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A California Flat Tax for Real Middle Class Relief

Assembly Republican Caucus Office of Policy Research

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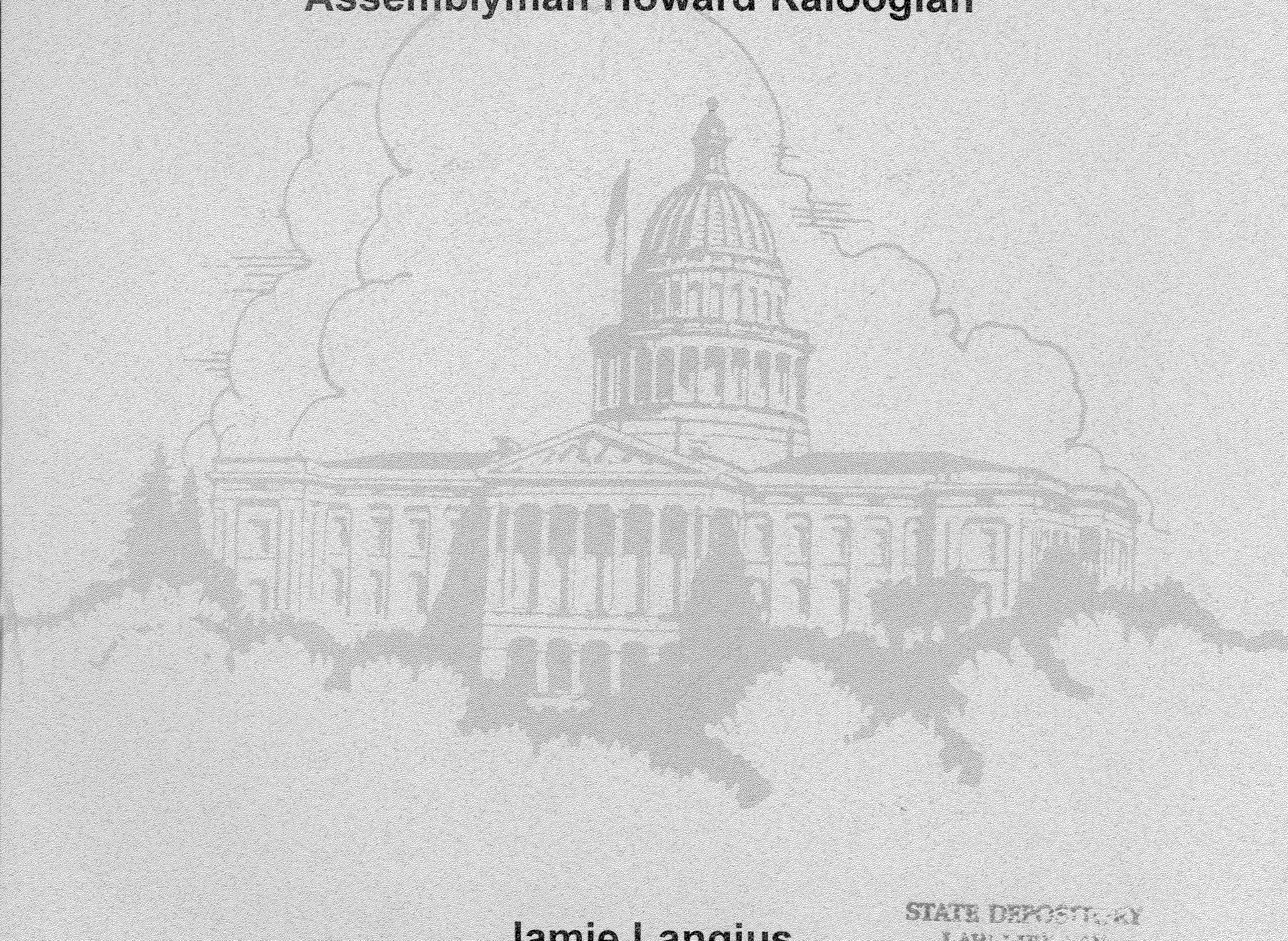
A Research Project Requested by Assemblyman Howard Kaloogian



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Executive Summary

California has been losing its luster as the Golden State of business opportunity for the last several years. Businesses are relocating to other states, talented people are migrating from the state and foreign investment has decreased. The climate is perfect and California sits on the edge of the Pacific Rim why then is California reeling from high unemployment and a decrease in manufacturing? This paper attempts to explain how California's woes are due in part to an onerous and infringing system of taxation that is stifling the state's production.

- California presently has a highly graduated system of taxation put in place by extremist legislators in a social engineering attempt that punishes the productive segments of California's society for being successful.

- A Joint Economic Committee (JEC) study titled, *State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform*, shows that states like California with higher rates of taxation have lower personal income growth and prosperity.

- California must raise money from its citizens to run the government's essential programs and a just and fair method should be employed to appropriate capital from the private sector for the public sector. The JEC recommends lowering taxes and installing a flat-rate tax system.

- One proposed Flat Tax (ACA 29) would eliminate over 300 taxes and fees, including the personal income tax and the sales tax. The estimated personal flat-rate tax would be at five percent while the business flat-rate tax would be around 1.4 percent. Popular deductions, credits and exemptions have been written into ACA 29 including:

    1. Home mortgage interest payments;
    2. Renters' credit;
    3. A percentage of social security benefits designated for lower income taxpayers;
    4. Charitable contributions;
    5. Deductions or exemptions required by federal law; and
    6. Municipal-bond earned interest received.

- The real estate deductions for both the amount of home mortgage interest paid and the total amount of rent paid for the year are economically important to California's middle-class. A 100 percent rental deduction would pump life back into the state's sagging real estate and property management markets, and increase property values.

California's graduated income tax is defended by some politicians, who say that the flat tax is a tax break for the rich. This is classic liberal, class-warfare rhetoric aimed at keeping the truth from their constituents. In the real world, it is California's middle-class taxpayer who is going to reap the most benefits from the flat income tax. California's tax-clobbered middle class will be able to rise up and flex their muscles of consumer preference and added savings.

The flat tax bill's bottom line is more jobs for Californians who will be bringing home bigger paychecks. A state flat tax on personal and business income is a creative idea that needs to become part of California's overall growth oriented strategy, and help propel the Golden State into the twenty-first century.

A California Flat Tax for Real Middle Class Relief

Jamie Langius

Introduction

Across the nation presidential contenders are calling for a national flat tax and an end to the onerous and confusing federal tax system. It appears that the flat tax is truly an issue that is bipartisan. In the snows of New Hampshire back in the 1992 presidential primaries, Democrat contenders Jerry Brown and Paul Tsongas were calling for a flat tax for the American taxpayers. In January of 1996 Jack Kemp chaired a fourteen member Republican tax-overhaul commission created by U.S. Senate Majority Leader Bob Dole and House Speaker Newt Gingrich. The commission "urged adoption of a single-rate flat tax with generous personal exemptions to shield poor wage earners."[1]

On the national level flat taxes have also been discussed by Congressman Richard Armey (R-Texas), Congressman Richard Gephart (D-Missouri), Senator Phil Gramm (R-Texas), and Republican presidential candidates Steve Forbes and Patrick Buchanan. While all of these proposals differ in some respects, the underlying principles are the same: to simplify the tax codes, give Americans some tax-relief and promote economic growth.

All of the fifty states that comprise the United States of America have a different way of collecting the money needed to run their individual state's programs. Some states like Florida have no state personal income taxes, a zero percent flat-rate tax. California, on the other hand has one of the most steeply graduated tax codes of any state in the nation.

At the present time, Californians and people who transact business or purchase products and services in California are burdened with a crushing number of different taxes including: income taxes, sales taxes, gasoline taxes, property taxes, gross premiums taxes, unemployment insurance taxes, capital gains taxes, alcohol taxes, tobacco taxes and horse racing taxes. You could honestly argue that dog, driver and business licenses are a tax, as are car, boat, and off-road vehicle registrations a tax. In fact, it seems there is nothing you can do in California that doesn't have some sort of federal, local or state government fee attached to it that is in reality a tax.

Economically speaking, the suffocating tax levies in California have dampened economic growth and have led to a mass migration of businesses for other, more hospitable states. Not only has foreign investment decreased in California, but a "Brain Drain" has occurred as talented human resources have pulled up stakes and moved out. The bottom line is California suppresses its businesses and individuals by grossly overtaxing them.

Taxes have been despised throughout much of recorded history. Economists and statesman have warned the public repeatedly that taxes should be kept low and just. In his 1994 book *Lost Trumpets*, the Claremont Institute's Bruce Herschensohn stated taxes are "stolen goods" and that "our tax system is socialism — a system of transferring earnings of one person to another."[2] The French economic journalist Frederic Bastiat*, in the mid 1800's called taxes obstacles to the Free Market system.

If the point is conceded that taxes in one form or another are a necessary evil required to run the government's essential programs, then the situation highlighted in this paper should logically lead us to how these levies should be appropriated from the citizens. The extremist legislators who promote a "cradle to grave" caring government have increasingly denied people justice and liberty in the form of a misguided sense of obscure security. They have forced a dependence on the government by its citizens who now feel entitled to income distribution programs. To these legislators with socialistic tendencies, it's the "State's revenue" that needs to be increased, all the while neglecting to see the reality that the state has no revenue except what it takes from its citizens.

If it is indeed necessary for California to garner people's wages, then its

* Frederic Bastiat (1801-1850), A leader of the free-trade movement in France from it's inception in 1840, and founder/editor of the newspaper *Le Libre echange*. He was a deputy to both the Constituent and the Legislative Assemblies and a member of the Finance Committee. Bastiat was a prolific writer who refuted the French Socialists who at the time were assuming power. Harvard economist Joseph Schumpeter called Bastiat "the most brilliant economic journalist who ever lived."

legislators need to act with impartiality. As James Madison wrote about the apportionment of taxes in *Federalist Paper Number Ten*, "yet there is, perhaps, no legislative act in which greater opportunity and temptation are given to a predominant party to trample on the rules of justice."[3] The liberal ruling party in California for the past twenty-five years has trampled on every Californian at the gasoline pump, on April Fifteen and at the department store.

The question that needs to be answered is, what just and fair method should California's legislators employ to appropriate capital from the private sector to the public sector? According to a U. S. Senate Joint Economic Committee's study that shows how individual states perform by economic growth, productive output and prosperity, the states with the lowest taxes and those with flat-rate income tax systems are providing a better economic climate for citizens and businesses.

This report will study the Joint Economic Committee's report mentioned above and a bold proposal to institute a flat-rate tax in California. ACA 29, introduced by California Assemblyman Howard Kaloogian, proposes to replace more than 300 taxes and fees, including the personal income tax, sales tax and gasoline tax. Upon passage, this would immediately open up a new wave of economic prosperity and opportunity for California's overtaxed middle-class citizens. They will bring home more money every payday, money to spend, to pay down debts and to save.

State Taxation and Economic Growth

The Joint Economic Committee (JEC) study dated December 15, 1995, titled *State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform*[4], shows that most of the states that have lower levels of taxation have higher personal income growth and prosperity.

It is true that state governments need resources to carry out functions prescribed by its legislature. It is also true that dollars used to finance government are less productive than capital left in the private sector. Dollars given to the government in the form of taxes and fees reduce the income, savings and investments of the productive segments of society.

The JEC study suggests that highly progressive income taxes and "increases in tax burdens are harmful to the growth and vitality of any area."[5] Findings showed states that avoided tax increases by raising fees and charges also displayed negative growth effects. The tax that created the least burden was the sales tax.

States with lower taxes attracted more foreign investment, had greater migration of human resources, created more jobs, had less unemployment and pulled businesses from states that have higher taxes. California was compared to Florida during the 1960-1993 time period in Table A.

California Vs Florida in Real Per Capita Income Growth

	Income Tax	Real Per Capita Income Growth
Florida	0 % Flat Tax	118 percent
California	0 - 11% High Progressive	66 percent

Table A

The conclusion reached in the JEC study is that "state and local policymakers can improve the rate of economic growth by moving towards lower taxes on income."[6] States that had chosen to not raise taxes showed an increase in productive output and the income derived from that production.

Since it had been established in the JEC report that income taxes were detrimental to growth, what was the best way for governments to collect the revenue needed to perpetuate itself? After crunching the numbers and looking at the fifty various ways the states collected revenues, the study found that longrun growth and economic prosperity can be obtained by lowering taxes. Furthermore, the report indicated states like California, that have graduated income taxes should move to a flat-rate income tax to improve their economic performance as part of a growth oriented fiscal strategy.

A Flat Income Tax for California

California's graduated income tax is being defended by status quo politicians who say that the flat tax is strictly a tax break for the rich. This is classic liberal class-warfare rhetoric aimed at keeping the truth from their constituents. In the real world, it is California's middle-class taxpayer who is going to reap the most benefits from a flat-rate income tax. California's tax-clobbered middle class will be able to rise up and flex its muscle of consumer preference. The advantages afforded the middle-class by ACA 29 include:

1. More money to save for vacations or retirement.
2. Additional income to buy more products and services.
3. Ability to pay down personal debts faster.

The California Flat Tax . . . would replace that tangled web of taxes, fee exemptions, deductions, credits, carry-forwards, checkoffs, deferrals and loopholes with a simple, flat-rate, personal income tax of approximately 5 percent and a flat rate business net sales tax of about 1.4 percent.

It would eliminate more than 300 taxes and fees, including the sales tax, the personal income tax, the bank and corporation tax and the gasoline and diesel tax.[7]

Flat Tax Rate Formula

The flat tax percentage rate paid by taxpayers may actually fluctuate for the first three years. After these initial three years the flat tax rate becomes permanent. ACA 29 provides a formula for determining the revenue limit for state programs and agencies beginning in 1997.

1. The State Board of Equalization determines the ratio of total taxes repealed by the Flat Tax to the amount of the State's Gross Domestic Product (GDP) for the years 1991-1992, 1992-1993, 1993-1994, 1994-1995, and 1995-1996.

2. The State Board of Equalization (BOE) then calculates the average of the above ratios.

3. The BOE multiplies the average attained by the amount of the State's estimated GDP.

4. And then the BOE adds or subtracts the amount needed to match the state's 1995-1996 revenue limit set by the Governor and the Director of Finance.

5. The Governor's approved balanced budget flat-rate percentage is then sent to the legislature, where both houses must pass the flat tax rate by a super-majority or a two-thirds vote.

Reducing the Flat Tax Rate

ACA 29 was not designed to cut the state's budget, it was written to be "revenue neutral" to the state. If the established flat tax rate is perceived as too high by the voting public, the Legislature and the Governor can reduce the amount it plans to spend. "With a Balanced Budget Flat-Rate Tax, there would be tremendous political incentive to cut departments, agencies, and programs because the instant reward for the politician who advocates such cuts would be a lower tax rate to offer the voters."[8] Cutting the tax rate could be accomplished in either the proposed budget or by reform minded legislators passing Tax Rate Reduction Legislation.

Flat Tax Deductions

In writing the Constitutional Amendment, authors Assemblyman Howard Kaloogian and economists Arthur Laffer and Victor Canto deviated from a true flat tax that normally eliminates deductions and credits. Several deductions, credits and exemptions for personal flat income taxes that are important to California's middle-class were written into the bill and are to be established by the Legislature. and they briefly include:

1. Home mortgage interest payments;
2. Renters' credit;
3. A percentage of social security benefits designated for lower income taxpayers;
4. Charitable contributions;
5. Deductions or exemptions required by federal law; and
6. Municipal-bond earned interest received.

The real estate deductions for the amount of home mortgage interest paid and the total amount of rent paid for the year are economically important to California's middle-class. The proposed 100 percent rental deduction would pump life back into the state's sagging real estate and property management markets as property values increase.

Two of the key features of the proposed flat tax are how capital gains and business deductions will be handled. Capital gains would be treated as income and taxed only at the flat tax rate instead of at the highest graduated tax rate. A citizen who sells a home and then purchases a less expensive residence would be taxed the difference at five percent and not at nine and a half percent, an almost fifty percent reduction.

Business deductions are becoming increasingly important to California's cottage industries, and those who work out of their home. ACA 29 would give Californians another benefit, that of lump sum deductions. Currently, business equipment and capital investments are written off over a four-to-seven year period. After the flat tax is implemented, a person with a home office who buys a computer and printer would be able to write off the investment for the year it was purchased and wouldn't have to deduct certain percentages over long periods of time. This change alone should create a virtual boom in the commercial real estate market, as businesses would be able to accelerate the depreciation of buildings and structures purchased.

Just as the big businesses have enjoyed certain deductions over the years, now middle-class entrepreneurs and working people would be able to take advantage of these write-offs, without the burden of extra tax forms and tax accountants.

Conclusion

The passage of a flat-rate tax would open up new opportunities for the hard working men and women of California. It would save taxpayers money and pare down the intrusive size of state government. A secondary effect stimulated by ACA 29 would be to greatly benefit the consumers of California's goods and services. California's businesses are overtaxed and one of the first rules of economics is that businesses don't pay their taxes, the consumers of their goods and services do. Presently, California stifles new businesses because "startup cost" are driven excessively high by taxes, regulations and fees (which really are taxes), and this lowers competition in the market place. The combination of increased business competition and lower costs for goods and services due to less taxes on businesseswould result in lower costs to the consumers and an increase in the demand for California's products around the world.

The proposed flat-rate tax repeals more than 300 taxes and fees, replacing them with a single rate tax. The flat-rate tax on personal income would increase the incentive for Californians to save money. These savings in turn would add to the supply of money available for the creation of more jobs and businesses. California's expanding businesses would be able to increase research and development, bringing new innovations and technology to the world. The flat tax bill's bottom line is more jobs for Californians, who will be bringing home bigger paychecks. A state flat tax on personal and business income is a creative idea that needs to become part of California's overall growth-oriented strategy and would help propel the Golden State into the twenty-first century.

Notes

1. "Kemp Makes Pitch for Flat Tax," *San Francisco Chronicle*, East Bay Edition, 1 February 1996, n.p.

2. Bruce Herschensohn, "Lost Trumpets: A Conservatives Map To America's Destiny" (Claremont, CA: Claremont Institute Press, 1994), 37.

3. James Madison, "Number Ten," *The Federalist Papers*, 80.

4. "State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform," Joint Economic Committee Staff Report, December, 1995.

5. Ibid., 21.

6. Ibid., 24.

7. Howard Kaloogian, "A State Flat Tax Would Reap Rewards," *The San Diego Union-Tribune*, 24 December 1995, G-3.

8. Herschensohn, "Lost Trumpets," 39.

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SETTING THE EAGLE FREE

INTRODUCTION

> *"In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low, and the soundest way to raise the revenues in the long run is to cut the rates now...The purpose of cutting taxes now is not to incur a budget deficit, but to achieve the more prosperous, expanding economy which can bring a budget surplus."*
>
> John F. Kennedy
> Economic Club of New York
> December 14, 1962

These words of President Kennedy were a great inspiration to me as the tax reform movement was launched in the early 1980s with the Kemp/Roth tax cut. Kennedy's vision and courage can serve as examples for all Americans as we struggle to make this nation better for our children and grandchildren. His remarks from the Economic Club of New York ring as true today as they did in 1962.

At the first meeting of our commission back in June, I held up a blank sheet of paper and said, "This is what we start with." That was our charge: Senate Majority Leader Bob Dole and House Speaker Newt Gingrich appointed the National Commission on Economic Growth and Tax Reform to study the current tax code, listen to the suggestions and ideas of people from around the country, and submit to Congress our recommendations for comprehensive reform.

A very diverse and dedicated group of 14 people, with the help of an invaluable, overworked, and underpaid staff, set out to design an entirely new tax system for America's 21st century; one which would promise a booming economy, promote job creation, and ensure the greatest possible opportunity for all Americans to work, save, invest, and reach their potential. We operated under the premise that an economic growth rate of 2.5% is unacceptable to the American people.

This commission was empowered not merely to offer superficial reforms, to trim a rate here and close a loophole there, but to begin with a *tabula rasa* and map out a totally new tax structure for America's next century. We also wanted to help inform the whole world, particularly the emerging democracies, that the goal of tax policy is raising revenue, not redistribution of wealth.

Our nation has arrived at a unique moment in history. With the passing of the Cold War, we are standing at the edge of a new millennium with extraordinary possibilities. Our country is poised to help lead the world into a new era of economic growth fueled by an information-age technological revolution that can yield unparalleled expansion in jobs, productivity, innovation, and prosperity. We must embrace this opportunity and challenge. However, such an embrace will prove difficult, perhaps impossible, if we remain saddled with our current tax code. The current system is indefensible: it is riddled with special interest tax breaks, and it overtaxes both labor and capital. We must construct a tax system that reflects our highest values and unleashes our greatest potential.

The comments and concerns we heard from the American people over the last several months, coupled with a systematic review of the current tax code, helped us establish certain principles to guide us to our conclusions. Surely, a tax code which is simple and fair must generate sufficient revenue so that the federal government may carry out its legitimate tasks. Second, it must not place a tax burden on those members of society least able to bear one. And, perhaps most important of all, it must not restrict the innovative and entrepreneurial capacities of Americans upon which rising living standards and our general prosperity so greatly depend. Our proposals are in keeping with these principles.

Wildly excessive and unjust taxes have locked away access to capital and credit necessary for lower-income Americans to launch the next generation of entrepreneurship. Today, sadly, we see the American people's sense of dynamism and hope, their ability to strive and compete diminished by a tax code which penalizes success, retards investment, and sends capital fleeing overseas. The commission is united in the belief that only a pro-growth tax code can restore America's confidence at home and her greatness abroad. We want a tax code and an overall economy that will liberate the American dream and remove the barriers to upward social and economic mobility. The American ethos of entrepreneurship and optimism made America great once before. We believe these proposals will bolster that ethos again and help restore integrity and honesty to our system.

The author John Gardner has observed that there are many contributing factors to the rise of civilization - accidents of resources, geography, and military power. But whatever other ingredients comprise the greatness of nations, he writes, "There occurs at breathtaking moments in history an exhilarating burst of energy and motivation, of hope and zest and imagination, and a severing of the bonds that normally hold in check the full release of human possibilities. A door is opened, and the caged eagle soars." That eagle, the symbol of our nation, represents the creative spirit, talents, and aspirations of the American people. The charge of this commission and the intent of our recommendations is to open the door and help set that eagle in all of us free.

Jack Kemp
Chairman
National Commission on Economic Growth and Tax Reform