October 14, 2009– 12:00 pm
Policy Seminar with Michael Boskin and John Cogan
George Shultz Conference Room

PARTICIPANTS

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ISSUES DISCUSSED

Michael Boskin and John Cogan discussed the results and recommendations from the recent publication of the report of the Commission on the 21st Century Economy. This bipartisan commission consisting of 14 members was set up by California Governor Schwarzenegger and the Democratic Leaders of the State Assembly, Karen Bass, and State Senate, Darrell Steinberg, to re-examine and modernize California's out-of-date revenue laws.

Boskin started the presentation by outlining the current problems facing California which the commission set out to address. He pointed out that California, once leading other states on most economic indicators, has recently faced stiff competition from other states, resulting in out-migration across all income levels.

In particular, Boskin identified two primary problems with California's current tax code:

1. **Competitiveness**: California has the highest state sales tax, and amongst the highest top marginal income tax rates in the US (currently at 10.55%). The per household taxation of residents in California is second only to New York. Another problem with the current tax code is that business-to-business purchases are included in the sales tax base.

2. **Volatility**: The most important contributors to California's tax-revenues are the personal income tax, sales tax and corporate taxes. The reliance on a very progressive personal income tax schedule (where the top 1% of tax-payers contribute about 50% of the income tax revenue) in which capital gains are treated as ordinary income makes state revenues very dependent on the state of the economy. During periods of prosperity, this generates additional revenue that is quickly spent, requiring painful budget cuts during the subsequent downturn. Revenue volatility has increased substantially in the last 20 years, and California appears to have the most volatile revenues of any state. Boskin and Cogan suggested that this revenue volatility has recently been recognized as problematic across all parts of the political spectrum.

Cogan then proceeded to outline some specifics of the proposals made in the final report, focusing on reducing marginal tax rates to improve competitiveness while broadening the tax base to reduce revenue volatility. To separate the question of tax structure from questions about the size of government, the plan's proposals were designed to be revenue neutral on average over the business cycle.

The plan's key elements are:

- Reducing personal income tax rates
- Eliminating corporate income taxes and general fund sales taxes
- Introducing a new business net receipts tax (similar to a VAT).

These proposals would reduce average marginal tax rates by about 33%, while increasing the tax base by approximately 50%. Revenue volatility would be reduced by about 40%. Cogan estimated that this decline in volatility would have reduced the need for budget cuts in the current downturn by approximately $9bn.

In particular, the plan would reduce the total number of income tax brackets from 6 to 3, with a top statutory bracket of 6.5%. Combined with the constitutionally mandated additional 1% tax on millionaires to fund mental health programs, the top combined rate will be at 7.5%. Most credits and deductions would be eliminated. The business net receipts tax (BNRT) would take business gross receipts from all sources less purchases from other businesses as the tax base. This would apply to all businesses which have more than $500,000 sales in California. Cogan estimated that the long-term revenue-neutral BNRT tax rate would be at about 4%.

One of the key benefits of the proposal is that, by increasing the deductibility of more state taxes against federal taxes, the proposal would be equivalent to a 7-8% tax cut for Californians without losing any revenue for the state (on average over the business cycle).

Boskin then mentioned a number of additional proposals that were not part of the Commission's formal recommendation, but constituted some of the ideas that were deemed worthy of serious consideration (in addition to the main proposal) by a sizable bipartisan group:

- Introducing a larger rainy-day fund to cope with downturns.
- Potentially introducing a minimum income tax (currently about 40% of Californians do not pay any income tax).
- Combining tax authorities.
- Introducing an independent judicial body for the adjudication of tax disputes.
- Tapping off-shore oil reserves.

Following the presentation of the commission's report, the group discussed the next steps to implement the commission's proposals. It was debated whether a full discussion on the floor of the legislature, or an up or down vote were more likely to yield a successful adoption of the commission's recommendations.