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Governor's Tax Increase Proposal

L E G I S L A T I V E   A N A L Y S T ' S   O F F I C E

Presented To:

Senate Revenue and Taxation Committee

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Sales and Use Tax Issues

☑ **Sales and use tax (SUT) revenues have grown steadily over the last decade, but generally slower than the overall economy.**

- Between 1991-92 and 2002-03, the SUT revenues grew at an average annual rate of 4.2 percent versus 4.9 percent growth for personal income.

☑ **The SUT is somewhat more cyclical than personal income.**

- Notably, the SUT tended to "under perform" in periods of economic slowdown and "over perform" during periods of economic expansion.

☑ **Some of these features of the SUT are a result of underlying changes in that of the economy, particularly the growth in the consumption of services relative to tangible goods (which constitutes the base of the SUT).**

- Taxable transactions constitute only 39 percent of personal income, versus 47 percent 20 years ago.
- Further erosion in the SUT base may occur due to the growth in Internet activity, continuing growth in other remote sales, and development of intangible versions of personal property.

☑ **The SUT base has narrowed in many states—including California. This is one of the factors that has contributed to higher tax rates.**

- Higher rates can cause greater economic distortions in consumer choices and business investment.
- Thirteen states currently have maximum state and local SUT rates in excess of 8 percent—including California.

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Sales and Use Tax Issues (continued)

☑ **Generally, the SUT is a regressive tax, in that low income taxpayers tend to use a larger share of their income for taxable purchases than do high income taxpayers.**

- One recent study found that the share of personal income devoted to taxable purchases ranges from about 40 percent for low income households to around 20 percent for high income households.
- Exemptions for food, certain medications, health related items, and some utilities make the SUT less regressive than it otherwise would be.

☑ **Revenue options involving the SUT include eliminating certain tax expenditure programs and extending the tax base.**

- Extending the SUT tax base to include various services could be coupled with an eventual overall rate reduction.

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Personal Income Tax Issues

☑ **The Personal Income Tax (PIT) has shown significant growth in recent years, at times well in excess of overall growth in personal income.**

- This is because of the state's progressive PIT structure.
- Between 1991-92 and 2002-03, the PIT grew at an average annual rate of 6 percent versus 4.9 percent of personal income.
- Over the period, growth in PIT revenue from high income taxpayers was greater than overall PIT revenues.

☑ **The PIT can also be a volatile revenue source, due to its increasing reliance on high income taxpayers and their fluctuating revenues.**

- Overall PIT receipts went from $27.9 billion in 1997-98 to $44.6 billion in 2000-01 to $33 billion in 2001-02.
- Taxpayers with annual incomes of $500,000 or more constitute about 1 percent of returns but roughly 40 percent of revenue.
- High income taxpayers tend to receive more income than other taxpayers from volatile sources such as business income, stock options, and capital gains.
- These sources of income tend to fluctuate considerably, increasing from $25 billion in 1994 to $200 billion in 2000, before dropping sharply to $77 billion in 2001.

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Personal Income Tax Issues (continued)

☑ **The behaviorial issues associated with the budget's proposed PIT increase are worthy of consideration.**

- California's top marginal of 9.3 is higher than that of many other states.
- Taxpayers with adjusted gross incomes of $1 million or more would see increased taxes averaging more than $27,000—roughly an increase of 24 percent.
- Possible negative responses to the tax increase proposal could be lessened if the tax were made temporary.

☑ **Other issues are of concern with respect to the PIT increase proposal.**

- The tax would be deductible for federal income tax purposes (unlike the SUT) but not for all taxpayers.
- There would be a time lag in determining the amount of revenue actually received from the high income PIT. Thus, administrative measures would need to be devised to determine any allocation to local governments.

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Cigarette Tax Issues

☑ **Cigarette consumption has declined steadily over the last few decades both in per capita terms and in total consumption.**

- Consumption has declined due to health concerns, smoking restrictions on smoking in work places and public areas, and increases in prices and taxes.
- Per capita consumption (absent that caused by price increases) has declined on average by between 2 percent to 3 percent annually over this period.
- The revenue stream is also susceptible to increased federal, state, and local regulation, and possibly further taxation.

☑ **Cigarette tax evasion has been identified as a state problem by the Board of Equalization (BOE), and as a national problem by the Bureau of Alcohol, Tobacco and Firearms.**

- The BOE estimates current revenue losses due to tax evasion in the low hundreds of millions of dollars.
- Tax increases for cigarettes would result in higher losses and could encourage additional evasion.
- No new cigarette tax enforcement measures have been proposed as part of the Governor's tax proposal.

Cigarette Tax Issues (continued)

☑ **The appropriate level of taxation for cigarettes is subject to considerable debate.**

- The tax is generally regressive in its impacts based on income.
- Most analysts argue that taxation is warranted due to smoking's social costs.