers filing single returns) would increase state revenues by about $560 million in 1990-91 and $490 million in 1991-92.

ELIMINATE CAPITAL GAINS EXCLUSION FOR INHERITED PROPERTY

Description

Enact legislation to eliminate the exemption from capital gains taxation on the appreciation in the value of property which has occurred prior to the transfer from a decedent to an heir.

Background

Under current law, the income tax generally applies to capital gains on property transactions. Thes gains are equal to the appreciation in value between the time an asset is acquired and when it is transferred to another party. One exception to this occurs with respect to property which is held by a person at the time of his or her death and is passed on to other parties by inheritance. In this case, the asset's "tax basis," or acquisition value, is adjusted upward to equal the fair market value of the asset at the time of the decedent's death, and this value becomes the "tax basis" of the asset once it is transferred through inheritance to an heir. As a result, the capital gains on the decedent's property which accrued prior to death escape taxation permanently.

Analysis

California currently imposes two types of death taxes on property: (1) the estate tax, and (2) the generation-skipping transfer tax. Both are merely "pick-up" taxes, however, that collect money that would otherwise go to the federal government. They allow California to take maximum advantage of the federal credits that are allowed for state taxes paid, at no net cost to California taxpayers. Whatever increase they cause in state taxes is exactly offset by a corresponding decrease in federal taxes.

The most commonly cited reason for the capital gains tax exemption is that, together with the two death taxes, it would result in a form of state double taxation. This is not a valid argument, however, as neither the estate tax nor the

generation-skipping transfer tax impose any real state tax burden on California taxpayers.

The elimination of this exemption would take California law out of conformity with federal laws governing the treatment of capital gains on inherited property.

Fiscal Effect

Eliminating this exemption from capital gains taxation would result in additional General Fund revenues of approximately $200 million in 1990-91, and similar amounts thereafter. These revenues would be paid primarily by the estates of wealthy taxpayers.

ELIMINATE REMAINDER OF PERSONAL INTEREST DEDUCTION

Description

Enact legislation to eliminate the remaining 10 percent deduction for personal interest expenses.

Background

For pre-1987 tax years, personal interest was fully deductible as an itemized deduction. Beginning in 1987, the personal interest deduction is being phased out as shown in Figure 3.

Figure 3
Personal Interest Deduction
Phase-Out Schedule

Tax Year	Percentage Allowed
1987	65%
1988	40
1989	20
1990	10
1991	0

Analysis

The gradual elimination of this program arose out of a concern that it provided incentives for taxpayers to borrow to finance their consumer expenses by reducing the after-tax cost of doing so. In addition, some economists argue that the program encourages "over-consumption" or at least inflates current consumption at the expense of savings and investment. In order to allow taxpayers time to adjust to the new rules, both federal and state lawmakers adopted a policy to phase-out the deduction gradually. Eliminating the remaining 10 percent of this deduction one year early will result in only a temporary loss of conformity with federal law.

The elimination of the remaining deduction would affect those taxpayers who itemize and claim deductions for personal interest expenses.

Fiscal Effect

Elimination of the 10 percent personal interest deduction allowed in 1990 would result in additional General Fund revenues of approximately $40 million in 1990-91.

ADOPT ADDITIONAL FEDERAL CONFORMITY CHANGES

Description

Enact legislation to adopt additional provisions that would more closely conform California Personal Income Tax and Bank and Corporation Tax Law to federal tax law.

Background

Following the federal Tax Reform Act of 1986, California adopted a policy of selective conformity to federal tax law. The Legislature has considered at least one annual "conformity" bill to adopt the changes made to federal tax law in the prior year. However, legislation to conform to the 1987 and 1989 federal tax law changes has not been enacted. Legislation to adopt certain of the 1987 federal changes (AB 30, Klehs) received consideration in 1988 and 1989 but failed passage in the Assembly. Currently, there are two proposals before the Legislature to adopt certain of the changes made to federal tax law in 1989 (SB 1924, Garamendi and AB 2579, Klehs).

1987 Conformity Legislation

AB 30, Klehs (1987) proposed the following tax law changes:

- Repeal of the deduction for accrual of vacation pay;
- Repeal of the rules governing recognition of income attributable to installment sales for dealers in real property;
- Requiring the allocation of past service pension costs to cost of goods sold;
- Requiring accrual accounting for large family farms;
- Taxing publicly traded partnerships as corporations;
- Reducing the percentage of income from a long term contract which can be recognized under the "completed contract method" from 60 percent to 30 percent;
- Taxing exempt partners on partnership income from debt-financed real

estate;

- Reducing the deduction for dividends received;
- Restricting the definition of "controlling shareholders";
- Requiring the recapture of tax advantages from using a specific inventory accounting method (LIFO) upon making a "Subchapter S" election; and
- Placing limitations on capital losses.

1989 Conformity Changes

SB 1924 (Garamendi) and AB 2579 (Klehs) would adopt many of the changes made in the federal Revenue Reconciliation Act of 1989. The major provisions of these bills are:

- Requiring the recognition of a gain where appreciated property is transferred to a corporation in exchange for securities;
- Limiting the nonrecognition of gain on like-kind exchanges to similar properties or properties related in service or use held for at least one year following the exchange;
- Limiting the use of built-in losses to offset corporate income and the use of built-in gains to offset corporate losses following a change in control of a corporation;
- Restricting the exclusion for interest earned on loans to Employee Stock Ownership Plans (ESOPs) to cases in which the ESOP owns either (1) more than 50 percent of each class of stock or (2) more than 50 percent of the total value of all outstanding stock of the corporation;
- Limiting the deduction for dividends received from employer securities used to repay an acquisition loan to dividends paid on employer securities acquired with that loan;
- Restricting the amount of medical benefits which can be provided through a defined benefit pension plan;
- Modifying the method used to adjust earnings and profits to more accurately reflect economic gain and loss in computing alternative minimum

tax on corporations (AMT);

- Modifying the treatment of franchise, trademark, and trade name expenses.

Related Measures. The "Comprehensive Crime Reduction and Drug Control Act of 1990," an initiative measure that may qualify for the November 1990 General Election, would enact the 1987 federal conformity changes discussed above and use the revenues raised to fund anti-drug and law enforcement programs.

Fiscal Effect

The Franchise Tax Board (FTB) estimates that the adoption of the 1987 federal conformity provisions contained in AB 30 (Klehs) would produce revenue gains to the General Fund of approximately $100 million in 1990-91, $450 million in 1991-92, $400 million in 1992-93, $180 million in 1993-94, and $140 million in 1994-95 and annually thereafter. It should be noted, however, that these provisions have been required under federal law for the last two years, and some taxpayers may be filing their California tax returns on the basis of the calculations used for their federal returns, for convenience purposes. Thus, the state may already be receiving a portion of the conformity-related revenue gains. In addition, the FTB projections assume no behavioral changes among affected taxpayers as a result of the new rules. Accordingly, these estimates probably overstate the potential revenue gains.

With regard to the 1989 conformity provisions, the Franchise Tax Board (FTB) estimates that the adoption of these provisions would produce revenue gains to the General Fund of approximately $77.5 million in 1990-91, $74 million in 1991-92, and $85.5 million in 1992-93. As noted above, the FTB projections assume that taxpayers do not change their behavior in response to these new tax provisions. Consequently, these estimates may overstate the potential revenue gains.

ACCELERATE WORLD-WIDE CORPORATIONS' ESTIMATED TAX PAYMENTS

Description

Enact legislation requiring large world-wide corporations to make estimated income tax payments equal to at least 90 percent of their final tax liability.

Background

Under current Bank and Corporation Tax Law, corporations generally are required to make four estimated tax payments (paid in equal installments on the 15th day of the fourth, sixth, ninth, and twelfth months of the tax year) which total an amount greater than or equal to 90 percent of the tax shown on the final return. An exception to this rule provides that the 10 percent underpayment penalty does not apply if the total estimated payments equal or exceed the tax shown on the prior year's return. This exception does not apply to large world-wide corporations, however. Large world-wide corporations must make total estimated payments in an amount equal to or exceeding both (1) 100 percent of the prior year's tax, and (2) 70 percent of the current year's tax. A large, worldwide corporation is a corporation that (1) earned at least $1 million in one of the three preceding years, and (2) included income and apportionment factors of a corporation that derives all of its income from sources outside the United States in its tax return for the preceding three years.

Analysis

Requiring large, world-wide corporations to make estimated payments in an amount equal to or exceeding both (1) 100 percent of their tax in the prior year and (2) 90 percent (versus the current 70 percent) of their final tax liabilty would accelerate the receipt of certain tax revenues. This acceleration of tax revenues would increase General Fund revenues in a given fiscal year through (1) increased estimated payments in the fiscal year, and (2) increased interest earnings that accrue to the state from the investment of those accelerated payments.

Fiscal Effect

The Franchise Tax Board estimates that increasing the requirement for large, world-wide corporations' estimated tax payments (to the greater of 90 percent of the current year's tax or 100 percent of the prior year's tax) for all estimated payments due on or after January 1, 1991 would increase General Fund revenues by approximately $90 million in 1990-91 and $10 million in 1991-92.

ACCELERATE SALES TAX PAYMENTS

Description

Enact legislation to require most retailers to include three weeks rather than two weeks of June sales in their June sales tax payments.

Background

Existing law requires most retailers (those who average more than about $17,000 in taxable sales each month) to make monthly sales tax payments to the State Board of Equalization. The last sales tax payment of the fiscal year must be mailed by June 23. This payment is for taxable sales made during May and the first 15 days of June. Retailers generally have a choice of paying 95 percent of the tax owed on their actual sales during this period or 100 percent of the tax based on their sales during the corresponding period in the prior year. Taxes for sales occurring in the last half of June and any remaining tax liability for April and May are paid with the quarterly return at the end of July, and consequently those payments are counted as revenue in the next fiscal year.

Analysis

Including the third week's sales tax in the June payments would eliminate the "float" from interest earnings that retailers currently receive on these funds during the last week of June and the month of July. It also would require retailers to determine the amount of their June payment only two days after completing the third week's sales. The payment date could be extended, but only by one or possibly two days if the payments are to be received and deposited prior to June 30. Retailers would continue to have the option, however, of basing their June payment on prior-year sales and deferring a calculation of their actual sales until the time of the July quarterly payment.

Fiscal Effect

Based on the May Revise estimate of state sales and use tax revenues for 1990-91, we estimate that requiring retailers to include taxes through June 21 in their June sales and use tax payments would increase 1990-91 revenues by $210 million. After 1990-91, this payment policy would have only a modest effect on revenues because the loss of revenue at the beginning of each fiscal year (due to the shift of revenue into the prior June) would be offset by an equivalent gain at the end of the fiscal year.

EXTEND THE QUARTER-CENT EARTHQUAKE SALES TAX

Description

Enact legislation to extend the special quarter-cent earthquake relief tax through the end of 1990-91 and place the additional revenue in the General Fund.

Background

Chapters 13x and 14x of the 1989 First Extraordinary Session -- AB 48x (Areias) and SB 33x (Mello) -- increased the state sales and use tax rate by one-quarter cent (to 5 cents per dollar) from December 1, 1989 through December 31, 1990. The revenue is deposited in the Disaster Relief Fund to finance the costs of relief and recovery from the Loma Prieta Earthquake in October 1989.

Analysis

The extension of the additional sales tax would be administratively simple because the tax already is in place. Extending the quarter-cent sales tax, however, may have implications for voter approval of additional local half-cent sales taxes to fund transportation projects, justice facilities and other local programs.

Related Measures. The "Safe Streets Act of 1990," an initiative measure that may qualify for the November 1990 General Election, would increase the state's sales and use tax rate by one-half cent, to a total rate of 5.25 percent, as of July 1, 1991.

Fiscal Effect

Extending the quarter-cent additional sales and use tax through June 30, 1991 would generate $325 million in 1990-91. In addition, we estimate that continuing the additional quarter-cent tax through June 30, 1992 would generate about $820 million in 1991-92.

ELIMINATE SALES TAX EXEMPTION FOR CANDY

Description

Enact legislation to eliminate the current sales and use tax exemption for candy and confectionery.

Background

Most food items are exempt from sales and use taxes except when they are sold for on-premise consumption, such as restaurant meals, or when they are sold as hot takeout items. Sales tax does apply, however, to all sales of carbonated beverages and alcoholic beverages. Candy and confectionery currently are included in the food exemption, but these items were taxable prior to 1972. Fourteen other states tax candy, but exempt food generally from their sales tax.

Analysis

Candy generally is regarded as a luxury and not a necessary food item. It also is a relatively easy commodity to distinguish from other foods. Eliminating the candy exemption could be implemented as early as October 1990. Any such legislation should include a technical revision to increase the percentage of vending machine food sales deemed taxable, in order to account for candy sold in vending machines.

Related Measures. AB 2556 (Moore) would eliminate the candy exemption.

Fiscal Effect

The State Board of Equalization estimates that candy and confectionery sales in California total about $2 billion annually. If the exemption were eliminated as of October 1, 1990 the revenue gain to the state would be about $65 million in 1990-91. Also, cities, counties and special sales tax districts would realize $24 million of additional revenue in 1990-91. In 1991-92 and thereafter, the state and local revenue gains would be $95 million and $35 million, respectively.

INCREASE ALCOHOLIC BEVERAGE TAXES

Description

Enact legislation to increase the state excise taxes on beer, wine and distilled spirits to average national levels effective January 1, 1991.

Background

California's excise taxes on alcoholic beverages will yield an estimated $127 million in 1990-91. The $2-per-gallon tax on distilled spirits produces 76 percent of this revenue ($96 million). The taxes on beer (4 cents per gallon) and wine (1 cent per gallon for most wines) generate the remaining $31 million. Since 1980-81, revenues have been declining slowly as per-capita consumption of alcoholic beverages, especially distilled spirits, has declined faster than population has increased.

Alcoholic beverages sold in California also are subject to federal excise taxes. The federal taxes (per gallon) are $10 for distilled spirits, 29 cents for beer and 17 cents for most wines. The sales and use tax also applies to sales of alcoholic beverage, and the tax is levied on the full price of these beverages, including excise taxes. As a result, any increase in the excise taxes also increases sales tax revenue.

California's excise taxes on alcoholic beverages are less than the national average and were last raised in 1959 for beer, 1935 for wine, and 1967 for distilled spirits. The figure below compares California's current tax rates with the weighted average effective state and local tax rates in other comparable states (tax rates in states that operate their own liquor stores are not comparable with those in California because these states also control prices and receive profit revenues).

Figure 4
Alcoholic Beverage Excise Tax Rates
(dollars per gallon)

	Beer	Dry Wine	Fortified Wine	Sparkling Wine	Distilled Spirits
California	$0.04	$0.01	$0.02	$0.30	$2.00
Average Tax Rates[a] in comparable states	0.28	0.72[b]	0.72[b]	0.72[b]	4.15

[a] Based on state and local revenue from specific taxes on alcoholic beverages per gallon of sales volume for 1987.
[b] Average tax rate for all types of wine.

Analysis

Increasing California's tax rates to the national average would increase the tax on a six-pack of beer by 14 cents, on a liter of wine by 19 cents, and on a fifth of distilled spirits by 43 cents. These increases could be made effective on January 1, 1991. Alcoholic beverage taxes are levied at the manufacturer and distributor levels. In order to apply the new tax rates uniformly to all alcoholic beverages sold to consumers on or after January 1, 1991, a one-time tax on retailers' floor stocks also would need to be imposed on that date.

The burden of increased alcoholic beverage excise taxes on income groups would vary by type of beverage. Beer consumption does not increase greatly with income, so that this portion of the excise tax would be regressive. The tax burden probably would be more in proportion to income for wine, and the tax on distilled spirits probably would be progressive.

Increasing alcoholic beverage taxes would increase the prices of these beverages and reduce their consumption to some extent.

Related Measures. ACA 38 (Cortese), would increase alcoholic beverage taxes effective March 1, 1991. The tax rates imposed by ACA 38, however, would be

less than the national average rates. SB 1597 (Alquist) and SB 2686 (Marks) would increase taxes on wine only. Several other measures would increase alcoholic beverage taxes above national averages in order to fund designated programs. These include the Alcohol Tax Act of 1990, (an initiative measure that may qualify for the November 1990 General Election), AB 2573 (Connelly) and SB 2505 (Maddy).

Fiscal Effect

We estimate that increasing alcoholic beverage tax rates to the weighted national average rates would increase General Fund revenues by $155 million in 1990-91 (including the floor tax) and by $350 million in 1991-92, with comparable amounts in subsequent years.

CHANGE REVENUE RECOGNITION POLICY FOR TAX REVENUES

Description

Enact legislation to conform state revenue recognition policy more closely with forthcoming changes to Generally Accepted Accounting Principles (GAAP). Specifically, change state policy to recognize as revenue:

- Those sales and use taxes collected by retailers but not yet paid to the state at the end of the fiscal year; and
- Income taxes attributable to income earned prior to the end of the fiscal year, and which are either paid or acknowledged within one month of the end of the fiscal year, adjusted for expected refunds and other receipts which are not attributable to income earned during the period.

Background

The Governmental Accounting Standards Board has issued new standards to govern governmental accounting practices for governmental fund operating statements. These standards, which will be effective for the preparation of GAAP-based financial statements beginning in 1994-95, cover a number of issues related to the measurement of income and the recognition of expenditures. The new standards are intended to improve government financial reports by increasing their ability to accurately reflect revenues and expenditures that are attributable to the fiscal year for which the report is prepared. The delayed implementation date for these standards is intended to provide time for GASB to resolve several remaining issues and allow for the simultaneous implementation of all the new standards.

The state prepares two sets of financial statements. One of these reflects the budgetary or legal basis of accounting governed by state law and the annual Budget Bill. The other represents a "restatement" of the budgetary/legal basis financial statement to reflect the GAAP accounting standards.

One of the new standards deals with the appropriate means of measuring income for a given fiscal year, and has implications for the recognition of tax

revenues. The present state policy treats all cash received within the fiscal year as revenue for that year, and allows the accrual of monies not yet received only if the payment of the taxes has become delinquent and is expected to be collected within the next fiscal year. The new standard differs in two ways. First, it allows revenues to be recognized for a fiscal year only if they are attributable to economic activity occuring within that same fiscal year. Thus, cash received during the period may not be recognized as revenue if it is attributable to activity that occurs in a different fiscal period. Second, the new standard allows a greater accrual of tax revenue which is attributable to activity within the fiscal year but which has not been received by the state prior to the end of the fiscal year. Specifically, the standard allows cash received within one month of the end of the fiscal year to be accrued as revenue, and allows the accrual of cash received after that point if the taxpayer has acknowledged a specific liability or if the state has issued a billing for taxes due.

Analysis

Existing state law provides that it is the policy of the state to revise the state's budget accounting procedures as necessary to bring the state into conformity with GAAP standards, to the extent that the Director of Finance deems these changes to be in the best interests of the state. Changes to the state's policy on the measurement of income should be evaluated in the light of this existing policy. Because the use of these standards is intended to improve the accuracy of the state's reported financial condition, the adoption of accounting changes by the state should be carried out in a fashion which furthers that goal.

In our view, the adoption of all or even a portion of the new standards which would affect the amount of revenues recognized, without the adoption of changes required by the standards for expenditures, would *reduce the accuracy of the state's reported financial condition and make future conformity to the GAAP standards more difficult*.

Fiscal Effect

Based on data provided by the Board of Equalization and the Franchise Tax Board, we estimate that the adoption of the forthcoming GAAP standard on measurement of income would increase stated 1990-91 General Fund revenue by over $1 billion. However, concurrent adoption of the other accounting changes needed to conform with GAAP standards would eliminate these revenue gains.

INCREASE RESIDENT STUDENT FEES

Description

Increase resident student fees at the University of California and the California State University.

Background

The Governor's Budget proposes an increase of (1) $69 (4.7 percent) in UC resident student fee levels and (2) $36 (5.1 percent) in full-time and $18 (4.4 percent) in part-time CSU resident student fee levels--for an average increase of 4.8 percent--in 1990-91. The state's statutory resident fee policy enacted by Ch 1523/85 (SB 195, Maddy) sunsets on August 31, 1990. Chapter 1523 limited fee increases to no more than 10 percent above the fee level in the prior fiscal year. Last year the Legislature passed AB 1276 (Areias) which would have extended the sunset to August 31, 1995. The Governor vetoed this legislation citing "the need for flexibility in setting fees" if Prop. 111 does not pass in June. The veto message indicated the Governor's willingness to sign legislation this year extending the sunset if Prop. 111 passes.

Analysis

UC Residents. UC resident student fees in 1989-90 are less than student charges in comparable universities in other states. UC's undergraduate fees are $1,009 less than the average of UC's four salary comparison public universities (the University of Illinois (Urbana), the University of Michigan (Ann Arbor), the State University of New York (Buffalo), and the University of Virginia). UC's general campus graduate student fees are $1,801 less than the average charge for these same universities.

CSU Residents. CSU resident student fees in 1988-89 (the latest year for which information is available) were less than student charges in comparable universities in other states. CSU's undergraduate fees were $845 less than the average of

CSU's 14 salary comparison public universities (which include, among others, Arizona State University, the State University of New York (Albany), the University of Wisconsin (Milwaukee), North Carolina State University, and Rutgers, the State University of New Jersey (Newark)). CSU's graduate fees were $1,110 less than the average charge for these same universities.

Fiscal Effect

The revenue raised by resident student fee increases depends upon the amount of the fee increase and the amount of any allowance for additional financial aid for needy students.

10 Percent Increase. If UC resident fees were increased by 10 percent above the current-year level (by $148, which is $79 above the proposed 1990 Governor's Budget) the additional revenue raised would total $10.0 million. Similarly, if CSU resident fees were increased by 10 percent above the current-year level (by $72, which is $44 above the proposed 1990 Governor's Budget) the additional revenue raised would total $11.7 million.

25 Percent Increase. If UC resident fees were increased by 25 percent above the current-year level (by $369, which is $300 above the proposed 1990 Governor's Budget) the additional revenue raised would total $37.7 million. Similarly, if CSU resident fees were increased by 25 percent above the current-year level (by $180, which is $144 above the proposed 1990 Governor's Budget) the additional revenue raised would total $42.2 million. At these levels, UC and CSU fees would still be significantly below the fees of the comparison public universities.

These revenue gains reflect an offset for financial aid for needy students. Therefore, there should be no effect on access to UC or CSU.

INCREASE NONRESIDENT STUDENT CHARGES

Description

Increase nonresident student charges at the University of California and the California State University.

Background

UC Nonresident Charges. The Governor's Budget proposes a $186 (2.6 percent) increase in nonresident charges in 1990-91. Approximately 14,200 students (9 percent) of UC's students are nonresidents. Nonresidents constitute 5 percent (6,000) of UC's undergraduate student body and 23 percent (8,200) of UC's graduate student body. About one-half (7,162) of UC's nonresidents are residents of other states and the other half (7,070) are residents of other countries throughout the world.

CSU Nonresident Charges. The Governor's Budget proposes a $36 increase in nonresident charges in 1990-91, which is fully attributable to the change in resident fees. Of CSU's total FTE enrollment, 8,513 FTE students (3.1 percent) are nonresidents. Of CSU's nonresident FTE enrollment, 1,947 FTE (23 percent) are residents of other states and the remaining 6,566 FTE (77 percent) are residents of other countries throughout the world.

There is no state policy on setting nonresident charge levels, however, SB 2116 (Morgan) would establish a policy.

Analysis

UC Nonresidents. Nonresident students at UC pay resident fees and an additional nonresident tuition. Nonresident charges have increased by $1,611 (28 percent) between 1987-88 and 1989-90. (In comparison UC resident student fees increased by $102 (7.4 percent) during that same time period.) UC's undergraduate nonresident charges are $15 more than the average of UC's four salary comparison public universities (the University of Illinois (Urbana), the

University of Michigan (Ann Arbor), the State University of New York (Buffalo), and the University of Virginia). UC's general campus nonresident graduate student charges are $613 less than the average charge for these same universities.

CSU Nonresidents. As is the case at UC, nonresident students at CSU pay resident fees and an additional nonresident tuition. Nonresident charges have increased by $1,338 (27 percent) between 1987-88 and 1989-90. (In comparison CSU resident student fees increased by $78 (12 percent) during that same time period.) Based on 1988-89 data (the latest information available) CSU's undergraduate nonresident charges were $978 more than the average of its 14 salary comparison public universities (which include, among others, Arizona State University, the State University of New York (Albany), the University of Wisconsin (Milwaukee), North Carolina State University, and Rutgers, the State University of New Jersey (Newark)). CSU's graduate student fees were $987 more than the average charge for these same universities.

Fiscal Effect

The amount of revenue raised by increased nonresident student charges depends only on the amount of the increase. For each $100 that UC nonresident tuition is increased above the Governor's Budget, the additional revenue raised would total $1.3 million. For each $100 that CSU nonresident tuition is increased, the addititional revenue raised would total $800,000. If nonresident tuition were increased by $500 at both institutions, the additional revenue increase would total $11 million.