

A Tax System for the 21st Century: Protecting California Jobs and the Economy

The California tax system is complicated and relatively burdensome, but is also fundamentally balanced and responsive to the state's economy. Any changes to the tax system should be undertaken primarily with the health of the economy in mind. Therefore, care should be given to considering what aspects of the tax system are "broken," before prescribing remedies.

This paper provides commentary from the California Foundation for Commerce and Education regarding the state's tax structure, its advantages and disadvantages, and recommendations on what aspects of California taxation should be changed and what should be left alone.

The California Foundation for Commerce and Education is a policy institute dedicated to preserving and strengthening the California business climate and private enterprise through:

- education of the public and policy makers on the virtues of private enterprise and a strong economic base;
- accurate, impartial and objective research and analysis of public policy issues of interest to the California business and public policy communities; and
- education and outreach efforts in support of the research and public policy findings and recommendations.

Summary of conclusions

California has been generally well-served by broad-based, balanced tax sources levied on income, consumption and wealth. To the extent major changes are contemplated, they should aim to reduce the burden on job-creating income and investment.

California's tax system is very responsive to the state's economy, and sometimes produces highly volatile revenues. But the solution to this volatility is in a mandatory reserve and revenue smoothing mechanism – such as Proposition 1A on the May special election ballot – not by changing the mix of state taxes.

California has very high tax rates that undermine our state's economic competitiveness. The most effective reforms to the tax system would be to reduce and rationalize taxes to maximize our competitive position:

- California's corporate income tax is the highest in the West; it should be reduced. Nearby competitor states, like Texas, Nevada and Washington, have no corporate income tax. We should also leverage California's high-value innovation industry by gradually conforming the state's research and development tax credit to the federal credit. Finally, we should repeal the recently adopted, punitive understatement penalty.
- California has the highest personal income tax rate in the nation; the tax is also one of the most progressive. We should also consider reducing this tax rate since several of our strongest competitor states for economic development have no income tax, such as Texas,

Florida and Washington. Many taxpayers in the top PIT bracket are small businesses, and recruiters of highly skilled employees must consider the state's tax climate.

- The sales tax rate is also among the highest in the country, and applies to business inputs as well as consumer purchases. The sales tax should be rationalized by gradually eliminating the tax on business investments in tangible property. Few states, other than California, allow the taxation of business inputs.
- A new sales tax on services is unnecessary, fiscally imprudent and would be discourage job creation.
- A split roll property tax would have harmful consequences on rental property, open space, jobs and the economy.

Commission charge

According to the Governor in his Executive Order S-12-08, the Commission's charge is to make "recommendations to change laws to achieve the following goals:

- "a. Establish 21st century tax structure that fits with state's 21st century economy;
- "b. Stabilize state revenues and reduce volatility;
- "c. Promote the long-term economic prosperity of the state and its citizens;
- "d. Improve California's ability to successfully compete with other states and nations for jobs and investments;
- "e. Reflect principles of sound tax policy including simplicity, competitiveness, efficiency, predictability, stability and ease of compliance and administration;
- "f. Ensure that tax structure is fair and equitable."

These charges are a mix of vague and aspirational ("21st century tax structure," "promote long-term economic prosperity," "improve California's ability to successfully compete") with more specific and measurable goals ("reduce volatility," "simplicity, efficiency, predictability, stability, ease of compliance," "fair and equitable"). The Order does not mention whether the recommendations should be revenue neutral, although you should probably err on the side of revenue neutrality, given the requirement that the changes promote economic prosperity and competitiveness.

What is broken, and what are we trying to fix?

Common concerns with the existing tax system tend to fall in three categories: volatility, relation to economy, and sufficiency.

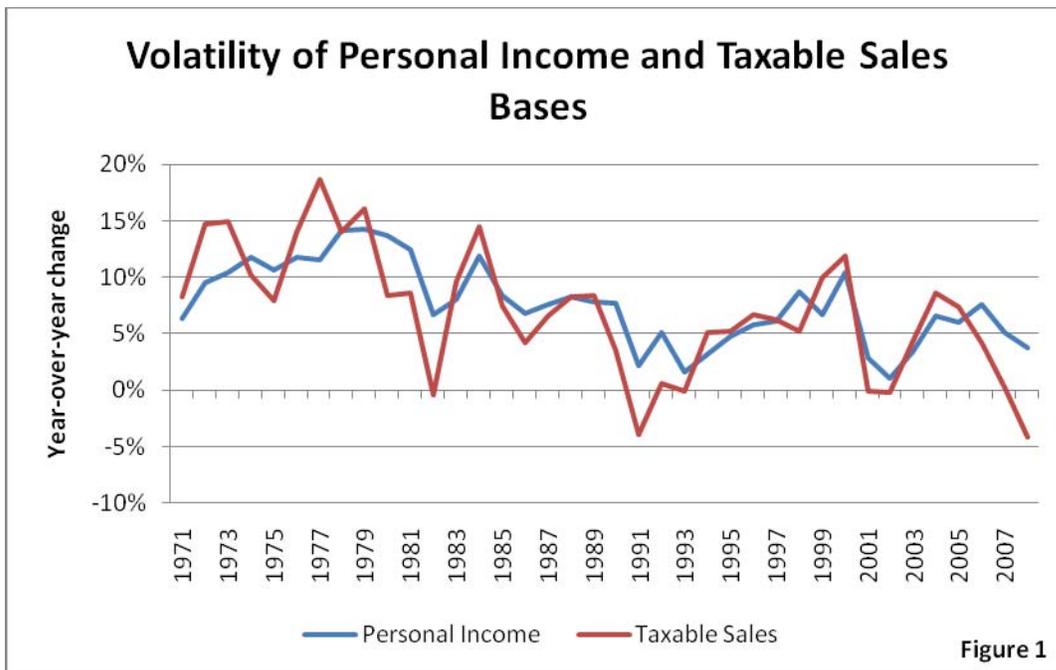
1. Volatility

Much is made in the Executive Order and testimony about the volatility of much of the state's tax system, in particular the Personal Income Tax (PIT). There is no doubt about the tax system's volatility, and that, in combination (but only in combination) with poor Legislative decision

making, it contributes to budget crises. But there are only three solutions to tax volatility, of which only one seems the least bit practical:

1. *Setting aside revenue peaks.* “Smoothing” revenues by requiring that “peaks” be saved to be spent during “troughs” manages volatility, rather than attempting to abolish it. This approach has been approved by the Legislature for a public vote at the next statewide election. It seems logical that this option be tried before considering more radical options.
2. *Modifying the personal income tax.* Volatility of the PIT could be reduced by flattening its progressivity or deemphasizing its dependence on capital gains, stock options or other income that is highly correlated with economic cycles. While this could work in theory, it would likely over the long term produce less overall revenues for the State. It also would reverse the historic principle of progressivity in the income tax system.
3. *Diluting the personal income tax.* The PIT now constitutes about 55% or more of General Fund revenues. Fifteen years ago it was 46%; 30 years ago it was 34%. Increasing other, less volatile revenue sources would reduce the impact of PIT volatility, but those sources would have to be substantially increased to make a difference. To reduce the influence of the PIT from 55 percent to, say, just 50 percent of General Fund revenues would require raising other taxes by about \$10 billion.

In fact, policy makers must be careful what they wish for: over the past 35 years, taxable sales have shown more volatility than personal income (see Figure 1). The PIT revenues have been more volatile because of capital gains and stock options, but both major revenue bases – not surprisingly – react to the economy. There is no such thing as a countercyclical revenue source.

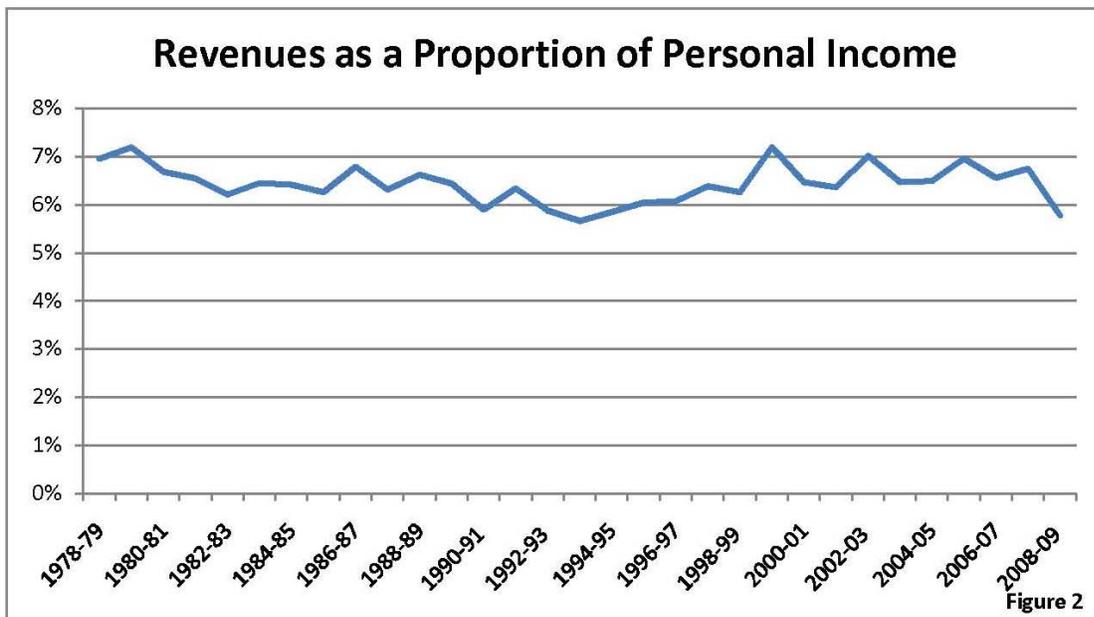


2. Relation to economy

Many of the complaints about California's tax system are couched in terms of whether the system is "reflective of the 21st century economy." But since nobody, including the Governor's Executive Order, has defined what attributes should be reflected by the tax system, answering this criticism will reflect as much on the ideology of the respondent as the nature of the tax system.

Tax systems are by their nature arbitrary, since some taxpayers are treated differently from others, based on rules of public policy. Some would argue, for example, that a flat income tax is perfectly reflective of a person's contribution to the economy, since all income is taxed in the same proportion. Exemptions for food, utilities and prescription medicines from the sales tax base were made for legitimate public policy reasons, but nonetheless are not reflective of the economy, since those categories constitute an enormous amount of personal consumption.

California's tax system is generally reflective of the economy, because it generally rises and falls with the economy. For the past 30 years, the amount of revenues raised by General Fund taxes in California has generally ranged between six and seven percent of personal income – a little more during big booms, a little less during recessions (see Figure 2). And when measured on a per capita basis, revenues have grown at a healthy clip (see Figure 3, next page). Whether these total revenues are the correct amount (and from whom) is appropriately the province of elected officials. But there is little doubt that the current tax system is responsive to the general trends in the economy.



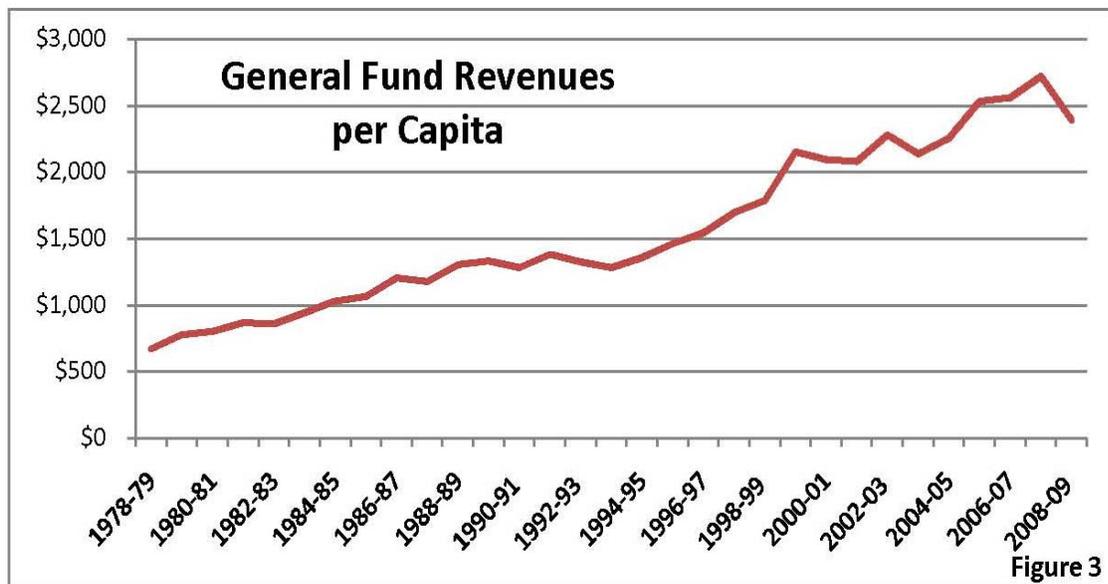


Figure 3

3. Sufficiency

The perennial question about California’s budget crisis, “Is it a revenue problem or a spending problem?” is relevant because the purpose of a tax system is to finance government services. It is the job of elected officials to determine if the level of services government provides is appropriate and adequate, and to decide if revenues are sufficient to maintain those services and also maintain a healthy and competitive economy. This question is appropriately not the province of this Commission, since it goes to allocation of societal resources.

Competitiveness

Since volatility can be addressed without changing the tax system, and since the tax system seems to grow along the lines of the economy, then the major criterion for examining whether and how to change the tax system should be if it improves the state’s competitiveness.

A tax system for the 21st century economy should above all do no harm to California’s competitiveness. Changing aspects of the state’s tax system may create disincentives for certain economic activity. In short, if you increase the cost of producing something, you will receive less of it. Also, increasing taxes on some parts of the economy may disadvantage them vis-à-vis other parts of the economy, and vis-à-vis other economies domestically or overseas. Therefore,

- Do not target specific industries with higher taxes.
- Do not target specific services (labor) with higher taxes.
- Do not target income and investment (business and job creation) with higher taxes.

If taxes must be raised, they should be broad-based, temporary and nondiscriminatory, and above all minimize adverse impacts on economic competitiveness and equity. California has been well-served by broad-based, balanced tax sources levied on income, consumption and wealth.

Comments on some specific tax proposals

Several tax proposals have drawn significant attention from policy makers and advocates – primarily as a way to increase revenues, but couched in terms of either better aligning the tax system with the economy, or by increasing equity among various taxpayers. We believe these targeted tax increases are inimical to a healthy business climate.

Broadening the sales tax base

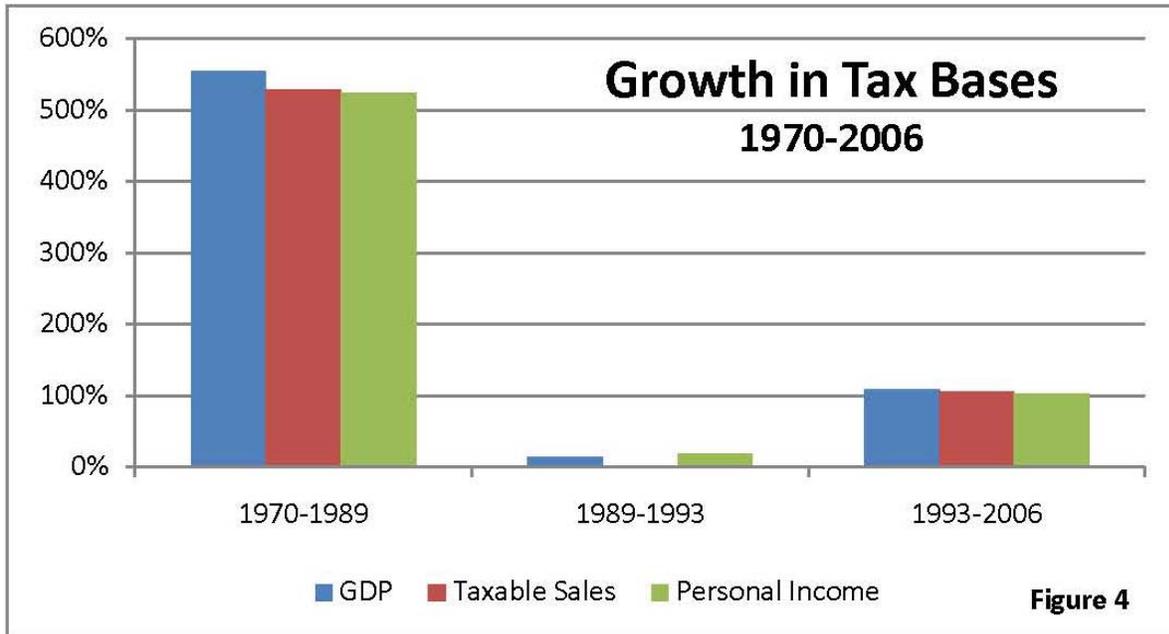
The sales tax is the most commonly identified culprit as out of touch with the 21st century economy. Exhibit A is usually a demonstration that taxable sales constitute a smaller share of the state's disposable income than before. Advocates conclude that one part of the economy is inappropriately subsidizing another, the taxable sales base is in danger of withering away, and the inevitable solution is to broaden application of the sales tax to services.

As discussed earlier, taxing services is every bit as arbitrary as taxing tangible goods. Advocates for broadening the tax base assume that the chief criteria for determining taxability is that a sale is made, rather than exploring the nature of the economic activity to determine whether it makes sense to tax it in the first place.

In fact, the most important characteristic of a tax on services is that it would be a tax on labor – just the wrong signal to send to an economy already struggling with job erosion. Services differ from tangible goods chiefly in that they are provided immediately, on-site, and by a worker. Whether the activity is lawn care, veterinary services, repair work, nursing, law, accounting or tattooing, all involve the labor of an individual to provide the service in real time at the site of consumption. A tangible good that is subject to the sales tax may have been made next door, or half-way around the world.

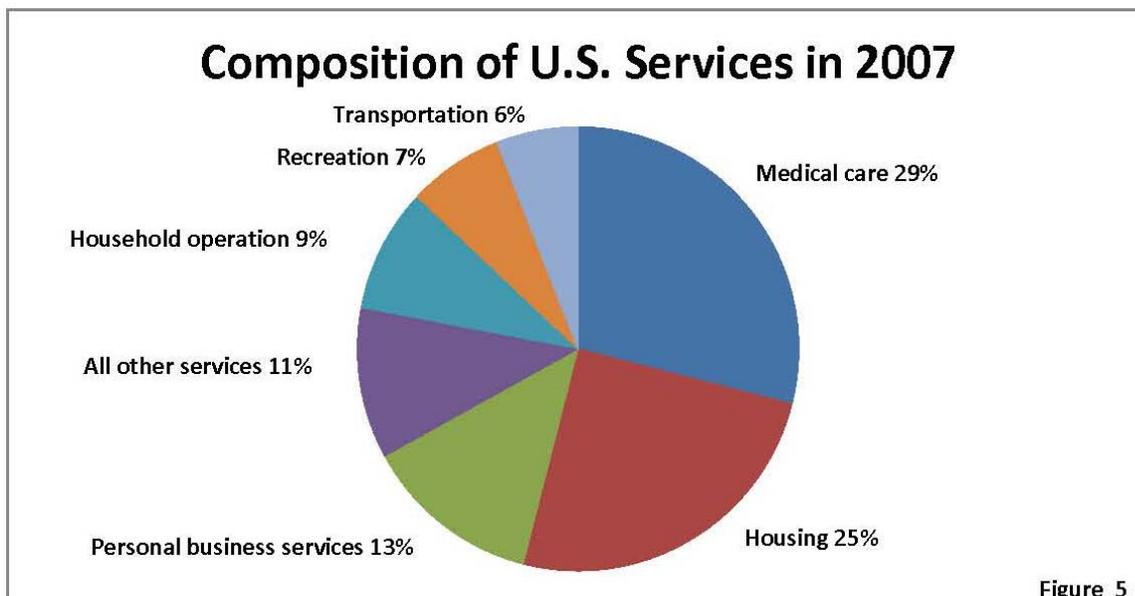
The Legislative Analyst has offered a chart showing taxable sales declining as a proportion of personal income, from about 50 percent in 1980 to something over one-third today. But why have taxable sales declined relative to the economy? Figure 4 on the next page demonstrates that the sales tax base lost ground almost exclusively during the 1989 to 1993 period, which of course coincided not only with California's (at-the-time) worst recession since the Great Depression, but with a tremendous loss of manufacturing capacity. So erosion of the sales tax base was episodic and not necessarily indicative of a long-term trend away from consumption of tangible goods.

Taxing services is every bit as arbitrary as taxing goods. And since there is no evidence that sales of taxable services are any more recession-proof than are sales of taxable goods, then applying a sales tax on selected services may not change the responsiveness of the tax base to the economy.

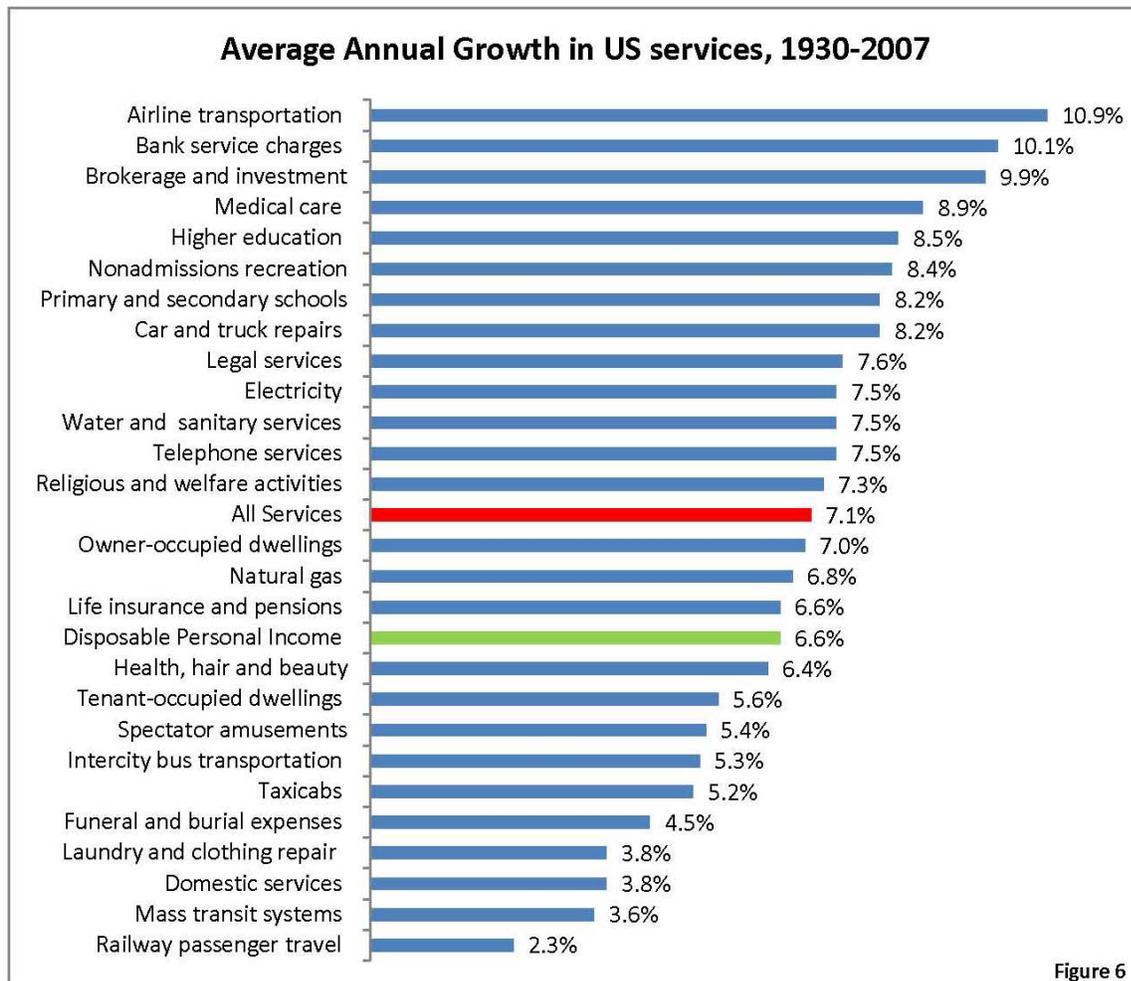


Last November, the State Board of Equalization made the following observations:

- There is no doubt that Americans are spending substantially more of their incomes on services than did their grandparents. Since the 1940s, the share of national disposable personal income devoted to services has increased from about 30% to about 55%.
- The largest components of services purchased are housing and medical care, which together amount to 54% of all purchases. Add transportation and 60 percent of services that Americans purchase would never be considered taxable in California. (See Figure 5.)



- The fastest growing components of the services economy tend to be those that would not be taxed, and vice versa. (See Figure 6.) The fastest growers are medical care, education, utility services, and legal, bank and brokerage services. Housing grew at about the same rate as the economy.
- It is the slow-growing services that are the targets for taxation: personal services and spectator amusements. Auto repair is an exception to this trend, although in the past decade, its growth rate has declined.



The bottom line, at least from the Board of Equalization analysis of national data: the biggest contributors to the services economy are just those services that are least likely to ever be taxed, and the growth trends are generally in the direction of those same services.

Increase the base and reduce the rate?

One of the key arguments for expanding the sales tax base would be to enable a reduction in the overall rate, which now averages about nine percent in California, including state, local and special district tax rates.

The key to determining if and how much the rate could be reduced is which services are most likely to be taxed. As we have seen, most of the services economy will very likely not be subject to sales taxation, including health care (29% of all services purchased), housing (25%) and transportation (6%).

Another large portion of the services base seems politically impervious to taxation. Attorneys, advertising, accounting and architects have successfully fought taxation of their services in many other states (and those are only the As!).

In fact, in California, the widest swath of services even suggested for taxation, by Board of Equalization chair Judy Chu last year, was \$183 billion worth of services transactions covering construction, repair, business services, warehousing, entertainment and recreation and personal services. This ambitious approach would enable the overall tax rate to be reduced by about one-and-a-half cents.

Recognizing this recipe may be a bridge too far, Ms. Chu also presented a mix of services that “are most frequently taxed by other states.” That list of services comprised:

- Automobile repair and service
- Entertainment and recreation
- Repair and maintenance
- Dry cleaning and laundry

Amounting to about \$56 billion in transactions, broadening the base would enable a tax reduction of one-half cent.

Finally, Governor Schwarzenegger briefly proposed a suite of services to be taxed, which were a subset of the list Ms. Chu proposed. Applying a tax to those transactions would enable the overall rate to be reduced by as much as one-quarter cent.

Even under the most optimistic scenario, expanding the base would allow a relatively small reduction in sales tax rates – only slightly more than the temporary tax increase recently approved by the Legislature. Advocates of this approach would be hard-pressed to demonstrate that the overall good to the economy and jobs from a small rate reduction would overcome the damage to targeted sectors of the economy from an eight or nine percent rate increase.

Consequences of a new sales tax on services

Imposition of a new tax on services would be unfair, harmful to jobs and the economy, and ultimately ineffective. Since a service is by definition intangible, it can be provided in a variety of ways that can defeat the tax:

- Companies that previously had contracted out for a service may decide to provide the service in-house. A business may expand its legal and accounting functions in-house; an office park or shopping mall could provide janitorial and landscaping from its own staff.

- Out-of-state (or out-of-country) providers would have an advantage over in-state businesses. An eight or nine percent services tax is simply adding another cost to labor. Many companies have overcome the existing high cost of labor in California by outsourcing jobs to other states or countries. Software consulting, telemarketing and graphic design services could be originated anywhere in the country or around the world. And while these services may be subject to a use tax, enforcement of that tax is difficult.
- In-house vs. out-of-house and in-state vs. out-of-state will provide some companies with significant competitive advantages over other companies. Large businesses will be much better able to avoid this tax than will small businesses.

As noted earlier, the average statewide sales tax rate for the next two to three years will be about nine percent, with some metropolitan areas close to ten percent. While every taxable good will see its price rise one percent, if a new sales tax is levied on services, their prices will rise nine percent or even more. This will have a depressing effect on numerous services that are subject to high elasticities of demand.

One of the distinguishing characteristics of a service is that the activity is generated and provided at the very time it is consumed. That is, it is essentially a function of labor, since there is no tangible product or any tangible product is incidental to the chief economic activity. Since labor is the chief component of the activity, a services tax amounts to a tax on labor, ranging from low-paid and low-skill (e.g. janitorial and landscape maintenance) to highly paid and high-skill (e.g., professional services and auto repair). A tax on labor will inevitably result in less labor purchased and produced, which is the wrong signal to send any time, but particularly during a recession.

Finally, the experience of other states that attempted to impose a comprehensive services tax should not be encouraging to those who may wish to take this step. Over the past two decades, three large states have adopted broad sales taxes on services – and then repealed them within months.

In 1987, Florida enacted a broad sales tax on services, which covered all manner of personal and professional services, including purchases from out-of-state providers. Within six months, the state legislature repealed the tax, replacing it with a penny increase in the sales tax on tangible goods.

In 1990, Massachusetts expanded its sales tax to services, but repealed it before the effective date.

And in 2007, Michigan adopted a sales tax on a wide range of mostly personal services. It was repealed before it even went into effect.

Most recently, Maryland repealed its expansion of the sales tax to computer services. Passed in November 2007, and set to become law the following July, the sales tax expansion was repealed by the Legislature before it could take effect.

Conclusions

- A. A sales tax on services is not needed to change the responsiveness of the sales tax to the economy. The current taxable sales base is already very sensitive to the economy, and adding services would not materially change that.
- B. Taxing services that would most likely be added to the sales tax base would provide only minimal opportunity to reduce sales tax rates in a revenue-neutral manner. Increasing the price of a haircut by 8% in return for a ¼% or ½% reduction in the price of a shirt seems to be an odd trade without much economic gain.
- C. Increasing taxes on selected (and likely the most politically vulnerable) services would be unfair, discriminatory and economically harmful.
- D. Imposing a services tax would increase the cost of labor, which is just the wrong signal when the economy needs to produce jobs.

Split roll property tax

Another tax policy proposal that uses myth as its founding principle is the split roll property tax, which in its simplest form would create a different rate or assessment basis for residential property than for commercial and industrial property. One of the consistent claims by supporters of the split roll is that since Proposition 13 was adopted in 1978, the property tax burden has shifted from commercial and industrial taxpayers to residential property taxpayers.

This is simply not true.

In a study published in 2008, Law and Economic Consulting Group, Inc. (LECG) found just the opposite. Using data from the Board of Equalization, LECG found that the assessed value to market value ratio for owner-occupied residential property in the 2006-07 roll was 53 percent, while the ratio for commercial and industrial property was nearly 60 percent. That is, commercial and industrial property is being assessed for tax purposes at values that are closer to market value than is the case for owner-occupied residential property.

LECG also prepared an analysis of the economic consequences of a split roll property tax, and found seven primary effects:

1. **More development.** Owners of undeveloped land will be more likely to develop the land, since the carrying costs of holding land as open space will go up.
2. **Increased fiscal zoning.** Localities will have a stronger fiscal incentive to favor the use of land for commercial purposes, rather than for homeownership opportunities, because they will be able to derive more revenue from this type of development.

- 3. Higher rents paid by families and small businesses.** A significant portion of the increase in property taxes will be shifted to renters. In some cases, the shift will occur automatically, under the terms of “triple net leases.” In other cases, the shift will be made possible by the fact that rent levels are below market levels, as is the case for apartments subject to rent controls. In still other cases, the reluctance of landlords to raise rents because they fear losing good tenants to neighboring apartment buildings will weaken, since all apartment owners will be subject to the same increase in costs.

The burden of higher rents will tend to fall most heavily on lower-income Californians, because they are more likely to occupy rental property. (According to the U.S. Census Bureau, the median household income of California renters was less than half the median income of homeowners.) The burden of higher rents will be felt disproportionately by small businesses, including many minority-owned businesses, because these businesses tend to rent the space their business occupies.

- 4. Reduced investment/fewer jobs.** Where it is not possible to fully shift the increased tax burden to tenants, the split-roll would reduce the after-tax returns from investment, causing a reduction in the volume of investment in rental housing and business plant and equipment within California. Less investment means fewer jobs. In the longer run, capital – and, hence, labor – will look for better opportunities outside California by migrating.
- 5. Reduced wages.** A shift in the tax burden to firms that continue to conduct business in California will reduce the after-tax productivity of labor. The after-tax productivity of labor will be further reduced because workers have less capital. Since wages are based on labor productivity, wages will fall, and workers’ ability to maintain purchases of other goods and service, will drop accordingly.
- 6. Increased consumer prices.** Since the prices that businesses charge customers must cover their costs (including the costs of capital), the increase in property taxes ultimately will bring about higher consumer prices to the extent the increase is not passed on to renters and consumers.
- 7. Decline in the value of financial assets held by public retirement funds.** Where it is not possible to fully shift the increased tax burden to tenants, employees, and consumers, the market value of commercial property will decline, and with it, the value of financial assets, such as common stocks, that are based in part on the value of real assets.