May 4, 2006

Hon. Bill Lockyer
Attorney General
1300 I Street, 17^{th} Floor
Sacramento, California 95814

Attention: Ms. Patricia Galvan
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 9005, we have reviewed the statutory initiative relating to state taxation (Initiative No. 06-0026).

BACKGROUND

The state levies a personal income tax (PIT) on the income of individuals and noncorporate businesses, such as sole proprietors and partnerships, doing business in California. The rates of the tax range from 1 percent to 9.3 percent, depending upon the taxpayer's income level. An extra 1 percent is levied on taxpayers' incomes greater than $1 million. The state also levies a corporation tax (CT) on the apportioned net earnings of corporations operating within California at the rate of 8.84 percent. Both the PIT and CT allow various deductions from income and credits against any tax owed. The state also levies an estate tax payable upon death, equal to the amount of any available state tax credit allowed under the federal estate tax (currently zero). Finally, residential and commercial property is subject to a general-purpose local ad valorem property tax rate of up to 1 percent annually, plus any additional tax for voter-approved indebtedness.

PROVISIONS OF THE INITIATIVE

This measure contains the following main provisions:

Establishes a Wealth Tax. The measure institutes a state wealth tax levied on the net assets of individuals with values in excess of about $40 million as of January 1, 2007. The wealth tax would be based on the tax rates established by the federal estate tax, whose top rate in calendar year 2007 will be 45 percent. It appears that the wealth tax would be levied on taxpayers in the state on a one-time basis, with revenues to be received in 2007-08 and 2008-09.

Alters Income Tax Rates. The measure reduces the CT rate from 8.84 percent to 4 percent, reduces the CT minimum tax, and enacts various other changes to the CT. In addition, it imposes an additional tax under the PIT for high-income taxpayers equal to 15 percent of their taxable incomes. It also eliminates the current Alternative Minimum Tax for both the PIT and the CT.

Curtails Certain Tax Expenditures. The measure eliminates or restricts certain so-called tax expenditure programs (TEPs). These TEPs are various provisions of the tax code such as tax credits, income deductions, and income exclusions that reduce the amount of revenues the state collects. Among the most significant of the TEPs that would be eliminated or restricted are: (1) personal and dependent exemption credits, (2) enterprise zone deductions and credits, and (3) research and development activity credits.

Institutes New Tax Programs. The measure establishes several new tax programs including tax credits for: (1) certain taxpayers with a federal estate tax liability, (2) income earned by teachers, (3) higher education tuition and fees, (4) qualified renters, (5) rents foregone by property owners due to rent control, (6) property tax payments, (7) the costs of purchasing health insurance for certain individuals, and (8) particular designated organizations. A number of these credits would be refundable.

FISCAL EFFECTS OF THE INITIATIVE

This measure would make major changes in the state and local tax system. Some of these proposals would generate significant behavioral and economic responses from taxpayers. For example, a wealth tax of the magnitude imposed by the measure would result in a significant shift in wealth from the private market to the public sector. Such a development could have a significant impact on economic activity and resulting revenues to the state and local governments. The changes in the PIT and CT could result in corresponding alterations in taxpayer behavior regarding investment and asset choice. Given factors such as these, the fiscal estimates provided below are subject to considerable uncertainty.

State and Local Revenues

One-Time Revenue Increase From the Wealth Tax. The measure would result in a one-time increase in state revenues (realized in 2007-08 and 2008-09) as a result of the establishment of the wealth tax. The combined increase for both years could be as much as $200 billion. The one-time revenue generated by the wealth tax would be deposited in the Capital Improvements Fund, created by the initiative. The monies in this fund would be used for unspecified capital improvements and to retire state debt. These revenues would not count towards the state’s appropriation limit or Proposition 98 (see below).

Ongoing Revenue Impact. The increase in the top PIT rate, the elimination or restriction of various TEPs, and certain other changes to the state's tax system would together result in additional combined revenues in the low tens of billions of dollars annually. Offsetting these additional revenues would be reductions associated with various TEP provisions and the CT rate reduction. The largest of these reductions involve the proposed teacher tax credit, health insurance tax credit, and CT rate reduction. These and other provisions would reduce state revenues (or result in increased expenditures in the case of refundable credits in excess of tax liabilities) in the low tens of billions of dollars annually. The net impact of all of the ongoing revenue increases would be roughly equal to the amount of the revenue decreases and expenditure increases. The net impact just on revenues, however, could be a gain in the range of $10 billion to $20 billion annually.

Impacts Related to Revenue Increases

The measure's ongoing revenue impacts on General Fund revenue could lead to significant interactions with State Constitutional provisions, particularly those regarding the state's spending limit and school funding.

Spending Limit. The proposal calls for a significant increase in tax credits that reduce tax liabilities and/or consist of refundable tax credits. It would appear that the refundable portion of these credits would require an appropriation and thus be subject to the state spending limit. State spending is currently subject to an annual limit on appropriations of tax revenues and is currently about $10 billion below this limit. Therefore, some portion of the net increase in tax revenues under the measure could be appropriated annually without exceeding this limit. In addition, the state could spend some of the remaining funds on appropriations *not* subject to the limit (such as debt service on outstanding obligations and capital outlay). However, to the extent that the state had remaining "excess revenues," existing law requires these to be allocated as follows:

- One-half to schools and community colleges.
- One-half to tax rebates.

These could total up to $10 billion annually, and would potentially result in commensurate reductions in noneducation spending.

Proposition 98. Proposition 98 consists of specific funding formulas for K-12 school districts and community colleges (K-14 education). The level of and changes to General Fund revenues are important factors in determining school funding under Proposition 98. The net increase in ongoing revenues could result in additional state education spending of several billions of dollars annually. These increased school expenditures would have to be offset by commensurate reductions in noneducation spending.

Summary of Fiscal Effects

The measure would have the following major fiscal effects:

- One-time increase in state revenues potentially up to $200 billion from imposition of a wealth tax. This revenue would be allocated to infrastructure spending and debt reduction.
- Annual increased state taxes—primarily from increased personal income taxes—in the low tens of billions of dollars annually, offset by a commensurate amount of state tax reductions and new refundable tax credits.
- Potential increase of several billion dollars in annual K-14 education spending and equal or greater reductions in noneducation spending.

Sincerely,

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Legislative Analyst

Michael C. Genest
Director of Finance