March 14, 2007

Hon. Edmund G. Brown Jr.
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Patricia Galvan
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the statutory initiative relating to state taxation (A.G. File No. 07-0001).

BACKGROUND

The state levies a personal income tax (PIT) on the California income of individuals and noncorporate businesses, such as sole proprietors and partnerships. The rates of the tax range from 1 percent to 9.3 percent, depending upon the taxpayer's income level. An extra 1 percent tax is levied on the portion of taxpayers' incomes greater than $1 million. The PIT allows various deductions from income and credits against any tax owed. Finally, residential and commercial property is subject to a local ad valorem property tax rate of up to 1 percent annually, plus any additional tax for voter-approved indebtedness.

PROVISIONS OF THE INITIATIVE

This measure contains the following main provisions:

Establishes a Wealth Tax. The measure institutes a state wealth tax levied on the net assets of individuals with values in excess of about $40 million as of January 1, 2008. The wealth tax would be based on the tax rates established by the federal estate tax, which has a progressive structure and whose top rate in calendar year 2007 will be 45 percent. However, the measure specifies that the tax rate applied must not be less than 45 percent, meaning that this rate would most likely apply to estates of all sizes. It appears that the wealth tax would be levied on taxpayers in the state on a one-time basis, with revenues to be deposited in the newly created Global Warming Fund in 2008-09 and 2009-10. The monies in this fund would be used to acquire a majority interest in outstanding voting common stock of various oil and gasoline companies as well as for other environmental protection-related purposes.

Taxes People Leaving State. The measure imposes a new tax on the income of specified individuals moving out of California. It defines this income to include both income that would ordinarily be reported and any gains in asset values. Individuals with incomes greater than $5 million would be subject to the tax, and associated revenues would be deposited in the Global Warming Fund. Whether these provisions would impair interstate commerce, and thus violate the U.S. Constitution, might be subject to court review.

Makes Changes to PIT. The measure lowers the income cutoffs for the state's existing PIT rates. It also imposes an additional tax under PIT for joint-return taxpayers equal to 17.5 percent of their total taxable incomes if greater than $250,000, with an additional tax of 17.5 percent (or 35 percent total additional tax) on incomes greater than $2 million. For single taxpayers the income cutoffs would be roughly one-half of the joint return amounts. In addition, the measure establishes several new tax programs including refundable tax credits for: (1) particular designated organizations, (2) the costs of purchasing health insurance for certain individuals, (3) income earned by teachers, (4) higher education tuition and fees, and (5) property tax payments. The first $7.5 billion of net annual PIT revenue from these changes would be allocated to the General Fund, with the remaining additional revenues directed to the Global Warming Fund.

FISCAL EFFECTS OF THE INITIATIVE

This measure would make major changes in the state and local tax system. Some of these changes could generate very significant behavioral and economic responses from taxpayers. For example, the taxes on people leaving the state and the additional PIT rates could have a significant negative impact on future economic activity and resulting revenues to the state and local governments. Given factors such as these, the fiscal estimates provided below are subject to considerable uncertainty.

Impact From New Taxes

One-Time Increase From the Wealth Tax. The measure would result in a one-time increase in state revenues (realized in 2008-09 and 2009-10) as a result of the establishment of the wealth tax. The combined increase for both years could be in the range of the low hundreds of billions of dollars. The one-time revenues generated by the wealth tax would be deposited in the Global Warming Fund.

The above estimated one-time revenue effects assume no behavioral changes on the part of taxpayers. These changes and their impacts could be very significant, in which case the estimates above would be overstated.

Ongoing Increase From Tax on People Leaving State. The revenue gain from the tax upon those leaving the state is unknown, and would depend upon taxpayer behavior, but would potentially result in additional revenues in the low tens of billions of dollars annually. This effect assumes no behavioral changes on the part of taxpayers. These changes and their impacts could be very significant, in which case the estimates above would be overstated.

Impact of PIT Tax Changes

Ongoing Revenue Impact. The revenue gain from changes to the PIT brackets and rates would—absent behavioral impacts—result in additional revenues in the range of the high tens of billions of dollars annually. Offsetting these additional revenues would be reductions associated with various tax programs. The largest of these reductions involve the proposed refundable health insurance tax credit, teacher tax credit, and property tax credit. These and other provisions would reduce state revenues (or result in increased expenditures in the case of refundable credits in excess of tax liabilities) in the tens of billions of dollars annually. The net increase of all of the ongoing PIT changes would be potentially in the tens of billions of dollars annually. The first $7.5 billion of additional revenue would be allocated to the General Fund annually, with any additional revenue above this amount allocated to the Global Warming Fund.

The above estimated ongoing revenue effects assume no behavioral changes on the part of taxpayers. These changes and their impacts could be very significant, in which case the estimates above would be overstated.

Behavioral Effects. If significant behavioral effects occur that reduce economic activity in California—such as employment, personal income, and investment decisions—then state and local government revenues would be adversely affected. The magnitude of these potential revenue losses is unknown but potentially in the tens of billions of dollars annually.

Summary of Fiscal Effects

The measure would have the following major fiscal effects:

- One-time increase in state revenues potentially in the low hundreds of billions of dollars from imposition of a wealth tax, and ongoing increase in state revenues potentially in the low tens of billions from imposition of the tax on certain people leaving the state. This revenue would be allocated to accomplish various goals related to environmental protection.
- Potential annual net increase in PIT revenues in the tens of billions of dollars annually. The first $7.5 billion annually would be allocated to the state General Fund with additional revenue allocated for environmental protection.

- Unknown but potentially major state and local revenue reductions due to changes in taxpayer behavior.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Michael C. Genest
Director of Finance