M E M O R A N D U M

TO: GOVERNOR JERRY BROWN

FROM: STANLEY ELLICOTT

DATE: DECEMBER 5, 2011

RE: RECOMMENDATIONS FOR IMPROVING CALIFORNIA'S TAX SYSTEM

1. EXECUTIVE SUMMARY

Reforming the state tax system should be a priority for California lawmakers. As a provider of key services and benefits to forty million citizens, improvements to the tax code must address volatile revenue sources, economic competiveness, and structural changes to the state's economy over the past three decades.

A fundamental overhaul of California's tax structure is necessary to stabilize revenue sources and grow receipts over the long-term. At the core of this tax reform package are the goals of increasing revenues and nurturing an environment that attracts capital and new jobs for Californians. This analysis recommends these goals be met through property tax assessment based on fair market values, expanding sales and use taxes to professional business and personal services, and by mandating a single sales factor for the calculation of business income taxes.

The following analysis first describes the characteristics of California's tax system, outlines the sources and uses of collected taxes, then diagnoses the inherent weaknesses in the existing tax code and recommended reforms.

2. CHARACTERISTICS OF CALIFORNIA'S TAX SYSTEM

The State of California relies on a broad range of revenue generating measures to fund government activities. Personal income taxes, sales taxes, local property taxes, corporate income taxes and vehicle excise taxes account for the largest share of revenues comprising the California State Budget. Smaller revenue-generating measures include insurance taxes, vehicle license fees, estate taxes and federal transfers. For fiscal year 2011-2012, revenue-generating measures are expected to total nearly $87.5 billion (CBP, 2011), or $2,335 for every person in the state.

The state's tax system is complex

California's tax code is difficult to understand and navigate for the millions of tax remitting citizens and organizations within the state. Multiple forms and worksheets are often necessary to appropriately calculate one's tax burden, due to deductions and credits. The cost of complying with federal tax law—including expenses for tax preparation services and the value of one's time—is estimated at more than 250 billion annually. If these numbers were revised to reflect state tax preparation, this number would soar even higher. To compliment low rates of tax literacy, Californians also are largely unaware of the major sources and uses state funding. In a 2011 poll, less than 6% of adult Californians knew the major sources of revenue for the state's budget, and how those revenues were allocated (Bay Citizen, 2011).

California has a somewhat progressive tax structure

At the expense of efficiency and simplicity, some elements of California's tax code embody the goals of a progressive tax system. Most notably, the top 1% of income earners pay close to 50% of all personal income taxes (LAO, 2011). In order to achieve a progressive tax structure, lawmakers establish credits and phase-ins/phase-outs for certain taxes. These devices shelter households from certain forms of taxation, or from higher marginal rates that are reserved for those most able to pay. On the whole, California maintains a somewhat progressive tax system, largely due to a refundable child credit for households with dependent child expenses.

Despite being somewhat progressive, other measurements of tax liability suggest the system is regressive, and increasingly so. In a 2011 report, The California Budget Project found that the bottom fifth of income earners, who earned on average $12,600, paid 11.1% of their income in state and local taxes. The top 1% of earners, averaging $2.3 million in annual income, paid 7.8% of earnings in state and local taxes. Depending on how one looks at tax liability—as a percentage of income, marginal rates, or absolute dollar value—conflicting accounts of progressivity and regressivity emerge.

California tax revenues chaotically fluctuate in response to economic factors

The personal income tax and sales and use taxes constitute the largest source of revenue for the State. During periods of economic expansion, payrolls increase and consumer confidence drives growth in sales tax revenue. However, during recessionary periods, trimmed payrolls and consumer belt-tightening reduce government receipts. At the same time, demand for government provided welfare services, such as food stamps, unemployment compensation, workforce training and general assistance increase. Reductions in overall tax receipts, coupled with demands for increased spending on safety net services, add to the state's structural debt.

These problems are worsening over time, as recessionary periods are occurring more frequently and subsequent economic recovery is taking longer. Employment levels recovered from the 1990-91 recession in 15 months, but following the 2001 recession, employment levels were not restored until 39 months. In a report issued in June 2011, McKinsey projected the latest recovery would require 60 months before the economy recovers a substantial portion of jobs lost since 2007. In its analysis, McKinsey determined that only under the rosiest of circumstances would the United States return to full employment before 2020.[1]

Volatility in government receipts is partly explained by a narrowing of the personal income tax base and high marginal rates. A majority of income taxes paid by the top 1% of

[1] In its analysis, McKinsey identifies full employment as an annual unemployment rate of 5%, an estimation of average pre-recession unemployment rates.

income earners—who themselves pay roughly 50% of collected personal income taxes—are from capital gains and dividends. Capital gains and dividends are even more volatile than earned income, and are buffeted by the economic climate.

Reforming California's tax system is difficult

A plethora of legislation has been enacted since tax-revolt rhetoric intensified in the 1970s. This period brought forth several key decisions that have made it increasingly difficult to increase tax rates, levy new taxes and fees, or broaden the definition of existing tax-generating measures. According to the Legislative Analysts Office, since 1978 more than 19 ballot measures have tied the arms of lawmakers in setting state fiscal policy. These measures have made it increasingly difficult to reform the tax code and bring the state's fiscal house into order.

3. SOURCES: CALIFORNIA'S REVENUE-GENERATING LEVIES

Personal Income Taxes

The single largest source of California's tax revenue is generated through personal income taxes (PIT). For fiscal year 2011-2012, personal income taxes are anticipated to generate more than half of the state's budget, or roughly 50.4 billion. In addition to individuals, the tax is levied on certain corporations, sole proprietorships, partnerships, estates and trusts.

The personal income tax is a progressive tax levied on wages, salaries, interest and dividends, business related income and capital gains realizations. Five different filing statuses and six brackets determine total tax liability, as depicted in

TABLE 1: PIT / SINGLE / FY11-12

If the taxable income is

Over	But not over	Tax is	Of amount over		
$0	$7,316	$0.00	Plus	1.00%	$0
$7,316	$17,346	$73.16	Plus	2.00%	$7,316
$17,346	$27,377	$273.76	Plus	4.00%	$17,346
$27,377	$38,004	$675.00	Plus	6.00%	$27,377
$38,004	$48,029	$1,312.62	Plus	8.00%	$38,004
$48,029	And over	$2,114.62	Plus	9.30%	$48,029

Franchise Tax Board, 2011.

Source: http://www.ftb.ca.gov/forms/2011_California_Tax_Rates_and_Exemptions.shtml

Table 1. In 2007, nearly 6 million Californians (40% of all tax units) were below the threshold and paid no PIT.

Tax systems are principally designed to generate revenue to fund government services, but are often used to affect economic behavior. Accordingly, California has built-in roughly 85 deductions and credits that are designed to encourage certain behaviors, or provide direct subsidies (LAO, 2011). These tax expenditures represent social values and provide lawmakers with an indirect method of spending when it is otherwise politically infeasible.

In California, the largest personal income tax expenditures include the home mortgage interest deduction, the exclusion of employer pension contributions, exclusion of employer contributions to heath plans, and exclusion of social security benefits. In the 2008-09 FY, these four measures resulted in 23.3 billion in forgone annual revenue. In their *Report on the Commission of the 21st Century Economy*, researchers found, “In total, the PIT tax expenditures account for about 60 percent of PIT liabilities, meaning PIT revenue would swell by about 60 percent if there were no tax expenditures” (COATHE, 2009, pg. 16).

Sales and Use Tax

Sales and use taxes (SUT) are assessed on all tangible personal property, unless exempted by state law. The base rate, currently at 7.25% provides revenue to the state general fund and other legally mandated funds, including public safety, fiscal recovery and public transportation. Cities, counties and special districts may also increase the rate within their jurisdiction–adding up to 2% on top of the base rate–with 2/3 voter approval. As of October, 2011, San Francisco levies an additional 1.25%, yielding a net 8.5% total sales and use tax. California sales tax revenues will gross 19 billion in FY 2011-12.

The SUT base has eroded over the past three decades, as growth in service consumption has outpaced goods consumption. In 1980, 55.4% of personal income was spent on consumer goods, it has since declined to 34.6% by 2008 (COATHE, 2009). California's SUT have not been reformed to reflect changing patterns of consumption. Presently only 21 types of services are taxed in California, whereas other states tax upwards of 141 discrete services. The SUT base has been further eroded by growth in remote sales placed with online vendors who hold no physical presence in California and are not responsible for collecting SUT taxes.

In FY 2008-09, SUT exemptions for food, utilities, prescriptions, snack foods and farm equipment totaled 9 billion. The biggest exemptions in dollar value—food, utilities and prescriptions—constitute living necessities and enjoy broad support from lawmakers and tax payers as exemptions to the SUT. These exemptions further the progressivity of the state tax code by reducing the tax burden on low-income households who pay a proportionately larger share of their income on these tangible living necessities.

Corporation Taxes

Corporate Taxes (CT) constitute the third largest source of revenue, with estimated receipts totaling 9 billion in FY 2011-12. California's corporation taxes are comprised of the franchise tax, the corporate income tax and bank tax, all of which are based on a corporation's net income. Currently, the rate is 8.84% for both the corporate income tax and franchise tax, and banks pay somewhat higher rates of 10.84%. Some s-corporations and other "pass through" entities pay a reduced rate of 1.5%; the bulk of income is later assessed personal income taxes.

Under current California law, net income is calculated by two formulas: either by a single sales factor or a four-factor apportionment formula, which doubly weights sales and includes payroll and property owned in California. Just like personal income taxes and sales taxes, tax expenditures exist to reduce corporate tax obligations. The largest of these measures include the research and development credit (1.2B), water's edge election (750M), and giveaways to subchapter S corporations (420M).

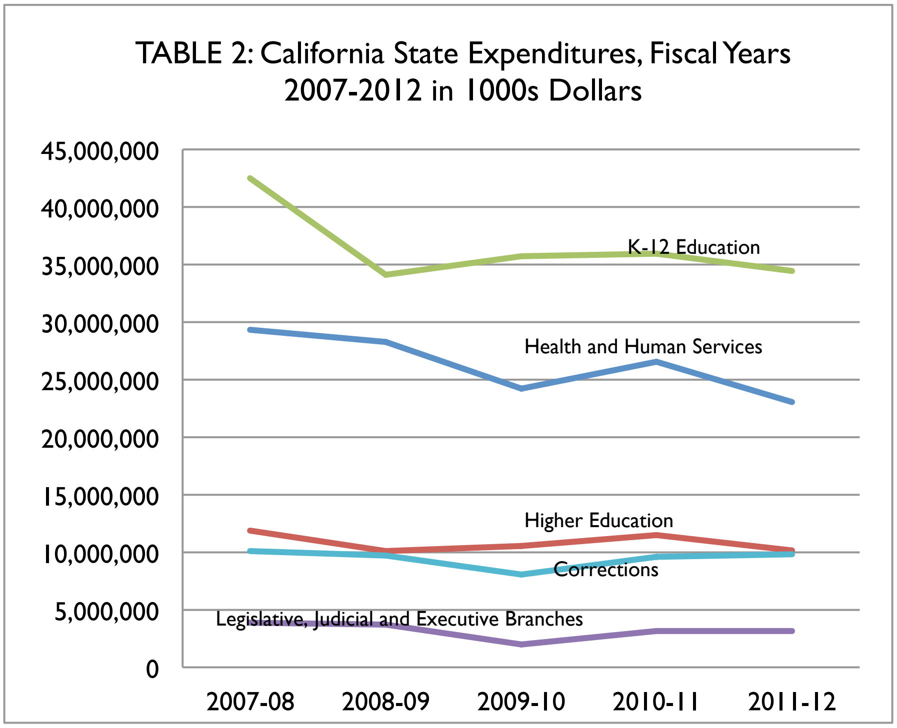
Because corporation taxes are based on net income, not all tax-remitting units pay the franchise, corporate income or bank tax above the minimum $800. Accordingly, this third artery of revenue for the state fluctuates in response to economic factors and business performance.

Property Taxes

According to the California State Controller's Office, in 2011 the net total of all assessed property in California was 4.2 trillion dollars. This includes all classes of assessed property, including commercial, residential, industrial, and agricultural. It is also applied to certain forms of personal property owned by businesses, including physical capital, machinery and equipment. Governmental and government-classified charity organizations are exempt from the property tax, applying to both real property and personal property.

Under current policy established in 1978 by the passage of Proposition 13, real property is assessed based on acquisition value, and not by present market value. Assessed property is taxed at 1% of its value, and is adjusted annually by up to 2% for inflation. Property taxes are not used for state-level general fund spending, but are instead collected by state and redistributed to local governments (LAO, 2011). In FY 2011-12, property taxes will provide 42 billion for schools, counties and cities, based on interlocking formulas. Prior to the onset of the Great Recession, property taxes grew 9% annually, from 1998-2008, during the housing boom. In 2009, for the first time in decades, the new total assessed value of property declined in the state, as devaluations and bad debt battered the state economy.

4. USES: EXPENDITURES OF CALIFORNIA'S TAX RECEIPTS



The state's budget generates the necessary financial support to sustain state-level operations. However, 70 cents of every dollar collected by the state is funneled back to local jurisdictions. Accordingly, the state's budget is first and foremost a local budget. These tax dollars finance a diverse range of government services provided by the state, counties, cities and special districts, including K-12 education, health and human services, higher education, corrections, and legislative, judicial and executive branches of government. Table 2 shows five-year trend data of state spending by area, and Table 3 shows FY 2011-12 spending estimates, as enacted in Governor Brown's 2011-12 budget.

TABLE 3: State of California
FY 2011-2012 by Spending Area in 1000s
Franchise Tax Board, 2011.

Business, Transportation and Housing	602,591
California Environmental Protection	50,856
General Government	1,775,962
Health and Human Services	23,043,060
Higher Education	10,145,588
K-12 Education	34,404,914
Labor and Workforce Development	370,742
Legislative, Judicial and Executive	3,151,385
Resources Agency	1,946,373
State and Consumer Services	624,225
Youth and Adult Corrections	9,821,163
Grand Total	85,936,859

5. IMPETUS FOR REFORM

Reform of California's tax code is necessary to stabilize revenues, grow receipts in the long-term and catalyze economic development that will bring new jobs and prosperity to the state. These broad goals must be met in such a way as to preserve and expand the progressive nature of the current tax system. Considerations of efficiency and simplicity should also not be forgotten in the design of reformed tax measures.

Small fluctuations in the rates of the personal income tax and sales and use tax can have significant impacts on revenue projections for the year. Relying on these two sources introduces significant vulnerability to the state's fiscal outlook. These points are underscored by the recent economic recession and the associated decline in government receipts. Before the events precipitating the Great Recession, government receipts peaked at 102.5 billion for fiscal year 2007-2008, and declined to 82.7 billion in the following fiscal year, 2008-2009, representing a loss of nearly 20 billion, or roughly 20% of year-over receipts (LAO, 2011). The volatility of these sources requires careful forecasting to ensure the enacted spending plan can be fully financed by anticipated revenues. During turbulent economic times, this is an impossibly complicated task.

Eroding confidence in the state's financial health as a result of volatile revenue sources has prompted credit rating agencies to downgrade California's credit rating in 2009. Credit rating agencies have cited poor fiscal management and concern that the state would be unable to shore up necessary revenues to cover financial commitments. As a result, California maintains S&P's lowest state bond rating [A-] (The Tax Foundation, 2011), and pays higher interest rates on debt-financing instruments. Small increases in interest rates forces the state to pay millions of taxpayer dollars in interest over the life of a bond, eating up financial resources that should be invested in state projects.

Only with increased revenues can California strategically position itself for robust, long-term economic development. Over the last four years, budget cuts and dwindling revenues forced a 25% reduction in public education spending. Revenues are necessary to increase the quality of public education, which is instrumental to California's competitive advantage in attracting capital that grows the state economy and creates jobs. New revenues would also provide a down payment to a series of underfunded investments that provide significant public good to all citizens: infrastructure, public transportation, workforce development, and the social safety net. These spending programs have been similarly neglected over the past five years.

Increasing taxes will also yield revenues that can be used to stimulate economic activity, as argued by supply-side or Keynesian economics. These arguments suggest that increased government spending, rather than tax cuts, do a better job of invigorating the economy. For example, government funding of unemployment benefits in lieu of a tax cut for high earners would better stimulate aggregate demand, because unemployment benefits are quickly cashed and funneled back into the economy. On a dollar-for-dollar basis, the tax cut will not yield the same impact on consumption.

Lastly, efforts should be made to eliminate tax giveaways provided to corporations and businesses that are not generating jobs (oil and gas extraction), and transferred to growing sectors that show promise in creating jobs (renewable energy).

6. OPPORTUNITIES TO REFORM TAXATION IN CALIFORNIA

Recommendation 1: Assess property tax by fair market value

Property taxes are a much more stable form of government revenues than SUT and PIT, and accordingly, should be increased to reduce volatility. Expanding property taxes does a better job of reducing volatility, while retaining progressivity, than flattening the personal income tax base and increasing rates. All assessed and taxed property should be based on fair market assessment, with a base rate determined by the state (1%). Local jurisdictions should also be empowered to tack on up to one-quarter of a percentage point to the base rate. These additional property taxes could then be used by the local jurisdiction at their discretion, rather than allocated by the state's existing interlocking formulas that funnel revenues to specific programs.

This change to the property tax would uniformly affect all forms of assessed property, including residential and commercial. Doing so would eliminate tax loopholes and legal mechanisms that allow businesses to avoid reassessment when property is transferred. The policy would be phased in over a long-term time horizon of 10-15 years to dampen the significant increase in some property owners' tax bills, and modifications could be installed to reduce the impact on the elderly and those who would face financial hardship.

Fair market assessment would improve horizontal equity in property taxation. For example, a business that builds a new store valued at 2 million would pay $20,000 annually in property taxes. However, an identical business across the street erected 10 years ago and valued at 1 million at construction, but which has appreciated to 2 million by fair market appraisal, currently pays only $10,000. Reassessment and taxation at fair market value would result in greater equity in the tax burden among property owners. Inequity in tax treatment unfairly disadvantages new businesses that must pay bear a significantly higher tax burden compared to a long-established competitor, discouraging investment and competition. The principle of horizontal equity would similarly be improved amongst residential property owners.

Lastly, local jurisdictions are increasingly reliant on sales tax revenues to support general fund expenditures. Because property taxes are collected and allocated for specific purposes by the State of California, cities and counties cannot tap into these revenue streams to subsidize public investments, beyond the uses defined in the statues of Proposition 13. This has led to the fiscalization of land use, wherein local governments prefer to zone and develop land for commercial business use which will generate sales tax revenue, rather than build new housing. Allowing jurisdictions to collect additional discretionary property tax revenues would mitigate this problem.

Recommendation 2: Expand SUT to include a broader range of services and eliminate loopholes for internet retailers

As of 2007, California only taxes 21 of 168 identified services (CBP, 2010). If California applied sales tax to professional business and personal services that are widely taxed across the country revenues would increase annually by $2.7 billion. Expanding the tax base to services would also increase the progressivity of sales and use taxes, since wealthier households increasingly spend more of their income on services. Refundable tax credits for low-income households could be offered to mitigate the impact of SUT applied to everyday personal services.

Secondly, out-of-state businesses must be required to collect sales tax on goods delivered to Californians from electronic sales. A similar policy was enacted earlier this year by California lawmakers, but is yet to take effect. The California Budget Project estimates that $1.1B in sales tax is lost annually from these transactions. Brick-and-mortar retail outlets suffer when consumers make online purchases that offer an added “discount” of zero sales tax liability.

Recommendation 3: Require use of the single sales factor for corporations

Current policy allows corporations to select from two forms of corporation income tax: a single sales factor or a four-factor system consisting of double-weighted sales, personnel and property owned in California. To a great extent, corporations benefit by switching between the formulas from year to year, based on net profits and losses, to choose the formula that yields the lowest tax obligation. Research conducted by the California Budget Project concluded that the shift away from a mandatory four-factor system to the choice-based approach would cost the state 260 million in revenues for FY 2011-12, and quickly rise to $1 billion annually by 2014-15.

To correct this decline in revenues, the state should mandate use of the single sales factor for calculating business income. According to the Legislative Analysts Office, this policy would encourage firms to produce in California and sell into other states—and would have a small positive effect on job creation. Allowing states to choose from the two options every year arbitrarily favors some firms over others. Further, the largest state economies have shifted to a mandatory single-sales factor. By not calibrating our corporate income tax, producers are disadvantaged from producing within the state and selling in other jurisdictions. Mandating a single-sales factor would increase state revenues by $215 million in 2011-11 and approximately $700 million in FY 2012-13.

5. CONCLUSION

Reforming the state tax system should be a priority for California lawmakers. As a provider of key services and benefits to forty million citizens, improvements to the tax code must address volatile revenue sources, economic competiveness, and changes to the structure of the state's economy over the past three decades. Assessing property tax by fair market value, expanding SUT to services, and mandating the single sales factor for corporations will help the state grow revenues, restore vital programmatic funding, and foster a climate of economic development in California. These policies will usher in a new era of progressive fiscal policy and pave the way for the continued prosperity of all Californians.

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