California's Tax System – Report #3a

Personal Income Tax Weakness & Possible Remedies: Volatility is Too Great

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This is one in a series of reports on weaknesses in California's tax system. Report #1 listed several structural weaknesses and policy issues that exist in most of California's taxes and the system overall. Subsequent reports provide further details on each of the weaknesses and issues, along with possible remedies. The purpose of this series of reports is to help promote serious discussion on the need to and the ways to bring California's tax system into the 21st century so it may best promote economic growth, be more equitable, efficiently meet state revenue needs, reduce taxpayer frustration, and be understandable and transparent. A blog accompanies these reports to enable online discussion and a website exists to access the reports and the blog:

http://www.cob.sjsu.edu/nellen_a/TaxReform/21st_century_taxation.htm

Introduction

The personal income tax (PIT) is the largest revenue generator for California. For 2007-2008, it is expected to yield $54.8 billion, about 54% of the state's General Fund revenues.[1] The PIT has not always been the state's major revenue generator. In 1963-1964, PIT represented 18% of General Fund revenues, growing 45% by 2003-2004.[2] In 1968, the state legislature noted that the state must rely on the sales tax as its main revenue source due to challenges of competing for income tax dollars against the high federal income tax and allowing the property tax to be used by local governments.[3]

The California PIT is computed starting with federal adjusted gross income (AGI) with various adjustments. The graduated rate structure is comprised of 6 rates: 1%, 2%, 4%, 6%, 8%, and 9.3%. In addition, individuals with taxable income over $1 million must pay an additional 1% on the amount over $1 million. This additional tax is designated as a mental health services tax.[4]

The 10.3% maximum tax rate (9.3% + 1% special tax) represents the highest maximum rate among the states. The top tax rates and number of tax brackets for selected states follows.[5]

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[1] Legislative Analyst's Office (LAO), *Analysis of the 2007-08 Budget Bill: Perspectives and Issues* (perspectives on state revenues); available at http://www.lao.ca.gov/laoapp/analysis.aspx?year=2007&chap=8&toc=1.

[2] LAO, Reforming California's Tax System, 1/22/04, pg. 4; available at http://www.lao.ca.gov/handouts/fo/2004/Reforming_California_Tax_System.pdf.

[3] Chapter 1265 (1968), Section 2; text available in Opinion No. 70-51.

[4] This tax was created by Proposition 63, passed by voters in 2004. This report includes this 1% rate as part of the PIT because it is computed using California taxable income and reported on the California personal income tax form (540).

[5] Information from Federation of Tax Administrators, as of 1/1/07; available at http://www.taxadmin.org/fta/rate/ind_inc.html.

State	Top rate	Top rate applies to income over	# of tax brackets
California	9.3% 10.3%	$86,934 $1,000,000	7
Colorado	4.63%	Flat tax	1
Hawaii	8.25%	$96,000	9
Illinois	3.0%	Flat tax	1
Iowa	8.98%	$60,436	9
Minnesota	7.85%	$123,751	3
New York	6.85%	$40,000	5
Oregon	9.00%	$13,702	3
Vermont	9.5%	$336,551	5

California's PIT is highly progressive. That is, individuals with the highest income pay significantly more and at higher rates than individuals with lower income. This is due to the six different tax brackets (from 1% to 9.3%) and personal exemptions and a standard deduction that bring the PIT liability for many low income individuals to zero. In 2004, 80% of the PIT was generated by the 12% of taxpayers with the highest incomes. About 30% of individuals with the lowest income pay no PIT.[6]

Because the PIT is a very significant revenue generator for California makes the volatility of the PIT even more significant of an issue. The following table compares California's tax mix to some other states.[7]

State	PIT	Corp. Income Tax	Sales/Use Tax	Licenses	Property Tax	Other
California	46.0%	9.3%	35.9%	6.8%	2.0%	< 1%
Colorado	50.0%	5.4%	38.2%	3.9%	0%	2.5%
Illinois	30.7%	8.5%	50.4%	8.8%	< 1%	1.4%
Massachusetts	54.1%	9.6%	30.6%	3.4%	< 1%	2.3%
Michigan	26.3%	8.0%	48.9%	5.8%	9.4%	1.6%
New York	56.5%	7.4%	29.9%	2.4%	0%	3.8%
Ohio	40.4%	4.5%	46.5%	8.6%	< 1%	< 1%
Texas	0%	0%	77.4%	13.8%	0%	8.8%
Virginia	52.8%	5.0%	33.3%	3.7%	< 1%	5.1%
State total	34.6%	6.7%	46.7%	6.4%	1.7%	3.9%

Weakness: California's personal income tax is too volatile because a significant portion of the amount collected is paid by a small number of individuals with unstable income.

Remedy: Reduce the volatility by replacing some portion of the PIT with other taxes and lower the threshold at which individuals become subject to PIT in conjunction with providing other tax relief for low-income taxpayers.

[6] See next section for references.

[7] From the U.S. Census Bureau, State Tax Collections 2006; available at http://www.census.gov/govs/www/statetax06.html. This data includes various license revenue in the tax collection data which is why California's PIT revenue is not greater than 50% of total revenues.

Extent and Causes of the Volatility

Exemptions and tax credits significantly lower PIT liability for many Californians. That leaves more of the tax to be collected from higher income individuals. In 2006, a married couple with two dependents did not owe California income tax until their income (such as wages and interest income) exceeded $44,670. For single individuals, they did not owe PIT until income exceeded $11,260.[8]

The Center for Budget and Policy Priorities reports that California has the highest threshold among all states for when low income individuals become subject to the PIT.[9]

State	Single-parent/2 children	Married parents/2 children
Alabama	$4,600	$4,600
Michigan	$11,100	$14,400
Illinois	$13,600	$15,600
Oregon	$14,600	$17,500
Massachusetts	$24,300	$26,200
New York	$32,500	$36,300
California	$42,400	$44,700
Average of states	$19,400	$22,500
Poverty line	$16,079	$20,615

In 2004, Californians with adjusted gross income (income before most deductions) over $100,000 paid 80% of the PIT collected by the state while roughly 64% of individuals with income under $50,000 paid about 3% of the PIT. The breakdown showing number of taxpayers and the percent of total PIT paid by that income group is shown in the following chart from the Governor's 2007-2008 budget report.[10]

[8] See 2006 exemption amounts and tax rates at http://www.ftb.ca.gov/forms/06_forms/06_540bktoc.asp.

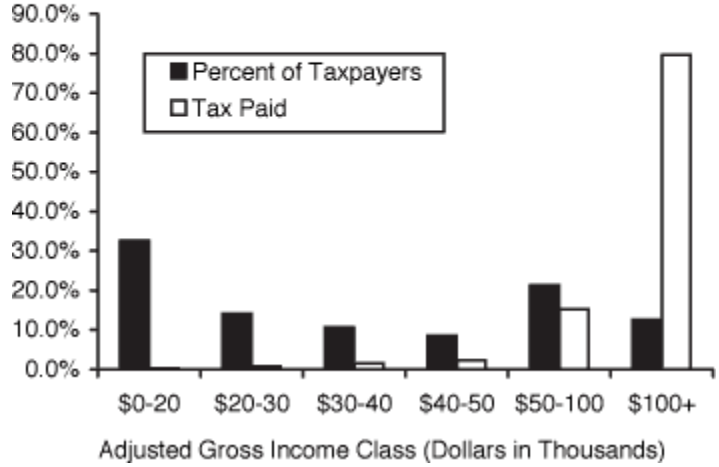
[9] Jason A. Levitis, Center for Budget and Policy Priorities, The Impact of State Income Taxes on Low-Income Families in 2006, 3/27/07, pg 12; available at http://www.cbpp.org/3-27-07sfp.pdf

[10] Governor's Budget 2007-2008, General Fund Revenue; available at http://www.ebudget.ca.gov/BudgetSummary/REV/26639985.html.

Figure REV-03

Percent of Taxpayers and Percent of Tax Paid by Adjusted Gross Income Class

2004 State Tax Data



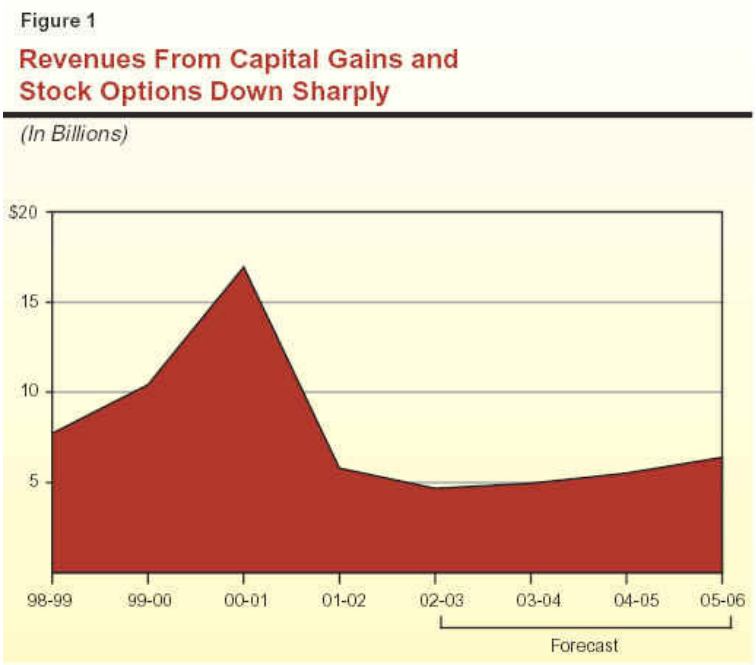
These figures indicate that the PIT primarily applies to top income producers. This dependence on collecting a significant portion of tax revenues from a small number of individuals though is risky so far as ensuring a stable revenue base. When there is a drop in the income of the top 10% of income-generators, as can easily happen in a weak economy, the entire state is impacted due to a drop in its largest revenue source. As noted in the Governor's 2007-2008 budget report: "Changes in the income of a relatively small group of taxpayers can have a significant impact on state revenues."[11] This is what happened in the "dot.com" boom and bust several years ago.

The "dot.com" boom generated larger than usual stock option spreads for many individuals as well as larger than usual capital gains from the sale of stock. The LAO reported that in 1999, income from capital gains and stock options increased about 50%, and increased 30% in 2000.[12] Then with the "dot.com bust," this revenue dropped. The unevenness of capital gain and stock option income is illustrated in the LAO chart below.[13]

[11] Governor's Budget 2007-2008, General Fund Revenue; available at http://www.ebudget.ca.gov/BudgetSummary/REV/26639985.html.

[12] LAO, California's Fiscal Outlook, LAO Projections, 2000-01 Through 2005-06, Chapter 3 Revenue Projections, 11/15/00; available at http://www.lao.ca.gov/2000/fisc_outlook/111500_fiscal_outlook_chapter_3.html.

[13] LAO, California's Fiscal Outlook, LAO Projections, 2002-03 Through 2007-08, 11/14/02; available at http://www.lao.ca.gov/2002/fiscal_outlook/fiscal_outlook_2002.html.



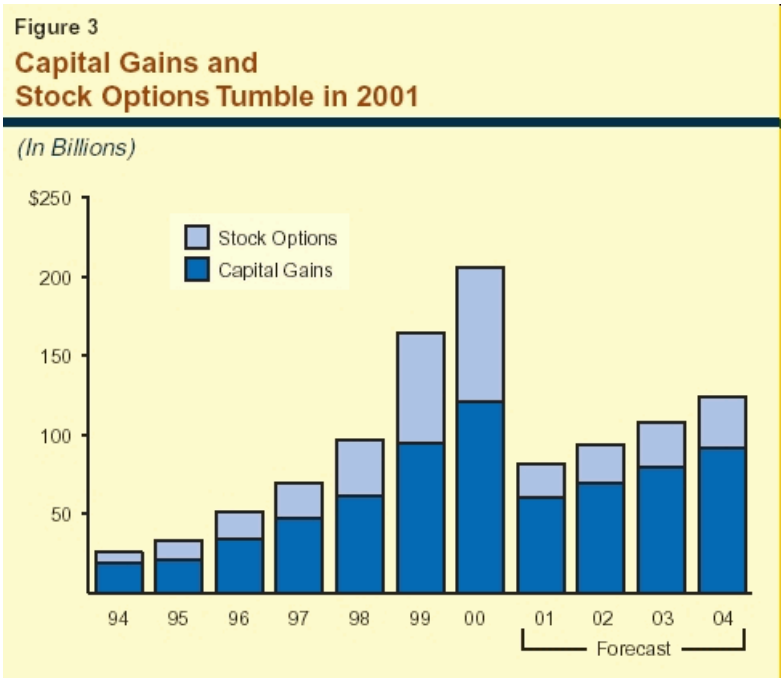
The situation as described by the LAO:

> "The dramatic impact of the stock market decline is depicted in Figure 1, which shows the amount of personal income taxes attributable to stock options and capital gains. It indicates that these tax revenues peaked at $17 billion in 2000-01, but fell abruptly following the stock market decline—to under $6 billion in 2001-02. This unprecedented 66 percent decline is the key factor behind the $10-plus billion annual mismatch between revenues and expenditures that began in 2001-02."[14]

The following chart, also from the LAO, shows the breakdown in capital gain and stock option income.[15]

[14] *Id.*

[15] LAO, California's Fiscal Outlook, LAO Projections 2001-02 Through 2006-07, 11/14/01; available at http://www.lao.ca.gov/2001/fisc_outlook/fiscal_outlook_2001_ch3.html.



The LAO report noted that in 2000, the over $17 billion of taxes paid on capital gains and stock option income represented over 22% of total General Fund revenues. The LAO projected that due to a declining stock market, these sources of PIT would decrease about $10 billion in the subsequent year.[16]

In summary, factors that make the PIT volatile are:

- Reliance on a small number of high-income taxpayers to generate a significant portion of the PIT revenue.
- The effect of unpredictable and uneven stock gains on the PIT base.
- Bracket compression that causes the 9.3% bracket to start at roughly $87,000 (in 2006).
- A large portion of the aggregate AGI base not being subject to PIT.

Why Volatility Should Be Addressed

A revenue base that is stable and predictable helps legislators and the governor make spending decisions and determine whether tax law changes are needed. A volatile tax that at times generates more revenue than expected can lead to spending problems if there are no provisions or efforts to either set the extra revenue aside for a future time when PIT collected is less than expected, or to use the extra revenue for one-time spending (rather than base spending).

California's volatile PIT is also a high rate PIT relative to other states which makes the state unattractive. It can also lead some individuals to move out of the state to a lower tax state thereby decreasing the tax base and adding to the volatility. Solutions that lower the PIT top rate and reduce its volatility will improve the PIT and California's tax base.

Challenges

The remedies for volatility problem are not ones that would be easy to implement. Also, solutions would need to be implemented in conjunction with other changes to keep tax collections steady.

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[16] *Id.*

Recommendations for Reducing Volatility

A combination of changes is needed to reduce the volatility in the PIT. The PIT needs to be collected from more taxpayers. That is, more aggregate income needs to be subject to PIT. The volatility could also be reduced by reducing the slice of the total tax revenue pie attributable to the PIT. Following are techniques for spreading out collection of PIT and reducing the state's reliance on this tax.

- Stretch out the PIT rate structure so that a low rate applies to lower income individuals. For example, apply the 1% rate (or perhaps drop the lowest rate to 0.5%) to lower levels of taxable income. Then apply the 2% rate to a higher income level as well as the 4% rate and so on until the 9.3% rate applies to higher levels of taxable income than is the case now.
- Add new taxes, such as on energy use, that apply to high levels of usage, such as might be the case for individuals with large homes (see Report #11). In addition, the sales tax base should be broadened and the rate lowered (see Report #2a). These changes would replace the revenue lost by reducing PIT collections.

Other techniques for reducing volatility include:

- Reduce the tax rate on capital gain income since that is the most volatile type of income currently subject to tax. Other changes would be needed to replace any lost revenue.
- Modify the PIT formula such that the amount owed is a percentage of the federal income tax liability, lower the amount collected and make up the difference with increased sales taxes (through base broadening) or alternative taxes.

Tax Policy Analysis[17]

The following chart explains how reducing volatility of the PIT would satisfy the principles of good tax policy. The rating in the last column indicates how change to reduce volatility would improve the current system.

Principle	Application and Analysis	Rating
Fairness		
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	The current PIT has a high degree of vertical equity (those with higher incomes pay significantly and proportionally more than those with lower income). Many individuals with income do not pay any PIT though which hurts vertical equity.	+
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	No change	

[17] This analysis uses a document prepared by the American Institute of Certified Public Accountants (AICPA) Tax Division and altered to the above format by Joint Venture: Silicon Valley Network. The AICPA document, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals* (2001) is available at http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf. The Joint Venture workbook is available at http://www.jointventure.org/PDF/taxworkbook.pdf. The principles laid out in these documents are frequently used tax policy analyses ones. For more information see Nellen, Policy Approach to Analyzing Tax Systems; available at http://www.cob.sjsu.edu/facstaff/nellen_a/Policy%20Approach%20to%20Analyzing%20Tax%20Systems.pdf. Note: The author of this report (Annette Nellen) was the lead author for both the AICPA and Joint Venture documents noted here.

Operability		
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	No change	
Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	No change	
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	No change	
Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	No change	
Minimum Tax Gap A tax should be structured to minimize non-compliance."	If more taxpayers become subject to paying PIT, the tax gap might increase.	**-**
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	Reducing the volatility of the PIT would make this tax a more predictable revenue source for the State.	+
Appropriate Purpose and Goals		
Neutrality The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	No change	
Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.	A more stable revenue source should stabilize spending and reduce the likelihood of budget deficits.	**+**