

Revised September 22, 2009

COTCE Proposals Would Increase Budget Gaps, Tax Low- and Middle-Income Californians

The Commission on the 21st Century Economy (COTCE) was established by an executive order issued by the Governor to examine California's tax system. The Governor's order instructs the Commission, which consists of seven members appointed by the Governor, four members appointed by Assembly Speaker Karen Bass, and three members appointed by Senate President pro Tem Darrell Steinberg, to recommend changes in law aimed at achieving:

"The following goals:

- a. Establish 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."

While not explicitly stated in the Governor's order, the Commission has defined its charge as changing the mix of taxes used to collect the existing level of revenue, rather than raising additional revenues. The Commission has held a series of meetings, all on campuses of the University of California, since January 2009. The Commission is charged with developing a set of recommendations no later than September 20, 2009.

The COTCE Proposals Would Shift Taxes From Income to Consumption

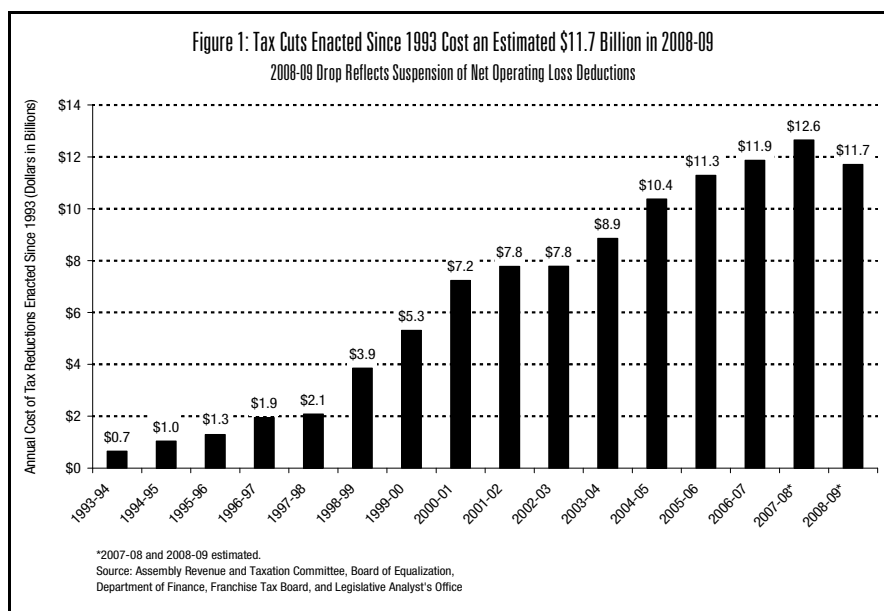
The core of the COTCE proposals would reduce the state's reliance on the personal income tax by reducing the number of rates and the maximum tax rate, eliminate the corporate income tax and the state's share of the sales and use tax, and replace the revenues lost by imposing a new business net receipts tax (BNRT).¹ The BNRT is a "value-added" tax on consumption that would be paid by businesses based on the difference between the amount they earn from the sale of goods and services

¹ Commission on the 21st Century Economy, *Tax Structure Options* (July 16, 2009), downloaded from http://www.cotce.ca.gov/meetings/2009/7-16/testimony/documents/STAFF_PRESENTATION_7-16-09.pdf on September 8, 2009.

and the amount they pay for goods and services.² The COTCE has also considered imposing a new tax on carbon-based fuels.

The Context for the Commission: California Faces Significant Budget Challenges and Inequality Is at an Eight-Decade High

Most everyone agrees that California faces severe and ongoing fiscal challenges. Even in good economic times, California's tax system fails to provide sufficient revenues to support "baseline" program demands.³ In bad economic times, such as now, the gap widens. More than three-quarters – \$47.3 billion – of the \$60 billion budget shortfall addressed by the February and July 2009 budget agreements stemmed from a shortfall in actual or anticipated revenue collections. The state's persistent revenue shortfalls reflect both a tax system that fails to keep pace with demands on the budget and, perhaps more importantly, on legislated tax policy changes that reduced 2008-09 revenue collections by \$11.7 billion (Figure 1). As a result, California's tax system fails the test of adequacy. That is, it fails to produce sufficient revenues to ensure a balanced budget, even in good economic times.



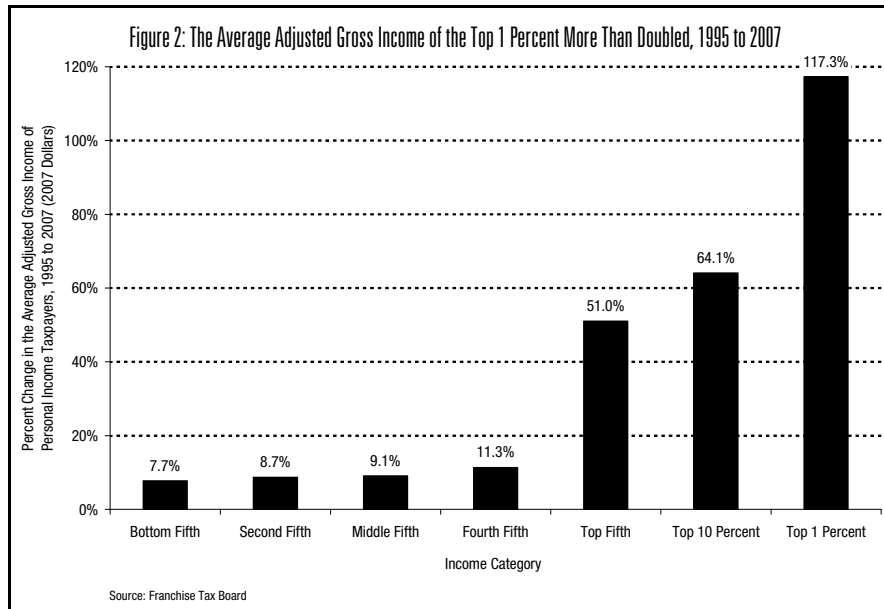
The second major trend that sets the context for the work of the Commission is that of widening inequality. One of the hallmarks of the 21st century economy is a widening gap between high-income households, on the one hand, and low- and middle-income households, on the other. The California Budget Project (CBP) and numerous other researchers have documented the magnitude of this trend in California.⁴ The inflation-adjusted adjusted gross income (AGI) of the average California taxpayer in the top 1 percent rose by 117.3 percent between 1995 and 2007 – nearly 13 times the gain of the average middle-income taxpayer (Figure 2).⁵

2 For a description of how the BNRT would work, see Robert Cline, *Analysis of a Business Net Receipts Tax* (June 16, 2009), downloaded from http://www.cotce.ca.gov/meetings/testimony/documents/Robert_Cline-CA_Tax_Commission_6-16-09.pdf on September 8, 2009.

3 Baseline or "current services" spending is generally defined as the level of programs and services required under existing laws adjusted for population, caseload, and/or enrollment growth and inflation. The Legislative Analyst's Office releases a multiyear baseline budget forecast each November as part of its *Fiscal Outlook* series.

4 See, for example, California Budget Project, *A Generation of Widening Inequality: The State of Working California, 1979 to 2006* (August 2007) and *In the Midst of the Great Recession: The State of Working California, 2009* (September 2009) and Deborah Reed, *California's Rising Income Inequality: Causes and Concerns* (Public Policy Institute of California: February 1999).

5 Franchise Tax Board.



Substantial income gains among the wealthiest Californians mean that the top 1 percent of taxpayers has nearly doubled its share of AGI since the early 1990s. One-quarter (25.2 percent) of total AGI went to the wealthiest 1 percent of taxpayers in 2007, nearly twice their share (13.8 percent) in 1993, the earliest year for which data are available.⁶ In contrast, taxpayers with incomes in the middle fifth of the distribution reported just 10.0 percent of total AGI in 2007, down from 13.0 percent in 1993.⁷ National data, which are available since 1913, show that the share of income going to the wealthiest 1 percent in 2007 was the second highest in history; the only higher share was in 1928.⁸

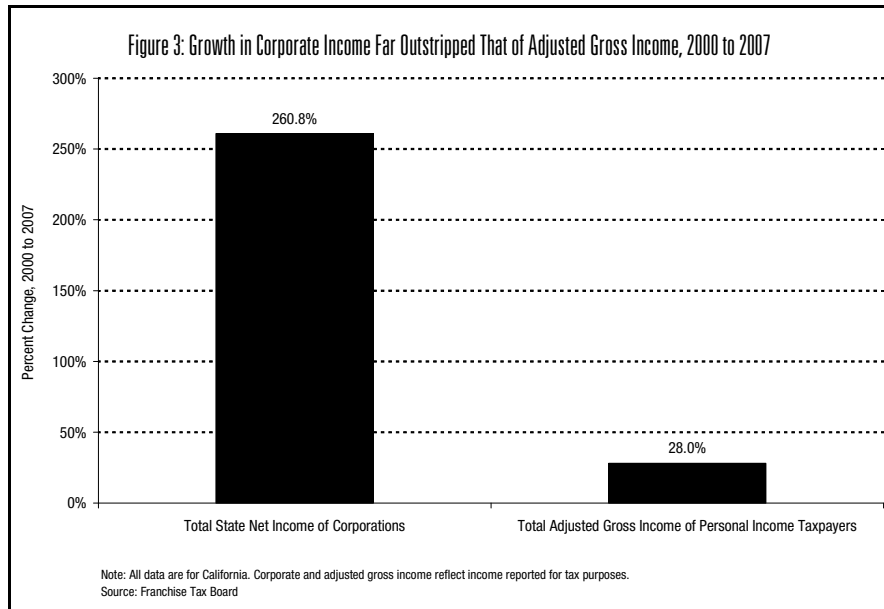
A final trend that sets the context for the COTCE's work is that, over time, corporate profits have grown at a rate that far exceeds the growth in individuals' incomes. This trend reflects the fact that productivity has increased more rapidly than wages. Nationally, corporate profits as a share of income rose from 17.9 percent in 1979 to 21.9 percent in 2007.⁹ Similarly, corporate profits reported for California tax purposes more than doubled between 2000 and 2007, while the total income reported by personal income taxpayers rose by a much more modest 28.0 percent (Figure 3).

⁶ Franchise Tax Board.

⁷ The wealthiest 1 percent of taxpayers' share of AGI peaked at 27.5 percent in 2000 at the height of the economic boom, then fell to 17.8 percent in 2002, largely as a result of the drop in investment income due to declines in the stock market. As the economy recovered, the wealthiest 1 percent of taxpayers' share of AGI rebounded. In contrast, the share of AGI going to taxpayers with incomes in the middle fifth of the distribution has been relatively flat since 2000.

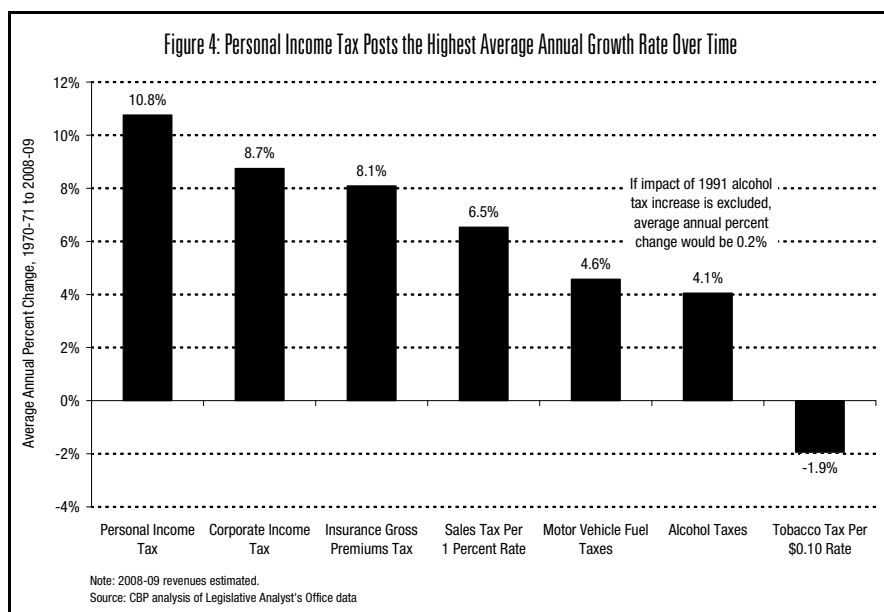
⁸ Emmanuel Saez, *Striking It Richer: The Evolution of Top Incomes in the United States (Update With 2007 Estimates)* (August 5, 2009).

⁹ Larry Mishel, Jared Bernstein, and Heidi Shierholz, *The State of Working America 2008/2009* (Cornell University Press: 2009), p. 88. After-tax profits rose from 5.7 percent in 1979 to 7.6 percent in 2007.



The Commission's Recommendations Would Reduce the Growth in State Revenues, Leading to Larger Budget Shortfalls

The COTCE's working proposals would reduce the growth in state tax revenues and thus lead to larger, not smaller, budget gaps in the future. Wider budget gaps would likely arise because these changes would reduce the state's reliance on relatively fast-growing taxes and replace them with a tax that is likely to grow more slowly over time (Figure 4). Specifically, the personal income tax and, in particular, taxes paid by the highest-income Californians have posted the strongest growth of any of the state's major taxes over the past four decades, followed by the corporate income tax. The COTCE proposal would significantly reduce the taxes paid by high-income individuals and eliminate the corporate income tax entirely.

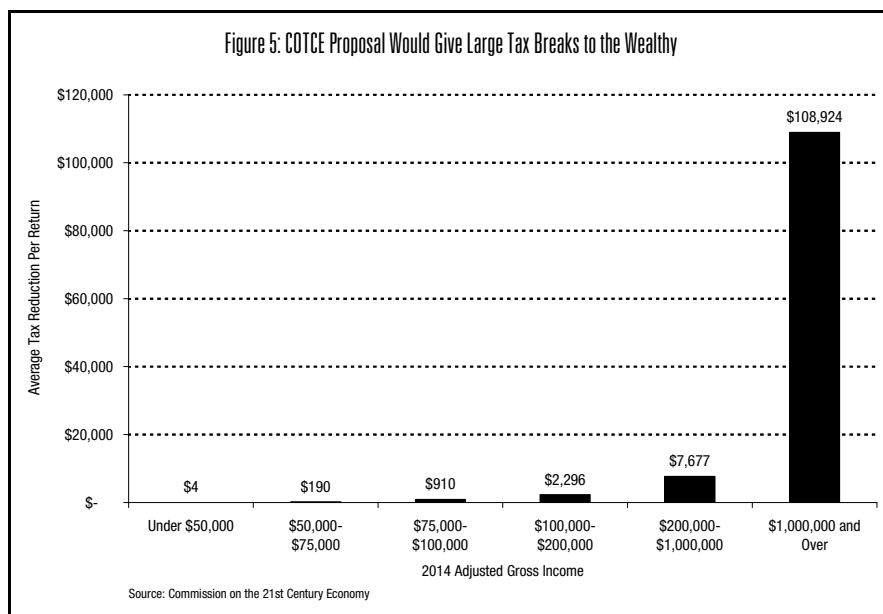


Modeling done for the Commission clearly shows that the changes under consideration would lower the rate of growth of state tax revenues.¹⁰ COTCE documents estimate that revenues raised by California's current tax system would rise by 40.2 percent between 2012 and 2016, while the options under consideration by the Commission would increase revenue collections by 32.4 percent or 35.6 percent over the same period. In dollar terms, the difference translates into \$4 billion to \$7 billion at the end of the five-year period. By way of comparison, the state currently spends about \$5 billion per year to support the California State University and University of California systems combined.

The COTCE Proposals Would Give Large Tax Breaks to the Wealthy

The COTCE's working recommendations would reduce the state's reliance on the personal income tax, particularly taxes paid by those at the high end of the income distribution, by reducing both the number of tax brackets and the rate that would apply to taxpayers at the high end of the income distribution. At its July 16, 2009 meeting, Commission Chair Gerald Parks directed staff to develop a proposal for flattening the personal income tax that would reduce the amount owed by taxpayers across the income distribution.

A draft proposal circulating among Commissioners would provide massive tax cuts to those with incomes above \$100,000 and virtually nothing to the 62 percent of taxpayers with incomes of up to \$50,000 (Figure 5).¹¹ The proposal would reduce 2014 personal income tax collections by \$15.1 billion; \$4.1 billion (26 percent) of the total reduction would go to the 0.2 percent of millionaire taxpayers (Table 1). In contrast, the 73 percent of California personal income taxpayers with incomes up to \$75,000 would receive 2.5 percent of the total tax reduction, while the 81 percent of taxpayers with incomes up to \$100,000 would receive 10.2 percent of the total reduction.



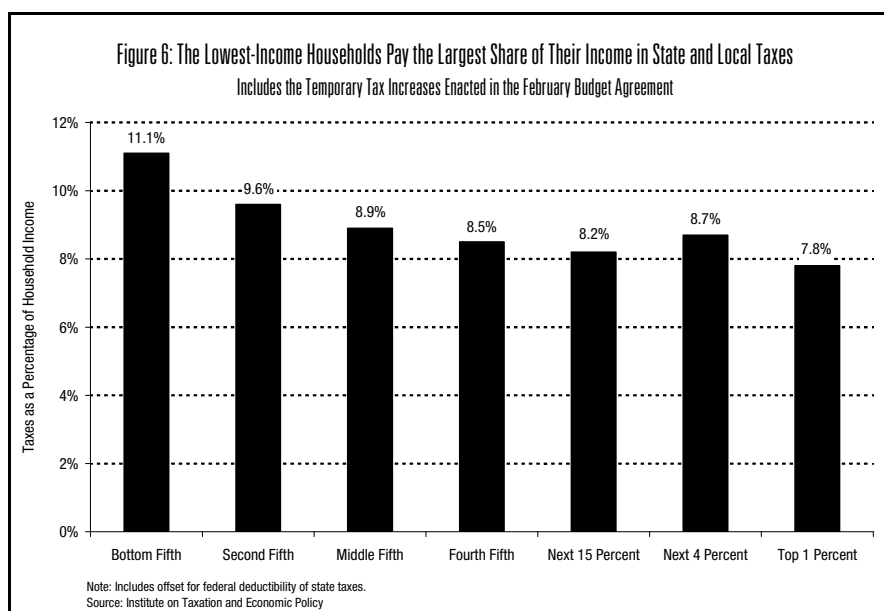
10 Commission on the 21st Century Economy, *Tax Structure Options* (July 16, 2009), downloaded from http://www.cotce.ca.gov/meetings/2009/7-16/testimony/documents/STAFF_PRESENTATION_7-16-09.pdf on August 31, 2009.

Table 1: COTCE Proposal Would Give Large Tax Breaks to the Wealthy						
	Percent of Tax Returns	Average Tax Per Return, COTCE Proposal	Average Tax Per Return, Current Law	Average Tax Reduction Per Return	Percent of Tax Reduction	Cumulative Share of Tax Reduction
Under \$50,000	62.2%	\$104	\$108	\$4	0.2%	0.2%
\$50,000-\$75,000	10.9%	\$1,099	\$1,289	\$190	2.2%	2.5%
\$75,000-\$100,000	7.9%	\$2,121	\$3,031	\$910	7.8%	10.2%
\$100,000-\$200,000	15.9%	\$5,164	\$7,459	\$2,296	39.5%	49.7%
\$200,000-\$1,000,000	2.8%	\$19,223	\$26,900	\$7,677	23.5%	73.2%
\$1,000,000 and Over	0.2%	\$240,641	\$349,565	\$108,924	26.8%	100.0%
Total	100.0%	\$2,264	\$3,188	\$924	100.0%	

Note: COTCE proposal estimates are based on projected 2014 adjusted gross income.

Source: Commission on the 21st Century Economy

The COTCE proposal would exacerbate California's already regressive tax structure. Currently, the lowest-income households pay a larger share of their incomes in state and local taxes than higher-income households (Figure 6).¹²



Replacing the Corporate Tax Will Also Shift Taxes From the Wealthy to Low- and Middle-Income Taxpayers

Eliminating the corporate income tax in favor of a consumption tax, such as the BNRT, would also exacerbate the regressive impact of the changes under consideration. Economists argue that taxes on corporate profits are generally passed on to the owners of capital – shareholders or business owners. Because stock ownership is concentrated at the high end of the income distribution, reductions in and/or elimination of the corporate income tax would largely benefit the highest-income taxpayers. Testimony provided to the COTCE in April by Robert McIntyre, director of Citizens for Tax Justice, references analyses showing that corporate income taxes cost the wealthiest 1 percent of

11 Commission on the 21st Century Economy, *Tax Structure Options* (July 16, 2009), downloaded from http://www.cotce.ca.gov/meetings/2009/7-16/testimony/documents/STAFF_PRESENTATION_7-16-09.pdf on August 31, 2009.

12 Statement of Robert S. McIntyre before the California Commission on the 21st Century Economy Regarding Tax Fairness and Economic Growth (April 9, 2009), downloaded from <http://www.cotce.ca.gov/meetings/testimony/documents/BOB%20McINTYRE%20-%20COTCE%20-%20McIntyre%20California%20Testimony,%204.9.09.pdf> on September 8, 2009.

Californians 0.5 percent of their personal income, while the bottom 80 percent of Californians pay virtually none of their income in corporate income taxes.¹³

The Business Net Receipts Tax Would Be Passed On to Consumers in the Form of Higher Prices and to Workers as Lower Wages

The proposed BNRT is a tax on consumption. Economic analyses show that most of the BNRT would be passed along to consumers in the form of higher prices for goods and services, while a smaller, but significant, share would be passed along to workers in the form of lower wages. Documents prepared for the Commission estimate that about three-quarters (71 percent) of the BNRT would be passed on to consumers in the form of higher prices, just under a fifth (19 percent) would be passed on to workers in the form of lower wages or fewer benefits, and the remainder would be divided between shareholders and business owners (9 percent) and individuals outside of California (1 percent).¹⁴ The same report estimates that the lowest-income Californians would pay twice as much of their income toward the new tax as the highest-income Californians. That makes the BNRT substantially more regressive than California's current tax system – which results in the lowest-income Californians paying about a third more as a share of their income than the wealthiest Californians.¹⁵

The BNRT Would Tax Child Care and Groceries To Pay for Lower Personal Income Taxes for the Wealthy and Eliminating the Corporate Income and Sales Taxes

Many of the exemptions in the state's existing sales and use tax law serve important public policy functions. Lawmakers have exempted food purchased for consumption at home, prescription drugs, and essential services such as health and child care based on the assumption that necessities should not be subject to tax. All of these items would be subject to tax under the BNRT, which would exacerbate the regressive impact of the tax on lower-income households.¹⁶ While there are good arguments for broadening the sales tax base, the BNRT would tax necessities to finance reductions in other taxes that would disproportionately benefit the wealthiest Californians. Similarly, the proposed changes to the personal income tax would eliminate deductions for medical care, as well as the child and dependent care tax credit, which are targeted to working families, while substantially reducing the taxes paid by the highest-income Californians.

The BNRT Creates an Incentive for Business To Outsource Jobs to Firms With No Presence in California

California's ability to impose the BNRT on firms with no physical presence in California touches on one of the most contentious and frequently litigated areas of tax law. Documents prepared by Commission staff suggest that the BNRT would look at business activities within the "water's edge," a concept that looks at activity within the US and a limited number of other jurisdictions.¹⁷ The use of a water's edge approach, combined with the questionable ability of the state to impose the BNRT on firms without a physical presence in California, would likely encourage businesses to outsource to firms outside the US that are not subject to taxation in California. The incentive to outsource results

13 Statement of Robert S. McIntyre before the California Commission on the 21st Century Economy Regarding Tax Fairness and Economic Growth (April 9, 2009), downloaded from <http://www.cotce.ca.gov/meetings/testimony/documents/BOB%20McINTYRE%20-%20COTCE%20-%20McIntyre%20California%20Testimony,%204.9.09.pdf> on September 8, 2009.

14 Robert Cline, *Analysis of a Business Net Receipts Tax* (June 16, 2009), downloaded from http://www.cotce.ca.gov/meetings/testimony/documents/Robert_Cline-CA_Tax_Commission_6-16-09.pdf on September 8, 2009.

15 Statement of Robert S. McIntyre before the California Commission on the 21st Century Economy Regarding Tax Fairness and Economic Growth (April 9, 2009), downloaded from <http://www.cotce.ca.gov/meetings/testimony/documents/BOB%20McINTYRE%20-%20COTCE%20-%20McIntyre%20California%20Testimony,%204.9.09.pdf> on September 8, 2009.

16 Purchases of services from nonprofit entities would not be taxed. However, many individuals purchase child and health care from for-profit entities.

17 Carl Joseph and Jeffrey Margolis, *Analysis of Tax Nexus Issues Concerning the Commission on the 21st Century Economy's Business Net Receipts Tax Proposal* (August 21, 2009), downloaded from http://www.cotce.ca.gov/documents/correspondence/staff_and_commissioners/documents/FTB%20Analysis%20for%20COTCE520-%208.21.09.pdf on September 8,

from the fact that wages are not taken into account for the purpose of calculating net receipts subject to tax, while purchases of services are taken into account. To the extent services are purchased from firms with a clear nexus in California, those firms would be subject to the BNRT. However, the state's ability to tax firms without clear nexus is uncertain and would likely be subject to lengthy and complex litigation. The negative implications of this are two-fold: a potential loss of California jobs and a reduction in state tax revenues.

The Business Net Receipts Tax Is a Risky Proposition

No state in the country currently imposes a tax similar to the BNRT, as outlined in staff documents. A letter signed by a number of prominent economists and lawyers highlighted the lack of experience with the BNRT, stating, "our concerns regarding the BNRT arise primarily from the numerous uncertainties relating to administration, compliance, legal challenges, and economic distortions of such a tax. As you know, there is almost no experience – in the United States or abroad – with an apportioned business net receipts tax of the sort under consideration by the Commission."¹⁸ The letter's authors note that the BNRT would likely be subject to legal challenge if the state attempts to impose the tax on entities without physical presence in California and that it will be subject to "aggressive tax planning" that could significantly erode potential revenue collections.

With sizeable budget shortfalls projected for the foreseeable future, California can ill afford to rely on an untested tax for upwards of half of state revenues. Other states that have recently adopted consumption-based taxes, such as Texas and Ohio, have seen revenues fall significantly short of initial forecasts. There is no guarantee that the BNRT will perform as projected, and the tax is likely to face significant legal and administrative challenges that could lead to devastating budget consequences. The constitutional requirement that state tax increases be approved by a two-thirds vote of the Legislature could make it difficult, if not impossible, to remedy such a shortfall if it were to occur.

Alternatives for Modernizing California's Tax System

As we noted in testimony before the Commission earlier this year, the CBP strongly believes that the Commission's recommendations should aim to maximize the growth potential of the state's tax system and should work to mitigate the widening gap between the state's rich and low- and middle-income Californians that typifies the 21st century economy. The Commission's proposals move in exactly the opposite direction and would slow the state's revenue growth and widen after-tax income disparities. Positive options for change include:

- **Extending the sales tax to selective services, preserving exemptions for necessities.** Selectively extending the sales tax to services, while preserving exemptions for food, health and child care, utilities (which are taxed at the local level), and other necessities, would strengthen the state's sales tax without the risks involved with the BNRT. There are multiple benefits of this approach relative to creation of a BNRT. First, the tax can be extended in a targeted manner to minimize the impact on low-income households and to avoid "pyramiding" through the taxation of business inputs. Second, this approach would build off the state's existing sales and use tax administrative structure and could be implemented quickly and reliably. An extension of the sales tax to services could be enacted in a "revenue neutral" manner by lowering the sales tax rate.
- **Creating an oil severance tax.** California is the only oil-producing jurisdiction in the world without such a tax. Imposing an oil severance tax, such as that previously proposed by the Governor, would make significant progress toward giving California a 21st century tax system.
- **Repealing the corporate tax breaks included in the September 2008 and February 2009 budget deals and using the revenues gained to restructure the personal income tax bracket structure in a manner**

¹⁸ Letter to COTCE Chair Gerald Parsky from Joseph Bankman, et al. (September 5, 2009)

that does not disproportionately benefit the wealthy. The corporate tax breaks in these two budget agreements – elective single sales factor apportionment, net operating loss carrybacks and the extension of loss carryforwards, and the ability of related firms to share tax credits – were approved almost literally in the dark of night with no opportunity for public review or comment. These provisions give massive benefits to a handful of firms.¹⁹ Revenues raised from the repeal of these tax breaks would reduce future budget shortfalls or, alternatively, could be used to modify the state's personal income tax bracket structure, so that as incomes increase, taxpayers move more gradually into higher marginal rates, while maintaining the existing 9.3 percent top bracket for taxpayers.

- **Collecting sales and use taxes owed on electronic sales.** A 21st century tax system should reflect the rising importance of electronic commerce and actively strive to collect taxes owed on internet sales. Estimates suggest that California loses \$2 billion to \$5 billion per year from untaxed internet sales. California should take the lead in encouraging Congress to overturn the 1992 US Supreme Court decision in Quill Corporation v. North Dakota. In the meantime, the state could increase collections by taking steps such as requiring businesses such as Amazon.com that enter into "affiliate" relationships with California-based entities to collect California sales tax and imposing the sales tax on digital downloads. These measures would have the added benefit of leveling the playing field for retailers that have a physical presence in California by ensuring that purchases from out-of-state retailers are subject to the same tax as those made from in-state businesses.
- **Improving the accountability and transparency of the state's tax code through greater disclosure.** Requiring disclosure of the name of any taxpayer receiving tax credits or expenditures worth more than \$5 million in a tax year would improve the accountability and transparency of California's tax system. Accountability could also be improved by instituting mandatory sunsets for existing and future tax expenditures, improved evaluation of the effectiveness of tax expenditure programs, and adoption of a "unified" budget that would consider tax expenditures as part of the annual state budget process.

The Bottom Line: The COTCE Proposals Would Shift Taxes to the Middle, Slow Future Revenue Growth

The COTCE proposals fail to respond to major trends that typify the 21st century economy: widening income inequality, significant growth in profits, and a rise in electronic commerce. As a result, the COTCE proposals would shift the cost of financing state services from the wealthy to low- and middle-income Californians and reduce future revenue growth.

Shifting who pays state taxes appears to be a key goal of the Governor and at least some Commission members. Earlier this year, the Governor's Chief of Staff, Susan Kennedy, outlined goals for the commission as follows: "Asked what she'd like to see from the tax commission, Kennedy didn't hesitate. 'Flatness,' she said. 'Our revenue stream is way too progressive.' But no matter how you slice it, she said, changes that come out of it may be seen as 'a tax increase to the middle of the structure.'"²⁰

The reasons for the reduction in future revenue collections under the Commission's proposals are rooted in underlying changes in the economy. The COTCE proposals would reduce the taxes paid by wealthy personal income taxpayers and eliminate the corporate income tax while relying more heavily on consumption taxes. This would reduce the growth in tax collections by reducing the taxes on income that is growing robustly – the incomes of the wealthy and corporate profits – while increasing the share of the state's tax base that is attributable to consumption, which is growing at a relatively slower rate.

¹⁹ See California Budget Project, *To Have and Have Not* (June 2009).

²⁰ SFGate Politics Blog, *Schwarzenegger's COS Susan Kennedy: Greater chance for change now than in last 50 years* (May 29, 2009), downloaded from <http://www.sfgate.com/cgi-bin/blogs/nov05election/category?blogid=14&cat=939&o=60> on September 8, 2009.