How to Improve California's Tax System: The Good (But Infeasible), the Bad, and the Ugly

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Introduction

Good morning, Members of the Commission. Having written at length of the "nuttiness" of state and local taxes,[1] including those levied in California, I welcome the opportunity to suggest once again how to eliminate some of the nuttiness of our state's tax system, or at least reduce it.[2]

I understand my assignment to be to suggest how, in a revenue neutral context, the system could be improved. I will concentrate on how to make the system more nearly neutral in its impact and thus more conducive to investment and competitiveness. I have subtitled my remarks, "The Good (But Infeasible), the Bad, and the Ugly." The good taxes, which I will discuss only briefly, are a flat tax and a state value added tax (VAT). It is not feasible to impose a state flat tax in a way that would be desirable, and the VAT is probably infeasible, at least for now. The retail sales tax is not inherently a bad tax, but it is bad as implemented in California. The state corporation income tax is ugly; it could be loved only by a tax expert who makes a living analyzing it – or by those who have no idea how it works. My comments on the corporate income tax are intended to help you know how to think about ideas you may hear. I will touch only briefly on the questions of revenue instability and distributional effects of tax reform.

You may find it useful if, before I begin my substantive remarks, I highlight one aspect of my professional experience, which is summarized in the biographical sketch you have been given. As Deputy Assistant Secretary of the US Treasury for Tax Analysis from 1983 to 1985, I was responsible for developing the Treasury Department's proposals to President Ronald Reagan that became the basis of the Tax Reform Act of 1986, the most comprehensive reform of the US income tax since its introduction in 1913.[3]

Much like this commission, we at Treasury were asked to develop a plan for tax reform for fairness, simplicity, and economic growth based on sound economic principles and free from political interference. In fulfilling our mandate, we focused on broadening the tax base, by eliminating undesirable tax preferences, and lowering tax rates, all within the context of revenue and distributional neutrality. Although our proposals were initially labeled idealistic and politically naive and were watered down considerably, the 1986 Act was ultimately enacted with overwhelming majorities in both houses of Congress. Even now, after more than two decades of erosion, the 1986 Act remains the high-water mark of post-war federal tax reform.

Finally, before I begin, I must tell you that reform of the California tax system is not the primary focus of my research and writing. Thus there may be questions, particularly of fact, that

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[1]See, for example, McLure (2001).

[2]For similar testimony along similar lines, see McLure (2002).

[3]U.S. Department of the Treasury (1984).

I will not be able answer. But I am sure that the experts from your own staff, the Legislative Analyst's Office, the Franchise Tax Board, or the Board of Equalization will be able to answer most of them.

Reforming the Sales Tax for Economic Neutrality, Investment, and Competitiveness

Since about 1980 there has been enormous interest among some tax policy experts in replacing some or all of the revenues from the federal income tax with a tax on consumption. Among the most appealing candidates for total replacement are the so-called flat tax designed by my Hoover colleagues Robert Hall and Alvin Rabushka and championed most visibly by Steve Forbes[4] and the X-tax, a graduated rate tax levied on the same base supported by the late David Bradford.[5] The value added tax (VAT), the type of sales tax employed by more than 100 nations, including all the developed ones other than the US, could replace part of income tax revenues[6] or be a source of additional revenues.[7] All of these consumption-based systems would be more conducive to saving and investment than the current income tax, and both the flat tax and the X-tax would also be a simpler than the income tax, if one of them could be enacted in its pure form. It is only natural to ask whether California should consider one of these options. I will return to that question later in my remarks – to the VAT after I discuss the sales tax and to the flat tax and X-tax after I discuss the corporation income tax. But first, I want to discuss how to improve the retail sales tax, which is California's most important source of state tax revenues.

If someone were to come before you today and suggest that California should impose a tax on production occurring within the state that would distort production incentives, discourage investment, and reduce the competitive position of the states's producers in California markets, in other domestic markets, and in export markets, you would probably think they were crazy. Such a proposal violates common sense, as well as accepted norms for the design of tax policy.[8] But that is exactly the kind of tax the California sales tax represents. It has been estimated that in 2003, 45 percent of the state's sales tax collections came from business purchases, rather then sales to households.[9] In my view, *the first order of business should be to eliminate sales tax on*

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[4]Hall and Rabushka (1985).

[5]Bradford (1985). I have proposed a similar tax in Colombia, Russia, and Bolivia. McLure and Zodrow (1996) describe a somewhat different "hybrid" approach for the US.

[6]Graetz (2008).

[7]McLure (1987).

[8]The principles being violated are neutrality toward choices of production techniques and among products, neutrality toward saving and investment, and the destination principle, which requires that tax be imposed where products are consumed, rather than where they are produced. Among the myriad places these principles are explained are McLure (2003) and Mikesell (2005), Cline, Mikesell, Neubig, and Phillips (2005). The formal argument for not taxing production is found in Diamond and Mirlees (1971a) and (1971b), co-authored by a recipient of the Nobel Prize in economics. It seems that, for present purposes the description in the text of the nuttiness of taxing business inputs is adequate. These principles – and their implications for my assessment of the California sales tax – are not new. I point out in Hellerstein and McLure (2000) that I studied them as an undergraduate more than 50 years ago.

[9]Cline, Mikesell, Neubig, and Phillips (2005). The California tax is not as bad as some;

business purchases. While it is perhaps most urgent to eliminate taxes on business investment and R&D spending, we should not stop there. We should eliminate tax on (virtually all) business purchases.[10]

Some may argue that there is no need to take this action, a) because California's reliance on sales taxes on business purchases is only slightly above the national average, which is estimated to be 43 percent, or b) because much of the tax on business purchases is exported to purchasers in other states. These views reflect faulty thinking. Regarding the first, let me use a simple analogy from sports to make my point. Suppose that, for historical reasons, each of the teams in a basketball league tied their players' shoes together. No one would argue that a team could not improve its competitiveness by untying its players shoes, simply because the other teams continued to follow such an uncompetitive policy. Similarly, whether California can improve its competitive position by rationalizing its sales tax does not depend on whether other states have equally (or more) irrational sales taxes.

Nor is it logical, with few exceptions, to argue that California can export its sales tax on business purchases. Tax exporting of this type can occur only if the taxing jurisdiction dominates the relevant regional, national, or international market.[11] California is large, but it is not that large. It dominates few of the relevant markets. Thus, rather than being exported, its sales tax on business purchases is likely to reduce employment and the incomes of its least geographically mobile factors of production, land and labor. Nor is it appropriate to say that California can export its tax on business purchases, because its reliance on this form of taxation is only slightly above the national average. In appraising how California's taxes affect prices, employment, and incomes, the taxes levied elsewhere are no more relevant than the weather in those locations.[12] Taxing business purchases reduces California's competitiveness, employment, and income, and reducing taxation would increase them.

Drastically reducing the taxation of business purchases would reduce sales tax revenues,

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in 2003 that "honor" went to Louisiana, where business purchases accounted for an estimated 67 percent of sales tax revenues. Between 2005 and the end of 2008, Louisiana supplemented its system of exemptions of sales for resale based on resale certificates with a provision, since repealed, allowing credit for tax paid on business purchases of the type found in VATs.

[10]It may be neither desirable not possible to eliminate all tax on business purchases. First, substantial amounts of personal consumption masquerades as business purchases. Given the difficulty of determining the real use of some "dual use" products, it may be best not to exempt purchases of some products that are ostensibly made for business purposes. Second, it may be difficult for technical reasons to exempt some business purchases, even when it would be desirable to do so. A subway ticket bought from a vending machine is one example. The only truly satisfactory way to address this problem is to introduce a value added tax, under which the business purchaser would take credit for tax on purchases against liability for tax on sales. As noted below, introduction of a state VAT, in the absence of a federal VAT, is problematical; see McLure (2009).

[11]McLure (1981b) provides a simple but rigorous demonstration of this important proposition.

[12]For a similar argument regarding the incidence of property taxes and state corporate income taxes, see McLure (1977), and (1981a).

unless the tax base were expanded or rates were increased. Actually, both would be required, and, subject to a qualification to be noted in a footnote below, neither would be undesirable. The sales tax base should be expanded, by including many of the intangible products and services that are provided to households that are now exempt. (Needless to say, most business purchases of intangible products and services should not be taxed, for reasons just stated.[13]) There is no sound reason to tax household purchases of goods, but exempt intangible products and services. The existing practice of taxing primarily goods, which dates back to the days when most sales were of goods, distorts consumer choices and, because services figure more prominently in the household budgets of higher-income families than of those with lower incomes, it has undesirable distributional consequences.

Broadening the sales tax base to include intangible products and services would not fully offset the reduction in the base occasioned by eliminating taxation of business purchases; a rate increase would be required to maintain revenue neutrality. Increases in tax rates are ordinarily seen to be undesirable. But a rate increase that is required to rationalize the tax treatment of business purchases in a revenue-neutral context would not represent a tax increase. Rather, it would bring the tax that is now concealed in the prices of products out in the open, making the cost of government more transparent.[14]

The Ohio Approach: Taxing Gross Receipts

Ohio recently adopted a "Commercial Activity Tax," essentially tax on gross receipts, including receipts from sales to business. The Ohio tax runs directly counter to what I have just said about the need to eliminate all tax on business purchases. California should not take such a backwards step.[15]

How about a State VAT?

The value added tax avoids imposing an unrelieved burden on sales to business by allowing VAT-registered businesses to take a credit for tax paid on purchases against their liability for tax on sales. Thus only sales to households are ultimately taxed. This feature, plus its administrative advantages, make the VAT the revenue workhorse in countries throughout the world. Moreover, the Canadian province of Quebec imposes a VAT. It is thus only natural to ask whether California might follow Quebec's lead and introduce a VAT of its own.

I believe that California should not attempt to impose a VAT. It must be noted that Quebec's VAT is imposed in the context of a similar federal tax, with which both the design and administration of the Quebec tax are coordinated. Absent the federal VAT, it would be difficult, for administrative reasons, for Quebec to impose its own VAT. Only if (and when) the federal government decides to impose a VAT should California consider doing so.[16]

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[13]For more on this, see Cline, Mikesell, Neubig, and Phillips (2005).

[14]Bringing the true sales tax rate out into the open by eliminating the taxation of business inputs and raising the statutory sales tax rate would, however, have the undesirable effect of encouraging tax evasion. (The taxation of business inputs is relatively difficult to evade.)

[15]I testified, to no avail, against imposition of the Ohio tax; see McLure (2005).

[16]This is explained more fully in McLure (2009), which argues that, even if there were a federal VAT it would probably be preferable for states to impose an improved retail sales tax that

Modifying the Corporate Income Tax

I am not a big fan of state corporation income taxes. It is hard to think of a good reason to tax corporate income, aside from the "backstopping" argument – preventing avoidance of the individual income tax by incorporating. The case against state corporate income taxes is even stronger. It is common among economists to acknowledge that a small open economy (one that cannot affect the world price of capital) should not tax the return required to elicit investment within its boundaries. (This presumption does not hold true in the special case of economic rents – returns in excess of what it required to elicit investment.) That is one reason for the need to eliminate sales tax on all business purchases. The difficulty of actually taxing corporate income where it originates is a further reason for not trying to tax it. I will focus on this difficulty and its implications.

In the international sphere, separate accounting is used to determine the income of the various members of a corporate group. Since, except in certain industries, distinct corporations are commonly used to operate in each country, this methodology is tantamount to using separate accounting to determine the income attributable to each country. Among the most important problems with this approach is the difficulty of determining the "transfer prices" that should be used to value transactions between related corporations, including those for financial transactions and the use of intangible assets for which there is not outside market. Because of economic interdependence between affiliated corporations determining transfer prices is a conceptually daunting task, and transfer prices may be manipulated to shift income to low-income jurisdictions.

At the state level these problems are even more daunting, as economic interdependence is even more pervasive. Moreover, multistate corporations do not ordinarily employ legally separate legal entities with separate books of account to operate in various states. (Notable exceptions occur for tax minimization reasons.) As a result, states have long used formulas to apportion the nationwide income of multistate corporations, based on the fraction of the taxpayer's operations occurring in the taxing state. Until the mid-1970s use of a formula that assigned equal weights to the state's percentages of nationwide payroll, property, and sales was almost universal.[17] While one could quibble with these weights, especially as applied to particular industries, this formula seems like a reasonable if arbitrary solution to a difficult problem. If all states used the same formula, at least all corporate income (except that attributed

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is consistent with the federal VAT, rather than switching to the VAT.

[17]Thus:

$$T = t\ I\ [(W_t/W) + (P_t/P) + S_t/S)]/3,$$

where T is tax liability;
t is the state's tax rate;
I is apportionable nationwide income;
W_t/W is the taxing states share of nationwide wages;
P_t/P is the taxing states share of nationwide property;
S_t/S is the taxing states share of nationwide sales.

to states that did not have income taxes) would be taxed once and (at most) only once.

All this began to change in 1978, when the US Supreme Court upheld the constitutionality of Iowa's use of only sales to apportion income.[18] Since then there has been a dramatic shift to assigning greater weight to sales and a correspondingly lower weight to payroll and property. Almost 80 percent of states that tax corporate income now assign at least one half the weight to sales, and at least six states now use only sales to apportion income.[19] California now assigns one half the weight to sales and one quarter each to payroll and property. I suspect you will hear suggestions that California should further increase the weight on sales, perhaps all the way to 100 percent, to encourage economic development.

In appraising this development and its implications for tax policy in California it is useful to note that, for a corporation with relatively little of its operations in California an apportioned income tax is not really – or not merely – a tax on income earned in California. Rather, it is a tax (or set of taxes) on whatever factors are used in the apportionment formula, with the effective tax rate(s) determined by the statutory tax rate, the corporation's nationwide profitability relative to those factors, and the weight placed on the particular apportionment factors.[20] In the extreme case of "sales-only apportionment," the result is a strange amalgam of taxes ranging along a spectrum from a tax on corporate profits earned in the taxing state by firms operating only there to a peculiar form of tax on sales in that state for firms operating primarily elsewhere.[21]

So, how should we think about the corporate income tax? On the one hand, it does not seem to make much sense to tax corporate income, except as a backstop to the individual income tax. But if we are going to tax corporate income, it seems that we should do so in a way that makes sense. Unlike sales-only apportionment, the present formula arguably reflects reasonably well where income originates. On the other hand, sales only apportionment would probably be more conducive to economic development, because it would convert the present tax into the strange amalgam described above. But if that is the objective, would it not make more sense and be more transparent simply to reduce – or eliminate – the corporate income tax and replace it with a higher sales tax rate?[22] Is backstopping the individual income tax the only reason to retain this tax? Does the federal corporate income tax provide adequate backstopping?

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18 *Moorman v. Bair,* 437 U.S. 267 (1978).

19 See Mazerov (2005), pp. 22-23. The Federation of Tax Administrators website provides information on apportionment formulas and tax rates; see http://www.taxadmin.org/.

20 I demonstrate this in McLure (1980). For the equally weighted three-factor formula the equation in note 17 can be rewritten as:

$$T = t\ I\ [(W_t/W) + (P_t/P) + S_t/S)]/3,$$

$$T = [W_t(tI/W) + P_t(tI/P) + S_t(tI/S)]/3.$$

21 For sales only apportionment the second equation in note 20 becomes:
$T = S_t\ (tI/S)$.

22 An increase in individual income tax rates would aggravate the increased incentive to incorporate induced by a decline in the corporate income tax rate. But see also note 14 on the encouragement of evasion resulting from an increase in sales tax rates.

How about a Flat Tax or X-Tax?

One of the primary attractions of the flat tax (and X Tax) is the elimination of all the deductions now found in the individual income tax. But if California were to eliminate the deductions, and the federal government did not, the result would not be simplification for California; it would be greater complexity. This is one area where California should not go it alone.

There are three aspects of the business component of the flat tax (and X Tax) that deserve note today. All business expenditures can be deducted in the year incurred; there is no deduction for interest expense; and interjurisdictional transactions are taxed on an origin basis. Origin-based taxation means that spending on imports would be deductible and exports would be taxable. A tax with these characteristics would encourage investment because it would not tax the minimum return that is required to elicit investment; it would hit only what economists call "economic rents" – returns over and above that minimal return. If, however, a state attempted to impose such a tax it would encounter the formidable problem of determining the transfer prices for all imports into the state and all exports from it – problems that would also plague a federal tax, but be less pervasive. It would thus be necessary, as it is with the corporate income tax, to utilize an apportionment formula to determine California's share of the taxpayer's nationwide tax base, but as calculated under the flat-tax rules. This implies that the California flat tax would encourage investment made anywhere in the US, not just in California.[23] But California would experience all the revenue loss (or the need for higher statutory tax rates). I do not think it worthwhile to substitute the flat tax for the income tax to achieve that.[24]

Distributional Issues

Sales taxes and excises impose burdens on low-income households. By comparison, exemption and credits under the individual income tax avoid such burdens, at least at the very lowest income levels. This suggests that the state could address distributional concerns by altering the "tax mix" to rely more heavily on the income tax and less on the sales tax. But it is important to avoid taxing income too heavily, because of the disincentive effects of doing so.

Some have suggested that the state should address distributional concerns by adopting an earned income tax credit (EITC) similar to that in federal law. This is not something I feel qualified to opine on. I have, however, provided references to papers by two respected authors who do so.[25]

If taxation at the bottom of the income scale could be eliminated in some other way (e.g.,

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[23] I am not a tax lawyer, but I think that an attempt to restrict the immediate deduction for expenses to those made in California in a business tax system otherwise based on formula apportionment would not pass constitutional muster. Also, it would it be extremely complicated to link borrowing to investment that benefits from immediate deduction, which would be required (in order to disallow interest deductions on such borrowing) if the flat tax (X Tax) were to be conceptually consistent. (Allowing both immediate deduction of business spending and a deduction for all interest expense would imply a state subsidy to investment made anywhere in the US – an expensive policy that obviously would not be in California's best interest.)

[24] Much more could be said to reinforce this conclusion. See Zodrow (1999).

[25] MaCurdy (2004) and Stark (2006).

via an EITC), it would be desirable to eliminate the sales tax exemption for food. The food exemption distorts consumer choices and necessitates a higher statutory tax rate, which encourages evasion. Moreover, exempting food is a notoriously inefficient way to deal with distributional concerns, because the vast majority of food is not bought by low-income households.

Revenue Stability

California tax revenues have recently been unstable, especially because of the increase and subsequent decline in income tax revenues, including those attributable to capital gains and the exercise of stock options, associated with the dotcom boom and bust. Whereas the response of federal tax revenues to cyclical events produces a desirable stabilizing effect, instability of state tax revenues is problematical. Since expenditures are expanded in flush times and cannot easily be contracted in lean times, budgetary crises occur. I have been asked to opine on how revenue instability could be reduced.

I can think of a few ways to reduce revenue instability, but I would not endorse most of them. Most obviously, we could eliminate the taxation of capital gains and change the tax treatment of stock options. Frankly, I think that this would be to allow a relatively small tail to wag a very large dog. The tax treatment of capital gains and stock options should be decided on principles such as equity, economic efficiency, effects on innovation and investment, and costs of compliance and administration (which are increased when state tax treatment diverges from the federal treatment), not on the basis of effects on the stability of revenues.

Another potential change would be to rely less on the income tax and more on the sales tax or on excises such as the tobacco tax. Since consumption, especially of things like tobacco, is more stable than income, such a change would reduce revenue instability. Again, I think the tax mix (and the role of excises) should be based on first principles, not effects on the stability of revenues.

Another change in tax policy that would reduce instability is to eliminate the sales tax exemption for food. Such a change would have the advantage of allowing lower statutory tax rates and reducing the distortion of consumption choices. But it would, of course, elicit howls of protest, because it would increase the tax burden on low-income families. This should not be a dispositive objection, if there are other ways to address distributional concerns.

At bottom the perceived problem of revenue instability is not one of tax policy. It is one of budget policy. The solution is relatively straightforward, at least in concept, if not politically. When revenues greatly exceed their trend line growth rate, all of the excess should not be spent; rather, the bulk of it should be placed in a “rainy day fund” to provide a cushion against declining revenues or used to retire debt.

Summary of Recommendations

To summarize, I have made several suggestions.

$ First, and most important, eliminate the sales tax on (virtually all) business purchases. An increase in the statutory rate will be required to maintain revenue neutrality.
$ Second, include sales of services and intangibles not made to businesses in the sales tax base. This will alleviate the need to raise statutory rates to maintain revenue neutrality.
$ Third, do not consider a state VAT until a federal VAT has been enacted.

- Fourth, consider reducing the corporate income tax and replacing the lost revenues with an increase in the sales tax.
- Fifth, do not consider enacting a state flat tax.
- Sixth, get better advice than I can provide on how to reduce any undesirable distributional effects of taxes or changes therein.
- Seventh, address revenue instability by instituting budgetary rules that will place most revenues in excess of a trend line in a “rainy day fund,” rather than by tinkering with the basic structure of the tax system, which should be determined by the principles of equity, efficiency, effects on innovation and investment, and costs of compliance and administration.

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