CALIFORNIA
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Budget Brief

February 1996

CAN CALIFORNIA AFFORD A 15% TAX CUT?

OVERVIEW

As part of his 1996-97 budget, Governor Wilson reintroduced his proposal for a 15% reduction in personal income and bank and corporation tax rates. The Governor also proposes eliminating the Renters' tax credit and adding or expanding ten additional tax breaks. The Governor's proposed tax cuts will:

- Decrease General Fund revenues by $4.7 billion in 1999.
- Cause per pupil spending to fall by $483 in 1999.
- Increase taxes for low-income working families due to the elimination of the Renter's Credit.
- Primarily benefit Californians with incomes above $100,000.
- Limit the state's ability to respond to reductions in federal funds.

While the immediate reduction in state revenues will be relatively small, the tax cut will severely constrain state spending over the remainder of the decade and beyond, limiting growth in state spending to a level below that of inflation. Spending for K -12 education, in particular, will not keep pace with inflation, causing California's schools to fall further behind the national average. Moreover, the Governor's proposal fails to provide an adequate reserve to guard against an uncertain economic future and the likelihood of significant reductions in federal funding in the move toward a balanced federal budget.

GOVERNOR REINTRODUCES 15% TAX CUT PROPOSAL

Under the Governor's proposal, personal income and bank and corporate tax rates would be reduced by 15%. The reductions would be phased in over three years, with personal income tax rates reduced 5% in each of 1997, 1998, and 1999. Similarly, the bank and corporation tax rate would also be reduced 15% in three phases, from the current 9.3% rate to 7.9% in 1999. The current proposal results in deeper revenue reductions than last year's proposal, since it combines a 15% tax rate cut with the elimination of the top income tax rates on the wealthy. For this reason, individuals currently in the 10% bracket would receive a 21% tax rate cut, while those in the current 11% tax bracket would receive a 28% tax cut. The personal income tax brackets at full implementation in 1999 are shown below.

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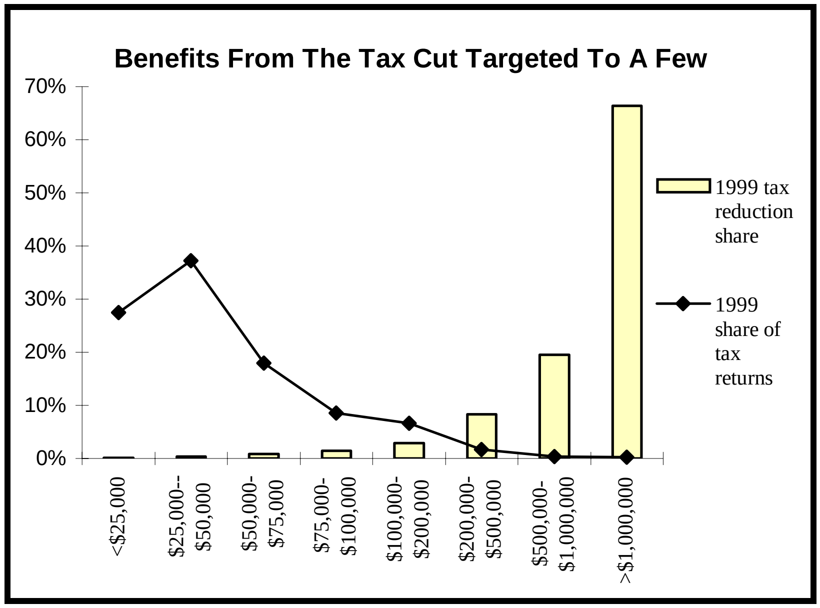
Table 1: Impact of the Governor’s Tax Cut on Personal Income Tax Rate				
Single Taxpayers	**Married Taxpayers**	**1995 Tax Rate**	**Proposed 1999 Tax Rate**	**New Rate As A % of 1995 Rate**
$0 - 4,831	$0 - 9,662	1.0%	0.85%	85%
$4,832 - 11,449	$9,663 - 22,898	2.0%	1.7%	85%
$11,450 - 18,068	$22,899 - 36,136	4.0%	3.4%	85%
$18,069 - 25,083	$36,137 - 50,166	6.0%	5.1%	85%
$25,084 - 31,700	$50,167 - 63,400	8.0%	6.8%	85%
$31,701 - 109,936	$63,401 - 219,872	9.3%	7.91%	85%
$109,937 - 219,872	$219,873 - 439,744	10.0%	7.91%	79%
Over $219,873	Over $439,745	11.0%	7.91%	72%

Majority Of Benefits Will Go To High Income Taxpayers

Wealthy taxpayers will receive most of the benefits from the proposed tax cut. The 9% of California taxpayers with incomes in excess of $100,000 will receive over half the benefits of the tax cut. In contrast, the 27% of all low income working families with incomes below $25,000 will receive only 2.8% of the benefits of the tax cut. In fact, they will likely see a reduction in services due to lower state revenues. Low income renters will fare the worst, and would actually experience a tax increase as a result of the Governor's proposal to permanently eliminate the Renters' Tax Credit.



Source: Franchise Tax Board

Table 2: What Would The 15% Tax Cut Mean For A Family of 4 in 1999?		
Adjusted Gross Income	**15% State Tax Cut**	**Net Value After Federal Tax Increase**
$20,000	0	0
$40,000	$94	$79
$60,000	$206	$175
$80,000	$373	$269
$100,000	$605	$436
$150,000	$1,189	$856
$200,000	$1,815	$1,252
$250,000	$2,398	$1,535
$500,000	$5,943	$3,590
$1,000,000	$12,684	$7,662

Source: Legislative Analyst's Office

Minimal Reduction In Taxes For Most Families

Most California families' state income tax bill is relatively small. As a result, the majority of state taxpayers will experience only a small reduction in their taxes as a result of the governor's proposal. Nearly two-thirds (64%) of all California families will have their state taxes reduced by less than $150 per year in 1999, when the tax cut is fully implemented. Increased federal income taxes will offset a portion of the impact of the tax increase. Currently, state income taxes are deductible for federal tax purposes for all business taxpayers and for individuals who itemize their deductions. Taxpayers who itemize their deductions will lose part of the value of the state tax cut to higher federal income taxes. Moreover, since the Governor proposes to phase the tax cut in over three years, the immediate reduction will be minimal. The value of the tax cut for a typical family of four in 1999 in Table 2. 1997 tax reductions would be approximately 1/3 of the amount shown.

Governor Proposes Ten Additional Tax Breaks

In addition to the 15% personal and bank and corporations tax cut, the Governor proposes ten additional tax breaks -- many of which are narrowly targeted to specific interests or firms. The estimated fiscal year 1996-97 General Fund revenue loss attributable to these new tax expenditures is $63 million.

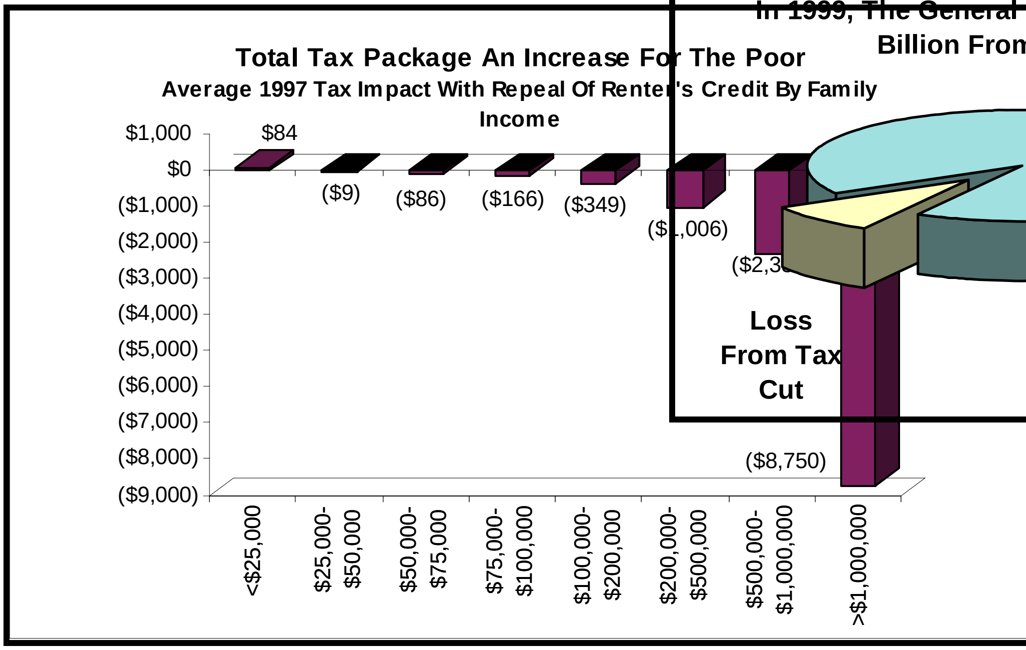
Table 3: Proposed New Tax Expenditures	
	1999-2000 General Fund Cost
Research & Development Tax Credit Enhancements	$48 M
Sales Tax Exemption for Aircraft Parts and Repair	$9 M
Investment Tax Credit Enhancement for Biotech	$1 M
Gross Premiums Tax Cut for Annuities	$101M
75% Foreign Dividend Deduction	$9 M
Increased Expensing Allowance for Small Business	$17 M
Investment Tax Credit Enhancement for Semiconductor Equipment Makers	$1 M
Enterprise Zone Hiring Credit Enhancement for Aerospace Workers	$2 M
Capital Loss Deduction for First-Time Homebuyers	$ 4 M
TOTAL	**$192M**

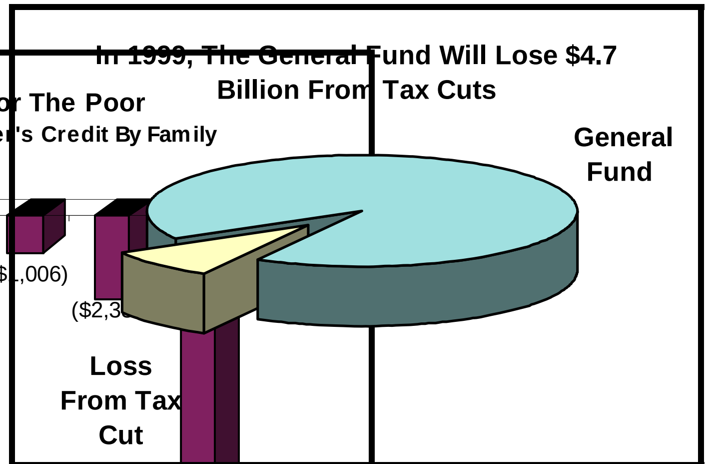
Source: Department of Finance

Renters' Taxes Will Increase

The Governor's proposed fiscal year 1996-97 budget assumes permanent elimination of the Renters' Tax Credit, one of the few state tax provisions targeted at low income taxpayers. The Renters' Tax Credit was instituted in 1972 as a means of allowing renters to share in the tax relief provided to property owners by Proposition 13. It was limited to low income taxpayers in 1991 and 1992, and suspended entirely in 1993, 1994, and 1995.

Repealing the Renters' Tax Credit results in a tax increase of over $520 million for the 5.7 million taxpayers eligible for the credit in 1996-97. Three-quarters of the households eligible for the Renter's Credit in 1996 earn less than $30,000 per year. The impact on a typical family of four is shown (right). The tax increase for these families in 1997 and 1998 will be even greater since the Governor proposes elimination of the Renters' Credit prior to full implementation of the tax cut.





Source: Franchise Tax Board

How Much Will The Tax Cut Cost?

In 1999, at full implementation, the Governor's tax package would reduce state General Fund revenues by $4.7 billion. Cumulatively, the tax cuts reduce revenues by $10.8 billion over the four year period between fiscal year 1996-97 and 1999-2000. The Legislative Analyst's Office (LAO) estimates General Fund revenues will only increase by 2.3% per year over the next four years if the tax cut is enacted. Without the tax cuts the LAO estimates a 4.6% growth rate.[1] Inflation in the same period is estimated to range between 3.1% and 3.4%.

Table 4: Revenue Loss From Tax Proposal (in millions)

	1996-97	1997-98	1998-99	1999-2000	Totals
Personal Income Tax Cut	$450	$1,550	$2,740	$3,640	$8,380
Bank and Corporation Tax Cut	$90	$330	$620	$870	$1,910
Annuity Rate Cut	0	$35	$65	$101	$201
R & D Tax Credit Enhancements	$16	$42	$45	$48	$151
Small Business Expensing	$5	$25	$20	$17	$67
All Other Provisions	$11	$23	$26	$26	$86
Totals	$572	$2,005	$3,516	$4,702	$10,795

Source: Department of Finance

How Will The Loss Of Revenues Affect Future State Spending?

[1] Legislative Analyst's Office, January 1996

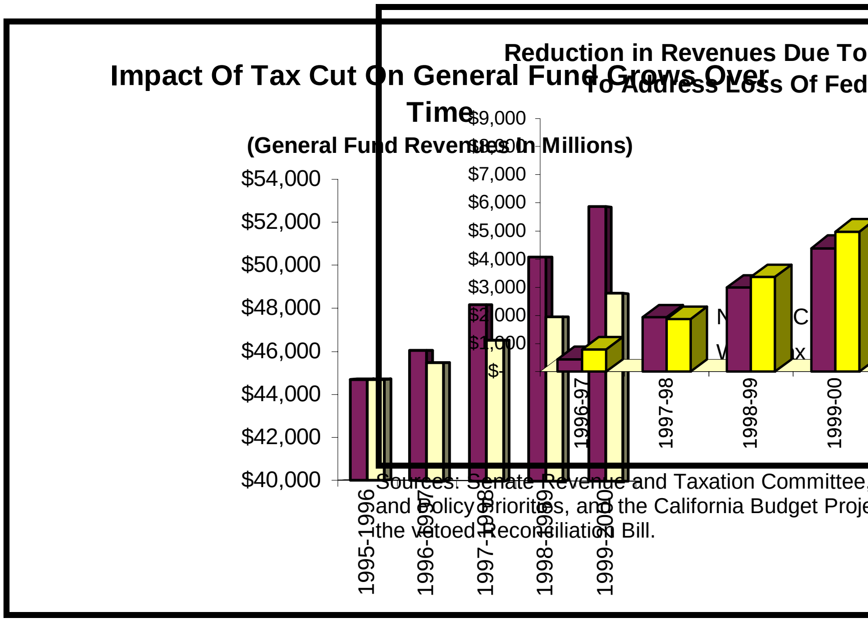
By delaying implementation of the tax cut, the Governor forestalls the difficult decisions over what programs should be cut in exchange for the tax cut. The impact in the upcoming fiscal year is much smaller than at full implementation, allowing legislators to delay difficult choices among spending priorities. The rising cost of the tax cut over time is particularly troublesome in light of uncertainty in the economy and the prospect of deep reductions in federal aid to the states.

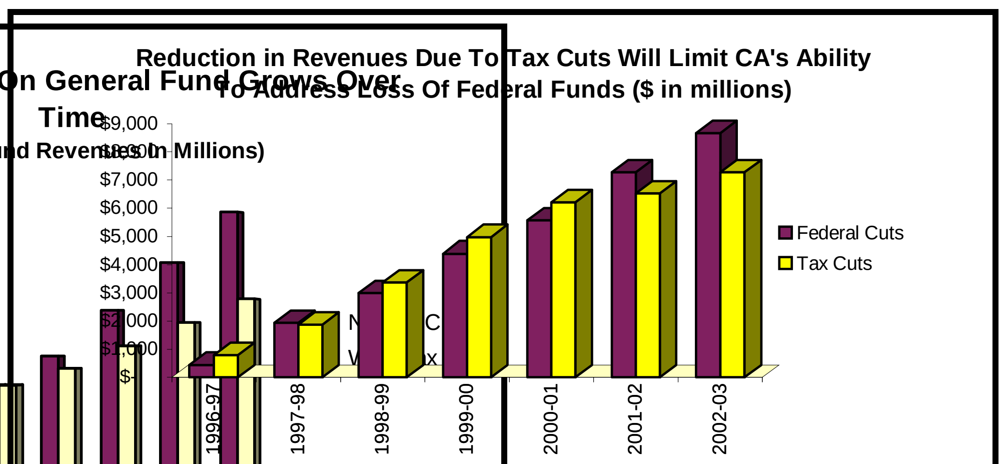
In the short term, rejection of the tax cut would allow restoration of many of the deep funding cuts proposed in the Governor's budget. An additional $572 million in the 1996-97 General Fund revenues could be used to:

- Increase spending for K-12 education by $105 per student.
- Eliminate student fees at CSU with money to spare.
- Pay the cost of incarcerating 27,902 persons in state prison for a year.
- Avoid the proposed 4.5% 1996-97 AFDC grant reduction and allow the temporary AFDC and SSI/SSP grant reductions to sunset.
- Return one-sixth of the property tax dollars diverted from counties, cities, and special districts as part of the 1992-93 and 1993-94 budgets.

These alternatives illustrate the difficult policy choices immediately confronting legislators. As the revenue losses increase in future years, deep reductions in program spending will likely be necessary to make up for the revenues lost due to the tax cut. In addition, since the impact of the tax cut is phased in over three years, the hands of future Legislatures would be tied once the cuts were enacted. While the proposal can be enacted by majority vote, any future changes which delayed or reduced the impact of the cut would require a 2/3 vote of the legislature. If after a year policymakers, for example, wished to forgo the remaining installments of the cut, a 2/3 vote would be necessary.

Tax Cuts Will Go Into Effect At Same Time California Loses Federal Funds

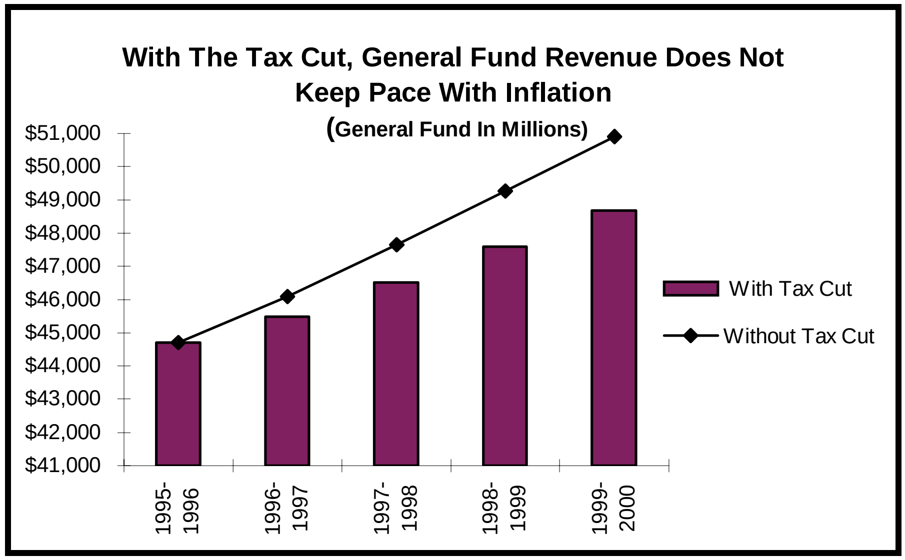




Sources: Senate Revenue and Taxation Committee, Governor's Budget Summary, Center on Budget and Policy Priorities, and the California Budget Project. Federal aid reductions are those contained in the vetoed Reconciliation Bill.

Between 1996 and 1999, California may lose up to $9.8 billion in federal funds under proposals to balance the federal budget. Reducing the size of the General Fund will make it harder for California to make up for the loss of federal funds in areas such as Medi-Cal and AFDC. If the legislature accepts the

Governor's tax package, the state could lose as much as **$20.6 billion** between 1996-1999 from the combined loss of federal funds and tax revenues.



Source: Governor's Budget Summary

With Tax Cuts, General Fund Will Not Keep Pace With Inflation

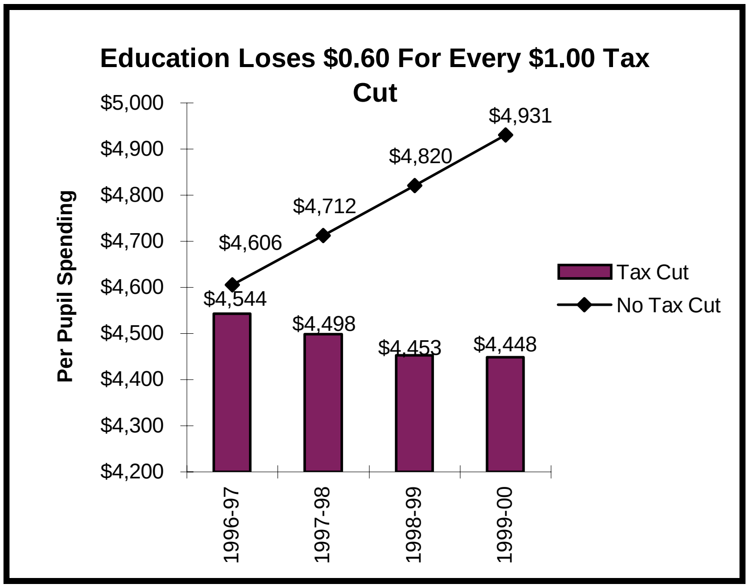
While the Governor argues that the tax cuts will only result in a lower level of growth in state revenues, this analysis fails to account for the impact of inflation, increasing population, and the need to reinvest in programs hard hit during the deficit years of the early 1990s. In reality, the tax cut will reduce amounts available for spending below the level necessary to keep pace with inflation, and fails to account for the need to rebuild a prudent reserve and make long-delayed investments in human capital and physical infrastructure.

Proponents of the Governor's plan also ignore a number of significant risks to the budget including the possibility that the state's fiscal condition could be weaker than projected. Perhaps most significantly, the proposal ignores the soon-to-skyrocket demand for spending on courts and correctional services related to enactment of the state's "3 Strikes" law.

If the tax cut is instituted, General Fund revenue growth will not keep pace with inflation. As a result, there will be less money available to maintain service levels, ensuring further cuts. The Legislative Analyst's Office estimates that in order for the General Fund to cover required spending for Proposition 98, debt service, and retirement funding, and to meet expressed goals in higher education and corrections, California would be forced to make cuts in health, welfare, and most state government operations - - program areas that have already suffered deep reduction in spending.[2]

School Funding Guarantee Would Be Cut By $483 Per Student

[2] Legislative Analyst's Office, An Overview Of The 1996-97 Governor's Budget, January 22.



Source: California Budget Project estimates based on estimates by the Legislative Analyst's Office and Department of Finance

Funding for K - 12 education and community colleges is based on a funding guarantee established by Proposition 98 of 1988 and modified by Proposition 111 in 1990. Proposition 98 specifies the minimum level of funding for schools from state and local sources based on certain 'tests' that link education spending to the size of the General Fund and the state's economy. Because of the interaction between Proposition 98 and the General Fund, for every dollar reduction in tax revenues, education loses $0.60. This reduction in state revenues translates into a loss of $483 per pupil.

While proponents of the tax cut argue that the Legislature could augment school spending, there is little likelihood that funds will be available to increase school spending beyond the minimal guarantee. In addition, under Proposition 98 there is a disincentive for the Legislature to increase funding for education, since this raises the minimum guarantee for future years.

Significant Tax Relief Granted In Recent Years

California has taken major steps to make its tax code more friendly to the business community. In 1993, legislation creating an investment tax credit for manufacturers, reforming the state's "unitary" method of determining corporate income tax liability, making the state's research and development tax credit permanent, lowering the tax rate on Subchapter S corporations, and providing preferential treatment of small business stock capital gains was signed into law as part of an overall legislative push to improve the state's business climate.

Other business tax relief granted in recent years includes a reduction in the bank and corporation tax rate from 9.6% to 9.3% in 1987, permanent extension of the ability for corporations to carry-over net operating losses in 1993, and authorization of the formation of limited liability companies in 1994. A 1993 Franchise Tax Board report noted that legislative changes resulted in a 5% reduction in bank and corporation tax revenues as compared to an increase of 1.9% that would have been expected in the absence of legislative action. Other actions taken to improve the state's business climate in recent years include substantial reform of the workers' compensation system.

How Does California's Tax Burden Compare To Other States?

Proponents claim that a tax cut is essential to future competitiveness of California. High tax rates, they claim, are a barrier to economic development. Based on the most commonly used indicators, however, California is <u>not</u> a high tax state and is, in fact, close to the average for all fifty states.

California ranks 22nd in collections of all taxes, fees, and assessments; 21st among the states in personal income tax collections; and 4th in bank and corporation tax collections (see Table 5). California ranks 29th in property tax collections and 18th in sales tax collections. California compares poorly to other states in terms of spending on critical areas of human and physical infrastructure. In 1992, California ranked 49th in spending for K - 12 education and highway spending.

Table 5: How Does California's Taxing & Spending Compare To Other States?			
Revenue Collections	**As A Percent Of Personal Income**	**Expenditures**	**As A Percent Of Personal Income**
All State Tax Revenues (1992-93)	27	Direct General Spending (1991-92)	23
State and Local Property Tax (1991-92)	29	K - 12 Education (1992-93)	49
Personal Income Tax (1992-93)	21	Welfare (1991-92)	18
Corporate Income Tax (1991-92)	4	Higher Education (1991-92)	34
State and Local Sales Tax (1991-92)	18	Highways (1991-92)	49
All State and Local Taxes (1991-92)	24	Corrections (1991-92)	5
State and Local Taxes, Fees & Assessments (1991-92)	22	Health & Hospitals (1991-92)	14

Source: Cal-Tax Research, Department of Finance, and National Center for Education Statistics

While California's marginal tax rates (that is, the rate at which the last dollar of income is taxed) are high, the tax code provides many preferences in the form of credits, deductions, and exclusions that lessen the tax bite for most taxpayers. Moreover, California's income tax law is among the most progressive in the country, minimizing the burden on middle income working families.

The California Budget Project (CBP) is a nonpartisan, nonprofit organization whose goal is to promote a better understanding of state fiscal issues in order to promote a healthy public sector based on a fair and equitable tax system. Publication of this brief is supported by grants from the James Irvine, Ford, and Annie E. Casey Foundations and individual donations and subscriptions.