Chapter 2

Here and Now: the Current Tax System

Overarching Characteristics

To assess a tax system, most analysts focus on four characteristics.

Volatility. The call for tax reform stems in large part from an understanding that California's current tax structure is highly volatile.

In 2010, Professor Alan Auerbach, director of the Robert D. Burch Center for Tax Policy and Public Finance at the University of California, Berkeley, determined that California's revenues are more volatile than those of most other states.[2] In part, this is because California relies more heavily on the personal income tax. Other major taxes—including the sales and use tax and the property tax—tend to be more stable, so a heavier reliance on income taxes will increase any state's risk of volatility. (Auerbach is a member of the Controller's Council of Economic Advisors.)

Auerbach also concluded that California's economy has been more volatile than the nation as a whole in recent decades. As the national economy moved through a business cycle, swings in year-over-year growth in California were larger. Further, he noted the state's personal income tax was pro-cyclical, with tax revenues changing at rates greater than the underlying economy.

Predictability. While volatility describes year-over-year variations in revenue streams, predictability measures how accurately fiscal managers can estimate revenues over an 18-month period. The governor's Department of Finance (DOF) follows how well its revenue estimates track performance.[3] Estimates of some revenue streams, like the property tax, tend to be very close to actual receipts. Other revenues, particularly the personal income tax, are harder to estimate. Sometimes, revenues

Figure 1

Personal Income Tax Much More Volatile Than Economy

(Percent Change From Prior Year)

Source: California Legislative Analyst's Office, December 8, 2014

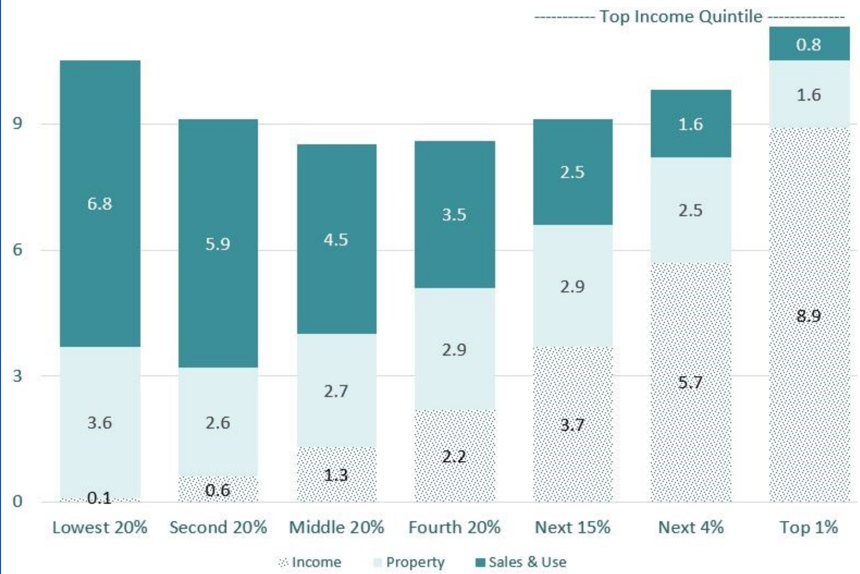
become less predictable at certain points in the business cycle. Sales tax revenues are more difficult to predict when the economy either enters into or recovers from a recession (Figure 1).

Sufficiency. Sufficiency is a measure of whether the tax structure produces enough revenue to meet cash or budgetary demands, but does not gauge whether the budget is balanced. The California budget was balanced in certain years even when disbursement outflows exceeded revenue inflows.[4]

Figure 2

Measuring Progressivity in California

(Share of Income Paid for Selected State and Local Taxes by Income Quintile)



Source: Compilation of data from Institute of Taxation and Economic Policy, 2015

Progressivity. A progressive tax system increases the tax burden as income goes up. Progressivity is often measured among cohorts of selected income ranges. Public finance experts generally consider tax progressivity a measure of a "good" tax system because they assume the marginal return on each new dollar is lower. A regressive system, by contrast, assesses a greater share of income at the lower end of the income spectrum.

The Institute of Taxation and Economic Policy in 2015 determined that California has one of the more progressive tax structures in the country. Figure 2 shows the share of personal income assessed by tax and by income. The personal income tax is steeply progressive, while the property tax is moderately regressive, and the sales tax even more so.

Personal Income Tax

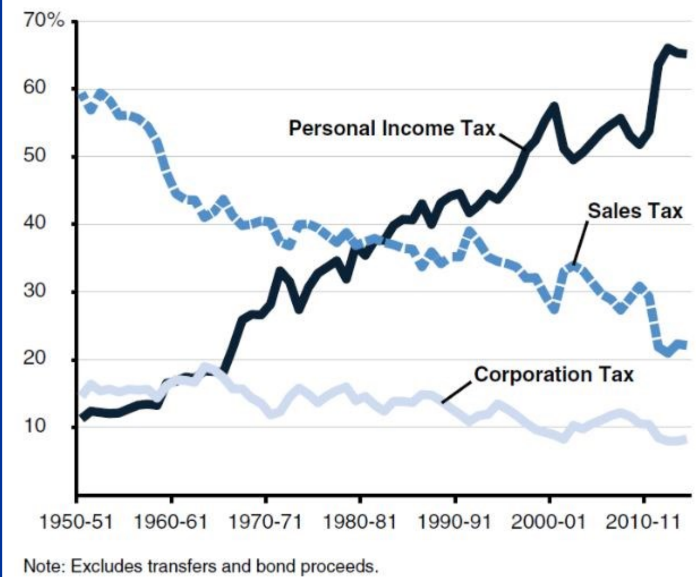
Figure 3 shows the personal income tax has grown to be the dominant source of state revenue. In the 2016-17 fiscal year, it accounts for 69.5 percent of General Fund revenues. California generally follows federal rules for the taxation of personal income, but there are exceptions. For example, California taxes capital gains at the same rate as income while the federal government applies a reduced tax rate to capital gains. Figure 4 shows estimated 2016 revenues attributable to capital gains at $12.7 billion.

Taming Volatility by Reducing Taxes on Capital Gains. Fiscal managers have focused on three possibilities for moderating revenue volatility associated with capital gains. First, capital

gains could be taxed at a lower rate than other income. This would permanently reduce state revenues. Second, investors could be allowed to spread gains over multiple tax years (so-called "income averaging"), moderating the peaks and valleys in state revenues. Third, investment income could be taxed as it is earned rather than when investors recognize returns.

The latter two proposals would have indeterminate effects on state revenue totals and would increase complexity for taxpayers faced with different state and federal assessment methods. Some tax experts argue that state treatment of capital gains has a small effect on investor behavior because the federal rate is so much higher.

Figure 3
Personal Income Tax is the Dominant State Revenue Source
All General Fund Revenues



Source: California Legislative Analyst's Office, December 9, 2014

Addressing Budgetary Effects of Volatility Attributable to Capital Gains. In 2014, California voters approved Proposition 2, a constitutional requirement known as the Rainy Day Fund Act that moderates spending swings associated with capital gains revenue. Under the provision, extraordinary revenue from capital gains is deposited in a separate account. Money from the fund can be allocated only under certain circumstances and conditions, so it cannot be used to build an unsustainable spending base.

Although a rainy day fund may better moderate spending after spikes in state revenues, it still may not reduce pressure on policymakers to use extraordinary revenue gains to expand

Figure 4
Capital Gains Revenue as a Share of General Fund Tax Revenues
(Dollars in billions)

Annual Values		2007	2008	2009	2010	2011	2012	2013	2014*	2015*	2016*
Capital Gains Realizations	$	132.0	56.3	28.8	55.3	52.1	99.9	79.9	130.3	134.9	124.8
Tax Revenues From Capital Gains		10.9	4.6	2.3	4.7	4.2	10.4	7.6	13.1	13.7	12.7

** Estimated*

Source: Governor's Budget Summary 2016-17, Revenue Estimates, p. 149

programs or reduce taxes. However, policymakers may allocate one-time revenue gains to necessary one-time purposes such as investments or deferred spending.

Sales and Use Tax

State law levies a sales tax on the final transfer of tangible personal property. For most Californians, this means retailers incur a liability each time they make a sale. The law provides for exceptions, notably for life and safety necessities such as food bought at grocery stores. The use tax—a companion to the sales tax—applies to the same kinds of transactions and ensures certain sales, like out-of-state transactions for goods consumed in California, do not escape taxation.

Current law imposes a uniform sales and use tax rate of 7.5 percent, with 6.5 percent apportioned to the state. Cities and counties get the remaining 1 percent. Local governments may levy an additional local tax of up to 2 percent. (Figure 5)

Figure 5

Statewide Sales and Use Tax Fund Allocations

(FY 2014-15)

Rate	How Funds Are Used
3.9375%	General Fund
0.25%	Education Protection Account (Prop. 30)
1.0625%	Local Revenue Fund 2011
0.50%	Local Revenue Fund
0.50%	Local Public Safety Fund
0.25%	Fiscal Recovery Fund
0.75%	County and incorporated cities general fund
0.25%	County transportation funds
7.50%	Total

Source: California Board of Equalization, Publication 41

Expanding the Base: Which Service Sectors Are the Largest? The sales and use tax was originally proposed as a tax on the final transfer of tangible personal property, with an explicit exclusion of labor. If labor were added to the sales tax base, what would be the potential revenue gain? State Board of Equalization (BOE) staff reviewed federal data to identify services purchased by Californians. Figure 6 shows the major economic sectors that provided services in 2011 (the most recent data available) but were not subject to the sales tax.[5] If all these services had been subject to the sales tax, 70 percent of new revenue would have come from five economic sectors:

- *Professional, scientific, and technical,* including lawyers, architects, accountants, engineers, graphic artists, computer designers, management consultants, researchers, advertising agents, translators, and veterinarians.

- *Health care*, including physicians, dentists, audiologists, physical therapists, nurses, and professionals in family planning, outpatient health, mental health, substance abuse treatment, emergency care, rehabilitation, and child care.

- *Finance and insurance,* including services provided by banks, credit unions, and brokerage houses.

- *Information services*, including employees of book publishers, newspapers, other periodicals, music producers, software companies, telecommunications, data processers, libraries, archives, and broadcasters.

- *Rental and leasing firms (not including real estate),* including warehousing, transportation (such as buses, limousines, and taxis), and cargo handling.

BOE staff adjusted the 2011 data to estimate the tax base in future years, specifically accounting for inflation and population changes. BOE staff estimated the service base to be about $1.5 trillion in the 2015-16 fiscal year and to grow in each subsequent year.[6] Figure 6 displays revenue estimates for services taxed at a quarter-percent rate. If the Legislature were to impose the full sales tax rate and allow local governments to piggyback on state administration, the average sales tax rate on services would be about 8.42 percent of receipts and generate more than $120 billion annually. (See Appendix III on page 65 for greater detail about the BOE staff estimates.)

Figure 6

Taxing Services: Revenue at the Quarter-Cent Rate and Number of Firms or Individuals

(Dollars in millions; totals may not add due to rounding)

Services Provided by Businesses (a business that has employees)	Revenue	% of Subtotal	Number of Firms or Individuals 2012	% of Subtotal
Professional, Scientific, Technical	$ 681.7	20.6	105,041	24.0
Health Care	614.3	18.5	84,817	19.4
Finance & Insurance	549.6	16.6	14,066	3.2
Information Services	378.3	11.4	7,789	1.8
Transportation & Warehousing	230.6	7.0	16,976	3.9
Administration/Waste Management	224.1	6.8	35,693	8.2
Construction	196.4	5.9	45,712	10.4
Real Estate	159.9	4.8	39,419	9.0
Arts, Entertainment, Recreation	91.0	2.7	20,331	4.6
Accommodations	66.0	2.0	5,454	1.2
Educational Services	18.0	0.5	8,541	2.0
Auto Dealers	14.3	0.4	2,919	0.7
Mining	7.0	0.2	273	0.1
Agriculture & Forestry	3.6	0.1	1,262	0.3
Other	76.9	2.3	49,494	11.3
Subtotal, Services Provided by Business	3,311.7		437,787	
All Other, Including Services (providers as individuals and independent contractors)	329.3		2,503,906	
Total	$ 3,641.0		2,941,693	

Source: Derived from California Board of Equalization analysis using 2012 U.S. Census data, April 2015

Consumer Spending Shifts. California's sales tax base has been shrinking. Every year, consumers spend less of their income on taxable products and more on services. According to the nonpartisan Legislative Analyst's Office (LAO), the total value of taxable sales has grown more slowly than the economy. This has necessitated higher sales tax rates to generate comparable revenue.

Some have expressed support for imposing a tax on digital downloads. Many products that used to be distributed as tangible goods and subject to the sales tax (video games, movies, music, software, books) are no longer taxed when they are sold digitally. Consider the shift from buying compact discs, VHS tapes, and software-in-a-box to subscriptions and downloads for music, television shows, films, and computer programs.

Prices have increased faster for services than for tangible goods because of global competition for products. With this structural shift, local governments also have had to cope with diminished sales tax revenues. If the outmoded sales tax puts the state at financial risk, then it puts cities, counties, and some special districts at risk.

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Alternatives to Expansion. Rather than expand the existing sales tax base, an entirely new scheme could be used to tax sales of tangible goods and services. In 2009, the Commission on the 21st Century Economy was established by Governor Arnold Schwarzenegger to evaluate and propose reforms to California's tax system. The Commission recommended, among other things, that the state adopt a business net receipts tax (BNRT) to tax profits on sales of goods and labor. Among its many attributes, a BNRT can be constructed to:

- Require a small tax rate on each transaction,
- Provide a deduction for business purchases,
- Minimize cascading tax liabilities (tax applied at each stage of production), and
- Extend taxation to out-of-state transactions not currently subject to the sales tax.

The proposal drew criticism from a broad spectrum of interests. Some, including the California Chamber of Commerce, criticized the BNRT as premature and were concerned that the proposed change was an "unproven experiment." Others such as labor interests expressed concerns that taxing labor—unlike the sales tax generally—would encourage employers to shift employment practices and lay off workers.[7] If a BNRT replaced the current sales tax,

state officials would certainly have to establish rules for the transition. Taxpayers and administrators could face significant compliance challenges during the phase-in.

Policymakers might also consider an alternative consumption tax like the European-style value-added tax (VAT) levied on goods and services at each level of production. The VAT's regressive impact could be offset by a personal income tax on those at higher income levels.

Corporation Tax

A corporation doing business in California is subject to the corporation tax. Other corporations receiving income from California sources also are liable for the tax. Of the three main state taxes, the corporation tax contributes the least to the General Fund.

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Under California tax law, a corporation is a legal entity that, in general, exists separately from the people who own, manage, control, and operate it. Such a corporation can enter into contracts, pay taxes, and be liable for its debts. The corporation issues stock as evidence of ownership to people or entities contributing money or business assets.

Stockholders or shareholders own the corporation and are entitled to any dividends. If the corporation liquidates, they are entitled to the corporation's assets after creditors are paid. The annual tax for these corporations is the greater of $800 or 8.84 percent of the corporation's net income. (Newly incorporated or qualified corporations are exempt from the annual minimum franchise tax for their first year of business.)

Some Council members are concerned the corporation tax could be used to shelter shareholder income and reduce the amount of investment income that would otherwise be subject to taxation through the personal income tax. California's corporation tax gained wide attention in 1986, when the state responded to concerns multinational corporations that sought to repeal mandatory worldwide combined reporting. Worldwide combination is the method of combining the income of multinational corporations for purposes of determining the amount of net income subject to California tax. Among the concerns expressed were unequal profits in all parts of the world; exchange rate fluctuations that result in inconsistent income apportionment; and excessive record keeping burdens.

The Legislature responded by enacting a new system whereby multinational corporations could elect one of two methods to determine income subject to tax in California: either worldwide combination or "water's edge" combination. The latter method provides that

affiliated corporations operating a unitary business may elect to combine only the affiliates that are designated as being within the water's edge—within the 50 states of the United States and specified tax havens. Affiliates outside the water's edge are disregarded, their income having no direct role in the income computation for California tax purposes. Business interests regard this 1986 change as recognition of a shifting trade and business environment.

California voters approved more recent changes to the corporation tax that affect multistate and multinational corporations. Proposition 39 of 2012 eliminated the ability of multistate entities to choose how taxable income is determined for state taxation purposes. (This change was enacted to provide a funding source for energy efficiency and alternative energy projects.) Prior to the passage of Proposition 39, multistate businesses could elect how their taxable income was determined by using either a three-factor method that included the location of the company's sales, property, and employees; or a single-sales-factor method that included only the location of the company's sales. Beginning in 2013, multistate entities were no longer able to choose and were required to determine their California taxable income using the single-sales-factor method.

Property Tax

The state constitution authorizes local governments to levy and collect the tax on property. BOE assists in tax administration by setting standards for assessment practices, assessing statewide property, and adjudicating property tax disputes. State law specifies certain assessment practices. BOE oversees the practices of the state's 58 county assessors, who are charged with establishing values for approximately 13 million properties each year. BOE set the values of state-assessed properties, primarily privately-owned public utilities and railroads, at $99.5 billion for the 2015 roll. This was a $6.2 billion increase from the year before.

Property tax revenue is generally considered a discretionary local revenue source.

Property tax revenue is generally considered a discretionary local revenue source. Proposition 98 (approved by voters in 1988) requires that the state make up for school funding deficiencies with state revenues. Consequently, the state has a strong fiscal interest in the performance of the property tax system. In this analysis, property tax revenues are fungible with state-levied revenues.

The property tax applies to all real and most personal property irrespective of use, including land classified as residential, commercial, industrial, agricultural, open space, and timberland. The state constitution and statute assess value based on the acquisition sale price, with increases for inflation of up to 2 percent each year. The basic countywide property tax rate is limited to 1 percent, although local agencies within each county may levy more for bonded indebtedness approved by voters.

Under Proposition 13 (approved by voters in 1978), similar properties can have substantially different assessed values based solely on the dates the properties were purchased. Disparities may be particularly dramatic in places where significant appreciation has occurred. Longtime property owners tend to have markedly lower tax liabilities than do recent purchasers whose assessed values approximate market levels. Proposals to treat some property categories differently (a split roll) could mean differing assessment ratios, tax rates, or exemptions.

Legislative attempts during the 2013-14 regular session to revise the definition of a change in ownership for legal entities failed. These bills would have specified that when 90 percent or more of the ownership interests in a legal entity are sold or cumulatively transferred in one or more transactions, the transfer would trigger property reassessment. Under current law, if multiple individuals or entities acquire another entity in a single transaction, but none of the purchasers acquire more than 50 percent interest, no reassessment occurs. Legal entities include corporations, limited liability companies, partnerships, joint ventures, and real estate investment trusts.

Almost all businesses pay property tax, while corporation tax revenue comes primarily from the biggest corporations.

Other property tax features may merit further scrutiny:

- Many properties are exempt from property tax, including most real property owned by schools, hospitals, religious organizations, charitable organizations, and government entities. Should these exemptions be re-examined?

- The authority to allocate property tax revenue shifted from local governments to the state with Proposition 13. The allocation is made pursuant to statutory formula whereby a local government generally receives a share of property tax revenue proportionate to what it got prior to Proposition 13. Proposition 22 (approved by voters in 2010) limited the Legislature's statutory discretion to reallocate local revenues, including property tax proceeds, though the state is still in the driver's seat. Some revisions have been made to these shares for both state and local government fiscal benefit. Should the allocation of property tax revenue continue to be a state responsibility? Should the allocation shares be re-examined?

- Ad valorem (Latin for "according to value") property tax payments are deductible for income tax purposes, for principal places of residence and second homes. Should the deduction for second homes be continued?

Also, pursuant to Proposition 13:

- Any proposed change in state taxes for the purpose of increasing revenues requires a two-thirds vote in each house of the Legislature. Should this vote threshold be revised?

- Cities, counties, and special districts may impose special taxes with proceeds designated for a specific purpose by a two-thirds vote of the electorate within those jurisdictions. General purpose taxes require a majority vote. Should these voter approval thresholds be revised?

Interaction between Property Tax Split Roll and Corporation Tax. Individuals and corporations own commercial/industrial property. If commercial/industrial property were to be taxed annually at fair market value (split roll), is it appropriate to reduce or eliminate the corporation tax to minimize the business tax burden? Such a tradeoff might not be equitable because businesses are affected in different ways by the two taxes. For instance, almost all businesses pay property tax, while corporation tax revenues come primarily from the biggest corporations. Some businesses that pay the corporation tax do not have any property in California.