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Commission considers flat tax for California

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SACRAMENTO — With great fanfare early this year, Republican Gov. Arnold Schwarzenegger and Democratic legislative leaders appointed a blue-ribbon commission to recommend fundamental changes in California's tax structure.

Among the chief charges given to the Commission on the 21st Century Economy was to come up with recommendations that would reduce the extreme volatility of state revenues.

In San Francisco Thursday, the commission will consider a plan that would indeed reduce volatility — by increasing the share of state income taxes paid by 93 percent of Californians.

That would be accomplished by jettisoning California's highly progressive income tax rates and replacing it with a one-size-fits-all tax rate that would apply to both the rich and poor. That would have the effect of shifting a large portion of the personal income tax load from the wealthy to low- and middle-income families.

State income tax rates now range from 1.25 percent on couples with taxable incomes up to $14,366 a year to a top marginal rate of 9.55 percent on couples with taxable incomes of more than $94,110. An additional 1 percent surcharge kicks in on taxable income in excess of $1 million.

That system would be replaced with either a flat tax that would levy a 6 percent tax on all income-earners or a modified flat tax that would have just two brackets of 3.75 percent and 7 percent.

The commission's staff analysis concludes that the 6 percent flat tax would increase the share of state income taxes paid by 93 percent of tax filers (those with taxable incomes of less than $100,000), slightly decrease the share paid by the 5 percent of tax filers with incomes between $100,000 and $200,000 and dramatically decrease the share paid by the 2 percent of filers with incomes of more than $200,000.

The share paid by that top category would drop from nearly 40 percent to less than 30 percent. The share paid by those with incomes between $20,000 and $50,000 would nearly triple, from about 5 percent to about 15 percent.

To longtime advocates of a flat tax such as Hoover Institution economist Alvin Rabushka, the alternatives before the commission are glorious news.

Rabushka, who has been advocating flat taxes for 28 years and is co-author of an influential book on the subject, believes a flat tax is a prescription for prosperity because it would reduce the tax load on the very wealthy, freeing them to use more of their money instead for wealth-creating investment.

"It's good for economic efficiency," he said. "It's good for simplicity, understanding and clarity. Simpler, lower tax rates do have an influence on people's willingness to make investments."

To advocates for tax equity, however, the idea of a California flat tax is a nightmare.

"What that does is give a tax reduction to the people who have experienced the strongest income gains over the last decade and a tax increase to those who have seen no gains or seen their incomes decline," said Jean Ross, executive director of the California Budget Project, a nonprofit group that advocates for state policies that benefit low- and moderate-income families.

The Budget Project last month analyzed the most recent income tax data released by the Franchise Tax Board (for 2007) and found the income gap between middle-income Californians and the wealthiest continues to widen. Since 1995, it shows that incomes of the middle-fifth of state taxpayers have grown by 9.1 percent. The top-fifth of taxpayers have seen their incomes rise by 51 percent.

A flat tax, Ross argues, would only compound that inequity.

Rabushka acknowledged it is a challenge for flat-tax advocates to respond to the charge of inequity. “I can’t defend it on the unfair redistribution argument in a sound byte,” he said.

The long and complex argument, he said, is that a flat tax, by providing relief to the wealthy, will ultimately result in stronger economic growth, which will produce revenue for government services.

“The only way to sustain spending is to get a little bit of extra revenue, and the way to get that is to expand the economy,” he said.

Ross has been following the work of the tax commission since its inception and says she is “deeply concerned that they haven’t taken issues of equity seriously.”

She said the commission is at risk of squandering an opportunity to make serious, realistic recommendations for tax reform in California by instead putting forth ideas that are neither practical nor helpful to the state. The commission must issue its final report by July 31.

“I think it’s time for the appointing authorities to give some direction to the commission,” she said.

Commissioners were appointed by Schwarzenegger, Assembly Speaker Karen Bass and Senate President Pro Tem Darrell Steinberg.

“I would hope they would view the commission’s direction as problematic,” Ross said. “They should make it clear that they’re not interested in increasing taxes on California’s working families and lowering taxes on the wealthy.”

Joel Fox, president of the Small Business Action Committee and a conservative advocate for tax reform, has also been following the commission’s actions and worries it is headed down a path that will consign its recommendations to the library shelf.

Fox notes there is a deep ideological divide among commissioners. “They’re pulling on different ends of the rope, and it’s more likely that they’ll tear the rope apart than tie a knot,” he said.

Fox said he believes a flat tax “would be an incentive for stimulating the economy,” but acknowledges it would be a hard sell to voters since it would result in most of them paying higher income taxes. “It’s going to be complex and difficult to convince people to make the move.”

Seven states now have some form of a flat income tax, but a switch in California would be a dramatic change because the state has historically had one of the most progressive tax structures in the nation. Under current law, for example, a couple with one child has no taxable income if they earn less than $39,990 a year.

Rabushka notes California currently has a deserved reputation of being a high-tax state for the wealthy, with a top marginal income tax rate of 10.55 percent for those with annual taxable incomes of more than a million dollars.

In flat-tax states, the tax burden is inverted. A 2007 study by the Institute on Taxation and Economic Policy on state taxes in Illinois, which has a flat, 3 percent tax rate, found that while the state’s total tax burden was below the national average, the state taxes paid by the poorest 20 percent of Illinois residents ranked them fourth in the nation.

“Illinois is both a very low tax state for the wealthiest and a very high tax state for the poorest,” it concluded.

The commission’s analysis shows that a flat tax would have the effect of reducing the year-to-year volatility of state government revenues. That’s mainly because the incomes of the very wealthy are largely derived from capital gains, which are hypersensitive to ups and downs in the general economy. Under the current system, for example, personal income taxes soared by 28 percent in 2000, then plunged 26 percent in 2001.

Shifting a greater share of personal income taxes onto the middle class would promote stability because their incomes are largely dependent on wages, which do not fluctuate dramatically from year to year.

Ross said while a flat tax might reduce volatility, it would also depress growth in state revenues, which would lock in today’s budget problems indefinitely.

“Our revenues wouldn’t keep up with demands,” she said. “It would be a recipe for future budget crises.”