Commission on the 21st Century Economy (COTCE) Findings and Recommendations on Tax Reform

Material for Presentation to the Revenue and Taxation Committees

September 1, 2010

Commission on the 21st Century Economy (COTCE)

Executive Order

Governor Schwarzenegger's executive order established the Commission on the 21st Century Economy (COTCE), and directed the commission to:

a. Develop a 21st century tax structure that fits with state's 21st century economy;
b. Stabilize state revenues and reduce volatility;
c. Promote the long-term economic prosperity of the state and its citizens;
d. Improve California's ability to successfully compete with other states and nations for jobs and investments;
e. Reflect principles of sound tax policy including simplicity, competitiveness, efficiency, predictability, stability and ease of compliance and administration;
f. Ensure that tax structure is fair and equitable.

COTCE Review of California Tax System

The Commission thoroughly reviewed the state's tax system, looking for reasons why the volatility of the state's revenues has increased so dramatically in recent years. As the first graph shows, revenues showed a pronounced departure from personal income changes beginning in 2000, although revenues have been more volatile than personal income in the preceding decades.

California's very progressive PIT is far more volatile than the sales tax. Consequently, the shift from sales taxes to PIT, as shown in the second graph, has led to an increase in volatility. The statistical method to measure volatility across time is the coefficient of variation index (see third graph). This index shows that California's tax system has increased by over 50% since the 1990's, and is twice as volatile as in the 1980's.

Rather than changes to state laws, economic changes have led to a dramatic reduction to the revenue share to sales taxes. In the 1950's the revenue share from the sales tax was in the high fifty percentiles. In the 1960's, it dropped to the mid forty percentiles. In 2007-08, it dropped to 26%. These changes ware largely the result of changes to consumption patterns, from goods to services. The decline of goods sales relative to personal income is shown in the third graph.

During that same period of time, the personal income tax (PIT) share of revenues went up from around 12% to 53%. By 2007, the top one percent was paying 48 percent of the income tax. In 1993, that percentage was only 33 percent. Reflecting the volatility of this income, the top one percent paid only 43 percent of tax in 2008.

Commission on the 21st Century Economy (COTCE) Findings:

The Commission determined that the California tax base is too narrow, and tax rates too high. The Commission also determined that California's tax system is too reliant on income taxes.

For each of its main revenue sources, PIT, sales tax, and the corporate income tax, California has among the highest tax rates in the country. COTCE found that high marginal tax rates harm California's competitiveness with other states and nations.

COTCE recommended that these high marginal rates be reduced substantially, that personal income taxes be reduced by 29 percent, and that the state's reliance on PIT revenues be lowered.

To finance substantial reductions in California's high tax rates, COTCE recommended that the tax base be broadened to better reflect the modern economy and reduce economically distortive preferences for service business activities that have expanded greatly in the decades since the sales tax was adopted. These significant increases in the breadth of California's tax base allow significant reductions to tax rates, improving California's competitiveness.

COTCE also recommended that tax reform should provide roughly the same amount of revenue as existing law over an economic cycle with the potential for better long term growth.

How the COTCE Recommendations Achieved These Goals:

Reduced Personal Income Tax (PIT) top rate from 9.3% to 6.5%. Adjusted all other brackets to a single rate of 2.75 percent. Adjusted standard deduction upwards to eliminate any tax increase on lower brackets.

Eliminated the Corporate Income Tax

Replaced sales tax with a broad consumption tax, the Business Net Receipts Tax (BNRT). The Commission recommended that the BNRT rate not exceed 4 percent. During the first year of the transition, their preliminary calculations indicated that the revenue neutral BNRT rate would be 1.6 percent.

The Commission recommended that the BNRT include an exemption for small businesses and a credit for research and development activities.

The Commission suggested a technical review panel and a method for evaluating the transition as it progresses. During the first three years of the transition, the panel would annually review the performance of the BNRT with respect to its estimated revenues relative to what revenues would have been raised under the old law. In each year, the panel would recalibrate the SUT transition process depending how the BNRT performs. For example, if in year three the BNRT produced less in revenues than necessary to replace the eliminated current law revenues, the SUT phase-in rate would be adjusted in order to make up the shortfall.

Additional Options to Further the COTCE Approach:

There are various options, similar to the COTCE recommendations, to finance significant reductions in personal income taxes, sales taxes on goods and corporate income taxes and to improve California's competitiveness. Such an alternative is a broad sales tax on services. Many variations are possible.

An illustration of what may be possible includes:

Reduce PIT rates to the COTCE recommendations, but without the changes in deductions proposed by the Commission. This would equate to a 26 percent reduction in personal income taxes.

Reduce Corporate Income Tax rates so that they equal the top PIT rate. This would equate to a 26 percent reduction in corporate taxes.

Institute a broad sales tax on services and dropping the state rate on goods to equal the new rate on services. There could be limited exclusions for services predominantly provided by government or where federal law restricts the ability of states to tax. This would equate to a 28 percent reduction in sales tax on goods.

Using rough estimates compiled by COTCE staff and Finance, the effect of this could be revenue neutral and state tax rates on sales of both goods and services could be set initially at about 4 percent, if health care and education services were excluded, or 3.6 percent if health care and education services were included. These estimates assume that California sale for resale law, which excludes goods and services incorporated into products or services, was adopted.[1] Similar to the BNRT proposal, some measure for mitigating the impact of the tax on services on small business could be incorporated.

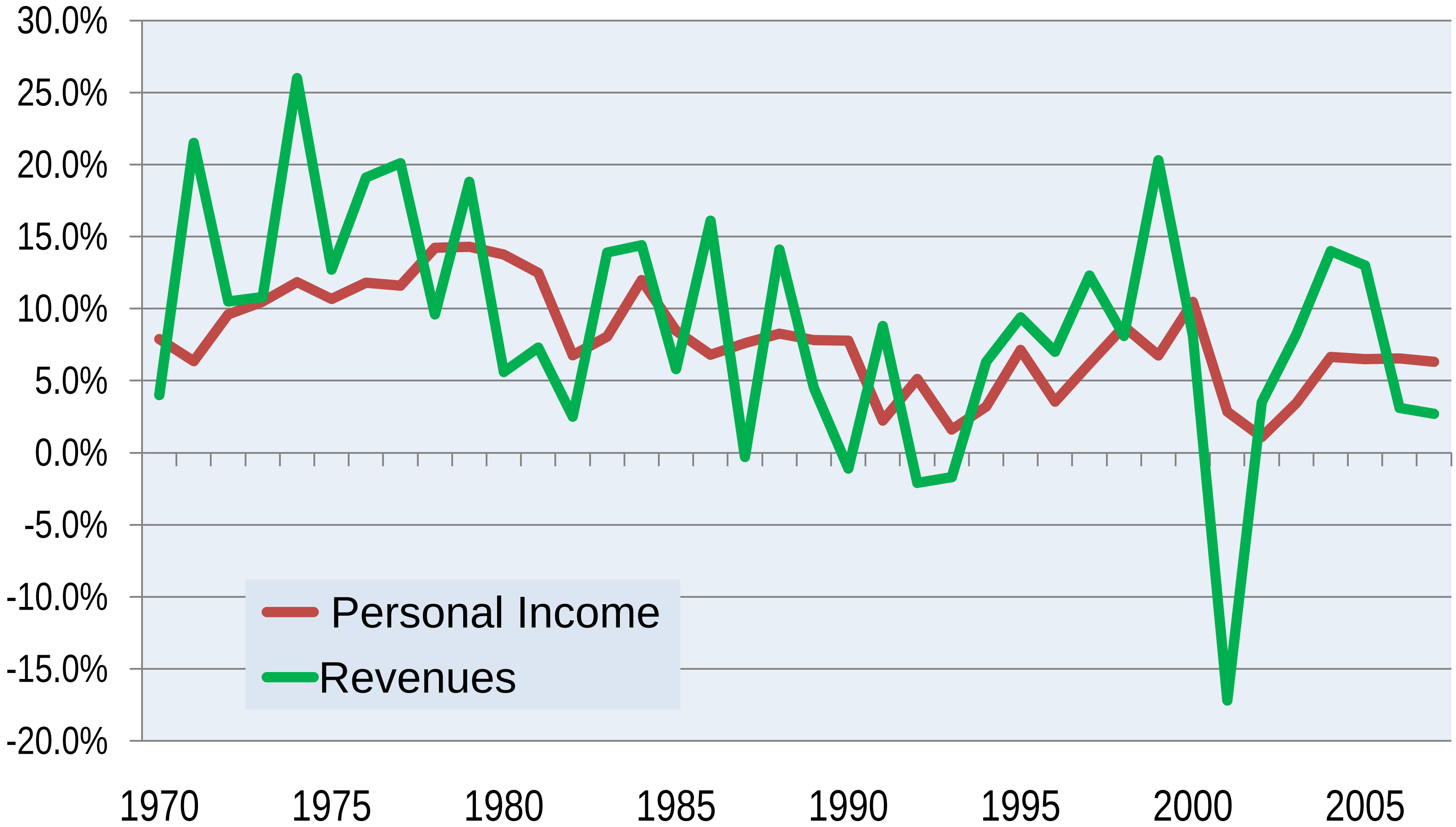
Initially it would be likely that compliance would be difficult and that both the administering agency and tax payers would have learning curves. To maintain rough revenue neutrality, one or more rate

---

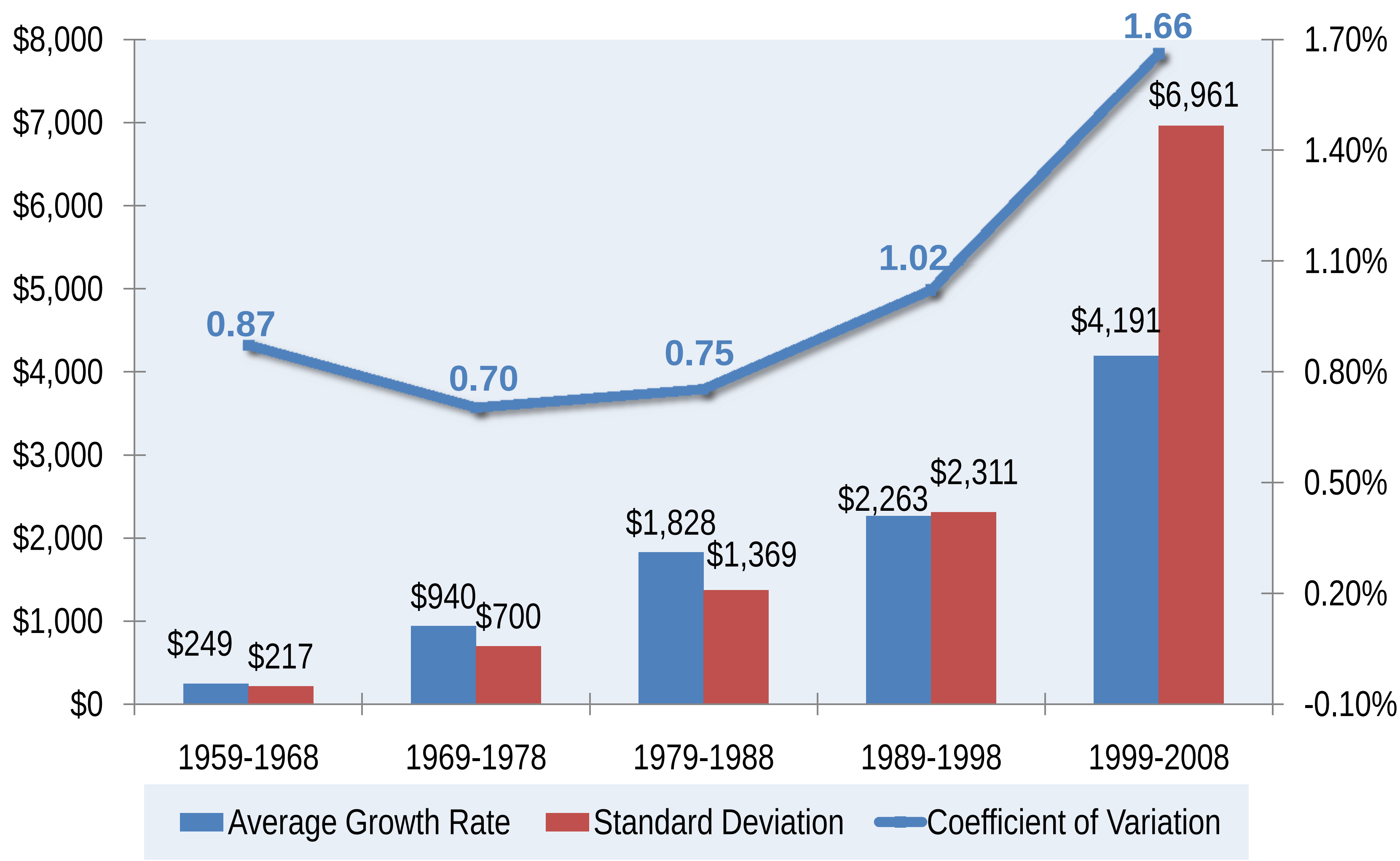
[1] For current law, the state sales tax rate is 5%. While it may be possible for local governments to adopt the services tax base in various ways, the focus of the Commission was only on state taxes.

adjusting mechanisms could be built into the law to operate in the first several years. This is also what the COTCE recommended.

Revenues are More Volatile Than the Economy

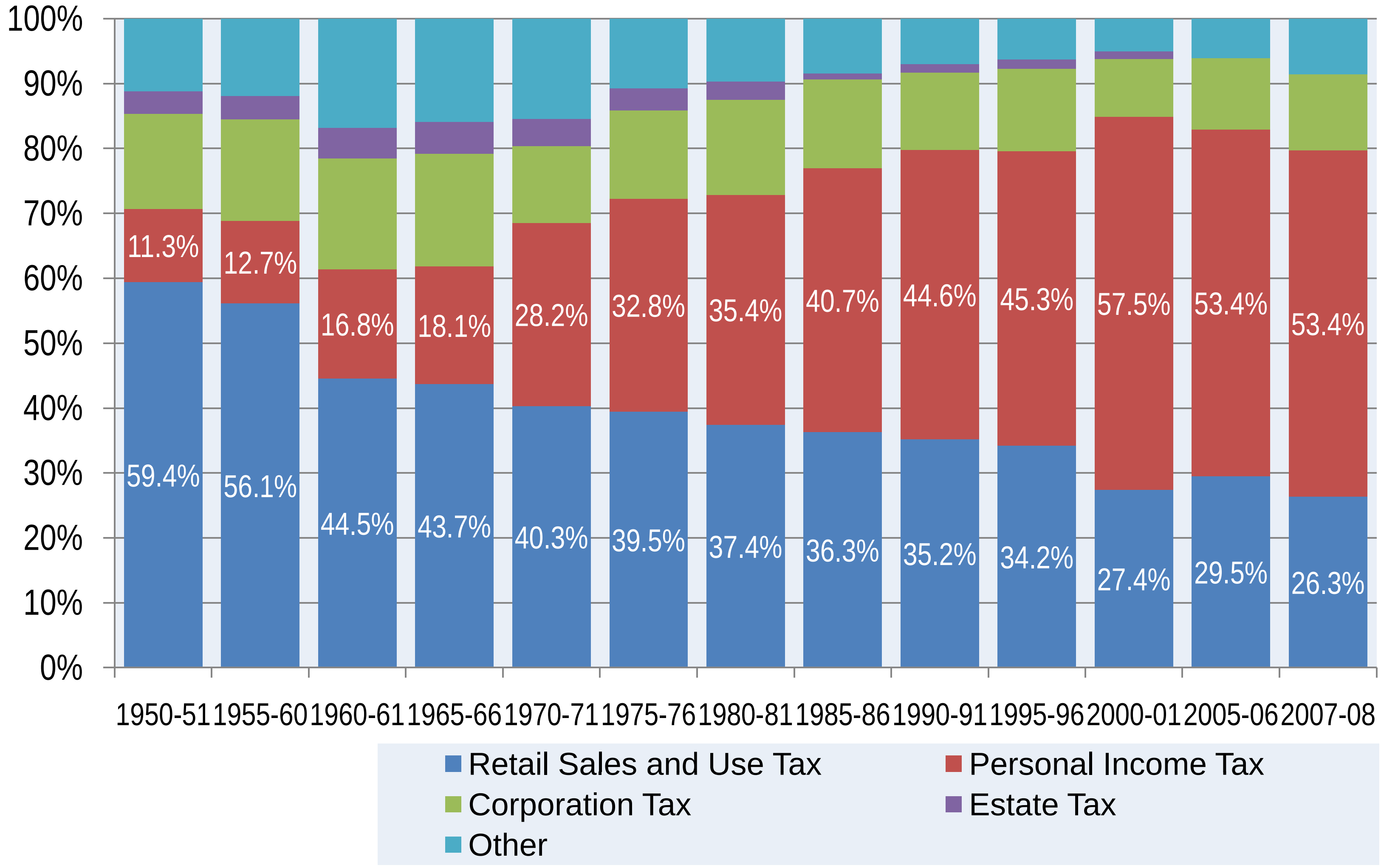


General Fund Variability

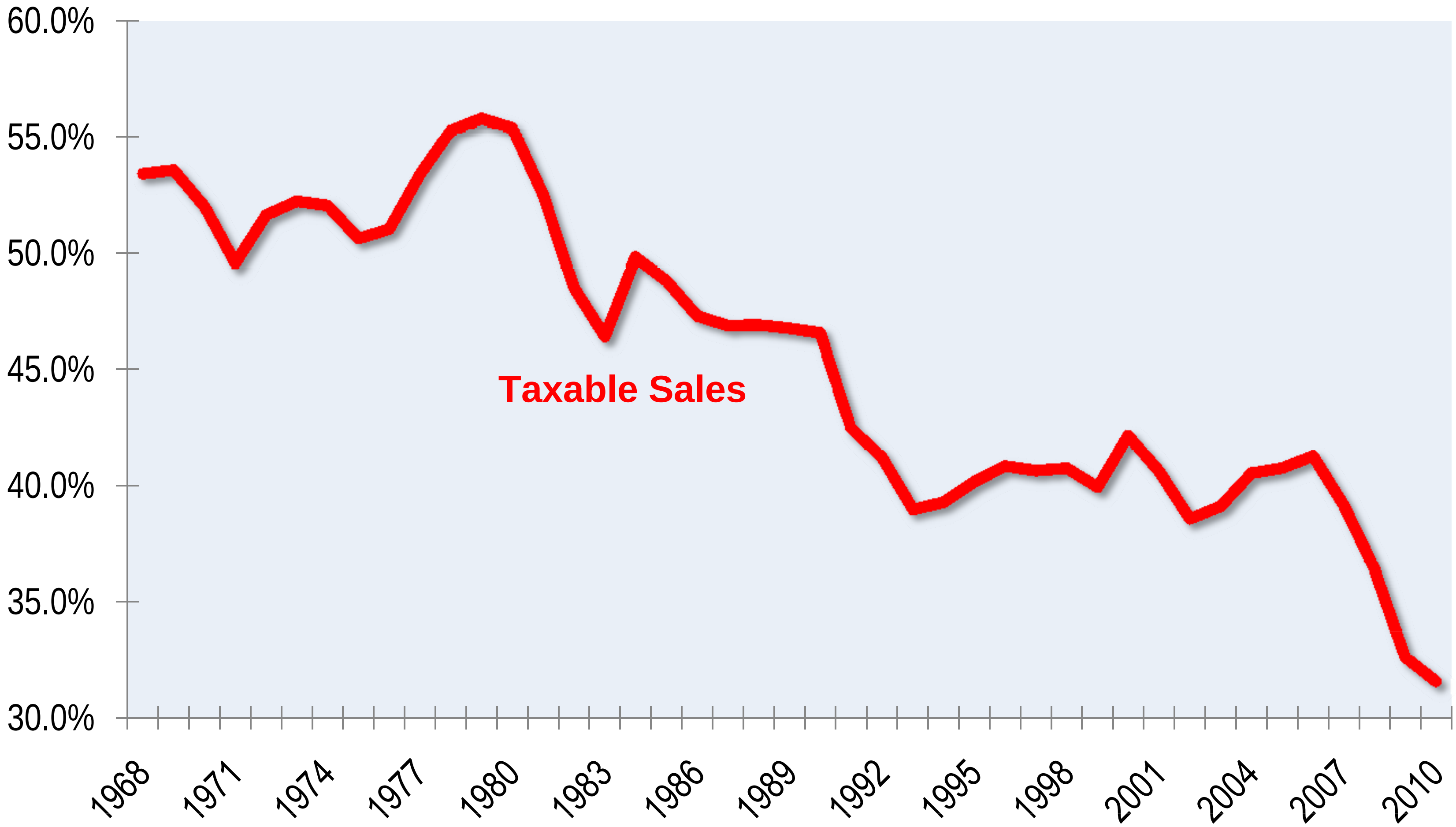


California State Revenues by Source

($ Billions)



Ratio of Taxable Sales to Income



For tax years 2012 and later, reduce PIT tax rates to 2.75% and 6.5%. The 2.75% rate would replace the 1%, 2%, 4%, and part of the 6% bracket; the 6.5% would replace the top part of the 6% bracket, the 8% and the 9.3% bracket. For married filing joint, raise the standard deduction amount to $30,000 ($15,000 for single). Starting at $80,000 AGI, the standard deduction would be phased-out between $80,000 and $230,000 ($80,000 to $155,000 for single).

Effective January 2012, reduce the state sales tax rate from 5% to 3.59%
Effective January 2012, apply the sales tax to all services.

Tax Year 2012
($Millions)

Income		Number of PIT Tax Returns	Adjusted Gross Income	Personal Income Tax	Percent Change	Tax Change per Return
*********	$ 30,000	6,618,535	104,547	(110)	-57%	$ (17)
$ 30,000	$ 60,000	3,921,410	175,856	(506)	-35%	$ (129)
$ 60,000	$ 80,000	1,434,436	103,397	(602)	-26%	$ (420)
$ 80,000	$ 100,000	983,655	91,573	(227)	-26%	$ (231)
$ 100,000	$ 300,000	2,145,894	341,292	(2,745)	-20%	$ (1,279)
$ 300,000	*********	296,171	276,584	(5,004)	-30%	$ (16,897)
Total		15,400,101	1,093,249	(9,195)	-26%	$ (597)