

The logo features the word "CALIFORNIA" in a large, serif font. Below it, the words "BUDGET PROJECT" are written in a smaller, sans-serif font, enclosed within a black rectangular box. A light gray silhouette of the state of California is positioned behind the text.

# CALIFORNIA - BUDGET PROJECT -

May 29, 2003

## **What Would Be the Impact of Reinstating the 10 and 11 Percent Personal Income Tax Rates?**

One option for helping to bridge the state's budget gap would be to reinstate the 10 percent and 11 percent tax rates for high-income Californians. This approach was used in 1991 when the state faced a budget crisis of similar magnitude. The higher rates would add a 10 percent tax rate for single taxpayers with taxable incomes in excess of \$136,115 and married taxpayers with taxable incomes in excess of \$272,230.<sup>1</sup> The 11 percent rate would apply to single taxpayers with taxable incomes of more than \$272,230 and married taxpayers with taxable incomes in excess of \$544,460. The state's alternative minimum tax rate, a rate that applies to taxpayers that claim certain preference items, would also be increased proportionately to 8.5 percent. The state's current top income tax bracket of 9.3 percent applies to taxpayers with taxable incomes in excess of \$38,291 (single) and \$76,582 (married). Reinstatement of the top rates would raise \$2.7 billion in 2003-04, \$2.1 billion in 2004-05, and \$2.4 billion in 2005-06.

### **How Many Californians Would Be Affected?**

Only 2.4 percent of California taxpayers would be affected by the proposed increase. Taxpayers with incomes in the top one percent of California households – with average incomes of \$1,518,700 – would pay more than 98 percent of the increase. The average increase for this group, after taking into account the deductibility of state income taxes for federal tax purposes, would be \$9,695. The average increase for taxpayers in the next 4 percent, with average incomes of \$254,500, would be just \$53 after adjusting for the deductibility of state income taxes.

### **Top Brackets Have Been Used to Bridge Prior Deficits**

The state's top tax rate has exceeded the current maximum for nearly half (33 years) of the 67 years since the state instituted the personal income tax. Former Governor Ronald Reagan signed into law two increases in the top brackets, one in 1967 and again in 1971. Governor Pete Wilson signed a measure adding 10 and 11 percent tax brackets in 1991.

### **Taxpayers Affected By Top Brackets Received Big Savings from the Federal Tax Package**

The recent federal tax cuts will provide substantial savings to high-income earners that far exceed the increased state taxes they would pay under the proposed top brackets. The top one percent of taxpayers nationally will receive a tax cut averaging \$63,460, once the 2001 federal reduction is fully phased in.<sup>2</sup> Nationally, the wealthiest one percent will receive an additional average tax cut of \$20,786 in 2003 from the newly enacted federal tax bill. In contrast,

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<sup>1</sup> Taxable income excludes income that is not taxed in California, such as Social Security benefits, and is the amount of income remaining after taxpayers subtract the deductions to which they are entitled.

<sup>2</sup> The top one percent received an average reduction of \$5,950 from the 2001 tax cut in 2002 and will receive increasing reductions through 2010. Urban-Brookings Tax Policy Center estimates downloaded from <http://www.taxpolicycenter.org/> on May 28, 2003.

reinstating the top tax brackets would increase the average tax bill of the top one percent by \$9,695, after taking into account the deductibility of state income taxes for federal tax purposes.

### Spending Cuts More Harmful to the Economy

Prominent economists argue that spending reductions may be even more harmful to the economy than taxing high-income taxpayers. A recent report co-authored by Nobel Prize winning economist Joseph Stiglitz argues that, “economic analysis suggests that tax increases would *not* in general be more harmful to the economy than spending reductions. Indeed, in the short run (which is the period of concern during a downturn), the adverse impact of a tax increase on the economy may, if anything, be *smaller* than the adverse impact of a spending reduction, because some of the tax increase would result in reduced saving rather than reduced consumption. For example, if taxes increase by \$1, consumption may fall by 90 cents and saving may fall by 10 cents. Since a tax increase does not reduce consumption on a dollar-for-dollar basis, its negative impact on the economy is attenuated in the short run. Some types of spending reductions, however, would reduce demand in the economy on a dollar-for-dollar basis and therefore would be *more* harmful to the economy than a tax increase.”<sup>3</sup>

Impact of Restoring the Top Income Tax Brackets							
All California Taxpayers, 2002							
2002 Income Group	Low 20%	2nd 20%	Mid 20%	4th 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$19,000	\$19,000 – \$31,000	\$31,000 – \$50,000	\$50,000 – \$84,000	\$84,000 – \$179,000	\$179,000 – \$648,000	\$648,000 – Or More
Average Income in Group	\$11,500	\$24,700	\$40,200	\$64,900	\$116,600	\$254,500	\$1,518,700
State Tax Change as a % of Income	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.0%
Average State Tax Hike	\$ —	\$ —	\$ —	\$ —	\$ 1	\$ 75	\$ 15,473
% of Total State Tax Increase	—	—	—	—	+0.06%	+1.83%	+98.11%
% of Taxpayers with State Tax Hike	—	—	—	—	1%	18%	100%
Federal Tax Savings as a % of Income	—	—	—	—	-0.0%	-0.0%	-0.4%
Net Federal/State Tax Change as % of Income	—	—	—	—	+0.0%	+0.0%	+0.6%
Percent of State Tax Hike Paid by Feds	—	—	—	—	-30.3%	-29.0%	-37.3%
Average Amount of State Tax Hike Paid by the Federal Government	—	—	—	—	-0	-\$22	-\$5,778
Average State Tax Hike Net of Fed Savings					\$0	\$53	\$9,695

**Note:** The proposal modeled here would add two new top tax brackets to the California personal income tax, including a 10 percent rate on taxable income over \$136,115 for single filers (\$185,275 for heads of household, \$272,230 for joint filers) and an 11 percent rate on taxable income over \$472,230 for single filers (\$370,550 for heads of household, \$544,460 for joint filers).

**SOURCE:** Institute on Taxation and Economic Policy, January 2003

<sup>3</sup> Peter Orszag and Joseph Stiglitz, *Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?* Center on Budget and Policy Priorities (November 6, 2001).