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August 20, 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. 07-0031).

BACKGROUND

Major State Taxes

The state raises about $115 billion in tax revenues each year, primarily through three main sources. The state levies a personal income tax (PIT) on the California income of individuals. A variety of exemptions, deductions, and credits are used when calculating taxable income and liabilities. Regular tax rates under the PIT range from 1 percent to 9.3 percent, depending on a taxpayer's income. Under Proposition 63, adopted in 2004, an additional 1 percent rate (or 10.3 percent total rate) is levied on the portion of one's income above $1 million. Revenues from this additional 1 percent rate fund mental health programs. Individuals are also subject to an alternative minimum tax (AMT) at a rate of 7 percent.

The state also levies a corporate income tax (CT) on the net earnings of corporations operating within California that are earned in the state. The regular tax rate is 8.84 percent, but corporations are also subject to an AMT at a rate of 6.65 percent. Corporate entities with a limited number of shareholders—called S-corporations—have a tax rate of 1.5 percent.

In addition, California levies a sales and use tax (SUT) on taxable purchases. The current state SUT tax rate is 6.25 percent, including 5 percent for the General Fund, 1 percent for specified local purposes, and 0.25 percent to pay off the state's deficit-financing bonds. Local governments also levy a SUT, with local rates currently ranging from 1 percent (a uniform local rate) to 2.50 percent (which includes the maximumallowable 1.5 percent optional rate primarily used for transportation-related purposes). Thus, the combined state-local SUT rate among counties varies from 7.25 percent to 8.75 percent, with a statewide weighted-average rate of 7.94 percent.

Proposition 42 Funding

Proposition 42, passed by the electorate in 2002, permanently directs to transportation purposes SUT revenues from gasoline sales, which previously had been deposited in the General Fund.

PROVISIONS OF THE INITIATIVE

This measure makes several changes to California's existing tax laws. Specifically, it:

- Repeals PIT.
- Reduces corporate tax rates, as follows: (1) the regular tax rate would be reduced by 1.84 percentage points to 7 percent and the AMT rate would be reduced by 1.13 percentage points to 5.52 percent; and (2) the tax rate for S-corporations would be reduced by 0.3 percentage points to 1.2 percent.
- Increases the SUT rate by 5.5 percentage points. Thus, the combined SUT rate would range from 12.75 percent to 14.25 percent. The measure would also create an exemption from SUT for personal property purchased for use in the manufacturing process.

FISCAL EFFECTS OF THE INITIATIVE

State Government Fiscal Effects

Revenues. If approved by the voters, this measure would:

- Reduce PIT General Fund revenues by $23 billion in 2008-09, $60 billion in 2009-10, and increasing amounts thereafter. It would also reduce PIT revenues to the Mental Health Fund attributable to the 1 percent levy on high incomes by about $1 billion in 2008-09 and $2 billion annually thereafter.
- Reduce CT General Fund revenues by approximately $1 billion in 2008-09 and by more than $2 billion annually thereafter.

- Increase net state SUT General Fund revenues by approximately $15 billion in 2008-09, and by more than $30 billion annually thereafter. This net amount reflects increased revenues due to the higher SUT tax rate partially offset by reduced revenues from the exemption for manufacturing-related property. The exemption would also result in reductions in state special fund SUT revenues of $100 million in 2008-09 and $200 million in 2009-10 and thereafter.

Thus, the state would experience a net annual revenue loss of over $30 billion a year.

The above estimates assume no behavioral responses from taxpayers as a result of the measure. These impacts, however, could be substantial. For example, the elimination of the PIT and the large net reduction in state taxes could spur investment and in-migration to California, resulting in increased revenues to state and local governments. In addition, the large increase in the sales tax rate—making it the highest in the nation—could induce greatly increased purchases of out-of-state goods. This would lower the revenue gain from the state sales tax increase and reduce local government sales tax revenues. Finally, the large net loss in state revenues would result in major reductions in state spending and/or lead to increases in other state revenues. The impacts of these behavioral effects are unknown but likely major.

Costs. The measure would affect state costs in the following ways:

- ***Proposition 42.*** Increased transfers would occur from the General Fund to transportation-related funds per Proposition 42 of about $1 billion in 2008-09 and more than $2 billion per year annually thereafter.
- ***Tax Agency Administrative Costs.*** The Franchise Tax Board, which administers the PIT and CT, would experience major cost reductions due to the elimination of the PIT. These savings would be offset somewhat by increased administrative costs to the Board of Equalization, which administers SUT. The net impact—once fully implemented—would be savings, potentially in the low hundreds of millions of dollars a year.

Local Government Fiscal Effects

The measure's manufacturing-related exemption would reduce local SUT revenues by an estimated $100 million in 2008-09 and $300 million in 2009-10 and thereafter. (These reductions are in addition to the above-discussed reduction in state SUT revenues to the Local Revenue Fund and Local Public Safety Fund, which are distributed to localities.)

Summary of Fiscal Effects

This measure would have the following major fiscal effects:

- Net reduction in state General Fund revenues of over $30 billion annually, primarily due to the elimination of the PIT and an approximate doubling of the state sales tax rate.
- Major behavioral effects in response to the measure, resulting in unknown impacts on state revenues and expenditures.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Michael C. Genest
Director of Finance