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California's Tax System And the Economy

LEGISLATIVE ANALYST'S OFFICE

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California's Tax System Has Worked Relatively Well

☑ The main elements of California's current tax system—the personal income tax (PIT), sales and use tax (SUT), and corporation tax (CT)—account for over 90 percent of the state's General Fund.

☑ The system has performed relatively well and generally received comparatively good marks from economists and public finance experts.

☑ The current system has the following features:

- ***Broad-Based.*** California's reliance on a variety of taxes ensures that the funding of public services is spread across many different types of economic activity.
- ***Diversified.*** The broad-based nature of the system has generally made revenue swings less than if more reliance were placed on fewer tax sources.
- ***Grows With the Economy.*** The system's "elasticity" enables revenues to keep pace over time with economic growth and the increased need for public services that such growth generates.
- ***Progressive.*** Wealthier taxpayers generally pay a larger share of their income in taxes than do lower income individuals, reflecting their relatively greater ability to pay.

☑ California's tax burden is about average relative to personal income.

- For example, in 2001-02, California's own-source state and local taxes were $10.66 per $100 of personal income versus $10.43 for all states combined. The comparable figures for selected states were: $12.98 for New York, $11.06 for Ohio, $10.18 for Washington, and $9.69 for Texas.

But the State's Economy Has Also Changed Considerably Over Time

- ☑ The composition and nature of spending by both individuals and businesses has changed considerably. For example:

  - Spending on services and telecommunications has increasingly become more important for both individuals and businesses.
  - Methods of handling transactions have also been changing, with increasing use of "remote sales" through such means as the Internet and catalog sales.

- ☑ The relative importance of different types of income has both changed and fluctuated.

  - During the latter half of the 1990s, for example, both capital gains and stock options soared to record levels.
  - Beginning in 2001-02, however, these sources of income declined dramatically.

- ☑ Corporate accounting and organizational structures have evolved, business activity has become much more interstate and international in nature, and the relationship between corporate economic activity and taxable corporate income seems less clear.

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Consequently, Some Changes to The Tax System Make Sense

☑ Because services are largely exempt from the SUT, the tax's base is less reflective of total spending than it once was. This means that:

- Not all consumption is treated the same, creating inequities in the treatment of consumption.
- Tax rates are higher than they would otherwise need to be to raise a given amount of revenue.
- Taxable sales as a percent of consumption has declined markedly, from 48 percent in 1981 to about 38 percent presently.

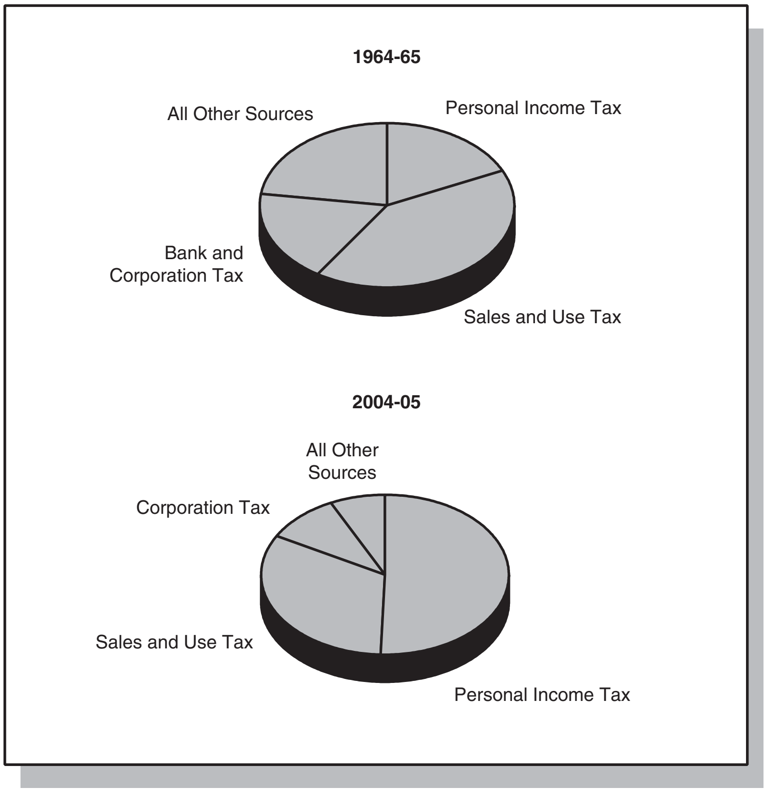
☑ Since capital gains and stock options fluctuate more than many other types of income taxed under the PIT, PIT revenues too are subject to greater fluctuations.

- This can result in large dollar variations in revenues and less predictable program funding.

☑ The effective administration and enforcement of the CT has become more difficult.

- Accurately apportioning income between different states and nations is more challenging than it once was, making it harder to ensure that the state is receiving revenues reflective of economic activity.
- Use of so-called "abusive tax shelters" (those that have no true economic or business purpose) has raised substantial challenges for tax enforcement.

The Composition of Revenues Has Changed Over Time



- ☑ The relative importance of different taxes has changed considerably over the years.

- ☑ Over the past four decades, the importance of the PIT has increased dramatically—rising from 18 percent of General Fund revenues in 1964-65 to 50 percent in 2004-05.

- ☑ This change is due to healthy growth in real incomes, the state's progressive tax rate structure, and increased capital gains.

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Various Options for Reform Could Be Considered

- ☑ Certain components of the state's taxes may simply need some relatively minor fine-tuning, while other components could benefit from a more fundamental overhaul.

- ☑ Subjecting certain services to the SUT would broaden the base, and thereby allow for lower rates and elimination of unequal treatment of different types of transactions.

- ☑ Other potential reforms involve the SUT and telecommunications taxation.

  - The SUT could be reformed to capture a greater percentage of consumption by better use of tax collection on remote sales. Participation in the streamlined sales tax project is one means by which the state is pursuing this option.

  - Telecommunications taxes are based on an industry structure that no longer exists. This has resulted in a tax burden on telecommunications firms that are very inconsistent across the industry and may be higher than on other businesses.

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Various Options for Reform Could Be Considered *(Continued)*

☑ Base broadening also could be applied in many other areas of the tax system as well—including the PIT, SUT, and CT—by the elimination or modification of ineffective and inefficient tax expenditure programs (TEPs).

- Currently, tax expenditures result in General Fund revenue reductions in excess of $30 billion annually.
- The effects of many of these programs are difficult to evaluate, due to data limitations and the absence of a formal institutional review process.
- Examples of TEPs that the Legislature may wish to review, among many others, include the mortgage interest deduction, tax treatment for large Subchapter S corporations, the Research and Development credit, and Enterprise Zone incentive programs.