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Fiscal Fact

Governor Brown's Tax Proposal and the Folly of California's Income Tax

By

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Introduction

Governor Jerry Brown signed a new California budget on June 27 that depends on voters to approve \$15.7 billion in new taxes in order to meet expected expenditures for fiscal year 2012-2013. The tax increases, which will be sent to California voters in November for their consideration, will appear on the ballot as Proposition 30.¹ The package of tax increases raises the California sales tax rate by 0.25 percent to 7.5 percent for 4 years and raises income taxes on those making above \$250,000 for 7 years. The income tax increase is retroactive and would apply to all income earned after January 1, 2012.²

The new revenues from the tax increases are estimated to total \$8.5 billion, with \$2.9 billion dedicated to new funding for schools, and the remaining \$5.6 billion devoted to the state's general fund. Roughly \$8.1 billion of budget cuts, along with \$2.5 billion in other measures, such as restructuring CalWORKS and Medi-Cal, join with the proposed new revenues to close California's remaining budget deficit.

While Governor Brown contends that the income tax increase is necessary to prevent cuts to popular government services, the historical record shows that California's budget has grown steadily in recent years. Additionally, the plan's heavier reliance on high income earners will only further exacerbate California's troubles with revenue volatility, impacting the state's ability to fund future government programs.

¹ *Gov. Jerry Brown's Tax Initiative Tops Full Ballot*, CBS NEWS, July 10, 2012,

http://www.cbsnews.com/8301-505245_162-57469477/gov-jerry-browns-tax-initiative-tops-full-ballot/.

² California Department of Finance, *Enacted Budget Summary, Governor's Budget 2012-2013* (June 28, 2012),

<http://www.ebudget.ca.gov/Enacted/BudgetSummary/BSS/BSS.html>.

Single Filers

Old Rates		New Rates		Old Rates		New Rates	
1.0%	> \$0	1.0%	> \$0	1.0%	> \$0	1.0%	> \$34,692
2.0%	> \$7,316	2.0%	> \$7,316	2.0%	> \$14,632	2.0%	> \$14,632
4.0%	> \$17,346	4.0%	> \$17,346	4.0%	> \$34,692	4.0%	> \$34,692
6.0%	> \$27,377	6.0%	> \$27,377	6.0%	> \$54,754	6.0%	> \$54,754
8.0%	> \$38,004	8.0%	> \$38,004	8.0%	> \$76,008	8.0%	> \$76,008
9.3%	> \$48,029	9.3%	> \$48,029	9.3%	> \$96,058	9.3%	> \$96,058
10.3%	> \$1,000,000	10.3%	> \$250,000	10.3%	> \$1,000,000	10.3%	> \$500,000
		11.3%	> \$300,000			11.3%	> \$600,000
		12.3%	> \$500,000			13.3%	> \$1,000,000
		13.3%	> \$1,000,000				

Proposition 30, the name under which the proposal will appear on the November ballot, is a merger of two previous, competing initiatives. Proposition 30 combines both Governor Brown's initial temporary tax increase proposal and the California Millionaire's Tax Initiative, which was written by the California Federation of Teachers. The new tax proposal, agreed to by both parties in March, raises the top income tax rate 1 percentage point higher than the tax increase initially proposed by Governor Brown but raises the sales tax by only 0.25 percent instead 0.5 percent, which was Governor Brown's initial proposal. The merger was widely seen as an attempt by both sides to limit the number of ballot initiatives focusing on a tax increase in November.³

The proposal will still face competition from Proposition 38, a measure supported by attorney Molly Munger, which would raise income taxes on virtually all Californians in order to increase education funding, with the top rate rising to 12.5%.⁴ Polling in late May placed support for Proposition 30 at 52 percent with 35 percent opposing it,⁵ while support for Proposition 38 is more divided, with 45% supporting and 45% opposing.⁶

If approved, the income tax increase is likely to exacerbate a number of problems within California's tax system. For the past 20 years, California has become increasingly dependent upon its income tax to raise revenue (Figure 2). Because of the volatility in California's income tax collection, the increasing dependence on income tax revenue has led to an explosion in the number of budget shortfalls.

³*Jerry Brown Hails Tax Compromise*, LOS ANGELES TIMES, Mar. 14, 2012, <http://latimesblogs.latimes.com/california-politics/2012/03/jerry-brown-tax-compromise-millionaires.html>.

⁴ California Secretary of State, *Tax Initiative Enters Circulations* (Feb. 1, 2012) <http://www.sos.ca.gov/admin/press-releases/2012/db12-037.pdf>.

⁵ David Siders, *Gov. Jerry Brown's tax measure holds uneasy lead in latest polling*, SACRAMENTO BEE, June 9, 2012, <http://www.sacbee.com/2012/06/09/4549500/gov-jerry-browns-tax-measure-holds.html>.

⁶ Anzalone List Research, *Summary of Polling on California Ballot Initiative* (May 6, 2012), <http://www.scribd.com/doc/92716444/5-7-12-Munger-PTA-Poll-Memo>.

In years where both the economy and the stock market grow, California can obtain a significant amount of tax revenue from high income earners. But California's tax collections are highly susceptible to sharp drops when there is a downturn in the stock market or the economy enters a period of anemic

growth.⁷ California, which in 2011 raised nearly 57 percent of its state tax revenue from its highly progressive state income tax,⁸ has seen its state budget fortunes become increasingly dependent upon earners with incomes greater than \$200,000.⁹

Figure 2. Taxes as Percentage of Overall Tax Revenue

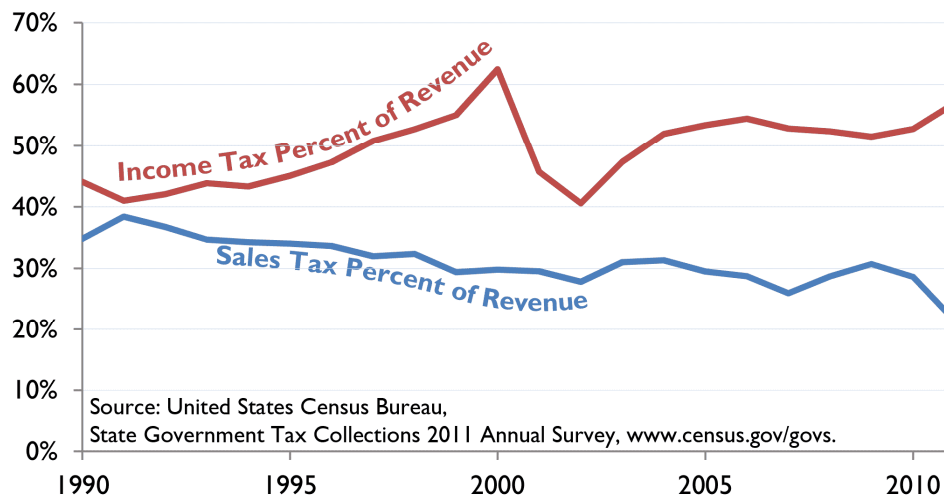


Figure 3: Change in GDP and Income Tax Revenue



Source: United States Census Bureau, *State Government Tax Collections 2011 Annual Survey*, www.census.gov/govs.
United States Department of Commerce, Bureau of Economic Analysis, *Gross Domestic Product (GDP) by State*, <http://www.bea.gov/regional/downloadzip.cfm>.

⁷ Brad Williams & Jon David Vasché, Legislative Analyst's Office, *Revenue Volatility in California* (Jan. 2005), http://www.lao.ca.gov/2005/rev_vol/rev_volatility_012005.htm.

⁸ California Franchise Tax Board, *Tax Year 2009*, https://www.ftb.ca.gov/aboutFTB/Tax_Statistics/Reports/2010_B-4A.pdf.

⁹ Commission on the 21st Century Economy, *Report Summer 2009*, http://www.cotce.ca.gov/documents/reports/documents/Commission_on_the_21st_Century_Economy-Final_Report.pdf.

California's state income tax revenue is significantly more volatile than economic fluctuations (Figure 3). This is largely due to a high dependence upon capital gains revenue and high income earners. California's state income tax applies the same rate to capital gains and dividends and labor income (unlike the federal tax code) and is highly dependent upon the revenue from these sources, which is volatile and heavily impacted by market fluctuations.¹⁰ California also gets roughly 54.5 percent of its personal income tax revenue from earners with incomes greater than \$200,000 (Figure 6) and gets over 33 percent of its personal income taxes from earners making greater than \$500,000, a group which comprises less than 0.67 percent of all tax returns (Figures 4 & 6). California has staked its fiscal solvency on the backs of a tiny percentile of the population with the most volatile income.

Figure 4: Taxes Paid by Income Level

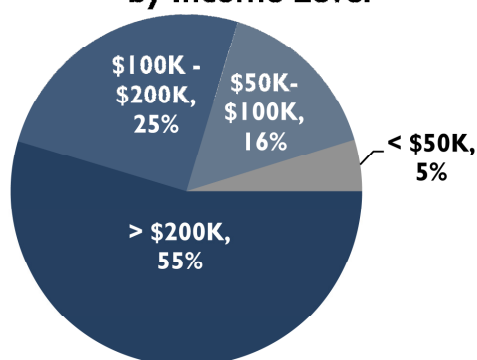
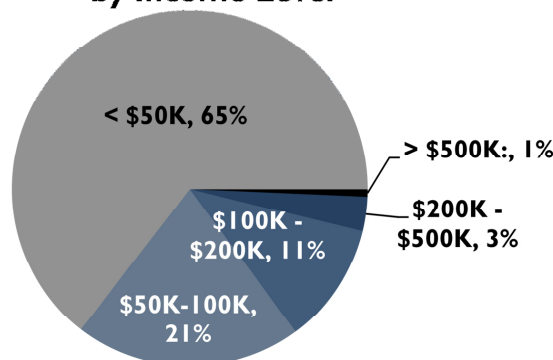


Figure 5: Tax Returns by Income Level



Source: California Franchise Tax Board, Tax Year 2009,
https://www.ftb.ca.gov/aboutFTB/Tax_Statistics/Reports/2010_B-4A.pdf.

Figure 6: Tax Liabilities by Income Level

	Value (thousands)	Percentage of Total	Number of Returns	Percentage of All Returns
Earners below \$50,000	\$1,829,436	4.70%	9,441,753	64.50%
Earners between \$50,000-\$100,000	\$6,049,084	15.56%	3,021,722	20.64%
Earners between \$100,000-\$200,000	\$9,788,724	25.18%	1,618,905	11.05%
Income Earners above \$200,000	\$21,202,402	54.54%	555,824	3.79%
Income Earners above \$500,000	\$12,839,178	33.03%	98,574	0.67%

Source: California Franchise Tax Board, Tax Year 2009,
https://www.ftb.ca.gov/aboutFTB/Tax_Statistics/Reports/2010_B-4A.pdf.

The Brown proposal seeks to balance the budget shortfall almost squarely on the backs of those making over \$200,000, who comprise less than 4 percent of tax returns (Figure 5). The new income tax brackets would raise an estimated \$7.8 billion in 2011-12 and 2012-13, and the quarter cent sales tax rate increase would

¹⁰ William McBride, *The Great Recession and Volatility in Sources of Personal Income*, TAX FOUNDATION FISCAL FACT NO. 316 (June 13, 2012),
<http://taxfoundation.org/article/great-recession-and-volatility-sources-personal-income>.

raise approximately \$700 million in 2012-13.¹¹ The proposal, which relies heavily on the income tax levied on high income earners, is simply a repeat of the same ill-advised tax policies which California has been pursuing for over a decade.

Lessons from Past Experience

Although Governor Brown's budget claims to strike a balance between tax hikes and spending reductions on paper, California has a poor record of accomplishing these goals in practice. California's spending has increased from \$98.9 billion in 2002-2003¹² to a projected \$142.4 billion in 2012- 2013.¹³ Despite the façade of belt tightening in California, the recent budget signed by Governor Brown increased spending by 7 percent over the last year, reinforcing the state's long established failure to achieve this balance.¹⁴ California already maintains the second highest top income tax rate in the country,¹⁵ and ranks 48th out of 50 states in the *2012 State Business Tax Climate Index*.¹⁶ If California enacts this income tax increase, it will surpass Hawaii to have the highest top income tax bracket in the nation at 13.3%.¹⁷ Given the state government's long history of budget shortfalls, Californians should be wary of balancing their budget almost solely on a tax with such volatile revenue.

Conclusion

California's fiscal problems warrant serious consideration, but also present an opportunity for constructive reform. Governor Brown should use his well-known creativity to address the California tax code, instead of continuing the state's destructive and volatile reliance on income tax increases. Instead of making the California tax code more dependent upon volatile high income earners, Governor Brown could propose to lower marginal rates and create a wider base of taxpayers. Governor Brown could also seek to end California's reliance almost solely on its income tax, and instead focus on creating a more balanced tax code. Californians would be better served by approaches that make revenue more predictable and stable than by another political budget maneuver.

¹¹ California Budget Project, *Governor Signs 2012-2013 Spending Plan* (July 9, 2012) http://www.cbpp.org/documents/120629_Final_Budget_Agreement.pdf.

¹² California Department of Finance, *California State Budget Highlights, 2002- 2003* (October 2002) http://www.dof.ca.gov/budget/historical/2002-03/documents/State_Budget_Highlights02-03.pdf.

¹³ *California State Budget 2012-2013, Summary Charts* (2012) <http://www.ebudget.ca.gov/pdf/Enacted/BudgetSummary/SummaryCharts.pdf>.

¹⁴ Michael B. Marois & James Nash, *Brown Seeks 7% California Spending Boost*, BLOOMBERG, Jan. 5, 2012, <http://www.bloomberg.com/news/2012-01-05/brown-calls-for-7-california-spending-increase-paid-for-by-higher-taxes.html>.

¹⁵ Based on most recent state tax law. See Tax Foundation, *California*, <http://taxfoundation.org/state-tax-climate/california>.

¹⁶ Based on most recent state tax law. See Mark Robyn, *2012 State Business Tax Climate Index*, TAX FOUNDATION BACKGROUND PAPER NO. 62, <http://taxfoundation.org/article/2012-state-business-tax-climate-index>.

¹⁷ California Chamber of Commerce, *Tax Hike Initiatives Aim for November Ballot Spot* (Feb. 22, 2012), <http://www.calchamber.com/headlines/pages/02222012taxhikeinitiativesaimfornovemberballotspots.aspx>.

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