

# Perspectives on the State's Tax Structure



Presented to:  
Senate Select Committee on  
Recovery, Reform, and Realignment  
Hon. Sam Blakeslee, Chair  
February 2, 2011

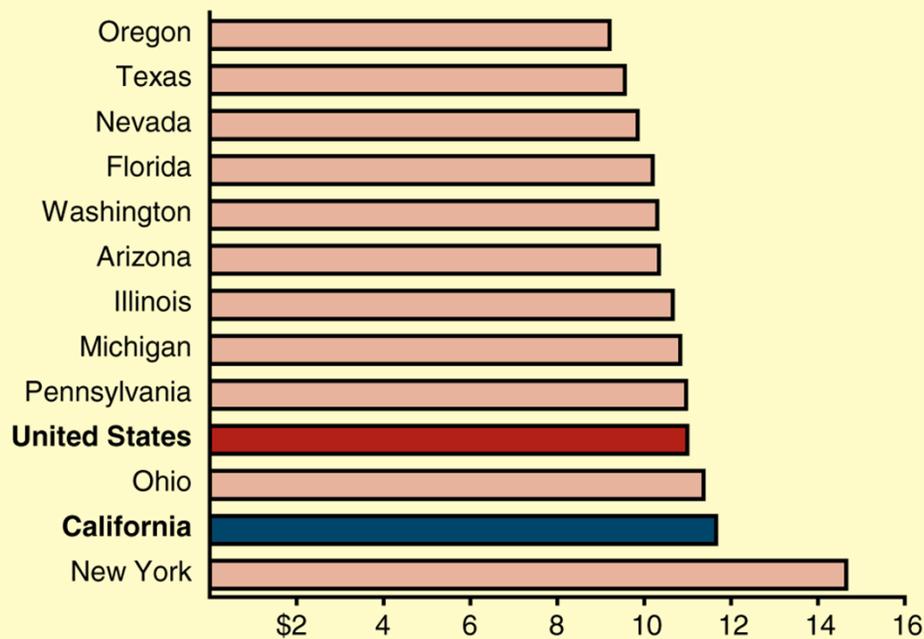
# Background: Taxes in California

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- **State and Local Governments Rely Predominantly On the Following Four Taxes:**
  - Personal income tax (PIT)
  - Sales and use tax (SUT)
  - Corporate tax (CT)
  - Property tax
- **For the State, Revenues From the First Three Taxes Comprise 95 Percent of Proposed 2011-12 General Fund Revenues**

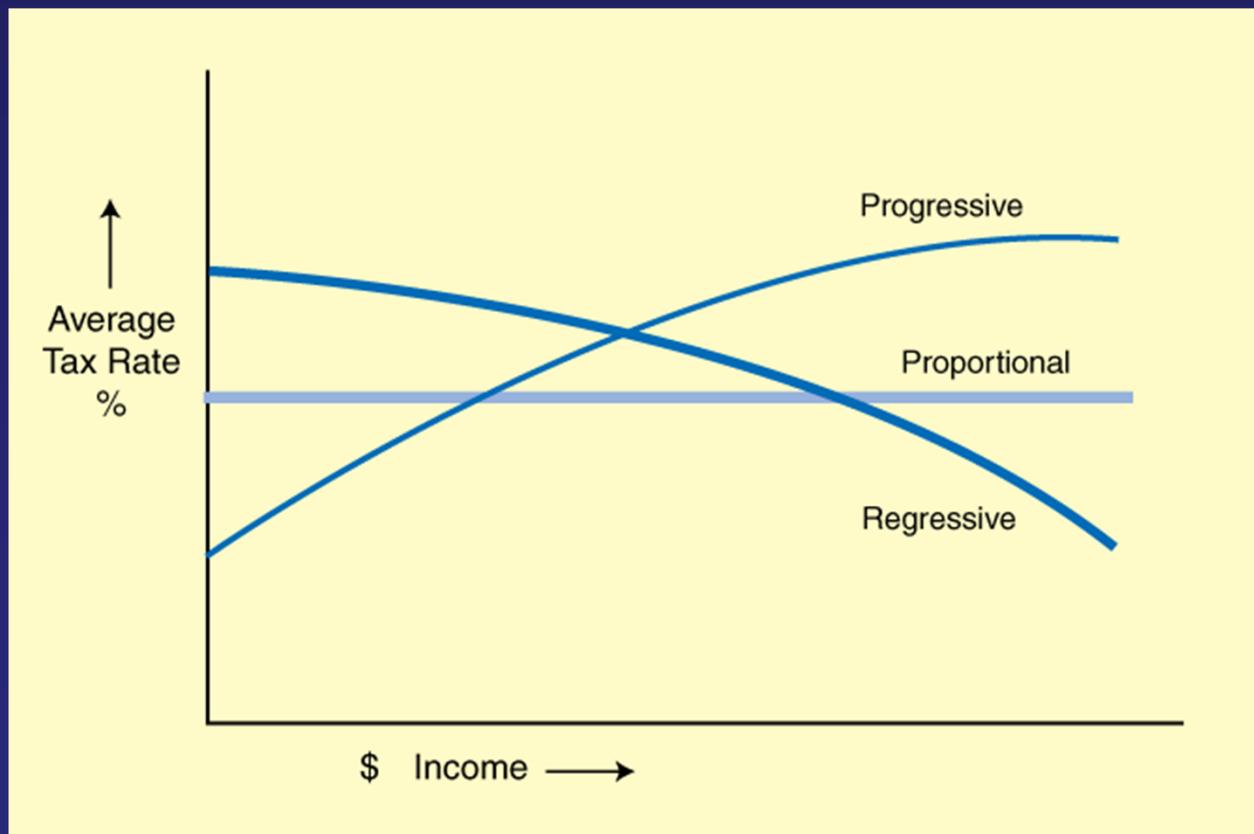
# Background: Tax Burden—Aggregate

*Combined State-Local Taxes Per \$100 of  
Personal Income, 2007-08*



# Background: Progressivity and Regressivity

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# Background: Tax Incidence

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- **Important Difference Between Who Pays a Tax And Who Bears the Burden of the Tax (Incidence)**
  - Corporations legally owe taxes, but the burden is borne by workers, consumers, and owners of capital
  - Retailers legally owe sales taxes, but the burden is borne in large part by consumers
- **Economic Perspectives**
  - General agreement on who bears PIT and SUT
  - Differing views on CT and, to some degree, on the property tax

# What Criteria Do You Use to Judge a Tax System?

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- **Reliability (Growth and Stability)**
- **Broad-Based Levies**
- **Impact on Economic Activity**
- **Equity Considerations**
- **Administrative Feasibility**

# How Our Tax System Stacks Up— The Positive

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- **“Robust” System**
  - Grows roughly in line with the economy
- **Broad-Based Taxes, Levied on:**
  - Income
  - Consumption
  - Wealth (property tax)

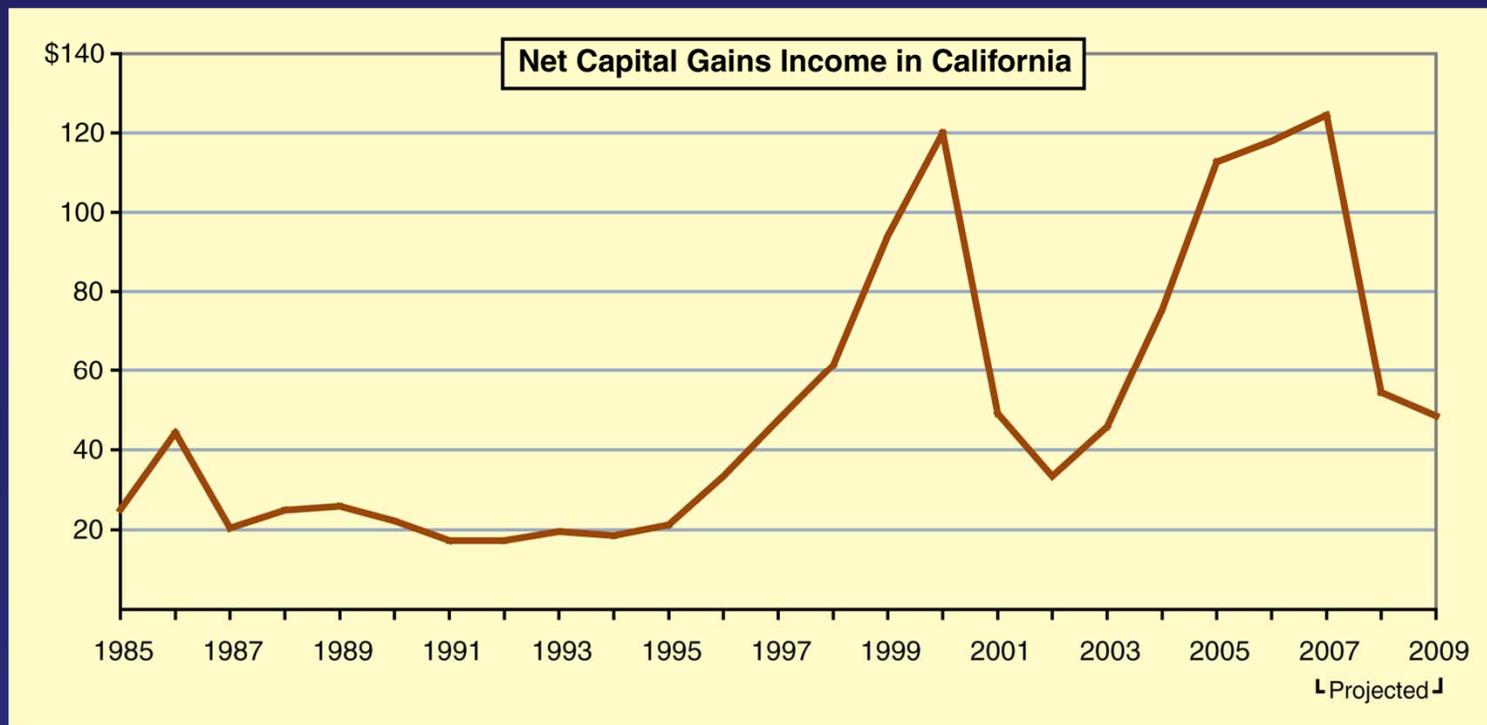
# How Our Tax System Stacks Up— The Negative

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- **Major Volatility**
- **High Marginal Rates**
- **Challenges to Tax Bases**
  - SUT (services and remote sales)
  - Tax expenditures
  - Tax gap

# Volatility— Capital Gains Are the Main Story

(In Billions)



# Volatility— Impact on State Revenues

|                             | Effects of a 1 Percent Change in Personal Income<br>On Percent Changes in Revenues |                            |
|-----------------------------|--|----------------------------|
|                             | 1979-80 Through<br>1990-91   | 1991-92 Through<br>2003-04 |
| Personal income tax         | 1.09%  | 6.24%                      |
| Sales and use tax           | 1.33   | 1.44                       |
| Corporation tax             | 2.57   | 3.33                       |
| <b>Totals, All Revenues</b> | <b>1.39%</b>   | <b>3.51%</b>               |

# Volatility— Impact on the State Budget

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- **Boom/Bust in PIT Revenues Complicated Our Budgeting Process Enormously**
- **Problems in Late 1990s and Mid-2000s**
  - Surge of revenues one-time or ongoing?
  - Over-committed ongoing spending programs
  - Failure to set aside revenues
- **Result: Huge Operating Shortfalls**

# Addressing Volatility: Budget Management Options

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- **Most Effective Tool: Set Aside Above-Average Revenue Growth in Reserves**
- **State Has Taken Action in This Regard**
  - Proposition 58
  - ACA 4 on 2012 ballot

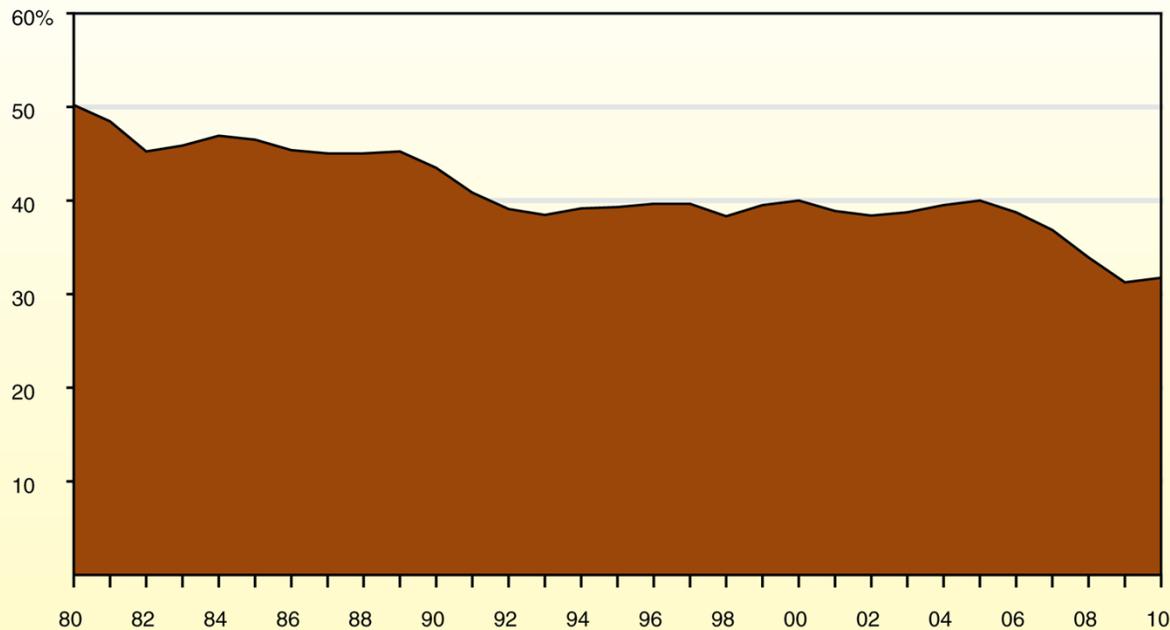
# Addressing Volatility: Revising the Revenue System

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- **Reduce PIT Rates on Capital Gains**
- **Reduce Progressivity of Rate Structure**
- **Rebalance Mix of Taxes Away From PIT**
- **Income Averaging on Capital Gains/  
Stock Options**

# Base Broadening— Declining Sales Tax Base

Taxable Sales as a Percent of Personal Income



# Base Broadening— Inroads on Income Tax Base

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# Base Broadening— High Marginal Rates

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- PIT—One of the Highest Rate in the Country
- SUT—Highest Uniform Rate  
In the Country
- CT—One of the Highest in the Country

# Addressing Base Broadening— Expand Sales Tax to Include Services

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- **Turn Tax on All Tangible Goods Into More of a Tax on Consumption**
  - Lower rate
  - Exclude “intermediate” business purchases
  - More equitable treatment of economic activity
- **Issues**
  - How inclusive? Will it apply to: Housing? Schooling? Medical?

# Addressing Base Broadening— Expand Income Tax Base

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- **Reduce/Eliminate Tax Expenditure Programs (TEPs) and Lower Rates**
- **Many TEPs Result in:**
  - Distortions
  - Inequitable treatment among taxpayers

# Addressing Base Broadening— Tackling Tax Expenditures

2006-07  
(In Millions)

## Largest PIT Tax Expenditure Programs

| Program   | Type of Provision   | Revenue Reduction |
|---|---------------------|-------------------|
| Mortgage Interest Expenses                          | Deduction           | \$4,885           |
| Employer Contributions to Pension Plans             | Exclusion/Exemption | 4,450             |
| Employer Contributions to Accident and Health Plans | Exclusion/Exemption | 3,975             |
| Basis Step-Up on Inherited Property                 | Exclusion/Exemption | 3,030             |
| Capital Gains on the Sale of a Principal Residence  | Exclusion/Exemption | 1,770             |
| Dependent Exemption                                 | Credit              | 1,650             |
| Charitable Contributions                            | Deduction           | 1,600             |
| Real Property Tax Deduction                         | Deduction           | 1,315             |

# Conclusion

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- **The State Has a Sound Tax System**
- **Improvements Should Be Focused on:**
  - Reducing volatility
  - Keeping bases as broad as possible and rates as low as possible