# COMPARING OPTIONS TO RAISE AND LOWER TAXES

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LAO

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# Introduction

Few topics are more challenging for policymakers than taxation. Taxes fund public services that Californians use every day, but they also exact costs on families and businesses. This presents difficult questions for policymakers. Who should pay taxes, how much, and in what form? At what point do the costs of taxes exceed the public benefits of the services they pay for? The Legislature often has turned to our office for guidance on these questions and, most recently, sought that guidance as part of last year's budget deliberations. These questions, however, have no objective answer. Rather, policymakers must attempt to strike a balance that they believe best reflects Californians' values. As the Legislature's nonpartisan advisor, we cannot tell policymakers where that balance should be struck. We can, however, offer context and information to help policymakers sort through these difficult choices.

One such type of information is the range of options available to raise or lower taxes and the trade-offs each of those options presents. What are the costs of raising taxes or the benefits of cutting them? Who would pay those costs or receive those benefits? How stable and reliable would the resulting changes in revenue be? With this information in hand, policymakers are better positioned to weigh changes in taxes against changes in public services. The aim of this report is to provide that information.

The report proceeds in four sections. The opening section discusses our analytical approach and provides guidance on interpreting our findings. The other three sections detail various tax options. First, we examine tax increase options that would each raise between $1 billion to $3 billion per year. Next, recognizing that policymakers soon will need to grapple with the expiration of temporary income tax rates put in place by Proposition 55 (2016), we turn to options that raise around $10 billion to $15 billion per year. Finally, we look at options to lower taxes by $1 billion to $3 billion per year.

# Understanding Our Approach

This report lays out a range of options for raising and lowering taxes and compares those options to each other on a variety of criteria. This section describes the process that went into developing our findings.

## Rubric

To evaluate tax options, we use a rubric with five categories: budgeting, economy, taxpayer experience, progressivity, and fairness. Each of these categories represents an important area of consideration for policymakers when evaluating tax options. No category is necessarily more important than another. Different policymakers will weigh these considerations differently based on their values and priorities. For example, some may prioritize options that are highly progressive. Others instead may favor options that improve stability and predictability in state budgeting. Our work does not aim to resolve these differences. Instead, we offer our assessment of how various options rank within each category. Policymakers may then use that information to decide which options they think are best. Below, we describe each category and discuss the criteria used to arrive at our rankings.

***Budgeting.*** The budgeting category focuses on three main criteria:

- ***Growth.*** How much will the new revenues (tax relief) grow over time? Will that growth keep up with the overall economy? Options that grow faster rank higher.
- ***Stability.*** How much will the new revenues (tax relief) fluctuate from year to year? Options that fluctuate less rank higher.
- ***Predictability.*** How well will we be able to predict the initial revenues when the change is first put in place? How well will we be able to predict these revenue changes from year to year? Options that are more predictable rank higher.

***Economy.*** Taken in isolation—that is, ignoring the benefits of the public services that taxes pay for—tax increases come with economic costs. Similarly, tax cuts bring economic benefits. This category attempts to gauge those economic effects. Overall, options that likely have smaller economic costs (larger economic benefits) rank higher. Taxes can affect the economy through many channels. Our review focuses on potential effects in three main areas:

- ***Jobs.*** How much could the tax increase reduce employment? Or how much could the tax relief increase employment?
- ***Disposable Income.*** How much could the tax increase reduce real disposable incomes? Or how much could the tax relief increase real disposable incomes? Real disposable incomes decline if wages go down or prices go up.
- ***Innovation.*** How much could the tax increase reduce productivity growth or consumer product innovation? Or how much could the tax relief boost productivity and innovation?

***Taxpayer Experience.*** The taxpayer experience category focuses on how difficult and expensive it would be for taxpayers to comply with the new tax or to receive the new tax relief. Relatedly, how easily can taxpayers understand the tax change and how likely are they to comply voluntarily?

***Progressivity.*** The progressivity category looks at two main criteria, in order of importance:

- ***"Ordinary" Californians.*** What share of the new tax costs (tax relief) fall on ordinary Californians (defined as individuals earning $250,000 or less and couples earning $500,000 or less)? Options that place a smaller share of costs (larger share of benefits) on ordinary Californians rank higher.
- ***Overall Progressivity.*** Do the new tax costs increase as the taxpayer's income increases? Or does the tax relief decrease as the taxpayer's income increases? The more costs increase (decrease, in the case of tax relief) as income increases, the higher the option ranks.

***Fairness.*** There are many, often subjective, concepts of fairness. For this reason, evaluating a comprehensive definition of fairness is beyond the scope of this project. Instead, we focus on two narrower criteria that we think better lend themselves to objective evaluation:

- ***Similar Treatment.*** Could the tax change result in incidental or unintentional dissimilar treatment of similar taxpayers? Conversely, could the change lessen or eliminate an existing dissimilar treatment among similar taxpayers?
- ***Historically Disadvantaged Groups.*** Does the tax change disproportionately burden historically disadvantaged groups? Conversely, does the change lessen or eliminate an existing disproportionate burden?

***Some Important Considerations Fall Outside Our Rubric.*** Some considerations that will factor into policymakers' decisions about taxes are not included in our rubric. These considerations include the difficulty of enacting the changes, public opinion, or more expansive notions of fairness. The exclusion of these considerations does not mean they are unimportant or that policymakers should ignore them. Rather, we cannot offer guidance because they are outside the scope of nonpartisan analysis.

## Selection of Options

Our process for selecting options to include in this report involved a handful of key considerations. First, we aimed to demonstrate the variety of options available to policymakers. We do, however, limit the options to changes in taxes paid, excluding options like refundable tax credits. Second, we excluded options if it appeared they (1) would not begin raising ongoing revenue within a few years, (2) raised significant legal concerns, or (3) could not be feasibly administered without extraordinary costs. Finally, to keep the scope of the report manageable, we excluded options we anticipated would score comparatively poorly across our rubric.

## Evaluation Process

***Consensus-Based Rankings.*** Our goal is to use the best available evidence to rank various tax options on the defined criteria of our rubric. We acknowledge that this exercise necessarily involves judgement. Two different researchers may reasonably disagree on which evidence is the strongest or how best to interpret certain statistics. Further, definitive evidence rarely exists on the questions we are considering, requiring the use of secondary evidence and rules of thumb. To mitigate this issue, we used a consensus-based approach. Our office's team of five economists reviewed the available evidence on each of the tax options. Following those reviews, each economist independently ranked the options using our rubric. Our results reflect the consensus of those rankings.

***Evidence Reviewed.*** Our team reviewed a variety of evidence, including:

- ***Tax Data.*** Historical data on tax collections; detailed taxpayer data from the state's tax agencies.
- ***Other Official Data.*** Census data on demographic and economic characteristics of Californians; various economic data from the U.S. Bureau of Economic Analysis, Bureau of Labor Statistics, and others.
- ***Academic Research.*** A variety of academic studies, a selection of which is listed at the end of the report.
- ***Established Theory.*** Theories about how the economy works that have withstood scrutiny and have been corroborated by real-world experience.

***Making the Best of Limited Evidence.*** The quality of evidence varies across the options we evaluated and the criteria we used for evaluation. One topic for which clear evidence is rare is the economy. Only in very limited cases are rigorous studies available to speak directly to the effect of the taxes on jobs, real disposable incomes, or innovation. Where this type of evidence is lacking, we supplemented our analysis with secondary evidence:

- ***How Much of the Costs and Benefits Are Shifted Out of State?*** There are many ways that the costs or benefits of a tax change can go to people and businesses located elsewhere. For example, people may pay a tax for something they do while in the state temporarily, like a tourist paying sales tax on their vacation purchases. Multistate businesses may recoup part of a tax by raising prices for customers in other states. People and businesses sometimes can shift their state tax costs to the federal government through deductions against federal taxes. When more costs are shifted out of state, this likely reduces the risk of negative economic outcomes. Similarly, when more benefits of tax relief go out of state, this reduces the potential for a boost to the state's economy.
- ***Does the Tax Change Encourage People or Businesses to Act Unproductively or Inefficiently?*** Taxes can encourage people and businesses to take actions that are aimed primarily at reducing tax payments. Often these actions can be unproductive or inefficient. For example, if a manufacturing business has to pay taxes for buying machinery from another business, they may decide to make that machinery in house, even if it costs them more to do so. These kinds of actions can be a drag on the economy. When we find evidence that a certain tax change encourages these kinds of actions, we assume a higher risk of negative economic outcomes.
- ***How Much Does the Tax Change Discourage Productive Economic Activity?*** Taxes can discourage people and businesses from taking actions that grow the economy. For example, taxing the income of small business owners may discourage people from starting businesses. Similarly, taxing investment returns may discourage people from funding innovative ventures. When we find evidence that these kinds of responses are larger for a certain tax change, we assume a higher risk of negative economic outcomes. One common rule of thumb that we employ is that these kinds of responses tend to intensify as tax rates get higher.
- ***How Much Does the Tax Fall on Low-to-Middle-Income Taxpayers?*** While not conclusive, decent evidence suggests that taxes on low-to-middle-income taxpayers are a greater drag on the economy than taxes on high-income taxpayers. Consistent with this, we use the progressivity of the tax change to supplement any evidence in the other categories above. Where two options score similarly on other evidence, we assign a lower economy ranking to the option that falls more on low-to-middle-income Californians.

## Interpreting the Results

***Options Ranked in Tiers.*** Our evaluation assigns each tax option to a relative tier in each of the categories of our rubric. For example, an option that is among the most progressive is assigned to the top tier of progressivity, while an option that is among the most regressive is assigned to the bottom tier. The rankings include four tiers for options to raise taxes by $1 billion to $3 billion. In contrast, because we present fewer options to raise $10 billion to $15 billion, those rankings include just three tiers. Similarly, the rankings of options to lower taxes by $1 billion to $3 billion include three tiers. The results for fairness are different. Instead of tiers, we report one of three findings: (1) lessens existing fairness concerns, (2) neutral, or (3) raises new fairness concerns. Our results are presented graphically, as explained in Figure 1 (next page).

***Rankings Are Relative.*** All our rankings are relative. That means we are not scoring the options against an ideal standard. Instead, our rankings are based only on how an option compares to the other options. To understand why this is important for interpreting our results, consider the economy. If a tax increase is in the top tier for economy, it does not mean it has no economic costs. If a tax increase is in the bottom tier, it does not mean it would have severe economic consequences, such as a recession. Instead, economic outcomes will fall somewhere between these two extremes. Available evidence does not allow us to say exactly where each tax option falls on this spectrum. We can, however, suggest which tax increases pose more risk to the economy than the other options we consider. This is what our rankings are intended to communicate.

***Changes Are Incremental.*** None of the options examined in this report, by themselves, would be a fundamental change to the state's tax system or economy. None will make or break the state's economy. Instead, they could result in incrementally more or less economic growth. None will completely change the future course of state revenue growth, but they could make revenues grow slightly faster or slower. The incremental nature of these options is important to keep in mind when interpreting our findings, as well as when considering the trade-offs between tax options and changes in state spending. That being said, the situation is different if policymakers consider combining multiple options to raise tens of billions of dollars per year. Changes of that magnitude are considerably riskier and more unpredictable.

## Terminology

***Tax Base.*** A tax base is all activities or items that are subject to a particular tax.

***Tax Rate.*** A tax rate typically is the percentage of the taxable activity that the taxpayer must pay in taxes. Some taxes have a flat tax rate. This means the tax rate is the same for all taxpayers. Other taxes, like the personal income tax, have marginal tax rates. For the personal income tax, this means that the tax rate incrementally increases as taxable income increases. For example, the first $11,079 of a single taxpayer's income is taxed at 1 percent. Dollars of income between $11,079 and $26,264 are taxed at 2 percent. Rates continue to step up until you reach dollars of income over $742,953, which are taxed at 12.3 percent.

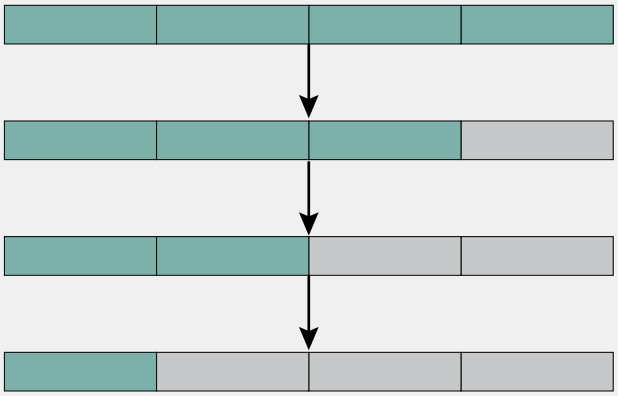
***Tax Expenditure.*** A tax expenditure is a component of the tax system that departs from the normal tax structure to reduce taxes for certain taxpayers, often to encourage particular behaviors or provide targeted benefits.

***Deduction.*** A tax deduction reduces the amount of an activity that will be subject to a tax. For example, a personal income tax deduction reduces the income to which tax rates are applied. Personal income taxpayers get a choice between taking a standard deduction or deducting certain itemized expenses. For example, one deductible expense that taxpayers can itemize is their costs for charitable giving. About 30 percent of taxpayers itemize their state deductions.

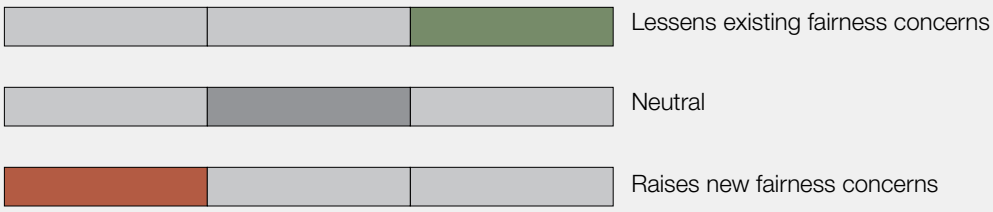
***Credit.*** A tax credit is a dollar-for-dollar reduction in the amount of tax a taxpayer owes.

## How to Read Our Results

Our results are displayed in a graphic that shows the ranking on each of the five categories. For all categories except fairness, the ranking is represented graphically as shown below.




Fairness is shown differently. Our results on fairness are represented by one of three graphics.



# TAX INCREASE OPTIONS

This chapter looks at 13 options that each raise taxes between $1 billion and $3 billion per year.

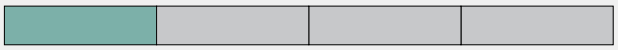
## Quarter-Cent Sales Tax Increase

This option would increase the state General Fund portion of the sales tax rate from 3.9375 percent to 4.1875 percent. The sales tax is collected on the retail sale of tangible goods. Services and digital goods are not taxed.

## Rankings: Quarter-Cent Sales Tax Increase

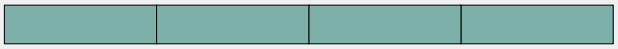
### Budgeting

Growth



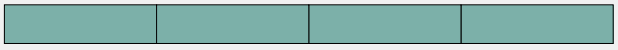
Grows slower than the economy. Growth slowing over time.

Stability



Less prone to large year-to-year swings.

Predictability

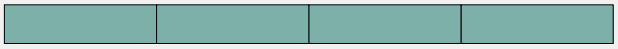


Relative stability and long historical record make this option comparatively easy to predict.

### Economy

Some of the costs are shifted out of state, but most fall on ordinary Californians. Could result in some unproductive business operations.

### Taxpayer Experience



Should require only minor changes to existing processes.

### Progressivity

Falls primarily on ordinary Californians.

### Fairness

Consumers who spend more of their money on tangible goods are disfavored compared to those who spend more on services and digital goods.

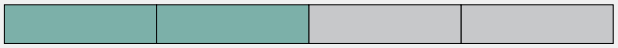
## Sales Tax on Digital Goods

Sales of digital goods, like software and digital media, currently are not taxed even though sales of similar tangible goods, like physical books and movies or games sold on discs, are taxed. This option would extend the sales tax to digital goods, applying both the existing 3.9375 percent state General Fund rate and local tax rates to those sales. About half of the revenue gains from this change would go to the state and the other half would go to local governments.

## Rankings: Sales Tax on Digital Goods

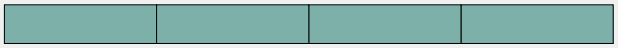
### Budgeting

Growth



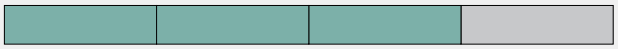
Grows about the same rate as the economy, but may slow somewhat over time.

Stability



Less prone to large year-to-year swings.

Predictability

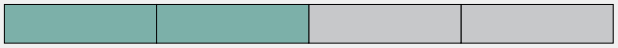


Limited historical data makes the initial estimate of revenue gains difficult, but year-to-year predictions should get better over time.

### Economy

Few of the costs are shifted out of state. Primarily hits finances of ordinary Californians.

### Taxpayer Experience



Requires creation of new processes. Businesses and consumers will have to adjust to paying taxes on previously untaxed purchases.

### Progressivity

Falls primarily on ordinary Californians.

### Fairness

Eliminates unequal treatment of similar tangible and digital goods, like books, movies, and games.

## Soda Tax

This option creates a statewide tax on sugary drinks equal to two cents per ounce.

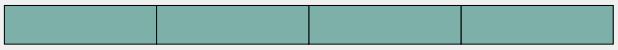
## Rankings: Soda Tax

### Budgeting

Growth

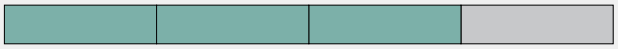
Grows somewhat slower than the economy.

Stability



Less prone to large year-to-year swings.

Predictability

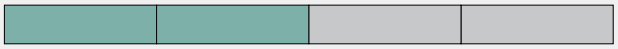


Limited historical data makes the initial estimate of revenue gains difficult, but year-to-year predictions should get better over time.

### Economy

Few of the costs are shifted out of state. Primarily hits finances of ordinary Californians.

### Taxpayer Experience



Requires creation of new processes. Businesses and consumers will have to adjust to paying taxes on previously untaxed purchases.

### Progressivity

Falls primarily on ordinary Californians. Could disproportionately fall on low-income consumers.

### Fairness

Costs likely borne heavily by Black and Latino consumers.

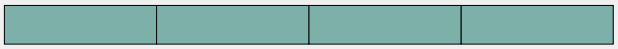
## Income Tax on Millionaires

This option creates an additional 1 percent surcharge on personal income over $1 million. This would increase the tax rate on this income from 13.3 percent to 14.3 percent. (This includes the 12.3 percent marginal rate plus the existing 1 percent surcharge on incomes over $1 million per year.)

## Rankings: Income Tax on Millionaires

### Budgeting

Growth

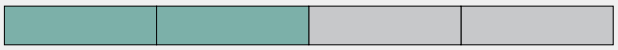


Grows much faster than the economy.

Stability

High dependence on performance of financial assets makes very large year-to-year swings likely.

Predictability

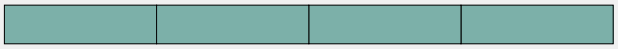


Inherent instability of incomes of high-income taxpayers makes this tax hard to predict. Slightly offset by having good historical data.

### Economy

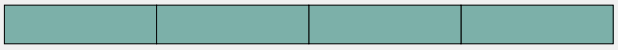
Some of the costs can be shifted out of state through federal tax deductions, but most of costs fall on Californians. Exacerbates existing challenge of millionaire outmigration.

### Taxpayer Experience



Should require only minor changes to existing processes.

### Progressivity



Highly concentrated on very high-income Californians.

### Fairness

Does not raise new major fairness considerations.

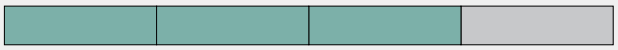
## 2 Percent Across-the-Board Income Tax Increase

This option increases personal income tax payments by 2 percent across the board. For example, if a taxpayer currently is paying $1,000 in taxes per year, they would pay $1,020 instead.

## Rankings: 2 Percent Across-the-Board Income Tax Increase

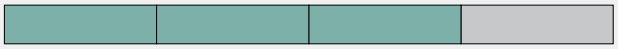
### Budgeting

Growth



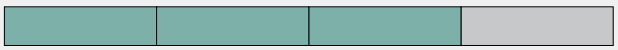
Grows faster than the economy.

Stability



Prone to large year-to-year swings, but less dependent on financial markets than other income tax options.

Predictability

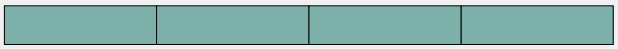


Year-to-year instability presents challenges, but long historical record helps make this option somewhat easier to predict.

### Economy

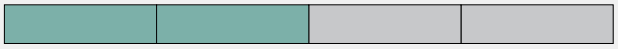
Some of the costs can be shifted out of state through federal tax deductions, but most costs fall on Californians. Probably discourages some income-generating activities.

### Taxpayer Experience



Should require only minor changes to existing processes.

### Progressivity



While high-income taxpayers pay the majority of the costs, a meaningful share still falls on ordinary Californians.

### Fairness

Does not raise new major fairness considerations.

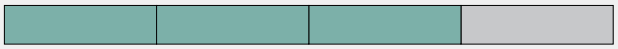
## Replace Charitable Contribution Deduction With a Credit

This option would replace an existing income tax deduction for charitable giving with an income tax credit for the same purpose. Under this option, the credit would be intentionally designed to have a smaller fiscal cost, resulting in state revenue gains. The credit would provide a smaller tax benefit but would be available to all taxpayers, not just those who itemize.

## Rankings: Replace Charitable Contribution Deduction With a Credit

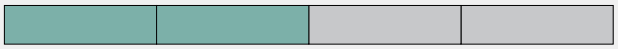
### Budgeting

Growth



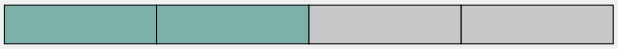
Potentially grows faster than the economy.

Stability



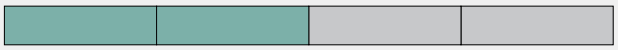
Prone to large year-to-year swings because giving is cyclical.

Predictability



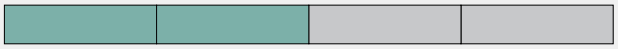
Initial revenue gain is difficult to predict because it depends on how taxpayers respond. Year-to-year predictions also could be complicated by underlying instability in giving.

### Economy



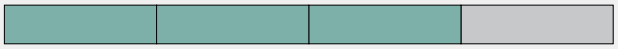
Californians bear most of the tax benefit losses. Nonprofit sector could lose some funding, but economic benefit of some current giving is unclear.

### Taxpayer Experience



Requires creation of new processes. Some taxpayers will have to expand their record keeping. Others will adjust their giving patterns.

### Progressivity



Lost tax benefits are concentrated on high-income taxpayers, while some ordinary Californians will get a new tax benefit.

### Fairness

Current deduction favors certain givers over other givers and nongivers. Currently favored givers are more likely to be high-income and white. This change reduces this disparity.

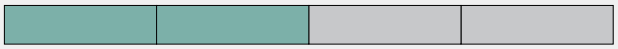
## Replace Mortgage Interest Deduction With a Credit

This option would replace an existing income tax deduction for mortgage interest costs with an income tax credit for the same purpose. Under this option, the credit would be intentionally designed to have a smaller fiscal cost, resulting in state revenue gains. The credit would provide a smaller tax benefit but would be available to all taxpayers, not just those who itemize.

## Rankings: Replace Mortgage Interest Deduction With a Credit

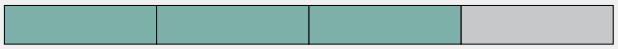
### Budgeting

Growth



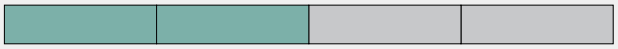
Mortgage interest payments grow somewhat slower than the economy.

Stability



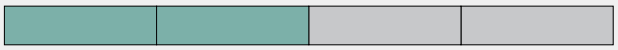
Less prone to large year-to-year swings.

Predictability



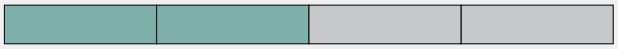
Initial estimate of revenue gain is difficult because of data limitations and uncertainty of how taxpayers will respond.

### Economy



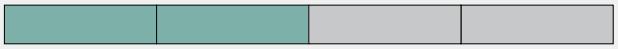
Californians bear most of the tax benefit losses. Current deduction likely pushes people toward bigger homes and inflates home prices. This change makes that less likely.

### Taxpayer Experience



Requires creation of new processes. Some taxpayers will have to expand their record keeping.

### Progressivity



Most of the lost tax benefits would have gone to ordinary Californians. At the same time, some ordinary Californians will see a new or increased benefit.

### Fairness

Current deduction favors purchasers of larger, more expensive homes but does not appear to increase homeownership overall. This change lessens these problems.

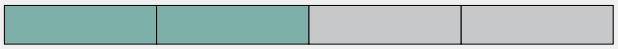
## Replace Property and Other Local Tax Deduction With a Credit

This option would replace an existing income tax deduction for costs of paying property taxes and other local taxes with an income tax credit for the same purpose. Under this option, the credit would be intentionally designed to have a smaller fiscal cost, resulting in state revenue gains. The credit would provide a smaller tax benefit but would be available to all taxpayers, not just those who itemize.

## Rankings: Replace Property and Other Local Tax Deduction With a Credit

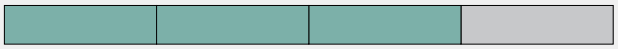
### Budgeting

Growth



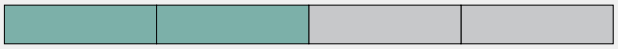
Property tax payments grow about the same rate as the economy.

Stability



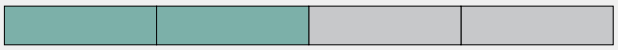
Less prone to large year-to-year swings.

Predictability



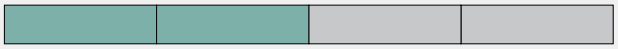
Initial estimate of revenue gain is difficult because of data limitations and uncertainty of how taxpayers will respond.

### Economy



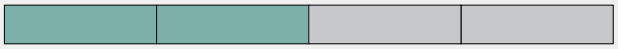
Californians bear most of the tax benefit losses. Current deduction likely pushes people towards more expensive property. This change makes that less likely.

### Taxpayer Experience



Requires creation of new processes. Some taxpayers will have to expand their record keeping.

### Progressivity



Most of the lost tax benefits would have gone to ordinary Californians. At the same time, some ordinary Californians will see a new or increased benefit.

### Fairness

Current deduction favors certain property owners over other property owners. Currently favored owners are more likely to be higher income and white. This change reduces this disparity.

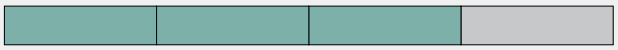
## Eliminate Income Tax Exemption for Inherited Assets

This option would calculate capital gains on inherited assets based on their original purchase price. Capital gains, which are taxed as income, are earnings from the sale of an asset. To determine a taxpayer's capital gain when they sell an asset, the sale price of the asset is compared to the price the taxpayer originally paid for the asset. The rules are different, however, for inherited assets. Right now, the capital gain on an inherited asset is determined by comparing the sale price of the asset to its value when the heir received it, instead of the original price paid for the asset. This effectively exempts from taxation all capital gains on the inherited asset that were earned during the life of the person passing it down. Historically, this rule prevented inherited assets that had already been taxed once under an estate tax from being effectively taxed again after they are sold. This rationale is no longer valid as the state no longer has an estate tax.

## Rankings: Eliminate Income Tax Exemption for Inherited Assets

### Budgeting

Growth



Grows faster than the economy.

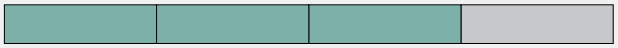
Stability

High dependence on performance of financial assets makes very large year-to-year swings common.

Predictability

Instability and lack of good information make this option very hard to predict.

### Economy

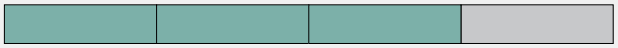


Modest effect on investment because the person who invests in the asset is different from the person who inherits it and pays the tax. Could encourage some outmigration of wealthy residents.

### Taxpayer Experience

Business owners and investors will have to expand their record keeping and will have to share more financial information with their families. Some may undertake additional estate planning efforts.

### Progressivity



Concentrated on high-income Californians.

### Fairness

Eliminates unequal treatment between people who buy and sell an asset directly and people who inherit a similar asset.

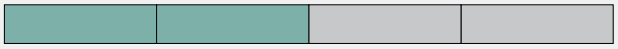
## 2 Percentage Point Increase in Corporation Tax Rate

This option increases the state's tax on profits of corporations (specifically, so called "C corporations") from 8.84 percent to 10.84 percent. Profits are a corporation's total earnings minus its total costs. For corporations that operate both inside and outside of California, additional calculations must be made to assign a share of their profits to California for taxation. This reduces the risk of a corporation being taxed on the same profits multiple times by different states. For most corporations, the share of their profits assigned to California is equal to the share of their national sales that occur in California. This means that a corporation's tax does not directly depend on how many facilities or employees they have in the state. If a corporation moves employees or facilities out of state but keeps selling the same amount of products here, its California taxes remain the same.

## Rankings: 2 Percentage Point Increase in Corporation Tax Rate

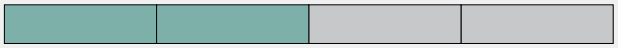
### Budgeting

Growth



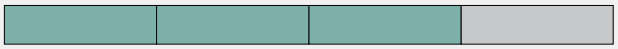
Grows about the same rate as the economy.

Stability



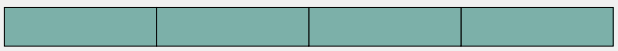
Prone to large year-to-year swings.

Predictability



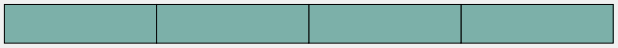
Year-to-year instability present challenges, but long historical record helps make this option somewhat easier to predict.

### Economy



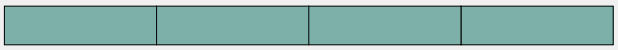
Significant share of tax cost likely shifted out of state. Corporations likely raise prices, including on out-of-state consumers. Shareholders, many of whom live elsewhere, would recieve lower returns. Corporations also would have larger federal tax deductions. Conversely, there is some risk some corporations exit the California market entirely.

### Taxpayer Experience



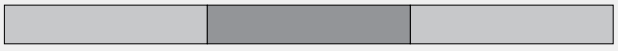
Should require only minor changes to existing processes.

### Progressivity



With a significant share of tax costs shifted out of state, a relatively small share of the cost would fall on ordinary Californians.

### Fairness



Does not raise new major fairness considerations.

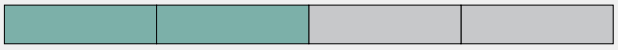
### Eliminate Certain Corporation Tax Expenditures and Increase Corporation Tax Rate

This option combines a slightly smaller tax rate increase (1.8 percentage points instead of 2 percentage points) on corporate profits with the elimination of two corporation tax expenditures. The first tax expenditure is related to credit unions. Credit unions are nonprofits and, therefore, their profits from providing services to their members are not taxed. Credit unions also earn profits from activities not related to providing services to their members—like ATM fees and investment income. Right now, these nonmember profits also are not taxed. This option instead would tax nonmember profits. The second tax expenditure is related to cable companies. Right now, cable companies with $250 million or more in qualifying annual operating costs in California effectively pay a tax rate 50 percent smaller than all other corporations. This option instead would tax cable companies at the same level as other corporations.

## Rankings: Eliminate Certain Corporation Tax Expenditures and Increase Corporation Tax Rate

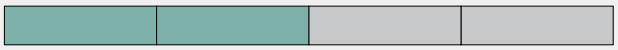
**Budgeting**

Growth



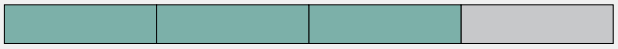
Grows about the same rate as the economy.

Stability



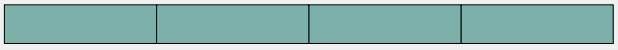
Prone to large year-to-year swings.

Predictability



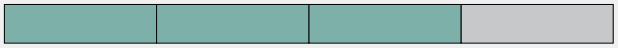
Year-to-year instability presents challenges, but long historical record helps make this option somewhat easier to predict.

**Economy**



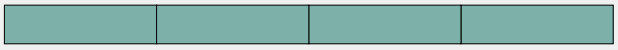
Very similar to 2 percentage point increase in corporation tax rate, except broader costs to corporations are modestly lessened. This is because part of the revenue comes from eliminating narrow tax expenditures that have uncertain economic benefits.

**Taxpayer Experience**



For most taxpayers, should require only minor changes to existing processes. Credit unions and cable companies will need to make meaningful changes to their tax processes.

**Progressivity**



With a significant share of tax costs shifted out of state, a relatively small share of the cost would fall on ordinary Californians.

**Fairness**

Eliminates favorable treatment of credit union customers over bank customers. Eliminates favorable treatment of cable companies that has an unclear rationale.

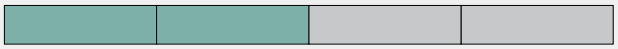
## Eliminate Water's Edge Election Under Corporation Tax

This option eliminates the possibility for corporations to make a "water's edge election" when calculating their California taxes. Corporations that operate in California and other countries can choose between two ways of assigning a share of their profits to California. One option is to start with the worldwide profits of the company and its related affiliates and assign a portion of those profits to California based on California's share of the group's worldwide sales. Alternatively, the corporation can make a water's edge election. Under this option, a share of the profits of the company and its affiliates is assigned to California based on California's share of the sales of the U.S. portion of the group. California provides the water's edge option for a few reasons. Some foreign countries and corporations have expressed concern that California taxing profits earned in other countries could result in those profits being taxed both by California and by foreign governments, increasing the risk of double taxation. In addition, record keeping and tax preparation for worldwide taxation is more complex. On the other hand, there are concerns that looking only at U.S. operations provides an opportunity for corporations to hide California profits from taxation through accounting that shifts those profits to affiliates outside the U.S.

## Rankings: Eliminate Water's Edge Election Under Corporation Tax

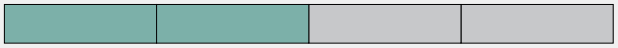
### Budgeting

Growth



Grows about the same rate as the economy.

Stability

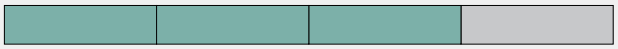


Prone to large year-to-year swings.

Predictability

Information about worldwide profits of many companies is limited. Year-to-year instability presents additional challenges.

### Economy

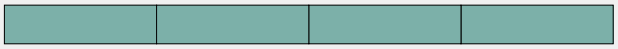


Similar to 2 percentage point increase in corporation tax rate, but with some additional risks. Response of large, sophisticated corporations is hard to predict. They make undertake new, economically unproductive steps to reduce their California taxes. Foreign trade partners may take actions against California.

### Taxpayer Experience

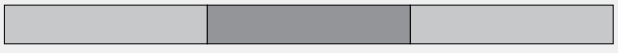
Many corporations will need to implement extensive new bookkeeping and tax administration activities.

### Progressivity



With a significant share of tax costs shifted out of state, a relatively small share of the cost would fall on ordinary Californians.

### Fairness



Offsetting fairness considerations. Current water's edge rules may give some multinational corporations unfair flexibility to limit their taxes compared to domestic corporations. On the other hand, shifting to worldwide taxation may raise concerns about double taxation.

## Oil and Natural Gas Severance Tax

This option would create a new tax on the extraction of oil and natural gas in California. The tax would be 15 percent of the value of extracted oil and natural gas. This would be in addition to an existing regulatory assessment on oil and natural gas collected by the California Department of Conservation, which currently is $1.28 per barrel of oil or thousand cubic feet of natural gas.

## Rankings: Oil and Natural Gas Severance Tax

### Budgeting

Growth

Declining over time.

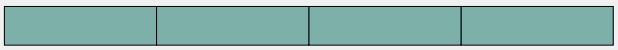
Stability

High dependence on oil and gas prices makes very large year-to-year swings likely.

Predictability

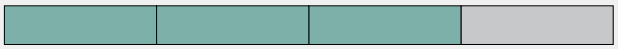
Unpredictability of oil and gas markets makes this tax very difficult to predict.

### Economy



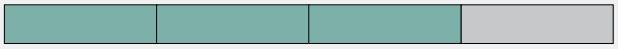
Extraction activities unlikely to change significantly. Impact to California consumer prices likely modest, as oil and gas are priced on a global market. Corporate shareholders, many of whom live elsewhere, bear much of the cost in the form of lower profits. Corporations also would have larger federal tax deductions.

### Taxpayer Experience



Existing assessment probably offers a framework to implement severance tax without significant challenges.

### Progressivity



Most costs borne by corporate shareholders who generally are higher-income.

### Fairness

Does not raise new major fairness considerations.

# MAJOR TAX INCREASE OPTIONS

This chapter looks at eight options that each raise between $10 billion and $15 billion annually.

## Extend Proposition 55

This option extends voter-approved income tax rates on high-income taxpayers. Voters approved Proposition 30 in 2012 to temporarily increase income tax rates on high-income taxpayers. In 2016, voters approved Proposition 55 to extend these higher rates until 2031. Prior to Proposition 30, California's top marginal tax rate was 9.3 percent. Proposition 30 introduced three new tax rate steps for incomes above $361,000 ($721,000 for joint filers), with the top rate reaching 12.3 percent for income over $721,000 ($1.4 million for joint filers).

## Rankings: Extend Proposition 55

### Budgeting

Growth

Grows much faster than the economy.

Stability

High dependence on performance of financial assets makes very large year-to-year swings likely.

Predictability

Inherent instability of incomes of rich taxpayers makes this tax hard to predict. Slightly offset by having good historical data.

### Economy

Some of the costs can be shifted out of state through federal tax deductions, but most costs fall on Californians. Exacerbates existing challenge of millionaire outmigration.

### Taxpayer Experience

Should require only minor changes to existing processes.

### Progressivity

Highly concentrated on very high-income Californians.

### Fairness

Does not raise new major fairness considerations.

## 1.25 Percentage Point Sales Tax Increase

This option would increase the state General Fund portion of the sales tax rate from 3.9375 percent to 5.1875 percent. The sales tax is collected on the retail sale of tangible goods. Services and digital goods are not taxed.

## Rankings: 1.25 Percentage Point Sales Tax Increase

### Budgeting

Growth

Grows slower than the economy. Growth slowing over time.

Stability

Less prone to large year-to-year swings.

Predictability

Relative stability and long historical record make this option comparatively easy to predict.

### Economy

Few of the costs are shifted out of state. Primarily hits finances of ordinary Californians. Could result result in some unproductive business operations.

### Taxpayer Experience

Should require only minor changes to existing processes.

### Progressivity

Falls primarily on ordinary Californians.

### Fairness

Consumers who spend more of their money on tangible goods are disfavored compared to those who spend more on services and digital goods.

## Increase "Big Three" Taxes

This option combines increases in the personal income tax, corporate tax, and sales tax. The tax increase is split evenly across each of these taxes. Specifically, the package includes (1) a 3 percent (not percentage point) across-the-board increase in income taxes, (2) a 3 percentage point increase in the corporation tax rate, and (3) a half-cent increase in the sales tax.

## Rankings: Increase "Big Three" Taxes

### Budgeting

Growth

Grows about the same rate as the economy.

Stability

Mixture of more and less stable revenue streams.

Predictability

Year-to-year instability of income and corporation taxes presents challenges, but long historical record helps make this option somewhat easier to predict.

### Economy

Mixture of economic effects. See comments in prior chapter on income, corporation, and sales tax rate increases.

### Taxpayer Experience

Should require only minor changes to existing processes.

### Progressivity

While a large share of the costs are paid by high-income taxpayers or shifted out of state, a meaningful share still falls on ordinary Californians.

### Fairness

Does not raise new major fairness considerations.

## Sales Tax on Consumer Services

California's sales tax generally does not apply to services. This option would extend the sales tax to various services primarily purchased by households, such as maintenance, repairs, entertainment, recreation, and transportation. About half of the revenue gains from this change would go to the state and the other half would go to local governments.

## Rankings: Sales Tax on Consumer Services

### Budgeting

Growth

Grows about the same rate as the economy.

Stability

Less prone to large year-to-year swings.

Predictability

Information limitations makes initial revenue gains very difficult to predict.

### Economy

Few of the costs are shifted out of state. Primarily hits finances of ordinary Californians.

### Taxpayer Experience

Requires creation of new processes. Consumers will have to adjust to paying taxes on previously untaxed purchases.

### Progressivity

Falls primarily on ordinary Californians.

### Fairness

Reduces unequal treatment between consumers who spend more on tangible goods and consumers who spend more on services.

## Income Tax Increases Focused on High-Income Taxpayers

This option combines three income tax changes that are focused on high-income taxpayers: (1) eliminate the income tax exemption for inherited assets, (2) replace the charitable contribution deduction with a smaller credit, and (3) enact a new 1 percentage point surcharge on income over $500,000 per year regardless of filing status.

## Rankings: Income Tax Increases Focused on High-Income Taxpayers

### Budgeting

Growth

Grows much faster than the economy.

Stability

High dependence on performance of financial assets makes very large year-to-year swings likely.

Predictability

Inherent instability, lack of good information, and uncertainty about taxpayer response make this option very hard to predict.

### Economy

Mixture of economic effects. See comments in prior chapter on income tax on millionaires, charitable deduction, and inherited assets.

### Taxpayer Experience

New forms and processes will need to be created and implemented. Some taxpayers will have to expand their record keeping. Others will adjust their giving patterns and estate planning.

### Progressivity

Highly concentrated on very high-income Californians.

### Fairness

Could lessen existing fairness concerns related to charitable deduction and inherited assets. See comments in prior chapter.

## Increase Corporation Tax Rates and Eliminate Water's Edge Election

The option combines three corporation tax changes: (1) eliminate the water's edge election, (2) eliminate tax expenditures for credit unions and cable companies, and (3) increase the corporation tax rate from 8.84 percent to 14.84 percent.

## Rankings: Increase Corporation Tax Rates and Eliminate Water's Edge Election

### Budgeting

Growth

Grows about the same rate as the economy.

Stability

Prone to large year-to-year swings.

Predictability

Information about worldwide profits of many companies is limited. Year-to-year instability presents additional challenges.

### Economy

Significant share of tax cost likely shifted out of state. See comments in prior chapter on 2 percentage point increase in corporation tax. Risk that corporations could leave California market entirely. Other responses of large, sophisticated corporations are hard to predict.

### Taxpayer Experience

Many corporations will need to implement extensive new bookkeeping and tax administration activities.

### Progressivity

With a significant share of tax costs shifted out of state, a relatively small share of the cost would fall on ordinary Californians.

### Fairness

Offsetting fairness considerations. Water's edge may give some multinational corporations unfair flexibility to limit their taxes compared to domestic corporations. On the other hand, worldwide taxation raises concerns about double taxation.

## Eliminate Tax Expenditures and Broaden Tax Base

This option combines changes that eliminate tax expenditures and broaden the state's tax base: (1) eliminate the income tax exemption for inherited assets; (2) replace the charitable, mortgage interest, and property tax deductions with smaller credits; (3) eliminate the water's edge election; (4) eliminate tax expenditures for credit unions and cable companies; and (5) expand the sales tax to digital goods.

## Rankings: Eliminate Tax Expenditures and Broaden Tax Base

### Budgeting

Growth

Grows about the same rate as the economy.

Stability

Mixture of more and less stable revenue streams.

Predictability

Lack of good information and uncertainty about taxpayer response make this option very hard to predict.

### Economy

Spreading cost of tax increase across several policy changes helps avoid some of the economic risks associated with a larger change that is more concentrated on a particular group of taxpayers.

### Taxpayer Experience

Requires many process changes. Many taxpayers would need to adapt to a variety of new policies.

### Progressivity

Some parts of the package have limited costs for ordinary Californias while others fall more heavily on them.

### Fairness

Could lessen existing fairness concerns related to inherited assets and various income and corporation tax expenditures. See comments in prior chapter.

## Split Roll Property Tax

This option, which would require voters to amend the State Constitution, taxes nonresidential property (like commercial, industrial, and vacant properties) based on its market value instead of its original purchase price. Local governments collect property taxes from property owners based on the value of their property. Right now, the taxable value of all properties is based on the original purchase price. In the year a property is purchased, its taxable value is its purchase price. Each year after that, the property's taxable value is adjusted for inflation by up to 2 percent. When a property is sold again, its taxable value is reset to its new purchase price. Under these rules, the taxable value of most properties is less than their market value—that is, what they could be sold for today. This gap is wider the longer a property has been owned. Taxing nonresidential properties based on market value would result in owners of those properties paying more property taxes. About 40 percent of these increased property taxes would go to schools. This would offset state spending on schools, resulting in a commensurate increase in available state funds.

## Rankings: Split Roll Property Tax

### Budgeting

Growth

Grows somewhat slower than the economy.

Stability

Less prone to large year-to-year swings.

Predictability

Information limitations make initial estimate of revenue gains somewhat difficult, but year-to-year predictions should get better over time.

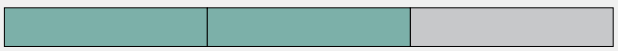
### Economy

Some costs shifted to people and businesses who own California property but are located out of state. Uncertainty about response of businesses and property owners. However, immobility of real estate somewhat limits risk of economically harmful responses.

### Taxpayer Experience

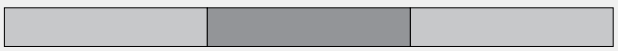
Major changes in tax processes. Increase in costs of compliance for taxpayers. Some risk of reduced transparency and comprehensibility for taxpayers.

### Progressivity



Some costs shifted out of state, and property owners tend to be somewhat higher income, but there is still a risk that a meaningful share falls on ordinary Californians.

### Fairness



Offsetting fairness considerations. Existing favorable treatment for longer-tenured property owners would be eliminated. However, a new favorable treatment of residential property would be created.

# TAX DECREASE OPTIONS

This chapter looks at nine options that each lower taxes between $1 billion and $3 billion per year.

## Quarter-Cent Sales Tax Decrease

This option would decrease the state General Fund portion of the sales tax rate from 3.9375 percent to 3.6875 percent. The sales tax is collected on the retail sale of tangible goods. Services and digital goods are not taxed.

## Rankings: Quarter-Cent Sales Tax Decrease

### Budgeting

Growth

Grows slower than the economy. Growth slowing over time.

Stability

Less prone to large year-to-year swings.

Predictability

Relative stability and long historical record make this option comparatively easy to predict.

### Economy

Most of the benefits stay in California as a boost to the finances of ordinary Californians.

### Taxpayer Experience

Should require only minor changes to existing processes.

### Progressivity

Primarily benefits ordinary Californians.

### Fairness

Somewhat mitigates existing concern that consumers who spend more of their money on tangible goods are disfavored compared to those who spend more on services and digital goods.

## Expand Sales Tax Exemptions for Business Equipment

This option expands existing sales tax exemptions for the purchase of certain business equipment. Right now, a partial exemption from the sales tax is provided for (1) farm equipment and (2) equipment purchases by manufacturers and electric utilities. This option expands those partial exemptions to a complete exemption from the sales tax. Further, this option creates a complete exemption for new categories of business equipment, like heavy-duty vehicles and large electronic hardware.

## Rankings: Expand Sales Tax Exemptions for Business Equipment

### Budgeting

Growth

Grows faster than the economy.

Stability

Prone to large year-to-year swings.

Predictability

Limited information and uncertainty about taxpayer response makes this option difficult to predict.

### Economy

May be particularly effective at encouraging businesses to expand their investments and employment in California.

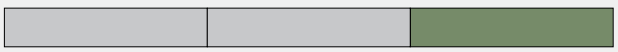
### Taxpayer Experience

Businesses will have to adjust to new tax treatment of equipment purchases.

### Progressivity

Benefits to ordinary Californians may be modest.

### Fairness



Current law favors businesses that purchase less equipment over those that purchase more. This option would mitigate that concern.

## Reduce Gas and Diesel Taxes

This option reduces the tax on gasoline from $0.61 per gallon to $0.45 per gallon and the tax on diesel from $0.47 per gallon to $0.35 per gallon. Revenue from these taxes is dedicated to transportation programs. The state could choose to backfill funding losses to these transportation programs with money from the state's General Fund.

## Rankings: Reduce Gas and Diesel Taxes

### Budgeting

Growth

Fuel consumption is declining over time.

Stability

Fuel consumption tends to swing somewhat more year-to-year than other consumption.

Predictability

Good historical data available. Prediction modestly complicated by year-to-year swing in fuel consumption.

### Economy

Most of the benefits stay in California as a boost to the finances of ordinary Californians.

### Taxpayer Experience

Should require only minor changes to existing processes.

### Progressivity

Primarily benefits ordinary Californians.

### Fairness

Does not raise new major fairness considerations.

## Exempt $10,000 of Value From Vehicle License Fee

This option exempts up to $10,000 of a vehicle's value from the vehicle license fee. The state collects an annual vehicle license fee from vehicle owners that is equal to 0.65 percent of their vehicle's value. Under this option, if a vehicle is valued at $30,000, its taxable value would be $20,000. If a vehicle is valued at less than $10,000, no vehicle license fee would be owed. Revenue from the vehicle license fee is dedicated to programs administered by local governments. The state would have to backfill funding losses to local governments with money from the state's General Fund.

## Rankings: Exempt $10,000 of Value From Vehicle License Fee

### Budgeting

Growth

Grows slower than the economy.

Stability

Less prone to large year-to-year swings.

Predictability

Relative stability and long historical record make this option comparatively easy to predict.

### Economy

Most of the benefits stay in California as a boost to the finances of ordinary Californians.

### Taxpayer Experience

Should require only minor changes to existing processes. Modest potential to simplify process for some taxpayers.

### Progressivity

Primarily benefits ordinary Californians.

### Fairness

Does not raise new major fairness considerations.

## 2 Percent Across-the-Board Income Tax Decrease

This option decreases personal income tax payments by 2 percent across the board. For example, if a taxpayer currently is paying $1,000 in taxes per year, they would pay $980 instead.

## Rankings: 2 Percent Across-the-Board Income Tax Decrease

### Budgeting

Growth

Grows faster than the economy.

Stability

Prone to large year-to-year swings.

Predictability

Year-to-year instability presents challenges.

### Economy

Most of the benefits stay in California. Probably encourages some income-generating activities.

### Taxpayer Experience

Should require only minor changes to existing processes.

### Progressivity

High-income taxpayers receive most of the benefits.

### Fairness

Does not raise new major fairness considerations.

## Decrease Marginal Income Tax Rates

This option decreases all marginal income tax rates on incomes below $361,000 ($721,000 for joint filers) by 0.4 percentage points. For example, the tax rate for single filers on income between $25,000 and $40,000 would decrease from 4 percent to 3.6 percent (a 10 percent drop in the tax rate). Similarly, the rate on income between $71,000 and $361,000 would decrease from 9.3 percent to 8.9 percent (a 4 percent drop in the tax rate.)

## Rankings: Decrease Marginal Income Tax Rates

### Budgeting

Growth

Grows faster than the economy.

Stability

Somewhat prone to large year-to-year swings, but less than across-the-board income tax cut option.

Predictability

Year-to-year instability presents some challenges, but less than across-the-board income tax cut option.

### Economy

Most of the benefits stay in California. Probably encourages some income-generating activities.

### Taxpayer Experience

Should require only minor changes to existing processes.

### Progressivity

High-income taxpayers receive the majority of the benefits, but ordinary Californias would get a larger share than with across-the-board income tax cut option.

### Fairness

Does not raise new major fairness considerations.

## Increase Standard Deduction

This option increases the standard deduction by $4,000 for single filers and $8,000 for joint filers.

## Rankings: Increase Standard Deduction

### Budgeting

Growth

Grows slower than the economy.

Stability

Changes in taxpayer choices and behavior could result in some year-to-year swings.

Predictability

Good historical data. Dependence on choices of taxpayers makes this option somewhat less predictable.

### Economy

Most of the benefits stay in California as a boost to the finances of ordinary Californians.

### Taxpayer Experience

Potentially simplifies tax filing and compliance for some taxpayers who will no longer need to itemize their deductions.

### Progressivity

Primarily benefits ordinary Californians.

### Fairness

Reduces scale of income tax deductions that present some fairness concerns. See comments in prior chapter on charitable giving, mortgage interest, and property tax deductions.

## Income Tax Credit for Low- and Middle-Income Taxpayers

This option creates a new nonrefundable tax credit of $500 for single filers and $1,000 for joint filers. The full amount of the credit would be available to single filers with incomes up to $50,000 and joint filers with incomes up to $100,000. A smaller, phased-out credit would be available to single filers with incomes between $50,000 and $75,000 and joint filers with incomes between $100,000 and $150,000.

## Rankings: Income Tax Credit for Low- and Middle-Income Taxpayers

### Budgeting

Growth

Grows slower than the economy.

Stability

Less prone to large year-to-year swings.

Predictability

Relative stability and good data availability make this option comparatively easy to predict.

### Economy

Nearly all of the benefits stay in California as a boost to the finances of ordinary Californians.

### Taxpayer Experience

Requires creation of new processes and forms.

### Progressivity

Exclusively benefits ordinary Californians.

### Fairness

Does not raise new major fairness considerations.

## 2 Percentage Point Decrease in Corporation Tax Rate

This option decreases the state's tax on profits of corporations (specifically, so called "C corporations") from 8.84 percent to 6.84 percent. See related option in "Tax Increase Options" chapter for more detail on how corporate profits are taxed.

## Rankings: 2 Percentage Point Decrease in Corporation Tax Rate

### Budgeting

Growth

Grows about the same rate as the economy.

Stability

Very prone to large year-to-year swings.

Predictability

Year-to-year instability presents challenges.

### Economy

Significant share of the benefits likely shifted out-of-state. Corporations may lower prices, including for out-of-state consumers. Shareholders, many of whom live elsewhere, would benefit from higher after-tax profits. Corporations also would have smaller federal tax deductions.

### Taxpayer Experience

Should require only minor changes to existing processes.

### Progressivity

With a significant share of the benefits shifted out of state, a relatively small share would go to ordinary Californians.

### Fairness

Does not raise new major fairness considerations.

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