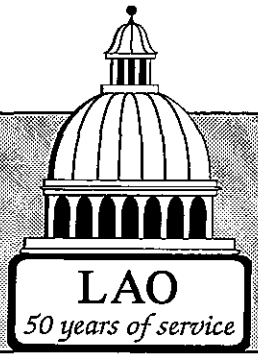

Reprint

FROM *THE 1995-96 BUDGET: PERSPECTIVES AND ISSUES*

THE GOVERNOR'S TAX PROPOSAL

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THE GOVERNOR'S TAX PROPOSAL

How Will the Governor's Tax Proposal Affect Individual Taxpayers, the State's Fiscal Condition, and the Performance of the California Economy?

Summary

The 1995-96 Governor's Budget proposes a 15 percent across-the-board income tax cut for both corporations and individuals, along with maintaining the high-income tax rates scheduled to sunset in 1996. The plan's stated purpose is to reduce the tax burden on individuals and businesses in California so as to stimulate business location and expansion in the state, thereby improving the economy.

The plan's net cost to the state is estimated in the budget to be $225 million in 1995-96 and $7.6 billion over the four-year period ending in 1998-99. A more recent analysis by the Franchise Tax Board (FTB) estimates the four-year cost at $7.3 billion. Two-thirds of the cost comes from reduced personal income taxes and the remainder from reduced bank and corporation taxes. Benefits to individual taxpayers will vary widely, with lower income individuals receiving no savings and high-income taxpayers initially paying more in taxes. After it is fully implemented, though, the plan will benefit most taxpayers, and will produce a more progressive personal income tax structure.

The proposal will reduce California's tax burden modestly. A number of measures suggest that California's current tax burden is about average when compared to other states. The proposal will not change this result dramatically. How much of a stimulative effect this decreased tax burden will have on California's economy is open to debate. Economists disagree on what its net impact will be, and no model currently exists that has a proven track record in accurately predicting the effect of a change of the type and size that the Governor is proposing.

Ultimately, whether the Governor's tax proposal is adopted is a legislative policy choice. Important policy decisions will need to be made regarding the tradeoff between reducing taxes and funding state services. The distributional consequences of any tax change and the resulting change in the mix of public versus private spending also would need to be considered.

INTRODUCTION

One of the key features of the Governor's 1995-96 budget is a proposed tax reduction for businesses and individuals. The proposal, which retains the two highest individual income tax brackets while phasing in an across-the-board rate reduction over three years, was developed with the view that California's tax rates are too high and that reducing them will stimulate the economy and attract more businesses to California.

In this analysis, we examine the arguments for adopting a tax cut and what its fiscal impact would be on the state and on individual taxpayers. We discuss how the tax burden would change under the proposal and what its effects would be on the progressivity of California's tax structure. We also consider California's tax levels, whether a tax cut will stimulate the economy, and the overall fiscal implications of the proposal. Lastly, we discuss some options available to the Legislature if this particular tax reduction plan is not adopted but a tax change of some other type is desired.

WHAT IS THE GOVERNOR'S PROPOSAL?

The Governor's tax proposal contains two key parts:

- *Continued High Income Tax Rates.* The 10 percent and 11 percent personal income tax rates for high-income taxpayers that were implemented in 1991 are scheduled to return to 9.3 percent in 1996. Under the Governor's proposal, these higher rates would remain in effect. In addition, the current 8.5 percent Alternative Minimum Tax (AMT) rate would stay in place, instead of returning to 7 percent in 1996. The phased-in rate reductions would be taken off of these higher rates.
- *Across-the-Board 15 Percent Rate Cuts for the Personal Income Tax (PIT) and the Bank and Corporation (B&C) Tax.* All tax rates will be reduced by 5 percent increments each year over a three-year period. Thus, by 1998, all PIT and B&C tax rates will be 15 percent lower than their 1995 levels. At that time, the highest rate under the proposal would be 9.3 percent—the same as it would be under current law.

Why Has a Tax Cut Been Proposed?

In January 1994, during his State of the State Address, the Governor requested that his Council of Economic Advisors organize a task force

to study and advise him on how to reduce taxes so as to stimulate job growth in the state. The resulting Task Force on California Reform and Reduction reviewed the state's fiscal structure in light of historical trends and present forecasts. It also focused on the reasons behind the decline of the state's tax revenues in the early 1990s. In late December, the Task Force presented its findings and recommendations on how to reduce taxes so as to spur employment and economic growth.

Findings of the Task Force

California's Tax Burden Is High. According to the Task Force, one of the key reasons for the decline in California tax revenues in the early 1990s was that California's tax rates had reached levels where they were inhibiting revenue growth. In particular, it concluded that the state's high marginal PIT and B&C tax rates gave individuals and businesses an incentive to locate elsewhere and shift economic activities out of state.

The Task Force emphasized that high corporate tax rates play a part in eroding California's competitive position relative to neighboring states, and that to improve the state's business climate, these rates should be reduced. Moreover, by lowering PIT rates for all Californians, businesses would not have to compensate workers for high taxes with higher wages, thus lowering their labor costs and increasing their profits. In addition, individuals would keep a higher percentage of their income, which would stimulate work incentives and increase productivity.

Reducing Taxes Will Stimulate Employment. According to the Task Force, firms and investors would see the rate reductions as a signal that the state is concerned about its business climate, and it would play a favorable role in business location decisions, both attracting new firms to California and encouraging already-established firms to remain and invest additional monies in the state. As more firms locate and expand in California, more jobs would be created, which in turn would benefit both individuals and the state's economy in general.

Government Funding Will Still Be "Adequate." The Task Force concluded that total funds available for spending on state programs would grow a little faster than needed to compensate for population and inflation, even with a tax cut in place. The Task Force acknowledged that spending restraint would be required, but noted that the state could provide public services more effectively and efficiently than it does currently.

A "top-down" budgeting approach was suggested by the Task Force. This approach takes the tax revenues that are available (in this case,

reduced for the proposed tax cut) and then sets aside funds for certain spending requirements (Proposition 98 and debt service). It then marks all remaining funds for "discretionary" use. As noted above, the Task Force acknowledged that because discretionary revenues would be limited, hard choices would have to be made regarding the funding of the remaining program areas in the budget.

What Is the Cost of the Governor's Tax Proposal?

Costs to Reach Over $7 Billion by 1998-99. Figure 1 shows the budget's estimate of how the state would be affected by the Governor's proposal. The cumulative cost by 1998-99 to the state of the rate reduction alone is $10.6 billion. However, this amount is offset by $3 billion due to retention of the high-income PIT rates. Thus, the budget estimates that the net state four-year revenue reduction would be $7.6 billion.

Since the budget was released, the Franchise Tax Board (FTB)—which administers both income taxes—has made its estimate of the proposal's fiscal impact. The FTB's estimate for the first four fiscal years is $7.3 billion, or $300 million less than the budget's estimate.

Figure 1

State Revenue Effects of the Tax Reduction Proposal 1995-96 Through 1998-99

(Dollars in Billions)

State Revenue Effects	1995-96	1996-97	1997-98	1998-99	Four-Year Total
Personal Income Tax					
Continuation of high-income tax brackets after 1995	$0.3	$0.8	$0.9	$1.0	$3.0
Phase-in of 15 percent tax cut	-0.4	-1.5	-2.7	-3.6	-8.3
Net effect	**(-$0.1)**	**(-$0.7)**	**(-$1.9)**	**(-$2.7)**	**(-$5.3)**
Bank and Corporation Tax					
Phase-in of 15 percent tax cut	-$0.1	-$0.4	-$0.7	-$1.0	-$2.3
Total State Revenue Effect	**-$0.2**	**-$1.1**	**-$2.6**	**-$3.6**	**-$7.6**

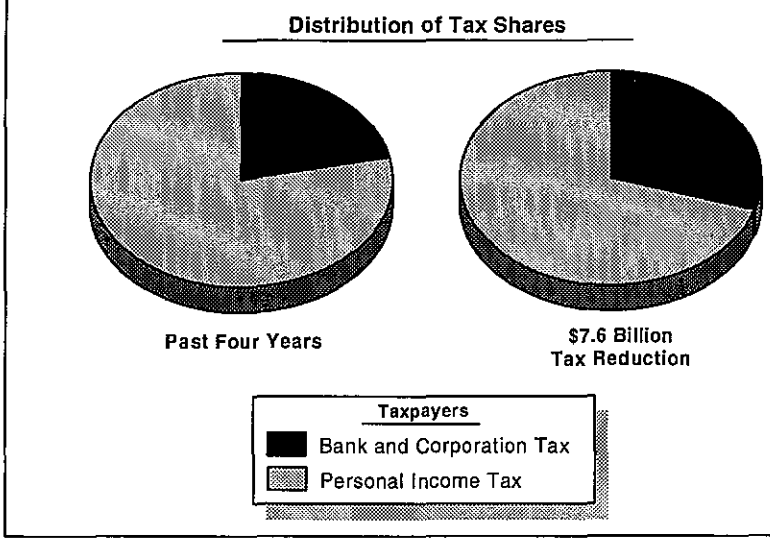
[a] Source: Department of Finance. Detail may not add to totals due to rounding.

Individuals Receive Over Two-Thirds of Benefits. Figure 2 shows the share of the net tax savings going to PIT filers versus B&C tax filers.

Based upon the budget, over two-thirds of the net revenue benefits go to individuals and the remainder to corporations. The share that corporations receive is a bit larger than their share of tax liabilities in recent years. This is because certain individuals do not receive the full amount of the rate reduction because of the retention of the 10 percent and 11 percent rates. In the following section, we show that these individuals initially pay more under the proposal than under current law. Absent these high brackets, the distribution of the tax reduction between the PIT and the B&C tax would be similar to their tax shares in recent years.

Figure 2

Distribution of Net Tax Reduction
1995-96 Through 1998-99



How Will Individual Taxpayers Be Affected?

Because the dollar amount of the tax reduction is based upon income levels and tax rates, the dollar amount of tax savings that individuals and businesses would receive varies widely. In general, by 1998, the higher an individual or corporation's tax liability, the greater the dollar amount of tax reduction they will receive under the tax proposal. How much specific taxpayers would benefit is addressed in the following sections.

About Half of All Corporations Will Benefit

According to the FTB's most recent annual report, nearly one-half of all corporations in California reported either a net loss or no income for the 1992 tax year. Such corporations would receive no tax savings because they do not have any tax liabilities. Of the 50 percent of corporations that did file with a positive net income, one-tenth of one percent had incomes over $10 million and paid nearly 60 percent of the total tax liability. Thus, most of the tax savings would be going to these corporations because of their high tax liabilities.

Benefits to Individuals Will Differ

Figure 3 shows how individual taxpayers with different income levels would be affected in 1996 through 1998, as the tax proposal is phased in. For illustrative purposes, the examples used in this section are for a married couple filing jointly, with two children and tax deductions equal to the average of California taxpayers having the same income level. The figure displays both the state tax savings from the rate reduction, and the net tax savings after adjusting for higher federal income taxes. Federal income taxes are increased because, in most cases, lower state tax liabilities reduce the amount of itemized deductions a taxpayer can claim for federal income tax purposes. This is because state income taxes are an allowable itemized deduction on federal tax returns. Thus, except for high-income individuals in 1996 and 1997, the taxpayers' federal income tax increases. This federal tax increase from current-law levels is deducted from total state tax savings to arrive at the net amount. In the case of B&C taxpayers, their state taxes also are deductible, but as a business expense; thus, they also would generally see their federal taxes rise.

Figure 4 displays the aggregate impact of the federal offset. About one-fourth of the state tax savings for individuals and businesses is offset by an increase in federal income taxes because of lower deductions. In the case of the PIT, however, this proportion differs by income level. By 1998, taxpayers with income over $1 million have over one-third of their state tax savings offset by higher federal income taxes, compared to less than one-tenth for those individuals with income levels under $25,000. This reflects the progressive nature of the federal PIT bracket structure. Figure 5 (see page 118) shows how the tax proposal distributes savings over the phase-in period taxpayers.

Low-Income Taxpayers Receive No Benefits. Individuals that have no tax liabilities, as with corporations having no liabilities, do not receive any tax savings under the proposal. Thus, a married couple with income of $20,000 or below would not receive any tax reduction from

Figure 3

Tax Reduction Proposal
Effects on Individuals, by Income Level[a]
1996 Through 1998

Adjusted Gross Income	1996 State Tax Savings	1996 Net Tax Savings	1997 State Tax Savings	1997 Net Tax Savings	1998 State Tax Savings	1998 Net Tax Savings
$20,000	$0	$0	$0	$0	$0	$0
40,000	34	29	66	56	96	82
60,000	74	63	142	121	206	175
80,000	130	94	252	181	365	263
100,000	210	151	407	293	593	427
150,000	410	283	807	557	1,193	823
200,000	628	402	1,244	858	1,849	1,276
250,000	826	529	1,639	1,049	2,441	1,563
500,000	384	232	2,562	1,547	4,666	2,818
1,000,000	-5,078	-3,067	-175	-106	4,896	2,957

[a] Data are for a married couple filing jointly, with two children and average itemized deductions for their income level. Negative amounts reflect tax increases. Net savings equals state savings adjusted for related increases in federal income taxes (resulting from lower itemized deductions).

Figure 4

Total Versus Net State Tax Savings
Individuals and Businesses
1996 Through 1998

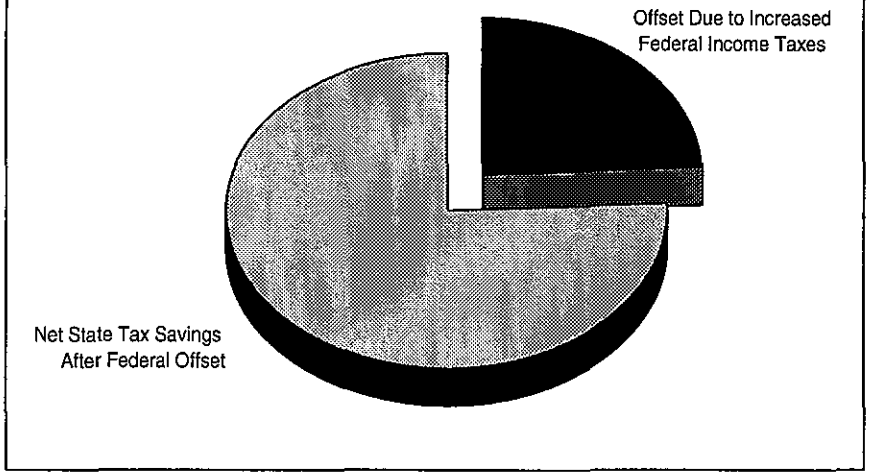
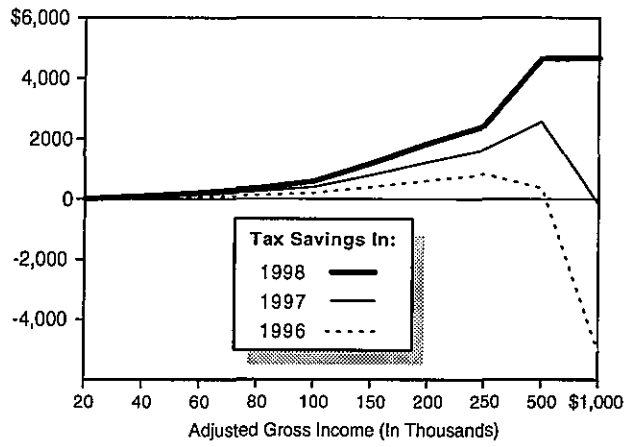


Figure 5

Tax Proposal — State Tax Effects On Individual Taxpayers By Year and Income Class 1996 Through 1998



the tax proposal. Such taxpayers have no current-law liability, either because they have little taxable income or what taxes they do have are eliminated because of their personal and dependent credits.

High-Income Taxpayers Will Initially Pay More. A married couple with income over $1 million would initially pay more under the tax proposal because of the retention of the high-income tax rates. Specifically, a married couple with income of $1 million would have net tax increases of $3,067 in 1996 and $106 in 1997. Under certain conditions, high-income individuals may end up paying more under the proposal even after it is fully phased in. This is because their Alternative Minimum Tax (AMT) could increase.

All Other Taxpayers Will Eventually Benefit. In 1996, all taxpayers with income levels under $500,000 (except those low-income taxpayers mentioned above) would receive some tax savings. By the time the proposal is fully-phased in, high-income individuals would also realize a reduction in their taxes.

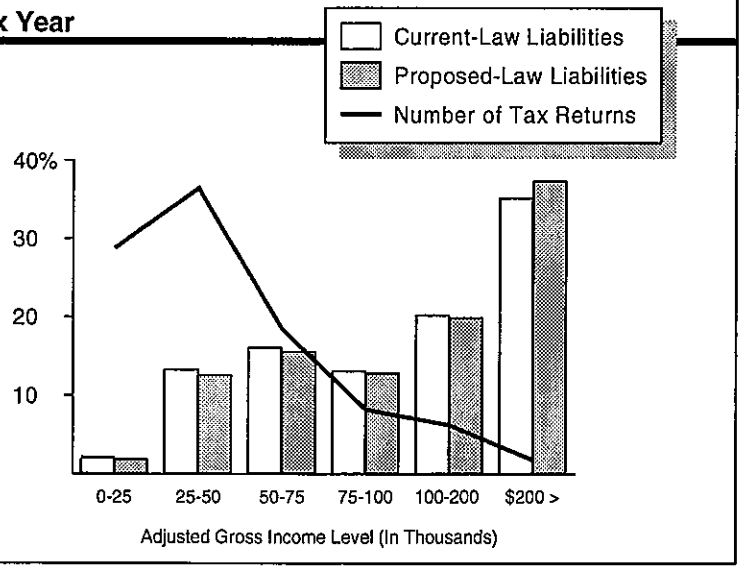
Tax Structure Slightly More Progressive

The tax proposal would produce a slightly more progressive PIT structure for California, largely due to retaining the high-income rate brackets. Under both current law and the tax proposal, taxpayers with higher levels of income bear a proportionately greater share of total tax liabilities than do lower-income taxpayers. Under the proposal, this effect increases.

Figure 6 shows the distribution by adjusted gross income (AGI) of tax liabilities under both current and proposed law, compared to the distribution of taxpayers. It shows that taxpayers with income over $200,000 as a group would pay a larger share of total tax liabilities—about 2 percent higher under the proposal, whereas all income levels below this would experience slight drops in their shares of total tax liabilities. The figure also shows that under current law, high-income taxpayers, who represent less than one-tenth of all taxpayers, would pay almost 60 percent of the total tax burden. This proportion would increase slightly under the proposed system. Thus, the PIT structure becomes more progressive under the tax proposal because a greater share of the tax liabilities is borne by higher income individuals.

Figure 6

Taxpayers and Tax Liabilities By Income Class
All California Residents
1998 Tax Year



The average tax rate is another indicator of how the distribution of the tax burden changes under the proposed tax plan. Figure 7 shows that, for 1998, there is over a half a percentage point drop in the total average tax rate under the tax proposal. The average rate drops the least in percentage terms for individuals with income levels over $1 million (1.8 percent) and the most for individuals with income less than $20,000 (22 percent). Thus, the average tax rate structure becomes more progressive under the proposal.

Figure 7

Average Tax Rate by Income Class, 1998[a]

Adjusted Gross Income	Current Tax Law	Proposed Tax Law	Percentage Decline
$0-25,000	0.77%	0.60%	22.1
25,000-50,000	2.44	2.02	17.2
50,000-75,000	3.67	3.10	15.5
75,000-100,000	4.78	4.09	14.4
100,000-200,000	6.33	5.43	14.2
200,000-500,000	8.13	7.15	12.1
500,000-1,000,000	8.80	8.16	7.3
1,000,000 and over	9.08	8.92	1.8
Totals	**4.43%**	**3.87%**	**12.6%**

[a] Rates are for all filing statuses (California residents only).

WHAT ABOUT CALIFORNIA'S TAX LEVELS?

High tax rates were cited by the Governor's Task Force as a key problem for California's business climate and the state's economy. The following section compares California's tax levels to other states to see how we rank in terms of tax levels.

Marginal Rates Are High

California's tax rate for corporations is generally a flat 9.3 percent under current law. Compared to other western states, it is among the highest, being surpassed only by Alaska. Arizona has the next highest rate at 9 percent. Among major industrial states, California's tax rate is more comparable. Pennsylvania and Massachusetts have higher rates than California, and New York, New Jersey, and Ohio are currently at or near 9 percent.

Figure 8 shows the 1994 marginal PIT rate schedule for individuals. While the example is for a married couple filing jointly, the structure is the same for single tax filers but all dollar values are halved. The marginal tax rates for high-income individuals are above those for other western states. Lower-income Californians, however, face lower tax rates than in many other western states. For example:

- Oregon's highest tax rate (9 percent) applies to a married couple with joint taxable income slightly over $10,000. In California, a similar couple would be taxed at a 2 percent marginal rate and would not face a 9 percent tax rate until taxable income was over $60,000.
- A married couple in Utah with income of about $15,000 would be taxed at a 7.2 percent marginal rate (this includes the effect of a large exemption). In California, a similar couple would be taxed at a 2 percent marginal rate and would not face a 7.2 percent rate until taxable income exceeded almost $50,000.
- Californians with taxable income significantly over $60,000, however, would face lower marginal rates in both Oregon and Utah.

Figure 8

1994 Personal Income Tax Rate Schedule For Married Individuals Filing Jointly[a]

If taxable income is:		Computed tax is:			
Over	But not over				of the amount over:
$ 0	$9,444	$ 0.00	+	1.0%	$ 0
9,444	22,384	94.44	+	2.0	9,444
22,384	35,324	353.24	+	4.0	22,384
35,324	49,038	870.84	+	6.0	35,324
49,038	61,974	1,693.68	+	8.0	49,038
61,974	214,928	2,728.56	+	9.3	61,974
214,928	429,858	16,953.28	+	10.0	214,928
429,858	and over	38,446.28	+	11.0	429,858

[a] Tax rate schedule for single taxpayers is the same except all dollar amounts are halved.

Marginal rates, however, are only one part of the tax structure. Other factors that should be considered when making interstate tax comparisons include deductions, exclusions, exemptions, and credits. Two studies that have attempted to include such elements (completed by the Minnesota Department of Revenue and the consulting firm of KPMG

Peat Marwick for the Governor of North Carolina) arrive at conclusions similar to those illustrated above. That is, low-income taxpayers face lower tax liabilities and high-income taxpayers pay more in taxes in California than many other western states. While these studies make several generalized assumptions that may not reflect specific tax conditions for all taxpayers in each state, they give a sense of California's ranking relative to other states.

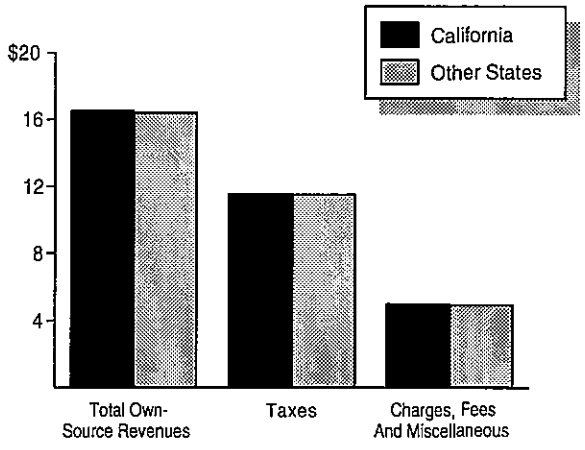
California About Average in Terms of Average Revenue Burden

Average revenue burden is another measure that can be used to make interstate tax comparisons. Most comparisons below are made in terms of revenues or taxes relative to personal income rather than in per capita terms. Many economists believe that expressing taxes relative to personal income is the better measure because per capita comparisons do not standardize for income level differences across states.

Figure 9 shows that, according to U.S. Department of Commerce figures for 1991-92 (the most recent data available), California is about average in terms of revenue burden per $100 of personal income. California is about 1 percent above the national average in total own-source revenues, while its total state and local tax revenues are less than one-half of a percent above the average.

Figure 9

State and Local Revenues Per $100 Personal Income 1991-92



If we focus strictly on tax revenues per $100 personal income, Figure 10 shows state taxes are about 11 percent higher than the average of other states, while local taxes were about 14 percent below the average.

Figure 10

State and Local Taxes Per $100 Personal Income 1991-92

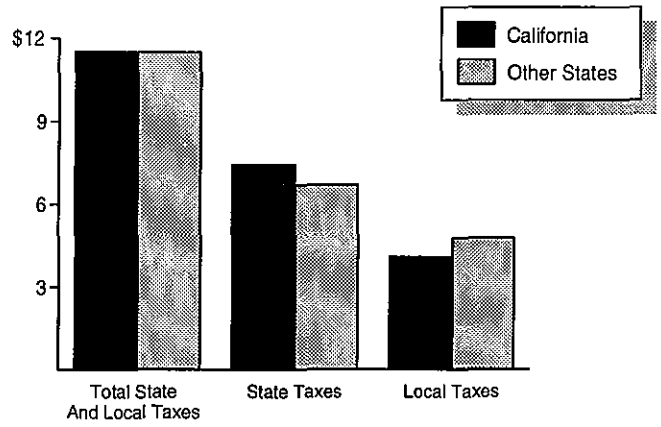


Figure 11 (see next page) compares California state and local tax burdens to the average of other western states (excluding Alaska) and the average of other major industrial states. California's total state and local tax burden per $100 of personal income is about 2.5 percent lower than the average of western states and about one-fourth of a percent lower than industrial states. California ranks between western and industrial states in terms of both state taxes and local taxes.

Figure 12 (see next page) shows that, in per capita terms, California is slightly higher than western and industrial states for state-local taxes combined and state taxes alone. By most measurements, California is about average in terms of average revenue or tax burden. This is a common view amongst economists who follow such data.

Figure 11

California Tax Revenues Per $100 Personal Income Compared to Other Western and Industrial States 1991-92

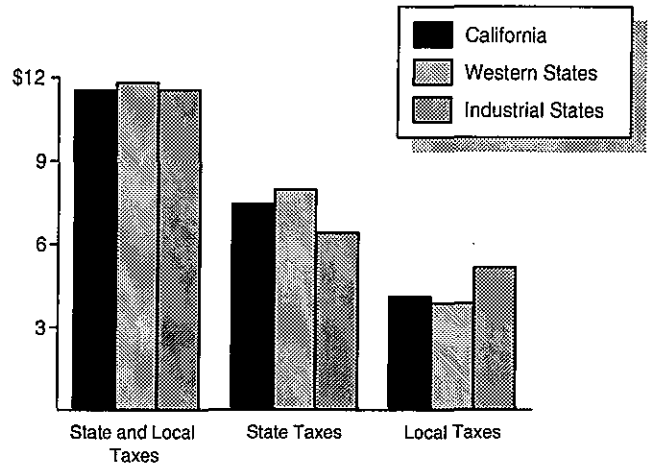
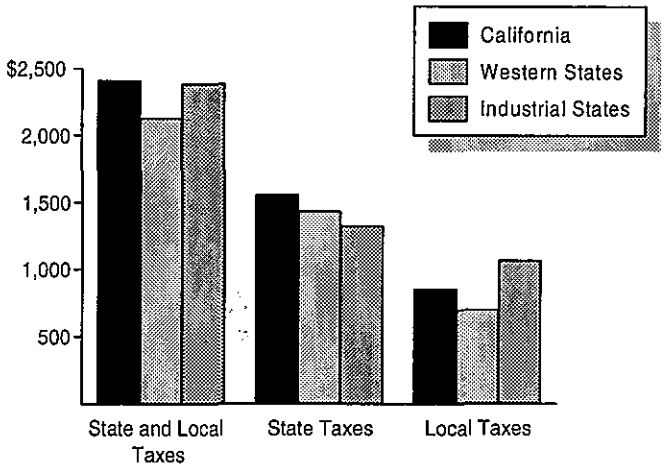


Figure 12

California Tax Revenues Per Capita Compared to Other Western and Industrial States 1991-92

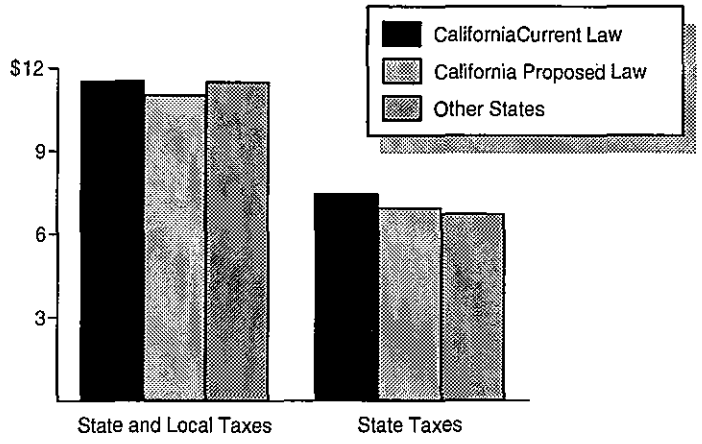


The Impact of the Proposal on Average Tax Burden

How does the tax proposal affect the comparisons made above? Figures 13 and 14 (see next page) show the level of California tax revenues under current and proposed law compared to average tax revenue levels in other states (again, as of 1991-92). (We calculated the impact of the proposed tax cut by applying the fully phased-in percentage tax reduction to 1991-92 California tax levels.) California state and local taxes per $100 of personal income with the proposal in place would have been 4.1 percent below the average of other states, and state taxes would have been 3.3 percent (instead of 11 percent) higher than other states. In per capita terms, California would still have higher tax levels, though the gap between it and other states would narrow. Even adjusting for the tax proposal, however, the drop in relative tax burden is fairly modest, and California still appears to be an average state.

Figure 13

Illustrative Effect of Tax Proposal on Taxes Per $100 Personal Income 1991-92

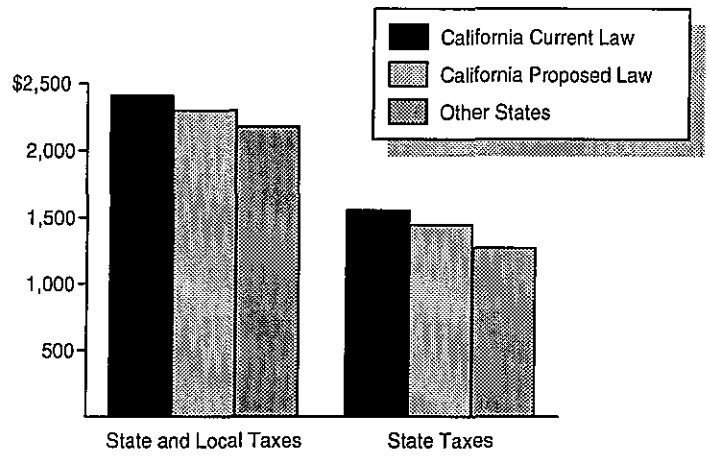


Other Factors Influencing the Business Climate

California's state and local tax burden clearly does play a role in affecting the state's business climate. There are other elements, though, that should be considered when evaluating the state's competitiveness

Figure 14

Illustrative Effect of Tax Proposal on Taxes Per Capita 1991-92



and comparing it to other states. Figure 15 lists some key factors that economists agree influence the business climate.

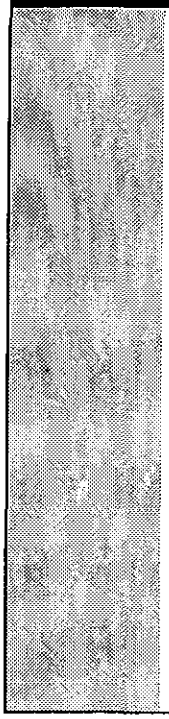
The effect of each factor on business location decisions varies, depending on the particular industry and taxpayer involved. However, taxes are sometimes focused more heavily upon in discussions and debates about the business climate than are some of the other elements in Figure 15, because taxes are one factor that is changeable in the short-run. Changes in other factors, such as infrastructure, usually require time to evolve, and some factors, such as climate, can not be altered by policy decisions at all.

How Will the Economy Be Affected By the Tax Proposal?

There is little debate that the proposed tax reduction would benefit most taxpayers, and the state's economy would profit from individuals and businesses investing or spending their tax savings in California. The question that remains, though, is how much net economic stimulus can we expect from the tax proposal, especially when offsets are considered.

Figure 15

Key Factors Influencing Business Climate



- ☑ Access to Markets
- ☑ Infrastructure, Including Transportation Facilities
- ☑ Labor Force Availability, Skill-Level and Costs
- ☑ Living Costs and Overall Quality of Life
- ☑ Regulatory Environment
- ☑ Resource Availability
- ☑ Tax Structure and Incentives
- ☑ Weather and Climate

Some Stimulus Will Occur

Behavioral and Dynamic Feedback Effects. The topic of behavioral and dynamic feedback effects relates to the revenue impacts that tax law changes produce in addition to their direct static revenue impacts. Static revenue analyses assume that economic activity is unaffected by tax law changes. In contrast, dynamic analyses recognize that tax law changes can result in both (1) direct behavioral responses by individuals, businesses and governments, and (2) feedback effects. Feedback effects occur because direct effects trigger further behavioral responses. For example, in the case of a gasoline tax increase, a static analysis would assume a revenue gain based on current levels of gasoline consumption. Alternatively, a dynamic analysis might predict less of a revenue increase, because of behavioral changes that could reduce gasoline consumption, such as driving less, and feedbacks, such as reduced spending on other goods after paying more for gasoline.

Increased After-Tax Income Will Encourage Growth. All else constant, increasing the amount of after-tax income individuals and businesses receive will tend to stimulate economic growth. A significant portion of the increase in individual after-tax income can be expected to go toward consumption. In addition, part of the tax savings will go towards investments by businesses and individuals, another form of spending, and some will go into savings. All of these responses can stimulate economic growth, directly or indirectly. However, the size of impact will vary according to the specific use of the funds.

How Much Growth Will Occur? There is considerable debate among economists regarding the fiscal and economic impacts of tax law changes, especially at the state-local level. One important reason involves the types of government spending that tax reductions displace, including how the public values the resulting cutbacks, and subsequently how much of the tax savings will go towards activities in the state that actually stimulate economic growth. Some research has concluded that these effects can be significant, while other studies conclude that the net impact is minimal. Other studies have concluded that state-local tax policies can definitely affect the behavior of certain *individual* taxpayers, but in the *aggregate* have much less identifiable or significant effects.

To date, state governments have rarely attempted to quantify feedback effects of state tax law changes on their economies or on their revenue collections. Revenue analyses done in California by the FTB, the Board of Equalization (BOE), and the DOF, have to varying degrees attempted to consider certain direct behavioral responses in evaluating tax law changes, but have not in the past comprehensively evaluated the dynamic feedback effects of such changes. The FTB in particular does estimate the effects of direct behavioral responses using various modelling approaches and assumptions; therefore in this respect, its estimates are not static. Existing law adopted in 1994 now requires the DOF to incorporate dynamic effects into its revenue analyses under certain conditions and when reasonable. Our office has a similar requirement, but only for tax law changes proposed in the budget. Initial steps have been taken toward developing methodologies to meet these requirements. For example, the DOF has requested funds in the 1995-96 budget to pay for contract work and staff in this area. At present, however, a proven tool for accurately estimating dynamic feedback does not exist, either in California or elsewhere.

In an effort to see whether we could draw any conclusions about what the dynamic feedbacks of the Governor's tax proposal might be, we conducted a review of what 25 other states had seen happen when

they made major changes to state taxes in the past. Figure 16 (see next page) summarizes what other states told us were their experiences with major tax law changes in the past 15 years. The bottom line is that little is known regarding dynamic feedback effects. Of those states that have attempted to conduct dynamic analyses, only Massachusetts has completed more than a few. And, even in this case, validating the results of this work and other static analyses is often difficult because states do not conduct retrospective analyses. (A retrospective analysis looks back at tax law changes and measures what their effects actually were.) While states are interested in discerning the dynamic feedback effects of tax law changes, many factors (including those in Figure 16) have precluded them from doing so.

Offsets Also Will Occur

Any feedback effects that occur from the Governor's tax proposal will be mitigated by several offsetting factors. The most significant are off sets resulting from various "leakages." For example, many corporations doing business in California have multi-state or multi-national operations; thus, a tax reduction might be used by certain companies for investments and activities outside of California, reducing the feedback effects on revenues here. Likewise, if the funds are saved, they might end up financing economic activities elsewhere, given the national and international nature of our capital markets today. And, as earlier noted, additional offsets would occur if the state cuts spending in certain areas to pay for the tax reduction. For example, some individuals and businesses might have to use tax savings to supplement activities that the state has chosen to cut-back, partially offsetting the positive impact of the tax cut on the economy.

Difficult Decisions Would Need to Be Made

As the Task Force noted, under a "top-down" budgeting approach, many hard choices would have to be made with a tax cut in place because of restricted revenue growth. Decisions would have to be made to cut certain program areas, and the state could be faced with ongoing tight budgets.

One-Third of New Revenues Would Be Lost. In Part One, we discussed what the budget pressures might be with the tax proposal in effect. We estimated, and Figure 17 shows, that of the $24 billion of cumulative new resources between 1995-96 and 1998-99 under a moderate-growth scenario, nearly one-third would be redistributed back to taxpayers through the tax proposal. After distributing revenues for

Proposition 98, debt service, and employee retirement, about one-fourth of increased revenues would be left for other program areas. The Proposition 98 amount is about $3.9 billion less than what it would be absent the tax cut because, under existing law, educational spending declines with reductions in General Fund revenues.

Figure 16

Experiences in Other States Analyzing Tax Law Changes

☑ **Few Dynamic Analyses Have Been Attempted**

- Static analyses are generally done
- Limited dynamic analyses have been done in two states—Massachusetts and Minnesota

☑ **Analyses are Prospective Rather than Retrospective**

- Results often cannot be validated

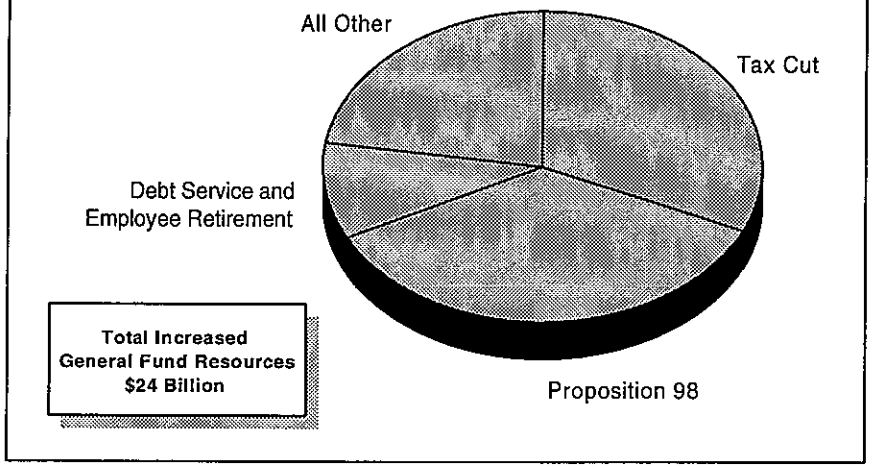
☑ **Many Factors Create Problems in Identifying and Measuring Effects of Tax Changes, Including:**

- Recessions, federal tax law changes, and structural adjustments in state economies that also are affecting revenues
- Data limitations
- Distinguishing between cause and effect when both tax laws and economic activity change
- Timing lags between when policy changes occur and behavioral effects result
- Lack of empirical evidence and limitations of economic theory
- Sorting out the effects of multiple law changes occurring simultaneously
- Resources constraints

This estimate did not include the establishment of a budget reserve fund, nor the impact of certain factors, such as the renters' credit, which is scheduled to go back into effect in the future. It also implicitly assumes the state will win several costly lawsuits currently being appealed. Thus, this analysis probably overstates the actual amount of resources available for other programs. It is likely that with the tax proposal in effect, the state would face tight budgets in the years to come.

Figure 17

Distribution of Increased Resources Under the Governor's Budget Plan 1995-96 Through 1998-99



SHOULD OTHER ALTERNATIVES BE CONSIDERED?

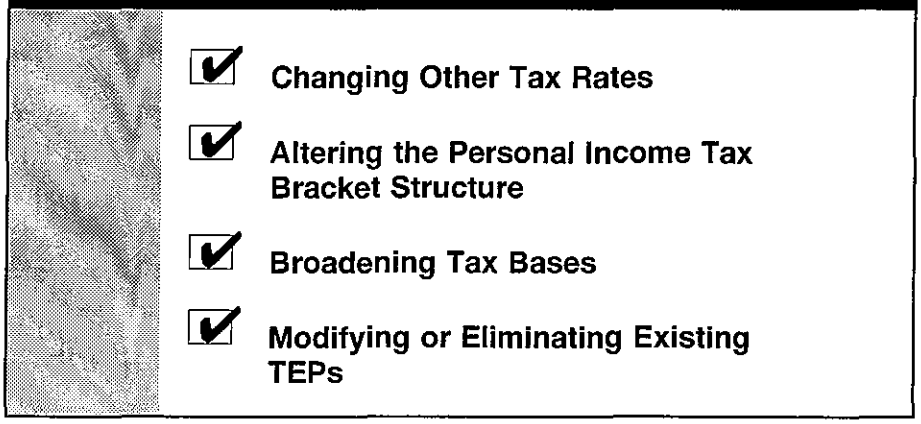
The Governor's tax reduction proposal is but one method for reducing the state's tax burden. Figure 18 (see next page) shows several of the many different other tax-related policy choices that could be considered, depending on the objective or desired outcome.

One would be lowering other tax rates, such as the state sales tax rate. This would affect essentially all Californians and have its own effect in terms of changing the distribution of the tax burden. Fundamental changes in the PIT bracket structure also could be considered, such as by eliminating certain brackets or establishing a flat tax. These

options would also redistribute the tax burden. In both cases, revenues would decline and the progressivity of California's overall tax structure would change.

Figure 18

Alternatives to the Governor's Tax Proposal



Broadening the tax base in order to lower tax rates also could be considered, such as a value-added tax (VAT) or a similar consumption-based tax. These again would change the distribution of the tax burden. The existing sales tax also could be applied to certain services. Another less sweeping possibility involves modifying or eliminating certain existing tax expenditure programs (TEPs), so as to broaden the tax base and thereby allow for rate reductions. By reducing the amount of TEPs, the tax burden could be eased for those taxpayers who do not currently qualify for them.

Thus, the Governor's tax proposal is but one of many options for changing the existing tax structure and providing for a tax reduction that changes the tax burden. In evaluating the Governor's tax proposal, or any alternative proposals, the Legislature will need to first decide what its fundamental tax policy objectives are, and then what types of tax changes, if any, are needed to best achieve these objectives. The fiscal and distributional consequences should be examined to ensure that they are consistent with legislative objectives, such as the desired mix of public versus private spending in the state.

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