CALIFORNIA BUDGET PROJECT

budget brief

AUGUST 2010

UNDERSTANDING THE TAX SWAP

On Tuesday, August 3, legislative leaders proposed a new budget plan, including a "tax swap" that would increase some of the state's personal income tax rates and the vehicle license fee (VLF) rate and lower the state's sales tax rate, raising $1.8 billion in revenues to help balance the budget in 2010-11 and $2.2 billion 2011-12. These changes would be permanent. The plan would also delay the implementation of three large business tax breaks enacted as part of the September 2008 and February 2009 budget agreements for two years.[1] On the positive side, the additional revenues would contribute to a balanced approach to closing the state's budget shortfall. However, the proposed plan would also shift a greater share of the cost of financing public services from the highest- to middle-income Californians and from businesses to households, a shift that runs counter to the advice of leading economists. The shift would also disproportionately affect families that have struggled to make ends meet during tough economic times, while lowering the taxes of the highest-income Californians and businesses.

How Would the Swap Work?

The proposed swap would:

- Increase the 1.25, 2.25, 4.25, 6.25, and 8.25 percent personal income tax rates by 1.0 percentage point to 2.25, 3.25, 5.25, 7.25, and 9.25 percent. Under current law, these rates would drop to 1.0, 2.0, 4.0, 6.0, and 8.0 percent in 2011. The highest rate of 9.55 percent would remain unchanged. Under current law, this rate would drop to 9.3 percent in 2011.
- Increase the VLF rate from 1.15 percent to 1.65 percent. Under current law, this rate would drop to 0.65 percent in 2011.
- Reduce the state's sales tax rate from 6.0 percent to 4.25 percent in 2010-11 and from 5.0 percent to 3.5 percent in 2011-12 and thereafter.

Proponents note that individuals who itemize deductions for federal income tax purposes – 38 percent of California taxpayers in 2008 – can deduct their state income tax and VLF payments, but not sales taxes, on their federal tax return.[2] Relatively few low-income Californians itemize deductions on their federal tax returns, while virtually all high-income individuals itemize their deductions (Figure 1).

The Proposed Increase in Personal Income Tax Rates Would Significantly Increase Amounts Paid by Low- and Middle-, But Not High-Income, Californians

The structure of the proposed increase in personal income tax rates would disproportionately affect low- and middle-income Californians by increasing the five lowest tax brackets, but not the highest marginal tax rate. Middle- and low-income households would have all of their income taxed at a higher rate, while only a portion of the income of wealthier households would be taxed at a higher rate. Taxes paid by a married couple with a taxable income of $40,000 would rise by 44.9 percent, for example, while those of a married couple earning $1.0 million would increase by just 1.0 percent (Figure 2).

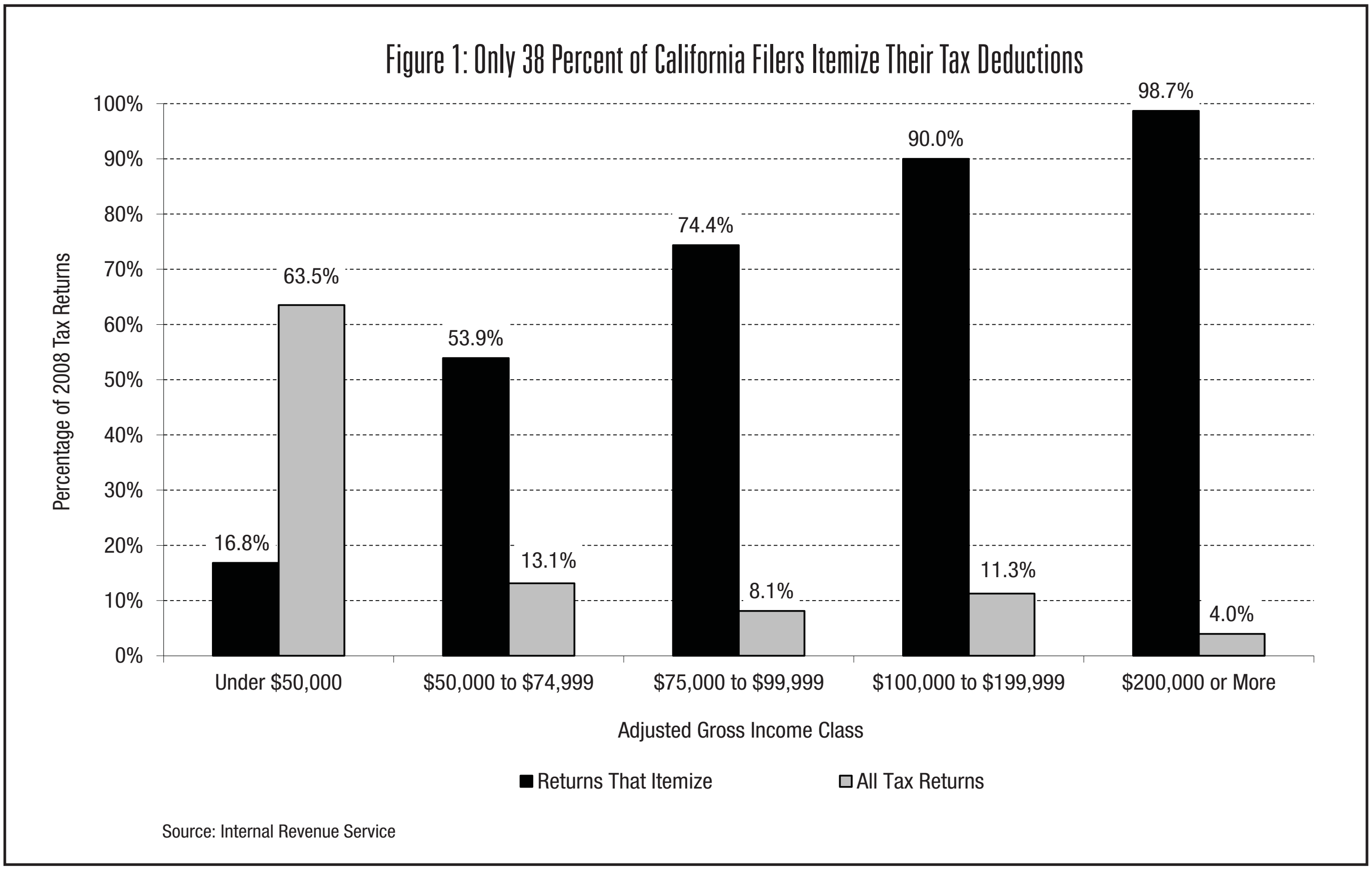


Figure 1: Only 38 Percent of California Filers Itemize Their Tax Deductions
Percentage of 2008 Tax Returns
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
16.8%
63.5%
53.9%
13.1%
74.4%
8.1%
90.0%
11.3%
98.7%
4.0%
Under $50,000
$50,000 to $74,999
$75,000 to $99,999
$100,000 to $199,999
$200,000 or More
Adjusted Gross Income Class
Returns That Itemize
All Tax Returns
Source: Internal Revenue Service

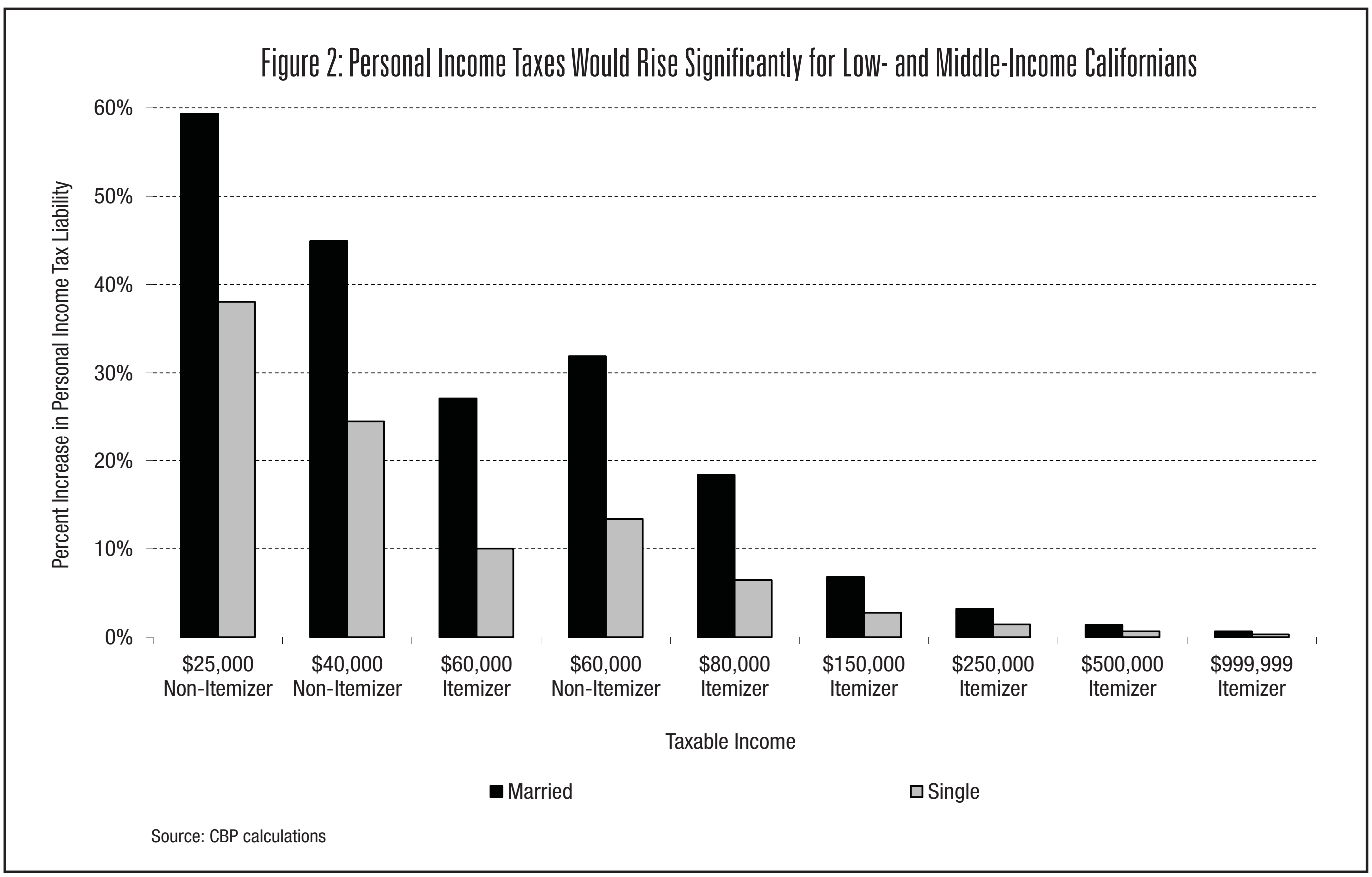


Figure 2: Personal Income Taxes Would Rise Significantly for Low- and Middle-Income Californians
Percent Increase in Personal Income Tax Liability
60%
50%
40%
30%
20%
10%
0%
$25,000 Non-Itemizer
$40,000 Non-Itemizer
$60,000 Itemizer
$60,000 Non-Itemizer
$80,000 Itemizer
$150,000 Itemizer
$250,000 Itemizer
$500,000 Itemizer
$999,999 Itemizer
Taxable Income
Married
Single
Source: CBP calculations

After accounting for the deductibility of state income taxes for federal tax purposes, the disparity would become even wider. The $40,000 income couple's taxes would likely rise by the same amount – relatively few households with incomes at this level itemize – while the increase on the $1.0 million couple would drop to 0.7 percent, after deductibility.[3]

The Bottom Line: The Sales Tax Reduction Would Offset the Personal Income Tax and VLF Increases for the Lowest-Income Households, But Not Middle-Income Taxpayers

The proposed reduction in the state's sales tax rate would reduce the share of income lower-income households pay toward state and local taxes. An analysis by the Institute on Taxation and Economic Policy (ITEP) that assumes that businesses pass their share of the sales tax reduction through to individuals shows that total state and local taxes paid by the lowest- and the next-to-lowest-fifth of households would decline, but taxes paid by middle- and just-above-middle-income households would rise (Figure 3). After taking the deductibility of state taxes into account, the amount paid by the top 1 percent of the California income distribution would be virtually unchanged.

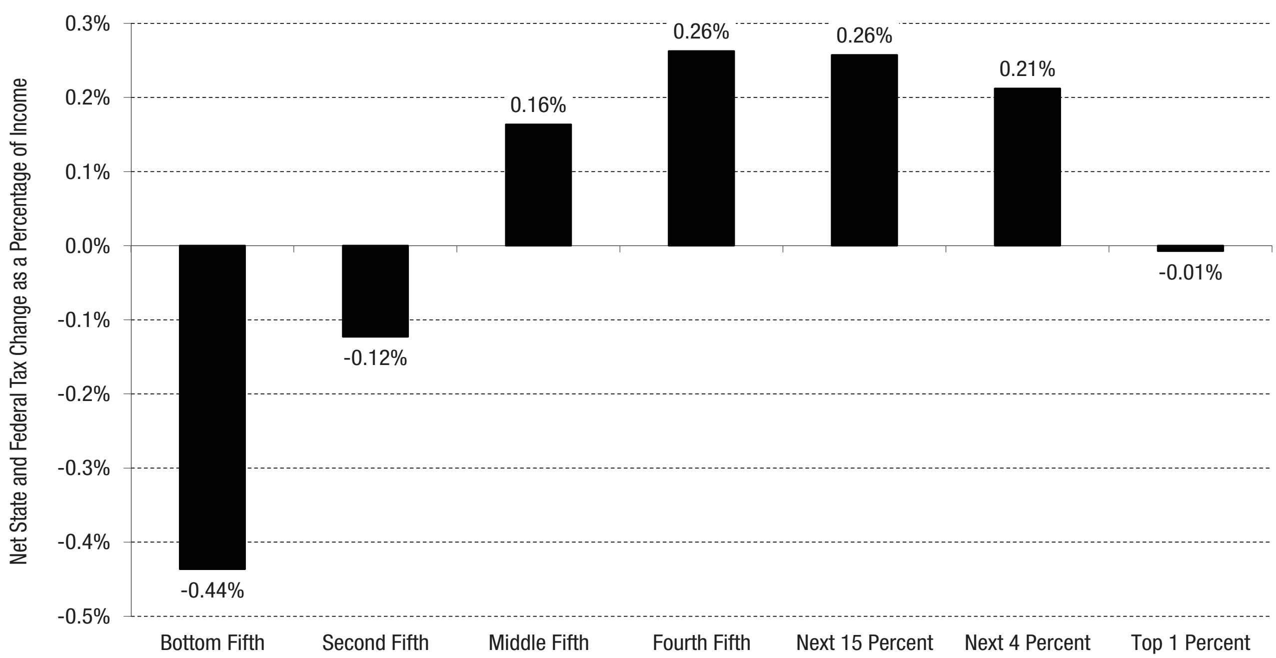
A similar analysis, which does not assume that businesses' share of the sales tax reduction passes through to households, shows that after taking the deductibility of state personal income taxes and VLF into account, taxes paid by the lowest quintile would go down, while those paid by other income groups would increase (Figure 4).

Individuals With Incomes Below the Poverty Line Would Pay Personal Income Taxes

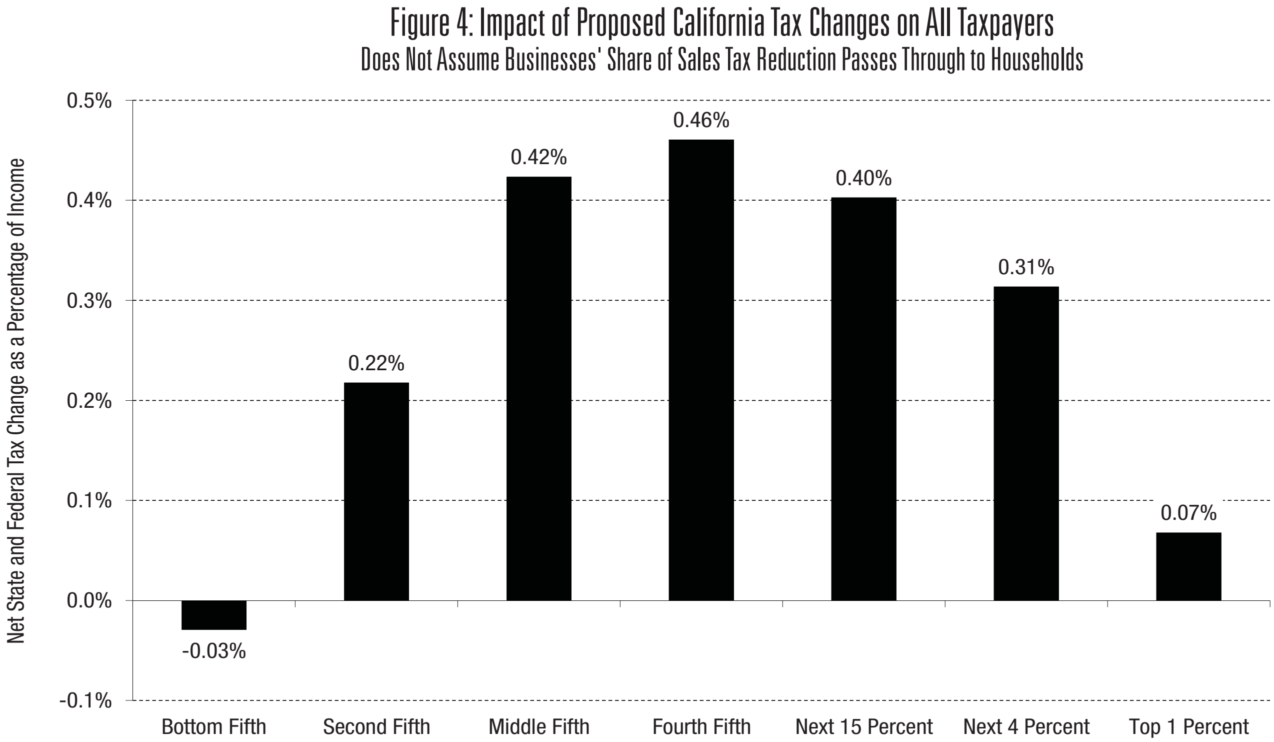
Historically, California families and individuals with incomes below the federal poverty line have not owed state personal income taxes. These households and individuals do pay sales, excise, and payroll taxes. Under the proposed plan, single individuals claiming a personal credit and the renters' tax credit would begin to owe personal income taxes at an income level below the federal poverty line (Table 1).[4] The plan would also significantly reduce the tax threshold – the income at which a family or individual begins to owe personal income taxes – for married couples and families with children. The tax threshold for a married couple with two children, for example, would drop from $50,893 to $40,357, and the threshold for a single parent with two children would fall from $48,446 to $37,345.

Figure 3: Impact of Proposed California Tax Changes on All Taxpayers

Assumes Businesses' Share of Sales Tax Reduction Passes Through to Households



Note: Results reflect the deductibility of personal income tax and vehicle license fee for federal tax purposes.
Source: Institute on Taxation and Economic Policy



Note: Results reflect the deductibility of personal income tax and vehicle license fee for federal tax purposes.
Source: Institute on Taxation and Economic Policy

Table 1: California's Personal Income Tax Thresholds Would Decline Under Proposed Changes

	2009 Tax Threshold	2011 Current Law Tax Threshold	2011 Proposed Law Tax Threshold	2009 Federal Poverty Line	2011 Proposed Law Tax Threshold as a Percentage of the Federal Poverty Line
Single, No Children	$13,788	$15,067	$10,659	$11,161	95.5%
Married, No Children	$27,625	$30,134	$21,319	$14,366	148.4%
Head of Household, Two Children	$32,025	$48,446	$37,345	$17,285	216.1%
Married, Two Children	$36,325	$50,893	$40,357	$21,756	185.5%

Note: Assumes tax filers claim the standard deduction and the renter's credit. The federal poverty line assumes non-elderly householders.
Source: Franchise Tax Board and US Census Bureau

The Tax Swap Would Shift a Greater Share of the Cost of Public Services From Businesses to Individuals

Businesses, which pay approximately one-third of the sales tax, would receive a net tax reduction under the proposed swap. While businesses also pay approximately one-third of the VLF, the additional amount businesses would pay in VLF is substantially less than their savings from the reduction in the sales tax. In 2011-12, for example, the first full year of the plan's implementation, businesses would pay an additional $1.0 billion in VLF, but would pay $2.5 billion less in sales tax, for a net savings of $1.5 billion.[5] Individuals, in contrast, would pay an additional $6.8 billion in personal income taxes and $2.0 billion in VLF, while paying $5.0 billion less in sales tax, for a net increase of $3.8 billion prior to taking into account the fact that personal income taxes and VLF are deductible for federal income tax purposes. After considering deductibility, individuals would pay an additional $1.3 billion.[6]

Economists Argue That Tax Increases Should Be Targeted During Tough Economic Times

Leading economists argue that carefully targeted tax increases are less harmful to the economy than spending reductions and that well-targeted increases target the highest-income earners. Nobel Prize-winning economist Joseph Stiglitz and Peter Orszag, formerly head of the Office of Management and Budget in the White House, conclude: "Tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run."[7]

These observations suggest that the recently introduced plan appropriately relies on the personal income tax, but inappropriately targets middle-income households with the largest increase. According to Stiglitz:

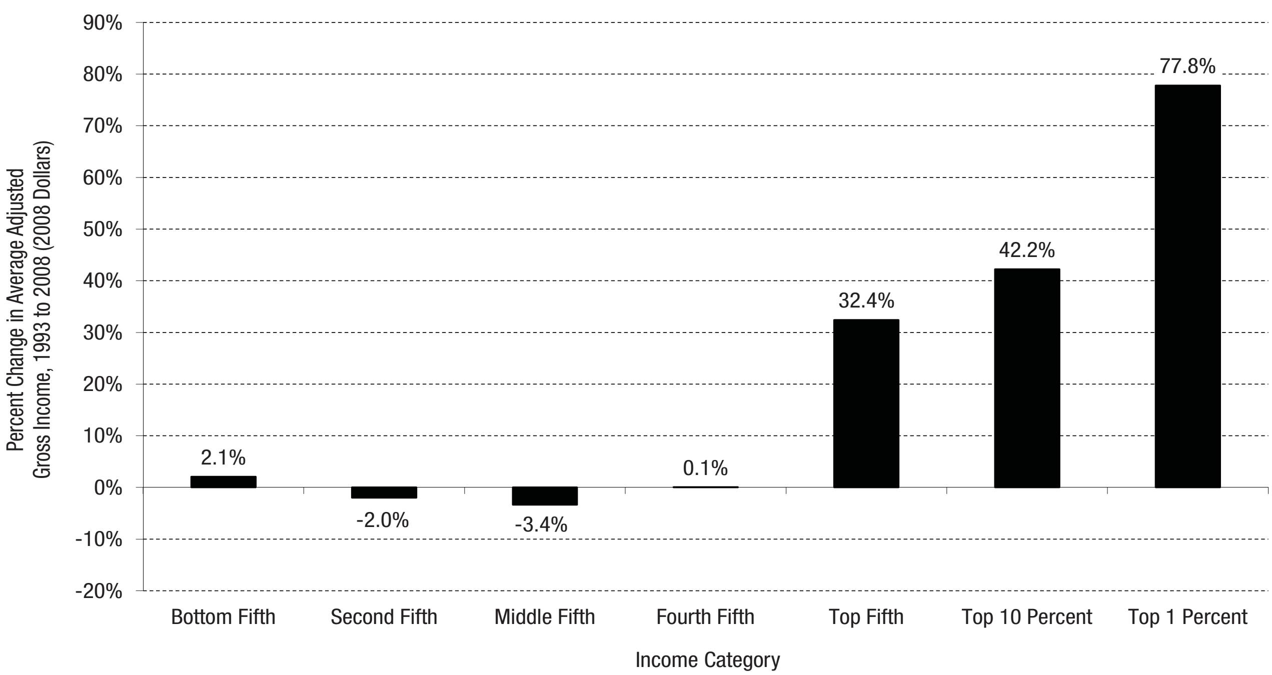
> "Every dollar of state and local government spending enters the local economy right away, generating a greater economic impact. The impact is especially large when the money goes for salaries of teachers, policemen and firemen, doctors and nurses and others that provide vital services to our communities." In contrast, "raising taxes on high income households also will reduce spending, but by less than the amount of the tax increase since those with plenty of income typically spend only a fraction of their income – and some of what they spend is spent on luxury goods made abroad."[8]

Incomes Have Stagnated for Most Californians

The average adjusted gross income (AGI) – income reported for personal income tax purposes – of most Californians has stagnated or declined since at least the early 1990s. After adjusting for inflation, the average AGI of Californians in the middle of the income distribution decreased by 3.4 percent between 1993 and 2008 – the only years for which data are currently available (Figure 5). In contrast, average AGIs of Californians at the top of the income distribution have increased substantially. While high-income-earners' average AGI decreased between 2007 and 2008 due to the downturn in the economy, over a longer period, wealthy Californians' incomes have increased at a rate that far exceeds the minimal growth at the middle and low end of the income distribution.

The disparate growth rate at the top and middle of the income distribution has led to widening income inequality (Figure 6). The proposed tax plan, which increases taxes on middle-income earners to a greater degree than those at the top of the income distribution, would further widen after-tax inequality.

Figure 5: The Incomes of the Wealthiest Californians Have Increased Significantly, While Those of All Other Californians Have Stagnated or Declined



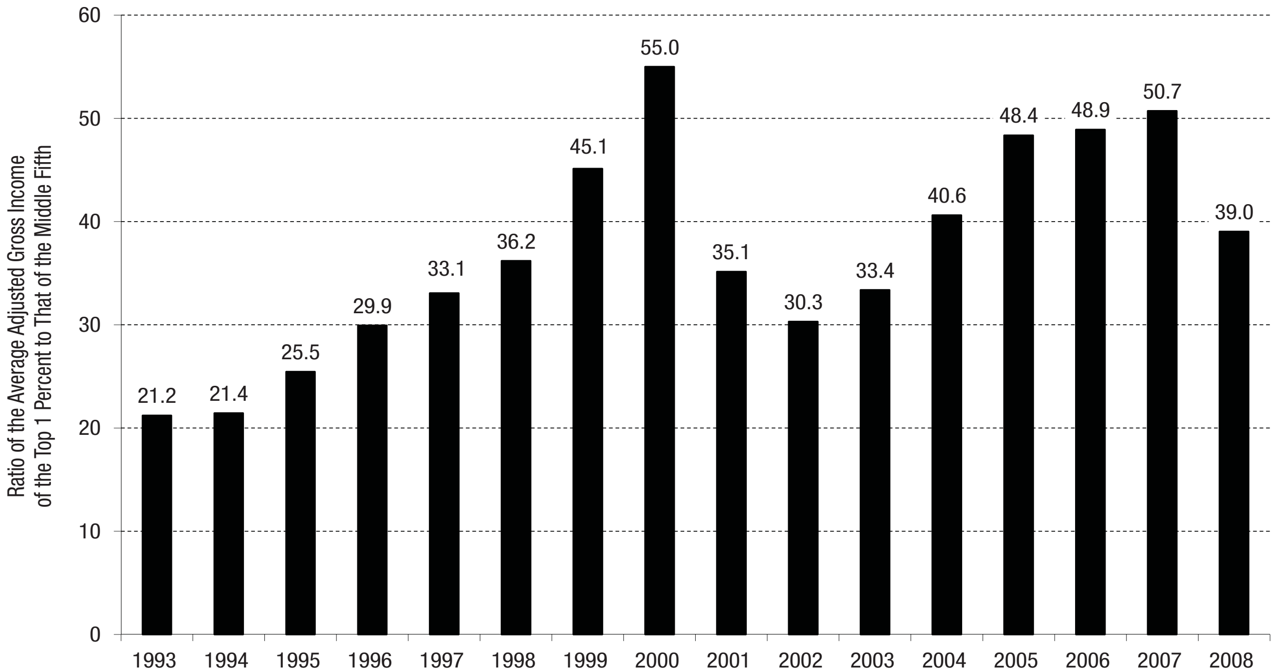
Source: Franchise Tax Board

Conclusion

The proposed tax swap would raise revenues needed to support a balanced approach to closing the state's budget gap. Absent additional revenues, lawmakers will be forced to make spending reductions that result in serious harm to the state's economy and the services Californians depend on in the short run and that impede the state's ability to compete effectively in the global economy in the long run.

Unfortunately, however, the approach adopted in the tax swap targets low- and middle-income working families, while imposing a minimal or no increase on the wealthiest Californians, whose incomes have posted strong growth over the past 15 years – a period when the incomes of most Californians stagnated. Thus, the proposed tax swap would serve to widen an already substantial gap between high- and middle-income Californians.

Figure 6: The Average Californian in the Top 1 Percent Had 39 Times the Income of the Average Middle-Income Californian in 2008



Source: Franchise Tax Board

Jean Ross prepared this Budget Brief. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's website at www.cbp.org.

ENDNOTES

[1] See California Budget Project, *To Have and Have Not* (June 2009).

[2] Businesses can deduct the sales taxes they pay from their federal taxes as an ordinary operating expense.

[3] As shown in Figure 1, nearly all high-income taxpayers itemize.

[4] CBP calculations, estimated for 2011.

[5] Assumes businesses pay one-third of the sales tax and the VLF.

[6] This calculation is based on the assumptions used by the proponents of the plan as outlined in *Budget Tax Reform Package,* downloaded from http://dist06.casen.govoffice.com/ on August 9, 2010.

[7] Peter Orszag and Joseph Stiglitz, *Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive Than the Other During a Recession?* (Center on Budget and Policy Priorities: Revised November 6, 2001), p. 2. According to Stiglitz and Orszag, "A much better approach [than spending cuts] would close more of the budget gap by levying an income-tax surcharge on higher-income families ... while leaving the current rate ... in place for others." See Peter Orszag and Joseph E. Stiglitz, *Biting the Budget Bullet: Why Raising Taxes Is the Least Painful Way out of the State's Fiscal Crisis* (Tax Policy Center: April 27, 2003), p. 3. An income-tax surcharge – an additional rate added on top of the existing rate structure – can raise a substantial amount of revenue with a relatively small increase in current tax rates. Moreover, state taxpayers would not bear the full cost of an income-tax surcharge because state income taxes reduce federal income taxes for taxpayers who itemize their deductions. Because most high-income taxpayers itemize, part of the cost of an income-tax surcharge targeted to high-income taxpayers would be offset by reduced federal income taxes. See Elizabeth C. McNichol and Andrew C. Nicholas, *Using Income Taxes To Address State Budget Shortfalls* (Center on Budget and Policy Priorities: February 21, 2008).

[8] Joseph E. Stiglitz, letter to New York Governor David A. Paterson, New York Senate Majority Leader Joseph L. Bruno, and New York State Assembly Speaker Sheldon Silver (March 27, 2008), pp. 1 and 2.