Defining a New Future for the State

February 17, 2010
The Governor’s Proclamation

In October 2008, Governor Schwarzenegger signed executive order S-12-08, establishing the bipartisan commission on the 21st Century Economy

Mandate of commission

- Recommend changes to California’s tax structure that reflected changes in our economy
  - Shift away from manufacturing and agricultural economy to an information and innovation based economy
  - Reduce the volatility of the State’s revenues
- Create incentives for private industry to increase employment and investment in the State’s economy
- Ensure that tax structure is fair and equitable
- Promote long-term economic prosperity
Commissioners represented a broad spectrum of California interests

- **Gerald Parsky**, Chairman, Aurora Capital Group
- **Ruben Barrales**, President and CEO, San Diego Regional Chamber of Commerce
- **Michael Boskin**, Senior Fellow, Hoover Institution and T.M. Friedman Professor of Economics, Stanford University
- **John Cogan**, Senior Fellow, Hoover Institution and Professor of Public Policy, Stanford University
- **William Hauck**, President and Chief Executive, California Business Roundtable
- **Rebecca Morgan**, President, Morgan Family Foundation
- **Curt Pringle**, Mayor, City of Anaheim
- **Edward De La Rosa**, Founder and President, De La Rosa & Company
- **Christopher E’dley**, Jr, Dean and Professor of Law, Boalt Hall School of Law, University of California Berkeley
- **George Halvorson**, Chairman and CEO, Kaiser Foundation Health Plan and Kaiser Foundation Hospitals
- **Jennifer Ito**, Director of Research, Strategic Concepts in Organizing and Policy Education (SCOPE)
- **Fred Keeley**, Treasurer of Santa Cruz County, Professor of Political Science, California State University, San Jose
- **Monica Lozano**, Publisher and CEO, La Opinion
- **Richard Pomp**, Alva P. Loiselle Professor of Law, University of Connecticut
Summary of Recommendations

Recommendations

• Reduce and restructure the personal income tax
• Eliminate the corporation tax and the minimum franchise tax
• Eliminate the state general purpose sales tax
• Establish the business net receipts tax
• Establish rainy day reserve fund

Ideas Worth Noting

• Permit additional offshore leases
• Implement oil severance tax
California State Revenue by Source

*Source: California Dept of Finance, COMPARATIVE YIELD OF STATE TAXES, 1970-71 THROUGH 2010-11
Shares of AGI and Personal Income Tax Paid by Top 1% of Taxpayers

*Source: Commission on the 21st Century Economy Report, Sept 2009, pg. 14*
Proposed Personal Income Tax Structure

Two rates

- 2.75% Tax rate
  - Single: up to $28,000
  - Joint: up to $56,000
- 6.5% Tax rate – anything above

Standard deductions

- Single: $22,500
- Joint: $45,000

Itemized deductions limited to mortgage interest, property tax and charitable contributions

<table>
<thead>
<tr>
<th>Tax Package Alternative</th>
<th>Tax Changes by AGI Class (In billions of $)</th>
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<tbody>
<tr>
<td></td>
<td>$0-$20</td>
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<td>$0.0</td>
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<td>$20-$50</td>
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<td>$200-$1,000</td>
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<td>-$1.7</td>
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<td>Over $1,000</td>
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<td>-$2.6</td>
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<td>Total Resident</td>
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<td>-$7.0</td>
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</table>

Nonresidents and Federal Offset $6.9

Total $0.0
Business Net Receipts Tax (BNRT)

- Business gross receipts from all sources less purchases from all other businesses times BNRT rate

\[
\text{Gross Receipts} - \text{Purchases from Other Firms} = \text{Net Receipts}
\]

\[
\text{Net Receipts} \times \text{BNRT Rate} = \text{BNRT Liability}
\]

- Applies to all businesses doing business in California
- Commission recommended a max BNRT tax rate of 4%
- Phase-in BNRT rate and increasing over the phase-in period
### Components of the Statewide Sales and Use Tax Rate

<table>
<thead>
<tr>
<th>Jurisdiction (Fund)</th>
<th>Purpose</th>
<th>Rate</th>
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<tbody>
<tr>
<td>State (General Fund)</td>
<td>Directed to State's General Fund (Total General Fund is 6%)</td>
<td>4.75%</td>
</tr>
<tr>
<td>State (Local Revenue Fund, SLRF)</td>
<td>Directed to State's General Fund (Total General Fund is 6%)</td>
<td>0.25%</td>
</tr>
<tr>
<td>State (Local Public Safety Fund, LPSF)*</td>
<td>Directed to State's General Fund (Total General Fund is 6%)</td>
<td>1.00%</td>
</tr>
<tr>
<td>State (General Fund, ASUT)</td>
<td>Directed towards state's Fiscal Recovery Fund to pay off Economic Recovery Bonds (2004)</td>
<td>0.25%</td>
</tr>
<tr>
<td>State (Fiscal Recovery Fund)</td>
<td>Directed to Local Public Safety Fund to support local criminal justice activities (1993)</td>
<td>0.50%</td>
</tr>
<tr>
<td>Local (County Transportation Fund)</td>
<td>Directed to Local Revenue Fund to support local health and social services programs (1991 Realignment)</td>
<td>0.50%</td>
</tr>
<tr>
<td>Local (City or County Operations)</td>
<td>.25% Directed to county transportation funds .75% Directed to city and county operations</td>
<td>1.00%</td>
</tr>
</tbody>
</table>

**Total Statewide Base Sales and Use Tax Rate** 8.25%

*Pursuant to revenue and taxation code sections 6051.7, 6201.7 (Operative 4/1/2009)

**Funds unaffected by proposed decrease in sales tax

***Source: California State Board of Equalization, Detailed Description of the Sales & Use Tax Rate
Proposed Rainy Day Reserve Fund Proposal

- Increase the target reserve percent
  - Increase: from 5% to 12.5% of state revenues
  - Require that revenues above 10-year trend to be deposited in the reserve

- Restrict the Governor’s ability to suspend transfers to reserve fund
  - Exceptions: fund transfers to reserve fund can only be suspended when tax revenues are insufficient to cover spending at prior years level (adjusted for population increases and inflation)

- Stricter controls for fund withdrawals

- Funds can only be used for:
  - Natural disasters
  - Maintain prior year spending
Tax Package Phase In

**Year 1**
- Eliminate corporate tax
- Reduce personal income tax
- Reduce sales and use tax by 1%
- Establish business net receipt tax

**Year 2**
- Reduce personal income tax
- Additional reduction of 1% in sales and use tax
- Increase business net receipts

**Year 3**
- Conversion to new personal income tax
- Additional reduction of 1% in sales and use tax
- Increase business net receipts

- As of 1/1/12, sales and use tax revenues generally deposited into the State’s General Fund will be reduced by 1%
- Beginning 1/1/16, the BOE would only impose those sales and use taxes that generate revenues deposited in special funds
- Tax on sale, storage, use or consumption of motor vehicle, diesel, and other fuel would not be reduced
Year 4
• Additional 1% reduction in sales and use tax
• Increase business net receipt tax

Year 5
• Additional reduction of 1% in sales and use tax
• Final increase business net receipts

Sales tax intended to be reduced only if the BNRT performs as expected
Effects of Commission’s Tax Package

Current

- Sales tax, 34%
- Personal income tax, 44%
- Corporation tax, 9%
- Other excise, motor vehicle, insurance taxes, 13%

Proposed

- Net Receipts tax 47%
- Other excise, motor vehicle, insurance taxes 13%
- Personal income tax 31%
- Sales tax 9%

*Comparison does not include Tobacco, Estate Inheritance and Gift, Alcoholic Beverages and Motor Vehicle Fuel Taxes

**Source: Commission on the 21st Century Economy Report
Closing Thoughts

• Concerns were expressed about certain aspects of the plan
  • Revenue neutrality
  • No consensus about whether volatility is a problem
  • Progressive and regressive nature of changes to PIT
  • Reliance on an untested BNRT

• Commissioners generally believed that it is a good idea to lower sales tax and apply it to a broader range of services
  • Local Government revenues are relatively unaffected by the plan
  • Would reduction of the State’s portion of the sales tax cause an administrative burden on local governments?
  • Any distribution of BNRT receipts to local governments were not contemplated
Status of the COTCE Plan

- Report was sent to the Governor on September 29, 2009

- Report was heard in the Committees of Revenue and Taxation in the State Senate and Assembly
  - 4 informational hearings were held
  - No legislator stepped forward to introduce a bill

- Deadline to introduce a bill is Friday, February 19

- Major ideas in the COTCE plan were not included in the Governor’s 2010/11 budget