California's Tax System – Report #1

Several Weaknesses Exist: An Introduction to Some of the Problems

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This is one in a series of reports on weaknesses in California's tax system. This report #1 lists several structural weaknesses and policy issues that exist in most of California's taxes and the system overall. Subsequent reports provide further details on each of the weaknesses and issues, along with possible remedies. The purpose of this series of reports is to help promote serious discussion on the need to and the ways to bring California's tax system into the 21st century so it may best promote economic growth, be more equitable, efficiently meet state revenue needs, reduce taxpayer frustration, and be understandable and transparent. Work on this series began through a two-year fellowship with the New America Foundation. A blog accompanies these reports to enable online discussion. To access the reports, articles, and the blog, please visit:

http://www.cob.sjsu.edu/nellen_a/TaxReform/21st_century_taxation.htm

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An Introduction to Some of the Problems

I. Introduction

California appears on the list of the ten largest economies in the world. Yet, its tax system does not rise to the level of respect one would think such a large economy deserves. Instead, California's tax system relies on some outdated sources of revenue, some taxes that are not paid by all who owe the tax, and the system operates with a tension against local and national systems that can be unproductive. The system is not able to effectively tax all types of commerce and is out of sync with some parts of the federal income tax. In addition, the system has not kept up to date with the changing economy as well as tax systems of some other states.

This paper is the first in a series of papers that explores key weaknesses in California's tax system. The series provides data on the California tax system as well as some comparisons to systems in other states to help illustrate problem areas and possible remedies. The weaknesses and remedies are also explained in terms of principles of good tax policy. Information is also provided about changes in some other states to modernize their tax bases. These changes help to highlight areas in the California tax system that are out of date with today's technology and economy. The reports will look at each major type of tax used in California, noting weaknesses and possible remedies; separate reports will focus on structural weaknesses and policy issues with each major tax.

II. Introduction to Significant Weaknesses and Issues

Following is a list of some of the weaknesses and issues in the California tax system. These are presented within two broad categories. The first category includes structural weaknesses for specific types of California taxes. For example, the sales tax is a consumption tax, yet a significant portion of consumption of individuals, such as services and digital downloads, are not subject to this tax. The second category consists of policy-oriented matters such as decisions regarding the mix of taxes, types of taxes, rate structures, appropriate tax deductions, and how certain personal welfare items (such as health insurance) should be subsidized by the government. Some of the significant weaknesses and issues within these categories are listed below and then further explained in later reports.

A. Structural Weaknesses

- Sales and Use Taxes
    - The tax base is narrow in that not all consumption is taxed and there are many exemptions.
    - Not many individuals (and some businesses) understand their use tax assessment and payment obligations.
    - The California sales tax is a pyramiding tax. That is, businesses pay on taxable items (unless purchased for resale). The sales tax paid by businesses is added to the cost of the goods they sell and subject to taxation at the consumer level – thus, there is a tax on a tax. This means that the taxes are really higher than stated and that items that are theoretically tax exempt, such as food, really have some sales tax hidden in their price because the seller has paid sales tax on its taxable purchases.
    - Businesses may not be clear as to when they are required to collect sales and use tax from California customers because they may not know whether indirect or

minor activity in the state will be viewed by the California tax enforcement agencies as being physically present in the state (nexus issues).

- Individual Income Tax
    - This tax is volatile due to its highly progressive structure and large exemptions (a significant amount of this tax is collected from a small number of high-income individuals).
    - Complexity due to lack of conformity with federal rules, various special rules and not using simplification techniques.

- Corporate Franchise Tax
    - Lack of conformity with federal income tax.

- Telecommunications Taxes
    - The base has become outdated with changes in technology.
    - Coordination of the tax between state and local governments could bring administrative simplification and improve transparency (visibility) of the taxes.

- Tax Administration
    - Administration of California's tax system is spread over three separate agencies – the Franchise Tax Board, the State Board of Equalization and the Employment Development Department. Prior proposals for consolidation and streamlining should be explored to see if there are savings and efficiencies that might be gained from some consolidation of the offices.

B. Policy Considerations

- Sales and Use Tax
    - What type of consumption tax should the state have that best meets the principles of equity, simplicity, economic efficiency and transparency? What types of exemptions, if any, should be provided for? Should California adopt the Simplified Sales and Use Tax Agreement (SSUTA)?
    - How should this tax interact with the personal income tax and other taxes to meet social and economic policies for the state?

- Personal Income Tax
    - This tax can be perceived as inequitable due to the significant portion of the tax that is collected from a small percentage of taxpayers.
    - Tax preferences (deductions, credits and exemptions) are not reviewed regularly for effectiveness and currency. Some may no longer serve their original purpose and some are not equitable in their distribution or application.

- Corporate Franchise Tax
  - It is not clear if this tax is meeting the principle of economic growth and efficiency – what does the state want to tax in order to encourage businesses to operate in California? What type of business activity should be encouraged?
  - How much conformity should there be between the federal income tax and the California income/franchise tax?
  - How can double taxation of corporate income be avoided? (This problem exists with the federal income tax as well.)

- Property Tax
  - This tax can be perceived as inequitable in several ways. Generally, only businesses pay property tax on personal property. Also, the valuation formula is inconsistent among taxpayers in that not all pay tax based on current fair market value. While the U.S. Supreme Court has found this valuation system constitutional for individuals, that case did not address the application of the valuation formula to businesses.
  - Exemptions are not periodically reviewed for currency and equity.

- Alternative Taxes
  - The State of California might benefit from new sources of revenue with the revenue likely used to address problems with current taxes and cover some state costs, as appropriate. One example of a new tax would be a polluter-pays or natural resource user-pays tax. Some activities result in costs for which the user who causes them does not have to pay directly, but instead, the cost is spread among all members of society. For example, the City of San Francisco has considered a tax on plastic and paper bags in order to reduce their use and to collect funds to help cover costs of finding additional landfill space and garbage cleanup from bags that are not recycled. A tax on the bags could be calculated to address the costs of using them. A tax would also lead to reduced use of bags which would reduce government clean-up costs. Several European countries and some states use these taxes. Some policymakers advocate a "tax shift" where revenue generated from polluter-pays taxes is used to reduce other taxes, such as the personal income tax. Consideration of these taxes in California could address some of the environmental concerns that exist and might reduce some of the volatility that exists in the personal income tax.
  - Should California consider the addition of a carbon tax or oil severance tax or some other type of polluter-pays or natural resource user-pays tax? If yes, how will regressivity of the tax be addressed?

- Tax Mix
  - Today, the personal income tax produces the largest amount of revenues for the state. Is it too much? Not enough? A review of the tax mix with consideration to possible better sources of revenues should be considered.

- State and Local Conflicts
  - There are some tensions between state and local tax systems. For example, the state prefers businesses with high-wage employees while the local governments prefer businesses that bring sales and use tax revenues into their coffers. High-wage employees can create extra costs for cities in terms of housing needs and related infrastructure.

- Strategy and Accountability Needed
  - It is not clear from looking at California's tax system and budget what California's goals are. For example, in February 2009, the budget act included a single sales factor to incentive businesses to locate here, but also increased the sales tax rate by one percentage point making it more costly to purchase equipment in the state. Also, despite aggressive goals for reducing GHG emissions, the budget bill pulled a 12 cent gasoline excise tax increase.
  - Accountability is lacking in that it is not easy to find out exactly how much the state and local governments are spending on economic development and whether those dollars are having a positive effect. A unified budget for economic development and other purposes would enable lawmakers and the public to better understand state spending.

- Chokeholds on the Tax Legislative Process
  - Some tax changes, including ones that would improve the system, are difficult for lawmakers to enact due to majority and supermajority vote requirements of the legislature or the citizenry.
  - Lawmakers face many restrictions on creating an appropriate budget and tax system because of ballot initiatives that restrict what they can and cannot do. For example, lawmakers may not apply sales tax to food, even if accompanied with a refundable credit for low-income households because of a ballot proposition that added a constitutional prohibition against taxing food.
  - Earmarking of certain tax collections (as is sometimes proposed on ballot propositions) can limit the budgetary authority that lies with the legislature and governor.

III. Can Weaknesses and Policy Matters Be Addressed?

Future reports will delve into more detail on many of the above weaknesses in order to get a better sense of their cause and possible remedies. Remedies usually cannot effectively be considered weakness by weakness. Instead, the whole system must be considered and the interaction of different taxes and the groups of taxpayers they are imposed upon.

Change is possible. In the past few years, some states have made changes in their tax systems to modernize them and others are currently considering significant reforms. Some of these reforms addressed weaknesses similar to those that exist in California and thus serve as good examples of possible remedies and for the fact that changes can be made. For example, in 2005, Ohio changed its tax law to replace two corporate taxes (the franchise tax and personal property tax) with a "Commercial Activity Tax" (CAT) based on gross receipts with a rate of 0.26%. The CAT is phased in (and the two eliminated taxes phased out) over a 5-year period. The changes also include a reduction in the individual income tax rate, a sales tax rate reduction from 6% to 5.5%, and a cigarette tax increase.[1] See http://tax.ohio.gov/divisions/communications/cat_other_tax_law_changes.stm.

In mid-2006, New Jersey's sales tax rate increased from 6% to 7% and the tax base was expanded to include more services and intangible/digital property. For example, a new category of taxable items includes "digital property" defined as "electronically delivered music, ringtones, movies, books, audio and video works and similar products, where the customer is granted a right or license to use, retain or make a copy of such item. Digital property does not include video programming services, including video on demand television services, and broadcasting services, including content to provide such services." The base was also extended to prewritten software delivered electronically unless used directly and exclusively in the conduct of business. See http://www.state.nj.us/treasury/taxation/salestaxbase.htm. Note: typically, when a tax base is broadened, it is accompanied by a decrease in tax rates. This is not what happened in New Jersey due to revenue needs.

In addition, various studies on improving the California tax system have been performed, including ones called for by legislation. For example, in 2003, after numerous public hearings and comments, the California Commission on Tax Policy in the New Economy issued a report detailing various reforms to help bring the California tax system into the 21st century. See http://www.library.ca.gov/CaTax/index.cfm.

IV. 21st Century California Tax System

In theory, and likely in reality, a 21st century tax system is possible (and likely required) for California . Such a tax system would recognize that our economy has moved into the information age from the manufacturing age, that intangibles and services are significant consumption items, that physical location is not important in all business operations, that high tax rates should likely not go higher but instead modifications to the tax base should be considered since California already has high rates relative to many other states, and tax bases should reflect how businesses operate and people live today. There are a variety of suggestions that can be offered to improve California's tax system. Given a changed economy, budget and public policy concerns that should not ignore taxes, and changes by other states, discussion of these topics is timely and relevant to protecting and advancing the California tax base and economy. Reports and blog discussions will address some possible reforms and their advantages and disadvantages.

[1] The author does not recommend a gross receipts tax for California (or any state) due to its inherent problem of pyramiding. Ohio is just noted above as an example of a state that made significant changes to its tax system.