Chapter 3

What If…? The Effects of Two Legislative Proposals as Components of Tax Reform

For purposes of applying the basic concepts of volatility, predictability, progressivity, and other variables, the Council examined two tax reform proposals introduced in California's 2015-16 legislative session.

Senate Constitutional Amendment 5

State law requires counties to assess real and personal property at the time of acquisition, for purposes of determining taxable value. This assessment may increase annually at the rate of inflation, but may not exceed 2 percent per year. Residential and commercial/industrial property are subject to this assessment method, as is business personal property such as fixtures.

If SCA 5 (as amended July 16, 2015) were approved by voters, the state constitution would be changed to require county assessors to annually reassess commercial/industrial property at fair market value, and exempt the first $500,000 of personal property from this assessment. The change in tax assessments for real property would be phased in over two years starting in 2018-19. The change in personal property assessments would begin in 2019-20.

Fiscal Effect. SCA 5 would have partially offsetting effects.

1. *Reassessing Commercial/Industrial Properties.* There are no reliable estimates of the revenue effect for the first year of the change, but the local revenue increase would probably exceed $1.0 billion. In the following year, revenue gains would likely surpass $5.0 billion and may add up to more than $10.2 billion, assuming a 1 percent property tax rate. In subsequent years, property tax revenue would grow commensurately with the rate of appreciation of commercial/industrial property. Properties subject to rates above the basic 1 percent would produce even more revenue. This revenue increase would be allocated to cities, counties, special districts, and K-14 school districts.

2. *Exempting Personal Property*. The personal property exemption would reduce revenue by an unknown amount, but probably by more than $900 million in 2019-20 and growing in subsequent years. The actual revenue loss would depend on how much business property was subject to the exemption and property tax rates greater than the basic 1 percent. The revenue loss would be shared by local governments. School districts would be held harmless.

3. *Reducing Corporation and Personal Income Tax Payments*. Corporations with higher business costs because of this change could reduce their taxable income, resulting in lower corporation tax payments beginning in 2018-19. Stockholders or partners with reduced income likewise could pay less personal income or corporation tax beginning in the 2018-19 fiscal year. The state revenue loss is unknown but would grow over time. FTB would have to estimate the revenue loss so that a portion of increased property tax revenue can be transferred to the General Fund to make up the difference.

4. *Increasing County Assessor Workload*. County assessors would see costs increase by an unknown amount as a result of having to do annual assessments, probably in excess of $10 million beginning in 2018-19.

Analysis. SCA 5 would increase the assessed values of commercial/industrial property now set at below-market rates. Properties that have not recently changed hands or had no new construction would be most affected.

A University of Southern California (USC) study estimates that more than half of commercial/industrial properties are currently assessed at or near market value. Steven Sheffrin, director of the Murphy Institute at Tulane University, estimates additional revenue would come predominantly from larger, long-established corporations or partnerships.

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BOE staff estimates 650,000 businesses have personal property that may qualify for the proposed business property exemption.

Property owners subject to more frequent assessment would range from large corporations to small family-run operations. Taxpayers facing large property tax increases may seek mitigating cost relief through regulatory reform at the state or local level, or cuts in other government-levied fees.

Impact on Overall Progressivity. The Institute on Taxation and Economic Policy (ITEP) calculated that the current California property tax is slightly regressive over nearly the entire range of incomes (Figure 2). In practice, the new tax—when fully implemented—could be more progressive because it would fall predominantly on owners of commercial and business real estate. Assuming most owners have incomes in excess of $150,000, the increased taxes would be paid by high-income taxpayers. However, if the affected property is held by a corporation, the cost could be shifted to the corporation's shareholders through reduced dividends or stock earnings, or passed on to customers.

Impact on Predictability. The property tax—even under the provisions of the proposed constitutional amendment—has the virtue of assessing a low tax rate on a very wide and stable tax base. This would mean small estimating errors, especially at the state level. Revenue would therefore likely be easier to predict than for most other taxes.

Impact on Volatility. For the same reason that the tax is predictable (stable base and low tax rate), it likely would exhibit very little volatility. If SCA 5 were to generate in excess of $10 billion each year, it could moderate overall volatility.

Impact on Tax Performance. It is unclear whether revenues generated pursuant to SCA 5 would keep pace with the economy and population.

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Potential Implementation Concerns. Appraisal of commercial/industrial properties is very complex, so county assessors would need to hire expert staff. Property tax appeals could increase, thereby driving up assessors' costs.

A split roll would require clear definitions of property types. For example, would second homes, owner-occupied bed-and-breakfast houses, and timeshares be treated as residential or commercial/industrial? Mixed-use properties and parcels of land with both residential and non-residential elements (live-work spaces and lofts) would require assessors to establish a method to allocate land values for the different elements.

Senate Bill 8

At the time of the Council's review, SB 8 was intended to achieve at least three policy goals:

- Increase revenues by broadening the sales tax base to include services. The tax rate would not necessarily be as high as the current state rate, but would be set to generate roughly $10 billion in its first year and increasing amounts thereafter. Local jurisdictions would not be authorized to impose a sales tax on services, as they now are authorized to do with goods.

- Provide tax relief to low-income households to help offset the impact of taxing services.

- Phase in additional tax relief for individuals and corporations after the sales tax on services is fully implemented.

Fiscal Effect. SB 8 was intended to generate a net state revenue increase of $10 billion in the first year. If the tax on services produced enough revenue, tax relief would be phased in,

Figure 7
Sales Tax on Services (estimated for 2014) by Selected Households: Household Income, Spending, and Revenue Numbers
(Totals may not add due to rounding)

	Average Spending on Services		Revenue Rate	
Household Income	Amount	Share of Income	0.25%	8.21%
$40,000	$ 18,832	47%	$ 47	$ 1,546
$100,000	$ 30,312	31%	$ 76	$ 2,489
>$150,000	$ 55,348	N/A	$ 138	$ 4,544

Source: Derived by California Board of Equalization using 2012 U.S. Census data and U.S. Bureau of Labor Statistics 2014 Consumer Expenditure Survey data

possibly leading to a brief period of higher tax burdens.

How Will Households Fare by Income Class? Figure 7 shows households with an annual income of $40,000 spend nearly 50 percent of their income on the purchase of untaxed services. For each quarter-cent rate increase, these households would pay about $47 per year. (Advocates for extending the sales tax to services often assume that low-income taxpayers do not buy many services. These calculations assume that a broad array of services would count, including some paid by low-income households such as rent. If rent were exempted, the cost to low-income taxpayers would fall substantially.)

Those with incomes of about $100,000 spend slightly more than 30 percent on services and would pay $76 more per year for each quarter-cent tax levied on services.

Analysis. Figure 8 shows 15 industries could be subject to the proposed tax on services. To offset the increased tax burden, the state could choose to lower the overall sales tax rate rather than providing relief through reductions to the personal income or corporation taxes. Alternatively, the new revenue could finance other changes in the state's tax structure.

Revenues from a sales tax on services would likely pose the same estimating problems as the existing sales tax.

The impact on fiscal management is unknown. However, the following generalizations can be made.

Impact on Overall Progressivity. The regressive nature of the sales tax could be mitigated by excluding basic services such as health care, rent, and education, or by offering low-income households tax advantages such as an expanded earned income tax credit. Though extending the sales tax to services does not necessarily increase progressivity, if the proposal were crafted to exclude health care, rent, and educational services, it would be less regressive. Additionally, if the proposal included other offsetting tax advantages for low-income taxpayers (like an expanded earned income tax credit) its effect on low- and middle-income taxpayers could be mitigated.

Impact on Predictability. Some services would likely provide a stable tax base. For example, revenues from commercial waste hauling would probably rise with inflation, population growth, and a general growth factor. Rents, if not exempted, would likely be stable. However, services such as haircuts and entertainment might be more challenging to estimate if they varied with employment rates or economic growth. More broadly, revenues from a sales tax on services would likely pose the same estimating problems as the existing sales tax. Reliability tends to diminish at specific points in a business cycle.

Impact on Volatility. The impact on systemic volatility is unknown.

Figure 8
Standard Business Classifications Used for Federal Statistics

NAICS	Service
11	Support activities for agriculture and forestry
21	Support activities for mining
23	Construction
44	Automobile dealers (labor charges for repairing the cars)
48-49	Transportation & warehousing
51	Information
52	Finance & insurance
53	Real estate & leasing
54	Professional, scientific, technical services
56	Administrative, support, waste management, remediation
61	Educational services
62	Health care & social assistance
71	Arts, entertainment, recreation
72	Accommodations
81	Other services except public administration

Source: North American Industry Classification System, 2015

Impact on Tax Performance. It is unclear whether revenues associated with SB 8 would keep pace with the economy and population.

Potential Implementation Concerns.
If improperly constructed, a service tax could be applied to the same labor at multiple stages of product development. Certain service providers are prone to this cascading effect—notably construction, automobile sales, arts, entertainment and recreation, accommodations, some real estate, education, transportation and warehousing, certain financial services and insurance, and professional, scientific, and technical services. To prevent cascading, perhaps the law should avoid taxing business-to-business transactions.

A sales tax that differentiates between goods and services would add complexity to tax administration, as some businesses would sell items and services subject to different rates. Those businesses already differentiate among their products. For example, an auto parts store applies the sales tax to brake pads but not to the service of replacing the old brake pads. Businesses not currently liable for collecting and remitting sales tax—like accounting firms—would have to start.