

# The FISCAL REPORT an informational update

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Volume 29

For Publication Date: October 2, 2009

No. 20

## Governor Calls Special Session on State Tax Reform

### Special Session Called

On Tuesday, September 29, 2009, Governor Arnold Schwarzenegger called a special session of the Legislature to review and act on recommendations made by the Commission on the 21<sup>st</sup> Century Economy, which released its report the same day. The proclamation puts it this way: "To consider and act upon legislation to address and improve the state tax system, including but not limited to the following: establish a tax structure that fits with the state's 21<sup>st</sup> century, stabilize state revenues and reduce volatility, promote the long-term economic prosperity of the state and its citizens, improve California's ability to successfully compete with other states and nations for jobs and investments, reflect principles of sound tax policy, and ensure that the tax structure is fair and equitable." Tax reform will be discussed in public hearings of the Senate and Assembly Revenue and Taxation Committees, with the Assembly scheduled to begin its hearings on October 8.

### The Need for Tax Reform

The Commission attributed the need for reform to the following:

- California has shifted from relying on the sales and use tax (SUT) to the personal income tax (PIT)
  - In 1950-51, PIT provided 11% of General Fund Revenue and SUT supplied nearly 60%
  - For fiscal 2009-10, PIT will provide about 54% of General Fund revenue
  - For fiscal year 2007-08, SUT was expected to supply about 31% of General Fund revenue
    - The growth in SUT revenues has remained fairly steady over the past ten years
    - But the SUT base has narrowed as consumer spending shifted away from the consumption of tangible goods and towards services and intangible goods
- High income earners are paying a larger share of the PIT than in the past
  - In 2006, the top 1% of income earners paid 48% of the PIT, compared to 33% in 1993
  - The composition of the PIT has also shifted to include more variable forms of pay than wages
- Many Californians are not paying PIT
  - In the 2007 tax year, nearly 40% of total filers were below the filing threshold and paid no PIT
  - California has among the highest fraction of nonpayers of any state
- Governmental operations are generally designed to reflect changes in population and demographics instead of fluctuating revenues, and some programs experience increased spending demands during periods of declining revenues

### Recommended Reforms

The Commission's recommendations, endorsed by a majority of the Commission's 14 members, if implemented, would, dramatically reform California's tax system. Most of the recommendations would require statutory changes, but a recommendation to strengthen the state's Rainy Day Reserve Fund would require a Constitutional Amendment.

Recommendations include:

- Reducing and restructuring the PIT
- Eliminating the corporate tax and the minimum franchise tax
- Eliminating the state general purpose sales tax, with the exception of the sales tax on gas and diesel fuels, which would continue to be dedicated to transportation.
- Establishing a new tax, the Business Net Receipt Tax (BNRT), not to exceed 4%, applied to the net receipts of a business
  - The new tax would apply to goods and services and to sales into California from businesses located outside the state
  - Unlike the sales tax, the tax would be deductible against federal taxes
  - But the Commission recommends more analysis and research on how the establishment of the BNRT will affect capital investment and job creation in the state, and recommends that the Legislature further examine how to structure the BNRT
- Creating an independent tax dispute forum
- Strengthening the state's Rainy Day Reserve Fund by increasing the target for the reserve from 5% of revenues to 12.5%, and restricting the government's ability to use the reserves
  - Revenues above a ten-year trend line would have to be deposited in the reserve
  - Transfers into the Fund could be suspended only when revenues were insufficient to provide spending at the prior year's level adjusted for changes in population and inflation
  - Reserve funds could be used to maintain spending at the prior year's level adjusted for changes in population and inflation

The Commission recommended implementing the proposed tax changes in 2012, and some would be phased in over a five-year period.

### Concluding Thoughts

It is unclear at this juncture what impact the Commission's overall proposal would have on K-12 and community college finance. We do note, that while the Commission considered property taxes, and briefly mentions the impact of Proposition 13 on the amount of property tax collected—property tax, as a share of personal income, declined from 5.0% in fiscal year 1977-78 to 2.4% in fiscal year 2005-06—the Commission does not propose changes to property taxes.

California desperately needs tax reform. Tax revenues are volatile, and that makes K-14 revenues volatile and unpredictable. The problems with the current tax system have been exacerbated by the volatility inherent in California's worst recession since the current tax system was created in the 1930s.

However, initial reaction to the Commission's specific recommendations, as reported by various media, has been lukewarm at best. *The Capitol Morning Report* quoted Senate President pro Tempore Darrell Steinberg (D-Sacramento) as saying, "The Senate will engage fully to change our outdated tax system. The particulars matter. Before we act, the Legislature must ask and answer the following questions and more: 1) Does reducing volatility result in more funding over time for education and essential services? 2) What has been the experience of a business net receipts tax in the United States or other countries? 3) Are there more effective ways to attract and retain a high wage job base to California?"

We expect the Commission's proposals to provide a starting point for discussion, but not be the final blueprint for reform. Any tax reform will be politically challenging. We don't think you'll need to change your payroll systems anytime soon; however, we'll keep you posted.

—*Deborah Harmon*

posted 10/01/2009