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A Golden Opportunity: California's Budget Crisis Offers a Chance to Fix a Broken Tax System

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Executive Summary

On May 19, Californians will go to the polls to vote on six statewide ballot propositions related to the state's budget problems. The headline initiative is Proposition 1A, which will extend a series of tax increases due to expire in 2010 and institute a rainy day fund.

No one observing California's fiscal situation has suggested that its enormous short-term budget deficit results from a reluctance to tax. Rather, it is a result of trying to keep spending commitments that were based on naïve assumptions about tax revenue growth from the boom. Ultimately California will need to reprioritize those commitments. The tax increases in Proposition 1A can be viewed as buying time for this reprioritization, or more likely, they can be viewed as buying time to put off the hard choices.

These tax increases are on top of what were already high taxes, especially for the individual income tax, corporate income tax, and sales tax. The high rates and collections from these taxes harm California's long-term competitiveness and economic growth. With respect to the so-called millionaires' tax on individuals, the idea of paying for broadly available public services through

disproportionate taxes on high-income earners raises serious equity questions. More pragmatically, such taxes are highly volatile and contribute to the boom-and-bust cycle of California's state budget.

Policymakers and stakeholders in California and other states considering reform of their tax systems should raise these concerns and resist efforts to substitute damaging short-term fixes for real long-term, pro-growth tax reform.

California Faces Extension of Increases in Income, Sales, and Car Taxes
The tax increases in question are:

- *Personal Income Tax.* The budget agreement tacked on an additional 0.25% to each bracket, retroactive to January 1, 2009 and expiring on December 31, 2010.[1] If Proposition 1A passes, the increase will be extended two years until December 31, 2012.

Table 1 California Personal Income Tax Table, Singles		
Bracket	Previous Rate	Rate Effective January 1, 2009
>$0	1%	1.25%
>$7,168	2%	2.25%
>$16,994	4%	4.25%
>$26,821	6%	6.25%
>$37,233	8%	8.25%
>$47,055	9.3%	9.55%
>$1,000,000	10.3%	10.55%

- *Sales Tax.* The budget agreement included a 1% increase in the state sales tax, effective April 1, 2009 and due to expire on June 30, 2011. If Proposition 1A passes, the increase will be extended one year until June 30, 2012.

Table 2 California Sales Tax (State and Key Cities)		
City	Previous Rate	Rate Effective April 1, 2009
(State Base)	7.25%	8.25%
Los Angeles	8.75%	9.75%
San Diego	7.75%	8.75%
San Jose	8.25%	9.25%
San Francisco	8.50%	9.50%
Long Beach	8.25%	9.25%
Fresno	7.975%	8.975%
Sacramento	7.75%	8.75%
Oakland	8.75%	9.75%
Santa Ana	7.75%	8.75%
Anaheim	7.75%	8.75%
Bakersfield	7.25%	8.25%
Riverside	7.75%	8.75%
South Gate	9.75%	10.75%

- *Car Tax.* The budget agreement raised the vehicle license tax back to where it was prior to the 2003 recall election, from 0.65% to 1.15%, beginning May 19, 2009 and due to expire on June 30, 2011. If Proposition 1A passes, the increase will be extended two years until June 30, 2013.

Table 3: California Vehicle License Tax	Current Rate	New Rate
Statewide	0.65%	1.15%

Note: An earlier proposal to increase the state gasoline tax did not meet legislative approval. The state gas tax rate remains unchanged at 18 cents per gallon.

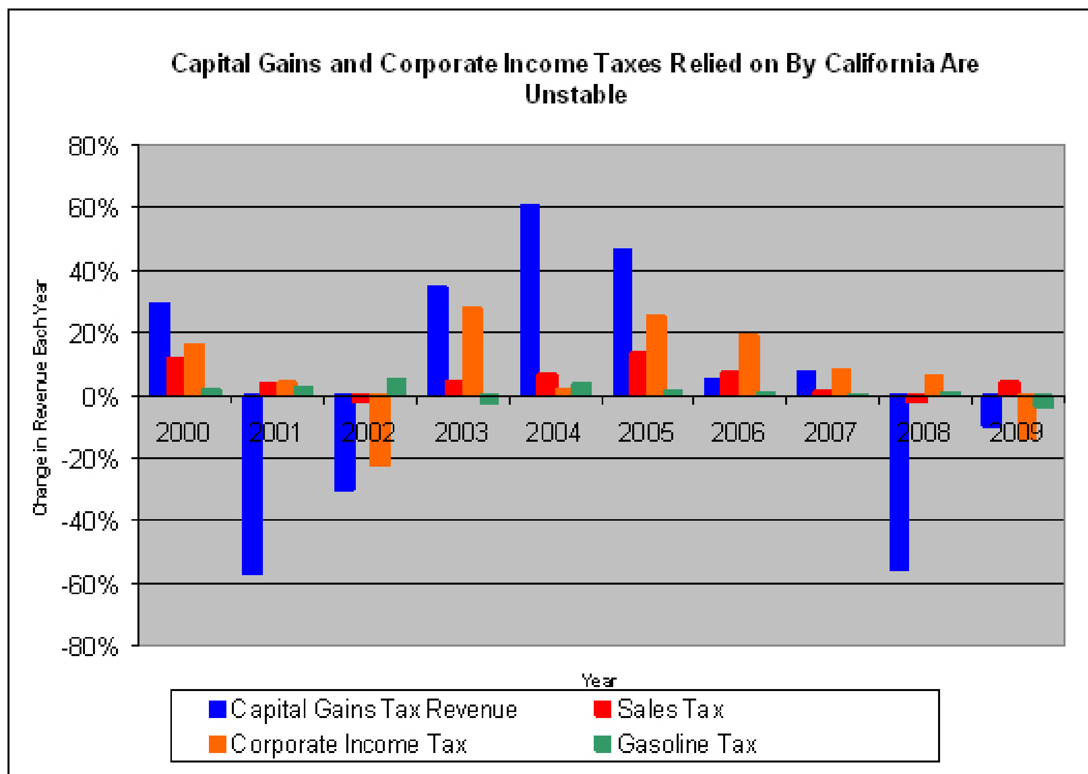
These tax increases are estimated to raise $10 billion, with the extensions from Proposition 1A generating a further $6 billion. California has been struggling to close a $40 billion budget gap between desired spending and expected revenues in its $92 billion 2009-10 budget.

California's Budget Has Grown at an Unsustainable Level

As we detailed in our state budgets report in February, California has been the worst offender of relying on volatile tax revenues that soar excessively in boom times but sour excessively in recessions.[2] Compounding this instability is California's decision to ratchet up spending to match boom-time revenue growth, resulting in a spending trend line that is ultimately unsustainable.

For example, in 2000, 15% of California's budget came from state income taxes on capital gains, in retrospect an unsustainable proportion. (It was in February 2000 that hopeful officials projected a $6 billion state budget surplus, the last time the state's budget was balanced without resort to borrowing or accounting tricks.) Because California heavily taxes high-income earners, and because high-income earners have incomes that are more volatile than incomes of other individuals, revenue growth from this source is heavily exaggerated. The figure below, reproduced from our state budgets report, illustrates the volatility of some revenue sources over more stable ones (like sales and gasoline taxes).

Figure 1
Unstable Revenue Sources in California's Budget over Time



Since 2000, year-over-year growth in capital gains income tax revenue ranged from minus 56.6% to plus 60.5%; year-over-year growth in corporate income tax revenue ranged from minus 22.7% to plus 27.6%. The new income tax bracket on those earning more than $1 million (enacted by proposition in 2004 effective January 1, 2005) is following a similar pattern, with year-over-year growth since then ranging from minus 35.1% to plus 10.0%.[3]

These wild swings in revenue are difficult enough for budget planners trying to find ways to pay for services that steadily increase in cost. Adding to this, however, are increases in spending that accompany the temporary increases in revenues during booms. Each year between 1999 and 2003, California general fund spending ranged between $71 billion and $75 billion. Buoyed by revenues, spending grew dramatically mid-decade, and by 2007 general fund spending had reached $99 billion. This is a 31% increase over 2003, during a period in which inflation increased 12% and the state population grew just 5%.

Once increased, it is difficult to bring state spending down. For all the discussion of budget cuts, the state's budget for 2009 is projected at $92 billion, a 23% increase over 2003 when Governor Schwarzenegger took office. In running in that year's recall election, Schwarzenegger seemed to recognize spending as a key driver of the state's fiscal woes, promising to restrain spending growth to a sustainable level. Key to this has been his push to create an effective state rainy day fund.

Proposition 1A is the culmination of these efforts. To resolve the short-term budget crisis, Schwarzenegger and legislative Democrats reached an agreement whereby broad-based taxes would be increased temporarily. Down the line, in order to avoid slashing spending, voters can choose to extend the taxes, but must in return agree to the creation of a rainy day fund. (The May 19 propositions do not contain any meaningful limit on spending, aside from depositing above-average revenues into the rainy day fund, and prohibiting their use for ongoing programs.)

Californians Faced High Tax Burdens Even Before the 2009 Increases

Prior to the early 2009 tax increases, Californians already paid some of the highest state-local taxes in the United States. As reported in the 2008 edition of the Tax Foundation's *State-Local Tax Burdens* study, Californians paid 10.5% of their income on state-local taxes, the sixth highest burden in the country; the national average was 9.7%. That translated into a payment of $5,028 per capita in state-local taxes.

Table 4
Top 10 State-Local Tax Burdens as Percent of State Income, FY 2008

State	Tax Burden	Rank
U.S. Average	9.7%	--
New Jersey	11.8%	1
New York	11.7%	2
Connecticut	11.1%	3
Maryland	10.8%	4
Hawaii	10.6%	5
California	**10.5%**	**6**
Ohio	10.4%	7
Vermont	10.3%	8
Wisconsin	10.2%	9
Rhode Island	10.2%	10

Structurally, California's tax system is not business-friendly. Anecdotal stories about a brain drain underscore the danger that intelligent and innovative people will leave or at minimum not enter if tax burdens are excessive. The Tax Foundation's annual *State Business Tax Climate Index* evaluates tax structures for business-friendliness, and the 2009 edition ranked California 48th, or third worst. The individual income tax ranked second to last, corporate income tax ranked 45th, and sales tax ranked 43rd. (Property tax structure was a bright spot, ranking 15th in the country.)

Corporate Income Tax

California's 8.84% flat corporate income tax rate is one of the highest in the United States (and combined with the 35% federal rate, in the world), and the state ranks 6th in the country in per

capita collections from the tax. It is worth noting that neighboring Nevada has a 0% state corporate income tax, with Arizona at 6.968% and Oregon at 6.6%.

Table 5
Top 10 States, Per Capita Collections from State Corporate Income Tax, FY 2007

State	**Collections Per Capita**	**Rank**
U.S. Average	$178	--
Alaska	$1,196	1
New Hampshire	$453	2
Delaware	$352	3
New Jersey	$332	4
Massachusetts	$327	5
California	**$307**	**6**
West Virginia	$298	7
New York	$281	8
Connecticut	$236	9
Kentucky	$234	10

Nationwide, states' reliance on the corporate income tax has been falling over time, from a high of 9.5% in 1977 to about 5 percent today.[4] The nightmarish administrative complexity associated with apportioning income from multistate companies to the various states, combined with a mess of inconsistent apportionment and nexus rules designed by each state to maximize tax revenue, results in a tax that raises very little revenue while imposing enormous costs on the economy.

California has been among the most aggressive states in attempting to squeeze more out of its corporate income tax. Besides its high rate, California officials have sought to extend tax obligations to LLCs, which already pay taxes through the individual income tax code. That action and attempts to reach income beyond California's frontiers have been stopped by the courts, but they give the impression that California is hostile to business. Dramatic reduction of the corporate income tax could reverse this impression, reduce administrative costs of doing business in the state, and reduce reliance on a volatile tax that is increasingly not worth the revenue it produces.

Individual Income Tax
Even prior to the recent increase, California's individual income tax was one of the highest top rates in the country. Unlike other states with high top rates, California's kicks in at a rather modest level of income. The now 10.55% rate applies to income of $1 million or up, but the second-highest 9.55% rate applies to all income over $47,055.

It should be remembered that much business income is taxed under the individual code (such as from LLCs, partnerships, and sole proprietors). By contrast, both Nevada and Washington State have no individual income tax, and Arizona's individual income tax reaches just 4.54% of income over $150,000.

Just before California enacted its "millionaires' tax," New Jersey implemented one in June 2004, when then-Governor James McGreevey signed into law an 8.97% rate on income over $1 million, retroactive to January 1, 2004. While the millionaires' tax raised revenue for the state and helped reduce a budget shortfall, it reduced the state's overall economic output and harmed its ability to grow during and after the current recession.[5]

Yes, new taxes on high-income earners will generally raise revenue in the short term without a sudden exodus of many wealthy people fleeing to the state next door. But over the medium term, the taxes will negatively impact location decisions. People expanding old businesses or creating new ones will incorporate the higher cost of doing business into their decision-making, and steer clear of the state. California currently faces an enormous brain drain of dynamic individuals after five years of double-digit income taxes.

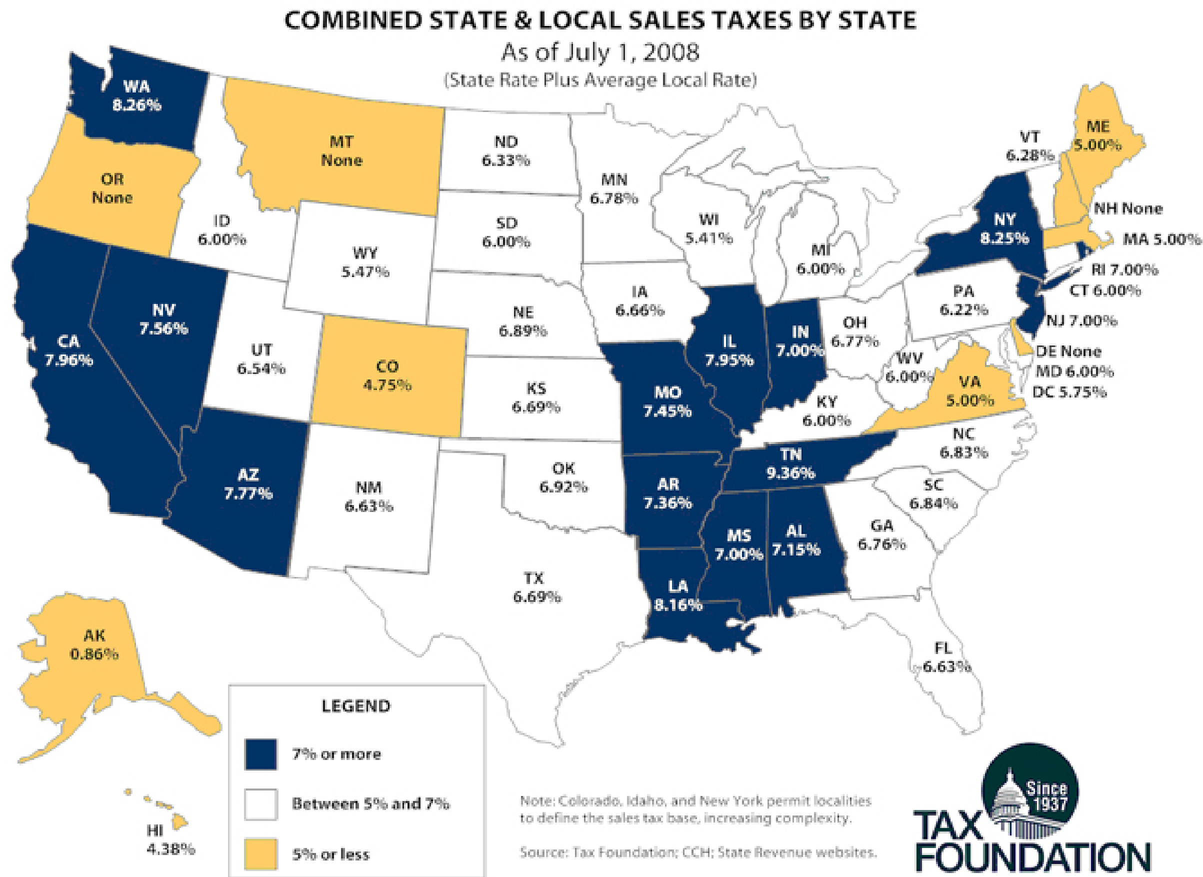
Sales Tax

California's sales taxes have high rates and a narrow base, the opposite of what fiscal experts generally recommend. Different sources calculate California's sales tax at different rates, primarily because even the rates are a complicated mess. The state portion of the sales tax is (as of April 1) 8.25%, consisting of:

- 5.00% for the state general fund
- 0.25% for the state general fund effective 2004 (shifted from Bradley-Burns local tax)
- 0.50% distributed to local health/welfare programs
- 0.50% distributed to local public safety programs
- 0.75% Bradley-Burns tax, returned to the local jurisdiction where the sale occurred (this tax was 1% prior to 2004, when 0.25% was shifted to the state)
- 0.25% Bradley-Burns tax returned to the county where the sale occurred for transportation purposes
- 1.00% increase effective April 1, 2009, to the state general fund

Additionally, local governments can add up to 2% in local add-on sales taxes; a 0.5% transportation sales tax is quite common. Prior to April 1, 2009, the average local add-on sales tax was 0.71%, leading to an average state sales tax of 7.96%, the fifth highest state-local average in the country. With the increase, California has the second-highest state-local average sales tax rate in the country, behind only Tennessee (see Figure 2).

Figure 2
Combined State and Local Sales Taxes by State



Notwithstanding the high rate, California sales tax collections are comparatively low. In Fiscal Year 2007, California brought in just $897 per capita in state sales tax revenue, behind twelve other states (Hawaii, Washington, Wyoming, Nevada, Florida, Tennessee, Mississippi, Arkansas, New Jersey, New Mexico, Arizona, and South Dakota).

Considering that California has a higher sales tax rate than most of these states and arguably more economic activity per capita than many of them, the low collections are a sign that California's high rate applies only to a narrow category of items. A 2003 study on sales tax breadth by Professor John Mikesell estimated that California's sales tax applies to just 34.7% of goods and services, below the national median of 43.3%.[6]

Rather than just increasing the rate, California should consider fundamental reform of its sales tax. At present, California exempts whole categories of consumption while taxing a few categories of business-to-business transactions. The latter harms transparency because it creates taxes passed to consumers but hidden in the price, while also punishing products that require multiple purchases in the production chain. If California broadened its sales tax base to that national median (by taxing all goods and services but exempting business-to-business transactions to prevent multiple hidden

taxes), the state rate (pre-increase) could drop from 7.25% to 5.8% with no loss in revenue. Even after including local sales taxes, the combined average rate of around 6.5% would be lower than most nearby states (except for neighboring Oregon, which has no sales tax).

Conclusion

A state that faces economic decline and an exodus of population has two choices. One is to ramp up state spending on education and infrastructure and offer targeted tax incentives for selected industries, and hope that these inducements will lure people back. All state governments do this to some extent, notwithstanding the risk. At best, however, these investments will take decades to pay off. At worst, the fate of Michigan could be more common: people take their degrees from the excellent state schools and use the excellent roads to drive to other states where there are jobs.

The other choice is to reduce reliance on burdensome and volatile revenue sources, prioritize state services and pare back on the non-essential, and set out a welcome mat of a simple, transparent, neutral, and stable state tax system for all. If tax increases have to occur, structure them in a way that spreads the burden and addresses spending growth. Such a choice will not generate billions of dollars immediately to recover from years of borrowing and spending beyond means. But it will lay the groundwork for long-term economic growth and ensure that the Golden State's tarnished decade will not continue forever.

Notes

1. The budget agreement raised every tax rate by 0.25 percentage points. The bill contained language to cut the increase to 0.125 percentage points if California received at least $10 billion in federal stimulus funds. On March 27, 2009, Treasurer Bill Lockyer certified that the state would receive only $8.6 billion in stimulus funds, resulting in the 0.25 rate increase.

2. See generally Joseph Henchman, *State Budget Shortfalls Present A Tax Reform Opportunity*, Tax Foundation Special Report No. 164 (Feb. 2009), at http://www.taxfoundation.org/publications/show/24321.html.

3. Following the addition of the new millionaires' tax top bracket, the California Franchise Tax Board has taken pains to deny that their 10.3% top tax rate is in the double-digits, referring on their website and on tax forms to a 9.3% top rate and elsewhere noting that there is a 1% surcharge. *See* William Ahern, "California Legislators Push for More Double-Digit Income Tax Rates," Tax Foundation Fiscal Fact No. 134 (Jul. 14, 2008), at http://www.taxfoundation.org/research/show/23370.html.

4. *See* David Brunori, State Tax Policy 84 (2005).

5. *See* Gerald Prante, "Did People Flee New Jersey After 2004 Income Tax Hike?," Tax Foundation Tax Policy Blog (Apr. 14, 2009), at http://www.taxfoundation.org/blog/show/24618.html.

6. *See* John L. Mikesell, *State Retail Sales Tax Burdens, Reliance, and Breadth in Fiscal 2003*, State Tax Notes 125 (Jul. 12, 2004).

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