CALIFORNIA BUDGET PROJECT

February 4, 2010

Options for Closing the Budget Gap

Basic Principles:

1. **California's budget gap is too large to be closed through cuts alone.** The reductions proposed by the Governor would endanger California's long-term economic competitiveness and dismantle the state's safety net for poor families and children.

2. **Voters support a balanced approach that preserves core public services.** Two-thirds of those surveyed by a recent Public Policy Institute of California poll would pay higher taxes to avoid cuts to education and a plurality of voters prefer a balanced approach to closing the budget gap rather than one that relies mostly on cuts or mostly on tax increases. Just last week, Oregon voters approved increases in that state's personal income tax rates imposed on wealthy earners and the state's minimum corporate tax rate.

3. **When you are in a hole, stop digging.** The permanent tax cuts enacted in September 2008 and February 2009, with no opportunity for public comment or review, will worsen California's ongoing budget crisis, will significantly weaken the integrity of the state's corporate income tax, and sends the wrong message to voters at a time when critical services are facing deep budget cuts. Require any bills that reduce revenues to be paid for by offsetting spending reductions or tax increases until the budget is restored to balance and the state has built a prudent reserve.

Options for Raising Additional Revenues

1. **Repeal the September 2008 and February 2009 tax cuts.** Repeal of the recently enacted corporate tax cuts would boost 2010-11 revenues by $685 million. Over time, the permanent tax cuts will cost the state upwards of $2.0 billion per year and, some estimates suggest, possibly as much as $2.5 billion per year.

2. **Reinstate the 10 percent and 11 percent tax rates on high-income earners at 1991 levels, adjusted for inflation.** The February tax increases disproportionately affect low- and middle-income taxpayers. Reinstatement of the top brackets would restore balance to the state's tax system and raise $4 billion to $6 billion in additional revenues.

3. **Impose an oil severance tax.** California is the only oil producing state without a severance tax. A tax similar to that proposed by the Governor in 2008 would raise upwards of $1 billion dollars.

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4. **Impose a "nickel a drink" tax or fee on alcoholic beverages.** Alcoholic beverage taxes have not been increased since 1991 and, since they are imposed on a per gallon basis, now represent a smaller share of the purchase price. A tax or fee of this amount would raise $585 million.

5. **Phase-out the enterprise zone program.** Public Policy Institute of California researchers David Neumark and Jed Kolko conclude that California's enterprise zone program doesn't increase employment and actually leads to a reduction in the number of businesses located within zones. Neumark and Kolko find that, "Our analysis of California's enterprise zone program fails to find that the program has increased job growth…At the same time, we find some evidence that enterprise zones reduce the number of establishments, which coupled with lack of an employment effect implies that establishments are growing in size." In 2006, the program cost $410 million. A phase out of the program would raise $100 million in 2009-10 and larger amounts thereafter.

6. **Extend the sales tax to selected services.** Options include repair services, entertainment and recreation, and cable TV and other pay-per-view programming. The revenues raised could range into the billions of dollars. One option would be to extend the tax to selected services and reduce the tax rate either immediately or at some point in the future.

7. **Limit mortgage interest deductions to owners' primary residences.** At a time when essential services are faced with deep cuts, the state can't afford to provide subsidies to vacation homes and boats. Elimination of this loophole would raise approximately $85 million per year.

8. **Consider options for "swapping out" special fund for General Fund taxes.** General Fund revenues could be increased by lowering taxes that are dedicated to special funds and raising taxes that support general state programs and services.

9. **Take advantage of all available avenues for boosting tax compliance.** As part of improving the efficiency and effectiveness of state government, the Legislature should boost collection of taxes that are owed under current law. Options include requiring withholding on payments to independent contractors, which would boost ongoing revenues by several hundred million dollars. In the long-term, requiring corporations to reconcile book and taxable income would increase transparency and corporate income tax revenues; and aggressively pursuing collection of use taxes on electronic sales would help eliminate a tax break that places "brick and mortar" businesses in California at a competitive disadvantage.

10. **Close the loopholes identified in the President's 2011 proposed budget.** The President's 2011 budget includes a number of provisions aimed at reducing the "tax gap" and eliminating obsolete and ineffective provisions in federal tax law. California could boost revenues by closing the same loopholes in state law, such as preferences for fossil fuel production and eliminating incentives for corporations to "offshore" jobs and profits. The President would also boost tax compliance through increased reporting requirements and initiatives such as offsetting tax debt from payments made to federal contractors. California could adopt similar provisions to ensure that firms that do business with the state pay the taxes that they owe under current law.