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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. Adding a 10 percent tax rate for married taxpayers with taxable incomes above \$277,132 (\$138,566 single) and an 11 percent rate for married taxpayers with taxable incomes exceeding \$554,265 (\$277,132 single) would raise \$2.9 billion 2004-05, \$2.4 billion in 2005-06, and \$2.6 billion in 2006-07.¹ The state's current top income tax bracket of 9.3 percent applies to taxpayers with taxable incomes in excess of \$39,133 (single) and \$78,266 (married).

How Many Californians Would Be Affected?

Only 1.8 percent of California taxpayers would be affected by the proposed increase. Taxpayers with incomes in the top one percent of California households – with an average income of \$1,318,700 – would pay more than 95 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 \$8,306. The average increase for taxpayers in the next 4 percent, with an average income of \$239,900, would be just \$131 after adjusting for the deductibility of state income taxes.

Taxpayers Affected by Top Brackets Received Big Savings from the Federal Tax Package

The recent federal tax cuts will provide substantial tax reductions for high-income earners that far exceed the increased state taxes they would pay under the proposed top brackets. The top one percent of California taxpayers will receive an average federal tax cut of \$77,495 in 2004.² In contrast, reinstating the top tax brackets would increase the average tax bill of the top one percent by \$8,306, after taking into account the federal deductibility of state income taxes, for combined state and federal tax savings of \$69,189.

Spending Cuts May Be 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,

“[E]conomic 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

¹Assembly Revenue and Taxation Committee, *Analysis of AB 1815 (Chan) as Amended March 15, 2004*. This measure would also increase the alternative minimum tax rate to 8.5 percent.

² Institute on Taxation and Economic Policy (April 2004).

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.”³

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 69 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.

Impact of AB 1815: Reinstating 10% and 11% Personal Income Tax Rates								
All California Taxpayers, 2004								
2004 Income Group	Low 20%	2nd 20%	Mid 20%	4th 20%	Next 15%	Next 4%	Top 1%	ALL
Income Range	Less Than \$17,900	\$17,900 – \$30,100	\$30,100 – \$47,600	\$47,600 – \$79,000	\$79,000 – \$163,700	\$163,700 – \$528,100	\$528,100 – Or More	
Average Income in Group	\$11,200	\$23,900	\$38,700	\$62,000	\$109,700	\$239,900	\$1,318,700	\$65,400
Average State Tax Hike	\$ —	\$ —	\$ 0	\$ 0	\$ 4	\$ 133	\$ 12,113	\$ 122
Average Hike of Taxpayers with an Increase	\$ —	\$ —	\$ 123	\$ 126	\$ 387	\$ 807	\$ 12,171	\$ 6,882
Percentage of Total State Tax Increase	—	—	0%	0%	0.5%	4.4%	95.2%	100.0%
Percentage of Taxpayers with State Tax Increase	—	—	0%	0%	1.0%	16.5%	99.5%	1.8%
Average Federal Tax Offset	\$ —	\$ —	\$ —	\$ —	\$ -0	\$ -2	\$ -3,807	\$ -37
Average Tax Change, Net of Federal Offset	\$ —	\$ —	\$ 1	\$ 7	\$ 4	\$ 131	\$ 8,306	\$ 85
Percentage of State Tax Hike Paid by Federal Deductibility	—	—	—	—	1%	1%	31%	30%
2001 and 2003 Federal Tax Cuts for Californians in 2004								
Average Cut	\$ -148	\$ -539	\$ -877	\$ -1,670	\$ -3,683	\$ -7,385	\$ -77,495	\$ -2,276
Net Impact of AB 1815 and 2001 and 2003 Federal Tax Changes in 2004								
Average Cut	\$ -148	\$ -539	\$ -877	\$ -1,669	\$ -3,679	\$ -7,254	\$ -69,189	\$ -2,190
Average Percentage of Federal Tax Cuts Offset by State Increase	—	—	0%	0%	0%	2%	11%	4%

Source: Institute on Taxation and Economic Policy, April 2004

³ 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).