The Governor's Tax Reduction Proposal

How Would the Governor's Proposed Tax Cut Affect Taxpayers, the State's Fiscal Condition, and the State's Economy?

Summary

The 1996-97 Governor's Budget proposes a 15 percent across-the-board income tax cut for both corporations and individuals, to be phased in evenly over a three-year period. This proposed rate reduction is similar to last year's tax proposal, except that it does not propose to continue the temporary 10 percent and 11 percent high-income tax brackets. The proposal's purpose is to reduce marginal tax rates and lower tax burdens, so as to make the state more economically competitive and thereby stimulate economic performance, including job growth.

The proposal's net revenue impact on the state is estimated to be a reduction of $572 million in 1996-97, rising to $4.7 billion by 1999-2000 (when it is fully phased in). Most taxpayers would receive some benefits. The dollar benefits to individual taxpayers would very widely, but would be roughly in proportion to their current-law tax liabilities. Thus, the plan would not materially affect the distribution of the tax burden.

The proposal would make California's highest marginal tax rates more competitive with other states. In addition, California's tax burden, which is currently about average, would decline somewhat.

How much of a stimulative effect the proposal would have on California's economy is open to debate, largely because there is no existing model which can provide a reliable answer to this question. However, the measure would raise the economic return to producing income, and therefore would doubtless result in increases in jobs and related economic activity. These gains would be offset by increased federal taxes and the effects on the economy of reduced state government spending.

Ultimately, whether the Governor's tax proposal is adopted is a legislative policy choice. Important decisions will need to be made regarding the trade-off between reducing taxes and funding state services. In addition, the Legislature may want to consider other tax-change alternatives, depending on its tax-policy goals and objectives.

INTRODUCTION

One of the key proposals in the 1996-97 Governor's Budget is a tax reduction plan that would benefit both individuals and businesses. This proposal is similar in principle to the one which the Governor made in last year's budget. The proposal's main provision is an across-the-board 15-percent reduction in income tax rates for individuals and businesses that would be phased in evenly over a three-year period. It also includes a number of largely business-oriented tax reduction provisions.

In this analysis, we discuss the Governor's rationale for making his proposal, detail the specific provisions contained in the proposal, and provide the Legislature with background information on California's current tax environment. We then identify criteria that the Legislature might wish to consider when evaluating the proposal, and provide information as to its likely economic and fiscal effects. Lastly, we present several alternative tax-change options that the Legislature may wish to consider, depending on what its goals and objectives are in considering tax law changes.

WHY IS THE GOVERNOR PROPOSING A TAX REDUCTION?

The current tax reduction proposal is part of the Governor's plan to strengthen California's competitive position, thereby resulting in job growth and economic expansion. The plan includes a variety of elements, including the tax reduction, regulatory reform, and infrastructure funding.

Both this year and last, the Governor's basic rationale for a tax reduction has essentially been three-fold:

- First, that California's marginal tax rates and overall tax burden are excessive.
- Second, that a reduction in these rates and the tax burden are needed to ensure continued healthy economic expansion and strong job gains in the future.
- Third, that California taxpayers should get to share in the "fiscal dividends" that the state will receive in the form of increased tax revenues due to a growing economy.

The proposal should not be viewed as, nor does it purport to be, a "tax reform" proposal, given that it does little in terms of changing the tax base or the fundamental way that taxes are levied.

Findings of the Governor's 1994 Task Force

In December 1994, the Governor's Task Force on California Reform and Reduction concluded its year-long study of California's fiscal structure, which included determining the reasons behind the decline in state revenues in the early 1990s. It concluded that California's tax rates had reached levels where they were inhibiting economic performance and revenue growth. These high tax rates, according to the Task Force, gave individuals and businesses an incentive to locate elsewhere and shift economic activities out of the state.

The Task Force concluded that reducing tax rates would send a signal to businesses that California is a "tax-friendly" state and influence business location decisions, both attracting new firms to the state and encouraging existing ones to remain in the state. As more firms locate to the state, additional jobs would be created, which in turn would benefit both individuals and the state's economy in general.

HOW DOES CALIFORNIA'S TAX ENVIRONMENT COMPARE TO OTHER STATES?

As noted above, one of the Governor's rationales for his tax reduction proposal is that California is a "high tax" state relative to other states that compete with it for businesses, jobs, and investment. Comparing the relative tax environments of different states can be done in a variety of ways, and there is no single universally agreed-upon view about which method is "right." This is because the "right" method depends upon what one's focus is. For example, if one wants to focus on overall tax burdens, looking at total taxes paid relative to income or on a per capita basis makes sense. On the other hand, if one's focus is on the ways that increments to income are taxed and the effects that this can have on marginal decision-making by taxpayers, such as whether to work more hours or hire more employees, looking at the marginal tax rates they face makes sense. And, in looking at comparative tax rates, it also is important to remember that states can differ markedly in terms of not just their tax rates, but the tax brackets, deductions, exclusions, exemptions, and credits they offer.

California's Marginal Tax Rates Are on the High Side

Figure 1 (see page 96) shows California's income tax rates and the number of tax brackets compared to other western states and major industrial states.

Figure 1

Marginal Income Tax Rates for Western and Major Industrial States[a]

	Personal Income Tax	Number of Brackets	Bank and Corporation Tax	Number of Brackets
California	1% to 9.3%	6	9.3%	1
Other Western States				
Alaska	—	—	1% to 9.4%	10
Arizona	3.0% to 5.6%	5	9.0%	1
Colorado	5.0%	1	5.0%	1
Hawaii	2.0% to 10.0%	8	4.4% to 6.4% income, 4% capital gains	3
Idaho	2.0% to 8.2%	8	8.0%	1
New Mexico	1.7% to 8.5%	7	4.8% to 7.6%	3
Nevada	—	—	—	—
Oregon	5.0% to 9.0%	3	6.6%	1
Utah	2.55% to 7.2%	6	5.0%	1
Washington	—	—	—[b]	—
Other Major Industrial States				
Florida	—	—	5.5%	1
Illinois	3.0%	1	4.8%	1
Massachusetts	5.95% income; 12% interest, dividends, and capital gains	1	9.5%	1
Michigan	4.4%	1	2.3%	1
New Jersey	1.4% to 6.35%	5	7.5% franchise, 7.25% income	1
New York	4.0% to 7.125%	5	9.0%	1
Pennsylvania	2.8%	1	9.99%	1
Ohio	0.743% to 7.5%	9	5.1% to 8.9%	2
Texas	—	—	4.5% net taxable earned surplus	1

[a] California's rates are as of January 1, 1996. For all states except California, rates shown are as of December 31, 1995. California's personal income tax rates for 1995 ranged from 1 percent to 11 percent with 8 tax brackets.

[b] Levies a business and occupation tax.

Source: Federation of Tax Administrators.

Corporate Income Tax Rates. Under current law, California's tax rate for corporations is generally a flat 9.3 percent. Among western states, California has the highest corporate tax rate with the exception of Alaska. (Alaska, however, has a progressive corporate tax structure, so only its largest corporations are taxed at its highest rates.) Arizona has

the next highest corporate tax rate at 9.0 percent. The corporate tax rates among other major industrial states are more comparable to California. Both Massachusetts and Pennsylvania have higher corporate rates than California, and New York and Ohio have rates close to California's—at or near 9 percent.

Personal Income Tax Rates. Figure 1 also provides marginal tax rate information regarding personal income taxes. As of 1996, California's top marginal rate is 9.3 percent, following the sunset of its temporary 10 percent and 11 percent top tax rates that had been in effect from 1991 through 1995. California's rate structure is quite progressive, with six marginal tax rate brackets with rates ranging from 1 percent upward. (In a progressive tax system, higher-income individuals pay a larger percentage of their income in taxes than lower-income individuals.)

Regarding other states, more than half of the major industrial states either have no personal income tax at all or apply a single tax rate to all levels of income, while most western states have a multi-rate structure with varying degrees of progressivity. California's current 9.3 percent top rate for higher-income taxpayers is much more in line with the top rates of other western states than when its 10 percent and 11 percent brackets were in effect. For example, Hawaii has the highest top rate of western states at 10 percent, and Oregon and New Mexico are at 9 percent and 8.5 percent, respectively. As regards industrial states, California's top rate is the highest among major industrial states with the exception of Massachusetts, which taxes interest, dividends and capital gains at 12 percent. For lower-income taxpayers, however, California has among the lowest rates. This is particularly true when comparing California to most of those states having a single income tax rate.

As noted above, however, marginal tax rates are only part of the tax structure. Various other factors, including deductions, exemptions, exclusions, and credits need to be considered when comparing state tax environments to one another. Two comparative state studies completed several years ago that took such factors into account (one by the Minnesota Department of Revenue, and the other by KPMG Peat Marwick for the State of North Carolina) concluded that high-income taxpayers face higher tax levels in California while lower-income taxpayers face lower tax levels in California than elsewhere, on average. While certain aspects of California's tax structure have changed since these studies were completed (such as the elimination of the 10 percent and 11 percent top tax rates), they still provide a general sense of where California ranks relative to other states.

Generally speaking, California currently is on the high end of the spectrum in terms of marginal tax rates for both corporations and individuals.

California Has High Income Tax Burden But Average Overall Tax Burden

As noted above, measuring the average total tax burden is another method for comparing tax environments across states. One approach—measuring taxes as a share of personal income—allows one to standardize for income level differences across states. A second approach—comparing taxes in per capita terms—focuses strictly on tax dollars paid, independent of average income levels. Figures 2 and 3 incorporate both of these approaches. They are based upon preliminary data from the U.S. Department of Commerce for 1992-93 (the most recent year available) and are adjusted to eliminate the impact of the 10 percent and 11 percent high-income tax rates.

Figure 2 shows that in personal income terms:

- California's income tax levels are about 11 percent higher than the average of other states. However,
- California is nearly 2 percent lower in terms of state and local taxes, fees and charges (also known as total own-source revenues). This is due largely to significantly lower local taxes in California—in particular, property taxes.

Figure 3 shows that in per capita terms:

- California income tax levels are about 18 percent higher that average. However,
- State and local taxes, fees and charges are only about 4 percent higher than average (again, due largely to local property tax levels).

Thus, California's income tax levels in both per capita dollar terms and relative to income are higher than the average, while its overall tax burden can best be characterized as "average."

Given this, the Governor's claim that California is a "high tax" state depends on the measurement used. The state is on the high side in terms of marginal rates and income tax burden, but about average regarding total tax burden.

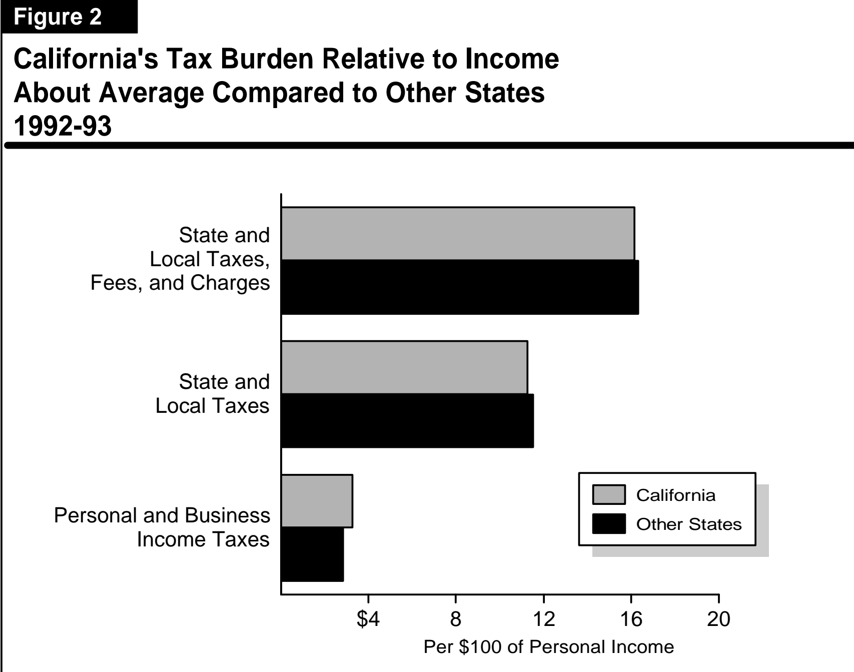


Figure 2

California's Tax Burden Relative to Income About Average Compared to Other States 1992-93

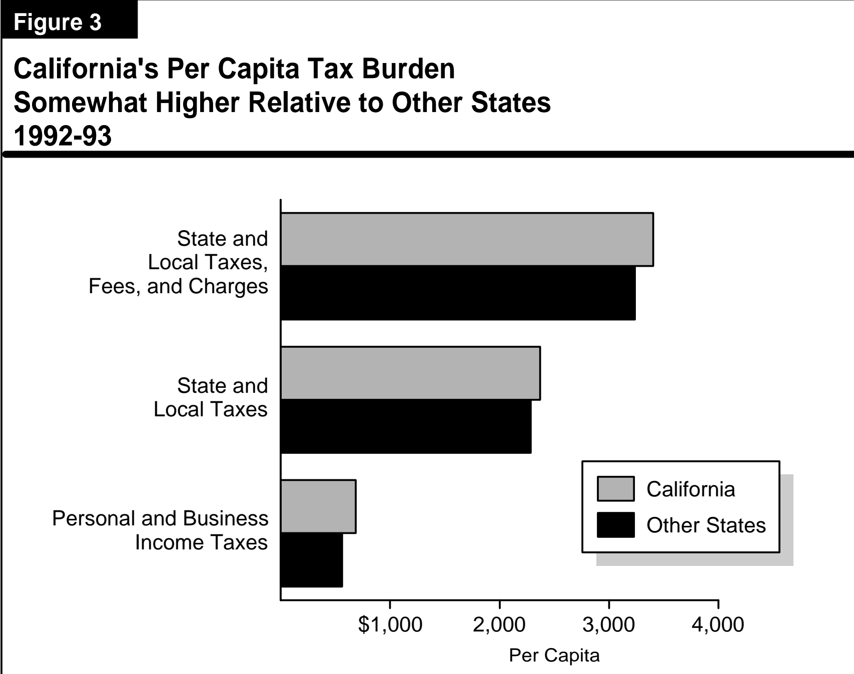


Figure 3

California's Per Capita Tax Burden Somewhat Higher Relative to Other States 1992-93

SPECIFIC FEATURES OF THE GOVERNOR'S TAX PROPOSAL

The various provisions contained in the Governor's tax reduction proposal are highlighted in Figure 4. As noted earlier, they include a combination of tax rate reductions, and increased, expanded or new tax reduction provisions.

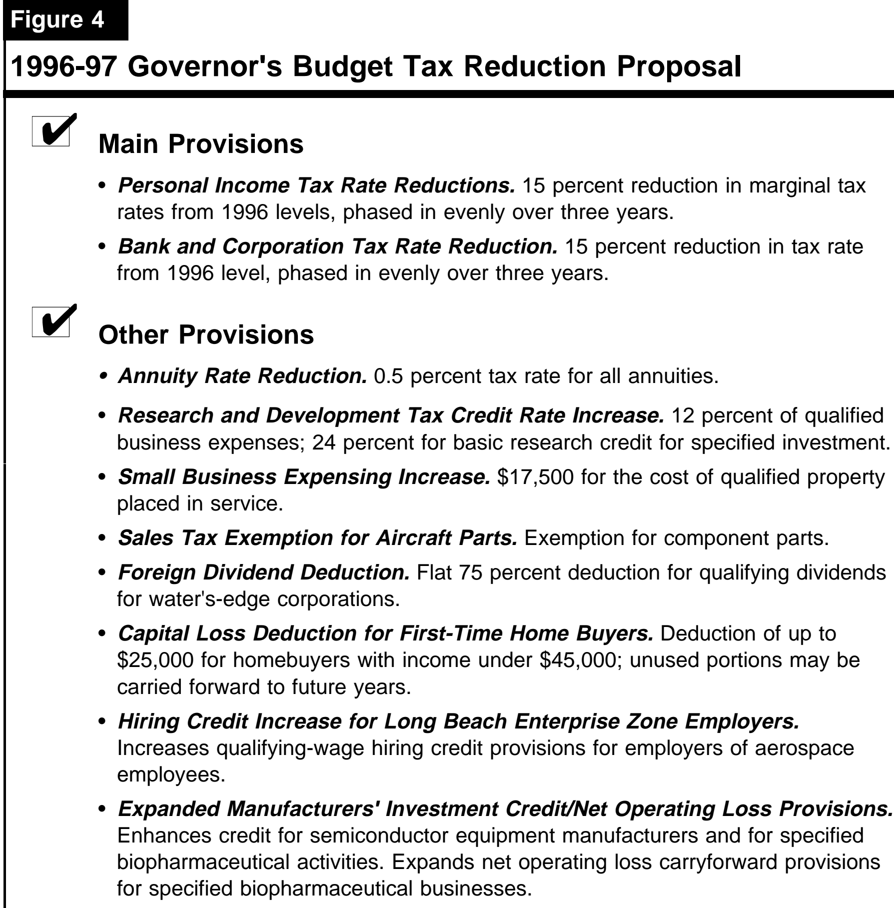


Figure 4

1996-97 Governor's Budget Tax Reduction Proposal

✔ **Main Provisions**

- ***Personal Income Tax Rate Reductions.*** 15 percent reduction in marginal tax rates from 1996 levels, phased in evenly over three years.
- ***Bank and Corporation Tax Rate Reduction.*** 15 percent reduction in tax rate from 1996 level, phased in evenly over three years.

✔ **Other Provisions**

- ***Annuity Rate Reduction.*** 0.5 percent tax rate for all annuities.
- ***Research and Development Tax Credit Rate Increase.*** 12 percent of qualified business expenses; 24 percent for basic research credit for specified investment.
- ***Small Business Expensing Increase.*** $17,500 for the cost of qualified property placed in service.
- ***Sales Tax Exemption for Aircraft Parts.*** Exemption for component parts.
- ***Foreign Dividend Deduction.*** Flat 75 percent deduction for qualifying dividends for water's-edge corporations.
- ***Capital Loss Deduction for First-Time Home Buyers.*** Deduction of up to $25,000 for homebuyers with income under $45,000; unused portions may be carried forward to future years.
- ***Hiring Credit Increase for Long Beach Enterprise Zone Employers.*** Increases qualifying-wage hiring credit provisions for employers of aerospace employees.
- ***Expanded Manufacturers' Investment Credit/Net Operating Loss Provisions.*** Enhances credit for semiconductor equipment manufacturers and for specified biopharmaceutical activities. Expands net operating loss carryforward provisions for specified biopharmaceutical businesses.

Reduced Marginal Tax Rates for Individuals and Businesses

At the heart of the Governor's tax reduction proposal is a 15 percent across-the-board tax rate reduction for both personal income and business taxes, to be phased in evenly over a three-year period beginning January 1, 1997. Thus, after the phase-in period, the top marginal tax rates for both businesses and individuals would drop from

the current 9.3 percent to 7.91 percent. The Alternative Minimum Tax (AMT) rate would also be reduced in a similar fashion for both businesses and individuals.

This rate reduction provision is similar to that of last year's proposal, except that no extension of the temporary 10 percent and 11 percent income tax brackets is being proposed this year as it was last year. Under last year's proposal, the top personal income tax rate would have ended up at 9.3 percent after three years, the rate now in effect under current law. Thus, this year's proposal would have a much more significant effect on the top personal income tax bracket than last year's.

Other Tax Reduction Provisions

In addition to the proposed reduction in income tax rates, the Governor's proposal includes numerous other tax reduction provisions, mostly aimed at reducing the tax burden on businesses. The provisions with the largest fiscal impact include:

- ***Annuity Rate Reduction.*** This would reduce the gross premiums insurance tax rate charged to businesses for "non-qualified" annuities from 2.35 percent to 0.5 percent, the rate charged to "qualified" annuities, phased in over a three-year period. Non-qualified annuities are generally purchased with "after-tax dollars" and do not receive special tax breaks that qualified annuities (such as 401k annuities) receive. California is the only state that currently has separate rates for different types of annuities.
- ***Research and Development Tax Credit Increase.*** This would increase the research and development tax credit rate from 8 percent to 12 percent of qualified business expenses, and the basic research credit for amounts paid to qualified organizations such as colleges and universities from 12 percent to 24 percent.
- ***Small Business Expensing Increase.*** This would increase the amount a small business taxpayer may "expense" (that is, immediately deduct) for the cost of qualified property placed in service for a tax year, from $10,000 to $17,500. This increase would not change the amounts allowed to be expensed for enterprise zone or revitalization zone deductions. The proposed increase would conform state law to federal law.

FACTORS TO CONSIDER IN EVALUATING THE PROPOSAL

There are a variety of different criteria that can be used to evaluate a tax proposal:

- Its effects on the distribution of the tax burden.
- Its "neutrality" with respect to decision-making by taxpayers.
- Its effects on the ability of the revenue base to fund public services over time.
- Its effects on the stability of the revenue base during times of fluctuating economic activity.
- Its administrative feasibility.
- Its general impacts on the economy.

In terms of the Governor's own objectives in proposing the tax reduction, the key issues to assess would appear to be the measure's effects on making the state's tax rates and tax burdens more competitive with other states, and its broad economic and fiscal consequences. As noted above, additional specific areas which may be of interest to the Legislature include the measure's effects on the distribution of the tax burden and its out-year implications for funding current state services.

Among other things, the analysis below indicates that the proposal would achieve the Governor's objectives in terms of making California's marginal tax rates competitive and modestly reduce its overall tax burden. It would have little effect on the distribution of the tax burden or administration of the tax system.

FISCAL AND ECONOMIC EFFECTS OF THE PROPOSAL

Four-Year Revenue Effect Will Exceed $10 Billion

Figure 5 shows the aggregate dollar effects which the Governor's tax reduction proposal are estimated to have in terms of reducing the state income taxes on Californians, both by year and on a cumulative basis. It indicates that the measure would reduce state revenues by an estimated $572 million in 1996-97 (a half-year impact reflecting primarily the first 5 percent rate reduction) and reach $4.7 billion by 1999-2000 (the first fiscal year it would be fully phased in). The cumulative effect of the measure over these four years would be $10.8 billion, which is $3.2 billion more than last year's proposal. The

revenue difference represents the net effect of not including last year's proposal to extend the high-income tax brackets, partially offset by this year's additional business-incentive tax provisions. The Governor's tax reduction proposal would automatically reduce the Proposition 98 minimum funding guarantee from what it otherwise would be. The amount of this reduction would be about $350 million in 1996-97, and reach approximately $2.7 billion by 1999-2000.

Figure 5

Governor's Tax Reduction Proposal (Effective January 1, 1997)

(In Millions)

	State Revenue Reduction				Four-Year
	1996-97	1997-98	1998-99	1999-00	Total
Personal income tax reduction	$450	$1,550	$2,740	$3,640	$8,380
Bank and corporation tax reduction	90	330	620	870	1,910
Subtotals	($540)	($1,880)	($3,360)	($4,510)	($10,290)
Other provisions					
Annuity rate reduction	—	$35	$65	$101	$201
Research and development credit	$16	42	45	48	151
Small business expensing	5	25	20	17	67
All other provisions	11	23	26	26	86
Totals	**$572**	**$2,005**	**$3,516**	**$4,702**	**$10,795**

Source: Department of Finance.

Personal Income Taxpayers to Receive Three-Fourths of Benefits

Over three-fourths of the tax reduction would go to personal income tax filers (which includes businesses such as partnerships and sole proprietorships). The remaining one-fourth would go to corporations. This split between personal and corporate tax reductions corresponds roughly to the relative current-law shares of these two taxes. The above revenue-reduction estimates do not include any partially offsetting adjustments for any behavioral or dynamic feedback effects that a decrease in tax levels might have on the California economy and state revenues (see discussion below). The proportion of the tax reduction going to personal income tax filers is higher than for last year's tax reduction proposal. This reflects the fact that, as noted above, last year's proposal would have kept the temporary high-income tax brackets in place and calculated the 15-percent rate reductions off of these higher rates.

Benefits Would Be Partially Offset by Increased Federal Taxes

A portion of the state tax savings to individuals and businesses would be offset by higher federal income taxes. This occurs because taxpayers that deduct state income tax liabilities on their federal income tax returns, whether as itemized deductions in the case of individuals or business expenses in the case of businesses, would have lower state tax liabilities to report. As a result, they would have lower federal itemized deductions, and consequently, higher federal income tax liabilities. The Franchise Tax Board (FTB) has estimated that the combined personal income tax and corporation income tax offset in terms of higher federal liabilities would be about one-fourth of the state tax reduction. The amount of the federal offset for any one taxpayer would depend upon their marginal federal tax bracket.

How Would Tax Rates and the Tax Burden Be Affected?

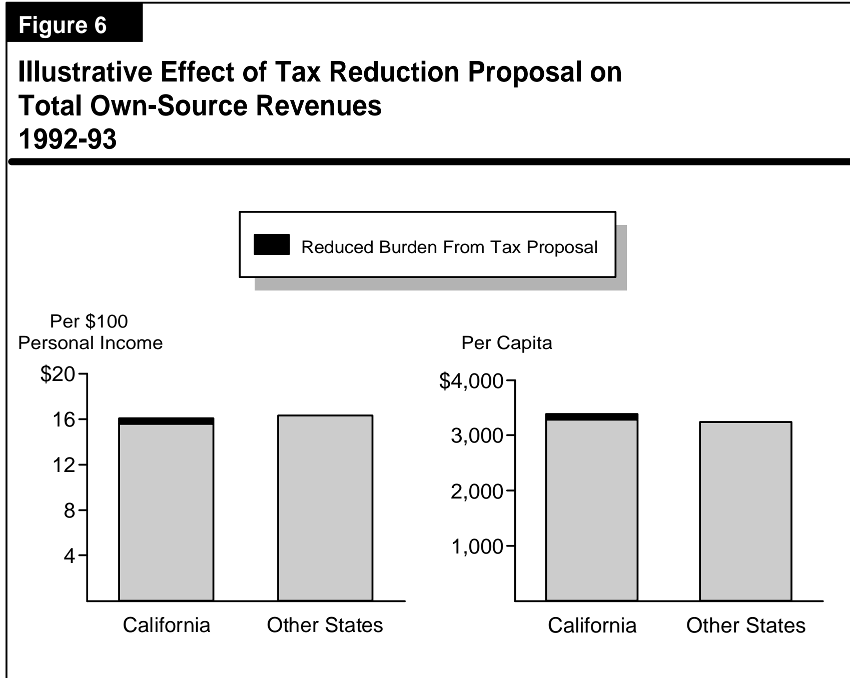
The Governor's tax reduction proposal, when fully phased in, would reduce all marginal tax rates by 15 percent. This would reduce the top income tax rates from 9.3 percent to 7.91, and generally would place California in the middle when ranked against the top marginal tax rates in other western and major industrial states (see Figure 1—page 96—for comparisons).

Figure 6 provides an illustration of the effect of the Governor's tax reduction proposal on the overall state tax burden. We calculated the impact of the Governor's tax proposal by applying the fully phased-in percentage tax reduction to 1992-93 California total own-source revenue levels (as specified in Figures 2 and 3—page 99). Total own-source revenues without incorporating the tax proposal are about 2 percent lower than the average for other states per $100 of personal income. After incorporating the effects of the tax reduction, California's overall tax burden would be 5 percent lower than other states. Similarly, in per capita terms, California's overall tax burden without incorporating the tax reduction proposal is about 4 percent higher than other states. Under the proposal, the total tax burden would be about 1 percent higher than other states. Thus, in terms of overall tax burden, California still would be about average.

While the *overall* tax burden would remain about average, the *income* tax burden would be lowered significantly. Without incorporating the tax reduction proposal, California's income tax burden is about 11 percent higher than other states relative to personal income and

Figure 6

Illustrative Effect of Tax Reduction Proposal on Total Own-Source Revenues 1992-93



about 18 percent higher in per capita terms. Under the tax reduction proposal, California's income tax burden would be 6 percent *lower* than other states and about 1 percent *higher* per capita compared to other states.

What Is the Effect on Individual Taxpayers?

The dollar amount of tax savings for specific individual and corporate taxpayers would vary widely because the tax reduction proposal is based upon income levels and tax rates. In general, those higher-income taxpayers with the largest tax liabilities would receive the largest *dollar* tax savings under the proposal. Lower-income taxpayers, however, would receive the greatest *percentage* reduction in average tax rates.

About Half of Corporations Would Receive Tax Savings

According to preliminary information from the FTB, nearly one-half of corporations reported no income or a net loss for tax year 1993. This split between profitable and unprofitable corporations has been typical in recent years. Corporations paying little or no taxes under current law

would receive no tax benefits from the tax reduction proposal, simply because they do not have any income tax liabilities. Of the corporations that do have income tax liabilities, nearly 60 percent of the total tax liabilities assessed were for corporations with net taxable income over $10 million. This share of corporations represents about one-tenth of the number of corporations with net taxable income in California. Most of the tax savings from the tax reduction proposal would go to the corporations with the high tax liabilities.

Personal Income Tax Structure Would Become Slightly More Progressive

Figure 7 compares the distribution of tax returns filed, current-law tax liabilities, and the tax savings projected to be received by individuals under the proposal in 1999. It shows that tax savings are generally proportional to total tax liabilities. For example, individuals with adjusted gross income over $100,000, who would account for almost 10 percent of tax returns filed, would pay over 55 percent of the total tax liabilities. These taxpayers would receive over half of the tax savings under the proposal. Taxpayers with income under $50,000, who would account for over 60 percent of returns filed, would receive about 17 percent of the tax reduction. This amount is slightly higher than their share of current-law total tax liabilities.

As a result, the progressivity of the income tax—the state's most progressive tax—would increase slightly under the tax reduction proposal compared to current law. Figure 7 implies that individuals with adjusted gross income over $100,000 would pay a somewhat larger share of total state tax liabilities compared to current law. (As discussed below, this result comes about because of the effects of the fixed-dollar personal and dependent tax credits, which would not be reduced under the proposal.) Broadly speaking, however, the overall state tax structure may become somewhat less progressive under the proposal. This is because, while the income tax would have a slightly more progressive structure, it also would represent a smaller share of total taxes levied by the state on individuals. The latter effect likely would outweigh the increase in progressivity in general terms.

Benefits to Individual Taxpayers Would Vary by Income Level

Figure 8 provides an example of how the across-the-board income tax rate reductions, when fully implemented, would affect the tax liabilities and average tax rates of taxpayers having different income

Figure 7

Distribution of Tax Liabilities and Tax Reduction 1999 Income Year

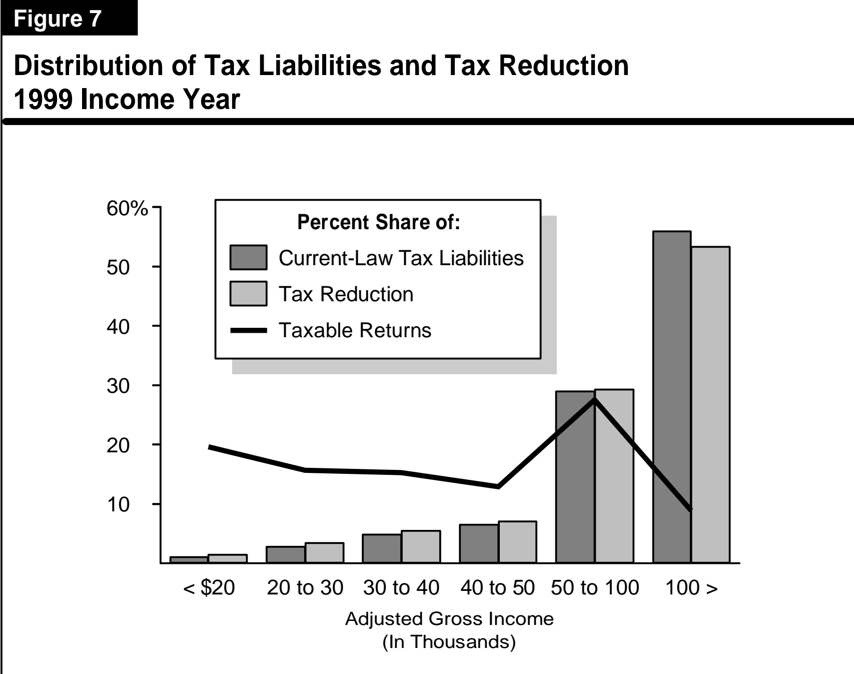


Figure 8

Effects on Individuals of Governor's Tax Reduction Proposal[a] 1999 Income Year

Adjusted Gross Income	Current-Law Tax Liabilities	Proposed Tax Reduction		Average State Tax Rate	
		State Savings	Net Savings[b]	Current Law	Proposed Law
$20,000	—	—	—	—	—
40,000	$324	$94	$79	0.81%	0.58%
60,000	1,071	206	175	1.78	1.44
80,000	2,189	373	269	2.74	2.27
100,000	3,739	605	436	3.74	3.13
150,000	7,645	1,189	856	5.10	4.30
200,000	9,551	1,815	1,252	4.78	3.87
250,000	15,736	2,398	1,535	6.29	5.33
500,000	39,751	5,943	3,590	7.95	6.76
1,000,000	84,856	12,684	7,662	8.49	7.22

[a] Data are for a married couple filing jointly, with two children and average deductions for their income level.

[b] Net savings equals state savings reduced by related increases in federal income taxes (resulting from lower federal itemized deductions for state income tax liabilities).

levels. For illustrative purposes, the example assumes a married couple filing a joint return with two children and itemized deductions equal to the average for California taxpayers with the same income level.

The example shows that taxpayers with income below $20,000 would receive no dollar benefits from the proposal. This occurs because these taxpayers under current law either have no tax liabilities, or the tax liabilities they do have are eliminated by the personal and dependent tax credits. The tax proposal does raise the threshold under which such a taxpayer would not have any tax liabilities. Under current law, taxpayers would have no tax liability if their income were under approximately $26,500 in 1999. Under the Governor's tax reduction proposal, these same taxpayers would have no tax liability if their income were under approximately $30,000 in 1999.

The example shows that higher-income taxpayers do receive a greater dollar tax savings. (As mentioned earlier, this occurs because these taxpayers have a greater share of the tax liabilities.) A taxpayer that has an adjusted gross income of $250,000 would receive about $2,400 in state tax savings. This amount would be partially offset by higher federal tax liabilities (in this example, about one-third of the tax savings would be offset).

Decline in Average Tax Rates Would Be Greatest for Lower-Income Taxpayers

While the share of the tax savings is greatest for higher-income taxpayers, the percentage decline in average tax rates is greatest for lower-income taxpayers. For example, Figure 8 (page 107) shows that for a taxpayer with an income level of $40,000, its average tax rate would fall from 0.8 percent to 0.6 percent, a drop of nearly 30 percent. In contrast, for a taxpayer with an income level of $250,000, its average tax rate would fall from about 6.3 percent to about 5.3 percent, a drop of approximately 15 percent. The percentage decline in average tax rates would be greater for lower-income taxpayers because the fixed-dollar personal and dependent tax credits (which are applied to tax liabilities *after* the rate reductions are calculated) are larger relative to tax liabilities for these taxpayers compared with higher-income taxpayers. The measure would not change the dollar amounts of these credits.

Out-Year Effects on the State's Fiscal Condition

Given the magnitude of the proposal's tax revenue effects over time, a natural question to consider is what its implications on the state's

fiscal condition would be after it is fully phased in. Specifically, how would it affect the state's ability to provide services under current law? The impact of the proposal on the fiscal condition of the state in the out-years would depend primarily on the strength of the economy and state revenue performance, state expenditure requirements, and future policy decisions made by the Governor and the Legislature.

Analysis Based on the Legislative Analyst's Office Revenue Projections. To provide some sense of what the likely magnitude of the out-year impact might be, we developed estimates using our own economic and revenue projections, and our own estimates of underlying expenditure trends and the effects of the Governor's budget proposals. Our findings, as discussed in detail in Part I, are that the budget would remain in balance through 1997-98. During the following two years:

- Revenue growth would continue to be slow, due to the tax reductions being fully phased in. We estimate that between 1997-98 and 1999-2000, General Fund revenue growth would slow from an annual average increase of 5.1 percent under current law to 2.6 percent under the proposal.
- This reduced revenue growth would accommodate current-law spending requirements for Proposition 98, debt service, and retirement funding during the remainder of the phase-in period. (It is important to note, however, that the tax reduction would cause the Proposition 98 minimum funding guarantee to grow more slowly than it otherwise would.) The remainder of the budget could grow slightly from its 1997-98 level, but not by enough to cover the impact of inflation.
- If the Governor's policy priorities in the areas of corrections and higher education also were funded, there would be insufficient revenues to maintain funding for the remainder of the budget at 1997-98 levels in the subsequent two years.

It should be noted that our projections assume continued modest economic growth through the end of the decade. An economic downturn would add substantially to the budgetary pressures in these future years.

What About the Dynamic Feedback Effects From the Proposal?

There is little doubt that the tax reduction proposal would have various stimulative effects on the California economy. It would provide tax savings to most taxpayers, and the state's economy would benefit from the spending and investment of these monies by taxpayers. In

addition, by raising the after-tax return on producing income, the lower marginal tax rates would encourage increased work effort, and certain business locations and investments in California would occur. These also would stimulate the economy and job creation in the state. State revenues would benefit from these effects, partially offsetting the direct revenue reductions to the state from the tax law changes.

However, in addition to these positive effects, various negative offsets also would occur. The first would be the substantial increase in the federal income tax liabilities of California taxpayers. As noted earlier, this leakage would be in the range of one-fourth of the savings, or $2.7 billion over the measure's first four years. Another form of leakage would be the investment outside of California of state tax savings by individuals and businesses. For example, many corporations in California are multistate or multinational corporations. If they invest their tax savings in portions of their operations that are outside California, then the feedback effects benefiting California from this portion of the tax reduction would be reduced. A third important type of offset involves the reduced spending on state government programs that would result. These programs have their own dynamic feedback effects on the economy and revenues.

How Large Would the Net Effect Be?

In our analysis of last year's tax reduction proposal in the *Perspectives and Issues,* we discussed the issues of estimating the behavioral and feedback effects of tax proposals, and noted that much remains to be understood about the subject. State-level dynamic modeling is especially challenging because of the high interstate mobility of labor and capital, the substantial extent to which states import and export goods and services among each other, and significant data limitations. This year, we did considerable additional research on this subject, including examining the current practices followed in this area by other states, the federal government, and academic and economic research organizations. The "bottom line" continues to be that providing reliable, comprehensive estimates of behavioral and dynamic feedback effects of state tax proposals is extremely difficult.

Status of the Department of Finance's Model. In last year's budget, the Legislature provided the Department of Finance (DOF) with funding it had requested to hire additional staff in this area, and also contract with the University of California for development of an economic model which would be available to analyze dynamic feedback effects for California tax proposals. The department had previously indicated that the model would be available by the start of 1996. Although most of the developmental work on the model has been

completed, it is still being tested and evaluated. As a result, we have not been able to analyze its results, or apply our own assumptions to it, in evaluating the Governor's tax proposal.

A Partial View of What Might Happen

Given that the DOF's California-specific model is not yet fully operational, we ran simulations using a large-scale national econometric model in an effort to shed at least some light on what certain of the impacts of this proposal could be. We specifically traced out over time the impacts of a proposal like the Governor's on such economic variables as personal income, investment, and employment. We then applied the results to California, adjusting them for the relative size of the state's economy. Applying a model of the national economy to California has obvious limitations. However, the results do provide a general indication of how such a proposal might affect California, given that its economy has much in common with the nation's. The findings suggest that:

- Looking at just the effects of the tax reduction on the private sector (and ignoring for the moment the impacts of reduced government spending that would likely have to occur), our simulations suggest that the proposed tax reduction would increase private sector spending, investment, and employment. For example, total private sector employment in California could increase by up to 100,000 jobs from levels that would otherwise occur over the four years in which the tax cuts are phased in. To put this estimate in perspective, consider that if a moderate economic expansion were to continue, California would produce about 1.2 million new jobs over the next four years. Under the tax cut proposal, the increase would be 1.3 million new jobs.
- However, after taking into account reduced government spending, (which would likely need to occur to maintain a balanced budget), the near-term gains in net new jobs and related economic activity would be *minimal*. The increases in after-tax incomes of taxpayers would boost income and employment in some private sector industries. However, these gains would be offset by the direct and indirect negative impacts on the economy of less government expenditures. In fact, in the near term, there could be a net loss of income to the economy, since such a significant portion of the tax reduction would be offset by higher federal taxes.

Thus, any net economic gains from the proposal would have to come from inflows of labor, capital, and other factors of production from

outside of California. These flows could be very important, particularly over the long term. This is because California competes with other states as well as with other nations, and state borders pose few barriers to hinder interstate flows. The national model used in the above simulations cannot fully account for these factors. It is exactly these kind of effects that the DOF's state-specific model is intended to capture when it is completed.

Taking account of interstate flows also requires recognizing that some of the proposal's beneficial effects to consumers and businesses in terms of higher after-tax incomes could accrue to other states, as California dollars are spent on goods and services produced directly or indirectly outside of California. Likewise, if tax benefits were saved rather than spent, they might not directly benefit California, given that the capital markets into which such savings go are national, not regional, in scope. Similarly, multistate and multinational corporations could use their tax savings elsewhere. These factors would contribute to the simulation results *overstating* the beneficial impacts on California.

The above simulations also do not address one other extremely important issue—the long-term effects on the economy of changed levels of private and public sector investments. For example, increased business investment spending will, over time, raise productivity in the economy and thus economic growth. Likewise, reduced public sector investment spending, whether in people (through, for example, educational programs) or infrastructure (such as roads), will have its own negative effects on economic performance. These are powerful but conflicting long-term factors. We believe that, to the extent the measure produces net economic benefits, the long-term effects probably would be more significant than the short-term ones.

The above are some of the issues that the Legislature will need to consider in evaluating the Governor's tax reduction proposal.

SHOULD ALTERNATIVE TAX PROPOSALS BE CONSIDERED?

The Governor's tax reduction proposal is but one method for achieving such objectives as reducing California's marginal tax rates and its overall tax burden. Depending on its specific tax-policy objectives, the Legislature may wish to consider various tax-change options other than the Governor's. Figure 9 shows several of the many alternative tax-related policy choices available to the Legislature, again depending on its objectives or desired outcomes.

Figure 9

Alternatives to the Governor's Tax Reduction Proposal

Reduce income tax rates differently

- Focus more on lowering highest marginal rates while still maintaining a progressive structure. Added revenue loss could be offset through compressing or collapsing tax brackets.

Reduce income tax rates by a smaller percentage

- Provide some marginal tax rate relief at less impact on the rest of the budget.

Reduce other tax rates, such as the sales tax

Expand tax base while lowering tax rates, at no overall cost to taxpayers

- Expand the sales tax to services and reduce the sales tax rate.
- Modify tax expenditure programs that are ineffective or inefficient in achieving objectives. These could include various income tax exclusions, exemptions, deductions, and credits.

Reduce Marginal Income Tax Rates in Other Ways. For example, if the Legislature wished to reduce marginal income tax rates but end up with less of an aggregate state revenue reduction than under the Governor's proposal, it could consider such options as narrowing tax brackets, focusing on lowering just the marginal rates where the largest amounts of income are taxed or reducing rates by less than 15 percent. If its primary focus were on reducing the highest marginal rates, the Legislature also could consider a flat tax approach, such as the flat tax proposals that already have been introduced in California or the ones being considered at the federal level. This approach would collapse all of the tax rates levied into a single tax rate. Large revenue reductions could be mitigated in both cases by broadening the tax base through the elimination or modification of certain exclusions, exemptions, deductions, and credits, in combination with rate reductions. This again would change the distribution of the tax burden on individuals.

Reduce Other Tax Rates. Alternatively, if the goal were reducing the state's overall tax burden, another option to the Governor's proposal would be to lower tax rates other than income tax rates, such as the

state sales tax rate. Reducing the sales tax rate would tend to affect all Californians, have its own unique impacts on the distribution of the tax burden, and could increase the portion of state tax reduction that Californians would actually get to keep, since federal income tax liabilities would not be increased as much. This option, however, probably would not encourage income-producing activities (such as investment and increased work efforts) as much as the Governor's tax reduction proposal. This is because the after-tax return on producing income is increased under the Governor's proposal, since taxpayers would retain more of the income that they generate.

Broaden Tax Bases to Reduce Rates. As with the income tax, some of the cost of reducing the sales tax rate could be offset by broadening the base, such as including services in the sales tax base. Other ways of broadening the tax base in order to achieve lower overall rates also could be considered, such as a value-added tax or a similar consumption-based levy. These again would change the distribution of the tax burden. Another less sweeping possibility for broadening the tax base in order to reduce overall rates would be, as noted above in the case of income taxes, to modify or eliminate certain existing tax expenditure programs.

Thus, the Governor's tax reduction proposal is but one of many options available for modifying the existing tax structure and providing for reduced tax rates and a lower overall tax burden. In evaluating the Governor's proposal, the Legislature will need to first decide what its fundamental tax policy objectives are, and then what types of tax changes, if any, are needed to best achieve these goals. Among other things, the economic, fiscal, and distributional consequences should be evaluated to ensure that they are consistent with legislative objectives, such as the desired mix of public versus private spending in the state.