

CALIFORNIA

• BUDGET PROJECT •

WHAT'S IN THE TAX "MEGA-DEAL"

In the final moments of this year's session, the legislature sent to the Governor a six bill tax package that will reduce state revenues by \$931 million at full implementation (SB 5, SB 455, SB 1233, AB 366, AB 1042, and AB 1217). The tax package was approved as one part of a "mega-deal" that includes \$450 million in trial court funds for counties and a promise by the Governor to bargain in good faith over a pay increase for state employees. The tax package:

- Increases the dependent credit by \$50 in 1998 and an additional \$100 in 1999.
- Conforms to a recent federal tax change that allows taxpayers to exclude up to \$250,000 (single) or \$500,000 (married) in capital gains from the sale of a principal residence.
- Indexes the phase out levels for the Alternative Minimum Tax (AMT). This change will prevent a number of middle income taxpayers from owing an AMT liability.
- Conforms to recent federal tax changes creating a new category of "back-loaded" IRAs, allowing the use of IRAs for educational expenses, and increasing the income limit for IRA contributions.
- Adds an additional Enterprise Zone with criteria designed to favor Tulare County.
- Expands eligibility for Subchapter S corporate status in conformity with federal law.
- Extends the sales tax exemption for bunker fuel through December 31, 2002.
- Conforms to a number of changes made in federal tax laws prior to this year.
- Expands the benefits available under the state's Research and Development tax credit in conformity with federal changes.

How Much Does The Package Cost?

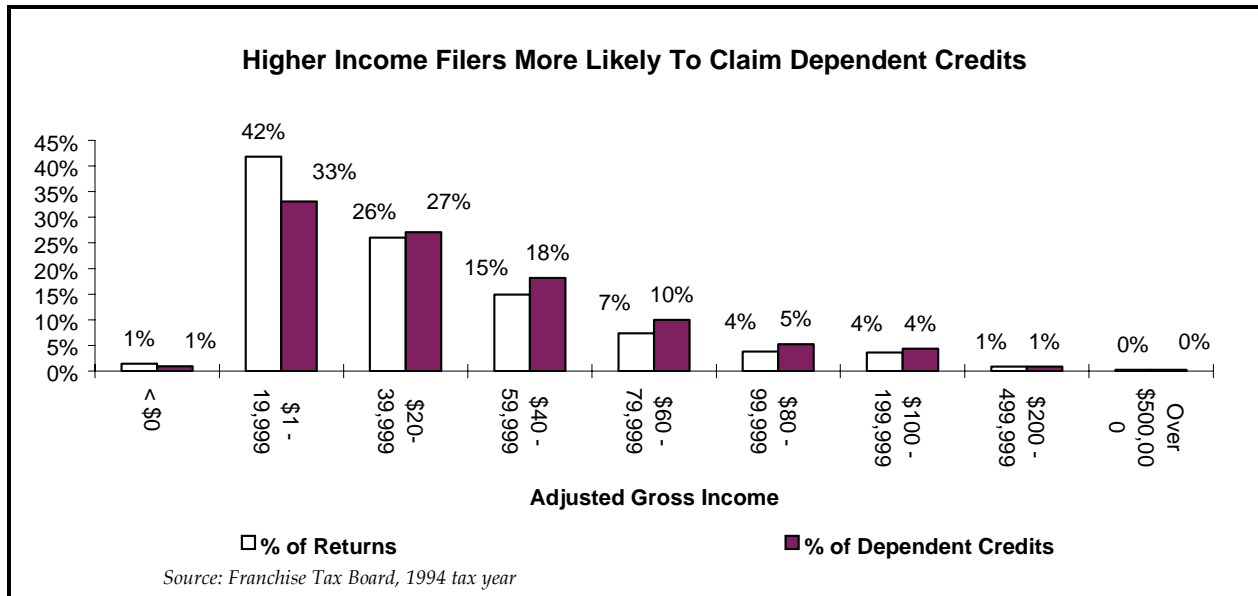
The tax package will reduce state revenues by \$166 million in 1997-98, \$683 million in 1998-99, and \$931 million in 1999-00. The estimated loss in the current year exceeds the \$112 million reserve provided in this year's budget. However, proponents of the plan argue that revenue collections are likely to exceed forecasts. At full implementation, over two-thirds of the cost of the package is attributable to the increase in the dependent credit. The cost of this provision will not increase significantly in future years, since it depends on the number of qualifying dependents. However, the revenue loss attributable to the IRA provisions grows significantly over time. While the 1997-98 loss due to the IRA provisions is only \$4 million, by 2002-03 the loss grows to an estimated \$185

Revenue Impact of the Tax Mega-Deal (Dollar loss in Millions)			
	1997-98	1998-99	1999-00
Dependent Credit Increase (SB 1233)	\$95	\$400	\$635
Capital Gains for Home Sales (SB 5/SB 1233)	\$25	\$110	\$70
Subchapter S Corporations (SB 5/SSB 1233)	\$18	\$21	\$22
Alternative Minimum Tax (SB 1233)	\$8	\$81	\$85
IRA Expansion (SB 1233)	\$4	\$14	\$31
R&D Tax Credit (AB 1042)	\$10	\$46	\$48
Federal Conformity (SB 455)	\$0	\$0	\$29
Bunker Fuel Sales Tax Exemption (AB 366)	\$5	\$10	\$10
Additional Enterprise Zone (AB 1217)	\$1	\$1	\$1
GRAND TOTAL	\$166	\$683	\$931

million.

Is The Mega-Deal A Middle Class Tax Cut?

The largest component of the tax deal is the increase in the dependent credit. This credit is claimed by families with children or other qualifying dependents. Most of the benefits of this change do accrue to moderate income taxpayers. However, as shown below, households claiming dependent credits are disproportionately represented among higher income households. Moreover, more than a quarter of the state's children live in families with incomes too low to receive any benefit from the increased dependent exemption. An additional 10 percent live in families without sufficient income to utilize the full value of the increased credit.



While a distributional analysis of the entire tax package is not available, some information can be gleaned from analyses of the federal bill. For example, Citizens for Tax Justice estimates that California families earning between \$100,000 and \$200,000 will save an average of \$823 per year from the federal IRA changes, while families earning between \$20,000 and \$30,000 will save an average of \$4. Families earning less than \$20,000 will, on average, see no change in their tax bill. Earlier this year, the legislature suspended the Renters' tax credit for an additional year. Many of the families that receive no benefit from the current package will receive a tax increase as a result of the previous suspension of the Renters' credit.

What About The Impact On Education?

Under most, but not all, circumstances, Proposition 98's constitutional spending guarantee for K - 14 education depends directly on the amount of revenues received by the state. The impact on public education will vary each year depending upon which of Proposition 98's three formulas is used to calculate the school funding guarantee. The applicable formula depends on factors defined in the state constitution, including change in enrollment, per capita personal income growth, inflation, and General Fund revenue growth. If the tax cut pushes the guarantee onto Test 3 -- the

test that applies in slow revenue growth years -- school spending could be reduced by as much as \$100 per pupil when the tax cuts are fully implemented.¹

¹ This estimate assumes that 60 percent of the revenue loss attributable to the tax reduction comes out of the school funding guarantee.