

August 16, 2007

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

Attention: Ms. Toni Melton
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. 07-0029).

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 needed to pay off voter-approved indebtedness.

In 1988, voters enacted Proposition 98, establishing a minimum annual funding level for kindergarten through grade 12 schools and community colleges (K-14 education). Each year, the school funding requirement is calculated based on the amount of General Fund revenues the state receives, among other factors.

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 petroleum and automotive companies as well as for other environmental protection-related purposes.

Taxes People When They Die or Leave the State. The measure imposes a new tax on the income of specified individuals when they die or move 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 the PIT. The measure 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 (for a 35 percent total additional tax) on incomes greater than \$500,000. For single taxpayers, these additional taxes would be applied to incomes greater than \$150,000 and \$350,000, respectively. In addition, the measure establishes several new tax programs that would reduce PIT revenues, 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 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 Dying or Leaving the State. The revenue gain from the tax upon those dying or leaving the state is unknown, and would depend upon taxpayer behavior, but would potentially result in additional revenues in the billions of dollars annually. These revenues also would be deposited in the Global Warming Fund. 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 Changes

Ongoing Revenue Impact. The revenue gain from changes to PIT tax 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.

Other Effects

Proposition 98 Impact. This measure exempts the additional revenue from tax increases from being used in the Proposition 98 calculation. However, it does not appear to exempt from this calculation the reduced revenue from the additional tax credits. This would drastically reduce the revenue base upon which the school funding requirement is calculated, and, correspondingly, would dramatically reduce the Proposition 98 minimum funding requirement in the short term. As such, during that time, decisions regarding K-14 education funding levels would be determined by the Legislature based on the state's overall fiscal situation rather than by a minimum requirement.

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 billions of dollars from imposition of the tax on certain people dying or 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 state and local revenue reductions—potentially in the tens of billions of dollars annually—due to changes in taxpayer behavior.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Michael C. Genest
Director of Finance