

## **REFORMING CALIFORNIA'S OUTDATED TAX SYSTEM**

by

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California has long been a harbinger of national and global trends. The Golden State's economy substantially outperformed the rest of the nation for many decades. Its residents enjoyed a rising standard of living, an outstanding education system, and unprecedented upward mobility. Despite its leadership in technology, agriculture and entertainment, California's economy now radically underperforms. The unemployment rate, at 12.2%, is the third highest of any state. Residents are leaving the state in droves – 144,000 more than entered last year -- for better, if not greener, pastures. And the state's bond rating is dead last. Much of the state's economic calamity is self-imposed. Ever-higher tax rates on a dwindling base, uncontrolled state spending, excessive regulation and litigation have created a business environment ranked third worst to New York and New Jersey.

Presaging what awaits the nation from the tax hikes brewing in Washington, California's nightmarish tax system is central to the state's woes. The top personal income tax rate (also levied on capital gains), the sales tax rate, the corporate tax rate and the gas tax are all at or near the highest of any state. The top 1% pay almost half the income taxes and a higher percentage of Californians pay no income taxes than in virtually any other state. Per

household, California's state and local governments tax citizens more than any state but New York.

Economic crises have been amplified into severe fiscal crises by the state's extremely progressive tax system, with boom-bust cycles of exploding revenues and spending followed by collapse and emergency retrenchment. Ironically, the state's allegedly progressive tax and spending policies now threaten the state's ability to fund everything from parks to prisons, education to health.

The state's highly volatile anti-growth tax system has also helped create a structural deficit problem. The excess spending during booms can never be entirely cut back during the busts. So instead, the state has also raised taxes and borrowed temporarily.

California has a related serious spending level and efficiency problem, evidenced by its ranking third per household behind Alaska and New York. One example: the state spends approximately \$50,000 per incarcerated inmate, equal to the entire budget for a typical family of four for housing, transportation, food, clothing, entertainment, education expenses, health care, and everything else. If state spending had increased at the rate of population and inflation since 1996, recession-level revenues plus reserves would now be more than sufficient to balance the budget.

In recognition of these facts, Republican governor Arnold Schwarzenegger and Democratic legislative leaders Darrell Steinberg and Karen Bass appointed a bipartisan Commission on the 21<sup>st</sup> Century Economy to provide recommendations for a reformed tax code that would be far less volatile and substantially more competitive and pro-growth. While the two of us believe California needs to control and reform state spending, and reduce as well as reform state taxes, the Commission, which included appointees from both sides of the political aisle, was limited to changes on the tax side of the state budget ledger that would neither raise nor lower the state's revenues on average over the business cycle.

The bipartisan majority Commission report was issued yesterday. The recommended tax reforms which, if enacted, would be phased in beginning in 2012, include: 1) a sweeping overhaul of the personal income tax code, the first major change in more than two decades. A modified flat tax would reduce tax brackets to two from six; eliminate all deductions and credits other than for charity, mortgage interest and property taxes; and reduce the top statutory tax rate to 6.5% from 9.3 percent (the current top rate of 10.55% includes a 1% tax on incomes over \$1 million imposed by Constitutional amendment; a quarter point temporary tax expires after 2011). Taxpayers in every income group would pay lower income taxes, and most taxpayers would receive a 25-30% reduction);

2) the state's corporate income tax code would be abolished; 3) the five percentage points of the sales tax that finance the general fund (as opposed to special funds, such as transportation) would be eliminated. 4) To replace the lost revenue, the Commission recommended a broad-based, low-rate state value-added tax, collected on business net receipts (revenues less purchases from other businesses, including immediate expensing of capital), capped at 4%. Unlike the current legislative stampede in Washington, the Commission recommended that the many economic, legal, administrative, and design issues surrounding a new business net receipts tax be thoroughly aired and satisfactorily resolved before it merits inclusion in tax reform.

These reforms will reduce the volatility of state revenues by 40% (using commonly accepted measures), mostly by reducing reliance on personal and corporate income tax, and moderate the current tax code's extreme progressivity. The package also results in a \$7 billion net TAX CUT per year for Californians (see chart), without losing any revenue for California, as some of the new tax would be borne outside the state, and more of Californians' taxes would be deducted against federal taxes (California gets back only about  $\frac{3}{4}$  of a dollar for every dollar of federal taxes paid, less than all but a few states).

Proposals to scale-down or eliminate existing taxes and replace revenues with a new tax raise legitimate concerns. The same political process that erodes the base and raises rates for income taxes might be repeated for a VAT. Such

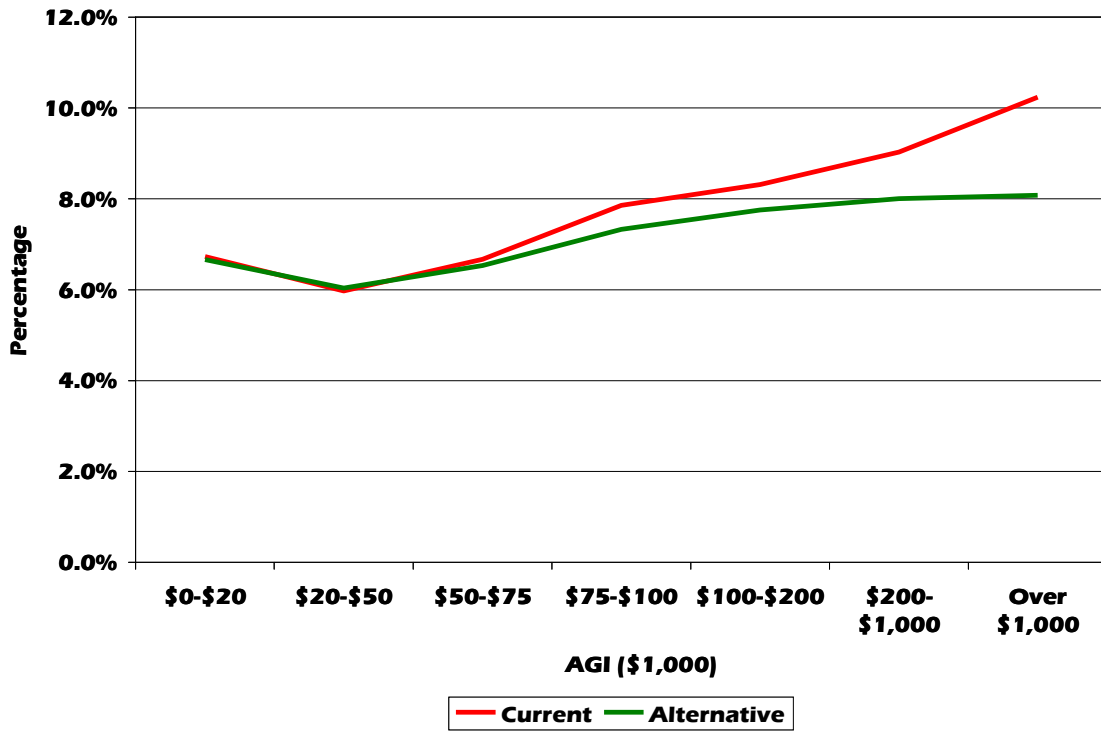
taxes have been used to grow government (for example, in Western Europe), with new taxes added without reducing others. Some protection is provided by California's wise constitutional requirement for a two-thirds vote for the budget and tax increases and the Commission's recommendation of immediate abolition of the entire corporate income tax as the new business tax begins phasing in. A hard spending cap would be still better.

Stay tuned to see if California can once again lead the nation, this time in moving away from ever-higher personal and corporate tax rates and excessive roller-coaster spending. If not, we fear that California and then the nation will lose the dynamism, growth and opportunity for upward mobility that once were a hallmark and crowning achievement.

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**A slightly condensed version of this paper appeared September 30, 2009 in the *Wall Street Journal* under the title, "How California Can Get Its Groove Back".**

### Effective Tax Rates: Current Law vs. Reform



Source: Commission staff