

## California's Tax System – Report #1a

# California Tax Problems: A Brief Summary

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Modern Tax Architecture

*This is one in a series of reports on weaknesses in California's tax system. 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 21<sup>st</sup> 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:*

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**Most of the specific tax problems in California's existing tax structure described below can be solved by fixing the tax base - they cannot be solved with a rate increase. A rate increase would make most of these problems worse.**

- ***High tax rates:*** The sales tax rate of 8.25% is the highest in the U.S. and even higher if local districts also impose a sales tax (for example, the rate is 9.25% in Santa Clara County). The top personal tax rate is the highest among the states at 9.3% (10.3% if income exceeds \$1 million). There are benefits to lowering a high tax rate and finding ways to broaden the tax base (what the rate is applied to). People tend to view a low rate tax with fewer deductions and exemptions as being more fair and simple.
- ***Equity and fairness often missing:*** The sales tax applies only to tangible goods; other consumption items such as digital goods and services are tax-free. A consumer must pay tax on a lawn mower, but not on lawn care services. Consumers pay tax on music CDs, but not on songs purchased from online stores or tickets to a concert.
- ***Uncollected taxes:*** Every year, over \$1 billion of use tax owed to California and its cities goes uncollected. Most people don't even know what a use tax is (which makes it hard to pay it). Different reporting techniques could make it simpler to calculate and pay.
- ***Some taxes are hidden:*** While the law says that food (except when eaten outside of the home) is exempt from sales tax, there is sales tax included in the price because the grocery store, distributors and growers/manufacturers all pay sales tax and pass it along to buyers.
- ***Some tax breaks are unfair and too costly:*** Some tax deductions and exemptions don't make sense today or are too generous for some taxpayers (usually those with high incomes). For example, federal and state law allows for mortgage interest to be deducted on two homes and on up to \$1.1 million of debt. While there are reasons why the government would want to encourage ownership of a principal residence, there is no reason to encourage or subsidize ownership of a vacation home. Also, even in the Bay Area, the average home doesn't cost \$1.1 million, so why provide an extra deduction to individuals with extra large mortgages? While the state struggles to figure out how to help those without health insurance, most individuals with employer-provided health insurance get a significant tax break because the employer contribution is tax-free income (that costs California around \$4 billion per year). We should look at (1) reducing these and other generous tax breaks to more reasonable amounts and (2) providing tax breaks using credits rather than deductions to make the benefits more equitable across income groups (a \$100 credit provides \$100 of tax relief to every taxpayer, but a \$100 deduction provides \$2 of benefit to a taxpayer in a 2% tax bracket and \$10 to one in a 10% tax bracket).
- ***Personal income tax is unstable:*** The largest source of state revenue - the personal income tax is too volatile. The state is too dependent on a small number of high income individuals continuing to earn high wages, stock options and capital gains so state revenues don't drop. While some argue that this is a good thing because it means that tax

revenues will track the economy, the problem is a small number of individuals contributing a significant amount of the tax base, which is risky for revenue stability.

- ***E-commerce issues:*** Most of our tax rules and systems today were not designed with the electronic-commerce model in mind. E-commerce raises tax issues not adequately addressed by existing rules and presents some possible technological simplifications for tax administration. There is not enough focus at federal and state government levels on how tax laws and systems need to be modernized to address e-commerce taxation issues. These issues include how to determine if a business has income or sales tax nexus in a state, how to tax cloud computing transactions, and how to improve use tax collection.
- ***City and state conflicts:*** Cities don't share in the state income tax and are very dependent on sales tax revenues. So cities tend to want big retailers that generate sales tax (and low-wage workers who usually already have housing - they live with someone else) while the state would prefer employers with a high-paid workforce (who tend to need housing which is costly for cities to support). Also, much of the local revenues are controlled in some manner at the state level. Property taxes are allocated per state rules and the base of the sales tax is controlled by state law as is the maximum rate that can be imposed by local governments.
- ***Strategy and accountability lacking:*** 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 incentivize 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 excluded a proposed 12 cent gasoline excise tax increase. Accountability is also lacking in that it is not easy to find out exactly how much the state and local governments are spending on economic development and what the outcome is of those expenditures. A unified budget for economic development and other purposes (such as housing and social services) would enable lawmakers and the public to better understand state spending.
- ***Chokeholds on the tax legislative process:*** California has numerous budget problems which often lead to shortfalls and delays in getting balanced budgets passed. California is one of just a few states that requires a supermajority (2/3) vote in the legislature to increase any taxes. This results in stalemates and the minority party having a lot of control. Another problem is that the legislature doesn't control the entire budget due to a variety of tax and spending restrictions, many of which are constitutional provisions made by the voter initiative process. For example, the legislature may not subject most food to sales tax because voters added a constitutional provision prohibiting it. Finally, there is a tendency to earmark new taxes to specific spending when often, it is the type of spending (such as for education or health care) that should be from the General Fund.

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