November 30, 2009

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

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the constitutional initiative relating to state and local taxation (A.G. File No. 09-0051, Amdt. #1-S).

BACKGROUND

California currently levies a variety of state-level taxes, including the personal income tax (PIT), the bank and corporation franchise tax and income tax (CT), the state portion of the sales and use tax (SUT), the insurance tax, various excise taxes, and state-assessed property taxes. At the local level, local governments levy locally assessed property taxes, the local portion of the SUT, and other miscellaneous taxes.

The PIT represents the largest state revenue source. The PIT is a tax on income earned in the state. The PIT tax rate increases with income, although the effective tax paid by individuals also reflects exemptions and credits for things such as mortgage interest deduction. The second largest revenue source, SUT, is a 5 percent tax levied on the final sale of tangible personal property with exemptions for certain products such as food and medicine. (The state SUT is temporarily set at 6 percent.) The CT is the state's third largest revenue source, imposing an 8.8 percent tax on income earned by corporations that is attributable to California business activity. The state also levies certain excise taxes (on tobacco and alcohol), an insurance tax, and a vehicle license fee. Total state tax revenues from existing sources totaled $114 billion in 2006-07.

At the local level, about 80 percent of local government revenue comes from local property taxes and the local portion of the SUT. The property tax imposes an average of about 1.1 percent tax on residential and commercial property. The local SUT averages about 3 percent. Other local revenues come from utility taxes, Mello-Roos assessments, parcel taxes, and other sources. Additionally, local governments have the authority to levy special taxes and fees upon voter approval. In 2006-07, total local government tax revenues totaled $58 billion.

PROPOSAL

Tax Provisions

The measure limits state and local taxes to the following: (1) a land tax levied on the monthly rental value of land; (2) a personal income tax on income above $150,000 annually; (3) taxes on alcohol, tobacco, marijuana, and motor fuels; and (4) a severance tax on natural resources such as timber, minerals, and oil. The changes in the measure would take effect on July 1, 2011. At that time, all other existing state and local taxes would cease. The new taxes are discussed briefly below.

New Tax on the Rental Value of Land. The measure establishes a new tax on the rental value of land. Land would be assessed at its fair-market monthly rental value. The measure would not tax improvements, such as houses or buildings, except in cases where the rental value of improvements could not be reasonably distinguished from the rental value of land. The land tax rate would be set at 75 percent of each parcel's assessed monthly rental value. This rate could not be changed. Residential and agricultural land would be assessed annually. All other land having rental value would be assessed semi-annually. The measure also allows land tax exemptions from land owned by the government and for land that (1) serves a public purpose, (2) is used for religious worship, or (3) is a burial ground for the dead. The measure also authorizes the Legislature to offer exemptions in other situations.

Modified Personal Income Tax. The measure alters the existing PIT in two major ways. First, the measure exempts the first $150,000 of each person's annual income from the tax. This means that most people would not pay this tax. Second, the tax rate on personal income would be limited to 8 percent. Under existing law, the top PIT rate will be 10.25 percent in 2011.

Special Taxes. The measure allows taxes on the use; manufacture; sale; purchase; exchange; and storage of alcohol, tobacco, marijuana products, and motor fuels.

Severance Taxes. Under this measure, taxes could be levied on natural resources when they are severed from land. Resources that could be taxed include oil and natural gas, minerals, timber, and other forestry products.

Tax Credits. The measure creates new tax credits. First, it creates a PIT tax credit for land tax payments paid by businesses. When the land tax is paid by a company for which an individual is a shareholder or partner, the tax credit would allow the individual to deduct from PIT the amount of the land tax that is proportional to the equity share held in the business interest. Similarly, the measure creates a credit for severance tax payments made by a person or business entity against land taxes paid on the land from which the resource was taken.

Deferrals During Phase-In Period. During the initial implementation of the measure, land taxes could be deferred under specific conditions. Specifically:

- Persons 60 years or older could defer land taxes for a period of up to nine years.
- Land used for agricultural uses could be deferred for up to three years.
- Land used primarily for residential purposes that contains three or fewer units could be deferred for up to three years.

These deferrals would be payable at the end of the specified deferral period. Deferred taxes would accrue interest at a rate set by the Department of Finance.

Other Provisions

Local Government Apportionment. Counties, cities, and other local governments would receive a portion of the land tax revenue. The measure requires that, in the fiscal year following the passage of the measure, the apportionment would be at least equal to the annual average amount of total revenues collected by each entity during the three-year period from July 1, 2008 to June 30, 2011.

Administration. The Board of Equalization would be responsible for administering the land tax. Counties would collect the tax. The board would work with county governments to develop procedures for consistent assessments of land values. The measure does not specify how the other taxes would be administered.

FISCAL EFFECTS

This measure restructures the overall state and local tax system. Some of these changes would generate very significant behavioral and economic responses from taxpayers. Given factors such as these, the fiscal estimates provided below are subject to considerable uncertainty.

Additionally, the impact of the measure would depend on a wide variety of implementation decisions. The measure, for instance, does not set tax rates in many instances. As a result, the measure could result in billions of dollars of revenue gains or losses each year depending on how the new taxes are implemented by the state.

Impact From New Taxes

The measure would eliminate most of the existing state and local tax system and create a new system of taxes. Taxes under the current system totaled about $170 billion annually. We estimate the new tax system could generate roughly equivalent revenues. There would be significant administrative changes as well.

Land Tax. We estimate the tax on land would generate revenues of $130 billion to $160 billion annually. Our estimate is subject to considerable uncertainty, however, due to the difficulty in estimating the current fair market value of land.

PIT. We estimate the revised PIT would generate about $20 billion dollars at the proposed maximum tax rate of 8 percent. (In addition, we assume there would be additional revenues for the existing 1 percent tax that supports the Mental Health Services Act [Proposition 63].) This also assumes the continuation of current PIT credits, exclusions, and deductions.

Other Taxes. The measure does not specify a tax rate for these taxes. Therefore, we cannot estimate the fiscal effect of the measure's authorization for these taxes. Assuming, however, that current alcohol, gasoline, and tobacco excise taxes would not be affected, these taxes would continue to bring in about $4 billion each year.

Indirect Effects

Behavioral Effects. The measure proposes major changes to the way California raises revenues to fund public services. By reducing and removing existing taxes on business income, sales of goods, and property, economic theory suggests that the measure could increase investment and stimulate economic activity in the state. In the long run, greater economic activity would enhance income and land's rental value, and generate higher tax revenues. The size of these indirect effects is unknown.

Summary of Fiscal Effects

The measure would have the following major fiscal effect:

- Replaces virtually all existing state and local tax revenues (about $170 billion) with a roughly equivalent amount from a new land tax and other taxes. Major revenue gains or losses could result depending on how the measure is implemented by the state.

Sincerely,

Mac Taylor
Legislative Analyst

Michael C. Genest
Director of Finance