

Reforming California's Tax System

LEGISLATIVE ANALYST'S OFFICE

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California's Tax System Has Worked Well for Many Years

- The main elements of California's current tax system—the personal income tax (PIT), sales and use tax (SUT), and corporation tax (CT)—were established over half a century ago.
- The system has performed relatively well throughout most of the period and generally received comparatively good marks from economists and public finance experts.
- This reflects the fact that the current system has many positive features. For example, it is:
 - **Broad-based.** California's reliance on a variety of taxes ensures that the funding of public services is spread across many different types of economic activity.
 - **Diversified.** The broad-based nature of the system has generally made revenue swings less than if more reliance were placed on fewer tax sources.
 - **Grows With the Economy.** The system's "elasticity" enables revenues to keep pace over time with economic growth and the increased need for public services that such growth generates.
 - **Progressive.** Wealthier taxpayers generally pay a larger share of their income in taxes than do lower income individuals, reflecting their relatively greater ability to pay.
- California's tax burden is somewhat above average relative to personal income.
 - For example, in 1999-00, California's own-source state and local taxes were \$10.98 per \$100 of personal income, versus \$10.44 for all states combined. The comparable figures for selected states were: \$13.23 for New York, \$10.08 for Washington, and \$8.98 for Texas.



But, the Economy Has Also Changed Considerably Over Time

- ☑ The composition and nature of spending by both individuals and businesses has changed considerably. For example:
 - Spending on services has increasingly become more important for both individuals and businesses.
 - Methods of handling transactions have also been changing, with increasing use of “remote sales” through such mediums as the Internet and catalog sales.
- ☑ The relative importance of different types of income has both changed and fluctuated.
 - During the latter half of the 1990s, for example, both capital gains and stock options soared to record levels.
 - Beginning in 2001-02, however, these sources of income declined dramatically.
- ☑ Corporate accounting and organizational structures have evolved, business activity has become much more interstate and international in nature, and the relationship between corporate economic activity and taxable corporate income seems less clear.



As a Result, Some Changes to the Tax System Make Sense

- Because services are largely exempt from the SUT, the tax's base is less reflective of total spending than it once was. This means that:
 - Not all consumption is treated the same, creating inequities.
 - Tax rates are higher than they would otherwise need to be to raise a given amount of revenue.

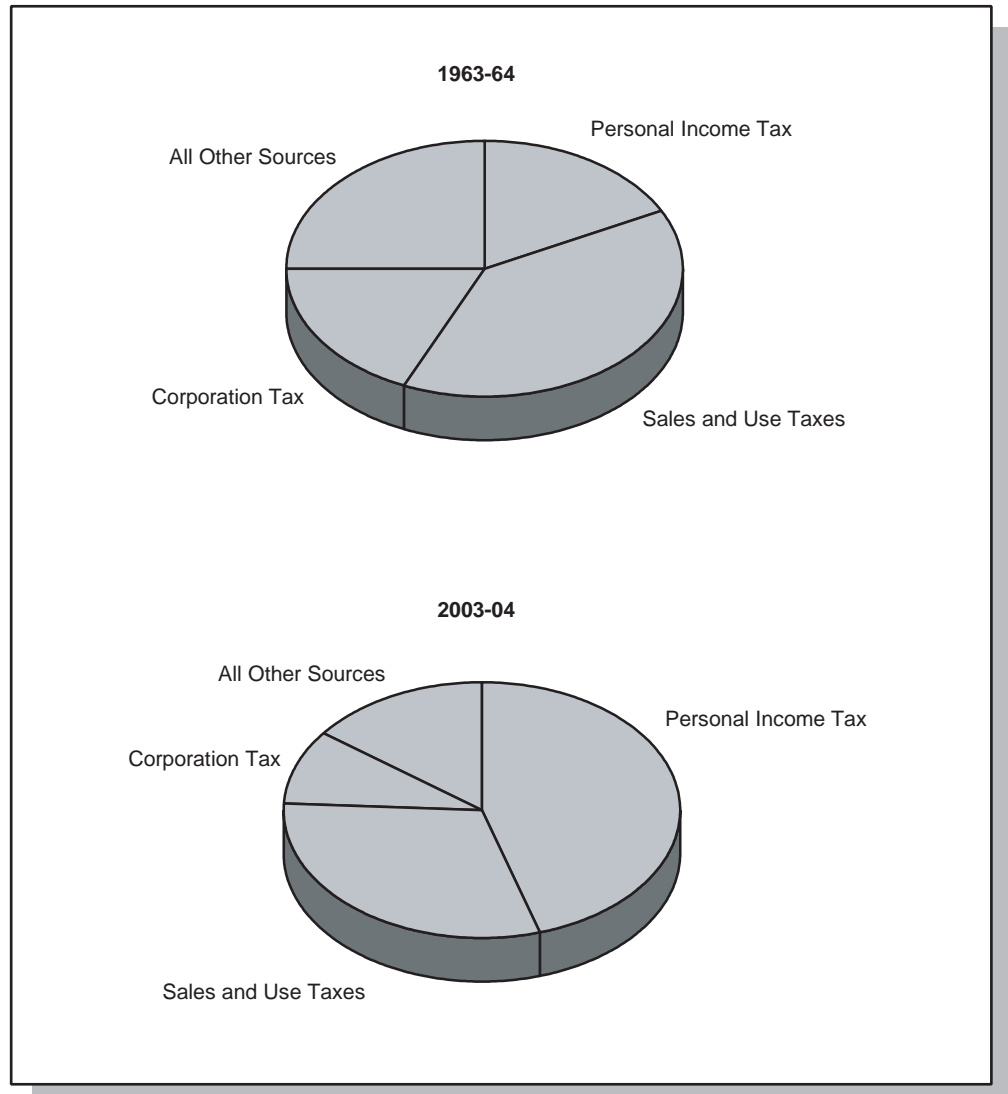
- Since capital gains and stock options fluctuate more than many other types of income taxed under the PIT, PIT revenues too are subject to greater fluctuations.

- The effective administration and enforcement of the corporation tax has become more difficult.
 - Corporate tax receipts have failed to grow commensurately with the economy.
 - Accurately apportioning income between different states and nations is more challenging than it once was, making it harder to ensure that the state is receiving revenues reflective of economic activity.
 - Increasing use of so-called "abusive tax shelters" (those that have no true economic or business purpose) has raised substantial challenges for tax enforcement.

- Partly reflecting these factors, the relative importance of different taxes has changed considerably over the years (see next page).



The Composition of Revenues Has Changed Over Time



- ✓ Over the past four decades the importance of the PIT has increased dramatically—rising from 18 percent of General Fund revenues in 1963-64 to 45 percent in 2003-04.
- ✓ This change is due to healthy growth in real incomes, the state's progressive tax rate structure, and increased capital gains.



Various Options for Reform Could Be Considered

- ☑ Certain of the state's taxes may simply need some relatively minor fine-tuning, while other components could benefit from a more fundamental overhaul.
- ☑ Subjecting certain services to the SUT would broaden the base, and thereby allow for lower rates and elimination of unequal treatment of different types of transactions.
- ☑ Base broadening also could be applied in many other areas of the tax system as well—including the PIT, SUT, and CT—by the elimination or modification of ineffective and inefficient tax expenditures (TEPs).
 - Currently, tax expenditures result in General Fund revenue reductions in excess of \$30 billion annually.
 - The effects of many of these programs are difficult to evaluate, due to data limitations and the absence of a formal institutional review process.
 - Examples of TEPs that the Legislature may wish to review, among many others, include the mortgage interest deduction, tax treatment for large Subchapter S corporations, and the Research and Development Credit.



Various Options for Reform Could Be Considered

(Continued)

- If fluctuations in revenues related to capital gains and stock options are a concern, these could be addressed through a variety of means.
 - For example, partial exemptions, reduced tax rates, or income averaging over a multiyear period could be considered.
 - One could also deal with these fluctuations not by changing their tax treatment, but rather developing budgetary tools for managing such fluctuations, including building up budgetary reserves during times of above-average growth.
- The progressive characteristics of the PIT may also deserve review. Currently, a married taxpayer with taxable income of \$78,266 pays tax at the same maximum marginal rate of 9.3 percent, as does a taxpayer with income of \$10 million. Should there be greater progressivity at the high-income end?
- Other potential reforms involve the SUT and telecommunications taxation.
 - The SUT could be reformed to capture a greater percentage of consumption by levying the tax on remote sales—such as Internet sales. Participation in the streamlined sales tax project is one means by which the state is pursuing this option.
 - Telecommunications taxes are based on an industry structure that no longer exists. This has resulted in a tax burden on telecommunications firms that is generally higher than on other businesses—suggesting the need for reform.
- As taxpayers and tax returns become increasingly sophisticated, steps could be taken to assure that adequate and appropriate audit, collection, and enforcement presence is maintained.



What About Local Taxes?

- To the extent the state undertakes reform with regard to its own tax structure, attention to local tax systems merits consideration, given the interactions between state-local finances in California.

- Over the years the business community and the public have been increasingly critical of the property tax system. The Legislature declared its intent to revamp the system to:
 - Increase taxpayer knowledge of the allocation of property taxes.
 - Provide greater local control over property tax allocation.
 - Give local governments greater fiscal incentives to approve land developments other than retail developments.

- A broader issue involves local control over local revenue bases.
 - Currently, the ability of localities to raise revenues is limited, largely to sales taxes and various fees and assessments.
 - To what extent should localities be given greater authority to determine and modify their revenue bases?

- Some local tax reform options have included:
 - Addressing differential commercial versus residential property tax burdens, such as through a “split roll” system.
 - Reducing property taxes on personal property, such as machinery (to stimulate investment).
 - Reducing reliance on sales taxes in favor of other revenue sources with less adverse incentive effects, such as the property tax.