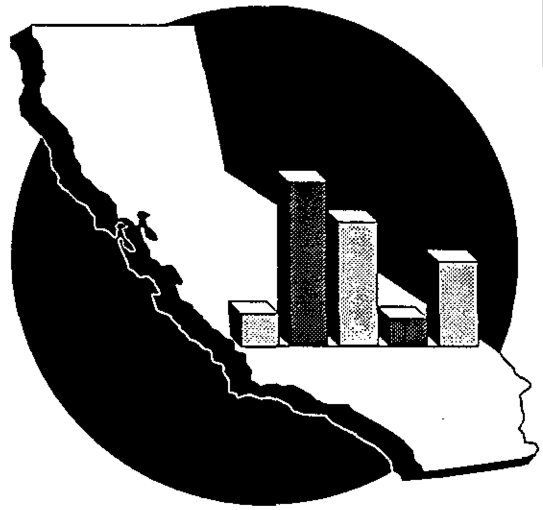
An Overview of California's Tax System



LAO
50 years of service

Elizabeth G. Hill
Legislative Analyst

Presented to:

Assembly Revenue and Taxation Committee

California's Governments Levy A Wide Variety of Different Taxes

LAO
50 years of service

State Taxes	Rate	Description
Personal income	Marginal rates of 1 to 11 percent; AMT[a] rate of 8.5 percent	For the 1995 tax year, married couples who earn less than $16,405 pay no tax. The 11 percent top rate applies to a couple's taxable income in excess of $439,744.
Sales and use taxes	6 percent[b]	Applies to the final purchase price of tangible items.
Bank and corporation taxes—general corporations	9.3 percent[c]; AMT rate of 7 percent	Applies to the net income earned by corporations doing business in California.
Bank and corporation taxes—financial corporations	11.1 percent; AMT rate of 7 percent	Applies to the net income earned by financial corporations. A portion of the tax is in lieu of local personal property or business taxes.
Vehicle fuel taxes	18 cents per gallon of gasoline or diesel fuel	Tax is collected from fuel distributors or wholesalers. Equivalent taxes are levied on other types of vehicle fuels.
Insurance tax	2.35 percent	Tax is assessed on the gross premiums received by most types of insurance companies.
Alcohol and cigarette taxes	Wine and beer: 20 cents per gallon; Sparkling wine: 30 cents per gallon; Spirits: $3.30 per gallon; Cigarettes: 37 cents per pack	Tax is collected from manufacturers or distributors.
Estate/inheritance/gift taxes	0.8 to 16 percent	The estate tax is a "pickup" tax to take advantage of the maximum state credit allowed against the federal estate tax. The inheritance and gift taxes apply only to deaths and gifts prior to Proposition 6.
Horse racing license fees/taxes	0.5 to 6.45 percent	Fees/taxes are levied on amounts wagered.

(Continued)

California's Governments Levy A Wide Variety of Different Taxes *(Continued)*

LAO
50 years of service

Local Taxes	Rate	Description
Property taxes	1 percent (plus amounts to pay off voter approved debt)	Tax is levied on the assessed value (usually based on purchase price plus a maximum annual inflation factor of 2 percent) of most real estate and various types of personal and business property (such as boats, airplanes, and business equipment).
Local sales and transaction taxes	1.25 to 2.75[d] percent	Collected with state sales and use tax. Revenues go to cities, counties, and special-purpose taxing districts.
Vehicle license fees	2 percent	Tax is applied to original purchase price less depreciation as determined by statute. Tax is collected by the state and distributed to cities and counties.

[a] AMT refers to the Alternative Minimum Tax.

[b] This rate includes all state-imposed tax rates including rates levied for program realignment and local public safety.

[c] Sub-Chapter S corporations have a 1.5 percent tax rate.

[d] Maximum allowable combined rate, except maximum is 3.00 percent in San Francisco and 3.25 percent in San Mateo County. Currently, the highest actual local rate in the state is 2.50 percent in San Francisco.

Recent Initiative Measures Having Tax and/or Revenue-Related Implications

Measure/Election	Major Provisions
Proposition 13—June 1978	• Limits general property tax rate to 1 percent and limits increases in assessed value after a property is bought or constructed. • Makes Legislature responsible for dividing property tax among local entities. • Requires two-thirds vote for Legislature to increase taxes. • Requires two-thirds voter approval of new local special taxes.
Proposition 4—November 1979	• Generally limits spending of "proceeds of taxes" by the state and local entities to prior-year amount, adjusted for population growth and inflation (now per capita personal income growth). • Requires state to reimburse local entities for mandated costs.
Proposition 6—June 1982	• Prohibits state gift and inheritance taxes, except for "pickup" tax qualifying for federal tax credit.
Proposition 7—June 1982	• Requires indexing of state personal income tax brackets for inflation.
Proposition 37—November 1984	• Establishes state lottery and dedicates revenue to education. • Places prohibition of casino gambling in State Constitution.

(Continued)

LAO
50 years of service

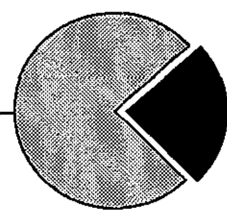
Recent Initiative Measures Having Tax and/or Revenue-Related Implications *(Continued)*

Measure/Election	Major Provisions
Proposition 62—November 1986	• Requires approval of new local general taxes by two-thirds of the governing body and a majority of local voters.
Proposition 98—November 1988	• Establishes minimum state funding guarantee for K-12 schools and community colleges. • Requires distribution to schools and community colleges of half of any state tax revenues in excess of the appropriations limit.
Proposition 99—November 1988	• Imposes surtax on cigarettes and tobacco products. • Limits use of surtax revenue, primarily to augment health-related programs.
Proposition 163—November 1992	• Repealed "snack tax" and prohibits any future sales tax on food items, including candy, snacks, and bottled water.

State Revenues in 1995-96

Total State Revenues $58.3 Billion[a]

General Fund Revenues (In Billions)	
Personal Income Taxes	$19.9
Sales and Use Taxes	15.5
Bank and Corporation Taxes	5.1
All Other	3.6
Total	**$44.1**



Special Fund Revenues (In Billions)	
Motor Vehicle-Related Taxes	$7.5
Sales and Use Taxes[b]	3.3
Tobacco-Related Taxes	0.5
All Other	3.1
Total	**$14.3**

[a] Includes transfers. Detail may not add to totals due to rounding.

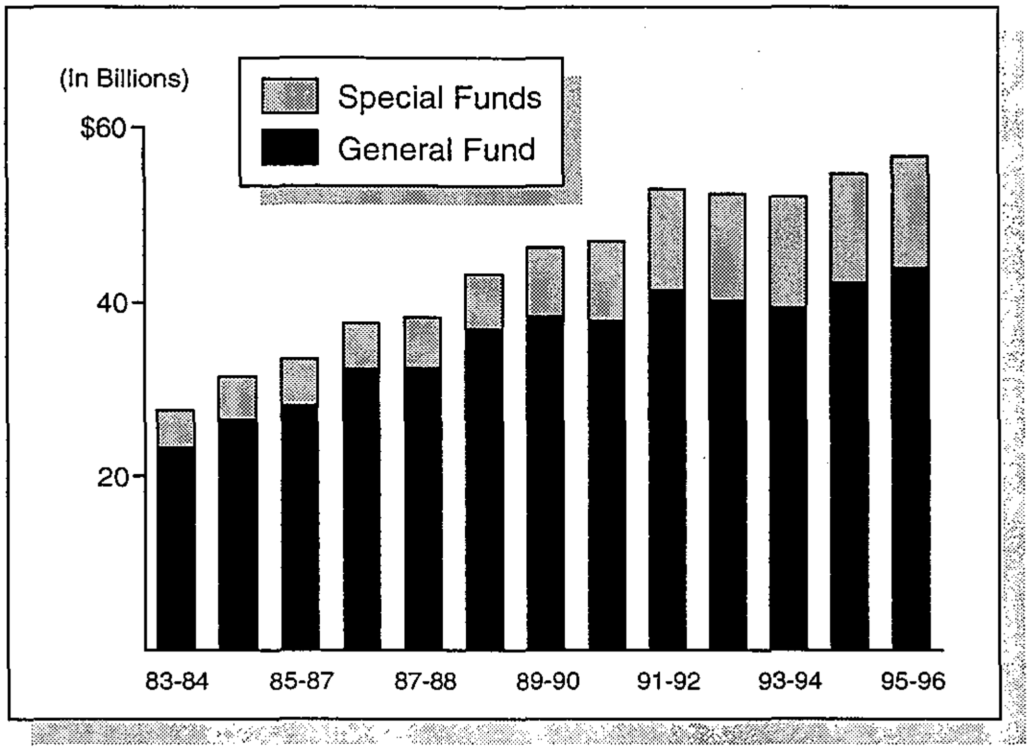
[b] Includes $1.6 billion to Local Revenue Fund, and $0.2 billion for transportation-related purposes. Also includes $1.6 billion allocated to Local Public Safety Fund which is not included in Governor's Budget totals.

- ☑ **General Fund revenues account for over three-fourths of total revenues.**

- ☑ **Personal income taxes are the largest individual revenue source—over one-third of total revenues and 45 percent of General Fund revenues.**

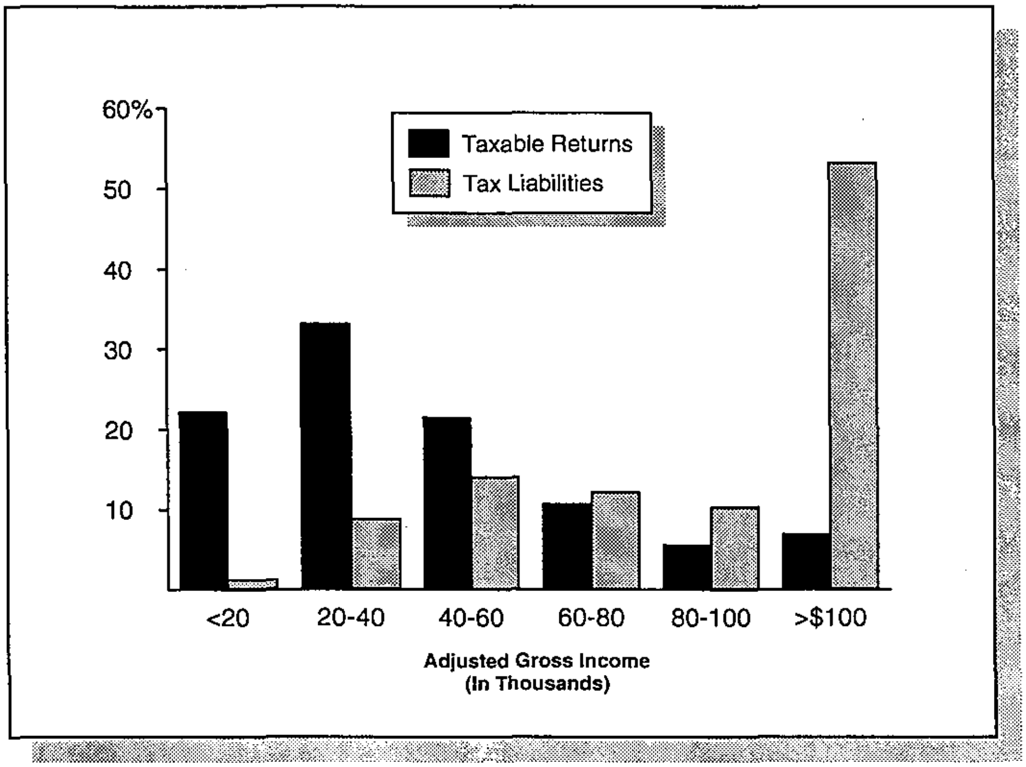
- ☑ **Special funds are usually earmarked for specific purposes, such as transportation funding. Motor vehicle-related levies account for over half of all special fund revenues.**

State Revenues Excluding Transfers 1983-84 Through 1995-96



- ☑ **After declining during the recession, total state revenues have grown in each of the last three years, averaging 4.3 percent.**
- ☑ **During the past 13 years, however, total revenue growth has averaged 6.2 percent.**
- ☑ **Average growth since 1983-84 has been faster for special fund revenues than for General Fund revenues—nearly 10 percent versus 5.4 percent.**

Personal Income Taxpayers and Tax Liabilities By Income Class—1993

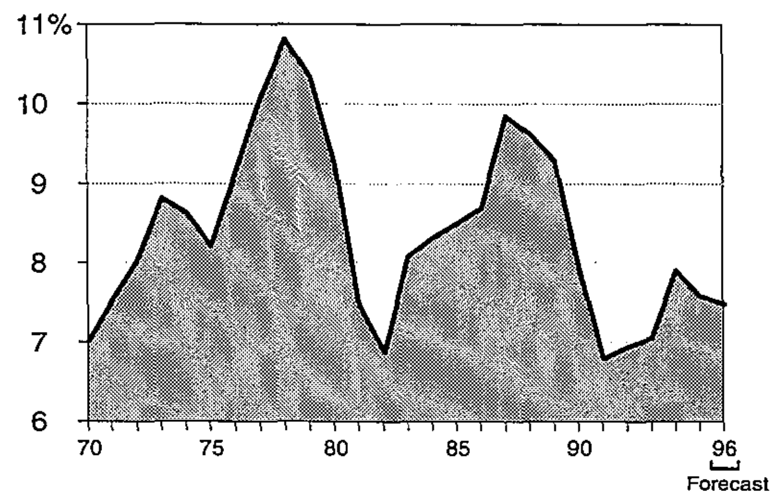


- California has a highly progressive personal income tax structure, meaning that as one's taxable income rises, so does one average tax rate.

- The progressivity of the tax structure, when combined with the distribution of taxable income, determines the distribution of California's personal income tax burden.

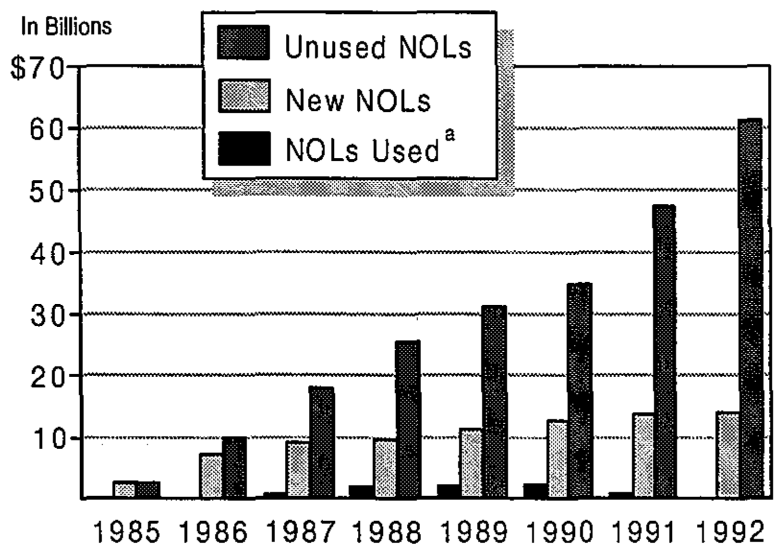
- In 1993, the top 10 percent of taxpayers paid nearly 60 percent of all tax liabilities, and the top 1 percent of taxpayers paid almost 30 percent of all liabilities.

Taxable California Corporate Profits As a Percent of Personal Income—Continued Softness



- The corporate profits ratio hit an all-time low in 1991-92, due to the recession.
- The current post-recession snapback has been weaker than in previous recoveries.
- There are a number of factors which may explain the recent softness in corporate profits. These include the recession, changes in industry mix, business relocations, and taxpayer noncompliance.

Net Operating Losses Will Constrain Revenue Growth



[a] NOLs could not be used until 1987 and were suspended for income years beginning in 1991 and 1992.

Source: California Franchise Tax Board.

- ☑ The stock of unused carry forward net operating losses (NOLs) has the potential to significantly reduce bank and corporation tax revenues.
- ☑ As of 1992, the unused NOL stock totaled over $60 billion. About 80 percent of this unused stock involves active corporations.
- ☑ Each $1 billion of NOLs deducted can reduce tax revenues by over $90 million.

Sales and Use Tax Rates Imposed in California

	Current Law
State	
General Fund	5.00%
1991 program realignment (Local Revenue Fund)	0.50
Local Public Safety Fund[a]	0.50
Totals, state	**(6.00%)**
Local	
Uniform local taxes[b]	1.25%
Optional local taxes[c]	1.50
Totals, local	**(2.75%)**
Statewide maximum rate	**8.75%**

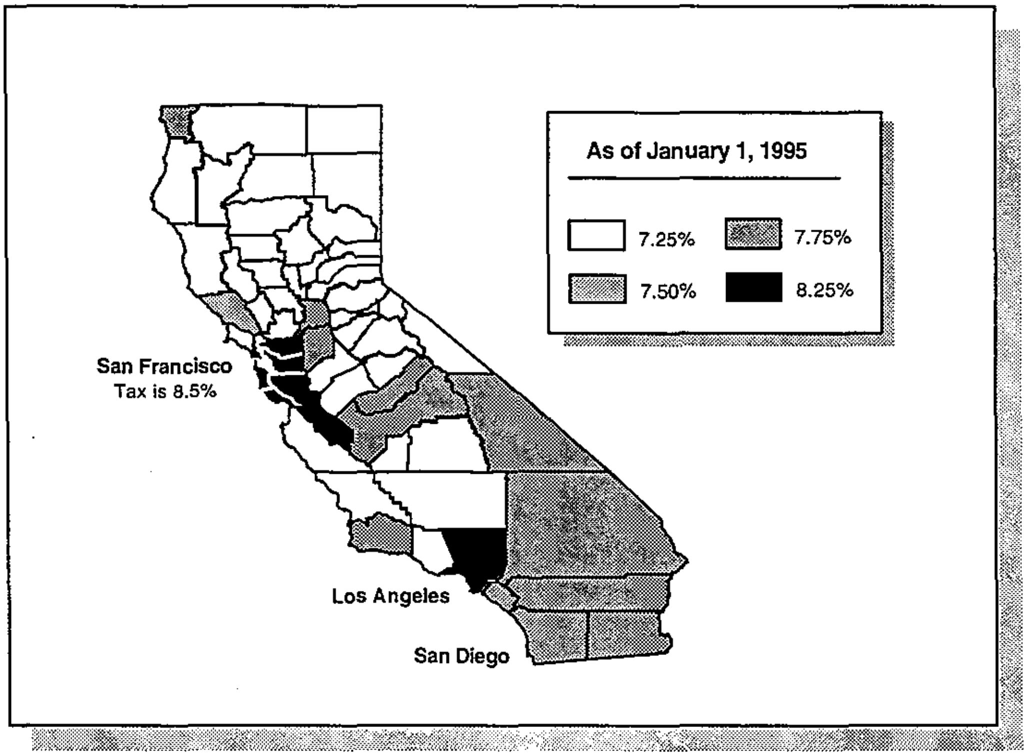
[a] These revenues are not shown in the Governor's Budget totals.

[b] Levied in all counties.

[c] Maximum allowable combined rate, except maximum combined rate is 1.75 percent in San Francisco and 2 percent in San Mateo.

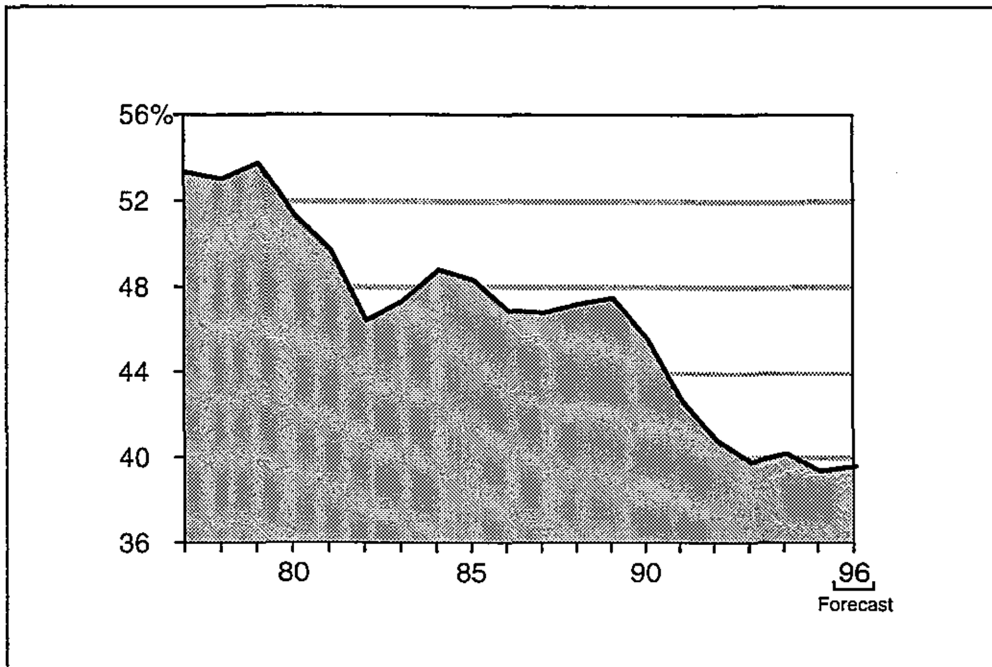
- ☑ **The overall sales and use tax rate actually consists of a number of different individual rates of tax.**
- ☑ **The maximum statewide rate is 8.75 percent, and the minimum is 7.25 percent.**

Sales Tax Rate Variations by County



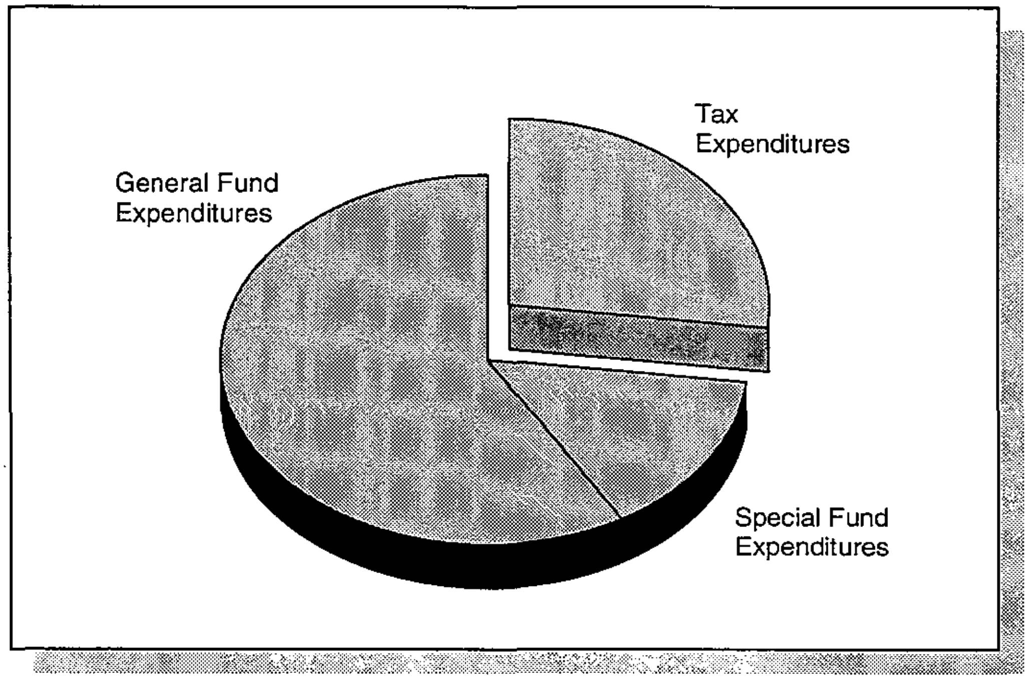
- Sales tax rates vary by county because of the optional sales taxes which localities can choose to levy.
- Existing sales tax rates range from 7.25 percent in counties with no optional taxes, to 8.5 percent in the City and County of San Francisco.
- San Mateo and San Francisco can impose an additional 0.5 percent and 0.25 percent rates, respectively, beyond the 8.75 percent maximum statewide rate.

Taxable Sales as a Percent of Personal Income Has Declined Over Time



- **Taxable sales as a percent of personal income generally has followed a downward trend over the past 15-plus years.**
  - The ratio stood at 53 percent in 1977. It is estimated to be 40 percent in 1994, 1995, and 1996.
  - This decline has occurred in large part because of increased spending on services.
  - Future growth in sales tax revenue will be constrained to the extent that services continue to expand in importance.
- **California taxes fewer services than most states.**

State Tax Expenditures Compared To Direct Expenditures

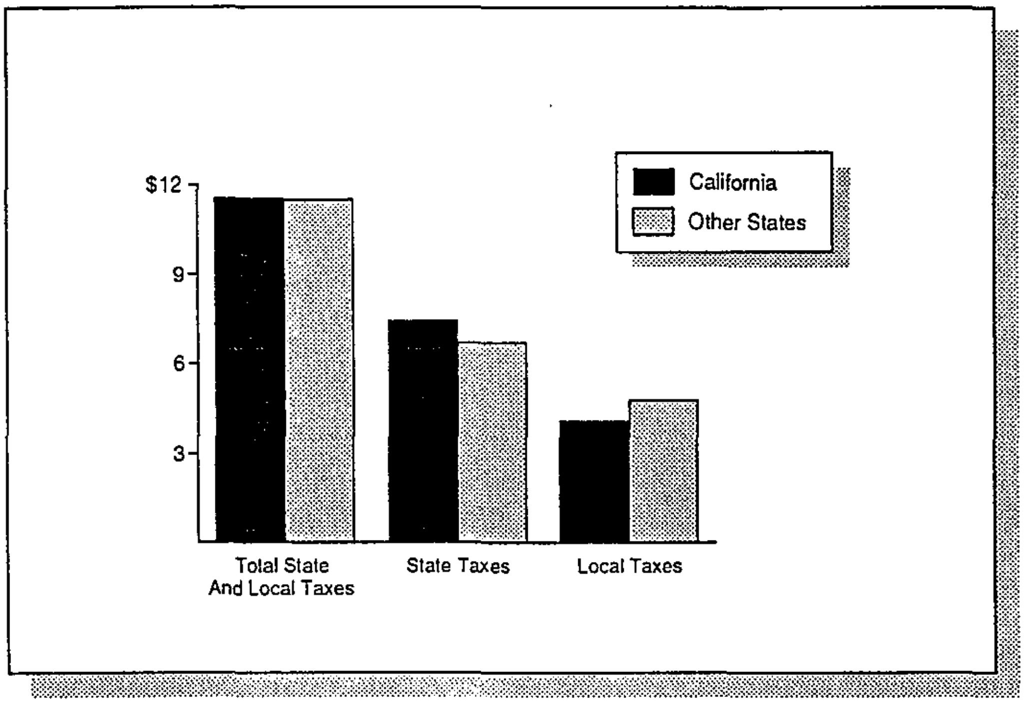


- ☑ Tax expenditure programs (TEPs) are the various tax exclusions, exemptions, credits, and deferrals which reduce the amount of revenues collected from the state's "basic" tax structure.

- ☑ State-level TEPs cost $20 billion in 1991-92, the most recent estimate available. This was equivalent to 37 percent of the direct expenditure budget.

- ☑ Personal income tax programs account for two-thirds of tax expenditures.

California Is About Average in Terms of Total Taxes per $100 Personal Income 1991-92



- Based on U.S. Department of Commerce data for 1991-92 (the most recent available), California state-local taxes per $100 personal income are slightly above (less than one-half of one percent) other states.

- California state taxes are about 11 percent above and local taxes are about 14 percent below other states.

Marginal Tax Rates for Western and Major Industrial States[a] 1994

Personal Income Tax

California	1.00% to 11.00%		
Other Western States		**Other Industrial States**	
Hawaii	2.00 to 10.00%	Massachusetts	5.95% income, 12.00% interest, dividends, capital gains
Oregon	5.00 to 9.00	New York	4.00 to 7.875
New Mexico	1.70 to 8.50	Ohio	.743 to 7.50
Idaho	2.00 to 8.20	New Jersey	1.70 to 6.58[b]
Utah	2.55 to 7.20	Michigan	4.40
Arizona	3.25 to 6.90	Illinois	3.00
Colorado	5.00	Pennsylvania	2.80
Alaska	none	Florida	none
Nevada	none	Texas	none
Washington	none		

Corporate Income Tax

California	9.30%		
Other Western States		**Other Industrial States**	
Alaska	1.00 to 9.40%	Pennsylvania	10.99%[b]
Arizona	9.00	Massachusetts	9.50
Idaho	8.00	New Jersey	9.00 Franchise, 7.25 Income
New Mexico	4.80 to 7.60	New York	9.00
Oregon	6.60	Ohio	5.10 to 8.90
Hawaii	4.40 to 6.40	Florida	5.50
Colorado	5.00	Illinois	4.80
Utah	5.00	Michigan	2.30
Nevada	none	Texas	4.50 Net taxable earned surplus
Washington	none[c]		

[a] Percentages shown are general rates. Special rates may apply to certain categories of taxpayers.
[b] Rates effective January 1, 1995.
[c] Levies a business and occupation tax.

LAO
50 years of service

How California's Tax Rates Compare

- ✔ California has one of the most progressive tax structures among western and industrial states.
- ✔ California's marginal tax rates for low income individuals are among the lowest; however, high income Californians are taxed at one of the highest marginal rates among western and industrial states.
- ✔ California's corporate tax rate is comparable to many other major industrial states, but is one of the highest among neighboring western states.
- ✔ Tax rates are only one element of a tax structure. Other factors that should be considered when making interstate comparisons include deductions, exemptions, exclusions, and credits available.

Commonly Cited Elements of a Good State Revenue System

☑ Diversity and Balance

Do a variety of revenue sources contribute in a balanced fashion to funding public services?

☑ Broad and Comprehensive Tax Bases

Are tax bases broad-based with a minimum of special exclusions and exemptions?

☑ Revenue Sufficiency

Does the system raise sufficient amounts of revenues to fund public services?

☑ Long-term Growth Potential

Is the pace at which revenues will grow over time sufficient to finance public services for a changing population?

☑ Reliability

Are revenues relatively stable or excessively volatile in times of cyclical economic activity?

☑ Economic Neutrality

Is the revenue system relatively neutral in terms of its effects on economic decision-making by individuals and businesses?

Continued

Commonly Cited Elements of a Good State Revenue System *(Continued)*

☑ Equitable Treatment of Taxpayers

Are tax burdens similar for taxpayers in similar circumstances (horizontal equity), and are the differing tax burdens on taxpayers with different characteristics appropriate (vertical equity)?

☑ Economic Efficiency

Is the revenue system consistent with a healthy business climate, responsive to interstate and international competitive pressures, and conducive to economic growth? Are the state's tax expenditures effective and efficient in accomplishing their intended objectives?

☑ Administrative Feasibility

Can the revenue system be administered in an efficient, effective, and uniform manner?

☑ Voluntary Compliance and Accountability

Does the revenue system result in a high degree of voluntary taxpayer compliance and taxpayer accountability, therefore minimizing required compliance and enforcement activities by the government?

☑ Intergovernmental Compatibility

Are the state and local elements of the overall revenue system complementary?

Selected California Tax Policy Issues

- ☑ Should the state's tax bases be further broadened so as to minimize tax rates and economic distortions? For example, should services be subject to sales taxation?
- ☑ Should the corporate and personal income tax bases be integrated?
- ☑ Should any modifications be made in the tax treatment of business "pass-through" entities (such as Sub-Chapter S corporations)?
- ☑ Should a value-added tax (VAT) be considered?
- ☑ Should Proposition 13 be modified to address the inequities and inefficiencies currently inherent in the property tax system?
- ☑ How should the state approach the issue of interstate tax competition for economic stimulus purposes?
- ☑ How can the administrative and compliance problems that result from an increasingly multistate and multinational business environment best be addressed, such as through improved interstate tax cooperation and coordination?
- ☑ How can the state's "tax gap" be further narrowed?
- ☑ Are current tax expenditures still desirable, effective and efficient?

Considerations Involving Sales Taxation of Services

- Our current sales tax is based on taxing exchanges involving tangible goods.
- When our sales tax was established in the 1930s, services were a much smaller share of our market economy than today. For example:
  - Services now account for nearly 60 percent of U.S. consumption spending, twice that of the 1930s.
- As a result, in California taxable sales as a percent of personal income has dropped dramatically in recent decades.
- The fact that services are not subject to sales taxation creates several types of tax consumption inequities.
  - Taxed commodities are disadvantaged relative to untaxed services, and
  - Services used to produce taxed goods are disadvantaged compared to services purchased for final consumption.
- States vary considerably in terms of the services they tax. In this regard, California taxes relatively few.
- The effect of taxing services on tax burdens will vary considerably, depending on what services are taxed and whether services taxation is used to raise additional revenues or lower the basic sales tax rate.
- Taxing services involves its own administrative, compliance and enforcement issues, all of which must be addressed. Nevertheless, many experts feel it is possible to design workable tax systems that include taxing at least some services.

Revenue Impact of Sales Tax on Selected Services 1995-96[a]

LAO
50 years of service

(In Millions)

	State	Local	Transit	Total
Coin operated amusement machines	$49.8	$22.4	$6.6	$78.8
Billiard/bowling facilities	14.3	6.4	1.9	22.6
Memberships to private clubs	22.5	10.1	3.0	35.6
Health clubs, tanning booths, and reducing salons	35.3	15.9	4.7	55.9
Laundry and dry cleaning services	93.6	42.1	12.4	148.1
Repair labor	725.4	326.5	95.8	1,147.7
Installation charges	0.8	0.3	0.1	1.2
Automotive services (including parking)	92.8	41.8	12.2	146.8
Landscaping (including pool service)	42.9	19.3	5.7	67.9
Taxidermy services	0.2	0.1	0.03	0.3
Pet grooming services	1.0	0.4	0.1	1.5
Exterminating (including termite service)	31.7	14.3	4.2	50.2
900 number services	6.2	2.8	0.8	9.8
Telephone answering services	12.2	5.5	1.6	19.3
Marinas	8.4	3.8	1.1	13.3
Preliminary art services	7.3	3.3	1.0	11.6
Custom computer programs	147.1	66.2	19.4	232.7
Funeral services	16.1	7.2	2.1	25.4
Janitorial services	99.6	44.8	13.1	157.5
Totals	**$1,407.2**	**$633.2**	**$185.8**	**$2,226.2**

[a] Assumes July 1, 1995 effective date and full-year revenue impact.
Source: California State Board of Equalization

LAO
50 years of service

Different Types of Spending As Percent of Total Consumption Spending[a]

Income	Taxable Goods	Entertainment Services	Personal Services	Medical Services	Food at Home
Under $5,000	43.4%	6.4%	19.5%	7.4%	18.2%
5,000-10,000	43.0	4.5	17.8	10.2	18.7
10,000-20,000	42.1	5.9	19.4	7.9	19.1
20,000-30,000	50.6	8.6	16.6	6.0	14.3
30,000-40,000	49.3	8.5	17.7	6.1	14.5
40,000-55,000	53.4	6.9	16.7	5.4	13.7
55,000-70,000	53.3	6.2	18.4	4.7	13.7
70,000-100,000	54.3	8.7	16.7	5.1	11.8
Over 100,000	54.1	8.7	17.0	5.2	11.7
Average	**50.7%**	**7.6%**	**17.5%**	**6.0%**	**14.9%**

[a] Total consumption spending excludes rent or housing payments.

Source: Professor Steve Sheffrin, U.C. Davis, based on 1989 U.S. Census data for California

Considerations Involving Flat Tax Proposals

- ☑ Flat tax proposals can differ considerably from one another. However, they generally share a common theme of simplifying the income tax structure by broadening its base, limiting the number of rate brackets, and lowering the highest marginal tax rates.
- ☑ Supporters argue that a flat tax would reduce average tax rates due to a broader tax base, lessen tax administration and compliance costs, and stimulate work incentives, investment, and overall economic performance.
- ☑ Depending on their specific characteristics, flat tax proposals have the potential to significantly change the distribution of the tax burden. Generally, some taxpayers will pay more and others will pay less.
- ☑ Under a revenue-neutral flat tax with little change in how taxable income is defined, high-income taxpayers would experience saving and other taxpayers would see increased liabilities.
- ☑ Flat tax systems can be made somewhat progressive, however, using such tools as selectively limitating existing exclusions, exemptions, and deductions, and the use of special exemptions that phase-out as income rises.
- ☑ The reduced marginal tax rates that flat tax proposals contain will have various stimulative effects in such areas as work and investment incentives. However, there is debate as to the exact nature and magnitude of these effects, especially at the state level.
- ☑ In considering flat tax proposals, the Legislature will need to weigh their benefits against its other tax policy objectives.

LAO
50 years of service

Action Steps for Legislative Review of Tax Expenditures

☑ **Review and agree upon the basic rationales and objectives of individual tax expenditure programs, including whether their purpose is to:**

- Provide tax relief to specific taxpayers.
- Provide economic incentives to encourage certain types of taxpayer behavior.
- Simplify or facilitate tax administration.

☑ **Review the available evidence on the overall effectiveness and economic efficiency of individual TEPs.**

☑ **Take the following actions with regard to individual TEPs:**

- Eliminate TEPs whose rationales and objectives are no longer valid or of low priority.
- Eliminate or modify TEPs which are not accomplishing their objectives.
- Eliminate TEPs which are not cost-efficient, even if they are effective, and if appropriate replace them with either tax expenditure or direct expenditure programs which *are* cost-efficient.
- Modify inadequately targeted tax relief and incentive-oriented TEPs so that they are better targeted to those who need or will respond to them, and so that "windfall" benefits to unintended taxpayers are eliminated.