

Perspectives on the State's Revenue Structure



Legislative Analyst's Office

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What Criteria Do You Use to Judge a Tax System?

- **Reliability (Growth and Stability)**
- **Broad-Based Levies**
- **Impact on Economic Activity**
- **Equity Considerations**
- **Administrative Feasibility**

How Our Tax System Stacks Up— The Positive

- **“Robust” System**
 - Grows in line with the economy
- **Broad-Based Taxes, Levied on:**
 - Income
 - Consumption
 - Wealth (Property Tax)

How Our Tax System Stacks Up— The Negative

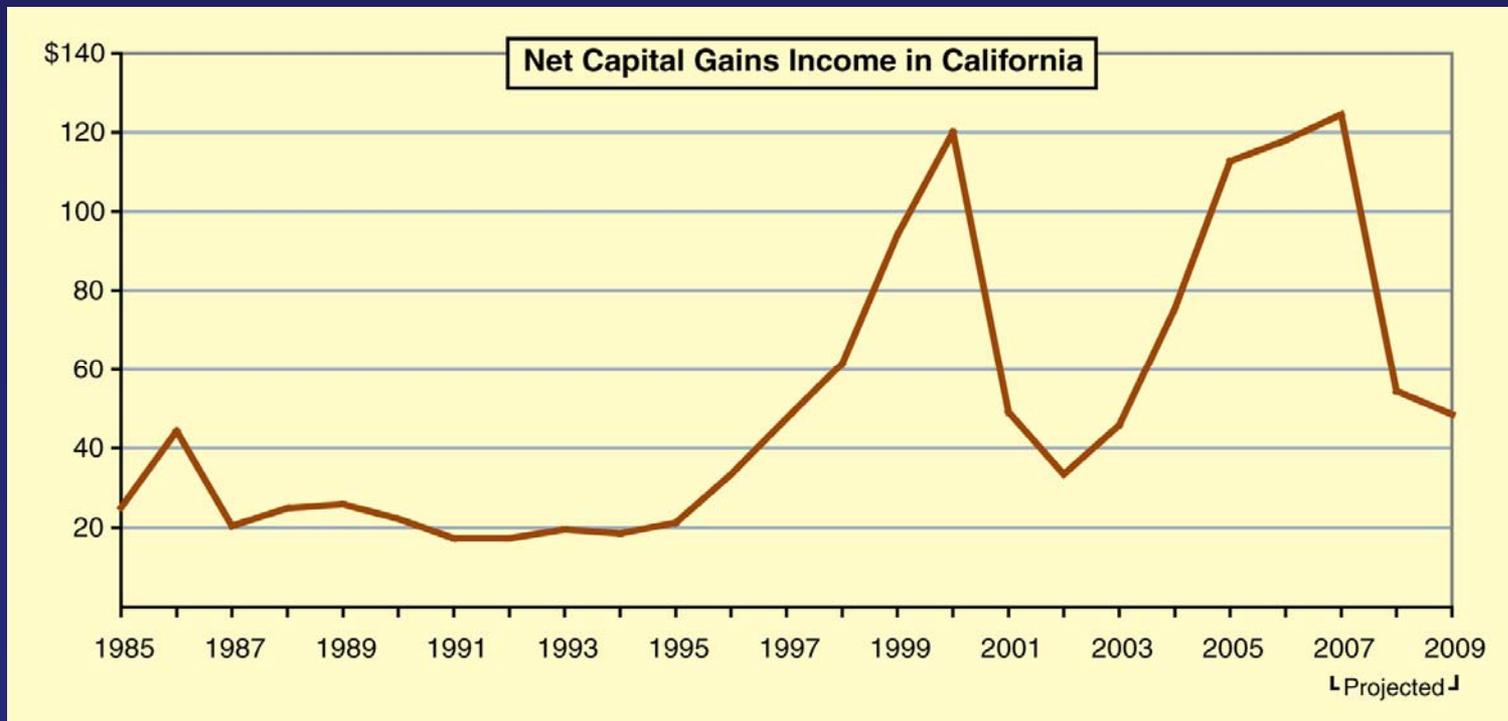
- **Significant Volatility**
- **High Marginal Rates**
- **Challenges to Tax Bases**
 - Sales tax (services and remote sales)
 - Tax expenditures
 - Tax gap

How Our Tax System Stacks Up— Other Issues

- **Tax Burden**
 - Overall distribution of tax burden
- **Administrative**
 - Complexity (particularly corporate tax)
 - Simplification
 - Conformity

Volatility— Capital Gains Are the Main Story

(In Billions)



Volatility— Impact on State Revenues

Historical Effects of Economic Cycles on General Fund Revenues

	Effects of a 1 Percent Change in Personal Income On Percent Changes in Revenues	
	1979-80 Through 1990-91	1991-92 Through 2003-04
Personal income tax	1.09%	6.24%
Sales and use tax	1.33	1.44
Corporation tax	2.57	3.33
Totals, All Revenues	1.39%	3.51%

Volatility— Impact on the State Budget

- **Boom/Bust in PIT Revenues Complicated Our Budgeting Process Enormously**
- **Problems in Late 1990s and Mid-2000s**
 - Surge of revenues one-time or ongoing?
 - Over-committed ongoing spending programs
 - Failure to set aside revenues
- **Result: Huge Operating Shortfalls**

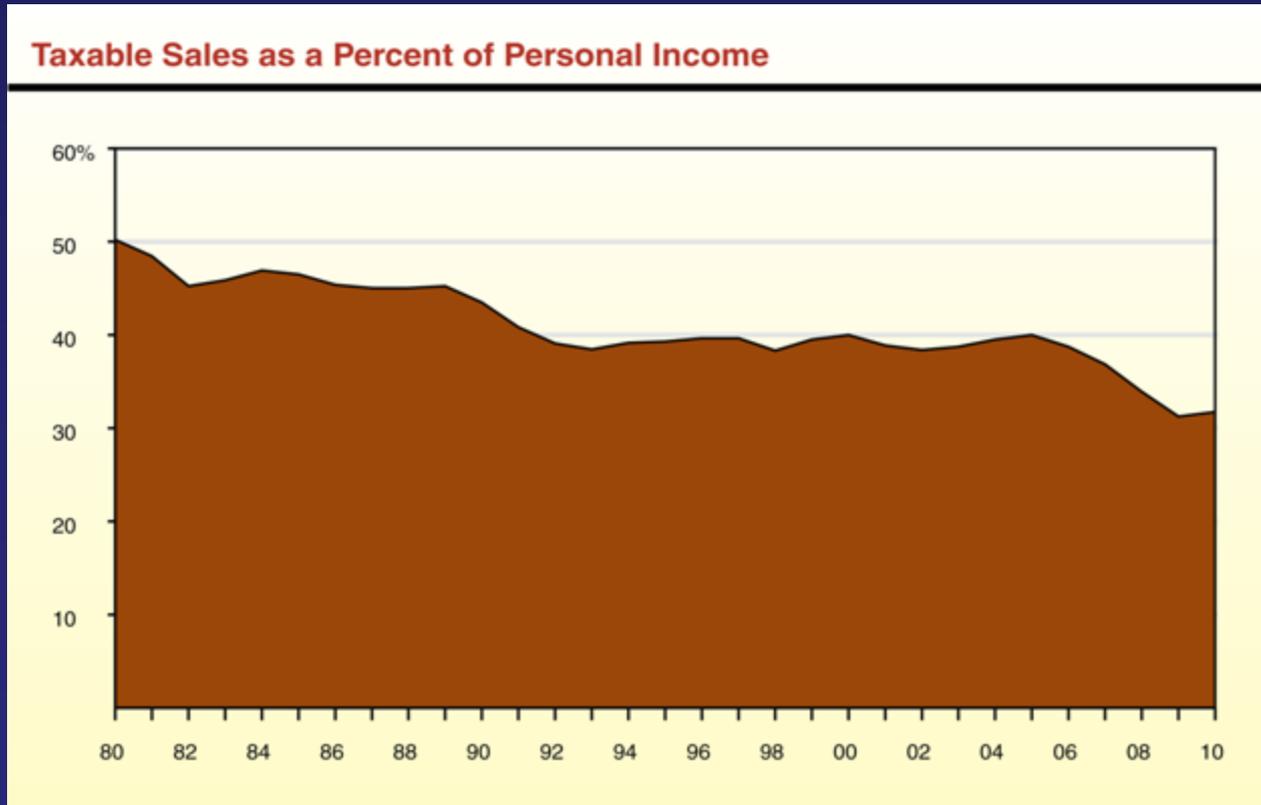
Addressing Volatility: Budget Management Options

- **Most Effective Tool: Set Aside Above-Average Revenue Growth in Reserves**
 - Funds are available during below-average years
- **State Has Taken Action in This Regard**
 - Proposition 58
 - Budget reform measure on spring ballot
- **Other Tools:**
 - Use “overages” on one-time spending
 - Spending cap

Addressing Volatility: Revising the Revenue System

- **Reduce PIT Rates on Capital Gains**
- **Reduce Progressivity of Rate Structure**
- **Rebalance Mix of Taxes Away From PIT**
- **Income Averaging on Capital Gains/
Stock Options**

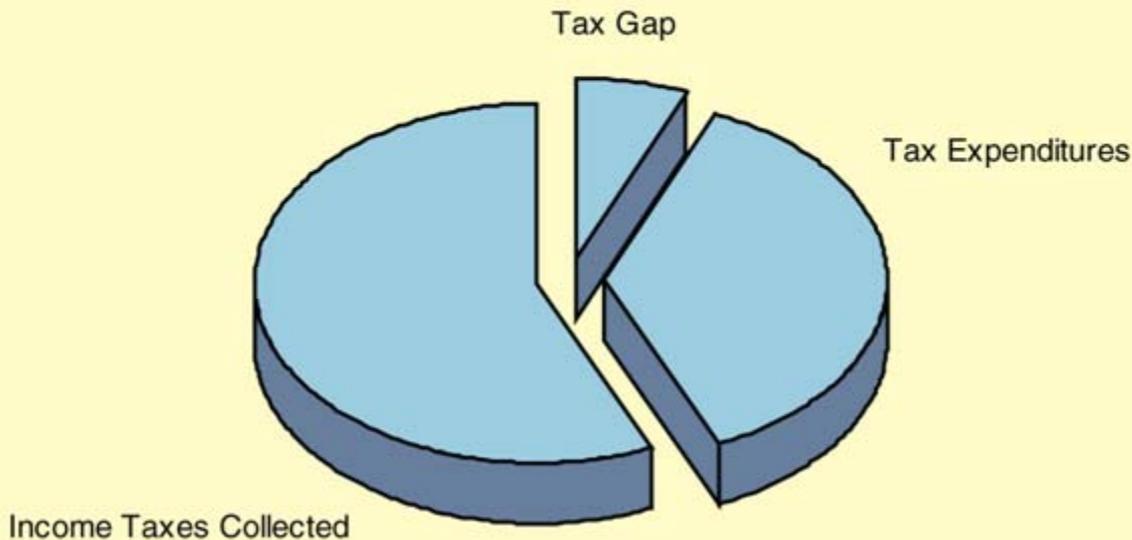
Base Broadening— Declining Sales Tax Base



Base Broadening— Inroads on Income Tax Base

**Income Taxes Paid Amount to Less
Than 60 Percent of the Income Tax Base**

2005-06 and 2006-07



Base Broadening— High Marginal Rates

- **PIT—Highest Rate in the Country**
 - Top rate starts at low income
- **Sales Tax—Highest Uniform Rate In the Country**
- **Corporate Tax—One of the Highest In the Country**

Addressing Base Broadening— Expand Sales Tax to Include Services

- **Turn Tax on All Tangible Goods Into More of a Tax on Consumption**
 - Lower rate
 - More equitable treatment of economic activity
- **Issues**
 - How inclusive?
Will it apply to: Housing? Schooling? Medical?
 - Administrative issues

Addressing Base Broadening— Expand Income Tax Base

- **Reduce/Eliminate Tax Expenditure Programs (TEPs) and Lower Rates**
- **Many TEPs Result in:**
 - Distortions
 - Inequitable treatment among taxpayers

Addressing Base Broadening— Tackling Tax Expenditures

2006-07
(In Millions)

Largest PIT Tax Expenditure Programs

Program	Type of Provision	Revenue Reduction
Mortgage Interest Expenses	Deduction	\$4,885
Employer Contributions to Pension Plans	Exclusion/Exemption	4,450
Employer Contributions to Accident and Health Plans	Exclusion/Exemption	3,975
Basis Step-Up on Inherited Property	Exclusion/Exemption	3,030
Capital Gains on the Sale of a Principal Residence	Exclusion/Exemption	1,770
Dependent Exemption	Credit	1,650
Charitable Contributions	Deduction	1,600
Real Property Tax Deduction	Deduction	1,315

Addressing Base Broadening— A More Radical Approach

- **State Could Adopt a Simplified PIT**
 - Start with federal Adjusted Gross Income
 - Few adjustments “below the line”
 - Fewer and lower rates
 - No Alternative Minimum Tax

Conclusion

- **The State has a Sound Tax System**
- **Improvements Should Be Focused on:**
 - Reducing volatility
 - Keeping bases as broad as possible and rates as low as possible