Comprehensive Tax Reform in California: A Contextual Framework

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California State Controller Betty T. Yee
& the Controller's Council of
Economic Advisors on Tax Reform

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A Message from California State Controller Betty T. Yee

Taxes touch on almost every issue we face in California, from funding education to filling potholes. Tax policy deeply affects the state's interaction with local governments and shapes important perceptions about the business climate. In my public service career, I have grappled with many aspects of tax policy. As chief deputy director for budget with the California Department of Finance, I was responsible for developing the state's budget in a time of volatile revenue cycles. As a member of the State Board of Equalization, I see how the complexity of the tax code affects small businesses and other taxpayers. As the state's chief fiscal officer, I am responsible for managing cash flow with continued revenue volatility.

Designed during the Great Depression, California's tax structure is outdated, unfair, and unreliable. It reflects economic patterns and demographics of the past. Newer economic sectors escape tax obligations because the structure was created for an industrial manufacturing base. Upper-income earners pay a substantially higher rate on personal income—a progressivity that, depending on the analysis, either helps counter growing income inequality, distributes the tax burden too unevenly, or produces unpredictability with episodic cuts to vital programs. Further punctuating these flaws, Moody's Investor Services in May 2016 ranked California as the state least able to withstand a recession.

In 2015, I established a Council of Economic Advisors on Tax Reform to map the inadequacies of the state's tax system and focus on what it would take to implement truly comprehensive change. I convened experts with perspectives from academia, research institutes, business, and local government. I asked them to refrain from considering expenditure proposals ("spending side" reform) or reaching consensus on specific recommendations. As the work evolved, I realized it merited a broader audience.

The following framework incorporates the diverse and sometimes conflicting insights of my Council. Pulling together the puzzling patchwork of tax policy, we show that reform must go beyond discussion of rates. Whether Council members are concerned about the business climate, income disparity, or funding for infrastructure, housing, and transportation, most agree tax reform at its core must facilitate job creation and economic health. Further, the state-local relationship must be an integral part of comprehensive tax reform.

I am deeply grateful for the care and time that the Council members generously invested in this complex and occasionally frustrating effort. Many thanks to my staff and staff at the California State Library, California Board of Equalization, and California Franchise Tax Board for providing support; and to Deputy Controller John Decker for developing this framework.

Our broken tax system is a common conversation topic, yet comprehensive reform has been elusive and politically unpalatable. Resurgent revenues after the Great Recession have lulled many into complacency about the need to prepare for future economic downturns. However, look closely and the signals are there: California's economic outlook is dimming and operating deficits are at risk of growing. Even if the state could weather the next downturn with new revenue and budget cuts, fiscal imbalance will persist until we dig deep into structural changes.

As the state official responsible for paying California's bills each month, I know we can't afford <u>not</u> to consider a better way to plan ahead. I urge leaders in local government, economic development, the business community, education, and others to join me in pushing for tax reform that facilitates business development and growth, supports local and regional public services, and expands our state's capacity to take on the challenges of growing income disparity, lack of affordable housing, climate change, and more.

The time for comprehensive tax reform is now. No more kicking the can down the road.

A Message from the Controller's Council of Economic Advisors on Tax Reform

Tax policy is one of the most common concerns for California's policymakers. According to the California State Library, the Legislature considered 4,600 tax proposals in the past two decades—an average of about 245 per year. About half would have changed the personal income tax. Another one-third would have adjusted either the sales tax or the property tax. (See Appendix I on page 39 for the history of recent tax changes prepared by the State Library.)

Few proposals were intended to achieve comprehensive reform. For the most part, they were directed at a single tax or group of taxpayers. Sometimes the proposals merely adjusted tax rates. Major increases, though rare, were often designed to be temporary, while tax cuts were conditioned on the state's fiscal health.

It appears that fiscal necessity, rather than overarching policy considerations, prompted most recent major tax changes. In fact, during the nearly 40 years since California voters approved Proposition 13 to limit property tax rates, policymakers adopted incremental adjustments to each of the major taxes, but no comprehensive change to the state's tax structure. To be fair, comprehensive tax change is difficult. During the same 40-year period, the U.S. Congress focused on systemic reform just once, when it simplified the tax code, broadened the tax base, and eliminated many tax shelters in the 1986 Tax Reform Act.

Many believe the current tax system does not serve California as well as it might, and that a review of the entire structure is long overdue. Post-Proposition 13 revenues from the sales and use tax, the corporation tax, and the property tax have diminished. This has increased California's dependence on the personal income tax. The increasing volatility of the state's economy (and the stock market) has translated into greater unpredictability of state tax revenue, presenting challenges for budget forecasts.

Some call for the quick technical fix of reducing income tax on the wealthy to soften the impact of market throes on state revenues. Others contend we should take into account economic cycles by building greater cash reserves when the economy is growing to better weather the inevitable downturns. Like policymakers and California taxpayers, our Council has a range of sometimes contradictory opinions about the best course.

We thank State Controller Betty Yee and her staff for convening our Council and compiling contextual economic and fiscal information. Understanding tax policy changes cannot by itself address all our concerns about state finances. We must start a broader discussion about the tax structure as a necessary area of reform for improving fiscal management and encouraging economic vitality. We hope the following pages provide useful information to explore the implications of comprehensive change.

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Table of Contents

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Chapter 1

Improving Fiscal Management

In the 166 years since it began, the California Legislature has made just two comprehensive changes to the state's tax structure: first in 1911, and again in 1935. These structural overhauls likely were responses both to the state's maturing economy and to changing preferences about how wealth should be taxed.

The tax structure that worked for the state during the Gold Rush emphasized the value of land and its potential for extractive wealth. In those years, the state relied on the property tax as its main revenue source. Later, the system that relied heavily on taxation of private utilities reflected a sympathy for Progressive-Era values.

The present system—perhaps unrecognizable to a 49er or Governor Hiram Johnson—depends on taxing current income, irrespective of the source of income or a person's underlying wealth. (See Appendix II on page 55, which traces the changing nature of the state's tax structure and policy considerations that motivated alterations.)

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In the 81 years since the last large-scale tax reform, California's economy has grown substantially and changed dramatically. Weighing the cumulative effect, the state should again overhaul its tax system. An analysis of the tax structure should consider whether it supports sound fiscal management, and how it could be modified to encourage future economic growth.

Does the Present System Support Sound Fiscal Management?

A primary function of any tax system is to finance the state's current and ongoing budgets. Does California's tax structure generate adequate revenue to finance the state's budget under a variety of conditions? For example, revenues are adequate for the 2015-16 budget, but the tax structure must keep pace with rising state costs, particularly for health care and post-retirement employee benefits.

The tax structure must generate enough revenue to finance both operations and investments. Capital projects require multi-year commitments that compete with the operating budget. While capital costs can sometimes be deferred, they cannot be eliminated.

A related concern is whether the current tax structure generates enough revenue over an entire business cycle. One might expect the structure to under-perform in the down part of the cycle and to over-perform relative to expenses in the good times. However, it appears the tax structure amplifies changes in the economy, resulting in even greater revenue gains and losses than would be expected from a tax structure that simply tracked economic cycles. In recent years, even a modest economic downturn (much less a recession or a Great Recession) could cause a precipitous decline in state revenues and create multiyear operating deficits.[1]

Further, a review must examine whether the tax structure generates revenue predictable enough to construct a responsible, balanced budget and to support future spending and investments. If estimators are unable to precisely predict revenue, then the budget likely will gyrate between balance and imbalance.

Can the Present System Be Modified to Encourage Future Economic Growth?

California's tax structure should serve the development of a robust and diverse private-sector economy.

Encouraging economic growth is essential to sound fiscal management. California's tax structure should serve the development of a robust and diverse private-sector economy including start-ups, small businesses, and established firms. Many desire a tax structure that can easily adapt as the economy changes.

Business interests express concern about the rising cost of regulations, such as labor expenses and environmental standards. They contend these costs, which have the same impact as taxes on the ability to sustain and grow a business, must be incorporated into the tax reform conversation. The effects of taxes and regulatory burdens vary across companies, industries, and geographic areas. Can mom-and-pop businesses be sustained as globally competitive industries continue to grow and thrive?

In an effort to build skills and knowledge for quality employment, many families encounter financial obstacles beyond taxes through steep tuitions and related expenses. How can the state invest in the productive potential of Californians through education, child care, and job training to broaden prosperity, translating into steadier revenues?

Local governments, just like the state, need to be able to anticipate revenues. Cities, counties, and special districts are primarily responsible for providing the services that businesses need. Should local governments be accorded more flexibility to raise taxes to cope with the state's revenue volatility, especially in higher-cost areas and communities that aspire to higher service levels?

Many businesses are concerned about the high cost of housing. Can taxes and other financial incentives encourage development of housing? How can the relationship between the state and local governments be strengthened to encourage job creation and private investment?

On a broader scale, many business interests recognize the state is pushing the "greening" of the economy and business climate, as evidenced by the enactment of numerous laws that create infrastructure financing entities, promote the development of sustainable communities, and accelerate greenhouse gas emissions limits. Are these policies sufficient to significantly stimulate growth of California's green economy?

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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

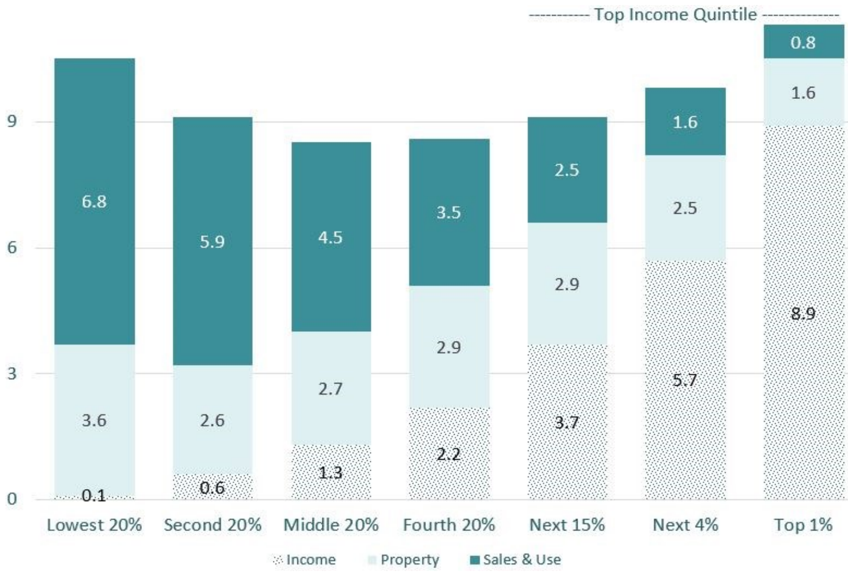
Personal Income Tax Much More Volatile Than Economy

(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.

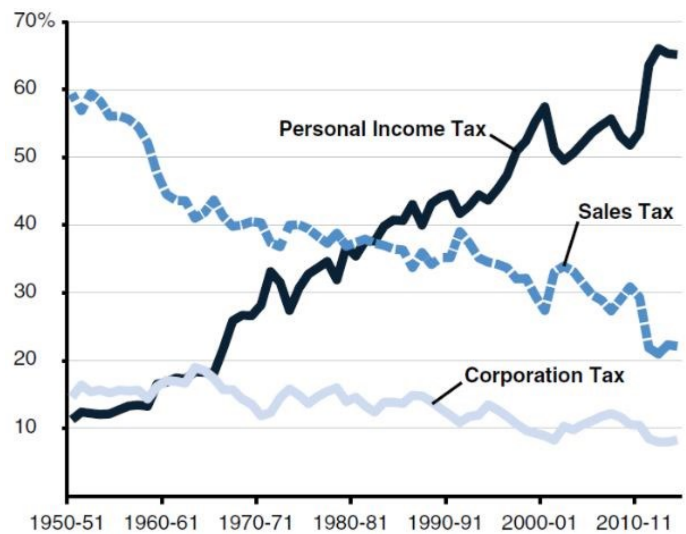
Personal Income Tax

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



Note: Excludes transfers and bond proceeds.

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)

			Number of Firms or Individuals	
Services Provided by Businesses (a business that has employees)	Revenue	% of Subtotal	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.

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.

A USC study estimates that more than half of commercial/industrial properties are currently assessed at or near market value.

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.

The property tax has the virtue of assessing a low tax rate on a very wide and stable tax base.

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.

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Chapter 4

From Gold to Silicon: California's Economy and Tax Structure

Economic changes have helped shape California's tax structure, from the expansion of the manufacturing base after 1929 to today's vibrant and diverse economy. As a result, California's tax structure and fiscal management look different than those in other states.

A Brief History of Growth in California's Manufacturing Base

California's manufacturing sector grew significantly between 1929 and 1997 as the state added manufacturing firms at an annual rate of 2.1 percent.[8] Meanwhile, manufacturing output grew by 5.8 percent each year.[9]

1929 through 1939. Resource processing, not manufacturing, accounts for half the state's industrial output through 1935. This activity—ranging from produce canning to winemaking, from lumber processing to petroleum refining—generates income for each region of the state.[10]

1940 through 1946. Manufacturing becomes the primary driver of the state's economic growth during World War II. Manufacturing employment increases from 271,000 in 1939 to 530,000 in 1947.[11] Manufacturing output triples as the state develops a base for building ships, aircraft, and electrical components (including radios, radar-jamming equipment, signal generators, and sonar).

1947 through 1971. The U.S. enjoys sustained economic growth despite cyclical recessions. California benefits in the period immediately following World War II. However, starting in 1958, the state's manufacturing base (as measured by output or employment) grows more slowly than the national average for 14 years. The state's manufacturing and service sectors grow more rapidly than the resource-processing sectors.[12]

Starting in 1958, the state's manufacturing base grows more slowly than the national average for 14 years… The state's industrial sector increasingly includes "knowledge-based" companies.

The state's industrial sector increasingly includes "knowledge-based" companies such as those involved in aerospace, electronic components, and technology parts.

1972 through 1995. Silicon Valley-based companies, including Hewlett-Packard, Apple, and Intel, lead the personal computer revolution. California-based software and components companies benefit from their proximity and association with Silicon Valley manufacturers. For 15 years starting in 1972, the number of California manufacturing firms grows by 42 percent (compared to the national average growth of about 12 percent).[13] California leads the nation in the manufacture of electrical components, computing equipment, printing equipment, and scientific instruments. Manufacturing employment grows by 5.8 percent in the state, but falls by 9.5 percent nationally.[14] During the 1970s and 1980s, California's old manufacturing base begins to experience major decline. Steel, auto, and tire manufacturers nearly disappear by 1990.[15] In the 1991-1994 recession, the state's aerospace sector is hit hard.

Since 1995. From 1995 until 2000, the state's economy—manufacturing and otherwise—consistently grows faster than the nation's as a whole.[16] There is a transformation from "old industries" to "advanced manufacturing." Although the sector employs fewer people, the jobs are good, productivity is strong, and manufacturing remains an important part of the innovation economy ecosystem. The internet/dotcom boom that began in 1995 accelerates and diversifies in 2000 and beyond—growing jobs at both ends of the technical, professional, software/internet, entrepreneurial sector.

Assessing California's Economy in Context

California, like other states, forged its own economic path based on its history, culture, and politics. How does its current economy and tax structure stack up, in terms of industrial sector diversity, other economic indicators, overall tax load, and fiscal resiliency?

Measuring Diversity. In 2011, the state of Hawaii, using two widely accepted indices of economic diversity, ranked California at fourth or sixth. These methodologies found other large states also near the top including Texas, Illinois, Michigan, Massachusetts, and North Carolina. Some smaller Western states also ranked highly such as Utah, Oregon, and Colorado. In 2014, a Missouri study ranked California the 20th most diverse economy. The state of Utah, in a 2012 analysis, put California just above the middle (25th among 50 states and the District of Columbia, the U.S. Virgin Islands, and Puerto Rico).

Figure 9 shows that California's top five sectors look much like those for the U.S. as a whole. For example, the sector that includes finance, insurance, real estate, and rental and leasing accounted for 21 percent of California's gross domestic product, compared to 20 percent for the nation. Not surprisingly, the information sector in California accounted for a bigger share of economic activity than for the U.S., 8 percent compared to 5 percent.

Figure 9

Top Five State Industries as a Percent of Total GDP (2014)

Source: GDP for California, U.S. Bureau of Economic Analysis Bearfacts (GDP last published on December 10, 2015.)

Some other states also resemble the U.S. as a whole in industrial composition, including Florida, Illinois, and Colorado. Obvious divergences show in Texas, for instance, where the sector including finance, insurance, real estate, and rentals and leasing accounts for 6 percentage points less than for the nation as a whole, while mining is 11 percentage points higher. New York's finance sector surpasses the U.S. average by 12 percentage points. Nevada relies more heavily on the sector of arts, entertainment, recreation, accommodations, and food services. Oregon's durable goods manufacturing sector is 17 percentage points higher than the national average, and Washington's is 4 percentage points higher.

Other Indicators. In other ways, California's economy differs from the rest of the U.S. Per capita personal income in 2014 of $49,985 was 109 percent of the national average and ranked 11th among the states.

For two decades, the state's unemployment rate has exceeded the nation's, but this can be attributed to a faster growing and younger labor force, according to a January 2016 publication by the Public Policy Institute of California (PPIC).[17] At the same time, California workers earn 12 percent more than their counterparts in the rest of the U.S., and output per worker is 13 percent higher. The states that border California (Nevada, Arizona, and Oregon) all rank lower in wages and productivity, PPIC found.

Employers, too, may be attracted by a more highly skilled workforce and more ready access to capital. California ranks first in venture capital per capita and first in patents granted per capita.

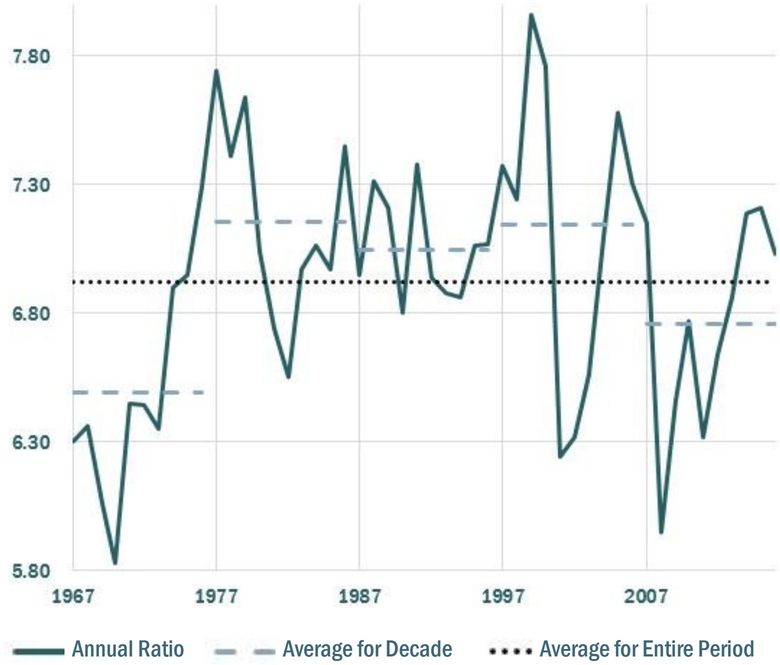
On the other hand, housing costs are substantially higher than the U.S. average. A 2015 LAO report showed this gap has been widening over the past four decades, with California home prices now two-and-a-half times the national average.

California's Tax Structure

Figure 10

Ratio of Total State Taxes to Personal Income

California (1967-2016)



Source: Governor's Budget Summary 2016-17, Schedule 2, January 2016

Figure 10 tracks an index of tax load, derived by dividing total revenues by overall personal income, between 1967 and 2016. This index can serve as a measure of "tax affordability."[18]

For the last 50 years, the annual tax load averaged 6.92 percent of overall personal income. In the 10 years starting in 1967, the annual tax load steadily increased from 6.30 percent to 7.50 percent, showing tax costs outpaced personal income for the decade.

The measure hit its lowest points—falling below 6.00 percent—in 1970 and 2008. In these years, taxes took the smallest share of the economy, making them more "affordable." The index went above 7.70 percent in 1977, 1999, and 2000, marking these three years as "least affordable."

The tax load statistics change annually, depending on:

- The tax structure, especially legislated adjustments to tax rates or the tax base. For example, the large increase in sales and income tax rates—adopted as part of Proposition 30—increased tax collections by more than $6 billion in 2012.
- Taxable income. If taxable income rises faster than personal income, the index will rise. For example, when investors realize stock gains, this typically triggers a taxable event that will increase tax collections.
- Personal income. When personal income increases—through inflation or productivity—without a commensurate increase in tax revenue, the index will fall. This can happen in periods of high inflation without commensurate wage increases.

Changes in tax loads are not simply a function of changes in personal income. The tax load measure also can respond both to changes in the tax system (such as rate or base changes).

Vacillating Tax Loads. The load index varies a great deal, even when the tax structure itself has not changed. Ten-year averages, as displayed in Figure 10, show moderate swings. For the years 1967 through 1986, the average tax load was 6.49 percent. It hovered around 7.10 percent in the next three decades, before falling to 6.76 starting in 2007.

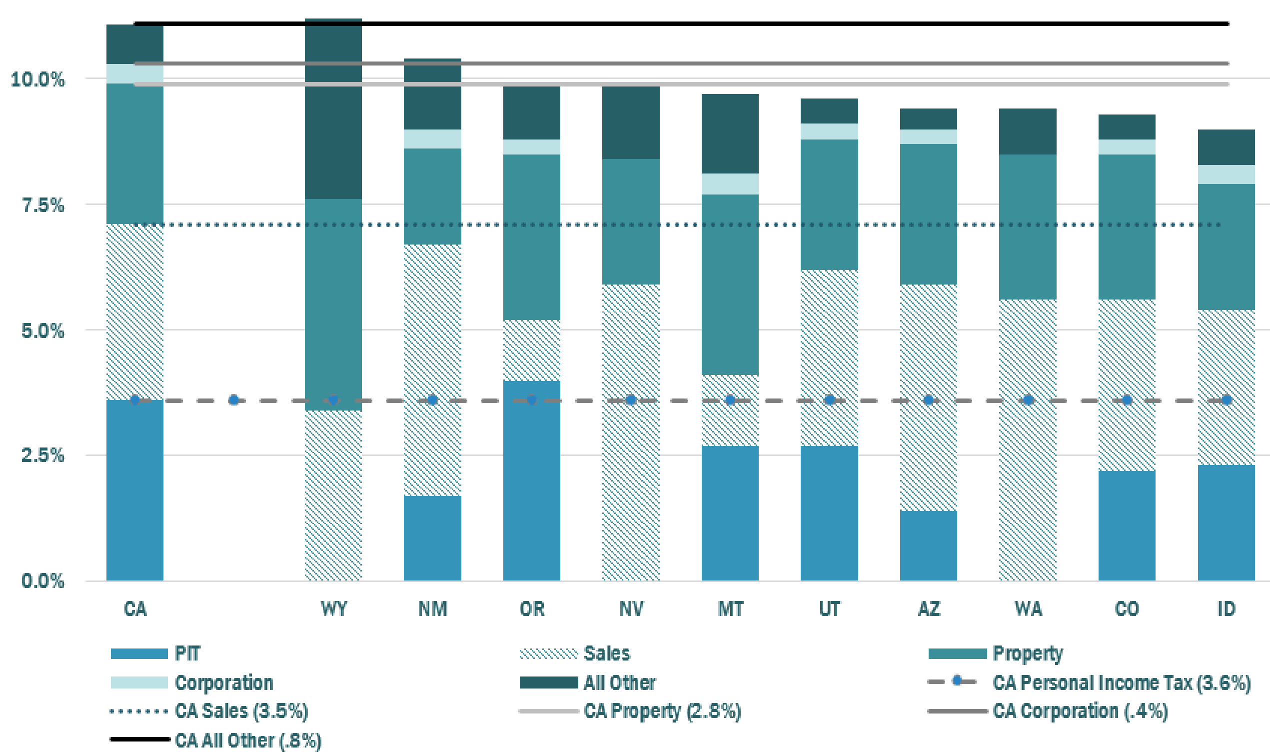
The tax load measure in Figure 10 is a broad index, not intended to gauge effects on individuals or classes of taxpayers.

Comparing California to Other States. Figure 11 compares California's tax structure to other Western states, from Washington to New Mexico. Figure 12 compares California's tax structure to that of other states with large economies in the Northeast, Midwest, and South.

To facilitate cross-state comparisons, the figures include all state and local taxes for 2013 as reported to the U.S. Census Bureau. Local taxes are included for a complete picture of the tax burden across states with very different ways of dividing up taxing authority between levels of government. For example, because its local governments have limited flexibility and authority to levy most kinds of taxes, California may raise comparatively more of its revenue at the state level than do most other states.

Figure 11

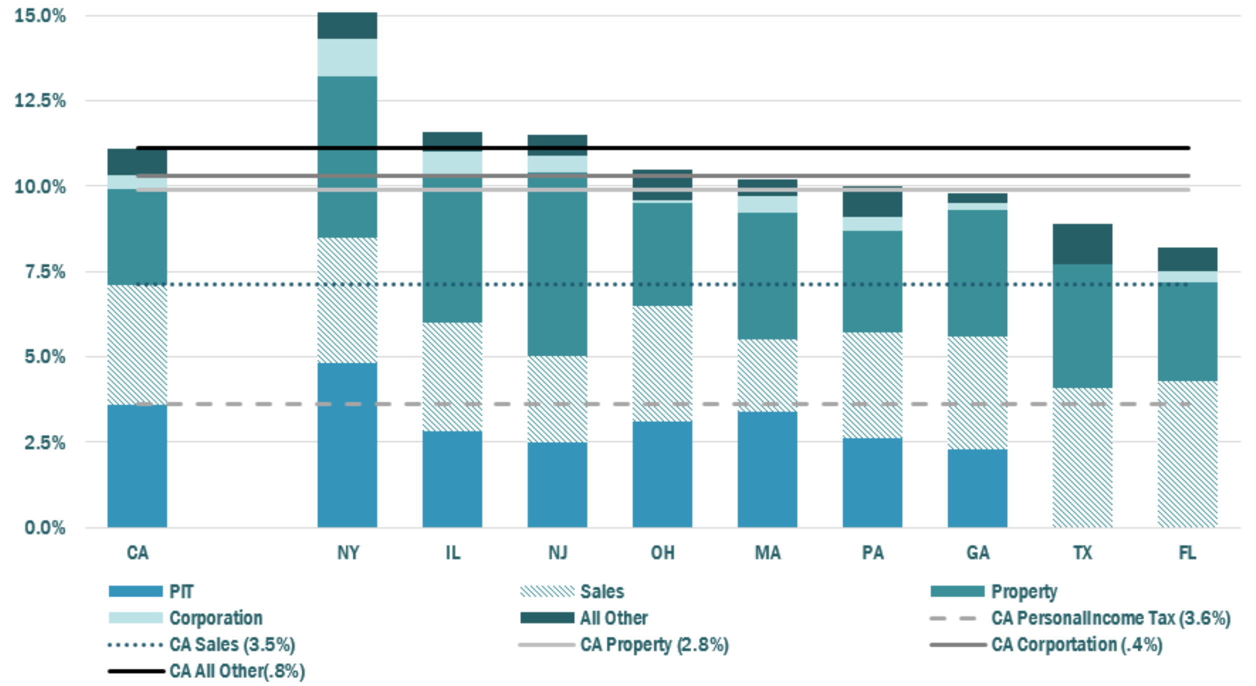
Comparison of State and Local Tax Collections as Share of Personal Income, Western States (2013)



Source: Derived from Tax Policy Center data, 2016

Figure 12

California Tax Structure Compared to Other States with Large Economies (2013)



Source: Derived from Tax Policy Center data, 2016

To account for these differences in fiscal capacity, Figures 11 and 12 show tax collections of both state and local levies for all states.

Western States—Similar Overall Tax Loads in 2013. Each Western state relies on a different mix of taxes. Even without a personal income tax, Wyoming generates about as much tax revenue, 11.1 percent of personal income, as does California. It relies more heavily, compared to California, on the proceeds of its property tax and other taxes—mostly an oil severance tax and a tax on mineral extraction.

Idaho, Washington, and Colorado report the lowest tax loads, between 9.0 percent and 9.3 percent.

The differences in loads can be explained by a number of factors that may be unique to the state, its tax structure, and a given tax year. Care should be taken in making generalizations from these comparative indices. At best, the cross-state index provides a one-year snapshot of a state's tax load relative to its neighbors. It is not clear, for example, whether the index would move uniformly for each state from year to year.

California generates revenue equivalent to 3.6 percent of personal income from the personal income tax. Though Washington and Wyoming do not levy a personal income tax, all other Western states do, collecting revenues between 1.4 percent and 2.7 percent of personal income. Only one other Western state—Oregon—generates more from this source.

California generates revenue equal to about 3.5 percent of personal income from its sales and use tax. All Western states, including Oregon, reported getting a significant share of revenue from the sales tax. New Mexico, Arizona, Nevada, and Washington generate more revenue than does California through this levy.

Three Western states, including Nevada, Washington, and Wyoming, do not levy a corporation tax. California and the other Western states levy this tax, collecting between 0.2 percent and 0.4 percent of personal income.

California generates revenue equal to about 2.8 percent of personal income from its property tax. Four Western states—Oregon, Montana, Colorado, and Wyoming—collected a greater share of revenues than California through property taxes.

Other Large States. Figure 12 shows that among other large states, New York, New Jersey, and Illinois all exceed California's state-local tax load, ranging from 11.6 percent to 15.1 percent of personal income.

Florida, Georgia, and Texas have the lowest tax loads among the large states, ranging from 8.2 percent to 8.9 percent. Neither Florida nor Texas levy a personal income tax but, compared to California, the two states collect a greater share of personal income through the sales and property taxes.

States Evidence Greater Differences in Tax Mix than Tax Load. Most states generate between 8.2 percent and 11.6 percent of personal income from state and local taxes. New York State may be something of an outlier with its concentration of financial services in New York City, allowing it to tax 15.1 percent of personal income—well above other states in this analysis.

Most states rely on a mix of sales, property, and personal income taxes. Yet some have chosen not to levy a personal income tax, relying instead on sales and property taxes (or extraction taxes). The most significant difference among states appears to be their relative reliance on the sales, property, or personal income taxes, possibly resulting from constitutional, judicial, or statutory limitations.

Do Tax Loads Affect Overall Economic Growth?

Senate Bill 1837 of 1994 required DOF to conduct a "dynamic" revenue analysis for any proposed legislation with a revenue impact of 10 million dollars or more. The goal of such a model is to account for how tax changes affect overall economic output, in contrast to direct economic responses under a "static" model. Since September 1995, economic modeling techniques, surveys of other states, literature surveys, and preliminary internal and external dynamic analyses have been examined. This work resulted in better understanding limitations to a dynamic revenue model, including the need to incorporate California-specific data. Further development of the model has halted.[19]

In December 2015, William G. Gale, Aaron Krupkin, and Kim Rueben, reported in the *National Tax Journal* that the "effects on state-level growth [of tax changes] have been the subject of continuing controversy with many conflicting and fragile results in the literature."[20] (Rueben is a member of the Controller's Council of Economic Advisors.) In constructing their own model, the authors found the interaction of tax revenues and personal income growth to be dramatically time-sensitive. Specifically, they found that states with higher revenues generally had lower personal income growth for the period from 1977 to 1991; they also found that states with higher revenues had higher personal income growth from 1992 to 2006. They also found marginal tax rates do not generally affect personal income tax growth. These findings suggest that policymakers should be more concerned about overall tax burdens than about the effects of particular taxes, specifically the marginal rates of the personal income tax.

California has one of the most progressive tax structures in the country, putting a higher relative burden on high-income taxpayers.

Moreover, they found that higher property tax burdens have a positive correlation with economic growth, suggesting that property values (and associated tax revenues) appreciate as the economy expands. The study did not examine the effects of tax expenditures such as those identified in Appendix IV on page 79. (Tax expenditures are credits, deductions, exclusions, exemptions, or other tax benefits.)

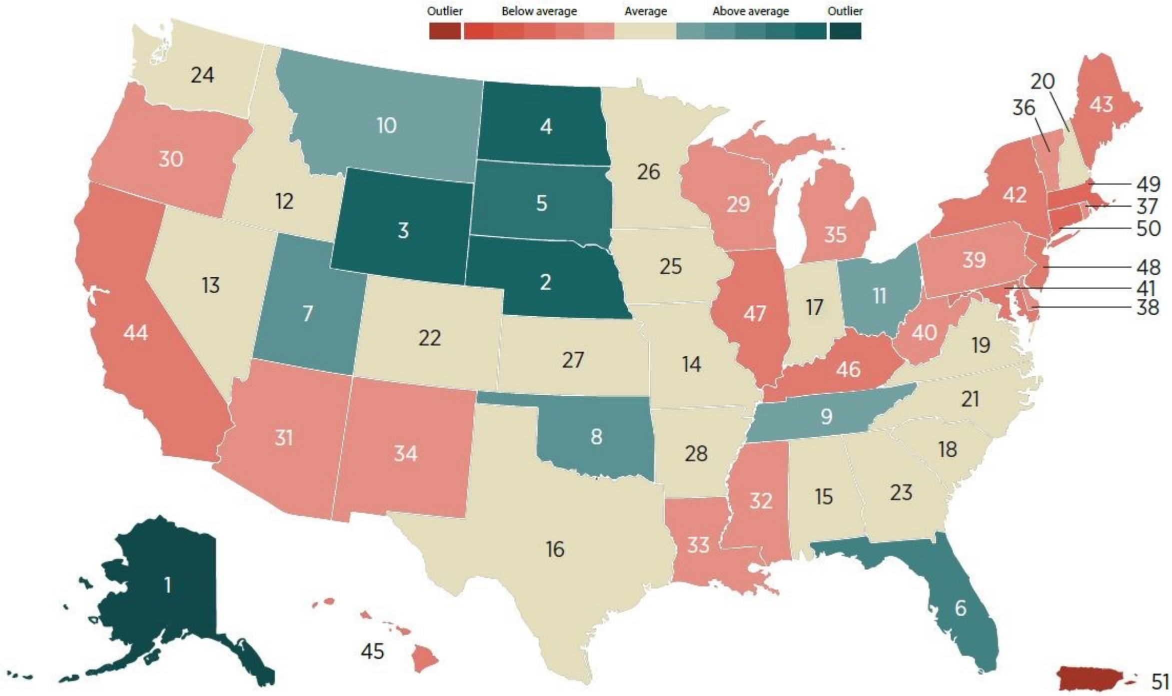
California has one of the most progressive tax structures in the country, putting a higher relative burden on high-income taxpayers. The alternative is lower revenues or shifting the burden to other taxpayers.

California's Fiscal Management: Where We Stand among States

A 2015 simulation by U.S. Government Accountability Office (GAO) highlights that the state and local government sector could continue to face fiscal imbalance (the gap between revenue and spending) during the next 50 years if reform are not implemented soon and sustained. The GAO simulation assumes no tax structure changes and spending remaining constant. While the GAO recognized that revenues are on the rise after the Great Recession, long-term challenges remain for states and localities about how they will meet expenditure demands, especially in the area of health care. The GAO estimates that states and localities without reform would have to cut spending or increase revenue by five percent and sustain those actions to permanently stave off operating deficits.[21]

Research has considered whether indicators can be developed to predict fiscal stress. For example, the Mercatus Center at George Mason University developed a measure of fiscal stress[22] based on:

Figure 13
Overall Fiscal Solvency: How Do the 50 States Rank?
(Based on FY 2013-14)



Source: Eileen Norcross and Olivia Gonzalez, "Ranking the States by Fiscal Condition, 2016 Edition" (Mercatus Research, Mercatus Center at George Mason University; Arlington, VA; June 2016)

- Cash solvency,
- Budget solvency (a measure of whether the state can cover fiscal-year spending with current revenue),
- Long-term solvency (assessing a state's ability to deal with large long-term obligations),
- Service-level solvency (a measure of "fiscal slack" that would allow a state to raise taxes),
- Trust fund solvency (taking into account unfunded pension liabilities, other post-employment benefit obligations, and other debt compared to personal income), and
- State debt (taken from comprehensive annual financial reports).

Figure 13 shows that California ranked 44th among the 50 states for 2013-14, according to the Mercatus Center. The state did poorly in the categories of cash solvency, long-run solvency, and trust fund solvency. Among other large states that placed better than California, Florida ranked sixth, performing well in its cash solvency and service-level solvency. Overall, New Jersey and Illinois fared worse than California.

California has made fiscal changes since 2014 including strengthening its budget reserves. Reform of the state's tax structure could further improve fiscal management.

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Chapter 5

Other Issues at Stake

Any change to California's tax system will necessarily take into account other relevant policy issues. For example, tax expenditures have been enacted over the years to address specific policy goals, such as encouraging homeownership with the mortgage interest deduction. Conversely, one might assert the development of public policy generally has been shaped by the limitations of our tax system. One such limitation is new taxes that address different policy outcomes, often resulting in the layering of burdens on the same group of taxpayers (e.g., sales tax levies for transportation, public safety, and libraries).

Sound fiscal management requires focusing on oversight of current tax expenditures, examining the state-local relationship, promoting economic growth, and minimizing income and wealth disparities. In addition, regulatory costs are perceived by many in the business community as analogous to taxes and merit consideration as such.

Tax Expenditures

Although the Council refrained from considering expenditure proposals (spending side reforms), the members generally discussed tax expenditures, recognizing that they reflect special tax provisions that result in foregone revenues.

Federal law defines tax expenditures as revenue losses attributable to provisions of federal tax law that allow a special exclusion, exemption, credit, preferential tax rate, or a deferral of tax liability.[23] According to the congressional Joint Committee on Taxation (JCT), legislative history indicates that tax expenditures should be thought of as deviations from the "normal income tax structure."

Figure 14

Top Expenditures of Personal Income Tax in CA

(Dollars in millions)

Personal Income Tax	Description	Revenue Loss	Federal Conformity
Home mortgage interest deduction	A deduction for interest paid for acquiring, constructing, or redefining a principal residence and one other residence.	$5,000	Yes
Basis step-up on inherited property	The basis of property acquired by bequest, devise, or inheritance is the fair market value at the date of death. Appreciation that occurred prior to death is not taxed.	$4,100	Yes
Exclusion of capital gains on sale of principal residence	An individual may exclude up to $250,000 of gain realized on the sale of a principal residence. For joint returns, the exclusion is $500,000.	$2,600	Yes
Real estate, personal property, and other tax deductions	Individuals may deduct certain taxes as itemized deductions.	$2,100	Yes
Dependent exemption in excess of personal exemption credit	A nonrefundable personal exemption credit is allowed for all taxpayers and their dependents. The exemption credit for dependents is more than three times greater than the exemption allowed for the taxpayer or spouse.	$1,400	No

Source: California Department of Finance (2014) and California Franchise Tax Board (2012)

Reports on California tax expenditures, prepared by both DOF and Franchise Tax Board (FTB), generally have followed the JCT methodology.

Figures 14 through 16 show the top tax expenditures for the personal income tax, the corporation tax, and the sales and use tax. (See Appendix IV on page 79 for more extensive lists.)

For most tax expenditures, legislative intent is not stated but there are often specific policy goals. For example, most corporate tax expenditures are meant to support businesses based on type or location. The legislative intent for the manufacturing exemption from the sales tax is to attract and expand manufacturing businesses. Most tax expenditures do not include a sunset date.

In August 2015, the California Bureau of State Audits initiated a review of the top six corporation tax expenditures. The objective of the review was to determine their purposes; whether studies have assessed their effectiveness and/or benefits to the state economy; whether some are more effective than others; and the impact of the state placing a cap on certain tax expenditures.

The review found that five of the six corporation tax expenditures required additional study to determine whether they were achieving their purposes. The audit concluded that implementing oversight methods from other states could improve the effectiveness of the state's current and future tax expenditures. It also recommended that the state conduct regular, comprehensive reviews of tax expenditures and their policy objectives.

Figure 15
Top Expenditures of Corporation Tax in California
(Dollars in millions)

Corporation Tax	Description	Revenue Loss	Federal Conformity
Research and development credit	Businesses are allowed a credit for increased research expenditures. The revenue loss is corporation and personal income tax.	$1,800	No
Sales factor apportionment	Corporations with income derived from sources both within and outside of California must apportion income to California. As of January1, 2013, most corporations are required to use the single-sales factor.	$974	No
Like-kind exchanges	No gain or loss is recognized when business or investment property is exchanged solely for like-kind property. The revenue loss is corporation and personal income tax.	$450	Yes

Figure 16
Top Expenditures of Sales and Use Tax in California
(Dollars in millions)

Sales & Use Tax	Description	Revenue Loss	Federal Conformity
Candy, confectionery, snack foods, and bottled water	Candy, confectionery, snack foods, and bottled water are exempt.	$1,503	N/A
Manufacturing exemption	Manufacturers and certain research and development businesses may qualify for a partial exemption.	$525	N/A
Farm equipment	Sales of farm equipment, machinery, and their parts are partially exempt when sold to qualified people engaged in producing and harvesting agricultural products.	$180	N/A

Figures 15 and 16 Source: California Department of Finance (2014) and California Franchise Tax Board (2012)

Many policy goals are embedded in tax expenditures. A broader conversation may focus on the following questions:

- Should a similar review be performed for the personal income tax, and the sales and use tax expenditures?
- Should tax expenditures that conform to federal law remain regardless of their effectiveness?
- Should tax expenditures that outlived their original policy goals or usefulness be modified, suspended, or repealed? Should current and newly enacted tax expenditures be subject to periodic review or sunset?
- Considering how the Legislature has suspended or changed the law for net operating loss deductions, should these deductions be treated as a tax expenditure?
- In general, should the definition of tax expenditures be changed?
- Are there more efficient ways to accomplish the same policy goals—through direct spending, for instance?

The State-Local Relationship

The connection between state and local governments is vital in the tax structure conversation. It is important to consider which level of government has the authority to impose taxes, for what purposes, and whether such authorities and responsibilities should be shared.

Fiscal control and responsibilities have shifted between state and local entities since the state's birth in 1850. In its earliest days, the state had limited responsibility for programs and narrow taxing authority. At least through 1900, counties were the most prominent level of government, with the greatest budgetary responsibility and revenue streams.

Economic shifts, governance and fiscal changes, and policy decisions have led to the concentration of tax resources at the state level.

Some have tried to rationalize the state-local fiscal relationship to reflect social and financial needs. A "separation of sources" policy, in place until 1935, was an attempt to create fiscal independence for both state and local governments. Voters repudiated this experiment during the Depression in part because local funding could not fully support K-12 schools, leading the Legislature to levy the sales tax and the personal income tax.

Local Governments at the Heart of Economic Growth. Some argue that while it may be important to compare California's tax structure to other states, it is imperative to compare the state's tax resources with those of local governments. Economic shifts, governance and fiscal changes, and policy decisions have led to the concentration of tax resources at the state level. Of particular note, the state's repeal of redevelopment laws eliminated what many consider the most important local financing tool for affordable housing and economic development.

> ***Local governments are key players in growing the economy through job creation and private investment.***

Today, the state-local relationship is so intertwined that local governments are key players in growing the economy through job creation and private investment. They provide the services and train the workforce that lays the groundwork for economic vitality. Businesses care about the functions local governments oversee, including public safety, street maintenance, housing construction, and quality-of-life amenities. Therefore, local governments, just like the state, need predictability and revenue growth aligned with service demands (population and job growth). In this regard, state tax volatility creates local volatility. Local governments need flexibility to increase taxes locally—especially in higher-cost communities that aspire to higher service levels. For example, some local officials have called for the authority to levy local sales taxes on services.

Regional Approaches Met with Limitations. Affordable housing production stalled after the 2011 repeal of redevelopment. Some cities are putting new tools in place, such as impact fees. However, these tools are just ramping up and will not come close to generating the level of financial investment that redevelopment did for low- and moderate-income housing.

To what extent should state law facilitate a regional response to addressing housing demand? California's tax structure encourages cities to use their land for commercial uses rather than housing. Except at high densities, even commercial uses do not generate the tax revenue to pay for services. In light of this, some propose allocating a portion of the sales tax not by situs (place of sale) but by proxy (where the purchaser resides).

Additionally, state and local governments have long recognized the regional nature of transportation. However, the shrinking sales tax base and the decline in fuel consumption are creating pressure for raising the cap on the combined local sales tax, especially in regions that have collaborated on regional transportation through a series of countywide sales tax measures.

In recognition of these limitations, some suggest that the state authorize new local and regional tax levies.

Constitutional Provisions to Encourage Local Revenue Sharing. Article 13 of the California Constitution authorizes cities and counties to share locally generated sales tax revenue. Under some circumstances, voters must approve these revenue-sharing agreements, a process that can lead to delays and cumbersome requirements. [24]

As an alternative, the state may want to authorize greater flexibility in sharing revenues—especially discretionary revenues—across local boundaries. Voluntary revenue-sharing agreements could help overcome limited local revenue capacity. For example, a revenue-sharing agreement to create a cross-jurisdictional fire department might be more efficient than a fire-service contract between two cities.

Promoting Economic Growth and Minimizing Economic Disparities

California and the nation are witnessing unprecedented levels of income disparity, stagnating household income, and record-setting compensation for corporate executives. The pay gap between CEOs and other employees continues unabated. California is among the top four states in income disparity as estimated by the Gini coefficient, a common measure of inequality based on income distribution among the nation's residents.[25] (The other three are New York, Connecticut, and Louisiana.)

Many assert growing income disparity dampens economic growth as income is concentrated in fewer hands and the wealthy spend less in local economies. In addition, growing economic disparity results in a rising demand for public services.

Growing economic disparity results in a rising demand for public services.

A Wealth Tax. Some have suggested a wealth tax could be phased in with a reduction to the income tax, offering some smoothing to state tax revenues. According to Daniel Altman, an economist from New York University, wealth tax brackets have been suggested of zero percent for up to $500,000 in wealth, 1 percent for wealth between $500,000 and $1 million, and 2 percent for wealth above $1 million.

Under this model, a family with $500,000 in wealth and $200,000 in annual income would pay $50,000 in federal income tax per year and no wealth tax. However, a family with $4 million in wealth and $200,000 in annual income would pay a total of $65,000 each year. Families relying more on wealth would pay more than they do now, while families depending on earnings would pay less.[26]

Investing in Californians. The sustainability of any tax structure relies on a well-trained workforce with high-wage jobs. Investing in the productive potential of individuals is essential to cultivating broad-based prosperity. Critical investments include K-14 education, higher education, child care, and flexible training and retraining opportunities. Offering means-tested support to help people move up the income ladder is a proven approach to growing economic prosperity. If employers are better engaged with the education and training community, curricula will be more relevant and employers will benefit from more successful outcomes.

Regulatory Challenges ... and Opportunities

> ***Costs and delays translate into revenue losses for any business or organization.***

Business interests that must comply with regulations, especially those associated with labor, assert the layering of local mandates on top of state mandates (and vice versa) results in excessive costs, unintended consequences, and unfair compliance burdens. While understanding and even supportive of the objectives of these mandates, they cite as an example the recently enacted state minimum wage increase to $15 per hour causing salary compaction with those already earning $15 per hour for performing more complex duties.

Across all industries and business sizes, the reform commonly identified as likely to have the most positive impact on California's business climate, housing development, job growth, and economic prosperity is revising the California Environmental Quality Act of 1970 (CEQA) in a meaningful way. CEQA was well-intentioned to protect our state's precious natural resources. Over time, it has spawned an approval process that is complex, burdensome, and prone to time-consuming and costly litigation. Speed to market can make or break a business, and projects can be brought to a halt by competitors or special interests abusing the CEQA process for their own material gain. These costs and delays translate into revenue losses for any business or organization, including the state. Reforming CEQA is as important as reforming our tax system. Similarly, it will require diverse stakeholders to rise above self-interests that impede any meaningful attempts to improve the situation.

Yet many of these business interests see new economic opportunities as the state colors the business climate green with its focus on sustainability. They regard the state as already invested in promoting an economic framework directed at environmental sustainability with a focus on greenhouse gas reductions by all sectors (e.g., public, private, utility, transportation). Therefore, there is potential to improve the tax system and induce economic development to achieve a more sustainable economy by blending green economic incentives and tax policy; and leveraging state laws that can foster public-public and public-private partnerships to generate investments.

Chapter 6

Time for Change

Given the significant demographic and economic shifts in California's economy, reform of the state's tax structure is long overdue. Achieving comprehensive tax reform is a long-term endeavor that requires public education and broad engagement. This effort must start now while California continues to experience fiscal stability.

The good news is that everyone has an opinion about taxes.

We invite community organizations, civic groups, universities and colleges, chambers of commerce, journalists, the philanthropic community, and others to join in facilitating meaningful future conversations. Some Council members suggest before major tax reform proposals are considered, a standard procedure should be established using the criteria discussed in this framework.

Some Guiding Principles

To assess specific tax reform proposals, the members of the Council agreed on the following guiding principles.

Effects on People
Promote tax fairness and equity

Budgetary and Fiscal Policy
Encourage revenue sustainability
Enhance comprehensive taxation
Promote revenue stability
Encourage systemic flexibility and adaptability
Adjust state-local alignment

Economy
Promote economic vitality
Encourage revenue sustainability
Address infrastructure, housing, and transportation needs

Compliance and Administration
Make it easier for taxpayers to comply
Ease tax administration
Ease regulatory requirements

Balancing Tradeoffs

Comprehensive tax reform has eluded policymakers because of the necessary hard choices such reform would entail. Among the tradeoffs are:

Local Fiscal Discretion. Will reform address current local dependence on state fiscal policy? Will local governments be given greater discretion to set their own tax and spending policy? If local governments are given discretion to raise taxes, should state tax levies be reduced commensurately?

Changes for the Tax on Capital Gains. If reform reduces income taxes paid by investors, will other taxpayers be expected to make up for the foregone revenue?

Financing an Increase in Critical Infrastructure like roads. Should users—like drivers—be expected to pay for the full cost of infrastructure improvements through user fees? Or, should taxpayers also pay a share through higher sales and personal income taxes?

Improving Government Performance. Will improved service cost more? Can taxes be cut and service delivery be improved? How will reform ensure improved transparency and performance? What can be done to improve accountability?

Fostering an Improved Business Climate. Will tax reform include reductions in regulations and compliance costs? If so, how will the changes affect Californians not directly regulated?

Who Bears What Burden? Should the poorest continue to bear the great burden of the state not investing adequately in child care and other programs with the potential of lifting families out of poverty?

At its heart, a tax system is a social compact detailing how to pay for the common good. Definitions of what constitutes the common good may vary. However, people across the political spectrum agree that California's current tax structure does not reflect the times. Regardless of our differences, we must work together now to fix it.

Appendix I

A Brief History of Major Tax Changes in California, 1979-2015

Since 1995, the California Legislature has considered more than 4,600 bills concerning taxation. On average, policymakers review 245 bills per year that propose changing the way Californians are taxed. The majority of these bills are considered in the Assembly (62 percent).

Over time, the yearly number of tax bills has declined from 368 bills in 1995 to just 85 in 2013. Personal income tax bills are the most prevalent (2,361; 50 percent), followed by property tax (804; 17 percent) and sales tax (768; 16 percent).[1]

In California, state tax collections are the primary source of state revenue. Two particular taxes, sales and use tax, and personal income tax, historically comprise and account for the majority of all tax revenues collected.[2] The central relationship of these two taxes to the financial health of California means that any change in them may increase or decrease state revenues, and may affect the quality of life for all Californians.[3]

While there have been proposals to reform the state tax system,[4] during the period this history attempts to cover there has not been a successful major reform. According to one scholar, "everyone agrees that tax reform is needed; it's just that they differ on how the tax system should be changed."[5]

Consequently, despite the "push and pull of the marketplace of ideas"[6] about the subject of tax reform, this 36-year history is left with "only minor tweaks to talk about"[7] and offers a summary of those proposals for change successfully enacted by the Legislature or the voters.

Prepared at the request of State Controller Betty Yee, this document presents a brief history of major tax changes in California from 1979 to 2015.[8]

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[1]These numbers are from a preliminary review of CalTax data and are most likely understated due to the incomplete categorization of the dataset.

[2]Research suggests that states that seek to pursue an ultimately stable course must include in their revenue streams both a retail sales tax and an income tax. See Herwig Schlunk, "Why Every State Should Have an Income Tax (and Retail Sales Tax, Too)," *Mississippi Law Journal* 78, No. 3 (Spring 2009) 637-703, included in California Research Bureau's Annotated Bibliography – Fiscal Policy and Revenue Structure (Oct. 2015).

[3]John Decker (2009), *California in the Balance: Why Budgets Matter*. Berkeley: Berkeley Public Policy Press, p. 53. Research into the relationship between state fiscal policy and economic performance suggests that the effects of such policies on personal income tax will be contemporaneous. See Victor Canto and Robert I. Webb, "The Effect of State Fiscal Policy on State Relative Economic Performance," *Southern Economic Journal,* 54, No. 1 (July 1987) 186- 202, included in California Research Bureau's Annotated Bibliography – Fiscal Policy and Revenue Structure (Oct. 2015).

[4]Concerning California's tax history, there have been two successful tax commissions which charted major reforms (1906, 1929) and two dramatic changes that took place outside of commissions: the Riley-Stewart initiative (1933) and Proposition 13 (1978). More recently, the California Commission of the 21st Century (2009) made some key recommendations but was not seriously considered. See Steven M. Sheffrin, "Tax Reform Commissions in the Sweep of California's Fiscal History, *Hastings Constitutional Law Quarterly*, Vol. 37, No. 4, Summer 2010, pp. 661-688.

[5]Kirk J. Stark, "Houdini Tax Reform: Can California Escape its Fiscal Straitjacket?." *California Policy Options*, 2011. p.1.

[6]John Decker, phone communication. October 2, 2015.

[7]Darien Shanske, Professor of Law, University of California, Davis, email communication, November 2, 2015. Professor Shanske does, however, identify three broad points about tax reform throughout the time period that may be relevant for the reader to consider: (1) the integration of the post-Proposition 13 state public finance system around education; (2) the consistent earmarking of revenue that serves as "piecemeal reform to earmark more and more of the state budget"; and (3) the continued decline, over time, of the sales tax and the corporate income tax.

[8]The primary published resource relied upon for the preparation of this brief history is David R. Doerr (2000, 2008), *California's Tax Machine: A History of Taxing and Spending in the Golden State*, Sacramento: California Taxpayers Association. Because understandings of the term "reform" can be different depending upon one's perspective, we use the phrase "major tax changes" to factually describe adjustments made to the tax structure over time that were the result of the budget process, legislation or voter approval.

1979

In the year immediately following the adoption of Proposition 13 on June 6, 1978,[9] policymakers reduced taxes, negotiated a repeal of the inventory tax, engaged in regulatory reform and nurtured the beginning changes to the way the state taxes multinational businesses, eventually to be known more commonly as unitary reform. Voters also played an active role in fiscal change. Passed in a special election (74 percent), Proposition 4 (1979) added Article XIIIB to the California Constitution.[10] This measure established and defined annual appropriation limits on state and local governmental entities based on annual appropriations for the prior fiscal year. Requiring adjustments for changes in cost of living, population and other specified factors, any revenues the (state and local government) received in excess of appropriations permitted were to be returned to taxpayers by revision of tax rates or fee schedules within the two following fiscal years. At the time, experts could not estimate the expected revenue impact of the measure, but they believed that the financial impact depended on whether state and local governments would have access to other appropriations that were not subject to the limitations of the measure.[11]

1980s

Throughout the early 1980s, policymakers maintained a careful balance between revenues and expenditures due to the expected uncertainties from implementing Proposition 13. Additional legislation ensured the continued shift of property taxes to aid local governments on a proportional basis, using an apportionment formula that allocates countywide property taxes to the various county jurisdictions.[12]

During the 1981 budget year, legislators repealed a major package of tax subsidies, and instead of shifting property tax revenues back to schools, they initiated an effort to recapture taxes on business personal property, boats, berths, and possessory interest in space from local government. They increased the gas tax and passed legislation accelerating revenue collections. The recession that began in 1981 continued into 1982, and as voters passed additional inheritance tax relief (Propositions 5 and 6) and partial indexing of state personal income tax (Proposition 7), policymakers negotiated accelerated sales tax collections to increase revenues.

Proposition 5 (1982) amended the tax code to repeal statutes governing gift and inheritance taxes. Expressly prohibited by this measure, gift and inheritance taxes would only be allowed as a state “pickup” tax on decedents’ estates at rates set by a schedule of credits for state death taxes in conformity with the Federal tax code. The Legislature was required to provide for both the collection and administration of the “pick up” tax. Voters approved the measure (62 percent) in a primary election.[13] At the time, it was estimated that the measure would reduce state inheritance and gift tax revenues by about $130 million in the current budget year, by $365 million in the subsequent year, and higher amounts in the years after that. Analysts believed that repealing the gift and inheritance taxes would save the state

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[9]For a review of the historical patterns and potential full effects of Proposition 13, see Fred J. Silva and Elisa Barbour. *The State-Local Fiscal Relationship in California: A Changing Balance of Power* (San Francisco, CA: Public Policy Institute of California, 1999), included in California Research Bureau’s Annotated Bibliography – Fiscal Policy and Revenue Structure (Oct. 2015).

[10]The measure was supported by Paul Gann, the coauthor of Proposition 13, and Carol Hallett, Assembly Minority Leader and Member of the Assembly, 29th District. It was opposed by the California Tax Reform Association, League of Women Voters of California, and California Labor Federation, AFL-CIO.

[11]Limitation of Government Appropriations California Proposition 4 (1979). http://repository.uchastings.edu/ca_ballot_props/864. Accessed 10/5/15.

[12]Terri Sexton, California State University, Sacramento, email communication. October 23, 2015.

[13]The measure was opposed by the League of Women Voters of California; California State Parent Teachers Association and California Gray Panthers.

approximately $6 million annually in administrative costs. However, any resulting reductions in state revenue from these expected savings would result in corresponding reductions in the amount of fiscal relief provided by the state to local governments and schools.[14]

A second initiative aimed at gift and inheritance taxes also passed in 1982. Opposed by the same group that opposed Proposition 5, Proposition 6 (1982) amended the tax code to allow for the "pickup" tax on decedents' estates to be measured by the maximum credit against federal estate taxes allowed by federal law. Further, the combined federal and state estate tax liability could not exceed the federal tax liability for property located in California if a state tax was not imposed. Supported by members of the Assembly, Senate, and the Senate Finance Committee, this measure was passed by voters (64 percent). Estimates prepared by the Legislative Analyst concerning this measure were the same as those for Proposition 5.[15]

Passed by 64 percent of voters in a primary election, Proposition 7 (1982) made possible the partial indexing of state personal income tax. Amending the tax code to allow for graduated state personal income tax brackets, these brackets would then be adjusted annually by applying an "inflation adjustment factor" determined by the percentage change in the California Consumer Price Index. While at the time the full percentage change was applied to selected brackets on a temporary basis, in the current year and going forward percentage changes in excess of three percent would be utilized. The measure was expected to reduce state personal income tax revenues by about $230 million in the current year, twice that amount in the next year, and increasing amounts in the future. Under existing law reductions in revenue would reduce fiscal relief provided to local governments and schools.[16]

In 1982, the Legislature reduced tax subsidies to local government. To balance the budget and ease the decline toward a deficit, legislators used one-time revenues, non-resident taxation, and a ridesharing tax credit. Tax increases, expenditure reductions, and revenue accelerations were measures discussed to mitigate declining revenues and turn the state around in 1983. The budget compromise bill that year included a "carry-forward" of a portion of the deficit, short term borrowing, and further reductions in tax subsidies to local government.

Further efforts in 1984, such as expenditure freezes and reductions, balance transfers from general fund to special funds, another "carry-forward" of the deficit, authorization of short term borrowing, and even more reductions in local government subsidies helped bring the budget back into significant balance and ensure a small surplus. Additionally, a set of supplemental reforms continued this positive trend, including: expenditure reductions and reversions to the General Fund, an increase in the corporate estimated payment percentage, accelerations of collection of withholding receipts from employers, and sales tax prepayments.

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[14] Gift and Inheritance Taxes (Proponent Miller). California Proposition 5 (1982). http://repository.uchastings.edu/ca_ballot_props/899. Accessed 10/5/15.

[15] Gift and Inheritance Taxes (Proponent Roger). California Proposition 6 (1982). http://repository.uchastings.edu/ca_ballot_props/901. Accessed 10/5/15.

[16] The voters had a second chance to index personal income taxes to the California Consumer Price Index in 1982. Whereas a similar effort had failed in 1980 (Proposition 9), this revised measure was presented to the electorate for their consideration a couple of years later in 1982. Major support for Proposition 7 came from Howard Jarvis and the Index the Income Tax Committee, the Lieutenant Governor, and a member of the senate. Major opposition came from a group named Californians for a Fair Index, a mathematics professor at California State University, and an assemblymember.

Legislators undertook renewed efforts toward federal conformity, closing loopholes, and enacted a trigger mechanism to conditionally increase sales tax.

As school finance started to become a more prominent issue, legislators took the following measures:

- Increased the sales tax rate;
- Repealed the candy sales tax exemption;
- Made additional efforts to close loopholes;
- Reduced and repealed numerous personal income tax credits and deductions;
- Accelerated remittances for property tax collections;
- Continued efforts at unitary tax reform;
- Evaluated tax amnesty;
- Developed enterprise zones;
- Considered a flat tax.

Unlike earlier years, there were no budget deficits in the mid-to late 1980s. During this brief 7-year span of positive revenues, policymakers focused on unitary tax and property tax assessment reforms. However, hitting the appropriation limits toward the end of the decade meant tax refunds and school finance again became the primary focus. A couple of key propositions enacted important tax changes in 1986: Proposition 47 and Proposition 62.

Passed with 82 percent of the vote in a primary election, Proposition 47 (1986) changed the California Constitution to provide for the allocation of vehicle license fee taxes to counties and cities.[17] At the time, the state was not required by the Constitution to allocate all revenue from vehicle license fee tax to local governments, only specified portions of the revenues. This measure now required all revenues from these taxes to be allocated to counties and cities, with limited exceptions.

The measure was expected to have no direct fiscal effect. Rather, it prevented the Legislature from changing the law to take any portion of vehicle license fees away from counties and cities. However, the state still could reduce other forms of aid to local government or change the existing formula for dividing vehicle license fee revenues between counties and cities.[18]

Proposition 62 (1986) added sections to the government code restricting new or increased taxation and revenue use by local governments and districts. Proposition 62 garnered 58 percent of the vote in a general election and required the following process with regard to taxes: approval by two-thirds vote of legislative body, submission of proposed tax to electorate, and approval by majority of voters concerning the imposition of special taxes, defined as taxes for special purposes. This measure featured language governing election conduct. It was believed that the measure could potentially result in the reduction of tax revenues to local agencies.[19]

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[17]The measure was supported by the California Taxpayers' Association, Santa Clara County President of the California State Sheriffs' Association, and a senator.
[18]Allocation of Vehicle License Fee Taxes To Counties And Cities. California Proposition 47 (1986). http://repository.uchastings.edu/ca_ballot_props/952. Accessed 10/5/15.
[19]The measure was supported by Howard Jarvis and the California Tax Reduction Movement; Deputy Assessor of Los Angeles County, and a senator. It was opposed by the League of Women Voters of California, California Tax Reform Association, and Federated Firefighters of California. Taxation. Local Governments And Districts. California Proposition 62 (1986). http://repository.uchastings.edu/ca_ballot_props/967. Accessed 10/5/15.

Despite a lack of yearly budget deficits, economic volatility,[20] that is, the effect of increases and decreases in revenues, led legislators during this time to establish more rigidity in the budget process to mitigate the volatility. In 1987, to avoid slipping into deficit spending and balance the budget, the notion of the supplemental roll[21] and the end of omnibus trailer bills returned.

The last two years of the decade found legislators trying their best to reverse an impending economic decline. Bills introduced to suspend tax indexing, adopt conformity items, defer the carryforward, and accelerate tax collections were voted down. In their place, a package of targeted tax reductions including sales tax exemptions for bunker fuel, motion picture production services, childcare facilities and senior citizens emerged.

In 1988 school funding was in sharp focus. In a general election, Proposition 98 (1988) passed with 51 percent of the vote. An initiative which amended the California Constitution and the education code to establish a minimum level of state funding for school and community college districts, Proposition 98 included provision for transferring to such districts, within limits, state revenues in excess of State's appropriations limit and exempting these excess funds from the limit. Excess funds were to be used solely for instructional improvement and accountability. Schools were required to report student achievement, drop-out rates, expenditures per student, progress toward reducing class size and teaching loads, classroom discipline, curriculum, quality of teaching, and other school matters. The measure was expected to cost of $215 million for the current year, and would have no excess revenues to transfer to schools and community colleges. Schools would be impacted by the requirement to produce School Accountability Report Cards.[22]

Since the mid-1980s, legislators had been seeking property tax reforms. The waning of the decade witnessed a set of adjustments to these taxes that included changes in:

- Purchase price presumption, full cash value and fair market value;
- Cable television assessment;
- Mining appeals;
- The property tax assessment process.

In 1988, voters increased the tobacco tax. Passed in a general election by 58 percent of the vote, Proposition 99 (1988) amended the California Constitution and the tax code to impose a yearly additional tax upon cigarette distributors for each cigarette distributed. Other tobacco products were subject to this additional tax, equivalent to combined rate of tax imposed on cigarettes. Funds raised by these taxes were earmarked for treatment, research of tobacco-related diseases, school and community health education programs about tobacco, fire prevention, and environmental conservation and damage restoration programs. The funds from this tax were not to be subject to appropriations limits. While this measure would increase revenues by $300 million in the current year and by twice that amount in the

[20]For a fairly recent evaluation of state revenue variability using a volatility model, see Thomas Garrett, *Evaluating State Tax Revenue Variability: A Portfolio Approach* (St. Louis, MO: Federal Reserve Bank of St. Louis, February 2006), included in California Research Bureau's Annotated Bibliography – Fiscal Policy and Revenue Structure (Oct. 2015)

[21]"The supplemental roll provides a mechanism for placing property subject to Proposition 13 reappraisals due to change in ownership or completed new construction into immediate effect. Changes in ownership or completed new construction are referred to as 'supplemental events' and result in supplemental tax bills that are in addition to the annual property tax bill." For more information see https://www.boe.ca.gov/proptaxes/faqs/suppassessment.htm. Accessed 11/13/15.

[22]Major supporters of Proposition 98 included the California Teachers Association, California State Parent Teachers Association, State Superintendent of Public Instruction, and Association of California School Administrators. Opposed to the measure were the Governor, California Commission on Educational Quality, and California Taxpayers' Association. School Funding California Proposition 98 (1988). http://repository.uchastings.edu/ca_ballot_props/979. Accessed 10/5/15.

second year, these revenues would decline gradually in later years. The measure would not to affect sales and excise tax revenues to local governments.[23]

As the decade came to a close, the implementation of unitary reform continued. To prevent tax agency abuses and to ensure better service from the Board of Equalization and Franchise Tax Board, a long awaited taxpayer bill of rights passed. To avoid difficulties with federal/state tax conformity, the Governor signed a bill in 1989 to address outstanding issues.

1990s

For 1990, an unexpected decline in revenues required Legislative compromises to raise them. Implementation of withholding on property sales by non-residents, a cut in the renter's credit, revision of policy concerning unclaimed property of Californians who die without legal heirs, and the authorization of counties to impose various taxes were forwarded as remedies. Emphasis on business climate issues resulted in a foreign purchases tax and a push toward diverse business regulations.

Voters weighed in on the congested state of California's transportation system at the ballot box, passing taxes on truck weight fees and fuel. Proposition 111 (1990) was approved by the Legislature and passed with 52 percent of the vote in a primary election. This measure enacted a statewide traffic congestion relief program and updated the spending limit on state and local government to better reflect the needs of Californians in terms of mass transit, health care, services for the elderly, and programs. It included provisions to ensure that school appropriations remain constant and that any excess revenues above the limits are shared between taxpayers and education.[24]

Further tax increases were necessary in the wake of a subsequent downturn in revenues in 1991. Policymakers again worked to reform the property tax shift initiated in 1979. The sales tax rate, vehicle license fees, alcohol and beverage taxes, the alternative minimum tax, and personal income tax rates were increased. Higher income taxpayers were excluded from the renter's credit, net operating loss tax deductions for businesses rose, and small business health insurance tax credits were delayed. Measures to improve the business climate included an extension of the research and development tax credit. Conformity with federal tax policy hiked taxes.

In 1992, efforts to reform the property tax allocation formula continued. Policymakers approved measures to shift property taxes from cities, counties, and special districts to schools. Tax relief for this year was thinner than in previous years, and it included credits and exemptions for forest fire victims, child care facilities, and the blind. Legislators agreed to an estimated tax increase paid by multinational corporations. A roll back of increases on taxes on fuel oil used aboard vessels was achieved.

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[23] Major supporters of Proposition 99 included a retired Surgeon General, the American Cancer Society, The Wilderness Society, Attorney General, State of California, American Lung Association, and California Association of School Health Educators and Health Teachers. Opposed to the measure were Paul Gann and the People's Advocate, the Latino Peace Officers Association, a couple of assembly members and the Chair of the Governmental Organization Committee, as well as the Vice Chairman of the Ways and Means Committee. Cigarette and Tobacco Tax. Benefit Fund. Initiative Constitutional Amendment and Statute. California Proposition 99 (1988). http://repository.uchastings.edu/ca_ballot_props/980. Accessed 10/5/15.

[24] Major supporters of this measure were the California Association of Highway Patrolmen, California Chamber of Commerce, Governor, California Taxpayers Association, and American Association of Retired Persons. Opposed to the measure were a Los Angeles County Supervisor, an assemblymember, and an economic consultant. The Traffic Congestion Relief And Spending Limitation Act Of 1990 California Proposition 111 (1990).

Once again, the 1993 budget compromise included a shift in property tax from cities and counties to schools to attain fiscal balance. A bundle of measures contributed to this cause, including an extension of the sales tax rate increase that had been set to expire, and the repeal of the renter's tax credit. Additional changes were: spending reductions, cash deferrals, rollover of the deficit, and the shift of special fund monies.

There was legislation to improve business climate, such as:

- Exempting new manufacturing equipment from sales tax;
- Offering income, bank and corporation tax credits for investment in equipment;
- Reducing the tax rate for corporations with 100 shareholders or less;
- Extending the research and development credit;
- Exempting specified gains on sales of small business stock.

Discussion of the nuances of unitary reform returned this year. These discussions were accompanied by increases in the cigarette tax, abatements to local taxes, and the modification of tax treatment of net operating losses.

Secure, adequate funding for public safety at the local level was on the minds of voters in 1993. Passed in a special election with 58 percent of the vote and approved by the Legislature, Proposition 172 (1993) provided a dedicated revenue source for public safety purposes. Revenue would be distributed to cities and counties for police, sheriffs, fire, district attorneys and corrections purposes. The measure generated $714 million in the first year, and $1.5 billion annually, in additional sales tax revenue for counties and cities.[25]

Closure of the budget gap in 1994 was handled by rolling over the deficit, but complicated by short term borrowing and federal/state tax conformity issues. Policymakers passed an adoption credit, considered a new investment tax credit, and recognized a new form of business (the limited liability company). Whereas in prior years policymakers had relied on static revenue models, these models were increasingly incapable of accurately predicting future economic circumstances and dynamic revenue forecasting methods were adopted in their place.[26]

Compromises of a different sort took center stage in the mid-1990s. Increased revenues from 1995-1998 shifted the debate from increasing declining revenues to how to spend surplus funds in the budget. Some legislators thought the extra funds should be returned to tax payers, while others wanted to fulfill unmet needs in existing programs or create new ones. Despite increased funds overall, a lack of consensus caused a set of temporary tax brackets to expire. This led to a significant reduction in income tax revenues.

A key turning point in taxation during this time was the recommendation of a three-year, phased in reduction of personal income, bank and corporation tax rates. Property taxes witnessed significant changes concerning possessory interest in property, escape assessments, interest rates on property tax

[25]Major support for the measure included the Orange County Sheriff-Coroner, a senator, the California State Sheriffs' Association, Los Angeles Police Department, Los Angeles County Sheriff, California Police Chiefs' Association, and California Fire Chiefs' Association. Opposed to the measure were a couple of assemblymembers and the Center for the California Taxpayer. Local Public Safety Protection and Improvement Act of 1993. California Proposition 172 (1993). http://repository.uchastings.edu/ca_ballot_props/1087. Accessed 10/5/15.
[26]A more recent use of a dynamic panel-data model to develop a measure of business cycle related revenue gap is featured in Sunjoo Kwak, "The Dynamics of State Fiscal Behavior Over the Business Cycle: Are State Fiscal Policies Procyclical?" *The American Review of Public Administration* 44, No. 5, (September 2014) 550-574, included in California Research Bureau's Annotated Bibliography – Fiscal Policy and Revenue Structure (Oct. 2015).

refunds, and assessment appeals. Confrontations between taxpayers and assessors over assessment practices led to attempts to reform, improve, and standardize how property is assessed for tax purposes.

Unresolved concerns about property taxes and assessment practices led voters to pass a measure that limited the authority of local governments to impose taxes and property-related assessments, fees, and charges. Passed by 57 percent of voters in a general election, Proposition 218 (1996) enacted a constitutional amendment that requires the approval of a majority to increase general taxes and reiterated that two-thirds of voters must approve any special taxes. Assessments, fees, and charges must be submitted to property owners for approval or rejection, after notice and public hearing. Assessments are limited to the special benefit conferred. Fees and charges are limited to the cost of providing the service and may not be imposed for general governmental services available to the public. Revenue losses in excess of $100 million a year were expected as a result of the measure, and long term losses even greater.[27]

Cuts to the bank and corporation tax and a set of targeted tax measures were negotiated in the wake of renewed budget difficulties in 1996. Included in this set of business-related measures were:

- Increases in the research and development credit and small business expensing;
- Standardization of the rate associated with the exclusion of foreign dividends;
- Exemption of aircraft repairs from sales tax;
- Reduction of the minimum franchise tax on new small businesses;
- Extension of the investment credit for manufacturers.

Individuals saw increases in the amount they could claim for long term medical care expenses and insurance costs. Federal/state tax conformity addressed moving issues, valuation of assets at recent market price ("mark-to-market" accounting), and corporate owned life insurance policies. Continued concern about aggressive enforcement by tax agencies led to legislation that favored business climate issues for exhibitors who visit California for trade shows. The source tax for non-resident former California pensioners was terminated this year.

Success with collective compromise in 1997 meant that the budget package passed on time. It featured an increase in the credit for dependents and an exemption for the alternative minimum tax. The budget included measures aimed at federal/state tax conformity focused on the research and development tax credit, capital gains, and corporations with 100 shareholders or less. Policymakers expanded the income limits deductible in individual retirement accounts and passed a variety of incentives aimed at fostering economic development. Business climate measures extended the bunker fuel sales tax exemption and authorized a capital investment incentive for qualified manufacturing facilities.[28]

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[27]Major supporters of the measure included the Howard Jarvis Taxpayers Association, Consumers First, Paul Gann's Citizens Committee, California Taxpayers Association the Council of Sacramento Senior Organizations, and Alliance of California Taxpayers and Involved Voters. Opposed were the League of Women Voters of California, California Police Chiefs' Association, California Fire Chiefs' Association, Congress of California Seniors, California Teachers Association, and California Association of Highway Patrolmen. Voter Approval for Local Government Taxes. Limitations on Fees, Assessments, and Charges. California Proposition 218 (1996). http://repository.uchastings.edu/ca_ballot_props/1138. Accessed 10/5/15.
[28]For an in-depth perspective on how policymakers may work to reduce revenue variability from business cycle swings, see Russell Sobel and Gary A. Wagner, "Cyclical Variability in State Government Revenue: Can Tax Reform Reduce It?" *State Tax Notes*, August 25, 2003, 569, included in California Research Bureau's Annotated Bibliography – Fiscal Policy and Revenue Structure (Oct. 2015).

Tax issues in 1998 focused on the vehicle license fee and a host of other measures. Rising revenues led policymakers to again negotiate a compromise between spending the increase and distributing the surplus back to taxpayers. This year, reaching a compromise took longer than the year before. The budget included a number of tax relief provisions:

- Reduction of the minimum tax for small businesses;
- Increase in the research and development credit;
- Expansion of manufacturers investment credit;
- Exemption for property used in production services for film and video;
- Increase in deduction for health insurance for the self-employed;
- Permanent extension of employer child care credits;
- Sales tax exemption for property used in space launches;
- Modification of enterprise zones;
- Equal tax treatment of perennial plants used in food production.

Important legislation passed to ensure the internet would remain tax free for 10 years, expand a use tax incentive for farmers to keep their land in agricultural use, and authorize a formula for the assessment of possessory interests for airlines. Federal/state conformity legislation involved the estate tax interest rate.

Conversely, voters focused on using a tax on tobacco to fund programs on smoking prevention and early childhood development. Exempt from the Proposition 98 requirement that dedicates portion of general tax revenues to schools, Proposition 10 (1998) was passed by 50 percent of voters in a general election as a constitutional amendment. To provide funding for state and county commissions and programs, monies were raised by an additional $.50 per pack tax on cigarette distributors and an equivalent increase in state tax on distributed tobacco products. The initiative created a state commission to provide information and materials and to formulate guidelines, and created county commissions to develop strategic plans with an emphasis on the new programs. New revenues for early child development from the measure were expected to amount to $400 million the first year, and $750 million annually to be allocated to the new state and county commissions for the new program.[29]

As the decade came to a close,[30] the vehicle license fee tax cut was increased, along with the credit for research and development. Whereas previously small businesses were required to pay a minimum franchise tax, this tax was completely eliminated. The tax exclusion for capital gains was made permanent and the deduction for health insurance for the self-employed was increased in conformity with federal tax policy.

[29]Major supporters of the measure were the I Am Your Child Campaign, American Cancer Society, California School Boards Association, and a former Surgeon General of the United States. Opposed to the measure were the Alliance of California Taxpayers & Involved Voters, California Manufacturers Association, a school board member, a physician, a teacher, and a business owner. State and County Early Childhood Development Programs. Additional Tobacco Surtax. California Proposition 10 (1998). http://repository.uchastings.edu/ca_ballot_props/1162. Accessed 10/5/15.
[30]For a characterization of state and local finance since Proposition 13, see Michael A. Shires, *Patterns in California Government Revenues Since Proposition 13* (San Francisco, CA: Public Policy Institute of California, 1999), included in California Research Bureau's Annotated Bibliography – Fiscal Policy and Revenue Structure (Oct. 2015).

2000s

Surplus monies in the budget drove the reductions, increases, extensions, and exemptions that continued into 2000. A prominent feature during these years was the use of trailer bills as a vehicle for making tax changes. Spending increases and tax reductions continued and the Legislature accelerated phased-in car tax reductions. Tax trailer bills in 2000 included:

- Increase in the research and development credit;
- A tax credit for teachers based on years of service;
- A tax credit for child care expenses for low and middle income taxpayers;
- An increase in the net operating loss that could be carried forward for businesses;
- A tax credit for donation of land to public agencies and non-profits;
- Property tax relief for low income seniors;
- A tax credit for persons needing long term care;
- A sales tax exemption in rural areas for purchases of machinery and equipment;
- Taxable income exclusion of graduate level school assistance.

Other tax bills featured: the expansion of innocent spouse relief, an increase to the tire tax, and capping of the tax on boxing and wrestling admissions. Efforts aimed to ensure conformity of state taxes to federal taxes were not passed. Efforts to tax electricity generators, based on consumer cost of electricity, failed.

Although the budget was balanced in 2001, anticipated shortfalls caused uncertainty. Despite this uncertainty, a substantive package of tax reforms passed. These included a restructuring of the sales tax "trigger" mechanism and sales tax exemptions for:

- Liquid petroleum gas purchased through main gas supply pipelines;
- Farm and forest machinery and equipment;
- Diesel fuel used in farming and food processing;
- Thoroughbred horses used for breeding.

The appeals process for property taxes changed, allowing owners more time to appeal. Property tax relief increased for low income seniors. Other efforts at property tax reform, such as taxes on electricity generators and efforts to allow trials to start from the beginning of the process (*de novo*) in property tax appeals, failed.

2001 is notable as the beginning of the "structural deficit" in California's budgetary history. This term relates to the difference between projections of revenues and expenditures in the context of normal and cost of living increases, as well as automatic spending formulas built into the budget.[31] Unsustainable spending of temporary tax revenues, the "auto-pilot" nature of initiatives, collective bargaining contracts, cost of living increases, debt service costs, and an added decline in revenues in the early 2000s brought on by the structural deficit forced legislators to find additional ways to balance the budget.

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[31]See Robert D. Ebel, ed., *The Oxford Handbook of State and Local Government Finance*, New York: Oxford University Press, 2012, included in California Research Bureau's Annotated Bibliography – Fiscal Policy and Revenue Structure (Oct. 2015) for a more complete evaluation of the persistent problems of state and local deficits in governmental fiscal systems.

In 2002, a rapidly rising structural deficit caused a general suspension of spending. Tax increases were proposed for cars and cigarettes. Budget negotiations stalled, and the budget did not pass until August. The following measures enacted in 2002 reflected this continuing concern about the structural deficit:

- The net operating loss "carry forward" deduction was suspended;
- Suspension of the teachers tax credit;
- Withholding on stock options and benefits increased;
- Real estate sales tax withholding expanded to include state residents;
- Limited amnesty to delinquent taxpayers;
- Bad debt losses at banks were actualized.

Businesses were affected. Workers compensation benefits and unemployment insurance premiums increased. Deductions for executive salaries and lobbying expenses were denied in conformity with federal tax law.

In 2002, more funding was needed for California's transportation system. This resulted in a sales and use tax measure on vehicle fuel, which provided increased revenues for public transit, streets, roads, and highways. Approved by the Legislature and passed by 69 percent of voters in a primary election, Proposition 42 (2002) required that state sales and use taxes revenues on sale of motor vehicle fuel were to be used for public transportation, city and county street and road repairs and improvements, and state highway improvements. The measure required a two-thirds vote of the Legislature to suspend or modify percentage allocations of revenues. The measure was expected to raise $1.4 billion in the first year, with revenues increasing in the following years.[32]

An even higher estimated structural deficit in 2003 led to continued concern. Again, the solution focused on the car tax, which was increased administratively despite legislative opposition. Lack of a trailer bill meant that tax changes were part of the budget package. Besides the increased car tax, parcel taxes on real property in rural areas rose, water rights holders now paid an annual tax, and hunters and fisherman were hit with increases in licensing fees. How best to tax services received stakeholder attention during 2003, but the idea did not catch on.

Further, legislators passed bills to curb the use of tax shelters and underreporting of taxes, increased the sales tax on television sets and computer monitors, and sought to charge employers new taxes on health care. They tried to require local governments to fund public pension obligations with property tax increases, to make changes to how multinational corporations account for former domestic enterprises, and have owners of non-residential property pay higher taxes.

Reduction of the premium costs for workers compensation insurance followed in 2004 as legislators sought to make California friendlier for business. In response to the structural deficit situation, policymakers reduced spending and increased borrowing to keep the state budget in balance. Legislators managed to again shift property tax monies away from local governments to the schools to meet the state's educational needs, suspend tax credits for teachers and natural heritage, and alter taxation of

[32]Major supporters of Proposition 42 included the California Highway Patrol, California State Automobile Association, California Organization of Police and Sheriffs, California State Office of Emergency Services, a former member of the California State Board of Education, and President California Taxpayers' Association. Opposed to the measure were the California Teachers Association, Congress of California Seniors, Health Access of California, California Tax Reform Association, Latino Issues Forum, and California State Firefighters' Association. Transportation Congestion Improvement Act. Allocation of Existing Motor Vehicle Fuel Sales and Use Tax Revenues for Transportation Purposes Only. California Proposition 42 (2002). http://repository.uchastings.edu/ca_ballot_props/1200. Accessed 10/5/15.

property purchased outside of California to benefit the state. Efforts to increase the property tax rate on commercial property to benefit schools received attention but did not move forward.

Tax amnesty was in focus in 2004. Passed as part of the trailer bill package, taxpayers could obtain waivers for late payment penalties if they cleaned up any unreported taxes, if they participated in an installment repayment plan. Attempts to forestall the expiration of the manufacturers' investment tax credit on the cost of new manufacturing equipment were unsuccessful.

Additionally, policymakers sought to increase the size of the General Fund reserve as a buffer against future economic uncertainty and passed a legislative constitutional amendment that would have increased size of state "rainy day" fund from 5 percent to 12.5 percent of the General Fund. The proposed measure called for a portion of the yearly deposits from the increase to be saved in a special fund for potential and future economic downturns. It allowed for any remaining funds to be available in an emergency for education, infrastructure, and debt repayment. The measure would provide $16 billion in higher revenues the first year, and increased revenues thereafter. While the measure was believed to stabilize state spending, it also meant greater budgetary spending to balance out potential temporary tax relief, debt and borrowing, as well as infrastructure projects. The measure, Proposition 1A (2004), was rejected by 65 percent of voters.[33]

In 2005, a reduced structural deficit initially meant significant reductions in proposed spending, but incoming higher revenues eliminated the need to make cuts. This year, minor changes in taxation took place in the form of a conformity bill and a bill changing the way commercial aircraft is assessed.

The budget passed on time in 2006 in spite of a continuing structural deficit, the result of unexpected higher revenues. The earlier suspension of the teacher tax credit continued. Changes were made to the way property (vehicles, boats, and planes) purchased outside of California is taxed. Bills requiring the development of property tax assessment valuation tables as well as joint income tax status for registered domestic partners passed. Initiatives that failed to become laws included: taxing the rich to pay for universal preschool, taxing cigarettes and oil produced in California to subsidize energy alternatives, a statewide parcel tax to fund education, and increasing business taxes to fund political campaigns.

Budget negotiations in 2007 were strained and late. The teacher tax credit ended, changes in taxation of fractionally owned aircraft were negotiated as well as changes in how to tax limited liability companies. Vehicle registration fees increased. Foster children were included in the parent-child definition when reassessing property tax and change-of-ownership. Reform legislation passed for the unclaimed property program. This legislation required the state to notify owners when assets are seized.

[33]The measure was supported by the California Taxpayers' Association, California State Sheriffs' Association, California Secretary of Education, California Chamber of Commerce, Senior Advocates League, and California Alliance for Jobs. Major opposition to the measure included the Congress of California Seniors, California Faculty Association, Consumer Federation of California, Health Access California, United Nurses Associations of California/Union of Health Care Professionals, and Older Women's League of California.
State Budget. Changes California Budget Process. Limits State Spending. Increases "Rainy Day" Budget Stabilization Fund. California Proposition 1a (2009). http://repository.uchastings.edu/ca_ballot_props/1294. Accessed 10/5/15. For a summary of the relationship between state and local fiscal concerns from Proposition 13 to Proposition 1a, see Elisa Barbour, *State-Local Fiscal Conflicts in California: From Proposition 13 to Proposition 1A* (San Francisco, CA: Public Policy Institute of California, December 2007), included in California Research Bureau's Annotated Bibliography – Fiscal Policy and Revenue Structure (Oct. 2015).

Revenues declined in 2008. An inability to effectively estimate the size of the budget's structural deficit led to continued turmoil. Tax changes this year included:[34]

- 20 percent penalty on corporate taxpayers with unpaid tax liabilities;
- Business tax credits reduced to aggregate of 50 percent of tax liability;
- Suspension of net operating loss carryforwards for the current and next fiscal year;
- Acceleration of the percentage of estimated tax payments;
- Elimination of property tax relief for low income seniors and Californians with disabilities.

Significant differences between structural deficit projections caused continued consternation during the 2009 budget process. It led to the passage of legislation that severely cut programs and services. Homeowners received some assistance by the authorization of a homeowner's tax credit.

The following temporary two year tax changes were passed:[35]

- Increase in sales tax rate by 1 percent;
- Increase in personal income tax rate by .25 percent;
- Increase in car tax rate to 1.15 percent;
- Reduction of the dependent exemption credit;
- A gross premium tax of 2.35 percent enacted on selected managed care health plans.

Businesses were affected by the temporary suspension of the net operating loss for two years, a new employee hiring credit, and a new film production credit. To provide for proper acknowledgement of the parent/subsidiary relationships that exist among companies, business tax credits concerning the unitary nature of companies were changed. The credit could be assigned, for tax purposes, to other members of the same reporting group.

2010-present

The unrelenting structural deficit from previous years signified the continuance of spending cuts into 2010. Legislators engaged in vigorous efforts to find ways to increase revenues. In turn, taxpayers sought to limit legislator's attempts to increase taxes by making sure that tax-like fees received the same level of scrutiny as taxes. At the voting booth, for example, Proposition 26 (2010) mandated a supermajority to pass a range of fees, charges, levies, and tax allocations that previously only required a simple majority. This proposition required certain state and local fees, specifically those that impact society or the environment as a result of the potential fee payer's business activities, to be approved by a two-thirds vote.[36] The purported impact of this change was decreased revenues in the range of billions of dollars per year, along with anticipated repeals of taxes and fees that would cost the General Fund an additional $1 billion per year.

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[34] "A Year Dominated by Tax Talk, but Overt State Tax Increase Proposals Are Rejected, CalTax Year in Review: 2008," http://www.caltax.org/Year_in_Review_2008.pdf. Accessed 10/30/15.

[35] "For Tax and Fiscal Policies, 2009 was a bad year, CalTax Year in Review: 2009," http://www.caltax.org/Year_in_Review_2009.pdf. Accessed 10/30/15.

[36] For an in-depth review of the debate concerning taxes vs. fees and how best to navigate the policy issues surrounding Proposition 26, see Joseph Henchman, *How Is the Money Used? Federal and State Cases Distinguishing Taxes and Fees* (Washington, D.C.: Tax Foundation, March 2013), Kurtis J. Swope and Eckhard Janeba, "Taxes or Fees? The Political Economy of Providing Excludable Public Goods," *Journal of Public Economic Theory* 7, no. 3 (2005): 405-26., and *Understanding Proposition 26: A Sponsor's Guide to California's New Tax Structure* (Sacramento, CA: California Taxpayers Association, August 2011), included in California Research Bureau's Annotated Bibliography – Fiscal Policy and Revenue Structure (Oct. 2015).

In 2010, the Legislature passed the following minor set of changes in a set of trailer bills:[37]

- Suspension of the net operating loss carryover and carry back;
- Adjustments to the 20 percent penalty on corporate taxpayers with unpaid tax liabilities;
- Changes to the way intangible sales are sourced for tax purposes;
- Services provided by nursing homes and other similar service providers subject to tax;
- Reporting of use tax from personal income tax made permanent;
- Increase in liquor license fees;
- Homeowners' tax credit reauthorized.

Further cuts and funding shifts from the state to the counties took place in 2011. As the state sought to overcome the impacts of the Great Recession, much discussion took place about tax reform options to promote fiscal recovery.[38] Concerning taxes, the Legislature passed a new sales tax for online retailers.[39] Additional legislation promoted conformity between the state and federal tax codes.

A central topic of economic policy discussion in 2012 was the issue of raising revenues through tax increases. Although a number of propositions on the ballot would increase taxes, a key initiative, Proposition 30, successfully raised much needed revenues. Passed by 55 percent of voters in a general election, the constitutional amendment imposed the following temporary measures:

- Increased taxes on individual earnings over $250,000 for seven years;
- Increased sales tax rates by .25 percent for four years;
- Allocated temporary revenues to K-12 schools and community colleges;
- Barred the use of temporary funds for school administrative costs;
- Guaranteed funding for public safety services affected by realignment.

The measure was expected to increases revenues over the future by around $6 billion on an annual basis. Additional funds would be available from this measure for state budget programs.[40]

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[37]The measure, which received close to 53 percent of the vote, was supported by the California Taxpayers Association, Howard Jarvis Taxpayers Association, Wine Institute, and Americans for Tax Reform. Opposed were the California Tax Reform Association, League of Women Voters of California, American Lung Association, Sierra Club, Peace Officers Research Association of California, California League of Conservation Voters, and California Association of Professional Scientists, as well as numerous other health, environmental, civic, public safety, labor, education, consumer and government organizations. "Taxpayers Send Message of 'No New Taxes' to Capitol as Gimmick-Filled State Budget Unravels, CalTax Year in Review: 2010," http://www.caltax.org/Year_in_Review_2010.pdf. Accessed 10/30/15.

[38]Discussion of the options before California in 2011 concerning tax reform are encapsulated in Joseph Henchman, "Recent State Tax Reforms in the United States and Opportunities for California at a Time of Fiscal Challenge," testimony, February 2, 2011, before California Senate Select Committee on Recovery, Reform and Realignment, included in California Research Bureau's Annotated Bibliography – Fiscal Policy and Revenue Structure (Oct. 2015).

[39]For more information on the tax treatment of internet purchases, see Ronald C Fisher, *State and Local Public Finance,* New York and London: Taylor & Francis Group, 2016, included in California Research Bureau's Annotated Bibliography – Fiscal Policy and Revenue Structure (Oct. 2015)

[40]The broad base of supporters of the measure included the Governor, League of Women Voters, California Democratic Party, California Teachers Association, California State Council of Service Employees, California School Employees Association, American Federation of Teachers, California Federation of Teachers, and a whole host of public safety associations. Major opposition included the Howard Jarvis Taxpayers' Association, Small Business Action Committee, California branch of the National Federation of Independent Business, California Republican Party, and Sacramento Taxpayers Association.Temporary Taxes to Fund Education. Guaranteed Local Public Safety Funding. California Proposition 30 (2012). http://repository.uchastings.edu/ca_ballot_props/1309. Accessed 10/5/15.

In addition to the tax increases associated with Proposition 30, there were a few other tax related measures in 2012:[41]

- Extension of the sales tax exemption on marine fuel;
- Imposition of a local car tax in San Francisco;
- A new state tax on fire prevention went into effect;
- A tax on lumber and engineered wood products.

Higher than expected revenues in 2013 led to a renewed discussion among lawmakers about how best to spend these excess funds. Specifically concerning taxes, the following measures were part of an economic development plan that the Governor proposed and approved after the state budget passed in June:[42]

- Sales and use tax exemption for manufacturing, and research and development equipment;
- Employment tax credit via Franchise Tax Board;
- Investment and employment tax credit via the Office of Business and Economic Development.

Legislation did not pass this year to bring federal and state tax structures into conformity. In 2013, significant debate occurred about the possibility of a split-roll property tax system. But no legislation was passed to support it or to make changes to Proposition 13.[43]

Budget negotiations in 2014 went smoother than in previous years. Higher than expected collections of personal income tax were a welcome surprise. Tax changes in 2014 included:

- Exemption of space flight property from local taxes;
- Extension of income exclusion for discharged debt on a principal residence;
- Increase in the tax credit for "California Competes";
- Expansion/extension of film and television tax credits;
- Transparency measure for parcel taxes;
- Tax credit for California-based Department of Defense bomber project;
- Expansion of the aerospace tax credit;
- Conformity to the Federal definition of limited liability companies employees;
- Businesses were required to file tax returns electronically.

Unsuccessful proposals for new taxes in 2014 were: carbon tax, oil production tax, and increased corporation taxes.

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[41] 'Governor's Tax Initiative Dominated 2012," CalTax Year in Review," http://www.caltax.org/resources/2012_year_in_review.html. Accessed 11/2/15.
[42] "2013 – The Gathering Storm," CalTax Year in Review, January 3, 2014," http://caltax.org/resources/2013_year_in_review.html. Accessed 10/30/15.
[43] "An Anticlimactic Election Year ends with Growing Talk of Future 'Tax Reforms,' CalTax Year in Review: 2014," http://caltax.org/resources/2014_year_in_review.html. Accessed 10/30/15.

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Appendix II

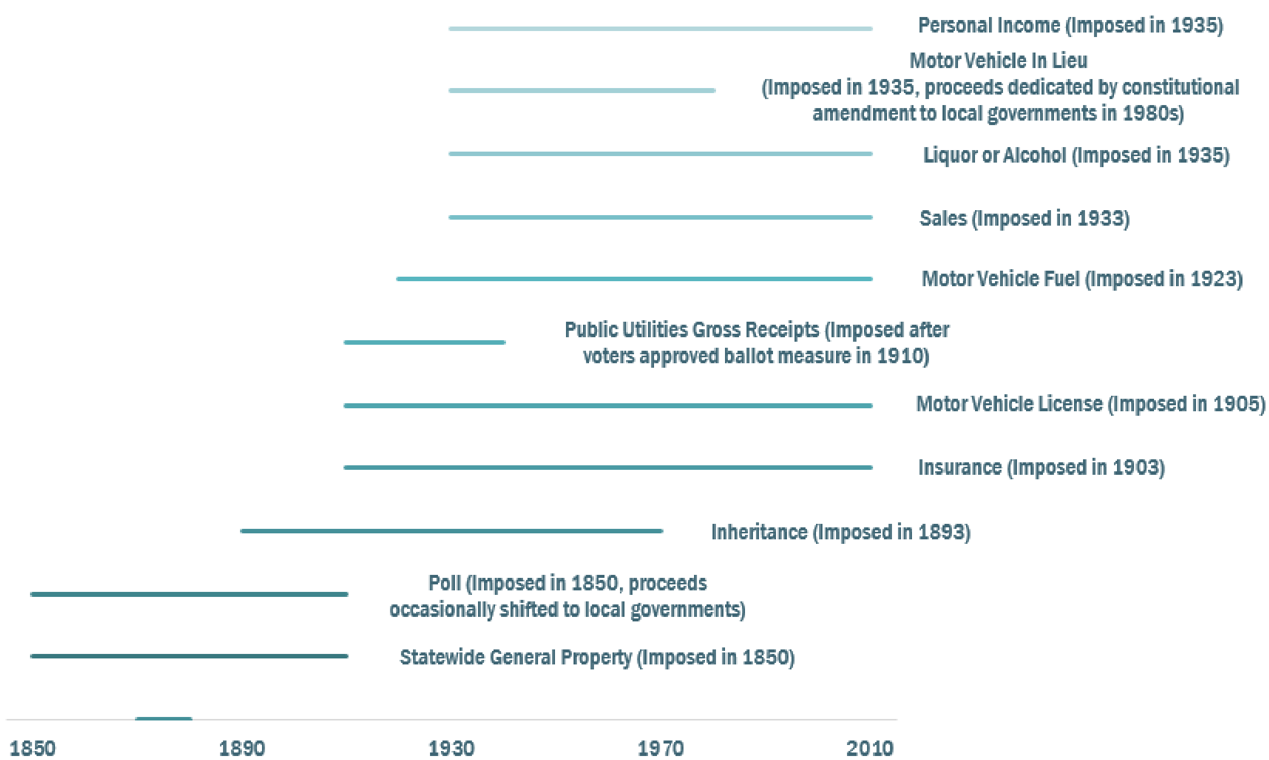
The State's Evolving Tax Structure

During its 166-year history, California has levied many kinds of taxes. Starting in 1850, it imposed a statewide ad valorem property tax, whose proceeds accounted for more than half of annual state revenues for the next 60 years. Then, for the following 20 years, the state relied on taxes levied on the gross receipts of regulated utilities (railroads, electrical companies, and telephone providers) to generate most of its revenue. Since the mid-1930s, California has relied heavily on the personal income and sales taxes.

Figure 17 graphs the history of selected statewide levies, showing when and for how long the state collected each tax. In each period, policymakers made adjustments to reflect the state's changing economic conditions. They pursued the sometimes conflicting goals of ensuring revenue sufficiency, minimizing tax burdens, and encouraging state/local financial viability.

Figure 17

Approximate Timeline for the Levying of Selected State Revenue Sources (1850 through 2010)



Source: Derived from Assembly Interim Committee on Revenue and Taxation, A Resume of California's Tax Structure, 1850-1959, pp. 9-61

Prior to adopting its structural reforms in 1911 and 1935, the Legislature appointed two tax study commissions. Strikingly, the commissions focused on four common issues:

- ***Improving Tax Fairness.*** The 1905 commission advocated a reduction in the state's reliance on the property tax because the tax was assessed differentially across counties, thereby spreading the tax burden unevenly based solely on where taxpayers lived. The commission argued that reliance on the property tax put a disproportionate tax burden on agricultural properties.

  The 1929 commission argued that the state's main tax, the gross receipts tax, was unevenly levied across utilities and imposed a higher tax burden on utilities than similar taxpayers.[27] It advocated establishing a "well-rounded" tax system relying on taxation of persons and businesses,[28] irrespective of the source of the income.

- ***Rationalizing State-Local Finance.*** The 1905 commission's most significant contribution to public finance may have been its advocacy for a separation of sources policy, which held that local governments be extended exclusive access to a robust tax base (the property tax) and that local governments be given full responsibility for managing certain programs (including K-12 education). Consistent with this policy, the state limited its tax levies to a distinct tax base it did not share with local governments. The commission recommended that the state rely on a tax on private utilities.

  In time, the separation of sources policy lost support as a financing scheme. The 1929 commission criticized the separated tax bases, saying that changes in government programs blurred the distinction between state and local services. It argued that because certain services were a shared responsibility, they should be funded jointly by state and local governments. (For example, some critics specifically argued that the separation of sources policy did not provide sufficient funding for the schools and the state should help pay.) The 1929 commission recommended the repeal of the separation of sources policy in favor of state and local governments sharing revenue bases.

- ***Improving Tax Administration.*** Calling the state property tax a "school for perjury, [which] puts a penalty on honesty," the 1905 commission called for the elimination of the statewide property tax.[29] It recommended the state establish a tax on public utilities as a way to improve the assessment and collection of state taxes. The later commission also advocated improved standards for assessing property taxes and the centralized administration of the state inheritance, automobile, and corporation franchise taxes.

- ***Aligning the Tax Structure to the Economy***. The 1905 commission called the state's tax structure "antiquated, having been adopted many years before, and not having been revised to meet modern conditions" which "distorted the symmetrical development of the State's resources."[30] Likewise, the later commission recognized the continuing diversification of the state's economy and recommended reducing the tax burden on utilities in favor of state levies on all forms of income, irrespective of source.

Getting Started (1850 to 1911)

For 15 years beginning in 1850, California financed its state operations by issuing debt and levying some taxes that were often collected episodically. By 1865, state debt had risen to an amount twice the size of the annual budget, about $5.0 million.[31]

Though the state's finances recovered after the Civil War and the state began paying down its accumulated debt, tax administration did not improve greatly until the Legislature codified its tax levies in 1871-72.[32] In that year, state revenue totaled $3.1 million. Nearly two-thirds ($2.0 million) came from the statewide property tax. Sales of state land generated another $338,000. Almost $738,000 came from other taxes.

From 1871 through 1911, the state experimented with general taxes and license fees, but its three major taxes were:[33]

- A property tax, set at 50 cents for every $100 of assessed value. It generated $3.7 million in 1881-82, $5.9 million in 1900-01, and $8.4 million in 1910-11.

- An annual poll tax set at between $3 and $5 for every male eligible to vote and aged at least 21 and under 61. The state allocated about 40 percent of poll tax proceeds to counties. The poll tax generated nearly $250,000 in 1881-82 and $740,000 in 1900-01. By 1910-11, it raised $1.5 million, or about 12.6 percent of state revenues.

Figure 18
First Period of State Taxation: Revenue Sources Reliance on the General State Property Tax (1871 through 1911, selected years)

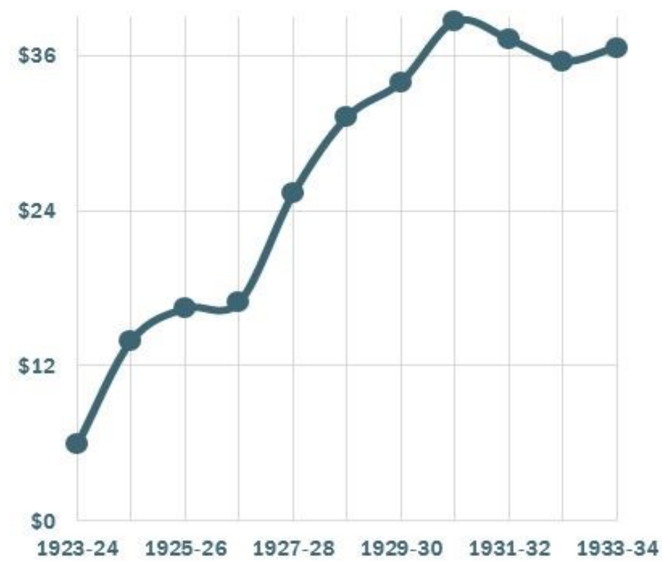
Source: Derived from Assembly Interim Committee on Revenue and Taxation, A Resume of California's Tax Structure, 1850-1955, pp. 16, 20, 26

- An inheritance tax that, by 1893, was imposed at 5 percent on all behests and property transfers to family members.

Figure 18 shows revenue collections by major taxes in selected years. Total collections rose to $4.7 million in 1881-82, $7.0 million in 1900-01, and $11.3 million by 1910-11. In each of these years, general property tax revenue accounted for between 65 percent and 85 percent of annual revenues.[34]

During this period, the revenue system—with its early emphasis on debt and subsequent dependence on property taxation—was similar to other states' systems. California's system was economically dependent on agriculture and natural resource extraction.

Figure 19
Motor Vehicle Fuel Tax Revenue, State and Local (1923 through 1934)



Source: Derived from Marvel M. Stockwell, Studies in California State Taxation 1910-1935, Berkeley: University of California Press, 1939, p. 95

A Transition (1911 to 1934)

In an attempt to address the growing tension between state and local governments, the state adopted the separation of sources policy,[35] creating distinct revenue and budget responsibilities between levels of government. Local governments were given almost exclusive responsibility for assessing and collecting the property tax and retained the proceeds. Local governments were also charged with funding schools.

From 1911 until 1934, the state itself received very little from the property tax. It continued to levy an inheritance tax, which by 1934 had grown to $5.8 million.[36] The state developed new taxes, including:

- ***Public Utilities Gross Receipts Tax***. This tax on certain utilities relied on only a few companies. The Southern Pacific Company had 49.2 percent of all taxable value of railroad and street railway companies, the Pacific Gas and Electric Company had 40.5 percent of all taxable value of power companies, and Pacific Telephone and Telegraph had 75.7 percent of all telephonic valuation.[37] In 1911-12, the public utilities gross receipts tax generated $6.6 million, which two decades later had grown to $12.9 million.

- ***Motor Vehicle Fuel Tax.*** With the advent of cars and trucks, California looked to tax fuel. The state taxed motor fuel (other than diesel and butane) by the gallon. It started with a tax rate of two cents per gallon in 1924,[38] allocating half the proceeds to the state and half to the counties. In 1927, the state added another penny-per-gallon charge and dedicated the proceeds to state road construction. Figure 19 shows how state and local fuel tax revenues rose rapidly, from $5.9 million in 1923-24 to a high of $38.6 million in 1929-30, falling slightly to $36.6 million by 1933-34.[39]

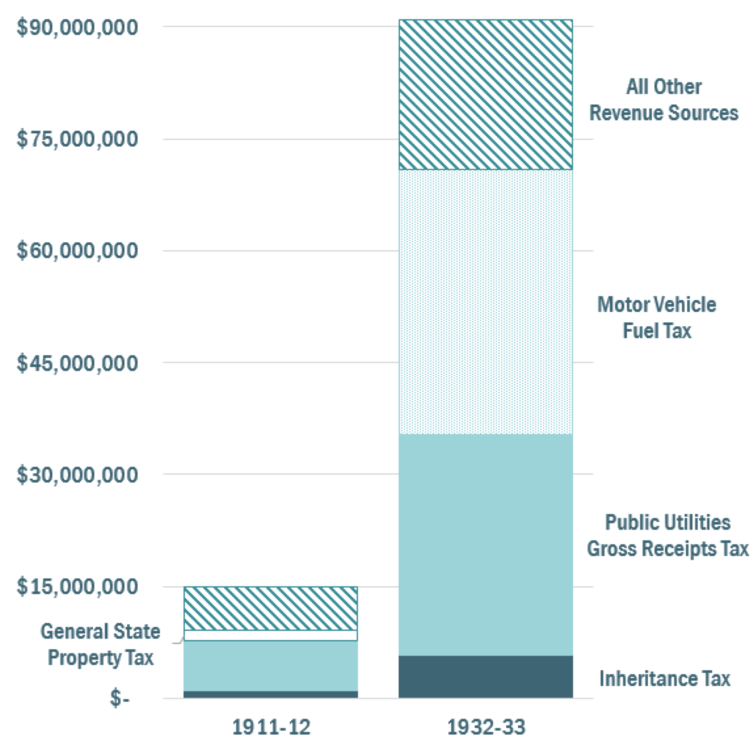
In all, state revenue rose fast during this period, from $15.0 million in 1911-12 to $90.9 million in 1932-33. Figure 20 shows that by the end of the period, the Motor Vehicle Fuel Tax and the Public Utilities Gross Receipts Tax accounted for 39.1 percent and 32.4 percent of all state revenues, respectively.

These two taxes reflected the changing nature of the California economy. As large utilities—railroads, power suppliers, and telephone providers—became prominent, the state generated new and significant revenues from them. With the automobile, too, the state found a new source of revenue.

Adopting the "Modern" Tax Structure (1934 to 1955)

Figure 20

Transition Period of State Taxation: Revenue Sources for State Expenditure Purposes (1911 through 1933, selected years)



Source: Derived from Assembly Interim Committee on Revenue and Taxation, A Resume of California's Tax Structure, 1850-1959, pp. 27, 41, 48

The state faced its first modern budget crisis during the Depression in 1933 when Governor James ("Sunny Jim") Rolph, Jr. estimated the 1932-33 budget would end with a $12 million deficit. He proposed taxes on tobacco, beverages, cosmetics, jewelry, and billboards.[40] When the Legislature rejected his proposal, the budget seemed headed to continuing fiscal difficulties as the public utilities gross receipts tax could not keep pace with spending demands. At the same time, local governments faced significant revenue shortfalls. School districts were unable to raise sufficient revenues for basic education.[41]

In early 1933, State Controller Ray

Riley and BOE Member Fred Stewart proposed a revision of state-local fiscal structure (the Riley-Stewart plan) with the following recommendations:[42]

- Effective January 1, 1935, eliminate the Separation of Sources policy. Many believed that it was unrealistic to assume that the state and local governments could act independently on either the spending side or revenue side of the fiscal equation.

- Shift a portion of financial responsibility for schools to the state, and authorize the Legislature to raise new revenues to finance this obligation.

- Reserve the public utilities tax to local governments. Riley and Stewart recommended that the state assist in the assessment and collection of the utilities tax, but allocate the revenue to local governments.

Voters approved the measure[43] in June 1933, shifting $38 million in local costs to the state and $30 million in state revenues to local governments, thereby creating a large state budget deficit.[44] To balance the 1934-35 budget, the Legislature passed its first sales tax law,[45] modeled on one in the state of New York.[46]

Figure 21

Third Period of State Taxation: Revenue Sources (1934 through 1955, selected years)

	1934-35	1938-39	1944-45	1949-50	1954-55	Average Annual Growth 1934 through 1955
Sales Tax	$ 56,471,540	87,981,896	150,314,238	321,673,936	492,917,379	11.4%
Personal Income Tax		20,672,014	47,133,088	60,499,577	106,738,235	*Not available*
Motor Vehicle Fuel Tax	36,602,767	47,180,298	43,967,429	133,247,029	230,431,580	9.6%
Public Utilities Gross Receipts Tax	27,913,372					*Not available*
Motor Vehicle Licenses or Motor Vehicle License Fee		11,667,639	14,223,300	53,712,275	99,802,192	*Not available*
Motor Vehicle License Tax or Motor Vehicle In Lieu Fee	9,162,602	10,772,803	15,448,527	48,032,729	85,703,056	11.8%
Insurance Tax or Insurance Premium Tax	5,413,245	7,631,077	11,791,875	23,285,220	29,493,026	8.8%
Inheritance Tax	4,945,034	8,371,589	9,833,490	18,651,686	28,429,071	9.1%
Bank and Corporation Franchise Tax or Corporation Income Tax	4,886,825	20,229,931	58,017,090	74,545,772	133,661,471	18.0%
Liquor Tax	1,530,823	9,854,134	19,301,964	24,063,756	29,493,026	15.9%
Other Taxes	3,449,546	7,060,856	17,515,427	29,291,820	63,083,377	15.6%
Total	$ 150,375,754	231,422,237	387,546,428	787,003,800	1,299,752,413	11.4%

Source: Derived from Assembly Interim Committee on Revenue and Taxation, A Resume of California's Tax Structure, 1850-1959, pp. 48-61

California also adopted a personal income tax. The federal government had imposed an income tax for 10 years in the 1860s, temporarily in 1894, and then again after passage of the 16th Amendment authorizing the current federal income tax. When the Legislature adopted an income tax law similar to the one in the federal tax code, it piggybacked on federal tax administration and practice.

Assuming a repeal of Prohibition, the state imposed a liquor tax. The Legislature also increased two existing taxes: the bank and corporation tax, and the inheritance tax.

In 1934-35, the Legislature phased out its tax on utilities and phased in the sales tax. Throughout the rest of the decade, as the state experienced higher unemployment, the budget relied primarily on revenue from the sales tax and the motor vehicle license tax. When California's employment and industries boomed during World War II, the state reduced the sales tax rate and still generated $150.3 million.

Figure 21 shows the tax collection totals for selected years through 1955. Between 1934 and 1955, revenues rose from about $150.4 million to almost $1.3 billion.[47]

Broadening Tax Collections (1955 to 1977)

By the early 1950s, the Legislature dedicated a portion of fuel taxes to road construction.[48] In 1955, it authorized cities and counties to levy up to a 1 percent sales tax rate for local discretionary purposes.

Beginning in the early 1960s, the state expanded its budget along with the growing California economy. When the federal government expanded its public assistance programs, it often required the state and local governments to match the federal spending. These programs—including food stamps, Aid to Families with Dependent Children (succeeded by Temporary Assistance for Needy Families), Medicaid, and Medicare—are major items in state and county budgets. Without the enactment of federal programs, state and local governments would likely have spent money on similar services without direct federal assistance. Nevertheless, the federal matching requirements to fund a large expansion of health and human services programs created revenue pressures for counties and the state.

On March 8, 1967, Governor Ronald Reagan proposed a major tax increase to fund a 40 percent increase in the budget. When proposing the change he said, "I wish the sum [of the increase] could be smaller but the responsibilities which we share for sound financial management of the state's government demand that we confront and solve the fiscal problem…" He proposed increasing all the major taxes, going so far as to raise the sales tax rate by one-third.[49] The Legislature adopted Reagan's tax reform in the 1970-71 session with modifications when it passed Assembly Bills 1000 (Bagley) and 1001 (Bagley).[50]

Proposition 13 and its Aftermath (1977 to 1990)

In June 1978, California voters overwhelmingly approved Proposition 13, a property tax limitation initiative. This amendment to the California Constitution was the taxpayers' collective response to dramatic increases in property taxes and a state revenue surplus that had grown to nearly $5 billion.

Before 1912, the state derived as much as 70 percent of its revenue from property taxes. Since 1933, the only property tax directly levied, collected, and retained by the state has been the tax on privately owned railroad cars. In contrast, California counties, cities, schools, and special districts depend on the property tax. Property tax revenue nonetheless exerts a substantial influence on the state budget because local property tax revenues allocated to K-14 schools offset mandatory state expenditures under the terms of Proposition 98.

In the immediate aftermath of Proposition 13, which halved local discretionary revenues, Governor Jerry Brown and state legislators struggled with ways to backfill local revenue losses with state revenues. In the end, the Legislature approved statutory changes to increase local discretionary revenue by allocating funds that would otherwise have been used for state support of schools.

In 1982, voters approved Proposition 5 to eliminate one of the state's oldest taxes, the inheritance and gift tax.

In the late 1980s, the state adopted measures to simplify personal income tax filings, consistent with federal changes in federal tax law. Later, when the state exceeded its constitutional spending, it returned more than $1 billion to taxpayers.

Coping with Revenue Shocks (1990 to 2000)

In the face of a prolonged and deep recession in 1991, the Legislature and Governor Pete Wilson agreed to a significant increase in all the state's major taxes, raising rates on the sales, property, alcohol, and vehicle license in-lieu taxes (also known as the vehicle license fee, or VLF). They also closed sales tax loopholes. By 1997, however, the same legislative leaders agreed to repeal most of these tax increases. They also increased the child deductions in the personal income tax and exempted middle-class taxpayers from the alternative minimum tax. The 1997 actions were among the most significant in making the state's tax system more progressive.

The tax reductions were financed with revenue associated with taxation of investment income, like capital gains. Between 1996 and 2000, the state experienced an unprecedented revenue boom associated with taxation of unearned income. This is commonly considered the five-year period of the dotcom bubble. While the bubble grew, the Legislature sought to reduce the VLF by as much as two-thirds.

When the bubble burst, so did the state's ability to finance tax cuts.

Managing Revenue Derived from Investment Income (2000 to 2008)

During the 2000s, the state experienced wild revenue swings associated with business cycle effects and yearly variations in investment income. Rather than raise taxes to finance gaping operating deficits, the state often used borrowed funds to finance budget shortfalls.

Proposition 30 (2008 to present)

In November 2012, voters approved Proposition 30, which:

- Raised the state sales tax rate by one-quarter cent for four years; and
- Imposed graduated personal income tax brackets for taxpayers with incomes in excess of $250,000 for seven years.

At the time the measure passed, it was expected to raise between $6.7 and $9.0 billion each year, depending on the estimate of taxable capital gains.

For the past 50 years, the state has relied on three major taxes—personal income, retail sales and use, and corporation—to generate at least 70 percent of general revenues.[51] Figure 22 compares the tax base, payer, and rates of each of these taxes.[52]

Figure 22
State Tax Structure, by the Three Major Taxes

	What is Taxed	Who Pays the Tax	The Tax Rates
Personal Income Tax	Wages, salaries, interest dividends, business-related income, and capital gains. Some income specifically excluded.	Individuals, families, sole proprietors, and trusts. Out-of-state residents pay tax on income earned in California.	Tax brackets with rates ranging from 1 percent to 12.3 percent, with an additional 1 percent surcharge on individuals earning more than $1 million.
Sales and Use Tax	Tangible goods, unless exempted by state law. Services are implicitly taxed when they are incorporated into the cost of a good.	Primarily consumers. Businesses also pay the tax unless the goods are purchased for resale.	7.25 percent base statewide rate. Cities and counties may add up to an additional 2 percent with voter approval.
Corporation Tax	Includes the corporation franchise tax, corporation income tax, and bank tax. All are based on net income. In addition, limited liability entities pay a fee.	Corporations, Subchapter S corporations, and other business entities. Multistate and multinational corporations pay taxes on their California share of total income.	8.84 percent for regular corporations, 10.84 percent for financial corporations, and 1.5 percent for Subchapter S corporations.

Source: Compiled from California Legislative Analyst's Office, Cal Facts (2012, 2013, 2014)

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Appendix III

Sales Tax on Services, by Industry, Activity (Employer Paid)

	Revenue (2011) at Rate: 0.25%	8.42%	Estimated Number of CA Firms (2012)
Support activities for agriculture & forestry			
Support: crop production	$2,819,326	$94,954,904	751
Support activities for animal production	804,272	27,087,881	435
Support activities for forestry	3,975	133,884	76
Subtotal, agriculture & forestry	***3,627,573***	***122,176,669***	***1,262***
Support activities for mining			
Drilling oil & gas wells	2,380,000	80,158,400	63
Support for oil & gas operations	4,476,442	150,766,576	201
Support activities: metal mining	104,161	3,508,134	9
Subtotal, mining	***6,960,603***	***234,433,110***	***273***
Construction			
Residential remodelers	16,735,365	563,647,103	9,208
Water & sewer line	8,046,398	271,002,679	711
Oil & gas pipeline	5,418,064	182,480,392	120
Power & communications line	10,908,468	367,397,197	335
Land subdivision	1,813,643	61,083,480	635
Highway, street, and bridge construction	15,559,588	524,046,924	670
Other heavy and civil engineering construction	3,968,658	133,664,399	297
Poured concrete foundation and structure contractors	7,211,159	242,871,851	1,400
Structural steel and precast concrete contractors	3,549,063	119,532,443	325

	Framing contractors	2,855,898	96,186,640	605
	Masonry contractors	2,409,426	81,149,471	1,036
	Glass and glazing contractors	1,980,529	66,704,201	540
	Roofing contractors	4,873,189	164,128,994	1,767
	Siding contractors	416,830	14,038,818	200
	Other building contractors	1,659,707	55,898,922	419
	Electrical contractors	28,833,354	971,107,376	6,126
	HVAC contractors	30,474,624	1,026,385,331	6,944
	Other building equipment contractors	4,921,546	165,757,655	487
	Drywall and insulation contractors	7,705,671	259,526,985	1,653
	Painting and wall covering contractors	4,897,496	164,947,675	3,129
	Flooring contractors	2,946,702	99,244,937	1,267
	Tile and terrazzo contractors	1,908,006	64,261,640	1,107
	Finish carpentry contractors	4,410,381	148,541,643	1,713
	Other building finishing contractors	2,210,326	74,443,795	598
	Site preparation contractors	12,560,154	423,025,988	1,981
	Other specialty contractors	8,085,812	272,330,148	2,440
Subtotal, construction		***196,360,056***	***6,613,406,687***	***45,712***
Automobile dealers				
	Automobile dealers: labor charges for auto repair services	14,275,000	480,782,000	2,919
Subtotal, automobile dealers		***14,275,000***	***480,782,000***	***2,919***
Transportation & warehousing				
	Scheduled air transportation	55,419,176	1,866,517,860	58
	Nonscheduled air transportation	3,552,305	119,641,623	231
	Deep sea, coastal, and great lakes water transportation	13,790,791	464,473,830	61
	Inland water transportation	124,305	4,186,597	41
	General freight trucking, local	10,967,957	369,400,804	2,962

Used household and office goods moving	3,657,451	123,182,957	940
Specialized freight (except used goods) trucking, local	12,629,175	425,350,611	2,112
Specialized freight (except used goods) trucking, long-distance	7,314,654	246,357,540	418
Urban transit systems	2,088,970	70,356,509	111
Interurban and rural bus transportation	248,301	8,362,770	23
Taxi service	490,698	16,526,719	192
Limousine service	1,522,809	51,288,220	659
School and employee bus transportation	1,911,925	64,393,642	107
Charter bus industry	1,038,638	34,981,337	194
Other transit and ground passenger transportation	2,195,816	73,955,078	478
Pipeline transportation of crude oil	1,351,380	45,514,483	4
Pipeline transportation of natural gas	277,733	9,354,044	4
Pipeline transportation of refined petroleum products	1,119,969	37,720,555	2
All other pipeline transportation	93,069	3,134,557	0
Scenic and sightseeing transportation, land	207,400	6,985,219	77
Scenic and sightseeing transportation, water	695,137	23,412,206	143
Scenic and sightseeing transportation, other	43,220	1,455,646	26
Airport operations	2,885,135	97,171,353	145
Other support activities for air transportation	3,717,164	125,194,080	360
Support activities for rail transportation	1,178,888	39,704,952	29
Port and harbor operations	172,657	5,815,088	50
Marine cargo handling	6,517,088	219,495,516	22
Navigational services to shipping	689,411	23,219,370	30
Other support-water trans	233,354	7,859,370	39
Motor vehicle towing	3,668,504	123,555,211	1,194
Other support activities for road transportation	1,031,947	34,755,986	299

	Freight transportation arrangement	25,015,687	842,528,324	2,081
	Other support activities for transportation	635,061	21,388,859	160
	Couriers and express delivery services	25,468,771	857,788,202	406
	Local messengers and local delivery	1,522,287	51,270,630	470
	General warehousing and storage	8,520,999	286,987,262	580
	Refrigerated warehousing and storage	1,979,543	66,671,022	104
	Farm product warehousing and storage	203,834	6,865,128	25
	Other warehousing and storage	2,353,537	79,267,126	188
Subtotal, transportation & warehousing		***230,638,068***	***7,767,890,134***	***16,976***
Information				
	Newspaper publishers	2,185,577	73,610,246	382
	Periodical publishers	1,917,716	64,588,665	571
	Book publishers	1,449,286	48,811,941	304
	Directory and mailing list publishers	716,633	24,136,198	85
	Greeting card publishers	3,040	102,390	8
	All other publishers	141,172	4,754,665	102
	Software publishers	117,519,258	3,958,048,610	1,077
	Record production	237,191	7,988,601	89
	Integrated record production/distribution	0	-	103
	Music publishers	3,149,614	106,079,004	228
	Sound recording studios	982,066	33,075,986	424
	Other sound recording industries	273,275	9,203,896	90
	Radio networks	1,541,648	51,922,699	81
	Radio stations	4,653,878	156,742,602	252
	Television broadcasting	25,548,779	860,482,865	97
	Cable and other subscription programming	20,361,157	685,763,769	90
	Wired telecommunications carriers	0	-	316
	Wireless telecomm-not satellite	0	-	168

	Satellite telecommunications	1,780,495	59,967,080	78
	Telecommunications resellers	6,348,830	213,828,583	207
	All other telecommunications	5,955,318	200,575,113	421
	Data processing, hosting, and related services	40,804,751	1,374,304,012	1,119
	News syndicates	546,834	18,417,379	41
	Libraries and archives	245,604	8,271,932	70
	Internet publishing and broadcasting and web search portals	141,589,682	4,768,740,485	1,342
	All other information services	371,636	12,516,717	43
Subtotal, information		***378,323,439***	***12,741,933,439***	***7,789***
Finance & insurance				
	Commercial banking	126,769,206	4,269,586,841	610
	Savings institutions	12,898,085	434,407,494	84
	Credit unions	16,789,467	565,469,264	619
	Other depository credit intermediation	349,001	11,754,352	11
	Credit card issuing	6,291,091	211,883,944	24
	Sales financing	22,811,491	768,291,012	189
	Other nondepository credit intermediation	145,150,168	4,888,657,657	1,204
	Mortgage and nonmortgage loan brokers	6,059,168	204,072,780	1,945
	Financial transactions	25,363,018	854,226,456	299
	Other activities related to credit intermediation	6,412,587	215,975,941	637
	Investment banking and securities dealing	17,304,540	582,816,909	411
	Securities brokerage	45,060,244	1,517,629,008	1,336
	Commodity contracts dealing	901,978	30,378,611	168
	Commodity contracts brokerage	567,138	19,101,224	66
	Securities and commodity exchanges	0	-	1
	Miscellaneous intermediation	9,046,089	304,672,280	987
	Portfolio management	85,798,511	2,889,693,850	2,944

Investment advice	12,065,881	406,378,888	2,095
Other financial investment	9,987,298	336,372,187	438
Subtotal, finance & insurance	***549,624,961***	***18,511,368,696***	***14,066***
Real estate & leasing			
Lessors of residential buildings and dwellings	37,476,184	1,262,197,869	7,299
Lessors of nonresidential buildings (except mini-warehouses)	44,446,332	1,496,952,452	3,918
Lessors of mini-warehouses and self-storage units	4,509,011	151,863,487	1,458
Lessors of other real estate property	3,985,690	134,238,044	1,321
Offices of real estate agents and brokers	30,134,700	1,014,936,703	10,897
Real estate property managers	21,045,609	708,816,104	7,568
Offices of real estate appraisers	2,057,938	69,311,343	1,060
Other activities related to real estate	5,093,866	171,561,399	2,680
Passenger car rental and leasing	565,994	19,062,685	469
Truck, utility trailer, and RV (recreational vehicle) rental and leasing	637,366	21,466,503	163
Consumer electronics and appliances rental	91,866	3,094,063	23
Formal wear and costume rental	12,670	426,734	65
Video tape and disc rental	151,726	5,110,116	186
Other consumer goods rental	567,089	19,099,568	691
General rental centers	100,400	3,381,475	221
Construction, transportation, mining, and forestry machinery and equipment rental and leasing	84,014	2,829,586	338
Office machinery and equipment rental and leasing	9,413	317,017	73
Other commercial and industrial machinery and equipment rental and leasing	893,114	30,080,064	687
Lessors of nonfinancial intangible assets (except copyrighted works)	8,073,929	271,929,934	301
Subtotal, real estate & leasing	***159,936,910***	***5,386,675,145***	***39,419***

Professional, scientific & technical services

Offices of lawyers	103,326,286	3,480,029,298	20,764
Other legal services	4,163,712	140,233,811	908
Accounting, tax preparation, bookkeeping, and payroll services	79,300,464	2,670,839,611	14,411
Architectural services	12,970,730	436,854,179	2,873
Landscape architectural services	2,183,327	73,534,449	786
Engineering services	93,311,820	3,142,742,102	6,557
Drafting services	292,666	9,856,997	249
Building inspection services	986,054	33,210,314	735
Geophysical surveying and mapping services	222,298	7,486,996	55
Surveying and mapping (except geophysical) services	1,226,227	41,299,319	473
Testing laboratories	6,163,071	207,572,240	694
Interior design services	3,816,070	128,525,237	1,552
Industrial design services	1,286,920	43,343,475	293
Graphic design services	4,001,333	134,764,879	2,333
Other specialized design services	1,275,892	42,972,043	455
Computer systems design and related services	135,294,768	4,556,727,778	16,223
Management consulting services	54,594,631	1,838,747,186	14,927
Environmental consulting services	5,592,360	188,350,686	1,262
Other scientific and technical consulting services	12,875,439	433,644,783	5,211
Research and development in the physical, engineering, and life sciences	89,017,788	2,998,119,084	2,511
Research and development in the social sciences and humanities	1,956,297	65,888,075	246
Advertising agencies	17,059,208	574,554,141	1,674
Public relations agencies	4,336,666	146,058,895	1,213

Media buying agencies	4,793,626	161,449,320	170
Media representatives	1,688,493	56,868,443	191
Outdoor advertising	2,588,631	87,185,083	248
Direct mail advertising	4,500,908	151,590,581	344
Advertising material distribution services	1,881,023	63,352,861	121
Other services related to advertising	4,816,019	162,203,526	793
Marketing research	7,037,294	237,016,049	864
Photographic services	2,243,314	75,554,825	1,259
Translation & interpretation	3,075,995	103,599,516	410
Veterinary services	8,928,646	300,716,785	2,723
All Other	4,907,274	165,277,004	1,514
Subtotal, professional, scientific & tech	681,715,249	22,960,169,570	105,041
Administrative & support, waste management & remediation services			
Office administrative services	20,083,793	676,422,145	4,192
Facilities support services	5,159,793	173,781,824	148
Employment placement agencies and executive search services	6,723,883	226,460,394	1,507
Temporary help services	42,976,482	1,447,447,912	1,450
Professional employer organizations	23,437,102	789,361,601	326
Document preparation services	969,168	32,641,583	565
Telephone call centers	4,225,065	142,300,177	402
Business service centers	1,735,797	58,461,641	1,209
Collection agencies	2,663,740	89,714,749	413
Credit bureaus	3,113,160	104,851,227	63
Other business support services	2,754,389	92,767,814	799
Travel agencies	4,000,595	134,740,033	1,466
Tour operators	2,356,728	79,374,585	380
Other travel arrangement and reservation services	4,396,332	148,068,476	341
Investigation, guard, and armored car services	14,213,276	478,703,129	1,764

	Security systems services	6,978,329	235,030,113	1,053
	Exterminating and pest control services	5,019,012	169,040,333	1,339
	Janitorial services	12,119,284	408,177,483	4,791
	Landscaping services	19,654,363	661,958,949	7,582
	Carpet and upholstery cleaning services	1,122,422	37,803,189	773
	Other services to buildings and dwellings	2,382,897	80,255,956	1,446
	Packaging and labeling services	265,297	8,935,191	218
	Convention and trade show organizers	5,139,067	173,083,776	684
	All other support services	4,531,280	152,613,505	1,226
	Waste collection	17,528,832	590,371,054	694
	Waste treatment and disposal	3,437,365	115,770,461	141
	Remediation services	4,329,314	145,811,285	313
	Materials recovery facilities	1,845,301	62,149,750	138
	All other	961,152	32,371,584	268
Subtotal, admin, waste management		***224,123,216***	***7,548,469,922***	***35,693***
Educational services				
	Business & secretarial schools	61,535	2,072,496	30
	Computer training	511,799	17,237,392	193
	Professional and management development training	2,492,314	83,941,134	741
	Technical and trade schools	4,933,707	166,167,263	903
	Fine arts schools	1,415,936	47,688,716	1,392
	Sports and recreation instruction	2,043,570	68,827,428	1,712
	Language schools	1,087,790	36,636,781	296
	All other schools and instruction	2,856,099	96,193,416	2,335
	Educational support services	2,582,089	86,964,746	941
Subtotal, educational		***17,984,839***	***605,729,371***	***8,541***
Health care				
	Offices of physicians	155,716,534	5,244,532,853	27,202
	Offices of dentists	43,502,557	1,465,166,124	20,138

Offices of chiropractors	3,364,617	113,320,284	4,103
Offices of optometrists	2,955,146	99,529,331	2,457
Offices of mental health practitioners (except physicians)	2,966,222	99,902,346	2,361
Offices of physical, occupational and speech therapists, and audiologists	7,112,785	239,558,604	2,120
Offices of all other health practitioners	3,009,756	101,368,586	2,539
Family planning centers	930,657	31,344,545	160
Outpatient mental health and substance abuse centers	3,086,954	103,968,623	457
Other outpatient care centers	28,618,107	963,857,828	1,308
Medical and diagnostic laboratories	15,227,407	512,859,052	1,021
Home health care services	13,864,293	466,949,378	2,109
Ambulance services	5,570,407	187,611,322	237
All other ambulatory health care services	5,581,108	187,971,714	310
General medical and surgical hospitals	230,429,203	7,760,855,567	236
Psychiatric and substance abuse hospitals	3,253,824	109,588,790	27
Specialty (except psychiatric and substance abuse) hospitals	4,963,233	167,161,702	19
Nursing care facilities (skilled nursing facilities)	24,804,173	835,404,561	843
Residential intellectual and developmental disability facilities	2,828,076	95,249,605	471
Residential mental health and substance abuse facilities	2,819,108	94,947,569	467
Continuing care retirement communities and assisted living facilities for the elderly	14,303,111	481,728,768	2,413
Other residential care facilities	2,099,694	70,717,690	504
Child and youth services	2,752,124	92,691,525	934

Source: California Board of Equalization, 2016

Services for the elderly and persons with disabilities	15,546,723	523,613,645	2,330
Other individual and family services	4,138,655	139,389,893	2,229
Community food services	1,445,809	48,694,849	277
Community housing services	1,437,112	48,401,926	710
Emergency and other relief services	143,731	4,840,873	50
Vocational rehabilitation services	2,535,524	85,396,441	480
Child day care services	9,302,218	313,298,715	6,305
Subtotal, health care	***614,308,869***	***20,689,922,708***	***84,817***
Arts, entertainment & recreation			
Theater companies and dinner theaters	1,975,980	66,550,999	386
Dance companies	131,166	4,417,680	71
Musical groups and artists	2,811,424	94,688,763	866
Other performing arts companies	184,629	6,218,295	55
Spectator sports	9,512,939	320,395,794	542
Promoters of performing arts, sports, and similar events with facilities	2,753,358	92,733,108	279
Promoters of performing arts, sports, and similar events without facilities	2,613,984	88,038,979	531
Agents and managers for artists, athletes, entertainers, and other public figures	6,948,181	234,014,751	1,218
Independent artists, writers, and performers	23,252,672	783,150,003	10,045
Museums	875,131	29,474,419	440
Historical sites	50,971	1,716,708	40
Zoos and botanical gardens	762,257	25,672,827	53
Nature parks and other similar institutions	75,117	2,529,947	64
Amusement and theme parks	6,452,118	217,307,325	40
Amusement arcades	462,997	15,593,736	207
Casinos (except casino hotels)	11,219,802	377,882,922	68

Golf courses and country clubs	4,636,742	156,165,470	648
Skiing facilities	493,063	16,606,378	28
Marinas	581,561	19,586,963	243
Fitness and recreational sports centers	9,299,241	313,198,431	2,819
Bowling centers	541,898	18,251,118	176
All other amusement and recreation industries	1,939,172	65,311,327	1,401
Subtotal, arts, entertainment, recreation	***91,024,361***	***3,065,700,471***	***20,331***
Accommodation			
Hotels (except casino hotels) and motels	53,515,737	1,802,410,020	4,242
Casino hotels	9,743,140	328,148,955	12
Other traveler accommodation	683,863	23,032,517	423
RV (recreational vehicle) parks and recreational camps	1,557,662	52,462,052	545
Rooming and boarding houses	398,201	13,411,411	231
Subtotal, accommodation	***65,898,603***	***2,219,464,954***	***5,454***
Other, except public administration			
Automotive mechanical and electrical repair and maintenance	7,406,319	249,444,808	9,883
Automotive body, paint, interior, and glass repair	6,308,900	212,483,762	4,197
Other automotive repair and maintenance	2,750,605	92,640,378	2,814
Electronic and precision equipment repair and maintenance	11,276,408	379,789,423	1,298
Commercial and industrial machinery and equipment (except automotive and electronic) repair and maintenance	7,915,405	266,590,838	1,630
Home and garden equipment and appliance repair and maintenance	803,586	27,064,789	499
Reupholstery and furniture repair	413,757	13,935,346	434
Footwear and leather goods repair	89,032	2,998,605	110
Other personal and household goods repair and maintenance	926,722	31,211,985	802

Hair, nail, and skin care services	5,917,596	199,304,626	8,693
Other personal care services	2,783,677	93,754,247	2,003
Funeral homes and funeral services	1,386,224	46,688,030	583
Cemeteries and crematories	1,200,941	40,447,683	147
Coin-operated laundries and drycleaners	1,561,225	52,582,070	1,034
Drycleaning and laundry services (except coin-operated)	2,953,384	99,469,976	2,470
Linen and uniform supply	578,518	19,484,499	125
Pet care (except veterinary) services	1,326,594	44,679,678	1,365
Photofinishing	1,310,244	44,129,011	144
Parking lots and garages	3,578,917	120,537,919	583
All other personal services	3,422,686	115,276,060	1,287
Grantmaking and giving services	650,064	21,894,160	1,983
Social advocacy organizations	682,918	23,000,691	1,641
Civic and social organizations	1,380,591	46,498,296	2,047
Business associations	3,678,162	123,880,496	1,386
Professional organizations	2,374,945	79,988,164	615
Other	4,252,548	143,225,827	1,723
Subtotal, other	***76,929,969***	***2,591,001,366***	***49,494***
Total, Employer Services	**$3,311,731,717**	**$111,539,124,242**	**437,787**

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Appendix IV

Top 10 Tax Expenditures: Personal Income, Corporation, and Sales and Use

Personal Income Tax	Description	Revenue Loss ($ in millions)	Federal Conformity
Exclusion of employer contribution health plans	Employer contributions for health and accident benefits are excluded from the employee's income.	$6,000	Yes
Home mortgage interest deduction	A deduction for interest paid for acquiring, constructing, or refinancing a principal residence and one other residence.	$5,000	Yes
Exclusion of employer pension contributions	Employer contributions to qualified retirement plans are generally excluded from employees' income.	$4,400	Yes
Basis step-up on inherited property	The basis of property acquired by bequest, devise, or inheritance is the fair market value at the date of death. Therefore, appreciation that occurred prior to death is not taxed.	$4,100	Yes
Exclusion of capital gains on sale of principal residence	An individual may exclude up to $250,000 of gain realized on the sale of a principal residence. For joint returns, the exclusion is $500,000.	$2,600	Yes
Exclusion of social security benefits	Social security benefits are not subject to California tax.	$3,200	No
Charitable contribution deduction	A deduction is allowed for cash or certain noncash contributions to qualifying nonprofits or governmental entities.	$2,200	Yes
Real estate, personal property and other tax deduction	Individuals may deduct certain taxes as an itemized deduction.	$2,100	Yes
Dependent exemption in excess of personal exemption credit	A nonrefundable personal exemption credit is allowed for all taxpayers and their dependents. The exemption credit for dependents is over three times greater than the exemption allowed for the taxpayer or spouse.	$1,400	No
Employee business and miscellaneous expenses deduction	Certain unreimbursed employee expenses may be deducted as a miscellaneous itemized deduction.	$1,400	Yes

Sources: California Department of Finance, 2014, and California Franchise Tax Board, 2012

Corporation Tax	Description	Revenue Loss ($ in millions)	Federal Conformity
Research and development credit	Businesses are allowed a credit for increased research expenditures.	$1,800	No
Sales factor apportionment	Corporations with income derived from sources both within and outside of California must apportion income to California using a single-sales factor method.	$974	No
Water's edge election	Unitary multinational corporations are allowed the option of computing their income attributable to California based on a water's edge (domestic) combined report, as opposed to a worldwide report.	$850	No
Enterprise zones and similar areas (repealed 1/1/2014)	Several tax incentives are available for certain types of expenditures or income earned in economically depressed areas.	$500	No
Like-kind exchanges	No gain or loss is recognized when business or investment property is exchanged solely for like-kind property.	$450	Yes
Subchapter S corporations	Corporations that meet specified criteria are allowed to elect Subchapter S corporation status. An S corporation pays a reduced tax rate.	$140	Yes, but there is no entity-level tax at the federal level.
Tax-exempt status for qualifying corporations	Qualifying nonprofit and charitable organizations are exempt from corporation tax.	$170	Yes
Accelerated depreciation of R&E costs	Research and experimental expenditures.	$180	Yes
Charitable contributions deductions	A deduction is allowed for cash or certain noncash contributions to qualifying nonprofits or governmental entities.	$110	Yes
Film credit	A nonrefundable credit to qualified taxpayers who produce a motion picture in California or relocate a television series or independent film to California.	$108	No

Sources: California Department of Finance, 2014, and California Franchise Tax Board, 2012

Sales & Use Tax	Description	Revenue Loss* ($ in millions)	Federal Conformity
Food products	Sales of food for human consumption are exempt. The exemption does not apply to hot prepared food or food sold and consumed at the seller's facility.	$10,140	N/A
Gas, electricity, water, and steam	Gas, electricity, and water delivered through mains, lines, or pipes are exempt.	$6,278	N/A
Prescription medicine	Medicine items that are prescribed for an individual and furnished by a registered pharmacist are exempt.	$4,028	N/A
Animal life, feed, seeds, plants, fertilizer, drugs, medicines	Sales of animals, generally used for human foods, as well as the feed and drugs used for those animals are exempt. Seeds and plants normally used for human foods and fertilizer for those plants are exempt.	$2,034	N/A
Candy, confectionery, snack foods, and bottled water	Candy, confectionery, snack foods, and bottled water are exempt.	$1,503	N/A
Manufactures exemption	Manufacturers and certain research and development businesses may qualify for a partial exemption.	$525	N/A
Custom computer programs	Transfers of custom computer programs are exempt.	$479	N/A
Fuel sold to common carriers	Sales of fuel and petroleum products to air common carriers for international flights are exempt.	$358	N/A
Exemption for farm equipment	Sales of farm equipment, machinery, and their parts are partially exempt.	$180	N/A
Water to common carriers	Sales of fuel and petroleum products are exempt when sold to water common carriers for immediate shipment outside of California.	$81	N/A
		**State and local revenue loss*	

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